

Rising from the Ruins

The Icelandic Economy – Status and outlook at midsummer 2010, Part 3

From its own experience, the general public knows all too well how heavy the blow was that struck the Icelandic economy with the collapse of its banks in the autumn of 2008. Due to their size and scope of operations, the difficulties that beset Iceland were considerably greater than problems faced by other countries of similar origin. Since I have already discussed the reasons behind this in previous articles, in this instance I will focus on the positive signs now to be seen in economic affairs in Iceland.

Public debate on economic questions has not been short on negative criticism, predicting nothing but doom and gloom on the horizon. More often than not these voices come from the same groups in society that gazed admiringly at the crony capitalists and neoliberalists, all of whom bear much of the responsibility for our misfortunes. When parliamentary elections were held in 2009, the leader of the Progressive Party declared that a second economic collapse was imminent. Others in this group have fuelled fears of a large-scale exodus from the country, of unemployment reaching 20% or more and of crippling taxes stifling the economy. Events, fortunately, have shown these prophecies to be exaggerated scaremongering.

Lower contraction – greater success

While there is no denying that the Icelandic economy still has a long way to go to achieve a full recovery, today, almost two years after the collapse, there are clear signs of a turnaround. Numerous indicators, giving us a clear picture of the economic situation, have developed more positively than forecasts of the Central Bank of Iceland, Statistics Iceland, the Economic Section of the Icelandic Confederation of Labour or the IMF suggested.

As a result of the interplay of many factors, the situation is markedly better than many feared. One of the most significant points is that the contraction in GDP has been less than anticipated. Instead of dropping to ISK 1,450 billion in 2009, GDP fell to around ISK 1,500 billion. And instead of a further sizeable drop in 2010, as had been forecast, most recent predictions now anticipate an insubstantial further contraction, with 2010 GDP of around ISK 1,600 billion at current price levels. If forecasts for GDP growth of 2.5-3% next year prove correct, this will mean an economy which is now beginning to grow once more and is ISK 70-100 billion larger than was first predicted following the collapse. This is no small difference.

The real economy has demonstrated its resilience and driven the economy forward. Both the export and non-sheltered sectors have benefited from a favourable exchange rate. Domestic production has increased its market share and new growth industries are advancing. The balance of trade in goods and services has been completely transformed. Deficits of hundreds of billions which had accumulated during the years preceding the collapse have now been replaced by a cumulative surplus on trade in goods and services since year-end 2008 - amounting to almost ISK 200 billion by mid-2010. This has contributed to a significant ISK appreciation and steadier exchange rate. The impact on the standard of living is already appearing.

Other important indicators also suggest the tables are definitely turning. Economic growth in the past two consecutive quarters refutes all claims of a paralysed economy. This growth has even appeared considerably earlier than expected by most analysts. The same is true of unemployment, which is currently 7.5% while most forecasts anticipated an unemployment rate as high as 10% around mid-2010. Some 2000 more jobs were on offer in the second quarter of this year than at the same time in 2009. Although these unemployment figures are a far cry from the traditional labour market situation in Iceland and plainly unacceptable, it is nonetheless noteworthy that unemployment in Iceland is among the lowest in the OECD, considerably lower than the EU average (over 10%) and lower than in the US (9.5%).

When this government took office, inflation was 17.8%; it is currently 4.8%. Over the past three months inflation has been replaced by deflation. The Central Bank's policy rate has dropped from 18% to 7%, and other lending rates have fallen accordingly. These positive economic

achievements, which make a major difference for the purchasing power and debt burden of Icelandic households, are based on steadfast monetary and currency policy, the positive outcome of financial system reconstruction and responsible fiscal strategy. With determination and responsibility we are regaining stability, slowly but surely, and building the trust which is a crucial premise for economic reconstruction.

Fiscal responsibility brings results

The current government inherited a Treasury deficit of ISK 215 billion. By the end of 2009 this figure had been reduced to ISK 140 million, or ISK 34 billion better than forecast. The reduction is no less than a full 6%, cutting the deficit from 15% of GDP to just over 9%. By comparison, the German government recently set itself the target of improving the Treasury balance by 3% over a three-year period, which is considered very ambitious.

Instead of taking no action in fiscal matters in 2009, as had been the intention, the new government decided to get to work immediately and introduced a number of measures in mid-2009, including both cutbacks and tax increases amounting to over ISK 20 billion. Cutting back is never an easy task, especially in public consumption, but it was and remains the only option and every effort was made and will be made to spare basic welfare services wherever possible. As a result, Treasury expenditure excluding interest was reduced from almost 44% of GDP in 2008 to around 33% of GDP in 2009, and is estimated to be around 29% of GDP this year. This percentage is similar to that in the years preceding the collapse, despite the addition of various unavoidable expenses connected with the ensuing situation.

Although government revenues were somewhat higher than estimated in 2009, they are nonetheless a much lower percentage of GDP than prior to the collapse. Measures were therefore taken to prevent an even greater fall in revenue than would otherwise have been the case. At the same time, the tax system was amended to increase its equalising effect and it has now been confirmed that low-income earners were spared the effect of tax increases. The first steps towards introducing environmental and resource levies have been taken.

Seven months into 2010, fiscal policy is completely on track to achieve its objectives and there is a good possibility that the Treasury deficit will be well under ISK 100 billion, or around 5.5% of GDP. This is a long way from the 15% deficit of 2008. What comes as a surprise is that our position in this respect will be much better than that of numerous European states which are struggling with two-digit fiscal deficit percentages.

The preceding discussion has compared the actual developments with forecasts. No one, not even the most pessimistic prophets of Armageddon, could deny the major achievements that have been made and that we are on the right track. This is the good news, but it is no less true that we still face an uphill struggle. The truth is that fiscal measures taken by the government in 2009 and 2010 were well aimed and have brought results. They did not magnify the downturn or smother economic activity, as critics claimed. Quite the opposite. And reality and the facts of the matter have the last word.

Seeing clearly from a distance

Some of the points mentioned here could have sparked a recent article by the US Nobel laureate in economics Paul Krugman, who wrote of the “Icelandic post-crisis miracle”. Krugman writes that a complete transformation occurred in economic policy management in Iceland, after a period of economic mismanagement that resulted in one of the proportionally largest economic catastrophes in history. The recovery in Iceland is astonishing. To this I would reply, we’ll talk about this when it’s over. Let’s not rejoice too early and remember that we’re not out of the woods yet. There is, however, every reason to point out how successfully the Icelandic economy is currently progressing. There is evidence enough that the sun is on the rise once more and definitely cause for optimism to prevail over pessimism.

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