

## **SPEAKING NOTES** (longer version)

### **The Global Financial Crisis and Iceland**

**Key message #1: The IMF economic stabilization program is on track**

**Key message #2: Wide-ranging reform process is ongoing**

**Key message #3: We are cautiously optimistic about Iceland's long-term prospects**

#### **Introduction**

- Iceland was among the first countries to be hit by the global financial crisis and was in the headlines of the international media for weeks for rather unenviable reasons.
- Allow me to give you a brief overview of the development in Iceland since the crisis started over 6 months ago. I will particularly focus on the various reform measures introduced by the Government, where Iceland currently stands, and the way ahead.

#### **[Key message #1: The IMF economic stabilization program is on track]**

- Early October 2008, Iceland's three largest commercial banks collapsed and were taken into administration by the Government. Their foreign liabilities had grown to up to 10 times Iceland's GDP. When market trust evaporated, the Central Bank of Iceland was not able to act as a lender of last resort in the required currency.
- On 19 November, IMF approved a Stand-by-Arrangement of 2.1 billion \$, with around 3 billion \$ worth of loans pledged by other states (the Nordic Countries, Russia, Poland and the Faeroe Islands).
- The primary goal of the IMF economic stabilization program is to re-establish confidence in the Icelandic economy by focusing on three key objectives:
  1. Stabilizing the exchange rate and rebuilding confidence in monetary policy.
  2. Reviewing and revising fiscal policy and maintaining a manageable level of public sector debt in spite of lost revenues and increased expenditures.
  3. Restructuring the banking sector and reforming the insolvency framework in accordance with transparent, internationally recognized principles.
- From the start, Iceland has been fully committed to the stabilization program and we are making progress on that front. In mid-March, an IMF delegation to Iceland concluded that the macroeconomic outlook remains broadly in line with what had been planned and that the program is largely on track.

- But Iceland still faces rise in unemployment and public debt, and has been forced to introduce temporary capital controls to stabilize the Icelandic krona.
- The good news, however, is that other economic data is slowly turning in our favour.
- The balance of trade is already positive and inflation is on the decline, expected to fall to the Central Bank's 2.5% target in early 2010. Last April, The 12-month inflation had dropped from 18.6 percent in January 2009 to the current rate of 11.9 percent
- Second, the devaluation of the krona has improved the competitiveness of Icelandic products and services, and foreign exchange revenues are gradually increasing.
- The government is confident that the financial sector that has been established after the collapse of the Iceland's three largest commercial banks will be reasonably healthy and able to serve the domestic economy.
- This demonstrates – and allow me to reiterate - that the IMF program is largely on track and we have the financial resources to make it work. We are confident that the first formal IMF program review, to be concluded early May, will indeed be positive. That provides a strong impetus for us to continue on the road to recovery.

**[Key message #2: Wide-ranging reform process is ongoing]**

- Allow me now to turn to the wide-ranging reforms that have been implemented in Iceland in the last 6 months.
- Although it was clear that Iceland had become victim to the international credit crunch and was suffering from certain systemic failures in the international financial world, it also became evident that Iceland had made its own mistakes.
- The commercial banks had overextended themselves with foreign liabilities up to ten times Iceland's GDP, making it impossible for the Central Bank of Iceland to act as a lender of last resort in the required currency when liquidity dried up.
- In short, the banks, their owners and their customers were all highly leveraged with overvalued assets due to an international pricing bubble.
- The authorities could have been more restrictive and fulfilled their supervisory role more vigorously.
- In the ongoing reform process, Iceland has sought the assistance and benefited from the advice of eminent international experts, particularly from fellow Nordic countries that experienced their own banking crisis in the early nineties, but also from the UK and from the IMF.

- **First, a thorough banking sector reform is taking place.** This re-structuring of the Icelandic banking system has been led by an internationally experienced banking expert from Sweden.
- The collapsed banks were split into old banks and new banks. This was necessary in order to avoid economic meltdown, secure the payments system and the continued operation of the domestic banking services. This goal was achieved.
- Solvency issues related to the old banks are being dealt with by special Resolution Committees for each bank and this process is monitored by the IMF. This spring, the new banks are expected to be re-capitalized by the Government of Iceland, and they will buy domestic assets from the old banks.
- This is a complicated process but our guiding principles are clear: Iceland remains fully committed to internationally recognized principles of transparency and equity with regards to fair treatment of foreign creditors. In fact, fair and legally sound treatment of creditors is key to Iceland's future relations with financial institutions.
- Parallel, a similar reorganization of the non-financial sector, companies and households, is taking place in which for instance equity and debt is being written down. In short, "The Icelandic Wall street collapsed, but main street survived."
- [*If applicable:* Talks are ongoing between Icelandic authorities and authorities in the UK and the Netherlands on the Icesave accounts. Iceland will cover deposits of insured depositors in Icesave accounts in accordance with EEA law, guaranteeing up to 20,887 euros for each account. Hopes are that this matter can soon be concluded in a mutually satisfactory manner.]
- **Second, wide-ranging regulatory reform is taking place.** New laws on the Icelandic Central Bank were passed in February, bringing major changes of the bank's administrative structure, with the appointment of one Governor instead of three, and with the establishment of a Monetary Policy Committee with domestic and international experts from within and outside the Central Bank.
- Subsequently, a provisional Central Bank Governor was appointed, a Norwegian economist, with a well-respected Icelandic economist as his deputy. Both positions have been advertised and new Governors will take over in May.
- Changes have also been introduced in the Icelandic Financial Supervisory Authority Late January, a new board was appointed and a new director was hired early April.
- Recently, the former head of the Finnish FSA presented a report on the legal framework and implementation of banking supervision in Iceland. In it, proposals are made for improvements for the strengthening of financial supervisory practices.
- **Third, a thorough investigation has been launched** on the sources of the crisis and possible legal wrongdoings in the run up to the crisis. The Parliament of Iceland has appointed a Special Investigation Committee led by three independent experts.

- An Office of a Special Prosecutor has been set up, with a broad mandate and funds to set up a team of up to 20 investigators, assisted by the renowned Norwegian-French investigating Magistrate Eva Joly as a special adviser on criminal cases.
- **Finally, political reform.** In January, the right-center coalition Government resigned and a center-left minority Government took office on 1 February under the leadership of Iceland's first female Prime Minister, Johanna Sigurdardottir.
- Following general elections on 25 April, a new Cabinet took office on 10 May. This center-left Government has a solid majority in the Parliament (34 out of 63 MPs).
- The primary goal of the Government's Cooperation Statement is to ensure economic and social stability, and to seek national unity on Iceland's path to reconstruction - a new stability pact.
- Also, for the first time in Iceland's history, the Government has stated its intention to seek the Parliament's approval for applying for membership in the European Union.
- These elections were also historic in the sense that 27 out of a total of 63 parliamentarians are women, or 43%.
- It can also be said that a certain political renewal is in the making, demonstrated by the fact that new chairmen have been elected in 3 of the 4 largest political parties.
- The political change was in many ways triggered by the so-called "Pots-and-Pans-revolution" in which ordinary Icelandic citizens took to the streets in what was for the most part a peaceful protest. In these extraordinary economic circumstances, Iceland's democracy proved to be vibrant and capable of bringing about change.

**[Key message #3: We are cautiously optimistic about Iceland's long-term prospects]**

- Finally, a reflection on Iceland's short- and long-term economic prospects. Although the IMF-program is working and reform has already been implemented, Iceland faces serious economic difficulties in the near term - we are not yet out of the woods.
- A few figures: With the collapse of the banking system, up to 95% of the stock market in Iceland was wiped out. Iceland's GDP is expected to drop by more than 10% in 2009. Also, unemployment has become a serious problem for the first time since 1930, possibly rising to 12% before the year's end.
- Government debt has increased significantly, to over 70% of GDP which is close to the average of OECD countries with net debt at a more manageable 60% of GDP. But fortunately, and almost uniquely among Western states, the debt was insignificant before the crisis and could be cut by around 25% of GDP with the banks resale. The debt of private households has also increased but remains manageable.

- There has been some mentioning in the international media that Iceland is on the verge of bankruptcy and practically “out of business”. Although truly unwarranted, such rumors and myths are hard to set right. Let me assure you, based on these figures, that the Icelandic economy is functional and its companies remain operational, competitive and progressive. Iceland is open for business.
- On the other hand, we do need to conclude talks with other countries on terms of loans, and on various solvency issues. The figures at stake are enormous for a small country. It is self-explanatory that the debt which subsequently falls upon the Icelandic people due to the collapse of the commercial banks must be sustainable.
- But despite the current difficulties, Iceland does have positive medium and long-term prospects; the simplest reason being that Iceland’s fundamentals remain strong. A financial crisis eliminates financial assets, but it does not destroy real assets.
- While economic forecasts agree that 2009 will be a year of contraction and 2010 likely a year of zero-growth, they agree that economic growth should pick up in 2011.
- Iceland’s Sustainable use of clean energy and marine resources backed by a good infrastructure, a strong pension system, culture of innovation and a flexible labour market, and last but not least a young and well educated workforce, holds great promise for the future. Iceland’s “social capital” remains intact.
- In fact, the economic crisis has also led to new initiatives by innovative companies, grass-root organizations and political movements, looking for ways to overcome the difficulties. There are opportunities in every crisis, and Icelanders are showing resolve and determination to embrace them.
- Iceland’s recovery will, of course, much depend on how the global financial crisis develops – we need our trading partners to be in good health. Dealing with the global financial crisis will require a strong and coordinated international effort to prevent a deep economic downturn in the world.
- My Government certainly appreciates the strong support and solidarity that has been shown to Iceland in these testing times. By the same token, Iceland expresses solidarity with other countries that are facing similar difficulties, and remains committed to common international solutions to solving the global financial crisis.

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- [*If applicable*: Regarding the effects of the UK Anti Terrorism Act against Iceland: The House of Commons Treasury Committee recently published a report on the actions taken by the UK government early October against Icelandic banks. The report concludes that the use of the Anti-Terrorism legislation against was inappropriate and stigmatised Iceland. The Icelandic Government considers the report to be a meaningful contribution to the explanation of events. ]