Europe, the Euro and Euroisation
The special case of Iceland

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Main points

It is now almost ten years since the start of EMU and 6 years since the euro was introduced in the form of cash. The experience so far has been positive for all member countries of the euro area, but this might not be relevant for Iceland since its economy differs in some key aspects from that of the ‘average’ euro area member country.

The euro area has weathered global shocks well and there have been few ‘asymmetric shocks’ within. However, one important divergence has been building up slowly over the last year, namely a drift loss of competitiveness of most countries vis a vis Germany. Tightly related to this, and probably its cause, has been a divergent drift in housing prices: down in Germany up in most other countries. The major test for the euro will start now that these trends are inverting (housing prices down in F, IT, Spain, etc.) and stabilizing in Germany. The experience with the German case of an (underrreported) housing bust suggests that housing busts tend to be shallower and last longer in a common currency area. The busts in Scandinavia during the 1990s were sharper, but also shorter.

The main case of adoption of the euro outside the euro area is Montenegro. The euro in Montenegro has been a success so far, even the European institutions (especially the ECB) which were very hostile at the start have now come to the conclusion that Montenegro should keep this arrangement for the time being. Montenegro is also a very small state (pop. Ca. 600 thousand) but it holds few lessons (except that unilateral euroisation is technically feasible) for Iceland because it practically did not have any banking system and was not integrated in the global financial system.

Iceland has two features which distinguish it from most euro area members (apart from size): its limited degree of trade integration and the extraordinary degree of financial integration. Both features are relevant for the choice of an exchange rate regime. On both counts joining the euro should be

advantageous for Iceland: Adopting the euro should stimulate trade.
Adopting the euro could avoid large shocks that arise from the mixture of very large onshore and offshore banking activities in domestic banks, which have become 'too big to be saved'.

Table 1 Increasing importance of trade due to increasing imports of capital and intermediate goods

ICELAND	**1995**	**2000**	**2006**
Imports of consumption goods as % gdp	8.8	8.6	9.8
Imports of capital&consumption goods as % gdp	13.4	15.4	20.3
Imports of capital goods as % gdp	4.6	6.8	10.5
Imports of intermediate goods as % gdp	11.5	11.9	16.4
Imports as % gdp	24.9	27.3	36.7

Germany and Iceland the comparing degrees of openness:

	imports of intermediate goods as % GDP		Total Imp/GDP	
	1995	2006	1995	2006
Germany	20.0	18.5	30.4	30.8
Iceland	11.5	16.4	24.9	36.7

Net foreign investment position
(In USD billion)

	Iceland			CH	
	2000	2006	Change	2006	CH scaled to size of ISL
Net FDI	0.2	5.7	5.5	314.1	9.5
Net PI	-1.9	-37.8	-35.9	119.1	3.6
Net PI Eq	2.1	7.9	5.8	-262.5	-8.0
Net PI debt	-4.0	-45.7	-41.7	381.6	11.6
Net banks	-2.0	14.6	16.6	-55.1	-1.7
Net other	-1.3	-4.0	-2.7		
Net IIP	-5.3	-19.5	-14.1	459.2	13.9

Table Rapid evolution of structure of foreign exchange sources in Iceland

	Foreign exchange earnings		Foreign exchange outlays	
	1999	2006	1999	2006
Goods	65.5	45	64	47
Services	30.3	24	28	21
Investment income	4.2	31	8	32

Percent distribution of foreign exchange earnings (2006) a comparison

	ISL	CH	LUX	CY
Goods	45	51	10	14
Services	24	16	31	77
Investment income	31	33	59	8

Percent distribution of foreign exchange outlays (2006)

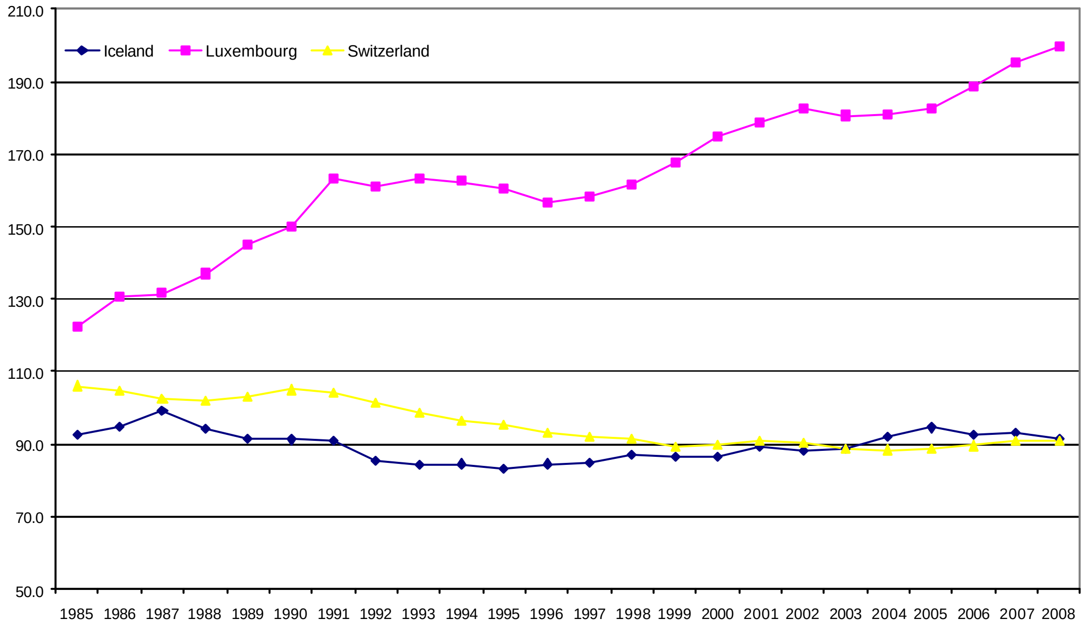
	ISL	CH	LUX	CY
Goods	47	63	13	57
Services	21	11	19	29
Investment income	32	26	68	14

3.2 Lender of last resort responsibility for the banking sector

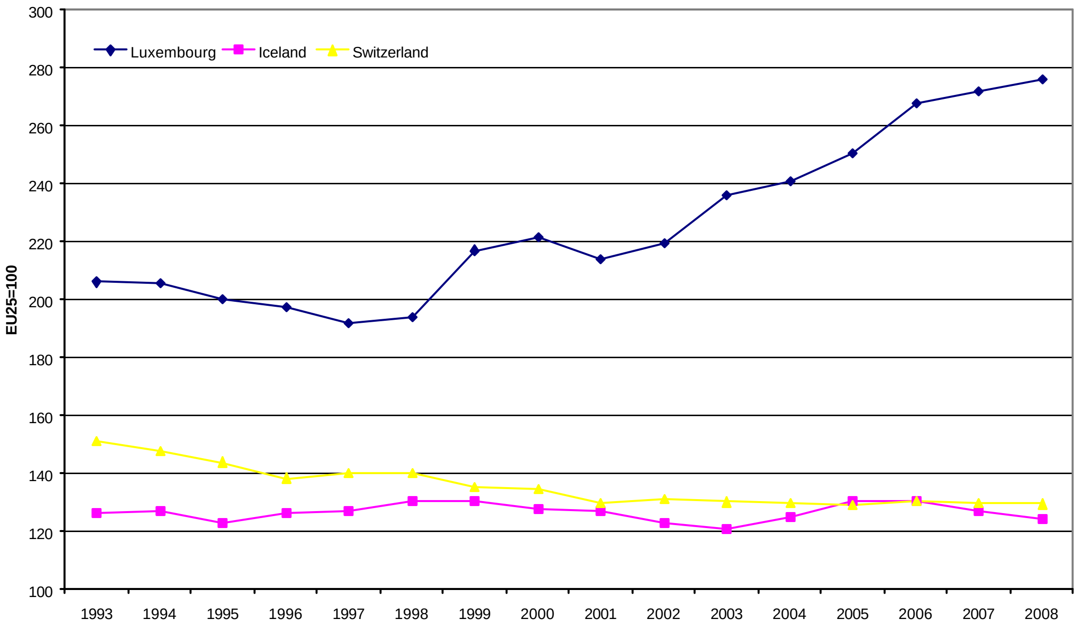
	Loan/deposit ratios		
	ISL	CH	LUX
2007/11	3.42	2.22	0.52
2003/11	1.93	1.04	0.48

Source: IMF banking statistics

GDP as % of US GDP (PPP per capita)



GDP PPS per capita
Eurpean Commission data



Concluding remarks:

Mixture of domestic and offshore banking business problematic with fluctuating exchange rate.

Overlaid with real estate boom. The bust now probably might be protracted.

Difficult to offset loss of domestic demand with exports as real openness low.