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## **IMF Executive Board Concludes 2010 Article IV Consultation with Iceland**

The Executive Board of the International Monetary Fund (IMF) today concluded the 2010 Article IV consultation with Iceland.<sup>1</sup>

### **Background**

The seeds of Iceland's 2008 financial crisis were sown during a prior boom of exceptional magnitude. Easy access to foreign credit fueled rapid growth of domestic demand that swelled the current account deficit and drove up asset prices. Over time, Iceland's gross external debt rose above 600 percent of GDP, while households and corporations accumulated heavy debt burdens with large exposures to foreign exchange and inflation risk. Moreover, short term obligations soared, while the growth of the central bank's international reserves lagged.

The global banking crisis exposed Iceland's vulnerabilities, triggering a balance of payments crisis, a collapse of the exchange rate and output, and the failure of financial and many non-financial firms. The cost partly fell on the public sector, which had to finance bank recapitalization, crisis-related central bank losses and recession-induced fiscal deficits. The pressure on the public sector balance sheet drove Iceland's interest rate spreads sharply higher, underscoring the risk of a debt crisis.

The Icelandic authorities put together an economic recovery plan supported by financing from the Fund, Nordics and Poland. The program included: (i) measures to stabilize the exchange

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

rate to contain balance sheet pressures; (ii) the initial operation of automatic fiscal stabilizers to cushion the economic collapse; (iii) a significant medium-term fiscal adjustment to bring debt dynamics under control; (iv) a blanket deposit guarantee, still in place, to preserve financial stability while new banks were being set up from the shells of the collapsed old banks; (v) the establishment of frameworks to facilitate household and corporate debt restructuring; and (vi) structural reforms to strengthen bank supervision and regulation and improve budget planning and debt management.

Under the recovery program, Iceland's recession has been shallower than expected, and no worse than in less hard-hit countries. At the same time, the krona has stabilized at a competitive level, inflation has come down from 18 to under 5 percent, and CDS spreads have dropped from around 1000 to about 300 basis points. Current account deficits have unwound, and international reserves have been built up, while private sector bankruptcies have led to a marked decline in external debt, to around 300 percent of GDP. The outlook is for an investment-led recovery to begin during the second half of 2010, and for growth of about 3 percent in 2011.

### **Executive Board Assessment**

Directors commended the authorities for their strong and determined program implementation and readiness to adapt policies as warranted. This helped Iceland overcome a deep financial and economic crisis. Growth is expected to begin to rebound, although uncertainties remain, including from the global outlook and the private debt overhang. To better secure the ongoing recovery, Directors encouraged the authorities to develop a strategy to unlock investment and to reach consensus with social partners on wage settlements. Continued steadfast implementation of the program will be crucial.

Directors emphasized that it is important to maintain the momentum towards restoration of the financial system. They welcomed the authorities' framework to secure bank capital in the face of legal uncertainty about banks' foreign exchange linked loans. Directors observed that the Supreme Court's most recent ruling has substantially lessened risks to the system and recommended that the authorities take the necessary steps to ensure that banks meet capital requirements within the expected timeframe.

Directors stressed the importance of accelerating the restructuring of banks' operations and balance sheets. They recognized recent steps to improve the frameworks for household and corporate debt restructuring, which would help support the economy. Directors underscored the need to expedite implementation of the framework and improve incentives for debtors to use it by limiting expectations of further debt relief.

Directors commended the authorities' commitment to further fiscal adjustment in 2011. They emphasized the need to reach the targeted primary surplus, and to build consensus for

measures taken. Directors observed that, subject to careful evaluation, there might be scope to moderately scale back the targeted adjustment if financial sector contingent liabilities prove contained and the government continues to resist absorbing private sector losses.

Directors welcomed the downward trend in inflation, supported by a stronger exchange rate and the central bank's careful execution of monetary policy. They noted that the mild undervaluation of the real exchange rate would support continuation of the underlying current account surplus.

Directors considered that it is critical for Iceland to build up its international reserves. They welcomed the central bank's purchases of foreign exchange and highlighted the need to build reserves as market conditions and balance of payment developments permit. Welcoming recent progress, Directors supported continued efforts towards an early normalization with international creditors, including towards finalization of negotiations regarding Icesave deposits, which would unlock bilateral program financing and ease Iceland's reintegration into global markets.

Directors noted that preconditions for capital account liberalization are falling into place, including stronger reserves and more secure public finances. They agreed that capital controls should be maintained until the stability of the financial system has been secured.

Directors noted the importance of strengthening policy frameworks. They welcomed the measures taken to improve budget planning and implementation as well as the new legislation to strengthen bank regulation and supervision. Directors encouraged the authorities to press ahead with reform of the local government fiscal framework, and with implementation of supervisory reforms.

**Public Information Notices (PINs)** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Table 1. Iceland: Selected Economic Indicators 2005–10  
(Percentage change unless otherwise noted)

	2005	2006	2007	2008	2009		2010	
					Prog.	Est.	Prog.	Proj. 1/
<b>National Accounts (constant prices)</b>								
Gross domestic product	7.5	4.6	6.0	1.0	-8.5	-6.8	-3.0	-3.0
Total domestic demand	15.8	9.0	0.2	-8.9	-20.7	-20.7	-1.3	-1.9
Private consumption	12.7	3.6	5.6	-7.9	-17.0	-16.0	1.4	0.6
Public consumption	3.5	4.0	4.1	4.6	-0.1	-1.7	-2.5	-3.5
Gross fixed investment	35.7	22.4	-11.1	-20.9	-50.6	-50.9	-10.0	-8.9
Export of goods and services	7.5	-4.6	17.7	7.1	-1.5	7.4	1.0	-0.6
Imports of goods and services	29.3	10.4	-0.7	-18.2	-30.5	-24.1	0.8	1.7
Output gap 2/	3.1	2.1	3.6	1.7	-3.2	-3.3	-3.5	-11.0
<b>Selected Indicators</b>								
Nominal GDP (bln ISK)	1,026.7	1,168.6	1,308.5	1,477.9	1,472.5	1,500.8	1,620.5	1,598.1
Central bank gross reserves (bln ISK)	67.3	167.8	162.8	429.3	617.5	485.7	854.4	868.1
Unemployment rate 3/	2.1	1.3	1.0	1.6	8.6	8.0	9.7	8.6
Real disposable income per capita	6.6	-2.0	5.4	...	...	...	...	...
Consumer price index	4.0	6.8	5.0	12.4	11.7	12.0	6.2	5.9
Nominal wage index	6.5	9.1	9.3	3.3	3.3	0.6	4.2	4.2
Terms of trade	1.0	3.5	0.1	-9.3	-8.5	-6.8	6.0	6.0
<b>Money and Credit</b>								
Base Money	32.2	27.9	190.7	-31.5	24.4	1.3	...	...
Deposit money bank credit (end-period)	76.0	44.4	56.6	-28.3	...	-28.9	...	...
of which to residents (end-period)	54.7	33.6	28.3	...	...	...	...	...
Broad money (end-period)	23.2	19.6	56.4	36.3	8.3	-4.4	...	...
CBI policy rate (period average) 5/	10.5	14.1	13.8	15.4	...	13.7	...	...
<b>Public Finance (in percent of GDP)</b>								
General government 6/								
Revenue	47.1	48.0	47.7	44.2	38.4	39.4	39.2	38.9
Expenditure	42.2	41.6	42.3	44.8	52.7	52.1	48.6	48.2
Balance	4.9	6.3	5.4	-0.5	-14.4	-12.6	-9.4	-9.2
Primary balance	6.1	6.7	5.7	-0.3	-8.3	-7.4	-2.7	-2.7
<b>Balance of Payments (in percent of GDP)</b>								
Current account balance	-16.1	-25.6	-16.3	-26.0	-3.5	-6.5	5.4	-0.9
Trade balance	-12.2	-17.5	-10.1	-2.3	8.6	9.2	10.8	10.8
Financial and capital account	13.9	44.0	-9.0	-77.3	6.8	-19.9	-5.2	4.9
Net errors and omissions	2.6	-11.1	25.8	-17.3	-5.3	29.2	0.0	3.0
Gross external debt 7/	284.5	433.5	605.9	564.7	306.9	300.7	299.0	278.5
Central bank reserves (US\$ billion)	1.1	2.3	2.6	3.6	4.9	3.9	6.7	6.9

Sources: Statistics Iceland; Central Bank of Iceland; Ministry of Finance; and staff estimates.

1/ Projections for 2010 use chain linking to eliminate the statistical discrepancy that arises from aggregating components in constant 2000 prices.

2/ Staff estimates. Actual minus potential output, in percent of potential output.

3/ In percent of labor force.

4/ A positive (negative) sign indicates an appreciation (depreciation).

5/ Data prior to 2007 refers to annual rate of return. 2007 and on, refers to nominal interest rate.

6/ National accounts basis.

7/ Including face value of old banks debt before 2009. Related interest transactions are not included from Q4 2008 on.