Íslensk Verðbréf conference on Rebuilding Iceland

Iceland: From Stabilization to Growth

Hilton Reykjavík Nordica

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Overview

1. The crisis
2. From stabilization to adjustment
3. From adjustment to growth

1. The crisis

Buildup of Vulnerability

Real sector imbalances

- Unsustainable current account
- Swollen non-tradables production
- Underlying fiscal weakness

Financial imbalances

- Short term funding
- Low quality assets
- Overleveraging/Banking sector too large
- Currency imbalances

The crash

Vulnerabilities + Global liquidity crisis precipitated collapse of confidence:

- Króna depreciation and inflation
- Collapse of the banking sector
- Increased debts for families and government
- Loss of jobs and incomes

The hallmarks of a BOP crisis.

Balance of payments crisis

Causes

- Access to liquidity shut down (impossible to borrow)
- Repayments are large (short term debt)
- External reserves inadequate (no effective buffer)

Effects

Painful adjustment by causing a recession (expenditure collapses)

….and a collapse in the exchange rate

which supports demand

but can wreak havoc on balance sheets

….and a collapse of the banks

2. From stabilization to adjustment

Stabilization and adjustment

First, emergency measures to soften the impact

mobilize exceptional financing (IMF, Nordics, Poland)

impose capital controls

allow a large budget deficit (fiscal automatic stabilizer)

stabilize the exchange rate

Then, credible policies to restore confidence

close the budget deficit over several years

lift capital controls when money starts flowing back in

replace exceptional financing with normal finance

structural reforms (to prevent it happening again)

Role of the IMF?

1. An IMF-supported program should not prevent adjustment…

2. …but it can make it less painful by

   access to emergency financing (IMF and other)

   creating conditions for a return of normal financing

      confidence via sound policy program (fundamentals)

      confidence via signal of an on track program

The aim is to adjust with minimum pain.

3. Getting back to Growth

IMF projections as of summer 2010

Projected five-year averages (2011-15)

Growth	2-3 percent
Trade surplus	7-8 percent of GDP
Current account surplus	0-1 percent of GDP
Inflation	2.5 percent

…and levels by 2015

Unemployment	3-4 percent (8.5 today)
External debt	190 percent of GDP (280 today)
Government debt	75 percent of GDP (115 today)

The Demand Side

Where will demand come from?

Government (G)	No. Fiscal consolidation
Households (C)	Maybe. But: debt overhang, saving, balance sheet uncertainty
Net exports (NX)	Yes. Competitive and profitable.
Investment (I)	Yes. But address governance, debts, business climate

Shifting mix in demand from G, C to NX and I

RER and shift to tradeables

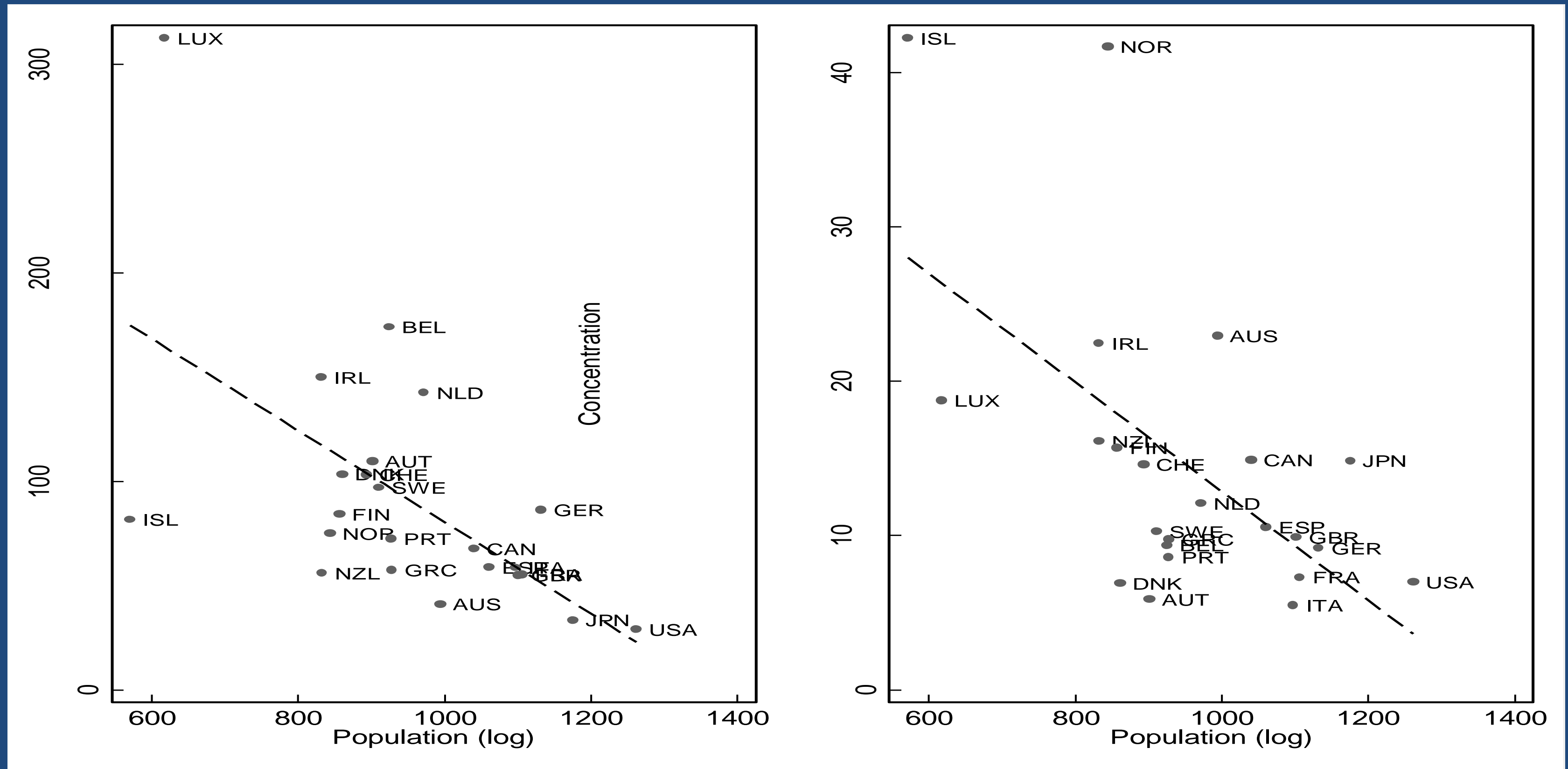
The supply side

Export sector capacity constraints

- fishing—not to overfish
- energy-related—long lead times and environmental concerns
- expand other sectors?

Ability to move to new sectors?

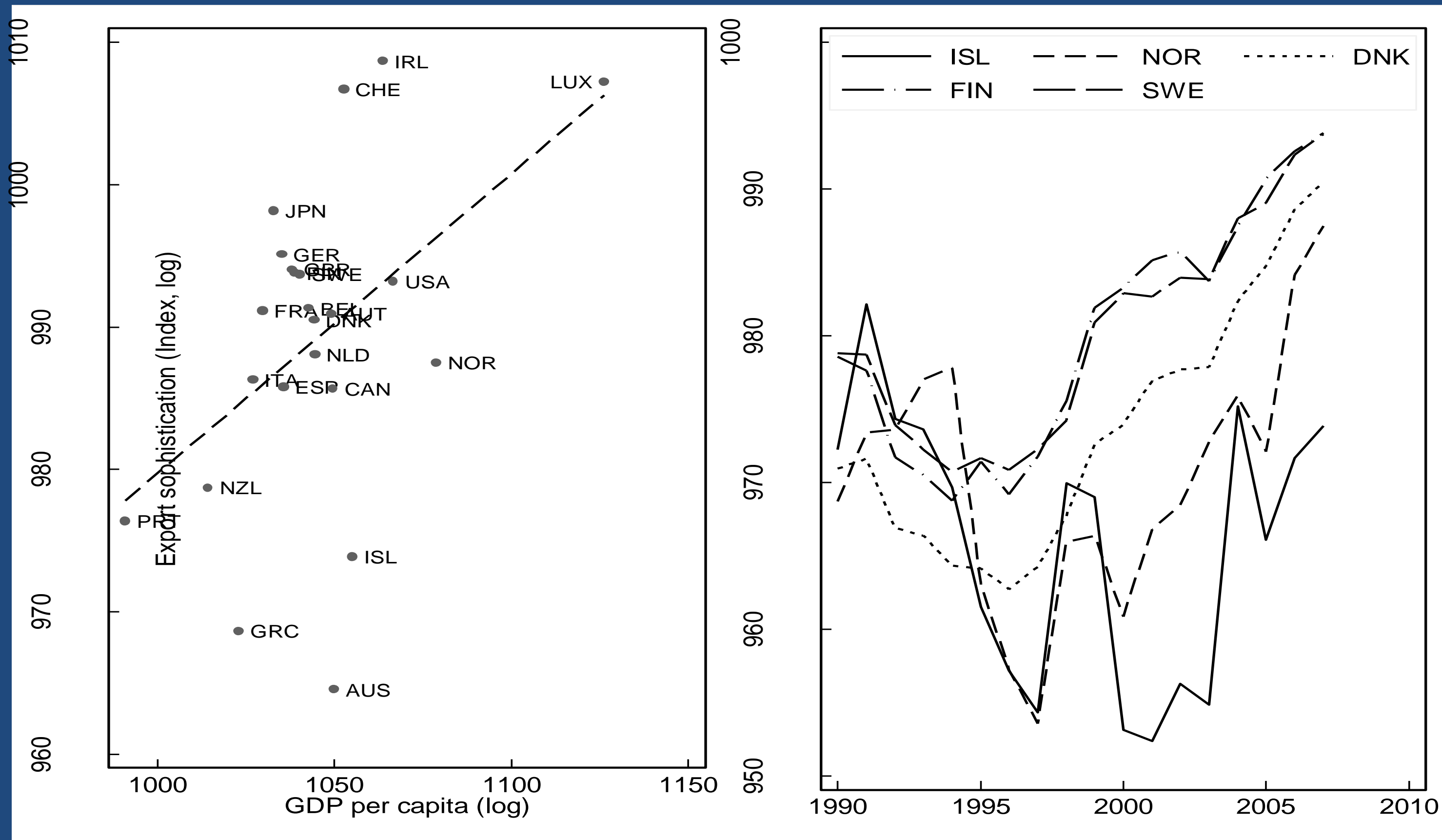
The export sector is small and concentrated…



Aluminium (1/3), Fishing (1/3), other (1/3)

Openness: (X+M)/GDP; Concentration: Herfindahl-Hirschmann index

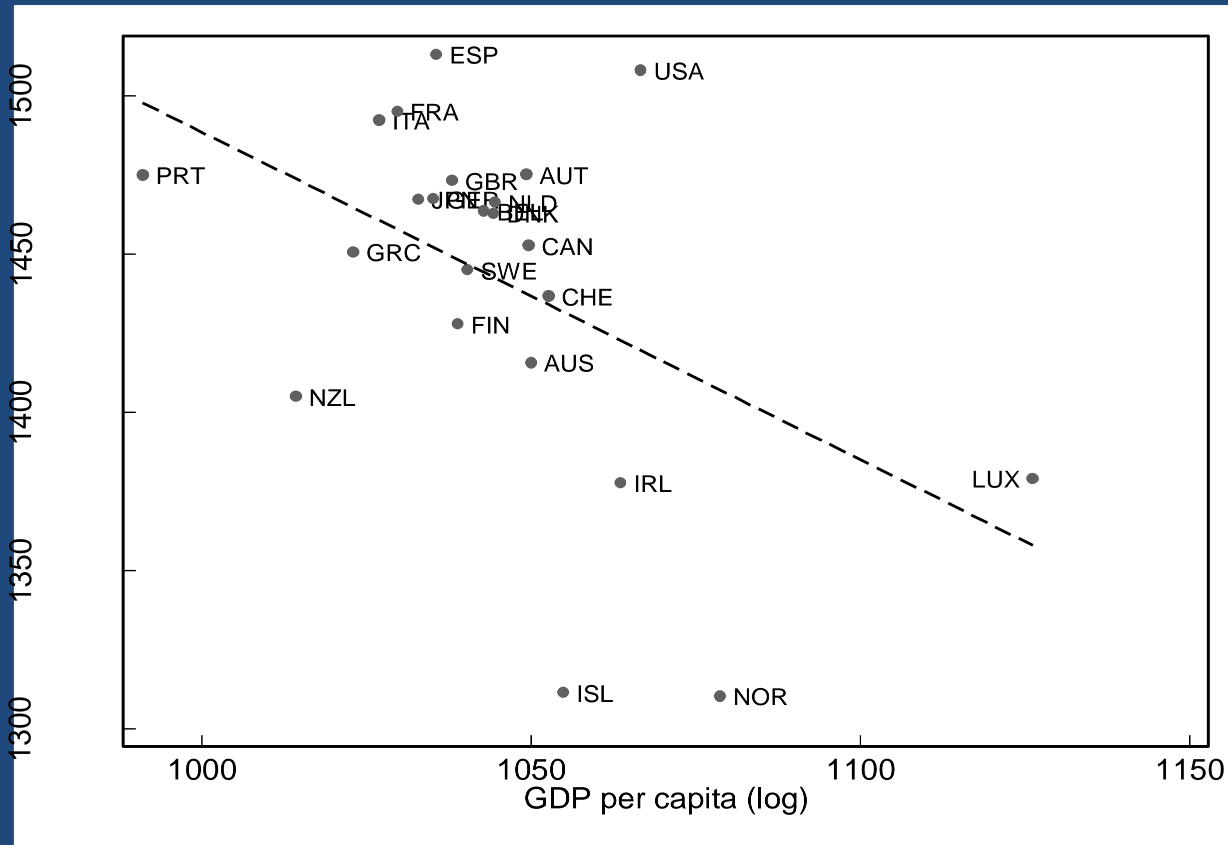
…with low "export sophistication"…



A "sophisticated" export is defined as one that is typically manufactured by a high GDP/capita country (Hausman et al, 2006).

"Sophistication" is associated with strong export growth.

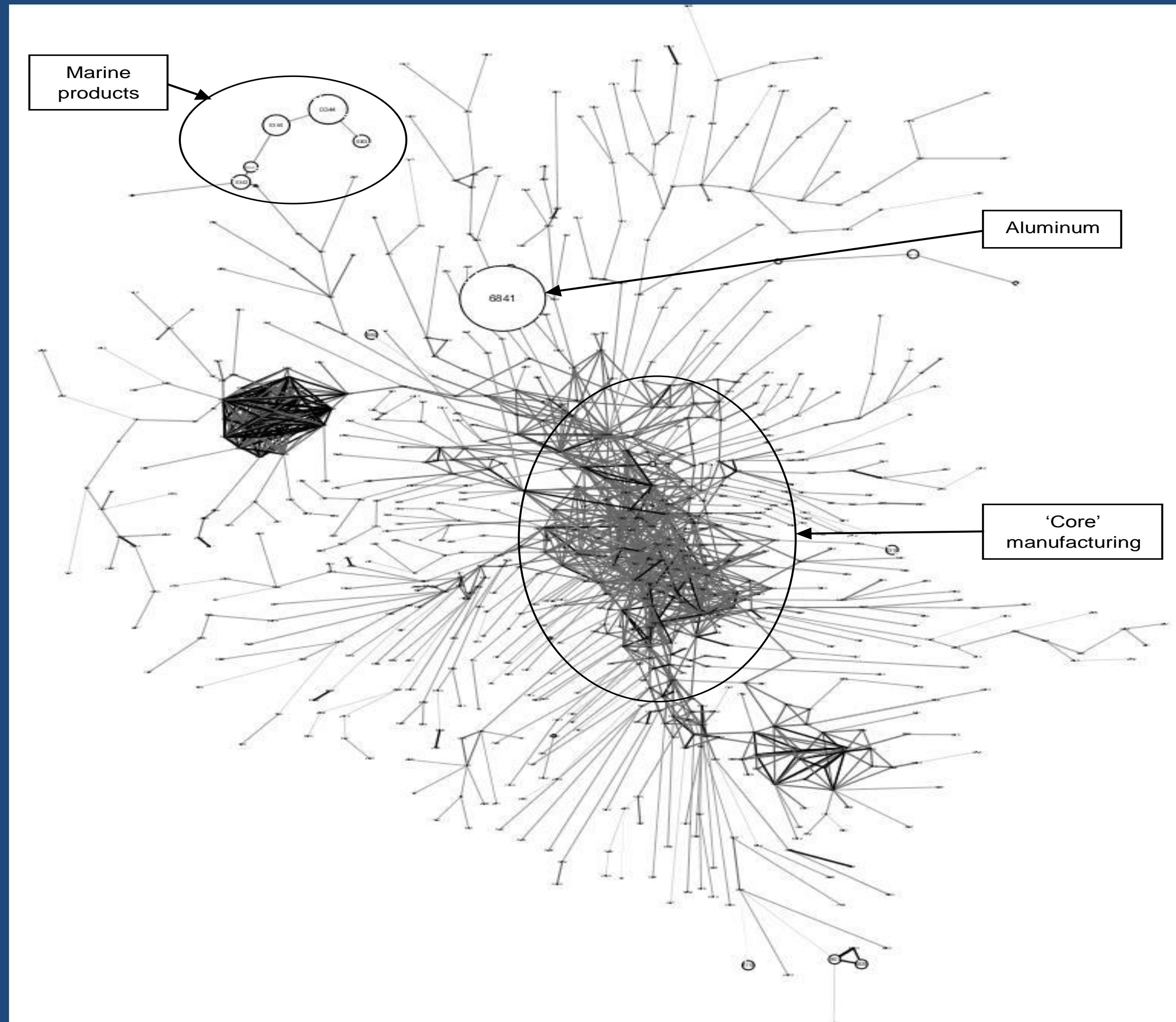
…and a low degree of "open forest"



'Open forest' is a measure of ability to move from the current export mix to similar 'nearby' products.

Open forest is correlated with the ease of export growth, owing to externalities and spillovers like preexisting skills and infrastructure. (Silicon valley effects).

Product space (2007)



Another perspective on open forest. See Barabasi et al.

What does this mean?

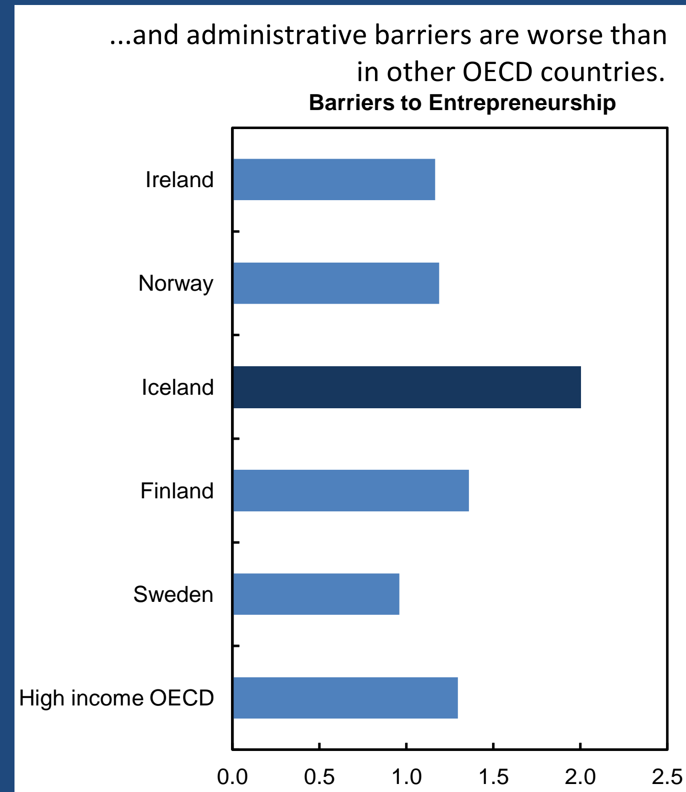
Relatively high costs to setting up new export industries

The indices likely overstate the costs because of the large weight of aluminium (1/3 of exports)

And they are to some extent offset by Iceland’s good infrastructure, price competitiveness and generally liberal trade regime

But they do suggest that barriers to FDI and entrepreneurship are costly…

Business climate

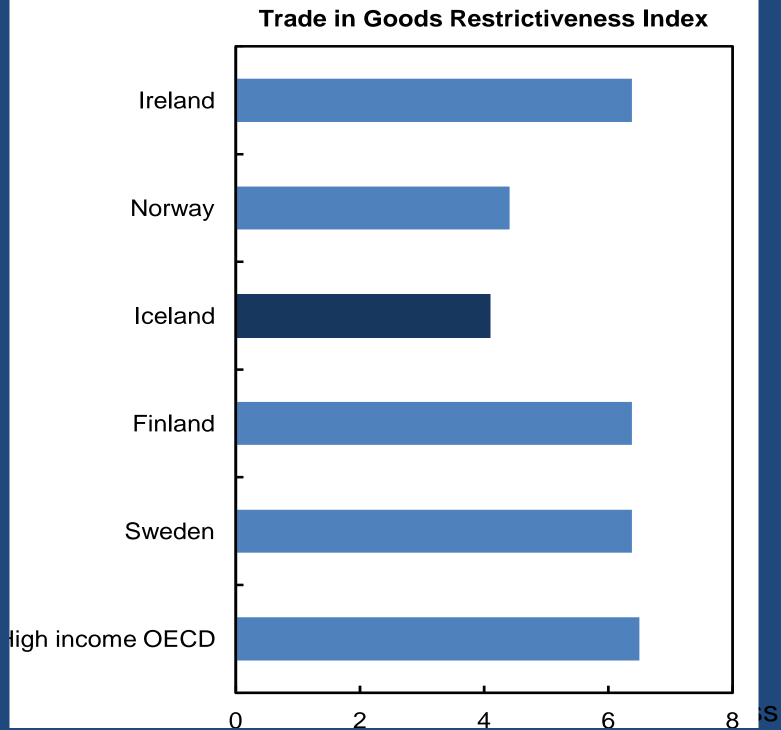


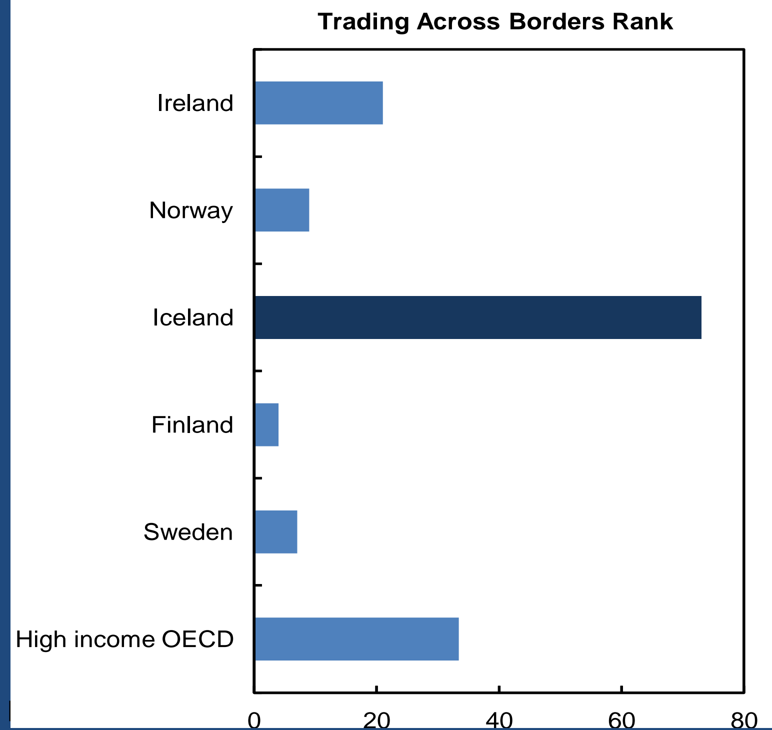
Restriction on foreign investment high relative to comparable OECD countries

Administrative barriers in permitting and regulations

Source: World Bank and OECD

Business climate (continued)





Time to process export and import transactions is long

Some implications

Strengthen the environment for investment

- Remove uncertainty about regulatory and tax environment (complete fiscal adjustment and gradually eliminate capital controls)
- Restore financial sector and accelerate corporate debt restructuring (remove financing constraints)
- Attention to rules for investment (restrictiveness as well as predictability and consistency of application)
- Preserve reservoir of human capital