Iceland

The IMF got Iceland "right" long in advance—by 7 years—pinpointing as early as 2001 virtually all the problems that would produce its crisis in 2008.

So amid all the self-defense by the IMF in response to criticisms of its global pre-crisis surveillance, why does one only hear from the IMF about Iceland as one of its program successes, but not as one of its major surveillance successes?

As in all matters, small things, including this silence from the IMF about its surveillance on this island, are telling. And few things come smaller than Iceland. —population 320,000, living back then with one big terrestrial and one big economic volcano. Much can be learned about how and why IMF surveillance in general goes wrong from a detailed examination of its work on this tiny case.

To show how prescient the 2001 IMF assessment was, the summary table below puts side by side the key elements of two IMF FSSAs—that in 2008 on crisis-eve, and that in 2001. Not only is the foresight of the 2001 assessment immediately apparent, but even moreso, on the key issue of supervisory quality (last item in the table), the earlier assessment has a far clearer grip on the problems, even though the signs of trouble from credit boom later were far more stark. The latter assessment, mistaking form for substance (as so often with FSSAs), misses the extraordinary depth of the supervisory shortcomings which the subsequent crisis all-too-clearly revealed.

Furthermore, the 2001 assessment did not restrict itself to warnings for the immediate future, but rather it emphasized underlying structural vulnerabilities:
- post-liberalization financial boom overwhelming the supervisory framework;
- unhedged exposures by households and corporations;
- low and over-reported bank capitalization;
- the interaction of all these with the exchange rate regime.

And it did not mince its words—it declares clearly that there is systemic risk and makes correspondingly sweeping and urgent recommendations. Without calling the bullets above a "fault line", that is clearly what Bill Allen, leader of the 2001 IMF staff team, found and emphasized, to his considerable credit.

The following table summarizes the two FSSAs. A full length table detailing each entry is shown at the end of this piece.

Iceland FSSAs — 2002 and 2008

	2001	2008
Overall	Systemic Instability	Vulnerability high
Background	Foreign financed lending boom	Foreign financed lending boom
Exchange rate	Peg set stage for moral hazard	Overvalued
Current account	Deficit ~ 10% GDP for 3 years	Deficit ~ 15 % GDP for 3 years
Mismatches	Overstretched private balance sheets	Overstretched private balance sheets
Non-bank exposures	Risks in insurance and pensions	Finance > 1,000 % of GDP
Liquidity	Doubtful in stress scenarios	High but fragile in stress
Bank capital	Low	Inadequate buffers
Supervisory quality	Inadequate	Strengthened and enhanced

I am a critic of IMF FSSAs—including because no FSSA in the EU in the decade runup to the global or Euro Area crises picked up any of the structural vulnerabilities that would produce those crises—but this one in 2001 on Iceland is a standout exception to their all-but-universal failure to spot systemic risk which was unseen before the FSSA.

So why does the IMF not promote Iceland as a major surveillance success ?

The answer to that is "because of what the IMF did between the stark warnings it issued in Iceland 2001 and the crisis that finally erupted in 2008".

And like the global financial and Euro Area crises, the problems concern what happens in the IMF between the sounding of the alarm and and eruption of crisis.

Certainly assessing fault lines is a difficult enterprise, subject to "cry wolf" and hindsight problems.

For that reason, consideration of these matters in Iceland should start with the numbers.

In the table below, the columns highlighted in brown show the data that underpinned the 2001 FSSA assessment, and those in yellow show the data for the 2008 crisis and beyond.

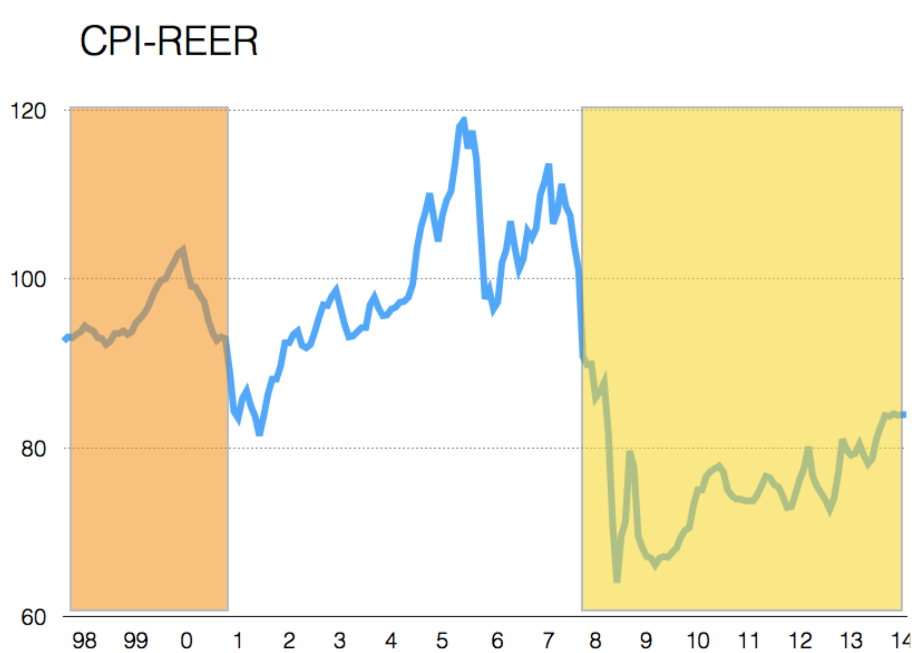
Those numbers indicate that the IMF fell at the first fence.

Following these warnings of risks of economic earthquake, Iceland experienced only tremors. The currency weakened somewhat through the fall of 2001 and then stabilized, partly through institution of inflation targeting, but mainly through a 5 percentage point of GDP collapse of fixed investment ratios between 2000 and 2002 and sharp increases in private savings rates. This helped to shrink the current account deficit by 11 percentage points of GDP in the same period to small surplus, albeit, extinguishing economic growth.

Alongside, the IMF completed an update to its 2001 FSSA in 2003 here. From that FSSA update:

Iceland - 1998 - 2014

	98	99	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14
GDP growth	6	4	4	4	0	2	8	7	5	6	1	-7	-4	3	1	3	3
Invest/GDP	24	22	23	21	18	20	23	28	36	29	25	14	12	14	15	14	14
Inflation	2	3	5	6	5	2	3	4	7	5	13	12	5	4	5	4	3
Exp vol gr	2	4	4	7	4	2	8	8	-5	18	7	7	1	4	4	5	3
Gov def/GDP	-0	1	2	-1	-3	-3	0	5	6	5	-14	-11	-10	-6	-4	-2	0
Gov debt/GDP	48	43	41	46	42	41	34	25	30	29	70	88	91	101	97	90	92
CA/GDP	-7	-7	-10	-4	2	-5	-10	-16	-26	-16	-28	-12	-9	-6	-5	0	1
Bank crdt. gr.	30	23	27	17	5	23	43	76	44	57	-44	-14	-1	7	0	1	3
House price g	7	22	14	3	3	10	14	43	20	9	7	-8	--5	1	6	3	
Ext dbt/GDP	72	83	109	125	113	143	181	284	434	606	565	270	294	259	246	247	221
GDP/cap US$	30	32	31	28	31	38	46	56	56	66	38	40	44	44	42	46	49



> "Iceland's financial sector has returned to a more balanced risk profile. The potentially destabilizing effects of the 2001-01 Krona depreciation were attenuated by the timely adoption of a credible inflation-targeting framework. While measures of private sector indebtedness remain high, Iceland's modern banking sector has managed to control credit risks, maintain profitability, and improve regulatory capital positions despite weak domestic conditions ... Since 2001, the FME has received increased funding and additional supervisory powers as a result of legislation. These changes have allowed the FME to become a more effective supervisor. A new assessment of the Basle Core Principles for Effective Banking Supervision finds major improvements in compliance."

The main IMF report on Iceland that year here went further:

> "There are, however, significant upside risks to this medium-term central scenario. While, at present, a weak global outlook and high levels of private sector indebtedness may temper the recovery, the investment demand push will soon gather momentum, including through forward-looking expectations. Thus, the main risks will be the emergence of overheating and loss of external competitiveness, especially if an asset price boom or unrealistic expectations of income develop. In this connection, the upcoming wage round in early 2004 will provide a first test. Also, the high level of external debt, particularly short-term liabilities, will continue to make the economy vulnerable to unexpected swings in sentiment and external financial conditions."

The IMF backed off its diagnosis of fault lines in the 2001 FSSA completely. Risks were "to the upside", the quality of Icelandic banks books was completely relegated as an issue of concern—"banks have managed to control credit risks"— and though the economy was vulnerable to swings in sentiment, these were "unexpected".

IMF confidence in Iceland's return to health was so strong that it changed the island's status from an annual inspection under Article IV of the IMF's charter to the much rarer two year inspection cycle—and this with the island's external debt still around 120 percent of GDP. None of the IMF staff who participated in the 2001 missions were present in these 2003 missions. The swing in the IMF assessment from two years earlier could scarcely have been more dramatic.

This confidence remained through late 2004 as the IMF mission concluded here:

> "The implementation of well-designed structural reforms over the last decade, the adoption of an inflation targeting framework, and significant improvements in financial supervision have transformed Iceland into one of the world's most flexible and dynamic economies."

And this confident assessment was given despite the resumption of dramatic credit growth and the associated deterioration in the current account balance since 2002 (See table above).

It did not take long before Iceland was back in trouble—in early 2006, another tremor—and was downgraded again from the two year to the annual IMF inspection cycle. The IMF mission concluding statement issued in May that year here includes the implicitly self-critical line in paragraph 2:

> "Looking back, these circumstances could have been mitigated by more coordinated policy actions that would have implied a tighter fiscal stance and reform of the housing finance fund."

Even so, the quality of the banks' books that had been an issue of such central concern in 2001 remained off the IMF radar screen. The IMF staff report of 2006 here intoned:

> "Although traditional indicators of financial sector health suggest the banks remain sound, the rapid expansion of their balance sheets has increased key risks in liquidity, credit, and interconnectedness through crossholdings of equity. However, banks have taken considerable steps to

> ensure their liquidity requirements are met; credit quality has remained high; and crossholdings of equity are being reduced. This notwithstanding, the process needs to continue to further reduce risks."

And later ..

> "Stress tests performed by the central bank and the FME suggest that banks' capitalization can withstand very large shocks. Should there be a sharp downturn in the economy, the impact would likely show up in reduced profitability through a reversal of trading gains, higher financing costs, and increases in non-performing loans."

A regrettable point to note is that this statement of unqualified confidence in bank credit quality in Iceland was issued just months after Rajan had presented his cautionary paper to the Jackson Hole conference.

Though the IMF staff in 2006 were concerned with the size and growth of the financial sector and saw both as vulnerabilities, staff remained confident in the the quality of lending—so that size and growth were problems of perception risk by markets only, not problems of substance. The conclusion of the IMF (in bold) was that "The financial system appears sound ..."

A year later in mid-2007 here, with macroeconomic imbalances widening and inflationary pressures growing despite carry trade inflows appreciating the Krona, the IMF called for greater fiscal restraint. But, critically, it found comfort in the fact that half of commercial bank's income was derived from outside of Iceland, and it emphasized:

> "The banking sector appears well-placed to withstand significant credit and market shocks. However, given the rapid expansion and increasing complexity of banks' businesses, continued vigilance and further development of stress testing and risk management techniques is crucial."

Yet again, a fault line (in the financial sector) was interpreted as a cyclical upswing in need of correction and the IMF concluded in 2007, in bold, "Iceland's medium-term prospects remains enviable."

And all this with the current account deficit above 27 percent of GDP and well into double digits the previous two years, bank deposits funding only 1/3 of bank credit, with credit growth above 30 percent annually for over three years, up more than 260 percent since 2002 and standing at 280 percent of GDP, and total assets of all credit institutions in excess of 8 times GDP, household debt at 216 percent of disposable income up from 160 percent 4 years earlier, and with house prices up 200 percent in the same period.

Only in 2008, as noted above, did reality sink in for the IMF. And even then, it persisted with its assessment (dating back to 2003) that the financial sector remained fundamentally sound.

There are many lessons here for IMF surveillance of advanced countries.

First, the propensity of the IMF to back off of warnings of systemic risk when they are not immediately realized. Once that had happened, even the additional tremors a few years later and the quite extraordinary credit, housing, and external indicators were insufficient to cause a reinstatement of its original (correct) call. And even on the eve of crisis in 2008, the IMF was still denying the fundamental cause of that crisis—namely financial sector bedlam.

Second, in light of aversion to call fault lines, the IMF assessment of risk reverted to up and downside assessments and assessment of the cycle. Frequently, the risks were assessed to the upside, and the country's medium-term prospects were routinely judged strong.

Third, there is almost no continuity in IMF staffing on Iceland over this period. None of those involved in the original 2001 alarm call were still there two years later. And the shift to the 2 year inspection cycle for Iceland reinforced that break.

Fourth, there is no sense of long-horizon analysis—what has been going on in Iceland over the past 10 years. The focus of IMF staff—after the rare 2001 exception—is routinely very short term so that extraordinary credit, external, and housing data (when viewed over that horizon) are missed as focal points.

Fifth, the analysis is entirely Iceland-focussed; at no point is there an examination of Iceland within higher levels of aggregation, notably its role the international financial sector. This gap is particularly extraordinary given Iceland's tiny stature. The analysis is entirely based on the assumption that it is a self contained small open economy in a broadly stable world. So all the vulnerabilities reflecting its place in international securitization are overlooked—beyond concerns that liquidity of last resort facilities should be adequate.

Sixth, there is the failure by the IMF to distinguish between actions by the authorities going in the right direction—supervisory frameworks were indeed strengthened following the 2001 FSSA—and reforms being "sufficient". The IMF is highly focussed on assessing direction rather than sufficiency. And this distinction emerges clearly in Iceland where reforms in the right direction on the supervisory framework were plainly wholly insufficient.

And last, there is the hubris and faith in free finance that if financial markets are funding it, it must be OK even if the flows are dubbed "carry trades", and that any countervailing measures should be fiscal rather than in the financial sector. Given that the IMF had been "wrong" on financial sector problems before on Iceland in 2001, it was deeply reluctant to make that call again, especially when the exchange rate was appreciating due to strong capital inflows, the economy was booming, and backward looking indicators of financial fragility such as bad debt ratios (in that booming context) were mute. And the IMF failed to rethink developments in global finance based on Iceland's trends.

The strength of that reluctance in the IMF to call systemic risk is evident from the depth of the crisis that eventually came from 2008 on. The collapse has been truly spectacular: the entire core banking sector became insolvent; the currency and real household incomes collapsed causing widespread household insolvencies; foreign exchange controls were reintroduced (and are still in place); GDP fell 10 percent and took six years to return to its pre crisis level, while US$ GDP has remains slumped to an extraordinary degree; emigration has surged; and through all this, gross public debt rose from some 30 percent of GDP pre crisis to 90 percent of GDP now. Working that back down will diminish the prospects for Iceland for a generation.

If *once such a systemic call has "failed"*, the IMF is not going to call systemic risk in such a tiny (politically non-influential) country facing such a huge calamity ahead of time, and in the face of such indicators flashing so red, it is never going to do so.

This is not just an issue of which precise words the IMF uses in a report, though the 2001 FSSA made no bones about using the word "systemic" despite conventional reluctance of the IMF to do so in case such words themselves set off crisis. Instead, the failure to diagnose such risks is evident from the pre crisis policy recommendations made by the IMF, notably in the case of Iceland from 2003 onwards, concerning supervisory and regulatory reform. Those recommendations in Iceland, as in the Euro Area and in the global financial system, make clear that the call was not made.

There is much to learn about how to fix IMF surveillance from this story not least because it so closely echoes what the IMF did after it received warnings of Euro Area and global financial vulnerabilities long in advance. And the problems have little to nothing to do with groupthink, not least as (despite groupthink) the IMF called the Iceland case correctly in 2001.

Whatever the role of Iceland as a program success story for the IMF (an issue not discussed here), it is a deeply revealing case in respect of what goes wrong with IMF surveillance of advanced industrial countries.

Iceland	2001	2008
	here	here
Overall	institutional features of the Icelandic financial system, which, in interaction with the macro economic environment, may give rise to systemic instability	vulnerabilities are high and increasing, reflecting the deteriorating financial environment. Global international liquidity has declined significantly in the past 12 months ..
Background	The annualized growth rate of lending by banks remains above 20% (for the third successive year), a significant portion of which has been funded by banking system through foreign borrowing	.. a long home-grown, foreign-funded boom led to large macroeconomic imbalances, overstretched private sector balance sheets, and high dependence on foreign financing
Exchange rate	The exchange rate regime in place until March 27, 2001- an adjustable peg against a basket of currencies-has likely been perceived as an implicit guarantee against exchange rate risks and, thus, has probably set the stage for moral hazard among domestic agents ...	the króna became overvalued;
Current Account	The current account deficit, which has been running around 7% of GDP since 1998, exceeded 10% of GDP at the end of 2000 and is being projected by IMF staff at 10.6% of GDP for the year 2001.	The current account deficit exceeded 15 percent of GDP in each of the past three years;

Iceland	2001	2008
Mismatches	while bank borrowing in foreign currency is essentially matched by lending in foreign currency, a significant share of foreign currency loans has been extended to the service and household sectors, which do not have fully matching sources of foreign exchange income.	overstretched private sector balance sheets, and high dependence on foreign financing
Non-bank exposures	significant credit risk in the insurance sector and, to a lesser extent, in pension funds, both of which have made consumer and mortgage loans to customers and members.	The financial sector expanded to over 1,000 percent of GDP, while gross external indebtedness reached 550 percent of GDP at end-2007, largely on account of the banking sector.
Liquidity	Financial markets—including the short-term money market and the markets for treasury bills, government bonds, and foreign-exchange—are small and highly concentrated by international standards. Their ability to supply the liquidity, particularly in a time of stress, appears to be somewhat fragile ...	Liquidity ratios, while high, now depend more than before on access to central banks' liquidity facilities because of the turmoil in global markets and any reduction in such access would require changes in the banks liquidity management strategy.

Iceland	2001	2008
Bank Capital	The FME and CBI have repeatedly warned that the CAR is low under current circumstances when compared to other Nordic countries, and they have urged the banks to take remedial measures	Capital levels, while above minimum levels, are below the average of the last five years and may not provide adequate buffers,
Supervisory quality	Inadequate legal authority and independence of the supervisor, lacuna in the coverage of the regulatory framework which left ... equity funds essentially unsupervised; deviations from international best practice in all parts of the regulatory framework (particularly with respect to connected lending, asset classification, loan-loss provisioning, and evaluation of collateral); weaknesses in the implementation of supervisory measures, such as on site inspections in the absence of written procedures for the evaluation of fit and proper criteria for managers and shareholders. The ... supervisory authority .. is understaffed.	The supervisory framework has been strengthened and the FME's capacity to supervise banks enhanced. All issues raised by the 2003 BCP assessment have been addressed. Prudential laws and regulations have been updated and the FME, in collaboration with the CBI, has increased its emphasis on liquidity management and contingency planning, extending its scope to cover the foreign activities of the banking groups. More consistent contact among supervisory authorities in host countries would enhance these efforts.

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September, 2014
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