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Statement by Daniel Gros on bill 76
(In advance of teleconference meeting, Wednesday morning at nine, 16th of December.)

The issue put to me is both simple and complex:
what are the likely consequences for the Icelandic economy if the bill will

a) Be passed?
b) Not be passed?

To summarize: my opinion is that with bill 76 the short term situation will be somewhat easier, but the long term perspective considerably worse. With bill 76 the government of Iceland would take on large long term liabilities at too high an interest rate.

Of particular concern is that the interest rate 5.55 %, might well be higher than the longer term growth rate of the Icelandic economy. As is well known this would imply a 'snow ball' effect which would make debt service more difficult the more it is pushed into the future.
The longer term growth rate of the Icelandic economy (in terms of nominal GDP) is thus a key parameter if bill 76 is adopted. Unfortunately, there is very little Iceland can do to influence this key parameter given that it is always difficult to change growth rates, and given that inflation in the euro area will be determined by the ECB.
It is not certain that a 'snow ball effect' situation (growth rate lower than interest rate) will arise. But in my view this is likely and this is a key risk should bill 76 be adopted.

What are the risks if bill 76 is rejected? The availability of official external financing might be reduced in the short run.
It is not certain that this will actually happen. The incentives for the main creditor governments in this respect are not clear. They might want to put pressure on Iceland, but they also know that by blocking IMF resources they will actually make it more difficult for Iceland to pay compensation on the Icesave issue. It is difficult to judge what will happen to the availability of foreign private capital. But, as argued below, this is in my view not really the key issue.

The key issue in reality is: Does Iceland need additional foreign capital? Iceland will anyway have to run current account surpluses if it wants not only to service its foreign debt, but also to reduce it over time to a less dangerous level. Hence Iceland should soon no longer need access to foreign, especially foreign official financing. The cost of no longer having access to additional foreign official financing should thus be minor in the medium run.
Another way to look at this issue is to say whether Iceland wants to continue the model it has followed over the last decades: accumulate debt which finances consumption and investment in aluminum production? This crisis has shown that this approach is dangerous because it relies on a continuing availability of foreign capital, which cannot always be taken for granted. Rejection of bill 76 would imply taking a different approach, one that is based on self reliance, even if this involves short term sacrifices.

Iceland has now such a high external debt that its future thus does not look rosy under any scenario. But given this balance of risks it is my opinion that the economic perspective of Iceland would be less bad if bill 76 is not adopted.

Annex on the economic criteria.

According to the latest version of the World Economic Outlook database of the IMF the GDP of Iceland is forecast to amount to 12.5 billion USD in 2014, or about 8.5 billion euro at current exchange rates, compared to 11.5 billion euro in 2008. This implies that under the IMF forecast the cap defined as 6 % of the increase in nominal GDP is likely to be binding for a very long time even after 2016.
It follows that under the terms proposed now Iceland would pay only interest for a long time after 2016 (until nominal GDP goes above 11.5 billion euro).
This implies that for a long time after 2016 there will be arrears on which interest accumulates at 5.55 % or even 5.85 (this is not entirely clear). The key question is now whether Iceland's economy can grow at more than this rate. If this is not the case Iceland could end up under a debt mountain that keeps snow balling.
Whether or not the GDP of Iceland can and will grow by more than 5.85 (or even 5.55) % is difficult to predict. The IMF's predictions assume a lower rate. If one gives Iceland a 'steady state' growth rate of 3 % (which would be rather high for a mature economy, but might be justified given its somewhat higher population growth rate) inflation (not CPI, in terms of the GDP deflator) would have to be above 2.5 %. This is more than the target of the ECB. The key point here is that once Iceland joins the EU and the euro it can longer control the rate of growth of nominal GDP. It is possible, for example that we will now have a decade of slow growth with inflation at only 1 %. In this case the difference between the interest rate and the growth rate would be over 1.5 % per annum.[1] This is the rate at which the debt service would be increasing as a share of GDP.
The situation would of course become even more difficult for Iceland if the euro area were to experience a Japanese style situation with falling prices.
Nothing is certain in this regard, except that there is a risk, in my view a very material risk that Iceland might end up in a debt trap.
In all of this I have not even considered a substantial appreciation of pound sterling against the euro, which could make the long run situation even more difficult.

[1] Nominal growth = 3 (real) + 1(inflation) = 4, but interest accumulating at 5.55 or 5.85.

Non discrimination under EEA rules
Also for Iceland?

When the Icelandic banking system collapsed last year the government of Iceland chose to guarantee all deposits in Iceland. The governments of the UK and the Netherlands then argued successfully that under EEA rules Iceland had also to indemnify depositors in other countries as well. Since the Icelandic deposit insurance fund did not have enough capital to pay compensation to British and Dutch depositors the governments of these countries offered to loan the Icelandic fund the required amount (almost 4 billion euro in total) at an interest rate equal to 5.55 %.

A fact that has not received any attention so far is that both the British and the Dutch deposit insurance systems are basically of the 'ex post' type, meaning that these deposit insurance schemes have not accumulated significant funds, but mostly pay compensation out of funds loaned to them by their respective governments.

The interesting question now is: at what conditions do the treasuries in the UK and NL finance their own deposit insurance systems?

For the UK the answer is: The Treasury advances the British deposit insurance fund (the FSCS) all the necessary capital at a rate equal to 12 month LIBOR plus 30 basis points[1] or around 1.5 % at present. During the first year this is about 400 basis points or 4 % less than the 5.55 % charged to Iceland by the UK (and the NL) under the loan agreements. If the UK were treating the Icelandic deposit insurance system in the same way as it treats its own deposit insurance fund (the FSCS) Iceland would have to pay about 100 million euro per year less (on the obligations towards the UK alone). LIBOR rates are of course subject to change. However, longer term very similar interbank rates do exist..[2] Even on the basis of these longer rates (which are of course higher) the difference in total payments (including compound interest) would amount to over 800 million euro for the UK alone. Should the pound appreciate against the euro this figure could easily become 1 billion over the life time of the loan agreement.[3]

In the Netherlands the situation is slightly different as the Dutch National Bank does not charge interests on the funds it advances its own deposit insurance system. It appears that the Dutch authorities waited for three years after the last major bank insolvency before Dutch banks had to refund the money advanced by the DNB (again without any interest charge).

The government of Iceland has been asked to treat domestic and foreign depositors alike because non-discrimination is a fundamental principle in the EEA. But this implies that

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[1] See the Annual Report of the FSCS in the UK.

[2] The Bank of England has a data base on 'UK commercial bank liability spot curve' which goes out to maturities over 20 years.

[3] Asset recovery would of course reduce these amounts, perhaps considerably. Unfortunately it is very difficult for an outside to estimate the likely size of asset recovery. Moreover, there is the issue of when assets that are recovered are actually available for sale and how much they yield in the meantime.

one can also ask the UK to abide by the same principle and treat domestic and foreign deposit guarantee systems alike in terms of the interest rate charged for the financing of pay outs from deposit insurance schemes. The interest rate of the loan that the UK treasury gives to the Icelandic deposit insurance scheme should thus be reduced to 1.5 %, at least for the short run.

Moreover, the UK treasury has also agreed that, for the next three years, the entire UK banking system will under no circumstances have to pay more than 1 billion pounds per year in interest on all the funds advanced to the FSCS by HM Treasury. If one were to apply the same cap to Iceland the upper limit on interest payments would be equal to about 5 million (not billion!) euro per annum since the economy of the UK is about 200 times larger than that of Iceland.

Daniel Gros
CEPS and Central Bank of Iceland
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