

INTERNATIONAL MONETARY FUND

ICELAND

Staff Report for the 2010 Article IV Consultation and Third Review Under the Stand-By Arrangement and Request for Modification of Performance Criteria

Prepared by the European Department in Consultation with Other Departments

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Stand-By Arrangement. A 24-month SBA in an amount equivalent to SDR 1.4 billion (\$2.1 billion, 1190.5 percent of quota) was approved by the Executive Board on November 19, 2008 (Country Report No. 08/362). A first purchase of SDR 560 million was made following the Board meeting. The first review, along with an extension of the arrangement to May 31, 2011 and rephrasing of access, was completed by the Executive Board on October 28, 2009 (Country Report No. 09/306). The second review, along with an extension of the arrangement to August 30, 2011 and rephrasing of access, was completed by the Executive Board on April 16, 2010 (Country Report No. 10/95). Second and third purchases equivalent to SDR 105 million each were made following the completion of these reviews. The fourth purchase, equivalent to SDR 105 million, would become available upon completion of the third review.

Summary. Iceland is expected to begin to rebound from its deep post-crisis recession helped by program policies (and all relevant performance criteria for the third review have been met). Still, there remain considerable risks to the outlook, including new challenges created by the June Supreme Court ruling declaring foreign exchange indexation clauses in loan contracts to be illegal. Program discussions focused on defining a process to recapitalize banks (taking into account the uncertain impact of the court ruling), the budget for 2011, and the pace of capital control liberalization (which was slowed down to support continued financial system stability). Article IV consultation discussions also illuminated medium-term challenges, including the overall growth strategy, medium-term fiscal consolidation options, and needed changes to Iceland's policy framework.

Discussions. See Fund Relations Appendix.

Previous Article IV Consultation. Discussions for the 2008 Article IV Consultation were held in Reykjavik during June 23–July 4, 2008. The Staff Report (Country Report No. 08/367) was considered by the Executive Board on September 10, 2008.

Data. Iceland subscribes to the SDDS; data provision has some shortcomings, but is broadly adequate for surveillance (Appendix III).

Exchange rate arrangements. Iceland has a de jure free floating exchange rate, and the krona was defacto floating during the last 16 months. Iceland has accepted Article VIII, Sections 2(a), 3, and 4 obligations, but maintains an exchange restriction arising from limitations imposed on the conversion and transfer of interest on bonds, whose retention has been approved by the Executive Board until the earlier of twelve months from the date of the Board Decision or the completion of the next Article IV consultation (Decision No. 14445-(09/106). The authorities are requesting Board approval of further retention of this exchange measure.

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I. CONTEXT

1. **From 2004–07, Iceland’s economy boomed, driven by capital inflows** (Table 1; Figure 1). Early in the decade, the newly privatized and deregulated banks rapidly expanded their lending and balance sheets, facilitated by easy access to foreign funding. The abundant and cheap credit fueled a domestic investment and consumption boom, rapid growth of asset prices, rising inflation, and a burgeoning current account deficit. This pattern was common to many countries, but the boom in Iceland stood out for its magnitude.

2. **Policies failed to counter the growing imbalances, and vulnerabilities built up.** Financial sector supervision did not detect growing banking sector risks.¹ Fiscal policy fed the boom through a series of tax cuts, which reduced the structural fiscal balance. The central bank responded by raising interest rates, which helped contain inflation by appreciating the krona, but this also contributed to a carry trade and induced households and enterprises to borrow in foreign currencies. Towards the end of the boom period, gross external debt had increased to over 600 percent of GDP, Iceland’s net international position turned negative, and corporations and households faced heavy debt burdens, with elevated exposure to foreign exchange and inflation risks. Short-term external obligations had soared, and the CBI was unable to keep up, with reserve coverage falling under 10 percent of short term debt by 2007.

3. **The global banking crisis in late 2008 rapidly exposed Iceland’s vulnerabilities, leading to a deep financial and economic crisis** (Figure 2). The three large commercial banks had insufficient liquidity to cope with global interbank funding pressures. They proved too big to save, and collapsed in the span of a week. Investors rushed to exit, the krona tumbled, inflation soared, domestic demand and output collapsed, and imports shrank abruptly. The remaining large financial institutions in Iceland would ultimately fail, along with a number of firms in the non-financial sector.

4. **The crisis left Iceland saddled with high external and public debt, threatening a debt crisis.** Iceland emerged from the crisis with external debt of 300 percent of GDP, down from 605 percent pre-crisis, but still very high. Projected public sector debt soared from 30 to over 125 percent of GDP, mainly because of the impact of the recession on public finances, the need to recapitalize the banking system, crisis-related central bank losses, and foreign deposit insurance requirements (which the authorities have agreed to cover pending agreement on details, but have not accepted as sovereign debt; this still unresolved “Icesave” dispute is now with the European Surveillance Authority, which has issued a preliminary finding that there is a sovereign obligation, but the dispute is expected to continue up to the EFTA court). With the impact of the crisis on debt, CDS spreads initially soared to close to 1000 bps, reflecting market fears.

¹ Report on Banking Regulations and Supervision in Iceland: past, present and future
http://eng.forsaetisraduneyti.is/media/frettir/KaarloJannari_2009.pdf

5. **Iceland's Fund-supported program, initiated after the crisis, has cushioned the economy and allowed for a gradual unwinding of imbalances.** Indeed despite the severity of the shock, the recession in Iceland has been less severe than expected, and no worse than in other hard-hit countries (Figure 3). A brisk response of net exports has been key, and to this end a combination of interest rate policy, capital controls and private sector wage restraint has helped stabilize the exchange rate at a competitive level, and tame the overshooting that could have worsened balance sheet impacts. Private consumption has also held up better than expected supported by an informal payment freeze on mortgages, and the operation of automatic fiscal stabilizers (supported in turn by a stable market for government debt, with capital controls making an important contribution to this end).

6. **The program has also rebuilt financial sector stability, and deflected a government debt crisis:**

- In the financial sector, deposit runs have been avoided, helped by the government's explicit full deposit guarantee and the capital controls regime. New banks have been set up with the domestic assets and liabilities of the failed banks. They have been recapitalized, with the exception of Byr and Keflavik savings banks (which were only intervened in April), and a few small savings banks. The process has taken longer than expected due to difficulties in valuing assets transferred (a necessary input for determining compensation to the old banks' resolution committees, and establishing the balance sheets of the new banks). A process of restructuring and some downsizing lies ahead, called for by lingering imbalances and high levels of non-performing loans on banks' books. Iceland also remains overbanked, with the core of the problem in the large number of inefficient smaller savings banks (Figure 4).
- Government debt dynamics are being rapidly brought under control (Figure 5). After the initial expansion of the deficit to cushion the economy, the authorities have stuck to an ambitious adjustment path calibrated on Nordic experience. Over 7 percent of GDP in fiscal measures have been taken to date, and the deficit has been reined in from the 14 percent of GDP projected in mid 2009, to a projected 9 percent of GDP in 2010. CDS spreads on government debt have now dropped to around 300 bps.

7. **Balance sheets are slowly being repaired:**

- Concerning overall **external debt**, the public position has improved through asset and liability management transactions, including repurchase of outstanding Eurobonds at a discount, and the repurchase of the Avens structure at a discount (this was a Netherlands-based company which held Icelandic government and government guaranteed bonds). The position of the non-financial private sector has gradually improved through debt restructuring agreements with creditors (some of which are still underway).

Discrete External Debt Changes (in percent of 2010 GDP)

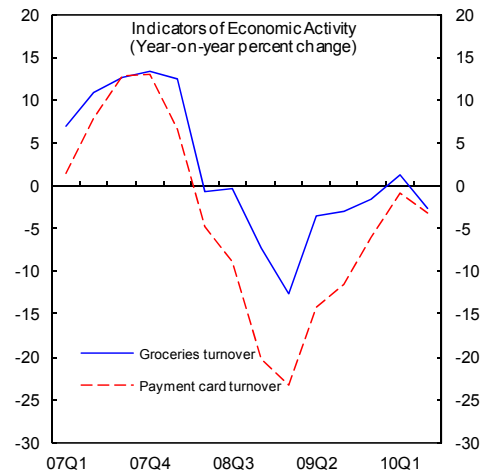
Transaction	Timing	Change in gross external debt	Change to net external debt
Avens	May-10	-3.5	-3.1
- Avens structure bought		-7.8	-7.8
- Paid by a new government fx bond and cash		4.3	4.7
Eurobond buy-back 1/	Dec-09 to Jun-10	-4.2	-0.2
- Eurobond 2011		-3.7	
- Eurobond 2012		-0.4	

Sources: Icelandic authorities and staff calculation.

1/ Include all buy-back since December 2009. The buy-back's change to NFA position reflects the discount received.

- Regarding overall **consumer and corporate debt**, progress has been very slow, largely due to delays in setting up effective debt-restructuring mechanisms (in part due to delays in making the new banks fully operational); problems with coordinating multiple creditors and preventing hold outs (especially amongst second and third lien holders); and problems with take up of existing mechanisms by debtors, as they reportedly hold out in the expectation that the government will provide a better debt reduction deal for them. Nonetheless, some 400–500 consumer cases have been completed or are in process out of court, and some 100 cases have been processed through the courts (Figure 6).

8. **Recent developments show an economy still facing headwinds.** The economy stabilized towards the end of 2009. However, indicators point to a setback in the first half of 2010, due to the March/April volcanic eruption (taking a temporary but significant toll on tourism); the slowdown in the global recovery (weakening demand for exports and worsening the terms of trade); and from the initial fiscal cutbacks (dampening momentum in private consumption). Inflation has continued to fall, with the 12 month rate now below 5 percent. The underlying current account remains in surplus.



9. **The restoration of the financial system is also confronting a new challenge** (Table 2). In June the Supreme Court of Iceland ruled that foreign exchange indexation clauses in loan contracts are illegal, but left open the question of what constituted a foreign exchange indexed loan (banks utilized many different fx and fx-linked contracts), and whether the foreign-currency related interest rate stipulated in the loan contracts would remain valid. A broad ruling upholding the contractual interest rate could have a deep impact on financial institutions' capital (since this is well below their funding cost, and almost half of all loans could be affected). Bank owners would bear the losses (almost two-thirds of the system's equity is in private hands, a feature of the compensation instrument that was introduced to have creditors bearing both upside and downside risks). While a recent District

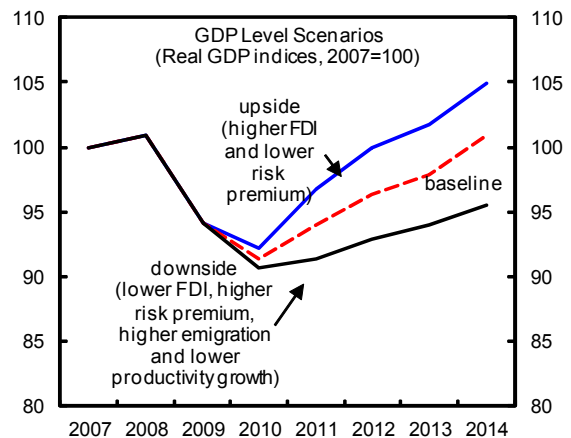
Court ruling appears to provide grounds to support that a krona interest rate should be applied to recalculate the illegal foreign exchange indexed loans, it may take some time until legal certainty emerges on this issue. Separately, the need to recapitalize the government owned and guaranteed Housing Finance Fund (HFF) has become more acute, as operational losses reduced its capital from 4.6 percent of risk weighted assets in end-2008 to 3 percent at end-2009.

II. OUTLOOK

10. **A durable recovery is expected to take hold during the second half of 2010** (Table 3–4; Figure 7; LOI ¶5). The expected pattern of recovery has not changed, and is broadly in line with experience in past crisis cases. The contribution of net exports to growth is expected to diminish, and a revival of investment and ultimately consumption is projected to generate a slow recovery going forward. The recovery is forecast to pick up steam in 2011, with growth reaching 3 percent, boosted by planned investments in power-intensive sectors (which will temporarily reduce the current account surplus). Disinflation is forecast to continue, with the 12 month rate remaining below 5 percent at year-end, reflecting subdued wages in the non-tradable sector and recent exchange rate appreciation. Medium-term current account surpluses are projected to improve slightly, driven mainly by a better outlook for the balance of services. Relative to post-crisis experience in other countries, Iceland’s adjustment is likely to feature a longer period of elevated trade balances and suppressed consumption, given the initial level of debt overhang.

11. **The forecast is subject to considerable uncertainty:**

- Concerning **growth**, issues noted in previous program reviews, including regulatory hurdles to further investments in energy-intensive sectors, the pace of balance sheet repair, and global factors (which may affect external demand for Iceland’s goods and/or Iceland’s terms of trade), continue to generate significant downside risks. To add to this list, a resumption of the recent volcanic eruption—which would not be out of line with the past pattern for the volcano in question—could hit transport and tourism. In addition, the June Supreme Court decision on foreign exchange indexed loans may delay private sector restructuring and discourage foreign investment (though over time it may deliver modest transfers to those benefiting from court decisions). Higher FDI could in contrast unlock higher growth.



Sources: Statistics Iceland and staff projections.

- Regarding **inflation**, supply-side influences could derail the projected disinflation path. Wage bargaining in Iceland is fairly centralized, and past post-recession patterns in Iceland point to the risk that wage increases in the tradable sector spread to non-tradables, sparking cost-push pressures. The Stability Pact with labor and employer organizations has to date been a vehicle to manage such pressures, but has broken down. The authorities agreed that it would be important to revive it during the fall 2010 wage negotiation rounds.

12. Iceland's external and public debt remain sustainable, but their high levels amplify risks (Tables A1–A2; Figures A1–A2).

- **Gross public debt** is expected to decline to about 76 percent of GDP by 2015. Against a backdrop of deteriorating ratios in other advanced economies, this could place Iceland in a comparatively favorable position. However, the path could be derailed by too slow a pace of fiscal consolidation or the realization of large contingent liabilities (for instance, through litigation over post crisis emergency measures, the status of which is discussed in more detail in the program modalities section below). Iceland must also address a period of high debt rollover during 2011–12.
- | Country | Percent of GDP |
|---------|----------------|
| CAN | 75 |
| EURO | 95 |
| FRA | 95 |
| GER | 82 |
| ICE | 88 |
| SPA | 90 |
| UK | 90 |
| USA | 105 |

Source: WEO, and staff estimates.
- **Gross external debt** is expected to fall to about 280 percent of GDP in 2010 and reach around 190 percent of GDP by 2015. Stress tests point to risks, mainly emanating from exchange rate depreciation. Although the gross level is still very high, it is not out of line with gross levels in other advanced globally integrated economies. Moreover, debts are very concentrated in multinational corporations with small footprints in Iceland, and these companies appear to have the foreign assets and foreign income necessary to service their debts.² (Figure 8)
 - **Public and external assets are relatively high.** Iceland's funded pension system is a net international creditor, and has been shifting assets into Iceland as opportunities arise (for instance, pension funds purchased the assets the government acquired in the Avens transaction). The public sector holds significant assets, including in the power sector, but also equity and collateral acquired during the crisis. Overall Iceland's net international position is -30 percent of GDP at end-March 2010, while net public debt is projected to

² See "How Vulnerable is Iceland's External Position" in *Iceland: Selected Issues*

be 76 percent of GDP at end-2010. On both measures, Iceland is well within the range defined by its peers.

III. POLICY DISCUSSIONS: PROGRAM ISSUES

13. **Discussions focused in large part on securing the program to the impact of the June Supreme Court ruling on foreign exchange indexed loans.** The authorities and staff agreed that the ruling—which put financial stability under pressure and created significant contingent liabilities—had implications across the policy spectrum. It was agreed that a process to ensure adequate bank capitalization had to be put in place, that the pace of capital control liberalization would need to be adjusted, and that measures would need to be taken to encourage greater participation in the existing private sector debt restructuring framework. The discussions also focused on securing the fiscal adjustment for 2011 and beyond, with the new financial sector contingent liabilities informing the decisions taken.

A. Financial Sector Policies

14. **The June Supreme Court ruling on foreign exchange indexed loans delivered a setback to the full restoration of financial stability (LOI ¶7).** The authorities noted that most financial institutions had expected the court to uphold these loans (particularly since similar loan contracts had in the past been enforced through the judiciary system), and at worst for the courts to order loan recalculation at krona interest rates. The impact on bank capital could be significant, and will depend on where courts draw the line between foreign currency denominated loans and foreign exchange indexed loans (it is reported that there are some 300 different contract types); the interest rate to be applied on the loans (contractual rate versus published best-available average krona rates); and possibly on the nature of the borrower (consumers appear to have extra protection in Iceland’s legislation). However, even under the most adverse scenario, all banks would retain positive net worth and a capital to risk-weighted assets ratio of over 4 percent. A new consumer case where the interest rate issue will be settled is expected before the Supreme Court as early as September, although full legal certainty about this matter will take some time. In these circumstances, the authorities indicated that they would actively keep under review whether new legislation could help reduce the uncertainty.

Capital Adequacy Ratios Under Different Scenarios
(percentage of Risk-Weighted Assets)

	Regulated		Actual		Interest rate 1/			
	Minimum CAR		Car 2/		CBI Non-indexed Rate		Contractual rate 3/	
	Total	Tier 1	Total	Tier 1	Total	Tier 1	Total	Tier 1
System	16	12	17.4	13.5	15.3	12.7	7.9	6.1

Source: FME and staff (preliminary estimates)

1/ Interest rate to be applied to fx-loans likely and possibly affected by recent Court's ruling

2/ At end March

3/ Includes staff calculation assuming limits on tier II capital

15. **A bank recapitalization process had to be designed to ensure the soundness of the system notwithstanding the legal uncertainty (LOI ¶7).** The authorities indicated that they did not wish to become the owners of the two large private banks, and accordingly wanted to give existing owners and creditors every opportunity to put new capital in as losses were realized. At the same time, it was recognized that strong assurance was needed that the system would be solvent even under a worst-case scenario, and that the government would thus need to be prepared to backstop the recapitalization, but in manner that would protect the public sector from absorbing further losses. The agreed approach achieves these aims through several pillars:

- *Timely monitoring and recognition of losses.* The FME has asked banks to classify loans into those probably affected, possibly affected and not likely affected by the Supreme Court ruling. The FME will closely monitor banks' assessment of affected loans supported by periodic reviews by independent lawyers.
- *A requirement that banks meet two capital benchmarks.* They should meet 16 percent of risk weighted assets after accounting for losses from probably affected loans (the current regulatory requirement) and 6 percent of tier I capital to risk weighted assets assuming that losses from possibly affected loans materialize (in parallel to standards set in recent European stress tests). Capital requirements will be kept under review.
- *Time for bank owners to recapitalize.* The new banks' owners are given until end-October to provide a credible plan to bring banks into full compliance with the two capital benchmarks within 60 days. This allows time to account for expected legal rulings. An FME decision about banks' plans is proposed as a new program structural benchmark for mid-November.
- *A government backstop for capital provision.* The authorities indicated that during October they would seek parliamentary authorization to issue enough bonds to backstop recapitalization, up to amounts that could be needed in the worst case scenario (up to krona 160 billion or 10 percent of GDP). This was proposed as a new program structural benchmark. The government would acquire preferred shares, or a similar internationally-accepted tier I capital instrument which would allow it to augment tier I capital while ensuring that common equity holders—the banks' owners—bear any future losses first.
- *A separate approach for Byr and Keflavik (which are not yet resolved).* Time will be allowed to get creditors, via the Resolution Committees, to absorb losses and recapitalize the banks. Barring this, the least-cost option for the government is to fully recapitalize them itself (after ensuring that creditors bear losses). This would cost about 3½ percent of GDP, versus 1½ percent foreseen in the program. End-December appears a feasible date by which to complete the recapitalization, taking into account the need for a new asset valuation and EU approval for state aid. Nonetheless, in view of the timing uncertainties, it was agreed not to propose to reset the existing program structural benchmark on

recapitalization (which was not observed), but the issue would be a topic for discussion at the time of the next review.

16. **The authorities and staff agreed that commercial banks need to accelerate their restructuring efforts to address various risks inherited from the resolution process (LOI ¶8).** These risks include high levels of nonperforming loans, high deposit concentrations, asset concentrations, large interest rate and exchange rate imbalances (albeit uncertain, in light of the recent Supreme Court ruling), low deposit growth, very little new lending, and high reliance on asset recovery to sustain profitability. A critical first step has already been taken with the recent appointment of new bank managers and directors (in May–June). Next steps include:

- *Revised business plans.* Through these plans, due by end-year, the authorities and bank managers will agree on quarterly operational targets covering the upcoming 24 months, especially regarding asset concentration and debt restructuring (which are critical to reduce financial imbalances and restore viability to the many non performing borrowers).
- *Revised prudential regulations.* Building on the amendments recently introduced to the banking law the FME will revise by end-October existing regulations on large exposures, connected lending, and related party loans. The aim will be to bring Iceland’s regulatory framework into line with current EU norms and practices.

17. **The work to stabilize the non-bank sector has also been partially disrupted by the Supreme Court ruling (LOI ¶9):**

- *The HFF.* The HFF is not affected by the court ruling, since it lends exclusively in krona (indexed to inflation). It submitted its business plan to the FME in late-June, incorporating the findings of an independent and experienced panel of technicians. The FME has also engaged an accounting firm to assess the HFF’s loan book. Preliminary estimates show that the HFF could require a capital injection of 2–3 percent of GDP to keep capital above the regulatory minimum for the period of its business plan (and this amount has been incorporated into public debt projections). The FME is expected to approve its plan by end-September (the program structural benchmark required plans for all non-banks to be approved by end-August). The government would inject the necessary capital by end-year.
- *Other non-banks.* The Supreme Court ruling has a large potential impact on non deposit taking private asset finance companies (which constitute about 5 percent of total financial system assets). For these companies exchange rate indexation is a common practice. It was agreed that no public funds will be made available to recapitalize them. In lieu of the original timeline for them to submit business plans, they would be given a timeline similar to banks to identify corrective actions and meet capital requirements with the support of their shareholders or creditors. If they cannot, they will be induced to exit in an orderly fashion. This would not be expected to have any market repercussions, and

indeed one small private asset financing company already exited in 2010 with no noticeable impact.

B. Private Sector Debt Restructuring

18. **The private sector debt restructuring process could be slowed down by the Supreme Court ruling (LOI ¶10).** While the ruling defacto restructures some foreign currency loans, it could take years for the legal process to determine which loans are subject to the ruling, with individuals foregoing the available restructuring mechanisms in the meantime. Moreover, the decision may encourage krona borrowers to delay their decision to restructure, in the hope that either they too benefit through future legal challenges to indexation clauses in their loans, or that the government succumbs to social and political pressures and grants them equivalent treatment through the budget. Delays in debt restructuring would be costly from a macroeconomic perspective, given the potential boost to demand that balance sheet repair could deliver.

19. **The authorities remain committed to a targeted, voluntary approach to restructuring (LOI ¶11).** They acknowledged a need to speed up the process, but despite political pressures they reiterated that they will not undertake across-the-board debt write-downs: this would do little to solve Iceland's overall debt overhang, and would merely shift problems from the private sector, including those able to pay, to the public sector. This would risk a public debt crisis, which could significantly raise interest rates for all Icelandic borrowers, and would ultimately have to be addressed by additional fiscal adjustment measures affecting all Icelanders, including higher taxes and additional spending restraint. In contrast, the cost of a voluntary approach targeted to truly distressed borrowers can largely be borne by banks (which have adequate provisions), and can deliver deeper debt relief to those viable debtors requiring it.

20. **Recent changes to the framework for household debt restructuring are expected to speed the process and encourage participation (LOI ¶13).** These changes are expected to address the major problems with the framework that have been identified (Table 6), and their implementation in legislation meets a program structural benchmark. The changes (i) create a Debtors' Ombudsman's Office, which will help debtors deal with multiple creditors and sift through the many available restructuring schemes; (ii) bring additional individuals into the scheme (e.g., individuals having some debts arising from business activities and debtors with two properties); and (iii) remove tax disincentives for households that receive relief. The authorities and staff agreed that efforts should be made to promote short sales of real estate properties as an alternative to foreclosure which can be costly and time consuming. With these mechanisms in place, the moratorium on foreclosures has been allowed to expire as envisioned, and this is expected to further mitigate the hold-out problem.

21. **A number of initiatives are expected to help expedite corporate debt restructuring (LOI ¶14).** Financial institutions have developed and put in place general guidelines, which aim to harmonize initiatives among banks. Special guidelines are now

being developed for small and medium sized enterprises. Meanwhile, the authorities are taking measures to give banks a stronger financial incentive to restructure debts (semi-annual audits will allow enforcement of more timely provisioning); and are essentially setting quarterly targets for restructuring of loans (the regulatory guidance about elimination of imbalances). If these measures are followed through, the process of corporate restructuring could be complete in 18–24 months (consistent with international experience).

22. **The corporate insolvency regime has been refined, but remains under review (LOI ¶15).** Amendments to the Bankruptcy Act have been passed, and among other things will help expedite restructuring agreements and liquidation proceedings. A Special Committee under the Ministry of Justice conducted an assessment of whether additional revisions to the Bankruptcy Act were warranted and concluded that there is no such need at this stage. However, it recognized that additional analysis should be made in the future concerning the possibility of introducing additional measures to further expedite restructurings, for instance, accelerated determinations of viability (the latter modeled on a recently passed Danish Law, Act no. 718 of June 25, 2010). In practice, some restructuring cases already mimic a pre-packaged rehabilitation plan approach, and formalizing such an approach as an additional tool available to all would be a useful alternative approach which would grant predictability and certainty to the now-informal process. The authorities acknowledged some capacity problems in the court system, and are determined to prevent delays by increasing the number of judges and court assistants (paid for by higher court fees).

C. Monetary and Exchange Rate Policy

23. **The authorities reaffirmed their commitment to preserve exchange rate stability (LOI ¶15).** This policy has contributed to the sharp decline of inflation and the shallower-than-expected recession (in the latter case by preventing deeply adverse balance sheet effects on fx borrowers). The authorities and staff agreed that the exchange rate was undervalued from a medium-term perspective (Box 1), but recognized a wide degree of uncertainty about the extent of undervaluation. Moreover, the more depreciated offshore rate sends an unmistakable signal that the currency would depreciate were it to be fully floated with no controls. Going forward, the authorities indicated that they would take advantage of recent krona strength. They have started to purchase foreign exchange from the market—realizing \$14 million by the first week of September—and regular auctions are planned going forward. The accumulation of reserves would improve confidence and set the stage for the gradual elimination of capital controls in a stable exchange rate environment, and thus help to resolve short-term tensions. Reserve coverage indicators support this approach. While they have recently improved, they remain low, unless the impact of capital controls is accounted for (Table 7; Figure 9). Program NIR targets were adapted to reflect this emphasis.

24. **Banking sector uncertainty stemming from the Supreme Court ruling has created an obstacle to the next capital control liberalization step (LOI ¶16).** Capital controls continue to be an essential policy to stem large-scale capital outflows which could destabilize the currency. Nevertheless, as they hinder investment, and cannot be administered

effectively for long periods of time, the program goal remains to remove them as quickly as feasible. The authorities have already taken a first step—liberalizing controls on new foreign exchange inflows—and some important preconditions to undertake the next step are now in place, including a better balance of payment outlook and an improving fiscal and public debt position. However, it was recognized that time would be needed to more fully secure financial system stability before proceeding. That is, banks should have enough liquidity to handle possible deposit outflows, and sufficient capital to buffer against potential losses (due to their currency position, and that of their borrowers). The recent Supreme Court decision on foreign exchange indexed loans had created considerable uncertainty along these dimensions. Once these uncertainties are sufficiently resolved, a next step can be taken, and consistent with the August 2009 strategy, this will involve release of controls on the sale and conversion of longer term assets.

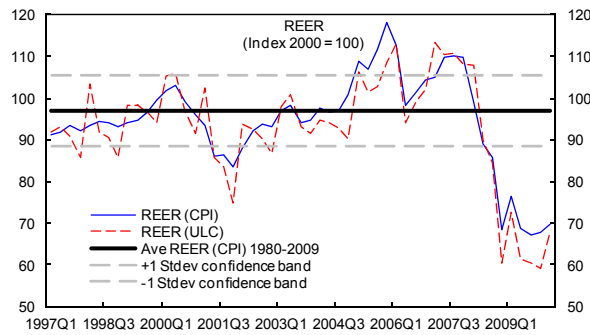
25. **It was agreed that effective administration of the controls remained a key priority (LOI ¶17).** In early May, the authorities took further steps to close loopholes in the system, and going forward they expect to regularly review and adjust as necessary. They indicated that they would make enough resources available at each stage of the enforcement process to ensure that circumvention cases would be prosecuted in a timely manner. For example, they had already transferred enforcement responsibilities from the FME (which must husband its resources to deal with banking sector challenges) to the CBI.

26. **As the capital control regime marginally affects the conversion and transfer of a certain component of current payments, it gives rise to an exchange restriction subject to Fund jurisdiction under Article VIII, Section 2(a) (LOI ¶17).** This restriction arises from limitations imposed by the capital control regulations on the conversion and transfer of interest on bonds. The authorities are requesting Board approval of further retention of the measure. In view of the measure's temporary nature (the goal of the program is to eliminate the control regime as soon as circumstances permit and the authorities have articulated a plan to this end), and on the basis that it has been imposed for balance of payments reasons and is non-discriminatory, staff supports the authorities' request for Board approval of the retention of exchange restriction until the earlier of 12 months or the completion of the next Article IV consultation.

27. **The authorities and staff both foresaw growing constraints on monetary policy (LOI ¶18).** Interest rates would need to be set in view of the program inflation objective and with due consideration to possible effects on the exchange rate. Since the second review, the sluggish economic recovery, easing inflationary pressures and favorable developments in CDS spreads had contributed to allow further gradual monetary relaxation (200 bps in three steps) without disorderly exchange rate movements. Going forward, decisions on interest rates would depend on the message in new data. In this context it was recognized that over time, capital control liberalization would increase the influence of monetary policy on the exchange rate, and the central bank would need to place additional emphasis on ensuring that the risk-adjusted interest rate differential remained sufficient to stabilize net capital flows and thereby the currency (Figure 10).

Box 1. Iceland: External Competitiveness and Stability

Iceland's price competitiveness has improved considerably since 2007. The nominal exchange rate collapsed in the wake of Iceland's 2008 financial crisis, falling from around krona 80 per euro, to a present level of krona 160 per euro. The inflation surge that followed was eventually contained, and the real effective exchange rate (REER) has thus depreciated by about 40 percent since 2007. The drops in the CPI-based and ULC-based REER, which are similar in magnitude, are the sharpest in the last 30 years.



Staff analysis shows a modest REER undervaluation. Three standard CGER methods suggest undervaluation ranging from 2 to 23 percent. The macroeconomic balance (MB) method shows that the medium-term equilibrium current account is close to balance, implying a slight undervaluation of about 2 percent. The external sustainability (ES) approach suggests a moderate undervaluation of 9 percent if Iceland's NFA (excluding the old banks) were to be stabilized at the end-2009 level of -38 percent of GDP. Finally, the equilibrium exchange rate (ER) approach indicates that the current level of REER is undervalued by about 23 percent, although this result is mainly driven by the use of historical average REER—assumed to be the equilibrium level—as a basis for the calculation.

Real Exchange Rate Assessment (Percent deviation from estimated equilibrium)	
Macro Balance Approach (MB) 1/	-2
External Sustainability Approach (ES) 1/	-9
ERER Approach (ER)	-23
Average	-11
<i>Memo items (in percent of GDP):</i>	
Current Account Norm	0.2
NFA-stabilizing Current Account at 2009 level	-2.0

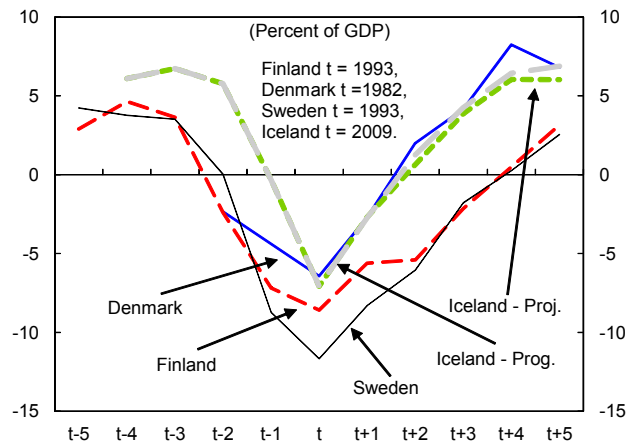
Source: Staff estimates.

1/ Based on April 2010 WEO projections.

Large uncertainties surround the analysis, given the large structural shift after the crisis. The time horizon is one important factor. CGER-type methods focus on medium-term factors, whereas in the short run other factors may dominate. In Iceland's case, without the capital controls, large potential outflows from the sizable nonresident krona positions could put significant pressures on the exchange rate. As a result, the current REER could be seen as being overvalued. Moreover, the level at which NFA will stabilize is debatable. The post-crisis adjustment of corporate and households is continuing, even after the already-large narrowing of the NFA position. In addition, there are still uncertainties regarding Iceland's NFA: further changes in the corporate landscape through restructuring, takeover or changes in domicile could abruptly change NFA and the NFA-stabilizing REER.

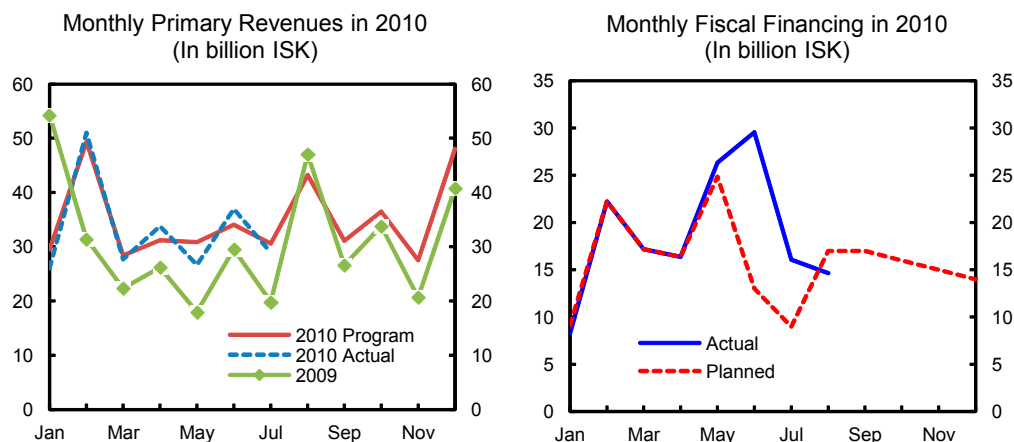
D. Fiscal Policy

28. **The authorities and staff agreed on some minor modifications to fiscal adjustment targets (LOI ¶19) (Tables 7–8).** The 2011 general government primary surplus target was reduced from $1\frac{1}{4}$ to $\frac{1}{2}$ percent of GDP, while the medium-term target was reduced from $6\frac{3}{4}$ to 6 percent of GDP. The combination of growing risks to the economic outlook and ample financing motivated the change for 2011, while strong projected debt dynamics underlie the medium-term modification. The revised consolidation path remains in line the ambitious consolidation programs in the Nordic countries. There was discussion about a further reduction of the medium-term target, but it was agreed that the uncertainty regarding contingent banking sector liabilities called for caution. Targets will be kept under review: Iceland's strong projected debt dynamics suggest more room to moderate the pace of adjustment if the government continues to avoid absorbing the private sector's crisis-related losses, and if contingent financial sector liabilities prove to be contained.



Source: WEO, Icelandic authorities, and Fund staff estimates.

29. **The authorities are broadly on track to achieve the 2010 fiscal target (LOI ¶20).** The apparent softening of activity during the 2nd quarter had a temporary impact on consumption tax revenue collections, but the overall revenue target remains within reach due to over performance of property and income taxes. Given under spending in some areas (totaling about $\frac{1}{2}$ percent of GDP) and over performance by local governments (about $\frac{1}{4}$ percent of GDP to date), the 2010 general government primary deficit target remains well within reach. Should revenues over perform during the second half of the year, the authorities are committed to saving the excess (to preserve the implicit targeted adjustment of the structural deficit).



Sources: Ministry of Finance of Iceland, Government Debt Management of Iceland, and IMF staff estimates.

30. **Sufficient measures have been identified to deliver the 2011 fiscal target (LOI ¶21) (Table 9).** The general government primary balance target of $\frac{1}{2}$ percent of GDP will be achieved by a central government primary balance of $\frac{1}{2}$ percent of GDP, along with a balanced local government position. The projected local government outcome will be supported by the introduction of a stronger framework (see paragraph 37), while the central government target will be met through $3\frac{1}{2}$ percent of GDP in measures. The authorities explained that they will emphasize spending cuts, to keep the broad balance envisioned in the consolidation plan originally agreed with social partners:

- **Revenue measures** will amount to about 0.6 percent of GDP. The authorities intend to increase the capital and corporate income tax rates from 18 to 20 percent. These measures will move Iceland closer to the tax rate prevailing in other Nordic countries, and enhance administration (by eliminating tax arbitrage opportunities created by the lower capital and corporate tax rates versus the lowest individual income tax rate).
- **Expenditure measures** will amount to about 3 percent of GDP. The authorities have approved lower spending ceilings by ministry, with underlying gains to be delivered primarily by administrative reorganization (including employment rationalization); wage restraint, and benefit restraint. The measures are expected to reduce general government employment and employee compensation by 13 percent relative to 2008, keeping them in line with historical values relative to the private sector.

31. **The near-term financing outlook is benign and discussions focused on how to orchestrate Iceland's return to international markets (LOI ¶23).** The authorities have now financed 79 percent of their 2010 need via domestic markets, and maintain some 14 percent of GDP in deposits in the CBI (enough to handle gross financing needs for the next 27 months). However, still muted global risk appetite, the uncertainty about banking sector contingent liabilities, and lingering uncertainty concerning the Icesave dispute create a

barrier to an immediate return to international markets. To continue to lay the groundwork for a return to markets at a better conjuncture, the authorities are working to update their medium-term debt management strategy to fully capture the impact of recent debt buyback operations. The strategy will be published in the fall. Concerning domestic debt, it was agreed that a key priority would be to reduce the level of non-market debt, including by repurchase (using excess government deposit balances) and via exchange.

IV. POLICY DISCUSSIONS: MEDIUM-TERM CHALLENGES

32. **Iceland’s crisis has spawned three key medium-term challenges.** The first is to generate conditions to grow out of the large post crisis debt. The second is to define the adjustment measures necessary to stabilize the public debt (with due consideration for their growth impact). And the third is to overhaul the policy framework to ensure that pre-crisis policy mistakes are not repeated, and policies are robust to shocks. The discussions focused on these challenges.

A. The Growth Challenge

33. **To restore growth in Iceland, key supply-side constraints must be overcome** (Figure 11).³ Iceland’s debt overhang and the restraint this places on domestic demand suggest that excess capacity in non-tradables sectors (e.g., construction) will not be used very soon. Growth will almost certainly have to come from an expansion of tradables production. The price signals to move resources to tradables are in place: the real depreciation of the currency and sharp improvement in Iceland’s unit labor costs have made Icelandic companies much more competitive. However, the export sector is now near capacity, implying a need for new investment. Here, the narrow production structure of Iceland’s economy presents constraints. Existing production, concentrated mainly in energy intensive industries and fisheries is “distant” from other types of production, implying relatively high investment costs to expand into new products (one source of growth in typical post-crisis recoveries). Meanwhile, scaling up existing production would be relatively straightforward, but confronts physical constraints (available stocks, in the case of fish), and potentially long lead times (e.g., investment in the energy intensive sector, which must be preceded by an expansion of energy production). Reducing the cost of investing in Iceland and the time lags for doing so were thus crucial issues.

34. **The authorities acknowledged that Iceland needs to put in place conditions to encourage investment in the tradables sector.** The authorities and staff saw several program elements that would lay the groundwork for higher investment. First, the full removal of capital controls and completion of fiscal adjustment (or at least the definition of adjustment measures) would remove uncertainty about key aspects of the regulatory and tax

³ See also “Iceland: Overcoming Constraints to Growth” in *Iceland: Selected Issues*

environment, and facilitate decisions. Second, restoring the financial sector, and accelerating corporate debt restructuring would help remove some of the financing constraints that would otherwise delay new investments. Third, the focus on preserving Iceland's valued Nordic social welfare model would help discourage emigration and preserve Iceland's reservoir of human capital, and the potential this brings to bridge gaps to new products, techniques and markets at lower cost. However, the staff and authorities both saw obstacles to investment, in part due to hesitancy about foreign investment in sensitive sectors (e.g., energy). Since the potential downside from long delays of planned investments in the energy intensive sector is large, how this debate plays out in Iceland may well have implications for other program policies, and it was agreed that this needs to be kept under review.

B. Medium-Term Fiscal Consolidation

35. **Completion of Iceland's medium term fiscal adjustment will require the identification and implementation of additional fiscal measures.** To achieve the fiscal target in the plan—a general government primary balance of 6 percent of GDP by 2013—3 percent of GDP in additional measures will need to be defined for 2012–13. There is a broad consensus in Iceland that the measures should be balanced between revenue increases and expenditure cutbacks. There is much less consensus about what underlying measures to take, although technical assistance has helped to lay out revenue options (Table 12). The authorities and staff agreed that different mixes would likely have different macroeconomic implications, with some Iceland-specific nuances: excessive reliance on capital and corporate income taxes may constrain investment, but sharp movements in consumption taxes would temporarily elevate inflation (and affect the large stock of CPI indexed debt). Excessive reliance on public investment cutbacks would affect the stock of public capital, putting another unwelcome barrier in front of private sector investment and sustained long term growth. A focus on wage and transfer restraint could have salutary effects on the labor market, contributing to restrained unit labor costs and higher employment levels, although this would depend on continued cooperation with representatives of labor unions.

36. **The discussions focused on better understanding the macroeconomic implications of different mixes of adjustment measures** (Figure 12).⁴ It was agreed that the work should examine the existing plan for balanced revenue and expenditure measures (and the implications of different compositions of specific measures within this), and that it should also examine alternative strategies that placed more reliance on expenditure measures, as well as those that placed more reliance on tax measures. The simulation results, using the IMF's Global Integrated Monetary and Fiscal Model calibrated to Iceland, suggest that an expenditure-oriented adjustment mix (an 80/20 division of measures) would bring a modest cumulative real GDP growth gain of about ¼ percentage points in 2011–15 compared to a

⁴ See also "Iceland: Fiscal Consolidation Options" in *Iceland: Selected Issues*

balanced revenue/expenditure adjustment and a cumulative gain of $\frac{3}{4}$ percentage points compared to a revenue-oriented mix. A potential negative effect on the trade balance could be offset if the expenditure-oriented adjustment plan places greater weight on better targeting of transfers, which would provide an additional $\frac{1}{2}$ percentage point GDP growth in 2011–15 while redirecting the economy towards export-led growth. The authorities anticipate that decisions will be taken about the policy mix and the remaining measures in the fall of 2010.

Table. Medium Term Consolidation Measures

	2011 1/	2012	2013
In ISK million			
Revenue	11,000		
Expenditure	32,000		
Total Measures	43,000	36,000	9,500
In Percent of GDP			
Revenue	0.6		
Expenditure	1.9		
Total Measures	2.5	2.0	0.5
Primary balance	0.5	3.9	6.0
Change in the primary balance	3.2	3.5	2.1

Sources: Ministry of Finance of Iceland, and staff estimates.

1/ Identified measures

C. Strengthening the Policy Framework

37. **Iceland must establish a stronger policy framework to support the achievement of program objectives and stability in the post-program period (LOI ¶25).** The authorities and staff saw the key issue to be stronger financial sector regulation and supervision—shortcomings in this area were at the heart of the recent crisis—but also recognized needed reforms to the budget framework, and a need to define the post-program monetary policy framework.

- *Financial sector regulation and supervision.* The Jannari Report⁵ and the Report of Parliament's Special Investigation Commission⁶ have identified a number of shortcomings in regulation and supervision preceding the crisis. Legislation has been enacted to address a number of these, and is pending concerning deposit insurance revisions (Table 11). The changes are expected to enhance the quality of bank supervision and regulation, provide a better overview of risk concentration, enhance bank resolution procedures and strengthen the safety net. It was agreed that key next steps

⁵ Report on Banking Regulations and Supervision in Iceland: past, present and future. Available at: http://eng.forsaetisraduneyti.is/media/frettir/KaarloJannari_2009.pdf

⁶ Available at <http://sic.althingi.is/>

include: (i) ensuring that enough well trained staff are placed in key areas of the FME such as risk identification and management and onsite examination; (ii) establishing the now-authorized credit risk bureau at the FME (which will cover almost two thirds of total loans of the three large commercial banks); (iii) incorporating regulatory changes now being developed by international standard setters (i.e., liquidity, capital, and macro prudential measures) and crisis management (i.e., enhanced framework on early measures and resolution tools); and (iv) defining a timetable for lifting the blanket deposit guarantee. These will be subjects for discussions under future program reviews.

- *The fiscal framework* (Table 12). Iceland has comparatively weak frameworks for the budget and for local governments, and this contributed to a spending bias that increased the amplitude of the pre-crisis boom (Figure 13). Strengthening these frameworks is desirable in itself, and a necessary condition for any post-program system of fiscal rules to be viable. Past technical assistance has identified needed reforms of the budget framework, which the authorities are in the process of implementing. The authorities indicated in particular that the 2011 budget would see the introduction of two-year nominal spending ceilings. An overhaul of the fiscal framework for local governments has also begun and is expected to be completed by year-end (a program structural benchmark). A working group charged with providing recommendations has made proposals in line with good international practice, including debt limits, a rule on the fiscal balance, and mechanisms for coordination.
- *The monetary framework*. The CBI institutional framework and the level of transparency concerning monetary policy have been strengthened since the crisis, in particular by the introduction of a five member Monetary Policy Committee (including two outside members). Still, the authorities and staff recognized serious challenges for implementing the de jure inflation targeting framework in Iceland, including (Figure 14): (i) smallness and openness make the economy subject to large shocks and make the output-inflation variability trade-off less favorable; (ii) a strong pass-through from exchange rate movements to inflation weakens the credibility of monetary policy; (iii) a shallow financial market limits trade and makes price formation more difficult and erratic; and (iv) a potential for large capital flows complicates policy conduct and makes the policy rate less effective. These weaknesses would need to be addressed if a revised IT regime were to be put in place (either as an end in itself, or as a lead in to possible euro membership). However the authorities and staff both acknowledged that a decision on Iceland's post-program framework would be premature at this point, pending further progress in extricating Iceland from its crisis and work on considering the costs and benefits of the various framework options.

V. PROGRAM MODALITIES

38. **Program commitments are set through end-2010:**

- **Program performance will continue to be monitored by quarterly reviews** (Table 13). All quantitative performance criteria have been specified through December 31, 2010, and indicative targets set for March 31, 2011 and June 30, 2011 (LOI Table 1 and TMU). Some modifications of the PCs for end-September 2010 are proposed: (i) an increase in the end-September floor on the change in net international reserves (NIR) of the CBI (to reflect a stronger emphasis on reserve accumulation); (ii) exclusion of government fx deposit liabilities from the calculation of NIR (given the sharp build up of these liabilities due to ALM transactions, and a need to protect levels of gross reserves); and (iii) the end-September ceiling on the change in net domestic assets of the CBI will be modified to be consistent with the revision in the NIR target.
- **New structural conditionality has been added in support of program objectives (LOI Table 2, and LOI ¶7).** Both the submission of legislation to parliament to authorize bond issuance to cover potential bank recapitalization needs (by October 15, 2010) and the FME's decision about the banks' recapitalization plans (by November 15, 2010) are key steps towards bank recapitalization. Progress in these areas will be critical towards securing financial stability, and supporting market and depositor confidence in banks' liquidity and solvency in the face of the legal uncertainties surrounding the Supreme Court ruling on foreign exchange indexed loans.

39. **Iceland continues to require substantial external financing under the program** (Table 14). Iceland must build up adequate reserve levels ahead of: (i) a sharp rise in external amortization in late 2011 and early 2012; (ii) the full opening of the capital account; and (iii) the outflows consequent on settlement of the old banks' estates (the resolution committees have about \$2 billion on deposit with the CBI). Fund and bilateral disbursements to date, combined with the Avens transaction, have dramatically improved Iceland's reserve position. Achieving the full amount of financing in the program will further raise reserves to about 80 percent of short-term debt by residual maturity—a level similar to that in other Fund programs—and would leave Iceland in a position to smoothly meet these obligations.

40. **Financing assurances are in place (LOI ¶26).** In view of the projected current account surplus and existing effective capital controls Iceland should have sufficient financing over the next 12 months to support the policies in place. As noted above, reserves do need to be built up to ensure medium-term viability, and remaining committed bilateral financing would deliver this outcome. The authorities intend to meet the Nordic's conditions to unlock this external financing before the end of the program period. Key amongst these conditions is that Iceland meet its "international obligations", in particular in relation to the Icesave deposit insurance dispute. Icesave settlement discussions are continuing and solutions have been found to a variety of technical issues, but some important issues remain

outstanding, including the interest rate, and the distribution of legal and economic risk. The authorities remain committed to finalizing a settlement, although it could prove difficult to continuously preserve the delicate cross-party political consensus now supporting the process, especially if legal proceedings on the status of the deposit insurance obligations move forward. A settlement remains the expected outcome, but could take some time to arrange and approve.

41. **Staff believes that the modified program continues to place Iceland in a position to fulfill its obligations to the Fund in a timely manner** (Table 15). External debt remains on a downward trajectory. Fund credit outstanding would peak in 2012 at 54 percent of gross reserves and then rapidly fall. Payments would peak in 2012–13 at a manageable 15 percent of reserves. As before, the ability to vary the pace of capital account liberalization, and Iceland’s past experience with import compression in the face of demand shocks, provide comfort that balance of payments shocks can be absorbed despite high debt servicing obligations.

42. **The balance of program risks has been shifting, but strict program implementation should help Iceland continue to cope with such risks:**

- Key program risks remain, including: (i) that high debt induces a low-growth, high-emigration trap; and (ii) that wider political barriers prevent a solution to the Icesave dispute, which cuts Iceland off from needed external financing. Continued calibration of the program to evolving demand and external financing conditions is expected to help the program cope with these risks should they materialize. In particular, the authorities have indicated that they are prepared to adjust the program as needed to deal with any financing shortfalls (and given the success to date in raising international reserves, the availability of marketable non-reserve foreign assets, and the potential to maintain the effective capital control regime, this could be accomplished without major policy changes).
- Policy mis-sequencing risk remains a concern, particularly in light of the recent Supreme Court ruling on fx indexed loans. The ruling raised concerns about underlying financial sector vulnerability, and dented public confidence in the banks. A misstep on capital control liberalization, before the banks are strengthened, could expose them to a deposit run. The risks to financial stability are, however, mitigated by the authorities’ commitments to a clear plan for a bank recapitalization process, and to pre-condition capital control liberalization on assurances of financial stability.
- Litigation risk has grown in importance. The recent Supreme Court ruling over foreign exchange indexed loans has opened a potential channel for litigation from creditors over the likely losses to be sustained by the new banks. Public debt stress tests show that within limits contingent liabilities can be managed by the program without endangering debt sustainability. Successful litigation over the recent Supreme Court ruling would fall within the limits. However, as noted in previous staff reports, successful litigation over the

Emergency Law would have broader consequences (see IMF Country Report No. 10/95, Paragraph 37, bullet 5).

VI. STAFF APPRAISAL

43. **Impressive progress has been achieved under the Fund-supported program.** The fears and concerns when the program was launched in the immediate wake of the collapse have diminished, reflecting the authorities' strong determination and policy implementation. Heterodox program elements like capital controls, the decision to allow automatic stabilizers to work, and a narrow structural focus on measures that had a direct and early bearing on program objectives have underpinned achievements. The authorities' willingness to refocus and change the program as circumstances have changed augurs well for continued success.

44. **Iceland is set to rebound from its post crisis recession.** The economy stabilized towards the end of 2009, and while it appears to have slowed again during the first half of 2010, quarter-on-quarter growth should resume during the second half. Meanwhile, a recovery of the exchange rate has helped engender a sharp downward shift in inflation. From a medium-term perspective the exchange rate remains mildly undervalued, which should support continuation of the underlying current account surplus.

45. **Still, a wide margin of uncertainty surrounds future prospects.** The private debt overhang, barriers to energy sector investment, and global factors could all slow growth, while cost push pressures emanating from wage agreements could threaten inflation. It will be important for the authorities to reach a consensus with their social partners on wage settlements in the period ahead, and on a growth strategy to support investment.

46. **Program implementation has been a key reason for success to date.** A significant amount of fiscal adjustment measures have now been put into place, stabilizing public debt dynamics, and the financial system is slowly being restored. Third review program targets have been met, along with a structural benchmark on improving the household debt restructuring framework.

47. **The program now must confront a significant new policy challenge.** The Supreme Court ruling on foreign exchange indexed loans could have significant implications for bank capital, and it could take some time to fully sort out the issue (given many different types of fx-linked loan contracts). This has implications for policies, and may have real economic effects, by delaying efforts to restructure private sector debts.

48. **Staff welcomes the framework being put in place to secure the capitalization of the banking system.** Banks' capital buffers ensure that they can maintain positive net worth even in adverse legal scenarios. This gives the opportunity to allow owners to bring in capital as losses are realized, but they must be held to the standard of a credible commitment. It will be critical for the government to backstop capital raising efforts, in support of financial

stability, but the authorities must structure their participation to minimize the risk that the government will have to absorb potential new losses.

49. **Until the stability of the financial system is secure, capital controls and the government's blanket deposit guarantee must be maintained.** There is a risk otherwise of a deposit run into foreign currency, which would be very difficult to manage. It will take some time to achieve a normal functioning of the financial sector: implementation of the recapitalization framework will need to be matched by work to restructure banks' balance sheets and their operations. It remains the aim of the program to work through this process as quickly as possible.

50. **It is time to bring to closure the work on setting up household and corporate debt restructuring frameworks.** The new household debt restructuring measures are welcome, and address the known problems with the framework, including creditor coordination and advice to debtors. The tools to guide the corporate work are now also essentially in place. Staff welcomes the end of the moratorium on foreclosures, but remains concerned that the authorities have not contained expectations of additional debt relief measures. A clear message to contain expectations is needed, particularly in the wake of the Supreme Court ruling.

51. **Passage of the 2011 budget would mark a significant milestone.** The projected primary position of the general government would move back into surplus. Of course, as total measures taken or proposed approach 10 percent of GDP, there are no painless options left. Firm political commitment will be needed to bring the budget to a conclusion, but it remains important to take efforts to build consensus behind the measures chosen.

52. **Looking forward there may be scope to reduce the total amount of fiscal adjustment now targeted.** Debt dynamics are very favorable under the existing program design, and can tolerate moderate reductions in the medium-term fiscal target, provided financial sector contingent liabilities prove to be contained, and the authorities continue to resist absorbing private sector losses.

53. **Iceland needs to build up its stock of international reserves.** Reserves appear high in gross terms, but remain inadequate relative to short-term external debt and given the risk of capital outflows from resident sources. Program financing will help to address this, but from a longer-term perspective, Iceland will need to purchase reserves in the market to help redeem program loans. Staff welcomes the CBI's commitment to get a head start on this in 2010.

54. **Iceland should continue its efforts to normalize relations with international creditors.** This is important to unlock program bilateral financing, but more generally is needed to revive market confidence in Iceland's re-integration into global markets. The staff welcomes Iceland's continued commitment to reaching an agreement with the U.K. and The Netherlands concerning Icesave deposits.

55. **Increased attention must be given to strengthening the policy framework.** Staff welcomes the work to date to amend the banking law towards stronger banking regulation and supervision, and the measures taken to improve the budget planning and implementation framework. Key steps ahead include reform of the fiscal framework for local governments, full implementation of legislated financial sector supervisory reforms, and further strengthening of the supervisory framework in line with the evolution of international norms, and reflecting the findings of a planned BCP assessment.

56. **On the basis of the considerable progress to date and accomplishments of the program, staff supports the authorities' request to complete the third review.** Staff also recommends the modification of NIR and NDA targets for end-September 2010, and establishment of quantitative performance criteria for end-December 2010. Iceland's capital control regime continues to marginally affect the conversion and transfer of a certain component of current payments, giving rise to an exchange restriction. Since it has been imposed for balance of payments reasons, is non-discriminatory and temporary, staff support's the authorities' request for Board approval of the further retention of the measure until the earlier of 12 months or the completion of the next Article IV consultation.

57. **It is proposed that the next Article IV consultation be held on the twenty-four month consultation cycle in accordance with the Board decision on the consultation cycle for program countries.**

Table 1. Iceland: Selected Economic Indicators, 2005–10

	2005	2006	2007	2008	2009		2010	
					Prog.	Est.	Prog.	Proj. 1/
(Percentage change unless otherwise noted)								
National Accounts (constant prices)								
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
Selected Indicators								
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
Money and Credit								
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	...	...
Public Finance (in percent of GDP)								
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
Balance of Payments (in percent of GDP)								
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.

Table 2. Iceland: Status of the Financial Sector

	Total assets				Capital adequacy ratio (in percent) 1/	Leverage ratio (in percent) 4/	Status
	end-Mar 2010		end-Dec 2009				
	ISK billion	in percent of GDP	ISK billion	in percent of GDP			
A. Commercial banks	2,722	169	2,598	173	17.4	13.5	
Landsbankinn 2/	1,113	69	1,061	71	16.3	14.9	Going concern
Arion 2/	846	53	757	50	16.4	11.5	Going concern
Islandsbanki	700	44	717	48	20.9	13.7	Going concern
MP bank	63	4	63	4	15.1	14.9	Going concern
B. Saving banks 2/	359	22	359	24	...		
BYR sparisjóður	203	13	203	14	...	...	In April 22, 2010 the bank was intervened, assets and deposits were transferred to a new Byr -commercial bank. Negotiations between creditors and the authorities are discussing recapitalization options.
Sparisjóður Keflavíkur	90	6	90	6	...	...	In April 22, 2010 the bank was intervened, assets and deposits were transferred to a new Spkef savings bank. Negotiations between creditors and the authorities are underway on recapitalization options.
Other saving banks	66	4	66	4	...	...	Include [6]small savings banks in process of recapitalization with public funds.
C. Housing Finance Fund (HFF) 2/	795	49	795	53	3.0	1.3	
D. Other credit undertakings 2/	359	22	359	24	...	...

Sources: Preliminary data from CBI and FME, and staff calculations.

1/ These capital ratios reflect the time given to banks to compute capital for market risks in the fx long position originated for fx denominated loans given to non unhedged borrowers as they are in process of being converted into ISK. If the full computation of capital requirements were calculated the aggregated CAR could drop from 17 percent to about [15] percent.

2/ No information available for end-March 2010

Table 3. Iceland: Medium-Term Projections, 2008–15
(Percent change, unless otherwise indicated)

	2008	2009		2010		2011	2012	2013	2014	2015
		Prog.	Est.	Prog.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
(Percentage change)										
Real economy										
Real GDP 1/	1.0	-8.5	-6.8	-3.0	-3.0	3.0	2.4	1.7	3.1	3.1
Real domestic demand	-8.9	-20.7	-20.7	-1.3	-1.9	5.3	4.2	1.3	2.4	3.3
Private consumption	-7.9	-17.0	-16.0	1.4	0.6	2.8	4.0	4.3	3.0	3.0
Public consumption	4.6	-0.1	-1.7	-2.5	-3.5	-3.5	-2.0	-0.5	2.0	2.0
Gross fixed investment	-20.9	-50.6	-50.9	-10.0	-8.9	36.5	13.2	-6.0	1.4	6.3
Net exports 2/	11.3	11.2	12.1	0.2	-0.8	-1.7	-1.2	0.8	0.9	0.2
Exports of goods and services	7.1	-1.5	7.4	1.0	-0.6	0.6	1.1	5.5	5.0	4.0
Imports of goods and services	-18.2	-30.5	-24.1	0.8	1.7	5.9	5.0	4.7	3.9	4.7
Output gap 3/	1.7	-3.2	-3.3	-3.5	-4.0	-1.5	-0.5	0.0	0.0	0.0
Unemployment rate 4/	1.6	8.6	8.0	9.7	8.6	8.4	6.6	4.7	3.4	3.4
Real wages	-8.1	-7.5	-10.1	-1.8	-1.6	1.4	3.4	2.4	2.4	2.4
CPI inflation	12.4	11.7	12.0	6.2	5.9	3.5	2.5	2.5	2.5	2.5
CPI inflation (excl. effect of ind. taxes)	12.6	...	11.4	5.1	4.9	2.1	1.9	2.5	2.5	2.5
CPI inflation (end of period)	18.1	7.0	7.5	4.2	4.0	2.7	2.6	2.6	2.5	2.5
Nominal ISK/EUR exchange rate	127.0	...	172.0	175.2	166.2	165.2	165.1	165.0	163.9	163.9
Real exchange rate (+ appreciation)	-20.7	...	-18.4	3.7	4.5	2.0	1.0	1.0	1.0	0.0
Nominal GDP (bln ISK)	1477.9	1472.5	1500.8	1620.5	1598.1	1717.2	1806.7	1908.3	2019.4	2135.2
(In percent of GDP, unless otherwise indicated)										
Balance of Payments										
Current account	-26.0	-3.5	-6.5	5.4	-0.9	2.1	-1.2	-0.7	-0.8	-0.4
Underlying current account 5/	-3.9	...	0.4	...	0.8	0.6	0.2	0.4	0.4	0.5
Trade balance	-2.3	8.6	9.2	10.8	10.8	8.0	6.6	7.8	8.5	8.3
Net income balance 6/	-23.4	-11.6	-15.1	-4.9	-11.2	-5.5	-7.6	-8.2	-9.1	-8.4
Capital and financial account	-77.3	6.8	-19.9	-5.2	4.9	-1.3	-28.3	10.1	9.8	0.7
Capital transfer, net	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0
Direct investment, net	30.5	8.4	-17.7	4.1	-0.8	11.3	8.2	4.5	3.5	2.8
Portfolio investment, net	-0.1	-6.6	-0.8	-5.3	-0.3	-5.4	-0.6	0.3	1.3	-2.0
Other investment, net 7/	-107.7	5.1	-1.2	-3.9	6.2	-7.2	-35.8	5.3	5.1	-0.1
Accumulation of arrears	158.3	-47.2	0.0	-42.6	-41.2	0.0	0.0	0.0	0.0	0.0
Extraordinary financing	6.8	61.8	5.5	64.5	59.5	4.7	-3.0	-3.8	-3.0	-3.0
Gross external debt 8/	564.7	306.9	300.7	299.0	278.5	270.6	222.6	214.2	205.8	192.7
Central bank reserves (US\$ billion)	3.6	4.9	3.9	6.7	6.9	7.7	3.1	4.0	4.9	4.5
General government accounts										
Revenue	44.2	38.4	39.4	39.2	38.9	38.5	39.5	40.4	40.5	40.4
Expenditure	44.8	52.7	52.1	48.6	48.2	44.1	40.6	39.2	38.7	37.6
Overall balance	-0.5	-14.4	-12.6	-9.4	-9.2	-5.6	-1.1	1.3	1.8	2.8
Primary balance	-0.3	-8.3	-7.4	-2.7	-2.7	0.5	3.9	6.0	6.0	6.0
Change in primary balance	-6.1	-8.0	-7.0	4.2	4.6	3.2	3.5	2.1	0.0	0.0
Gross debt	71.7	125.2	99.9	119.9	115.6	107.8	101.1	94.3	85.2	75.8
Net Debt	42.1	89.5	67.7	77.2	75.6	78.6	74.7	63.1	57.5	45.9

Sources: CBI; and IMF staff estimates.

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

2/ Contributions to growth.

3/ In percent of potential output

4/ In percent of labor force.

5/ Excludes old banks transactions. Since 2009 also excludes accrued interest payments on intra-company debt held by a large multinational.

6/ Includes interest payments due from the financial sector and income receipts to the financial sector.

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

8/ Including old banks before 2009.

Table 4. Iceland: Balance of Payments, 2008–15
(In billions of US dollars)

	2008	2009	2010	2011	2012	2013	2014	2015
	Prel.	Esti.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Current Account	-4.4	-0.3	0.2	0.3	-0.2	-0.1	-0.1	0.0
Trade Balance	-0.4	1.1	1.4	1.1	0.9	1.2	1.3	1.4
Balance on Goods	-0.1	0.7	1.1	0.6	0.6	0.9	1.1	1.1
Merchandise exports f.o.b.	5.3	4.1	4.6	4.6	4.8	5.2	5.7	6.1
Merchandise imports f.o.b.	-5.4	-3.3	-3.5	-4.0	-4.2	-4.4	-4.6	-4.9
Balance on Services	-0.3	0.4	0.3	0.5	0.4	0.3	0.3	0.3
Exports of services, total	2.1	2.3	2.5	2.7	2.7	2.8	2.9	3.0
Imports of services, total	-2.4	-1.9	-2.2	-2.2	-2.4	-2.5	-2.6	-2.8
Balance on Income 1/	-3.9	-1.3	-1.2	-0.8	-1.1	-1.2	-1.4	-1.4
Receipts	1.0	0.8	0.3	0.6	0.8	0.9	0.9	1.0
of which dividends and reinvested earnings	-0.9	-0.2	-0.2	0.2	0.4	0.4	0.5	0.5
of which interest receipts	1.8	1.1	0.4	0.4	0.4	0.4	0.4	0.5
Expenditures	-4.9	-2.1	-1.5	-1.3	-1.8	-2.1	-2.3	-2.4
of which dividends and reinvested earnings	0.9	0.4	-0.1	-0.3	-0.5	-0.7	-0.8	-0.9
of which interest payments	-5.8	-2.5	-1.4	-1.0	-1.3	-1.3	-1.5	-1.4
Current transfer, net	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Cap and Finan. Acct	-12.1	-3.3	0.2	-0.2	-4.4	1.4	1.5	0.0
Capital transfer, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	-12.1	-3.3	0.2	-0.2	-4.4	1.5	1.5	0.0
Direct investment, net	5.1	-2.1	-0.1	1.5	1.2	0.7	0.5	0.5
Portfolio investment, net	0.0	-0.4	-0.5	-0.7	-0.1	0.0	0.2	-0.3
Assets	2.2	0.4	0.5	-0.2	-0.4	-0.1	-0.2	-0.3
Liabilities 2/	-2.3	-0.8	-0.9	-0.6	0.3	0.2	0.4	-0.1
Net borrowing	-0.4	-0.8	-1.0	-0.7	0.1	0.0	0.0	-0.3
Equities	-1.8	0.0	0.0	0.1	0.2	0.2	0.4	0.2
Other investment, net 3/	-18.1	-0.1	0.8	-1.0	-5.5	0.7	0.7	-0.1
Assets	-2.1	0.9	-0.3	-0.2	0.0	0.0	0.0	0.0
Liabilities 2/	-16.0	-1.1	1.1	-0.8	-5.4	0.7	0.7	-0.1
of which external asset recovery (Landsbanki)	0.0	0.8	0.5	0.2	0.7	0.1	0.0	0.0
of which other external asset recovery	...	0.2	0.7	0.0	0.0	0.0	0.0	0.0
of which deposit insurance loan payments	0.0	0.0	-0.1	0.0	-3.2	-0.2	-0.4	-0.4
of which other asset recovery payments	0.0	0.0	-0.2	-0.8	-2.1	0.0	0.0	0.0
of which old banks foreign deposits	-18.8	...	...	...	...	...	...	...
Net errors and omissions	-2.9	3.3	0.5	0.0	0.0	0.0	0.0	0.0
Overall Balance	-19.4	-0.3	0.9	0.1	-4.6	1.4	1.4	0.0
Overall financing	18.7	0.3	-0.9	-0.2	4.6	-1.4	-1.4	0.0
Change in gross reserves ("-" = increase)	-0.9	-0.3	-3.0	-0.8	5.0	-0.8	-0.9	0.5
Accumulation of arrears ("-" = paydown)	18.8	0.0	-5.3	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing 4/	0.8	0.7	7.4	0.6	-0.4	-0.6	-0.5	-0.5
Fund ("+" = net disbursement)	0.8	0.2	0.5	0.6	-0.4	-0.6	-0.5	-0.5
Bilateral (earmarked/ non-cash)	0.0	0.0	5.3	0.0	0.0	0.0	0.0	0.0
Other identified new financing 5/	0.0	0.5	1.7	0.0	0.0	0.0	0.0	0.0
Financing Gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Level of gross reserves (eop)	3.6	3.9	6.9	7.7	2.7	3.6	4.5	4.0
Memo								
Underlying balance of income 6/	-3.5	-0.1	-0.5	-0.5	-0.7	-0.7	-0.9	-0.8
Underlying current account balance 6/	-3.9	0.9	0.8	0.6	0.2	0.4	0.4	0.5
Reserves (months of imports of G&S)	8.1	8.2	13.4	14.2	4.8	5.9	6.9	5.8
Reserves/S-T debt (residual basis, in percent)	68.0	42.2	80.3	66.5	47.7	60.1	76.0	57.6
Reserves/S-T debt (residual basis, adjusted, in percent) 7/	68.0	68.8	124.0	95.6	123.5	150.2	189.0	110.1
Reserves (in percent of GDP)	21.1	32.0	54.3	57.2	19.4	23.9	28.2	23.8
Principal and interest arrears of old banks 2/	3.0	14.8	...	...	...	...	...	...

Sources: CBI; and IMF staff estimates.

1/ Actual data include old banks' incomes.

2/ Principal and interest transactions related to old bank original obligations are not included from 4Q08 on.

3/ Includes inflows and outflows related to non-Icesave depositor obligations of Old Landsbanki.

4/ Debt service payments on extraordinary financing appear in the financial account, except for Fund repurchases.

5/ Excludes Polish loan (assumed to be converted into holding of Polish treasuries in zloty, which do not qualify as reserves assets).

6/ Excludes old banks transactions. Since 2009 also excludes accrued interest payments on intra-company debt held by a large multinational.

7/ Excludes short-term debt blocked by capital controls, and maturing loan with known matching assets.

Table 5. Iceland: Framework for Household Debt Restructuring

Household Debt Restructuring—Status of Proposed Reforms		
Problems	Actions Taken	Key Next Steps
Better access to Information Advice and Mediation Mechanisms	Debtors Ombudsman’s Office (DO). This entity will oversee debt mitigation procedures for individuals and provide them with advisory and mediation services.	Scale up DO, including via outsourcing Ensure adequate coordination between MoSA and MoJ on supervision and oversight of the DO.
Extending current framework to individuals not currently covered	The framework was expanded to include self-employed and individuals whose debt overhang includes debt arising from his/her economic/business activities. The framework was expanded to include debtors with two properties Debt mitigation extended to cover individuals that have emigrated to study or seek employment. Legal domicile in Iceland is no longer a precondition for debt mitigation	
Creating incentives for debtors and creditors to engage in voluntary debt restructurings	New legal framework on voluntary debt mitigation creates a connection with judicial remedies, introducing formal lodging of claims and time limits for processing applications. The moratorium on foreclosures is being phased out (with limited rights for continued residence linked to social considerations) Modification of the tax regime to remove tax disincentives for households that receive relief.	Promote short sales of properties, as an alternative to foreclosures. Contain public expectations about the possibility of new and more beneficial government-sponsored measures.

Table 6. Iceland: Money and Banking
(Billions of Krona, unless otherwise indicated)

	Dec-08 Est.	Dec-09 Est.	Mar-10 Est. 1/	Jun-10 Proj.	Sep-10 Proj.	Dec-10 Proj.
Central Bank						
Net foreign assets 2/	-96	-177	-190	-156	-143	-136
Assets	429	485	490	574	662	746
Liabilities	526	662	680	730	805	882
Net domestic assets	211	293	303	275	267	262
Net claims on the public sector	39	-52	8	-29	-58	-36
Net claims excluding recap bond	-231	-218	-172	-193	-222	-200
Recapitalization bond	270	165	181	164	164	164
Net claims on banks 3/	282	-16	-49	-57	-57	-57
Others, net	-110	361	343	370	382	355
Base Money 4/	115	117	112	119	122	124
Currency issued	24	29	27	30	31	31
DMB deposits at the central bank	91	88	85	98	91	93
Banking System						
Net foreign assets	-295	-190	-190	-190	-190	-190
Net domestic assets	2,022	1,820	1,828	1,836	1,844	1,853
Net claims on the central bank	-282	16	49	57	57	57
Credit to private sector	2,501	1,777	1,777	1,777	1,786	1,795
Credit to government	...	35	50	50	50	50
Other items, net	-197	-9	-48	-48	-49	-49
Domestic deposits	1,726	1,630	1,638	1,646	1,655	1,663
Local currency	1,549	1,450	1,458	1,465	1,472	1,480
Foreign currency	178	180	181	181	182	183
Consolidated Financial System						
Net foreign assets	-391	-367	-380	-346	-333	-326
Net domestic assets	2,061	1,963	2,002	1,971	1,998	2,025
Net claims on the public sector 5/	39	-17	58	21	-8	14
Net credit to private sector	2,501	1,777	1,777	1,777	1,786	1,795
Other, net	-479	202	166	172	220	216
Broad Money (M3)	1,670	1,596	1,622	1,624	1,665	1,699
Memorandum items:						
Base money (y-o-y percentage change)	-31.5	1.3	-15.8	-18.7	-24.4	6.5
Broad money (y-o-y percentage change)	36.3	-4.4	-1.8	-6.2	-2.4	6.5
Credit to private sector (y-o-y percentage change)	-28.3	-28.9	-21.7	-19.9	0.5	1.0
Money velocity (GDP/base money)	12.8	12.9	12.9	12.9	12.9	12.9
Broad money velocity (GDP/M3)	0.9	0.9	0.9	0.9	0.9	0.9
Multiplier (M3 / base money)	14.5	13.7	14.4	13.7	13.7	13.7

Sources: Central Bank of Iceland; and Fund staff estimates

1/ Although the balance sheets of the new banks have been finalized, the CBI has not received full monetary data reports.

Therefore the items under the banking system and consolidated financial system remain estimates for all periods after October 2008.

2/ Foreign liabilities include fx deposits of domestic banks and the government.

3/ Net claims on banks is the difference between CBI's lending to banks and banks' holding of certificates of deposits.

4/ Base money includes currency in circulation and DMBs deposits at the central bank in krona.

5/ Net claims on the public sector of the consolidated system include only net claims of the central bank up to January 2009.

Starting Feb 2009, the data also include outstanding government bonds held by the banks.

Table 7. Iceland: General Government Operations, 2008–15
(GFS modified cash basis, percent of GDP 1/)

	2007	2008	2009		2010		2011	2012	2013	2014	2015
			Est.	Mod.	Cash	2nd Rev.					
Total revenue 2/	47.7	44.2	39.4	39.2	38.9	38.5	39.5	40.4	40.5	40.4	
Taxes	37.4	33.9	30.6	30.0	30.1	29.3	29.6	29.9	29.9	29.9	
Taxes on income and profits	18.4	17.8	16.5	15.5	15.5	15.1	15.5	15.7	15.8	15.8	
Personal Income Tax	13.8	13.2	12.7	12.8	13.0	12.5	12.9	13.2	13.3	13.3	
Corporate Income Tax	2.5	1.9	1.2	0.9	0.9	0.9	0.9	0.9	0.9	0.9	
Capital gains tax, rental income	2.2	2.7	2.8	1.7	1.7	1.7	1.6	1.6	1.6	1.6	
Taxes on payroll and workforce	0.0	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	
Taxes on property	2.4	2.2	2.1	2.0	1.8	1.6	1.5	1.4	1.4	1.4	
Taxes on goods and services	16.0	13.2	11.1	11.7	11.8	11.6	11.6	11.8	11.8	11.8	
VAT	10.5	9.1	7.5	7.6	7.9	7.8	7.8	8.0	8.0	8.0	
Other taxes on goods and services	5.5	4.1	3.7	4.1	3.9	3.8	3.8	3.8	3.7	3.8	
Taxes on international trade	0.4	0.4	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4	
Other taxes	0.1	0.1	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4	
Social contributions	3.1	2.8	2.8	3.8	3.8	3.6	3.7	3.8	3.9	3.9	
Grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	
Other revenue	7.1	7.4	5.9	5.3	5.0	4.8	4.6	4.8	4.8	4.7	
o/w Interest income	2.3	3.1	3.4	2.5	2.2	2.0	1.8	1.9	1.9	1.8	
New discretionary revenue measures 2/						0.6	1.5	1.8	1.8	1.8	
Total expenditure 2/ 3/	42.3	44.8	52.1	48.6	48.2	44.1	40.6	39.2	38.7	37.6	
Current expense 3/	39.8	42.1	50.2	48.5	48.1	45.7	43.5	42.4	40.9	39.1	
Compensation of employees	14.8	14.6	14.5	14.7	13.5	12.8	12.4	12.2	11.8	11.6	
Use of goods and services	10.8	11.6	12.1	12.2	11.6	11.1	10.8	10.4	10.1	9.9	
Consumption of fixed capital	1.7	1.8	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	
Interest	2.6	3.3	8.7	9.1	8.7	8.1	6.8	6.6	6.1	5.0	
o/w Accrued on IceSave guarantee	..	..	2.7	2.6	2.6	2.6	1.3	1.0	0.9	0.9
Subsidies	1.8	1.8	1.9	1.3	1.8	1.7	1.7	1.6	1.6	1.5	
Grants	0.2	0.2	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	
Social benefits	5.8	6.1	7.8	6.8	7.4	7.1	7.0	6.7	6.6	6.5	
Other expense	2.2	2.6	2.8	2.1	2.7	2.6	2.5	2.4	2.4	2.3	
Nonfinancial assets	2.4	2.6	1.9	0.1	0.1	0.3	0.4	0.4	0.5	0.7	
Non-financial assets, acquisition	4.2	4.5	4.1	2.2	2.2	2.5	2.6	2.5	2.6	2.8	
Consumption of fixed capital (-)	-1.7	-1.8	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	
New discretionary expenditure measures 2/						-1.9	-3.3	-3.7	-2.7	-2.2	
Net lending/borrowing 3/	5.4	-0.5	-12.6	-9.4	-9.2	-5.6	-1.1	1.3	1.8	2.8	
Net lending/borrowing incl. write-offs	5.4	-13.5	-26.8	-9.4	-9.2	-5.6	-1.1	1.3	1.8	2.8	
Stock of debt 4/											
General government gross debt 4/	29.3	71.7	99.9	119.9	115.6	107.8	101.1	94.3	85.2	75.8	
Domestic	15.9	47.0	61.0	62.6	66.2	62.9	56.6	50.9	45.1	39.0	
Foreign currency 4/	13.3	24.7	38.9	57.3	49.4	44.9	44.5	43.4	40.2	36.8	
of which:											
Bilateral loans to support CBI reserves	0.0	0.0	3.1	17.5	15.2	14.5	13.7	13.1	11.0	9.2	
'Net present value' of depositor guarantees 5/	0.0	0.0	11.8	18.3	13.7	15.3	15.9	16.0	16.1	15.2	
Other	13.3	24.7	24.0	21.5	20.4	15.1	15.0	14.3	13.1	12.4	
General government net debt 6/	11.0	42.1	67.7	77.2	75.6	78.6	74.7	64.5	58.6	51.8	
Structural Balances 7/											
Structural balance	2.6	-1.8	-6.6	-4.8	1.9	-3.9	-0.3	1.3	1.8	2.8	
Structural primary balance	3.5	-1.1	-2.7	1.6	7.7	2.1	4.7	6.0	6.0	6.0	
Memo Items											
Nominal GDP (billion ISK)	1,309	1,478	1,501	1,621	1,598	1,717	1,807	1,908	2,019	2,135	
Output gap 9/	3.6	1.7	-3.3	-3.5	-4.0	-1.5	-0.5	0.0	0.0	0.0	
Real GDP	6.0	1.0	-6.8	-3.0	-3.0	3.0	2.4	1.7	3.1	3.1	
Inflation (avg)	5.0	12.4	12.0	6.2	5.9	3.5	2.5	2.5	2.5	2.5	
Primary revenue	45.4	41.1	36.1	36.8	36.7	36.5	37.8	38.6	38.6	38.6	
Primary expenditure	39.7	41.4	43.4	39.5	39.4	36.0	33.9	32.6	32.6	32.6	
Primary balance (excl. interest income)	5.7	-0.3	-7.4	-2.7	-2.7	0.5	3.9	6.0	6.0	6.0	
Change in the primary balance	-1.0	-6.1	-7.0	4.2	4.6	3.2	3.5	2.1	0.0	0.0	

Sources: IceStat, Ministry of Finance, and Fund staff estimates.

1/ Historical data are semi-accrual; projections are modified cash.

Projections for 2010 reflect the consolidation of the central government (cash) budget, and projections for local governments and social security funds.

2/ Measures have been divided about equally between tax and expenditure measures in 2012. In the current projections, measures are reflected only in these lines.

Measures are counted cumulatively from 2011 onward.

3/ Excluding write-off claims on banks. Write-offs in 2008 are the result of central bank recapitalization and securities lending contracts that failed after the bank collapse.

Write-offs in 2009 relate to an estimate of the NPV of depositor guarantees (liabilities not recovered by assets) and retroactive interest paid to new banks to compensate for late capitalization.

4/ Includes bilateral loans to support foreign currency reserves at the Central Bank of Iceland (CBI).

Loan from the Norwegian government directly to the CBI is excluded from general government debt. Includes the estimated net present value of the outstanding guarantee, net of asset recovery, on the UK/Dutch IceSave loans to the Icelandic Depositors' and Investors' Guarantee Fund. Does not include Fund liabilities.

5/ Cash flow impact of the outstanding IceSave guarantee after asset recovery. It estimates, under given assumptions for asset recovery, the residual obligation for the government and growth there due to accruing interest.

6/ Gross debt minus liquid assets at the CBI (including assets from bilateral loans to support CBI reserves, which are assumed to be liquid).

7/ In percent of potential GDP. Structural estimates for 2009 were normalized to account for the impact of the asset bust price cycle. The deterioration in 2009 does not reflect the fiscal stance.

8/ State guarantees only. Excludes guarantee on IceSave loans.

Table 8. Iceland: Central Government Operations, 2008–15
(GFS modified cash basis, percent of GDP)

	2008	2009	2010		2011	2012	2013	2014	2015
		Est.	2nd Rev	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Cash receipts from operating activities 1/	30.1	27.8	28.1	27.9	27.8	28.8	29.6	29.6	29.5
Tax revenue	23.7	21.2	21.4	21.3	20.9	21.0	21.3	21.3	21.3
Taxes on income, profits, and capital gains	10.3	9.3	8.7	8.6	8.4	8.5	8.6	8.6	8.6
Personal income tax	6.0	5.5	6.0	6.0	5.8	6.0	6.1	6.1	6.1
Corporate income tax	2.0	1.2	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Other taxes on income and profit	2.4	2.6	1.7	1.7	1.7	1.6	1.6	1.6	1.6
Taxes on payroll and workforce	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Taxes on property	0.5	0.3	0.5	0.3	0.3	0.2	0.2	0.2	0.2
Taxes on sales and services	12.1	10.8	11.4	11.4	11.3	11.3	11.5	11.4	11.5
Taxes on international trade and transactions	0.4	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Other tax revenue	0.1	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Social contributions	2.8	2.8	3.8	3.8	3.6	3.7	3.8	3.9	3.9
Grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other receipts	3.6	3.6	2.8	2.8	2.6	2.4	2.6	2.6	2.5
<i>of which:</i>									
Interest income	2.6	3.1	2.2	1.9	1.7	1.5	1.6	1.7	1.6
New revenue measures (cumulative) 1/					0.6	1.5	1.8	1.8	1.8
Total spending 1/	30.6	34.4	33.6	33.6	30.2	28.2	27.2	27.0	26.6
Cash payments for operating activities	28.3	31.9	32.2	32.2	30.8	30.1	29.5	28.4	27.5
Compensation of employees	8.5	8.5	7.9	8.0	7.7	7.7	7.7	7.6	7.5
Purchases of goods & services	5.6	6.0	6.0	6.1	5.8	5.7	5.6	5.4	5.3
Interest 2/	1.9	3.0	5.3	4.9	4.6	4.7	5.1	4.7	4.4
Transfer payments	12.4	14.4	13.0	13.2	12.6	11.9	11.2	10.6	10.3
Net cash inflow from operating activities	1.8	-4.1	-4.1	-4.3	-1.0	2.0	3.7	4.0	4.2
Investments in NFAs	2.3	2.5	1.4	1.4	1.4	1.4	1.4	1.3	1.3
New discretionary expenditure measures (cumulative) 1/				0.0	-1.9	-3.3	-3.7	-2.7	-2.2
Surplus / deficit (before adjustment to cash)	-0.5	-6.6	-5.5	-5.7	-2.4	0.6	2.4	2.7	2.9
Adjustment to cash	0.8	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall deficit (incl. adjustment to cash)	0.3	-7.5	-5.5	-5.7	-2.4	0.6	2.4	2.7	2.9
Memorandum Items:									
Nominal GDP	1,478	1,501	1,621	1,598	1,717	1,807	1,908	2,019	2,135
Inflation (avg)	12.4	12.0	6.2	5.9	3.5	2.5	2.5	2.5	2.5
Real GDP growth	1.0	-6.8	-3.0	-3.0	3.0	2.4	1.7	3.1	3.1
Primary revenue	27.5	24.7	25.9	25.9	26.1	27.3	28.0	28.0	28.0
Primary expenditure	28.7	31.4	28.3	28.7	25.6	23.4	22.1	22.2	22.1
Primary balance (excl. interest income)	-1.3	-6.7	-2.4	-2.8	0.4	3.9	5.8	5.7	5.8
Change in primary balance		-5.5	4.4	4.0	3.2	3.4	2.0	-0.1	0.1

Sources: IceStat, Ministry of Finance, and Fund staff estimates.

1/ Measures, added in total revenue and expenditure lines, are about equally divided between revenue and spending measures, except in 2009.

2/ Interest paid cash. Excludes accrued interest from inflation indexed bonds.

Table 9. Iceland: Estimated Impact of 2011 Fiscal Measures

Revenue Measures 1/	Nominal Amount (In ISK Billion)	Amount (In Percent of GDP)
Raising CIT and the capital gains tax rates to 20 percent	2.00	0.12
PIT on early withdrawal of private pensions	3.00	0.17
Other tax measures 2/	6.00	0.35
Total Revenue Measures	11.00	0.64
<hr/>		
Expenditure Measure 1/	Nominal Amount (In ISK Billion)	Nominal Amount (In Percent of GDP)
Current expenditure, of which:	27.17	1.58
5 percent reduction of health service costs, including through reorganization of health service agencies;		
5 percent reduction in police service costs;		
5 percent reduction in education costs	18.24	1.06
7.5 percent reduction in university education costs;		
9 percent reduction in general administrative costs, including through reduction in overtime and travel costs, reorganization of shift plans, contract renegotiations, etc.		
Salary and benefits freeze	8.93	0.52
Transfers	22.59	1.32
Freeze in social security benefits, disability compensations, and pensions.		
Reduction in parental leave and child benefits, interest cost rebates, and transfers to the Municipal Equalization Fund	22.59	1.32
Capital expenditure	2.93	0.17
Reduction in road construction	2.93	0.17
Total Expenditure Measures	52.70	3.07

Sources: Ministry of Finance of Iceland, and staff estimates.

1/ Fiscal measures are relative to 2010.

2/ Other tax measures include raising the net wealth tax, the inheritance tax, the CO2 tax, the vehicle tax, the tax on alcohol and tobacco and introducing a bank tax

Table 10. Iceland: Revenue Options Identified by IMF Technical Assistance
(Net revenue in percent of GDP)

Recommendation	Basic Measures	Alternative Measures
Raising the reduced VAT rate to 14 percent, limiting reduced rate to food and eliminating non-standard exemptions, while compensating low income households.	1.1	
Eliminating reduced rate for VAT and non-standard exemptions, while compensating low income households		1.5
Increasing the fuel excise half way to Norwegian levels, while compensating public transport	0.25	
Improving the progressivity of the personal income tax by moving to a two-bracket system	0.25	
Improving the progressivity of the personal income tax by restructuring the three-bracket system		0.43
Total revenue	1.6	1.93

Source: FAD TA Report: "Iceland: Improving the Equity and Revenue Productivity of the Icelandic Tax System."

Note: The revenue presented here for the VAT and fuel excise reform are net of proposed compensation measures for low-income groups.

Table 11. Iceland: Status of Financial Sector Supervision and Regulation Reform

Problem	Recommendation 1/	Status
Inadequate cooperation between domestic supervisory institutions	<ul style="list-style-type: none"> Decrease the number of Ministries that have a hand in Financial Supervision Bring FME and CBI under the same administrative umbrella 	Supervision centralized under Ministry of Economic Affairs (FME, CBI). Exception: HFF, which remains under Ministry of Social Affairs
Inadequate communications with other regulators before and during the crisis	<ul style="list-style-type: none"> Participate more actively in international cooperation within the EEA and EU. 	
A focus on the letter of the law allowed banks to use high powered legal help to effectively skirt regulation.	<ul style="list-style-type: none"> Give more discretionary powers to the FME, and encourage it to use them more forcefully 	The FME now has discretionary powers to: (i) compute capital; (ii) rule on stock options and incentive schemes; (iii) prohibit the establishment of foreign branches; (iv) supervise closely the role of board members; and (v) define whether there is an economic connection between borrowers.
Build up of large exposures.	<ul style="list-style-type: none"> Create a national credit registry at the FME, to provide a better overview of large exposures. Lay down tougher rules on large exposures, and strictly enforce them 	Work is underway by the FME and CBI staff to establish a credit risk registry (CRR) by end-June 2011. Borrowers above ISK 300 million will be reported by banks to the CRR (about 70 percent of existing system loans).
Level of capital	<ul style="list-style-type: none"> On the basis of pillar II, Iceland's banks should be subjected to higher minimum tier I capital (12 percent) 	The authorities continue requiring banks to hold a minimum of 12 percent of tier I capital given the still sizable level of nonperforming loans and number of borrowers that need restructuring.
Significant connected lending	<ul style="list-style-type: none"> Lay down tougher rules on connected lending and strictly enforce them 	The FME's opinion on economic links between specific borrowers and bank owners will prevail at all times, unless it is shown to be wrong.
Fit and proper requirements were only applied from 2005 on, and narrowly (covering only MDs)	<ul style="list-style-type: none"> Strengthen fit and proper requirements and more strictly enforce them 	Changes in accordance with directive 2007/44/EC. The FME will decide on eligibility of applicants to qualify for holding.
Offsite reports on credit risk exchange rate risk and liquidity risk were never verified	<ul style="list-style-type: none"> Conduct more on site inspections 	The FME has increased the number of staff. A high level committee has been set up to revise and update supervisory powers at the FME law; draft proposals are expected in early 2011.
Failure of deposit insurance fund	<ul style="list-style-type: none"> Review and improve the deposit insurance system, following developments in the EU 	The draft bill was submitted to parliament for approval. The deposit insurance limit would be raised to euro 50,000 and will aim to protect a large number of depositors. Banks will be given sufficient time to absorb the increase in contributions, and the DIS will be able to borrow to ensure sufficient resources.
Bankruptcy regime	<ul style="list-style-type: none"> Create a separate regime for financial institutions 	A committee has been set up to propose new legislation on bank resolution.

1/ See "Report on Banking Supervision in Iceland: Past, Present and Future" by Kaarlo Jannari, March 30, 200 Table X.

Table 12. Iceland: Reforms of the Fiscal Framework 1/

Weakness	Reform	Steps	Progress
Strengthening the Budget Framework			
The legislative framework is not complete, particularly in defining roles and responsibilities of key actors, in budget preparation, and in specifying the circumstances and procedure for approval of supplementary budgets.	<ul style="list-style-type: none"> • Introduce a Parliamentary standing order to enshrine a greater medium-term orientation and top-down sequence to budget preparation. • Restrict use of supplementary budgets to genuinely unforeseen and unavoidable expenditures. 	<ul style="list-style-type: none"> • Update Parliamentary standing order governing preparation of the budget in Parliament to introduce two-stage sequence to approval of the budget • Amend the 1997 Budget Act to restrict use of supplementary budgets 	Commitment to introduce changes to budget preparation, approval and execution procedures according to July 2009 report by MoF to Parliament.
The medium-term framework does not inform the cabinet's and parliament's policy prioritization discussions; it does not enable spending agencies to prepare long-term budget plans; nor does it ensure multi-year expenditure discipline and fiscal sustainability.	<ul style="list-style-type: none"> • Set up a more comprehensive, transparent and binding fiscal framework for general government and rationalize the process of budget formulation and approval. • Establish a top-down approach to budget preparation, discussion, and approval in Cabinet and Parliament. 	<ul style="list-style-type: none"> • More disciplined procedure to prepare 2011 Budget: presentation to Parliament of medium-term fiscal objectives and nominal spending ceiling for 2011–12 in early Summer. • Include in the budget an account of changes to individual and overall expenditure ceilings and ministerial ceilings in a four-year perspective. • Parliamentary approval of the budget to follow the top-down procedures voting the medium-term fiscal objectives and expenditure ceiling before individual allocations. 	<p>July 2009 report by MoF to Parliament announced a range of reforms to introduce a two-year fixed expenditure ceiling and top-down sequence to budget preparation and approval.</p> <p>2011 Budget and medium-term fiscal objectives under preparation with the objective of presenting them to Parliament in early fall.</p>
Operational spending overruns routinely legitimized by supplementary budgets. Positive and negative carryovers vis-à-vis a fully fledged system of contingency funds makes frequent recourse to parliament necessary and complicates budget management.	<ul style="list-style-type: none"> • Introduce tighter controls over budget execution including through curtailing carryover of unused budget appropriations, carry forward of future appropriations, earmarking of revenues, and unfunded expenditure commitments by line ministries, and excessive recourse to supplementary budgets. 	<ul style="list-style-type: none"> • Expand contingency funds at the line ministry level. • Ensure that new legislation introducing new spending is part of the budget preparation process or absorbed within ministerial budget ceilings during the year. • Ensure that supplementary budgets do not imply an increase in total appropriations. 	July 2009 report by MoF to Parliament announced tighter controls on carryovers, reduction in the earmarking of revenue, and limitations on the use of supplementary budgets.
Performance management is only partially developed and is not integrated with the budget cycle.	<ul style="list-style-type: none"> • Require an independent audit of the achievement of the annual fiscal policy targets 	<ul style="list-style-type: none"> • Widen the scope of INAO's audit to verify the consistency of both fiscal plans and outturns with the government's overall fiscal framework. • Rate ministries and agencies on the basis of their financial management. 	July 2009 report by MoF to Parliament invited INAO to report on achievement of fiscal policy targets at the end of each budget year.

Source: FAD TA Report: "Iceland – Strengthening the Budget Framework."

1/ Based on FAD TA recommendations.

Table 13. Iceland: Access and Phasing Under the Stand-By Arrangement, 2008–11 1/

Date Available	Purchases		Conditions include
	SDR mns	Percent of quota	
November 2008	560	476.2	Board approval of arrangement
28 October 2009	105	89.3	First review completion and observance of end-December 2008 PCs
15 December 2009	105	89.3	Second review completion and observance of end-October 2009 PCs
15 July 2010	105	89.3	Third review completion and observance of end-May 2010 PCs
25 November 2010	105	89.3	Fourth review completion and observance of end-September 2010 PCs
25 February 2011	140	119.0	Fifth review completion and observance of end-December 2010 PCs
25 May 2011	140	119.0	Sixth review completion and observance of end-March 2011 PCs
15 August 2011	140	119.0	Seventh review completion and observance of end-June 2011 PCs
Total	1400	1190.5	

Source: IMF staff estimates

Table 14. Iceland: External Financing Requirements and Sources, 2010–15

(In billions of US dollars)

	2010	2011	2012	2013	2014	2015
	Proj	Proj	Proj	Proj	Proj	Proj
A Gross Requirements	9.1	9.1	12.4	5.7	6.1	6.0
Current account deficit	-0.2	-0.3	0.2	0.1	0.1	0.0
Amortization (MLT)	2.7	2.1	4.2	1.2	1.4	1.3
Official (excl. IMF)	1.4	1.2	0.5	0.3	0.4	0.4
Deposit insurance loans	0.1	0.0	3.2	0.2	0.4	0.4
Private	1.3	1.0	0.5	0.7	0.6	0.5
Short-term debt	6.6	7.3	8.0	4.5	4.6	4.6
B Sources of Financing	6.4	8.4	12.8	6.3	6.5	6.4
Foreign Direct Investment (net)	-0.1	1.5	1.2	0.7	0.5	0.5
FDI outflows Abroad	0.1	0.8	0.1	-0.1	-0.1	-0.2
FDI inflows to Iceland	-0.2	0.8	1.1	0.7	0.6	0.6
Net inflows of equity and other capital	0.5	-0.1	-0.2	0.1	0.2	-0.1
Disbursements (MLT)	1.0	0.8	1.3	1.2	1.5	0.7
Short-term debt	7.8	7.0	5.1	4.6	4.6	4.3
Other net assets	0.2	0.0	0.4	0.5	0.6	0.5
Reserves accumulation (-: increase)	-3.0	-0.8	5.0	-0.8	-0.9	0.5
C Financing Gap (A-B)	2.7	0.7	-0.4	-0.6	-0.5	-0.5
Errors and omissions	0.5	0.0	0.0	0.0	0.0	0.0
Accumulation of arrears	-5.3	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing	7.4	0.6	-0.4	-0.6	-0.5	-0.5
Fund	0.5	0.6	-0.4	-0.6	-0.5	-0.5
Bilateral (earmarked/ non-cash)	5.3	0.0	0.0	0.0	0.0	0.0
Other identified new financing	1.7	0.0	0.0	0.0	0.0	0.0
Residual Financing gap	0.0	0.0	0.0	0.0	0.0	0.0

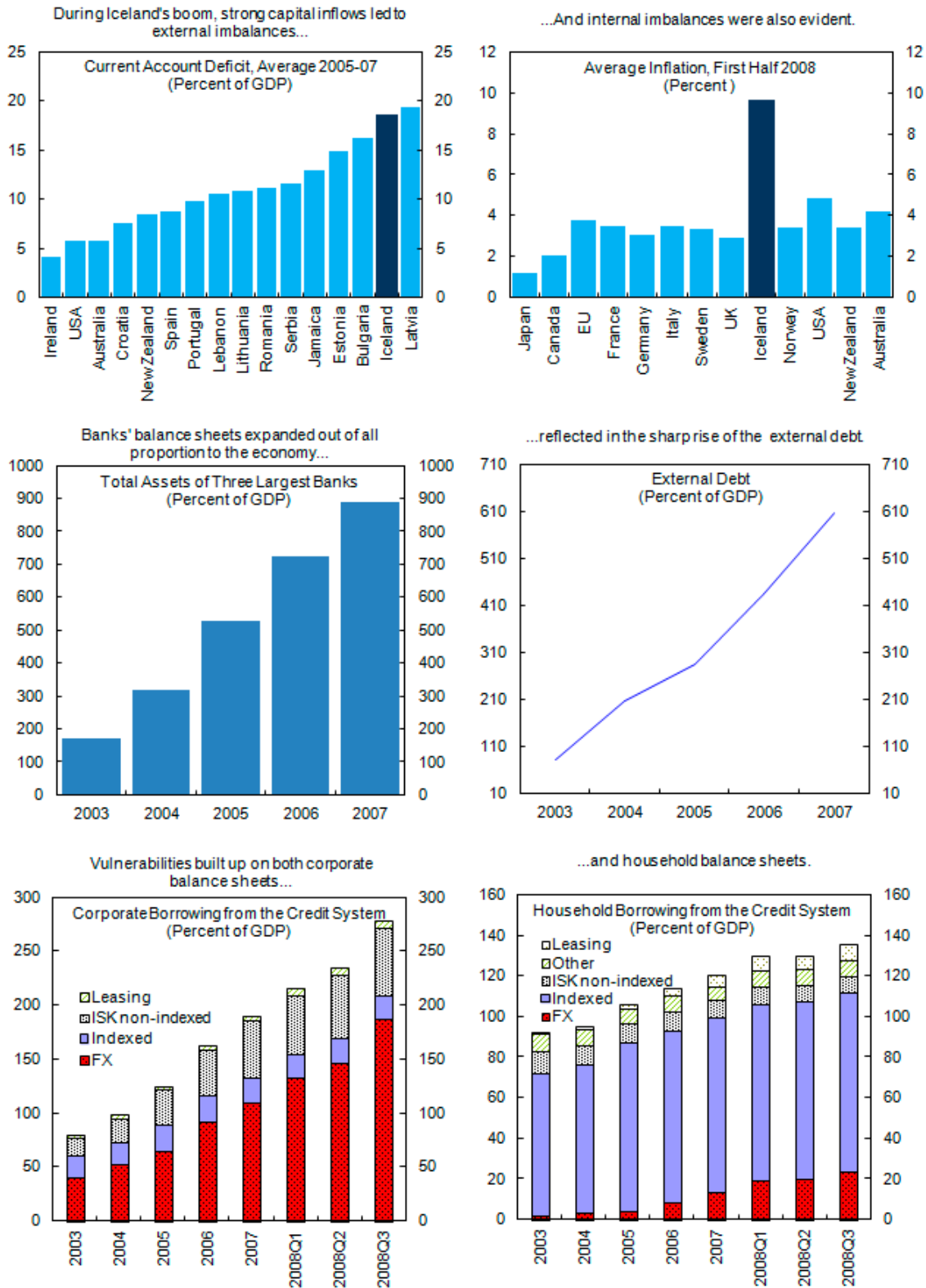
Sources: CBI; and IMF staff estimates.

Table 15. Iceland: Indicators of Fund Credit 2008–15
(in millions of SDR)

	2008	2009	2010	2011	2012	2013	2014	2015
Existing and prospective Fund credit								
Disbursements	560	105	315	420	0	0	0	0
Stock	560	665	980	1400	1120	748	433	105
Obligations	0	10	17	34	317	399	330	333
Principal (repurchases)	0	0	0	0	280	372	315	328
Charges and interest	0	10	17	34	37	27	15	5
Stock of existing and prospective Fund credit								
In percent of quota	476	565	833	1190	952	636	368	89
In percent of GDP	5.1	8.7	11.5	15.5	11.9	7.6	4.1	1.0
In percent of exports of G&S	11.6	16.5	20.8	28.9	22.5	14.0	7.6	1.7
In percent of gross reserves	24.3	27.1	21.2	27.2	53.7	28.3	13.3	3.5
Obligations to the Fund from existing and prospective Fund arrangements								
In percent of quota	0	8	15	29	269	339	281	283
In percent of GDP	0.0	0.1	0.2	0.4	3.4	4.0	3.2	3.0
In percent of exports of G&S	0.0	0.2	0.4	0.7	6.4	7.5	5.8	5.5
In percent of gross reserves	0.0	0.4	0.4	0.7	15.2	15.1	10.1	11.2

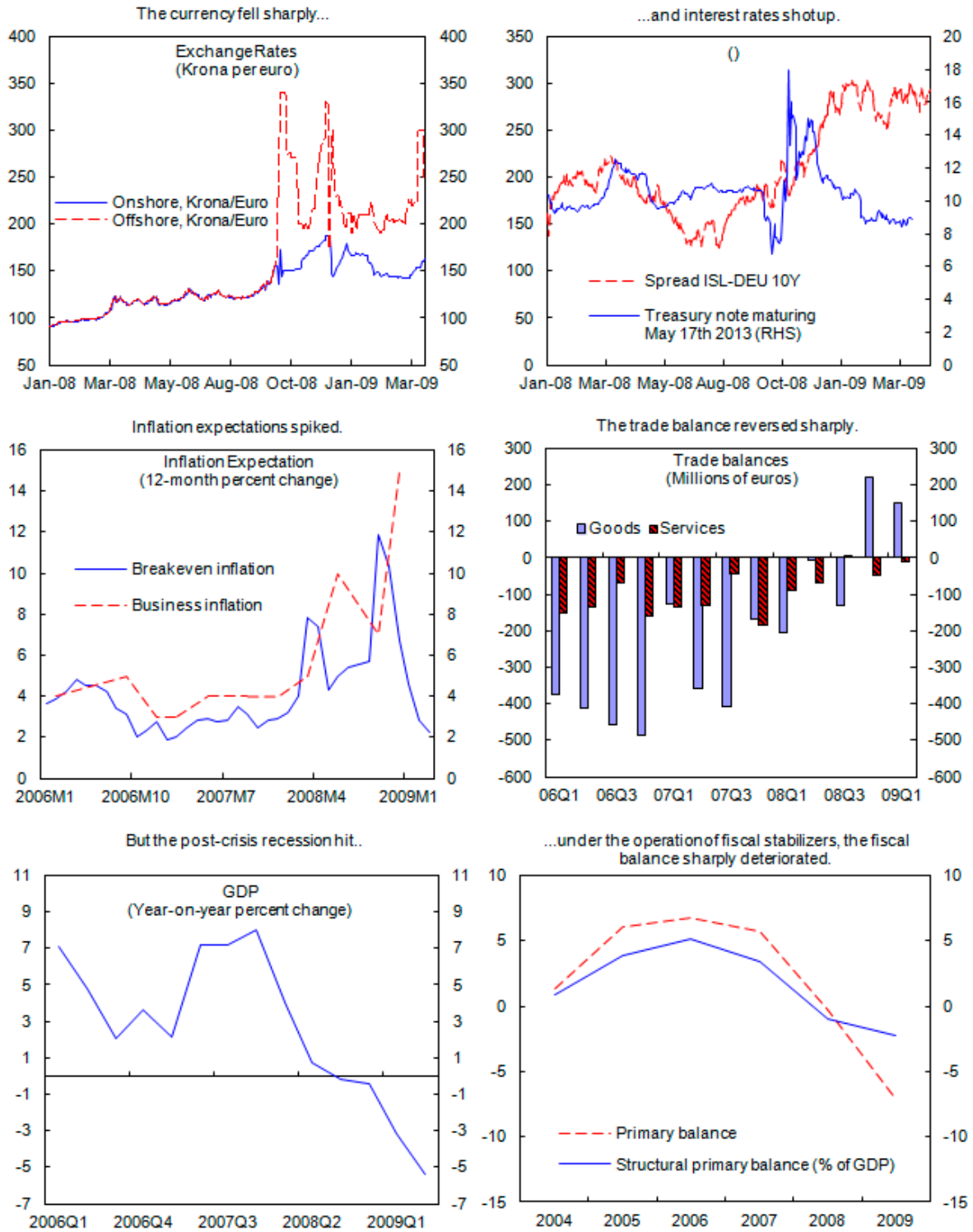
Source: IMF staff estimates and projections.

Figure 1. Iceland: Pre-Crisis Developments



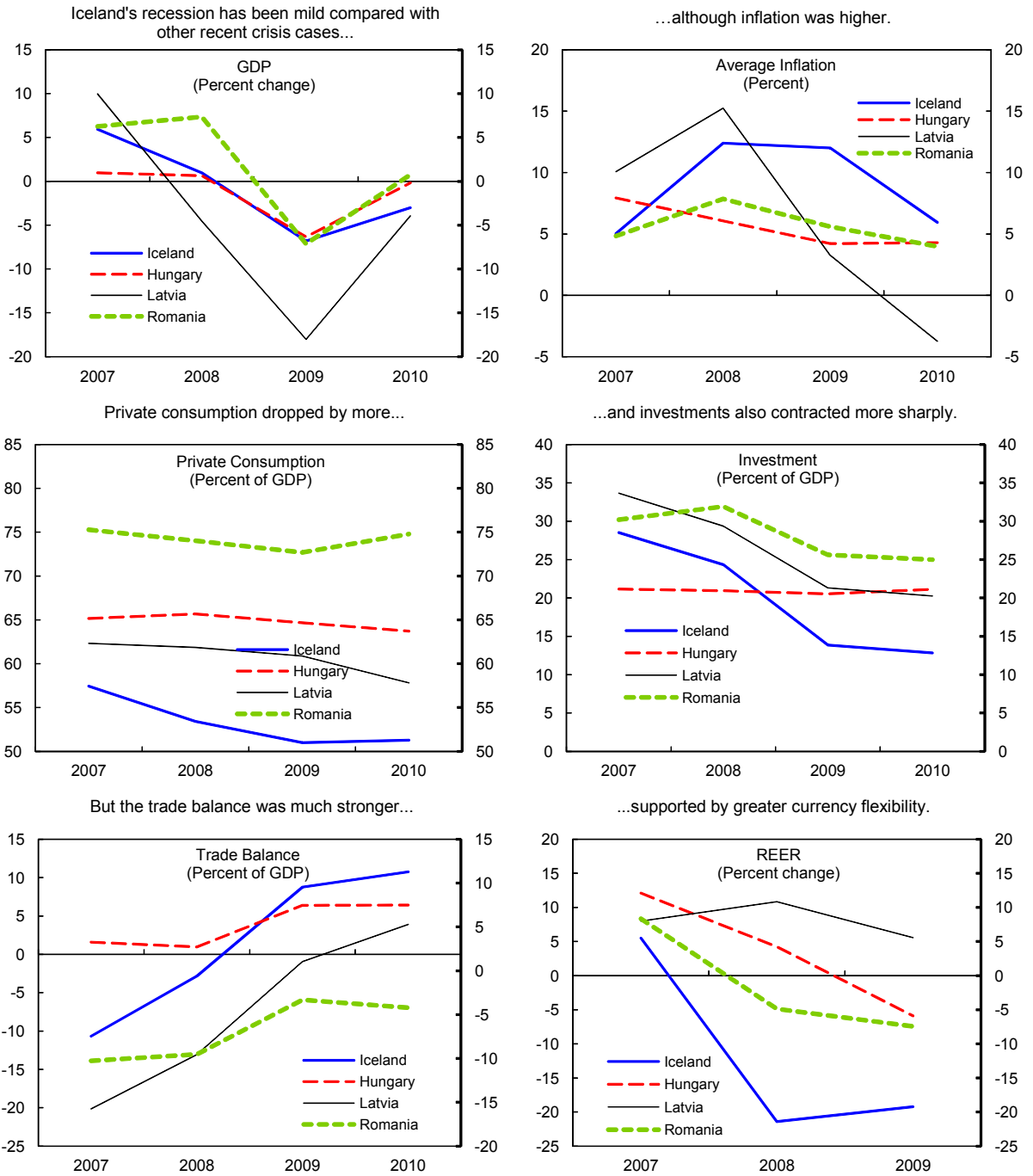
Sources: Statistics Iceland and CBI.

Figure 2. Iceland: Aftermath of the Crisis



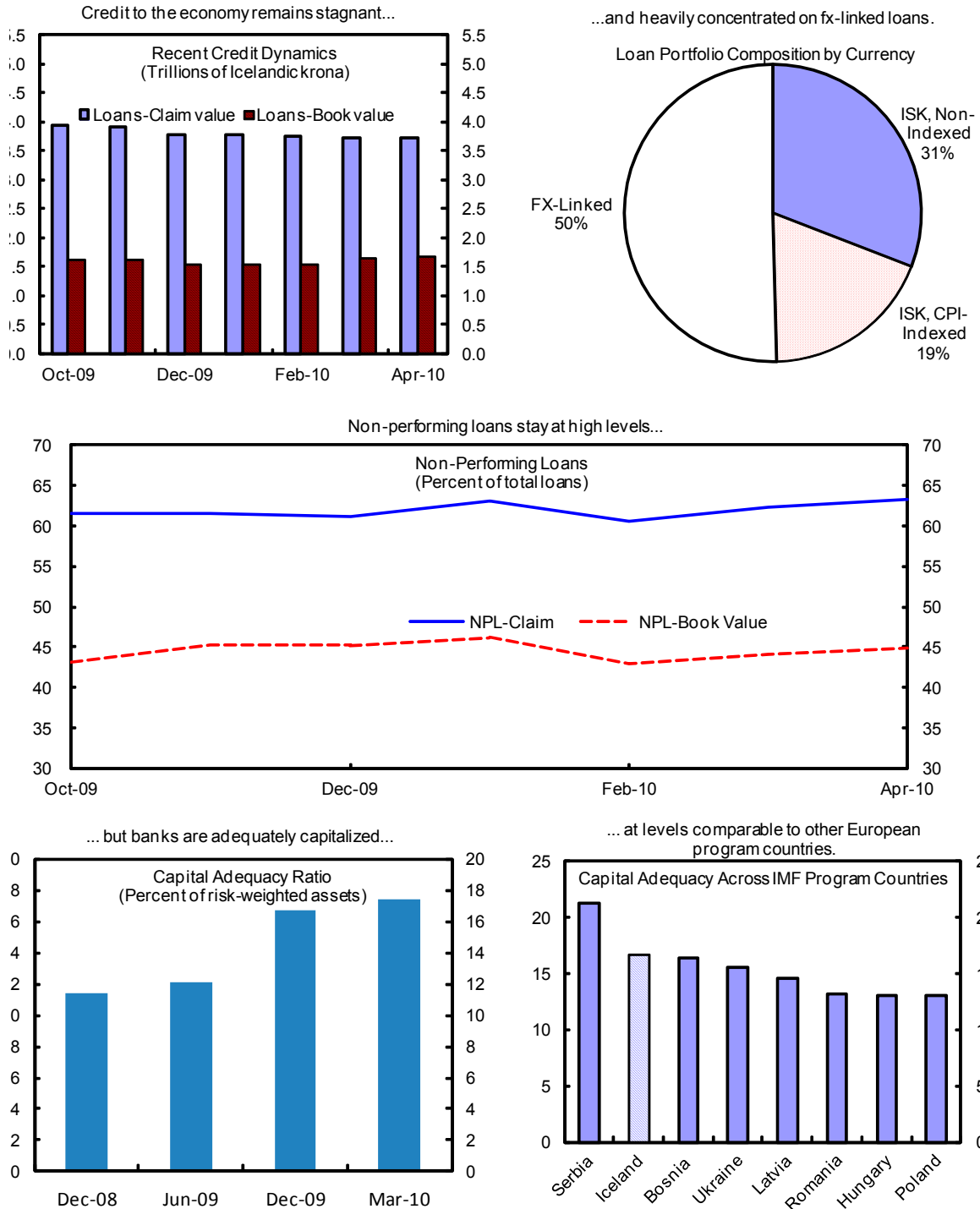
Sources: Statistics Iceland and CBI.

Figure 3. Iceland: Macroeconomic Developments Compared to Recent Crisis Cases



Sources: WEO and staff projections

Figure 4. Iceland: Financial Sector Developments



Sources: FME, and staff estimates.

Figure 5. Iceland: Fiscal Performance

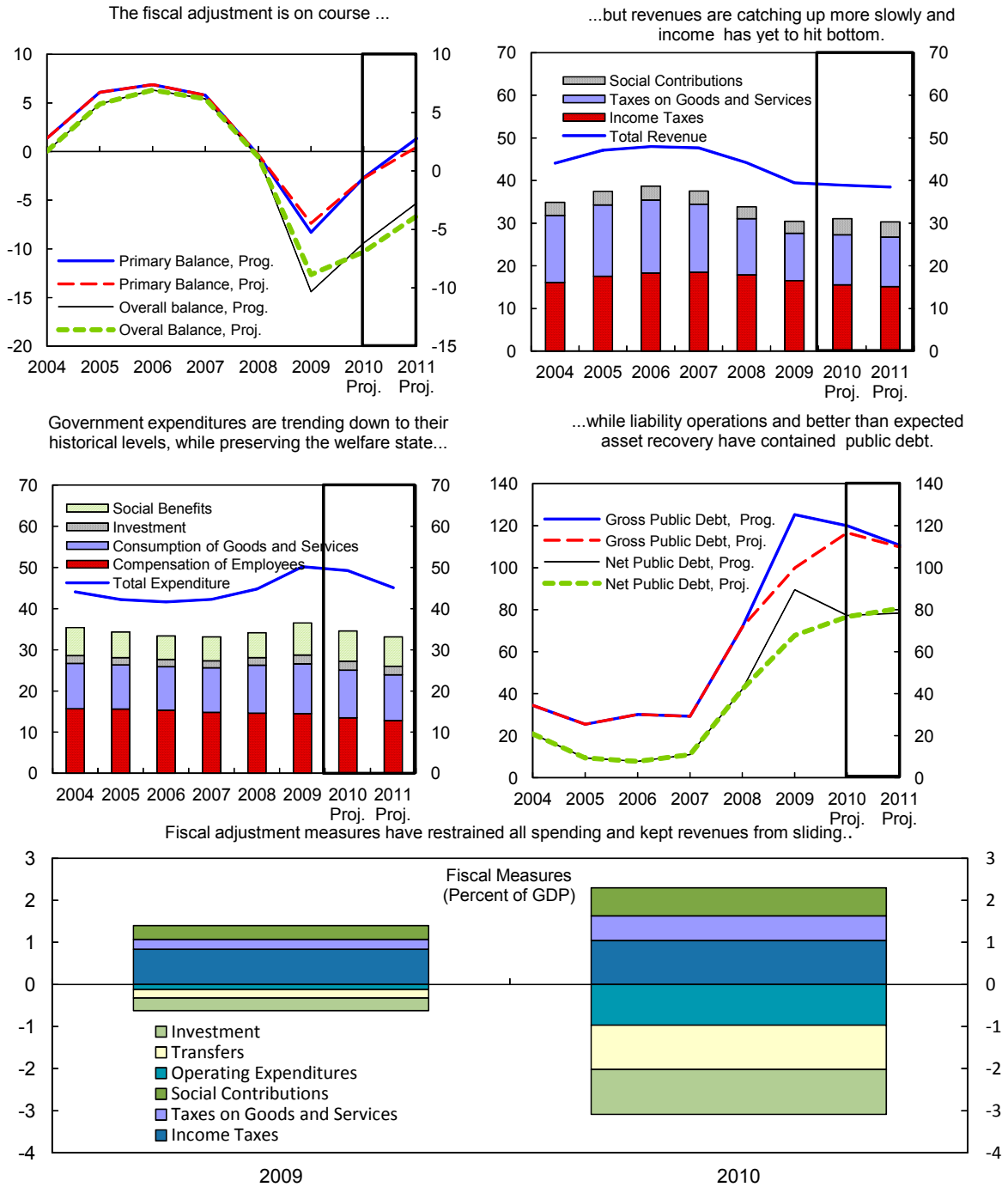
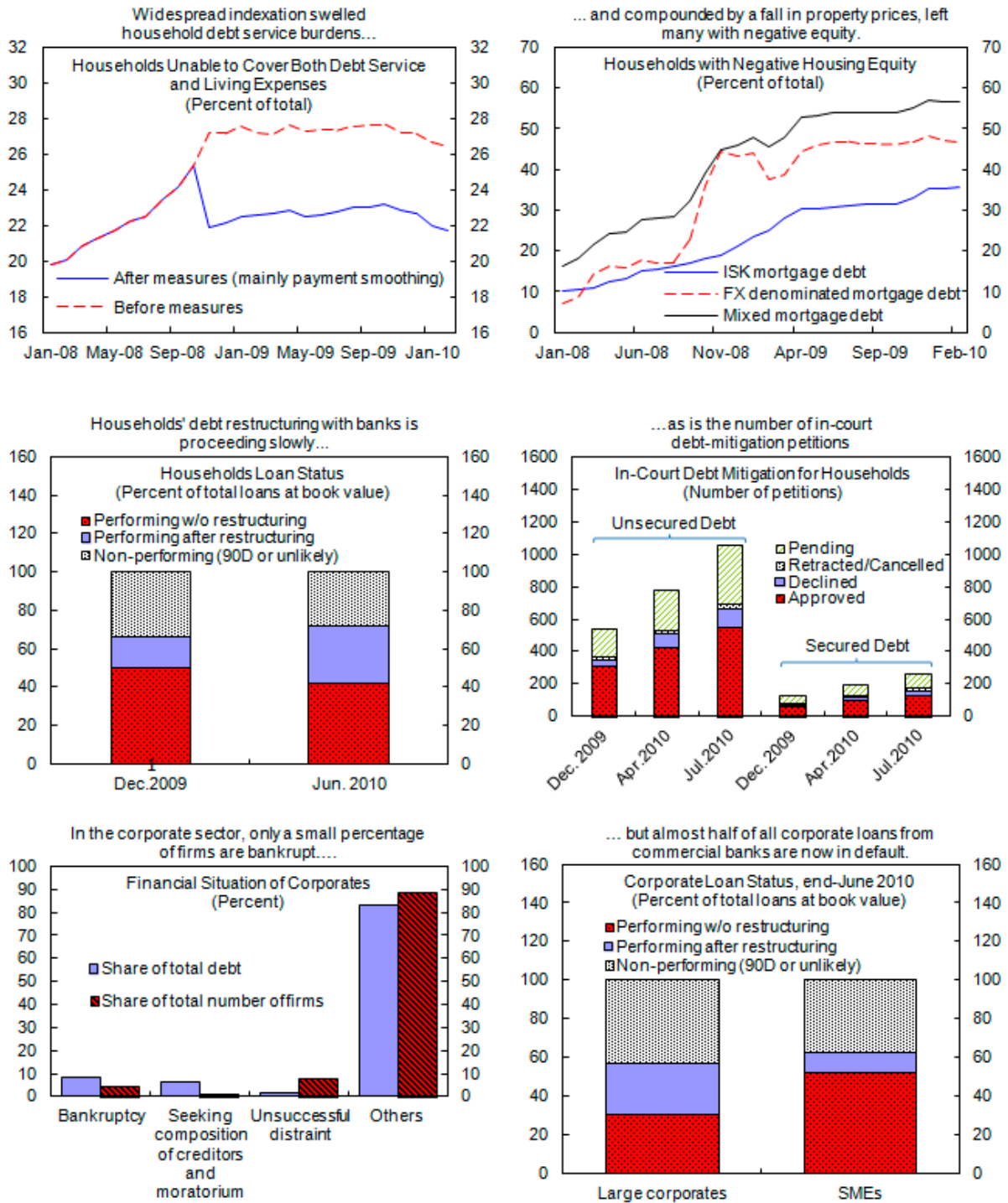
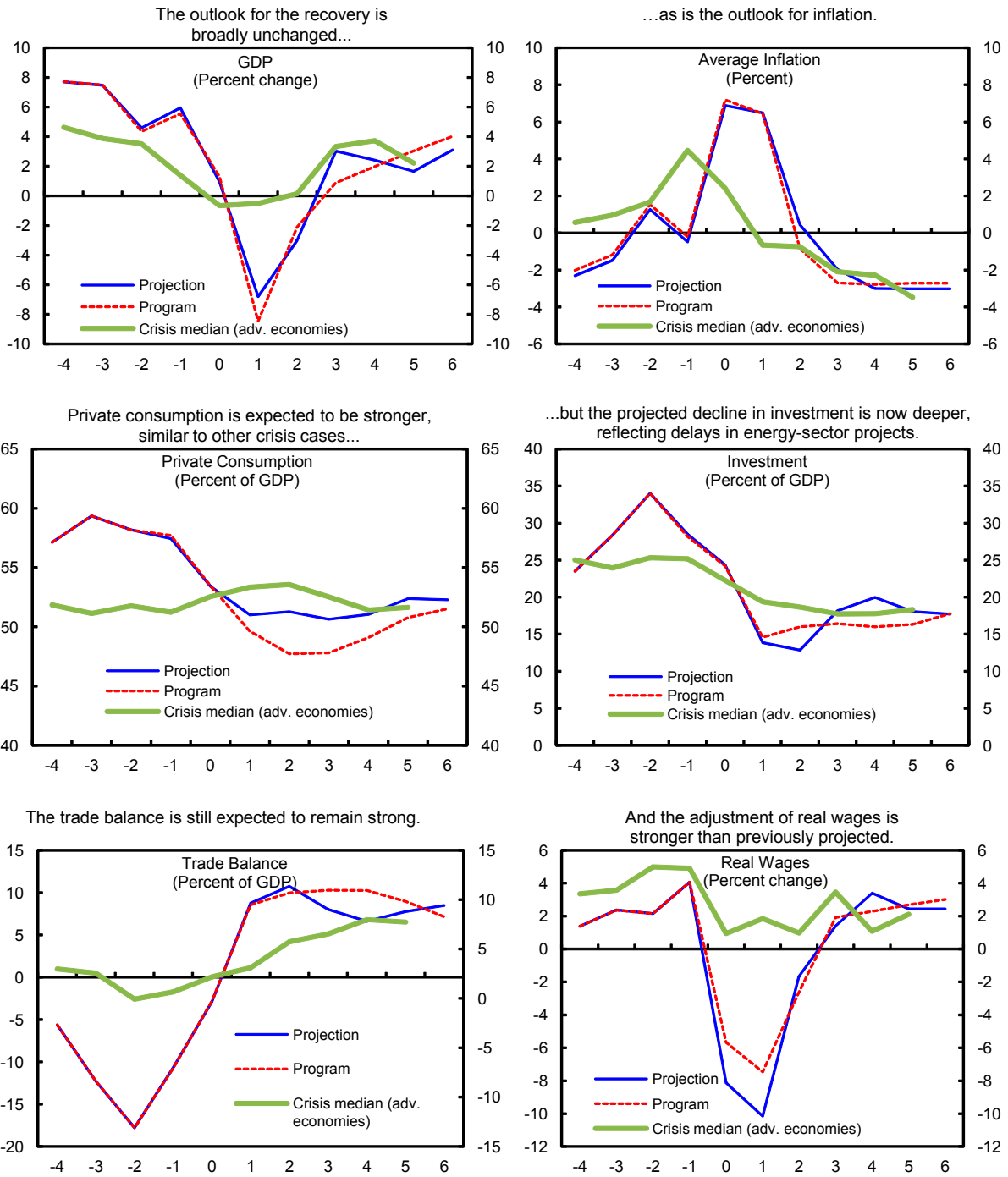


Figure 6. Iceland: Debt Restructuring Process



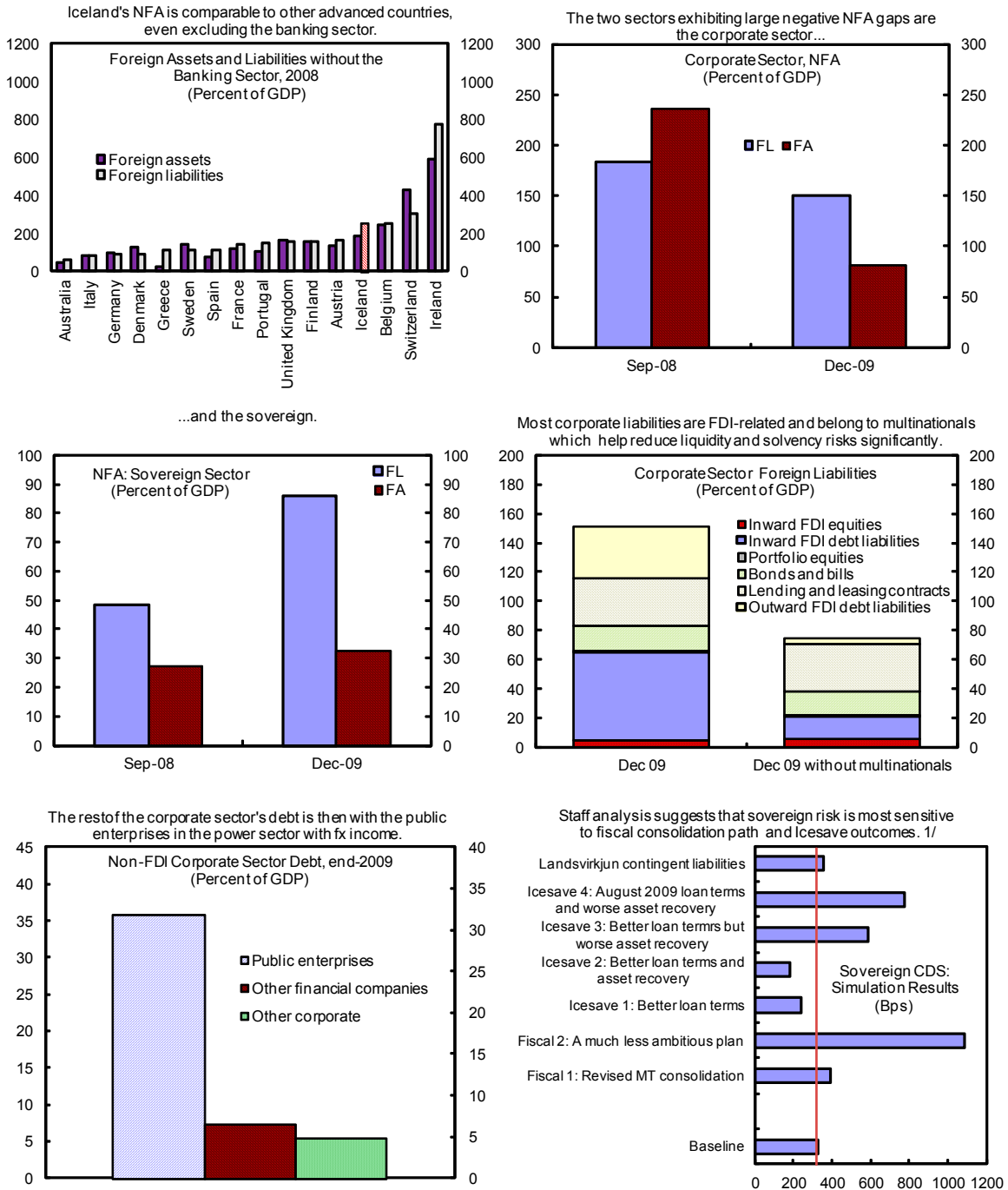
Sources: FME, CBI, and staff estimates.

Figure 7. Iceland: Macroeconomic Outlook Compared to the Original Program and Other Crisis Cases



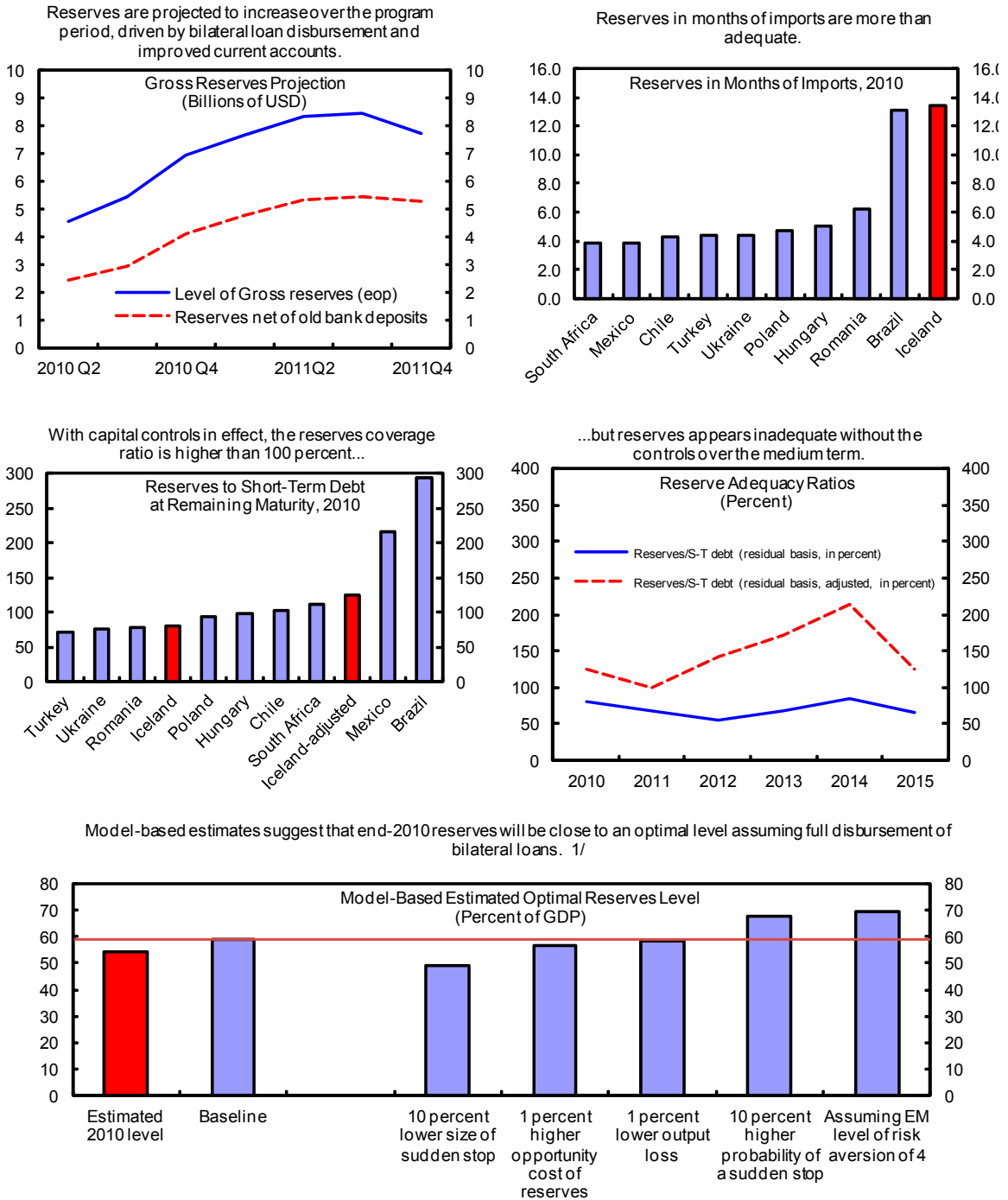
Sources: Program documents and staff projections.
 Notes: Crisis year = 0. Advanced crisis countries include Finland, Norway, Sweden and Spain.
 Dates of the crisis defined as in Laeven and Valencia (2008) (2008 for Iceland).

Figure 8. Iceland: External Debt and Balance Sheet



Sources: CBI, IMF and staff estimates.
 1/ Simulation scenarios for fiscal consolidation compares the baseline (second review) with the latest revised plan and a much less ambitious plan (primary surpluses of 0.6 percent of GDP for the medium term). Icesave scenarios include better loan terms compared to the August 2009 agreement and better (100 percent) and worse (50 percent) asset recovery rate compared to the baseline (88 percent). Landsvirkjun scenario considers a 10 percentage points increase in Aluminum price volatility and a 30 percent fall in Landsvirkjun's asset value.

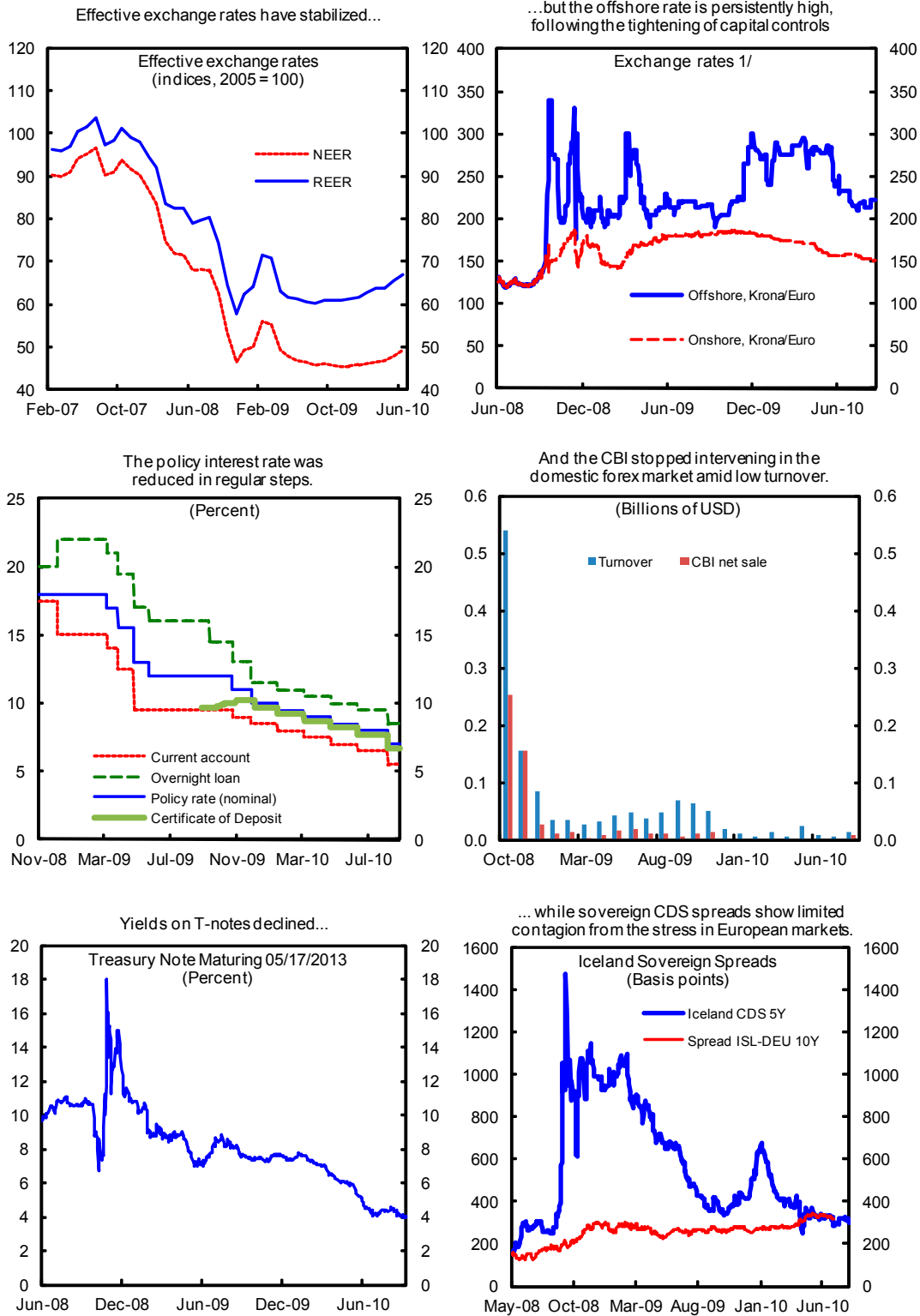
Figure 9. Iceland: Reserve Adequacy Metrics



Source: CBI and staff estimates.

1/ Model-based estimates are based on Jeanne and Ranciere (2006). The model calibrates optimal reserves level for a small open economy that may be hit by a sudden stop in capital inflows, and maintains a stock of reserves to smooth the impact of the sudden stop on domestic absorption. Baseline optimal reserves level assumes: 74 percent of GDP in the size of sudden stop (short-term external debt), 10 percent probability of a sudden stop, 6.5 percent output loss, 3 percent potential output growth, 6 percent opportunity cost of reserves and a relative risk aversion parameter of 2 (higher number means higher risk aversion). Emerging markets usually observe higher risk aversion level than advanced countries (see Salman (2005) for example).

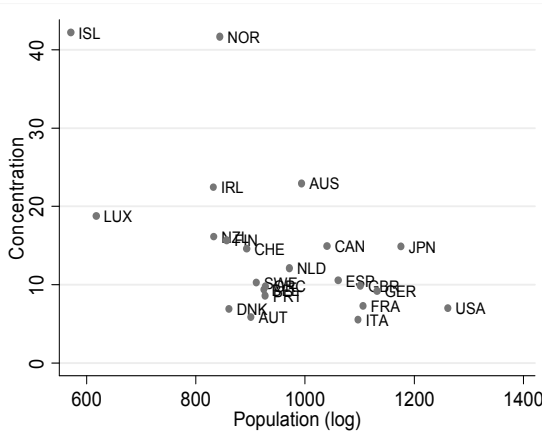
Figure 10. Iceland: Financial and Asset Markets Developments



Source: Central Bank of Iceland, Bloomberg, and DataStream.
 1/ Onshore volatility calculated as a 1-month moving standard deviation.

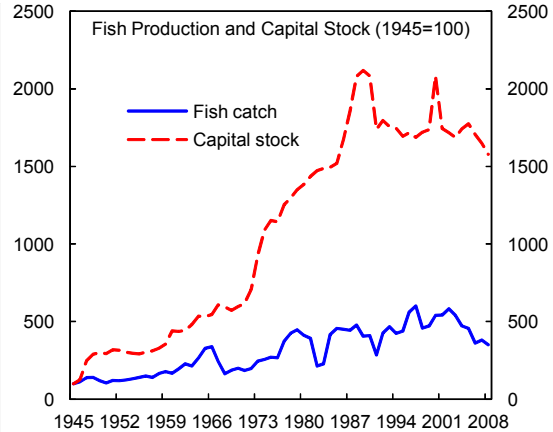
Figure 11. Iceland: The Growth Challenge

Iceland exports are heavily concentrated in fishery and aluminum products.

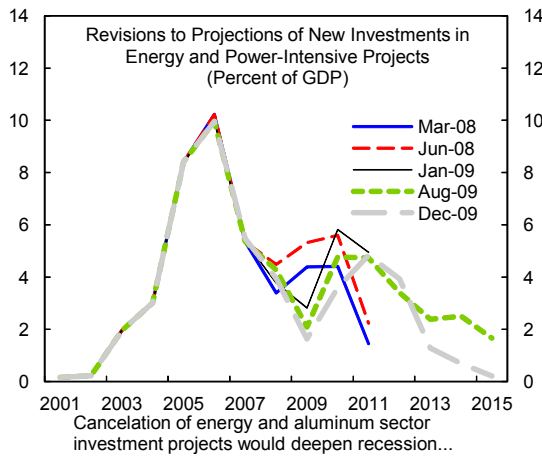


...and aluminum investment projects face delays because of financing constraints and administrative hurdles...

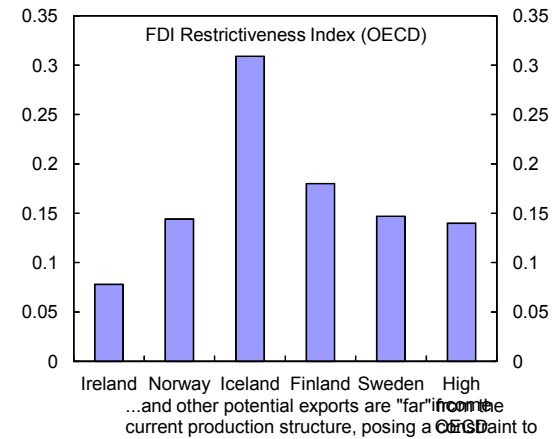
Further expansion of fishing is limited by sustainability concerns...



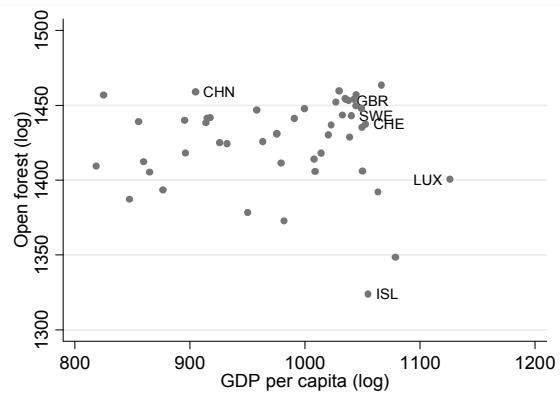
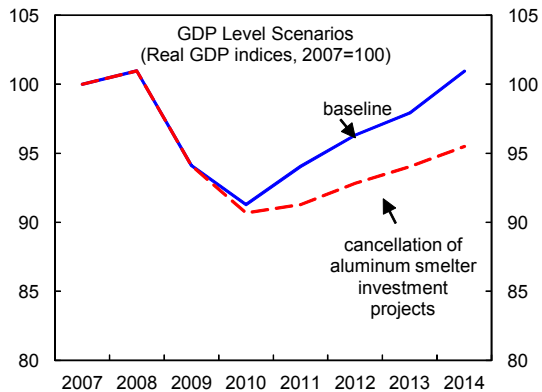
...and strict restrictions on foreign participation.



Cancellation of energy and aluminum sector investment projects would deepen recession...



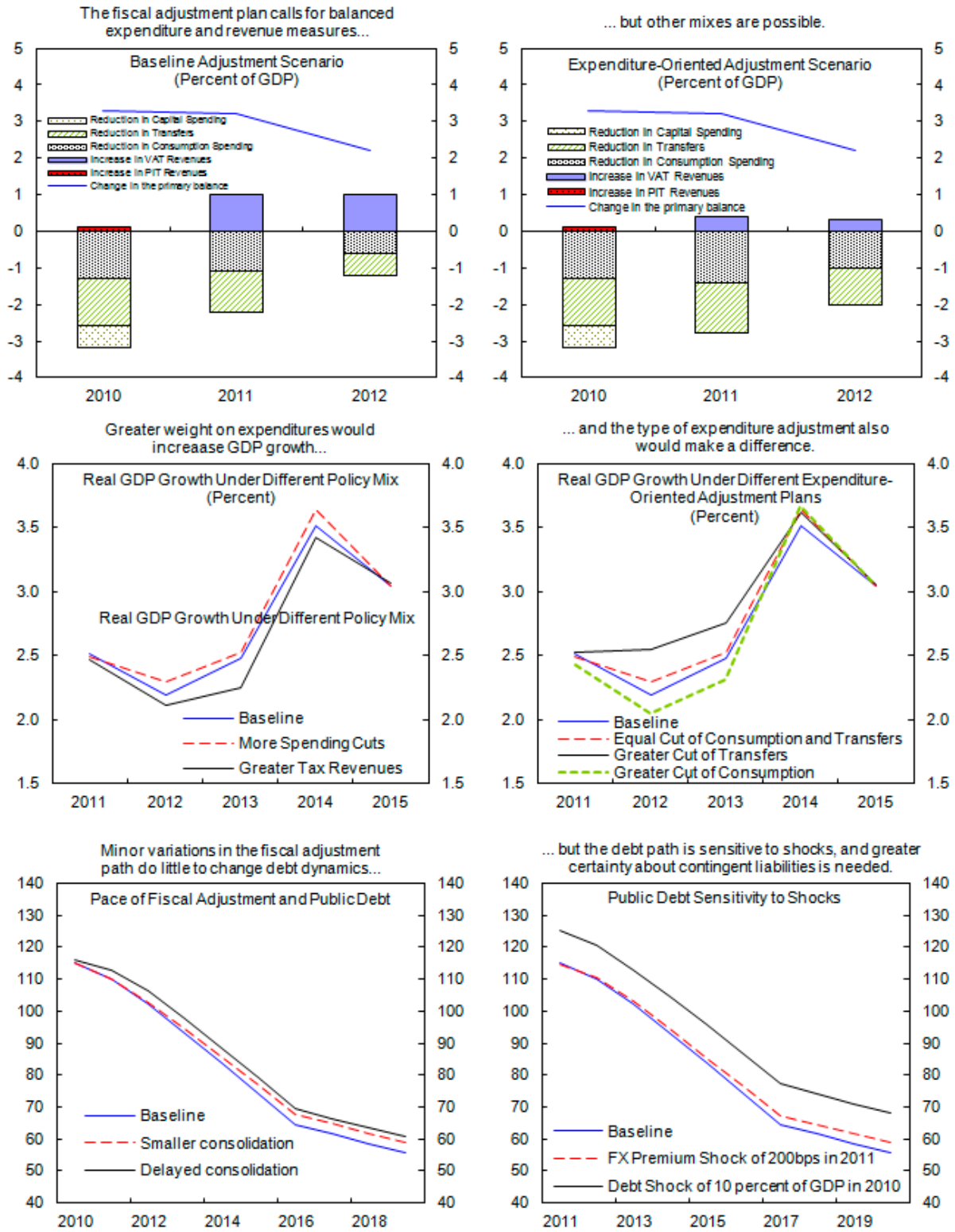
...and other potential exports are "far" from the current production structure, posing a constraint to



Source: CBI, Statistics Iceland, OECD, WDI, PWT, and Staff calculations.

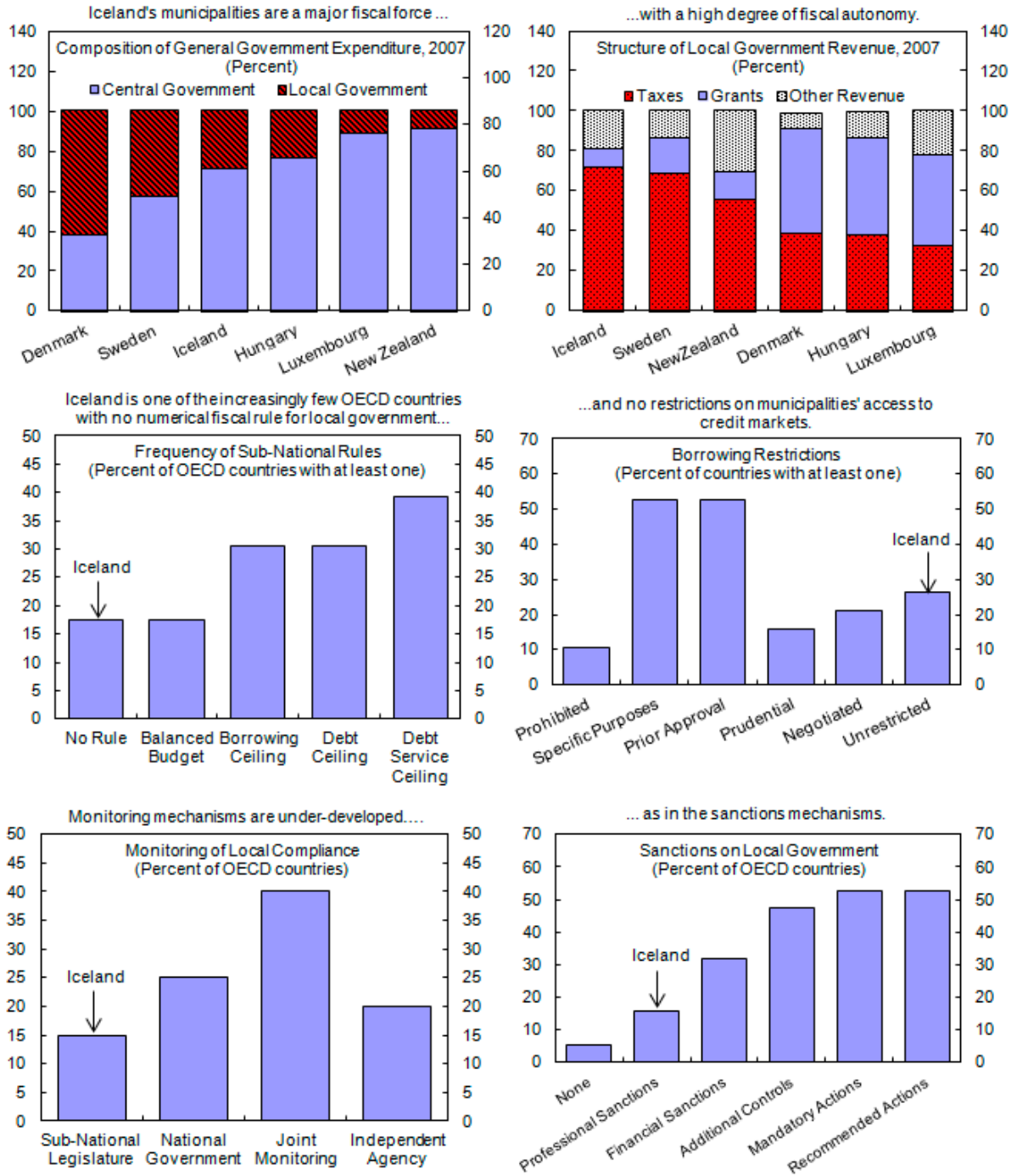
Notes: Export concentration is measured by Herfindahl-Hirschmann export product concentration index; "Open forest" is an index measuring how close the current export basket is from profitable new exports.

Figure 12. Iceland: The Fiscal Consolidation Challenge



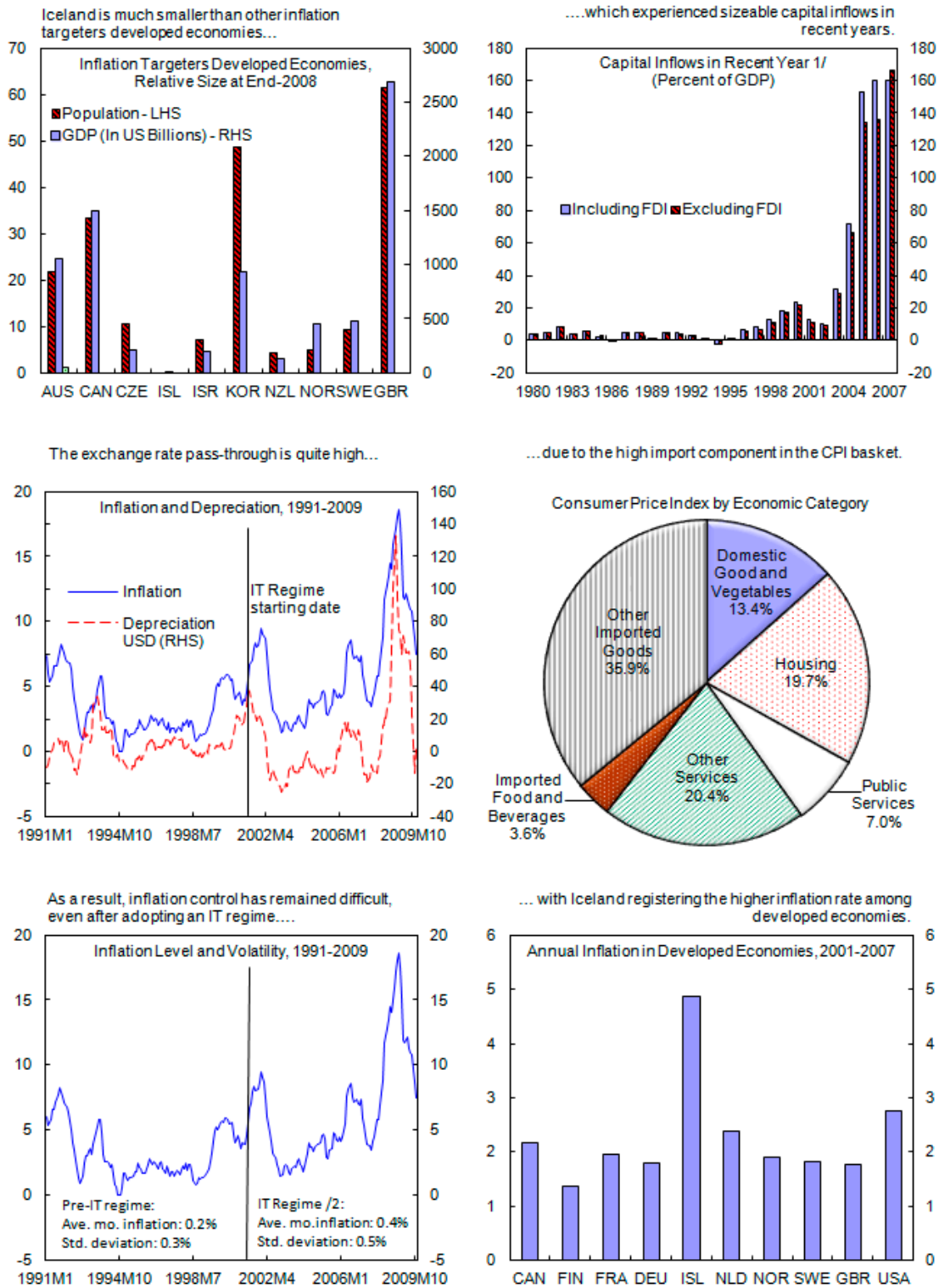
Source: IMF staff estimates.

Figure 13. Iceland: Fiscal Institutions in International Context



Source: OECD and Fund staff calculations.

Figure 14. Iceland: Experience with Inflation Targeting



Source: CBI, WEO and Staff calculations.
 1/ Sum of direct investment in reporting economy, other investment (liabilities) and portfolio investment (liabilities).
 2/ Until December 2007.

ATTACHMENT I. LETTER OF INTENT

Reykjavik, September 13, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington D.C., 20431
U.S.A.

Dear Mr. Strauss-Kahn:

- 1. Iceland's economic program is laying the foundation for a sustainable recovery.** Progress towards fiscal consolidation has been reflected in improving confidence, falling debt spreads and an appreciating krona. The post-crisis recession eased in the fourth quarter of 2009, unemployment appears to have peaked, and while the economy faces headwinds, we expect a durable but gradual recovery to take hold in the second half of 2010.
- 2. Our policy implementation remains broadly on track.** All end-May performance criteria have been met. The end-June structural benchmark concerning the passage of legislation to strengthen the framework for household debt restructuring has also been met. Although we have taken steps to intervene in weak savings banks, as discussed below their recapitalization, a structural benchmark for end-May, has been delayed to account for the impact of a recent court decision. The status of all program measures is summarized in Tables 1 and 2.
- 3. On this basis, we request completion of the third review under the Stand-By Arrangement.** As set out in Table 1, we request that ceilings and floors for the quantitative performance criteria under the arrangement be modified for end-September 2010, and established for December 31, 2010, and that indicative targets be set for March 31, 2011 and June 30, 2011. As detailed below, we also propose two new structural benchmarks covering bank recapitalization and authorization for bond issuance in support of bank recapitalization (Table 2).
- 4. We believe that the policies set forth in this and previous letters will deliver the objectives of our program.** We stand ready to take any further measures that may become appropriate for this purpose. We will consult with the Fund on the adoption of any such measures and in advance of revisions to the policies contained in this letter, in accordance with the Fund's policies on such consultation.

The outlook

5. **Iceland's economy is beginning to emerge from recession, and a gradual recovery remains our expectation:**

- The outlook for real GDP growth remains broadly unchanged, with a durable but gradual recovery expected to take hold in the second half of 2010. Economic activity broadly stabilized at the end of 2009, driven by strong exports and a recovery in consumption. However, continued delays in large investments projects and the impact of the spring volcanic eruption on tourism have led to a temporary setback during the first half of 2010. Deleveraging and external demand remain the key downside risks. Upside could conversely be realized through higher investment, particularly in the now competitive tradables sector, and we are committed to removing obstacles to investment.
- We expect the headline 12-month end-period inflation rate to continue to decline. It should reach 4 percent by end-2010 and 2–3 percent in 2011. Significant slack in the economy helps, but our cautious monetary policy, which has contributed to a gradual appreciation of the krona, has been crucial towards disinflation. Risks to the outlook emanate from possible wage increases in export sectors spreading to non-tradables sectors, and from still volatile inflation expectations. To attenuate these risks, the government is committed to discuss a new stability pact with our social partners, with a view to reach an agreement by end-September.
- The outlook for the balance of payments is strong. Over the next 12 months, we expect continued reserve accumulation due to a continuing trade surplus and the realization of program financing. Looking further ahead, our asset and liability management transactions (paragraph 6) have markedly reduced debt service through 2012. Overall, our reserve coverage stands at a healthy 125 percent of short term debt (by residual maturity, adjusted for continuing capital controls).

6. **While Iceland's gross debt levels remain high, they are being addressed.** We have significantly reduced both gross and net external and public debt through the purchase of a Luxemburg-based holding company and its assets, comprised of krona deposits and Icelandic government and government guaranteed bonds ("Avens"); and through direct Eurobond repurchases from the market. We expect continued declines in gross public and external debt over the medium term, but levels will remain high for the time being, with gross general government debt expected to peak at about 120 percent of GDP in 2010, and gross external debt projected to amount to 280 percent of GDP in 2010. The high debt ratios pose risks, which are attenuated somewhat by significant public and external assets (the net international position amounts to only -30 percent of GDP at end-March 2010). Remaining risks can be managed through firm implementation of the program, including the policies laid out below.

Restoring the financial system

7. **A ruling by Iceland's Supreme Court has required us to revisit the issue of recapitalization of banks.** The three new commercial banks were set up with significant capital buffers, and all exceeded the regulatory minimum prior to the ruling. However, capital levels will be affected by the decision (which stated, among other things, that foreign exchange indexation clauses in domestic currency loans are illegal). The ongoing strategy and timetable to restore the solvency of Byr and SpKef (successors to savings banks intervened in April) has also been affected by the court ruling. To preserve market confidence in the financial system and protect depositors, while encouraging bank owners to bring new capital in (thus minimizing fiscal costs), the following steps will be taken:

- *Assessment.* The FME has asked banks and savings banks to assess potential losses on their pool of fx loans. The loans have been provisionally classified as probably affected by the ruling, possibly affected by the ruling, and not likely to be affected. A legal audit of banks' loan contracts, to be completed by end-September, will help refine the classification, and the classification will be updated as necessary, as court rulings bring further clarity.
- *Accounting for losses.* The FME will require banks to fully provision likely losses on probably affected loans by end-October. To the extent court rulings establish additional probably-affected loans (as losses on possibly affected loans crystallize), we will require these loans to be provisioned fully and immediately.
- *Recapitalization of the three new commercial banks.* Banks will be required by end-October to commit to a credible plan to meet within 60 days: (i) minimum regulatory capital requirements; and (ii) at least 6 percent total tier I capital to risk weighted assets (after deducting from capital potential losses on possibly affected loans). The FME will adopt a decision on all three banks' plans by November 15 (a **structural benchmark**). In the event that subsequent court decisions crystallize possible losses, banks would have 2 weeks to present revised credible plans to meet these targets, and a new 60 day period would be provided to meet the targets.
- *Government participation in recapitalization.* If any of the three new commercial banks cannot demonstrate that they will be able to meet their capital requirement within the designated time frame, or proves unable to do so, we will support their recapitalization by injecting tier I capital using an instrument that will be structured to isolate the government from initial impact of potential future losses (for instance, preferred shares). Recapitalization could have a substantial cost to the government and taxpayers, but it is a cost that will have to be borne to preserve financial stability.

To facilitate potential recapitalization, the 2010 supplementary budget, which we will submit to Parliament by October 15, will: (i) authorize sufficient bond issuance to cover the recapitalization need if losses on all probably affected and possibly affected loans are realized; and (ii) enable the Ministry of Finance to recapitalize the banks in amounts needed (on the request of the Icelandic State Bank Agency which will manage, on behalf of the government, any shares acquired (a **structural benchmark**). We anticipate that this supplementary budget will be considered by Parliament by mid-November. Enactment would ensure that funds are available if government participation in recapitalization becomes necessary at this early juncture. The authority to issue sufficient bonds will be renewed in the 2011 budget.

- *Recapitalization schedule for Byr and Keflavik.* By end-September we aim to complete negotiations with the Resolution Committees on recapitalization plans. The plans would account for losses on loans that are affected by the Supreme Court ruling, and would require enough capital to address losses from loans that may possibly be affected by future rulings. If agreements cannot be reached, new asset valuations would be undertaken to prepare the ground for recapitalization by the government. In either case we expect that by end-December these institutions will meet FME capital requirements.
- *Reducing uncertainty.* It is in the interest of both lenders and borrowers to reduce the uncertainty surrounding the status of foreign currency linked loans, and this would also contribute to better macroeconomic performance. To this end we will identify any remaining legal uncertainties regarding foreign currency linked loans, and address them in a manner that protects the government from absorbing private sector losses.

8. **We are working to address bank balance sheet vulnerabilities.** This will set the stage for a durable renewal of lending:

- *Updated prudential rules.* On the basis of the recently passed amendments to the banking legal framework, by end-October the FME will strengthen prudential rules, including on connected parties, large exposures, foreign exchange lending, and liquidity.
- *Revised business plans.* By end-December 2010, the FME, with technical support of an internationally recognized consulting firm, will assess progress made by banks in reducing operational, risk management and governance gaps, and in addressing the capital implications of the Supreme Court ruling on foreign exchange loan indexation clauses, and sign off on the revised business plans submitted by the institutions.
- *Implementation.* On the basis of revised business plans, the FME will negotiate a timetable on quarterly targets with banks covering the gradual reduction of remaining

financial imbalances, restructuring of their operations, and adjustment of their credit exposures and liquidity positions to the new prudential regulations (if they are not already in compliance).

9. **We are also working to address weaknesses in the non-bank sector:**

- *The Housing Finance Fund (HFF)*. By end-September, we expect to formulate a rehabilitation and recapitalization plan based on the HFF's business plan. This will cover, inter alia: (i) recapitalizing the HFF by end-December 2010, by injecting enough marketable government securities to keep its capital above the regulatory minimum for the period defined by its business plan; and (ii) the establishment of a timetable for harmonizing capital and other requirements with those of other financial institutions.
- *Other non-bank financial institutions*. Since these institutions were affected by the Supreme Court ruling on foreign exchange indexed loans, the FME has requested an acceleration of the work on rehabilitation and recapitalization plans, following the requirements laid out above for commercial banks. For these other non-banks, public funds will not be available for recapitalization, and if they cannot identify corrective actions, they will be resolved in an orderly fashion.

Restoring private sector balance sheets

10. **We remain committed to a targeted, voluntary approach to debt restructuring.** Moreover, we are determined to see the work through to a conclusion as soon as possible and in particular to ensure that the frameworks we have designed for household and corporate debt restructuring function efficiently and productively. While we remain committed to simplifying the process, we have ruled out an across-the board debt write down (e.g., for borrowers not affected by the Supreme Court ruling on foreign exchange indexed loans). This reflects the enormous and unaffordable fiscal cost, the need to preserve an operating and stable banking system, and the detrimental impact this would have on Iceland's payment culture. We will continue to focus attention on the distressed borrowers who fortunately remain a minority of total borrowers.

11. **We have amended Iceland's voluntary framework for household debt restructuring** (meeting the end-June **structural benchmark**). Key aspects of the changes include the establishment of a Debtor's Ombudsman (to provide advisory and mediation services to debtors, and help address creditor hold-out problems); and the extension of the framework to several classes of solvent borrowers who have not previously been eligible (e.g., individuals having some debts arising from business activities). We have implemented changes to forced auctions to address market failures and have also clarified the conditions under which debtors can temporarily remain in a foreclosed home (they must pay market rent and can be asked to provide a guarantee against damages). Guidelines provide for a

minimum stay of 6 months (and longer if specific social criteria are met). Finally, we will encourage banks to offer debtors the option of short-selling their properties, and we have removed tax disincentives for households that receive relief.

12. **With the framework now finalized, our focus will be on encouraging greater participation by households.** We set up in August the new Debtors' Ombudsman's Office, and are scaling its operations up (including via outsourcing), and engaging in enhanced public outreach to explain the framework. This should help quickly guide debtors through the many options available to them. Finally, with the framework in place, we are proceeding as planned to remove temporary post-crisis measures—like the moratorium on home foreclosures—the continuance of which represent a barrier to debtor participation.

13. **We have made further progress in operationalizing a framework for voluntary corporate restructuring.** Banks have now developed and put in place general guidelines. The FME will also instruct banks to produce specific guidelines covering the treatment of small and medium sized enterprises (where a case-by-case approach would prove difficult to implement). A special committee will monitor and continuously report on the application of these guidelines, putting special emphasis on ensuring transparency and fairness. One by-product of the recent strengthening of supervisory oversight powers, and actions to strengthen banks' balance sheets, will likely be faster progress with restructuring. This would come both via the quarterly targets for eliminating remaining fx imbalances, and via a requirement for banks to adopt semi-annual audits (which will speed the FME's ability to detect loan losses associated with delays in debt restructuring, and thus speed up provisioning, giving banks a financial incentive to restructure).

14. **The insolvency regime has been refined.** Recent amendments to the Bankruptcy Act simplified and expedited in-court proceedings for restructuring agreements and liquidations; addressed operational issues arising in the context of cross border insolvency of companies; and ensured preservation of secured creditors' rights. A Committee on Procedural Law under the Ministry of Justice assessed whether there is a need to introduce additional changes to Iceland's insolvency regime to better expedite out-of-court restructurings. The Committee has concluded that such changes are not needed at this stage while recognizing that further assessments of specific measures could possibly be undertaken at a later stage based on the experience of a recently passed Danish Law (Act no. 718 of June 25, 2010).

Monetary Policy and Capital Controls: Preserving Currency Stability

15. **Given the recent krona strength and continuing balance of payments inflows, we will place increased emphasis on reserve accumulation.** A higher level of non-borrowed reserves will improve confidence in the economy (lowering debt spreads), and strengthen the CBI position ahead of the phase out of capital controls. The aim of the purchases will be to accumulate non-borrowed reserves, not to set a level or direction for the krona. The CBI began to undertake auctions beginning at end-August 2010, and these will continue on a

regular schedule. Initial purchases will be small, and will gradually mount over time in a manner tied to projected market conditions. The CBI may undertake additional purchase, via auctions if possible, in the event of large and irregular inflows into the market.

16. **Once the preconditions are in place, we will take the next step towards capital account liberalization.** Capital controls continue to be an essential tool to stem large-scale capital outflows which could destabilize the currency. However, they do represent an obstacle to higher investment in Iceland, and we are committed to careful removal of the controls, in a manner that preserves currency and financial system stability. Consistent with our liberalization strategy, the next step will involve lifting controls on long term assets. Assuming the balance of payments outlook remains unchanged, the next step can be taken once the banking system is deemed sufficiently strong (with enough liquidity to handle possible outflows, and sufficient capital to buffer against any losses). Any subsequent steps will be taken on the basis of the outcome of previous steps.

17. **We remain committed to effective enforcement of the capital control regime.** To help deliver continuing compliance as liberalization proceeds, we will ensure that enough resources are available to take cases from their initial stages of investigation right through court proceedings. As the capital control regime marginally affects the conversion and transfer of a certain component of current payments, namely interest on bonds (whose transfer the foreign exchange rules apportion depending on the period of the holding). We request temporary Fund approval of further retention of the measure that gives rise to the existing exchange restriction in line with Fund policies.

18. **The CBI's policy stance will be set to preserve currency stability and continued disinflation.** Currency depreciation brings with it significant inflation pass-through and additional balance-sheet stress, both of which must be minimized to secure Iceland's economic recovery. Looking ahead, each step towards capital control liberalization will increase the influence of monetary policy on the exchange rate, and we will thus need to ensure that Iceland's risk-adjusted interest rate differential is sufficient to preserve currency stability. We expect currency stability and Iceland's significant output gap to promote continued disinflation, but in the event of inflation persistence, will adjust our policy to attain end-year inflation objectives.

Fiscal Policy: Securing Public Debt Sustainability

19. **We are on track to hit our 2010 primary fiscal deficit target.** Government revenue collections are broadly on track, and central government spending remains below budget limits. The general government primary deficit should reach the targeted level of 2¾ percent of GDP in 2010 (an improvement of about 4¼ percent of GDP over 2009). Should revenues exceed targets during the second half of 2010, we will preserve the structural adjustment implicit in the 2010 budget targets.

20. **We aim to achieve a general government primary surplus in 2011.** Based on the updated forecasts for 2010, we are preparing the 2011 budget for the central government aiming at a general government primary surplus of $\frac{1}{2}$ percent of GDP (implying an adjustment of $3\frac{1}{4}$ percent of GDP). This is broadly in line with the planned adjustment in our medium-term consolidation plan ($3\frac{3}{4}$ percent of GDP); the slight reduction is to provide insurance against downside risks to domestic demand. We expect that local governments will deliver a balanced primary position, backed by a strengthened fiscal framework. The central government will therefore target a primary surplus of $\frac{1}{2}$ percent of GDP (implying a central government primary adjustment of $3\frac{1}{4}$ percent of GDP).

21. **A package of measures has been identified to help deliver the central government fiscal adjustment in 2011.**

- *Revenue measures.* These will yield about 0.6 percent of GDP, and include increasing the corporate income tax and capital income tax rates from 18 to 20 percent. The tax measures will mainly offset the impact of expiring one-off measures from the 2010 budget, but will also generate a small increase in the ratio of primary revenue to GDP.
- *Expenditure measures.* These will amount to 2 percent of GDP relative to the budget baseline for 2011 (and 3 percent of GDP measured against the projected 2010 outturn). The measures include no nominal wage or benefit increases; a 5 percent reduction of health, primary education, and police service costs; a $7\frac{1}{2}$ percent reduction in higher education costs; and a 9 percent reduction in general administrative costs (including through reduction in overtime, reorganizations, and contract renegotiations).

22. **We have updated our medium term fiscal consolidation plan.** We remain firmly committed to stabilizing the fiscal position by achieving a positive primary balance in 2011, a positive overall balance in 2012, and a significant general government primary surplus by 2013 (6 percent of GDP). To the extent that debt falls faster than expected and if contingent bank recapitalization liabilities prove to be contained, then we may revisit the medium-term targets. We have identified a number of options to help us achieve our targets. On the revenue side, the entire structure is under review, and technical assistance has identified several options including, among others, restoring aspects of the VAT system to their pre-crisis status; and improving the progressivity of the personal income tax. On the expenditure side, we remain committed to improving the progressivity of benefits.

23. **We will steadily improve our financial balance sheet.** We have increased issuance of long-term bonds, responding to investor appetite for longer maturities and in line with our objective of extending average time to maturity. To ensure that investors are aware of changes in our annual borrowing plan, we have published an update and have committed to announcing any further changes at the end of each quarter. Our recent repurchase of Eurobonds has helped smooth the profile of our external debt coming due. To prepare the

ground for a return to the international market, we will publish our medium-term debt management strategy. Consistent with our medium term debt strategy, we will maintain an adequate deposit buffer in our treasury single account. To the extent a surplus of funds emerges, we will use it to repurchase outstanding government debt, beginning with non marketable issues (e.g., the CBI recapitalization bonds).

Strengthening the policy framework

24. **A stronger institutional framework will support the achievement of our program objectives.** To date we have focused on rectifying the key financial sector regulation and supervision shortcomings that contributed to the crisis. We have also addressed issues with our fiscal-framework, to support our fiscal consolidation objective. Over the course of the coming year we plan to identify ways to strengthen our monetary policy framework to better secure our objective to deliver low and stable inflation, and a stable financial system.

25. **Reforms to banking regulation and supervision are on track:**

- *FME.* Following the recent amendments to the banking law, the FME has introduced organizational reforms to enhance on-site inspection and off-site supervision. Looking forward, the FME will articulate an action plan to operationalize its registry of large exposures by end-June 2011; and by December 2011, the number of staff in the areas of risk assessment, forensic accounting, and information technology will be brought into line with numbers in peer advanced countries. The FME will also take a more proactive role in the oversight of financial products, and will require banks to strengthen their approval policy for new products
- *Bank resolution procedures and prudential requirements.* The recent amendments to the banking law did not address all framework issues, and in any event the upcoming Basel capital and liquidity requirements may require further revisions. We intend a two-part approach to deal with remaining issues. By end-February 2011, we plan to submit legislation to parliament to tackle the resolution framework for banks, and to address the respective powers of the FME and CBI to supervise and regulate the financial system. We remain committed to a new Basel Core Principles assessment in March 2011. This and any revised EU directives on capital and liquidity requirements will form the basis for further revisions during the second quarter of 2011.
- *Deposit insurance and phase out of blanket deposit guarantee.* We now expect that the draft bill of law harmonizing the deposit guarantee regime with the relevant EU directives will be passed by end-September 2010. The blanket guarantee will remain in place when the law becomes effective. As the financial system strengthens, we will gradually phase out this blanket deposit guarantee. To help define a timetable, the CBI and the FME will jointly prepare a report for the Minister of Economic Affairs on the resilience of the banking system, and undertake a survey of public confidence

and market belief in the strength of financial institutions and prudential regulation and supervision.

26. Public financial management reforms are also on track:

- *Budget framework.* We have been implementing the various reforms adopted in mid-2009, in particular, the two-stage budget approval process, the creation of an adequate budget contingency, and limits on and closer scrutiny of carryovers. Looking forward, the 2011 budget will continue these practices, and establish binding two-year nominal ceilings, a crucial reform to help guide consolidation efforts. We are also committed to reduce the earmarking of revenues.
- *Framework for local governments (a structural benchmark for end-December).* We are on track to propose amendments to the Local Government Act and complete the reform in time for fiscal year 2011. Two key fiscal rules embedded in the framework will be: (i) a zero-balance fiscal rule requiring corrective measures if a local government is in breach; and (ii) a ceiling on the ratio of local government debt and commitments to tax revenues.

External Financing

27. Our ability to fully implement the program described above remains dependent on access to adequate external financing. This financing will help us smoothly manage our external debt rollover during 2011–12, and contribute to confidence during the gradual capital account liberalization process. We have already fully drawn on available tranches from our bilateral partners, and have obtained significant additional resources through the Avens transaction. We intend to draw remaining amounts of committed financing, as financing gaps require. Progress in covering our financing need will continue to be assessed during quarterly program reviews. In the event of any shortfalls, we stand ready to consult with the Fund on any additional measures that would prove necessary to meet program objectives (consistent with our undertaking in paragraph 4 above).

28. We expect to meet the preconditions of some of our bilateral partners to access bilateral program financing. In particular, we remain committed to finalizing arrangements for the reimbursement of the governments of the United Kingdom and the Netherlands for amounts expended to settle retail deposits in the fallen banks. In this regard, we here reiterate the undertaking contained in our Letter of Intent dated 15 November 2008 and our Letter of Intent of 7 April 2010, to ensure that the United Kingdom and the Netherlands will be reimbursed in respect of deposits of Landsbanki branches in those two countries (up to the Euro 20,887 minimum provided for under Icelandic Law and the EU Deposit Guarantee Directive 90/19/EC); and will receive the reasonable time value of money, provided that comprehensive agreements are reached. Discussions on this topic have taken place since the Second Review (and drafts of the legal documents have been exchanged and discussed).

While a number of issues remain outstanding we remain committed to bringing those arrangements to a close.

Very truly yours,

/s/

Jóhanna Sigurðardóttir
Prime Minister

/s/

Steingrímur J. Sigfússon
Minister of Finance

/s/

Már Guðmundsson
Governor of the Central Bank of Iceland

/s/

Árni Páll Árnason
Minister of Economic Affairs

Iceland Quantitative Performance Criteria and Indicative Targets 1/

	Performance Criteria						Indicative Target			
	Oct 09 Prog.	Oct 09 Actual	Dec 09 Prog.	Dec 09 Actual	May 10 Prog.	May 10 Actual	Sep 10 Ceiling/Floor	Dec 10 Ceiling/Floor	Mar 11 Ceiling/Floor	Jun 11 Ceiling/Floor
	(In billions of Króna)									
1. Floor on the change in the central government net financial balance 2/	-175	-139.5	-200	-166.7	-55	-41.0	-140	-150	-40	-80
2. Ceiling on the change in net domestic assets of the Central Bank of Iceland 3/	20	34	42.6	30.3	65	16.3	40	40	20	20
3. Ceiling on the change in the net domestic claims of the Central Bank of Iceland to the central government (Indicative targets)	70	8.6	70	13.8	80	19.5	80	80	70	70
	(In millions of U.S. dollars)									
5. Floor on the change in net international reserves of the Central Bank of Iceland 4/	-425	-278	-475	-319	-325	-122.9	-530	-580	-210	-250
6. Ceiling on the level of contracting or guaranteeing of new medium and long term external debt by central government 5/	3500	54.5	3500	486.6	2500	0	2500	2500	2000	2000
7. Ceiling on the stock of central government short-term external debt 6/	1400	0	1400	0	750	0	750	750	700	700
8. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors 6/	0	0	0	0	0	0	0	0	0	0

1/ Cumulatively from the beginning of each year (unless otherwise indicated).

2/ The net financial balance excludes the capital injection cost of bank and central bank recapitalization and excludes the increase in debt from guaranteeing the repayment of depositors in foreign branches of Icelandic banks.

3/ Excluding changes due to central bank recapitalization bond.

4/ (-) indicates decrease. NIR is defined as the difference of gross foreign assets and foreign liabilities (including all foreign currency deposits and other liabilities of financial institutions and the general government at the CBI; from September 2010, the definition excludes foreign currency deposits of the general government at the CBI, as specified in the TMU. NIR adjuster is specified in the TMU.

5/ Excludes IMF and excludes official bilateral loans for deposit insurance. Short term external debt has an original maturity of up to and including one year. Medium and long-term external debt has an original maturity of more than one year.

6/ Applies on a continuous basis.

Table 2. Structural Conditionality

Structural Conditionality	Status
<p><i>Structural Benchmarks</i></p> <ul style="list-style-type: none"> • Passage of legislation to strengthen the fiscal framework for local governments, covering (i) the fiscal rule to be applied; (ii) restrictions on municipal borrowing; (iii) mechanisms for dealing with revenue volatility; (iv) surveillance modalities; (v) coordination mechanisms; and (vi) sanctions for non-compliance (LOI ¶26). <i>By end-2010.</i> • Recapitalization of Byr and Keflavik, the two largest savings banks, up to 16 percent of their risk weighted assets. (LOI ¶7). <i>By end-May 2010.</i> • The FME to require rehabilitation and/or recapitalization measures to be taken by non bank financial institutions and the Housing Finance Fund, as determined to be necessary by a review of their business plans (LOI ¶9). <i>By end-August 2010.</i> • Publication of a Basel Core Principles assessment of weaknesses in Iceland’s supervisory framework, along with a strategic plan to address the weaknesses (LOI ¶25). <i>By end-March 2011.</i> • Passage of legislation to strengthen the framework for household debt restructuring, addressing (i) access to information, advice, and mediation mechanisms in the context of voluntary workouts; (ii) eligibility; and (iii) incentives for financial institutions and debtors to expedite voluntary restructuring agreements (LOI ¶18). <i>By end-June 2010.</i> <p><i>New Structural Benchmarks</i></p> <ul style="list-style-type: none"> • A decision by the FME on commercial banks’ plans to meet capital requirements as defined in the Letter of Intent (LOI ¶7). <i>By November 15, 2010.</i> • Submission of a supplementary budget to parliament requesting authorization to issue sufficient bonds to cover recapitalization needs of the banking system if losses on all probably affected and possibly affected loans are realized (LOI ¶7). <i>By October 15 2010.</i> 	<p>Not met 1/</p> <p>Not met 1/</p> <p>Met</p>

1/ Delayed because of SC ruling

ATTACHMENT II. TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This memorandum sets out the understandings between the Icelandic authorities and the IMF staff regarding the definitions of quantitative and structural performance criteria, as well as respective reporting requirements for the Stand-By Arrangement (SBA). These performance criteria and indicative targets are reported in Tables 1 and 2.
2. The exchange rate for the purposes of the program is set at 113.9 Icelandic króna per U.S. dollar. The corresponding cross exchange rates are provided in Table 3.

Central Government

3. **Definition:** For the purposes of the program, the government includes the central government, which includes government entities of group “A” as defined in the Government Financial Reporting Act No.88/1997.
4. **Supporting material:** The Ministry of Finance (MoF) will provide to the IMF detailed information on monthly revenues and expenditures both on a cash and accrual basis, domestic and foreign debt redemptions, new domestic and foreign debt issuance, change in the domestic and foreign cash balances of the central government at the central bank of Iceland, all other sources of financing including capital transactions, and arrears of the central government. Data will be provided within 30 days.

Quantitative Performance Criteria, Indicative Targets, and Continuous Performance Criteria: Definitions and Reporting Standards

A. Floor on the Cumulative Net Financial Balance of the Central Government

5. **Definition:** The net financial balance of the central government will be measured from the financing side at current exchange rates, and will be defined after contributions to the government employee’s pension fund. The net financial balance will be defined as the negative of the sum of (i) net domestic financing and (ii) net external financing.
 - **Net domestic financing (NDF)** is defined as the change in the stock of the net domestic debt of the central government. Domestic central government debt consists of ISK-denominated debt financed by the banking system (the Central Bank of Iceland (CBI) and commercial banks) and non-bank financial institutions to the central government. It consists of treasury bills, government bonds, promissory notes and other domestic debt instruments issued by the government, including any interest arrears, and loans and advances to the central government by the commercial banks, including any interest arrears. Net domestic central government debt is calculated as the gross debt plus proceeds from the sale of financial assets (including, but not limited to, government, government-backed, or other bonds obtained during the central bank recapitalization process, and as a result of failed securities lending) or

proceeds from privatization, minus ISK-denominated government deposits with the central bank of Iceland and commercial banks. ISK-denominated government deposits at the central bank of Iceland include the deposits in the treasury current account, government institution current accounts and other time deposits. Domestic debt will be valued at the nominal price for T-notes. For T-bonds and other loans, both of which are indexed, the nominal value of the debt will be adjusted by the consumer price inflation.

- **Net external financing** is defined as the total of foreign currency denominated financing disbursed to the central government minus the net accumulation of foreign currency deposits at the CBI and at commercial banks, plus accrued interest from the Icesave-related debt, net change in external arrears, minus amortization paid. Amortization includes all external debt-related payments of principal by the central government. Disbursements and amortization will be valued at the exchange rate at the time of the transaction. Net accumulation of foreign currency deposits is defined as the sum of daily change in the stock of foreign currency deposits at the CBI and at commercial banks in foreign currency, valued at the current daily exchange rate. Accrued interest on Icesave-related debt will be calculated based on the average monthly value of the outstanding stock of Icesave-related debt. The stock of outstanding Icesave-related debt will be calculated as sum of the outstanding loans and the accrued interest from the previous period minus the amount paid out from recovered assets. The stock of Icesave-related debt will be calculated in the currency of the loan agreements (sterling and euro). Accrued interest will be converted to krona at the current (monthly average) exchange rate.
 - **Adjustments:** For the purposes of the program, the net financial balance will exclude any debt issuance for the purposes of bank restructuring and central bank recapitalization. It will; however, include the accrued interest on inflation indexed debts related to central bank and bank recapitalization. Net domestic financing will exclude the retro-active accrued interest on the bank capitalization bonds from October 8, 2008 to October 8, 2009.
6. **Supporting Material:**
- Data on domestic bank and nonbank financing will be provided to the IMF by the Central Bank of Iceland and the Financial Management Department of the MoF within three weeks after the end of the month. This will include data on redemptions of domestic central government liabilities and data on the cash balances in domestic currency of the MoF at the Central Bank of Iceland and in commercial banks.
 - Data on net external financing (disbursement, net change in external arrears and amortization) as well as other external borrowing will be provided to the IMF monthly by the Financial Management Unit at the MoF within three weeks of the end

of each month. Data on the fx cash balances of the MoF at the Central Bank of Iceland and in commercial banks will be reported daily.

B. Floor on the Net International Reserves of the Central Bank of Iceland

7. **Definition:** Net international reserves (NIR) of the Central Bank of Iceland (CBI) are defined as the U.S. dollar value of gross foreign assets minus foreign liabilities of the CBI.

- **Gross foreign assets** are defined consistently with SDDS as readily available claims on nonresidents denominated in foreign convertible currencies. They include the CBI's holdings of monetary gold, SDRs, foreign currency cash, foreign currency securities, deposits abroad, and the country's reserve position at the Fund. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered, claims on residents, precious metals other than gold, assets in nonconvertible currencies, and illiquid assets.
- **Gross foreign liabilities** are defined consistently with SDDS as all fx liabilities to residents and nonresidents, including commitments to sell foreign exchange arising from derivatives, and all credit outstanding and SDR allocation from the Fund. Foreign currency deposits and other liabilities of financial institutions (both active and in the process of winding up) will be included in gross foreign liabilities. General government fx liabilities at the CBI will not be included in gross foreign liabilities.
- **For program monitoring purposes**, the stock of foreign assets and foreign liabilities of the CBI shall be valued at program exchange rates as described on paragraph 2 above. The stock of NIR amounted to \$634 million as of December 31, 2009 (at the program exchange rate).

8. **Adjustment mechanism:**

- The NIR floor will be adjusted downward at the program exchange rate by the amount of Nordic disbursements relative to the technical assumption below. For every one dollar of disbursements, the NIR floor for each period will be adjusted downwards by 0.5 dollars. Nordic disbursements are defined as external disbursements from Denmark, Finland and Sweden to the Government of Iceland, and from Norway to the CBI
- For each period, the NIR floor will be adjusted up to an amount specified in the table below. The Figures indicate a cap on the cumulative use of NIR.

NIR Adjustment

Cumulative flows from End-December 2009	In millions of US dollars at program exchange rate	Adjustment per one dollar of additional Nordic disbursements
Nordic Disbursements (technical assumption for the adjuster purpose)		
End-September 2010	0	-0.50
End-December 2010	0	-0.50
NIR cap		
End-September 2010	-750	
End-December 2010	-880	

9. **Supporting material:** Data on net international reserves (both at actual and program exchange rates) and on net foreign financing (balance of payments support loans; cash grants to the consolidated government; amortization (excluding repayments to the IMF); interest payments on external debt by the MoF and the CBI) will be provided to the IMF in a table on the CBI's fx flows (which include details of inflows, outflows, and net international reserves) on a monthly basis within two weeks following the end of the month. Flows of net international reserves will be provided on a daily basis.

C. Ceiling on Net Domestic Assets

10. **Definition:** Net domestic assets of the CBI are defined as the sum of net credit to the government, net credit to the private sector and other items net.

- **Net credit to the central government** is defined in criteria D.
- **Net credit to the private sector** is defined as the difference between credit to the private sector and liabilities of the private sector to the CBI. Credit to the private sector is defined as the sum of CBI lending to banks and other financial institutions (through its overnight and weekly collateral facilities and any other instruments to which the CBI would extend credit to the private sector) and other assets. Liabilities of the private sector to the CBI is defined as the sum of current account balances of the banks and other financial institutions at the CBI, central bank CDs in issuance and other liabilities.
- **Other items net** are defined as the sum of capital contributions, revaluation accounts and retained earnings. Performance against the NDA target will be measured at program exchange rates.

11. **Supporting material:** The CBI will provide to the IMF with data on net credit to the government and net credit to the private sector. Data on central bank lending to banks and other financial institutions through its overnight and weekly collateral facilities, any other instruments to which the CBI would extend credit to the private sector, current account balances of the banks at the CBI, and central bank CDs in issuance, on a daily basis. The CBI will provide the net domestic assets data based on the monthly balance sheets on the monthly basis within two weeks following the end of the month.

D. Ceiling on Net Credit of the Central Bank of Iceland to the Central Government (Indicative Target)

12. **Definition.** Net credit of the CBI to the central government is defined as the difference between CBI lending to the central government and central government deposits at the CBI in domestic currency.

- **Deposits of the central government** at the CBI in domestic currency include the sum of deposits in the treasury current account, government institution current accounts and other time deposits.
- **Adjustment.** For the purpose of the program, the net credit of the CBI to the central government will exclude any debt issuance for the purposes of recapitalizing the CBI.
- **Supporting material:** The CBI will provide the IMF with data on central bank lending to the central government and central government deposits at the central bank, on a daily basis with a lag of no more than 10 days.

E. Ceiling on Contracting or Guaranteeing of New Medium and Long Term External Debt by Central Government

13. **Definition:** The performance criterion covers public and publicly guaranteed external debt in foreign currency with an original maturity of more than one year. Debt falling within the limit shall be valued in U.S. dollars at the time the contract or guarantee becomes effective.

The term “debt” will be understood to mean a liability created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows.

- **Loans.** That is, advances of money to an obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers’ credits) and temporary exchanges

- of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements).
- **Suppliers' credits.** That is, contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided.
 - **Leases.** That is, arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the leaser retains the title to the property. For the purpose of the program, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property.
 - **Arrears, penalties, and judicially awarded damages** arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.”
 - **Adjustments.** (i) Previously contracted debt that has been rescheduled will be excluded from the definition of “new debt” for the purposes of this performance criterion; (ii) excluded from the limits are purchases from the IMF Stand-By Arrangement and bilateral official loans extended and earmarked for payments on foreign deposit guarantees; (iii) changes in the stock of nonresident holding of medium and long-term debt in krona will also be excluded from definition of new debt; and (iv) arrears arising from intervened banks will be excluded.

14. **Supporting material:** Details of all new commitments and government guarantees for external borrowing, with detailed explanations, will be provided by the MoF to the IMF on a monthly basis within two weeks of the end of each month. Data will be provided using the actual exchange rates in effect at the time of contract or guarantee.

F. Ceiling on the Stock of Central Government Short-Term External Debt

15. **Definition:** The limit on short-term external debt applies on a continuous basis to the stock of short-term external debt in foreign currency owed or guaranteed by the central government of Iceland, with an original maturity of up to and including one year. It applies to debt as defined in paragraph 10 above. Excluded from the limit are any rescheduling operations (including the deferral of interest on commercial debt) and nonresident holding of short-term debt in krona. Debt falling within the limit shall be valued in U.S. dollars at the time the contract or guarantee becomes effective.

16. **Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors.** This performance criterion applies on a continuous basis. External payment arrears consist of external debt service obligations (principal and interest) falling due after October 20, 2008, and that have not been paid at the time due, taking into account the grace periods specified in contractual agreements. Data will be provided on a monthly basis with a lag of no more than 20 days.

G. Reporting Requirement for Financial Institutions in the Winding-up Process

17. The CBI will provide to the IMF data reports from all financial institutions in the winding-up process on a quarterly basis. The reports will be in the format according to the CBI reporting template agreed with the IMF. The required data will allow the CBI and the IMF to track asset recovery and payout to creditors against their claims for both domestic and external assets and the cross-border movement of the proceeds.

Table 3. Program Exchange Rates

Icelandic króna per U.S. dollar	Icelandic króna per euro	Icelandic króna per pound
113.9	150.5	193.6

APPENDIX I. DEBT SUSTAINABILITY ANALYSIS

1. **External and public debt remains sustainable, with lower levels compared to the second review, but risks remain** (Tables A1–A2; Figures A1–A2).

A. External DSA

2. **A number of assumptions underlying the analysis have been modified, reflecting new information since the time of the second review (Table A1):**

- The authorities' recent eurobond buy-back and the Avens transactions have reduced public external debt by about 6 percent of GDP in 2010.
- The payment of assets by Resolution Committees (RCs) of old banks is now expected to be in 2012 instead of 2011 due to the anticipated delay in clearing legal challenges.
- A new asset recovery path for Landsbanki has been taken into account. The main change is a more front-loaded nature of the recovery.

3. **Under the program macroeconomic baseline, external debt is projected to have peaked at about 300 percent of GDP in 2009 and to fall slowly to around 190 percent of GDP by 2015** (Table A1; Figure A1). Key factors driving the decline include payout from asset recovery, deleveraging by Icelandic companies, and growth and current account dynamics. Indeed, by the end of the period, Iceland's non-interest current account balance (12 percent of GDP) is well above the debt-stabilizing level (-1 percent of GDP), suggesting that external debt reductions will continue further in the medium-term.

4. **Stress tests suggest that the downward trajectory is a robust result, provided the program is implemented.** Standard shocks would slow, but do not stop the downward trajectory. External debt would sharply increase with exchange rate depreciation: a permanent depreciation of 30 percent would drive up external debt as a percent of GDP to a much higher level, although the downward trajectory would still be expected to resume. Only the historical scenario leads to negative debt dynamics, but is not thought likely. The collapse of the banking sector was a permanent shock, and the events of the 2003–07 boom are unlikely to be repeated any time soon.

B. Public Debt Sustainability

5. **New information since the time of the second review led to changes in several assumptions:**

- The adjustment path for the general government primary balance (excluding interest revenues) reflects a 4½ percent of GDP improvement in 2010, and a 3½ percent of GDP

improvement in 2011. The primary balance stabilizes at 6 percent of GDP in 2014 instead of reaching 6¾ percent of GDP as in the second review.

- The Icesave assessment has been updated. Recovery is now expected to be more frontloaded, with nearly 60 percent of assets recovered by end-2011. With payouts commencing in 2011, despite higher accrued interest, the total residual public obligation is estimated to be about 16 percent of 2015 GDP.
- Eurobond repurchases of about 5 ¾ percent of GDP in 2010.
- HFF recapitalization of 3 percent of GDP in 2010.

6. **Under these assumptions, the 2010 gross public debt to GDP ratio is about 5 percent lower compared to the second review.** Public debt will peak due to the disbursement of bilateral loans and stand at 115 percent at end-2010.

7. **Under the program baseline scenario, Iceland's public debt declines steadily over the medium term** (Table A2, Figure A2). The downward path continues to be driven by the consolidation plan and the gradual improvement of the real interest rate/GDP growth differential. By end-period, the actual primary balance would exceed the debt-stabilizing level, with debt reduction continuing beyond the projection period.

8. **The downward debt trajectory is robust to shocks, provided the program is implemented** (Figure A2). Debt remains on the downward trajectory under all standard shocks. The unchanged primary balance scenario is the exception: it would imply a reversal of the adjustment path and a quick deterioration in the debt position.

Table A1. Iceland: External Debt Sustainability Framework Current Baseline, 2005-2015
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest current account 6/ -1.0
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	
Baseline: External debt (including old banks)	284.5	433.5	605.9	564.7								
Baseline: External debt	65.9	101.3	171.8	189.0	300.7	278.5	270.6	219.9	211.3	202.6	189.2	
Change in external debt	-6.5	35.4	70.6	17.2	111.7	-22.2	-7.9	-50.8	-8.6	-8.6	-13.4	0.0
Identified external debt-creating flows	46.4	31.3	26.8	40.0	1.0	-7.0	-18.6	-14.8	-6.6	-11.4	-9.1	0.0
Current account deficit, excluding interest payments	14.3	22.2	10.1	13.1	-3.6	-10.2	-11.3	-10.5	-12.0	-12.2	-11.8	1.0
Deficit in balance of goods and services	12.2	17.5	10.1	2.3	-9.1	-10.9	-8.0	-6.6	-7.8	-8.5	-8.3	
Exports	31.4	32.1	34.5	44.2	52.4	55.2	53.8	52.8	53.8	54.3	54.7	
Imports	43.6	49.6	44.6	46.5	43.3	44.3	45.8	46.2	46.1	45.8	46.4	
Net non-debt creating capital inflows (negative)	44.1	7.3	28.9	-23.0	-23.3	-14.2	-8.5	-9.8	-3.6	-5.9	-3.3	-2.0
Automatic debt dynamics 1/	-11.9	1.9	-12.2	50.0	27.9	17.4	1.2	5.5	9.0	6.8	6.0	1.0
Contribution from nominal interest rate	1.8	3.4	6.1	12.9	10.1	8.8	9.1	11.7	12.5	12.9	12.0	12.4
Contribution from real GDP growth	-4.4	-3.0	-4.9	-2.0	17.8	8.6	-7.9	-6.2	-3.5	-6.2	-6.0	-5.9
Contribution from price and exchange rate changes 2/	-9.4	1.4	-13.4	39.1	43.0	...	...	...	...	...	...	-5.4
Residual, incl. change in gross foreign assets 3/	-52.9	4.1	43.7	-22.8	110.6	-15.2	10.7	-35.9	-2.1	2.7	-4.3	0.0
External debt-to-exports ratio (in percent)	209.6	315.8	498.4	427.9	573.7	504.2	503.3	416.4	392.4	373.0	345.9	
Gross external financing need (in billions of US dollars) 4/	5.7	8.0	8.7	13.1	6.0	9.0	8.3	11.8	5.8	6.0	5.9	
in percent of GDP	35.1	47.6	42.8	78.1	49.6	70.8	61.7	83.3	39.1	38.2	35.5	
Scenario with key variables at their historical averages 5/					300.7	278.5	283.5	242.0	235.1	231.4	219.9	-19.1
Key Macroeconomic Assumptions Underlying Baseline												For debt stabilization
Real GDP growth (in percent)	7.5	4.6	6.0	1.0	-6.8	-3.0	3.0	2.4	1.7	3.1	3.1	3.1
Nominal external interest rate (in percent)	3.1	5.3	7.4	6.2	3.9	3.1	3.5	4.5	6.0	6.5	6.3	6.5
Growth of exports (US dollar terms, in percent)	13.7	4.5	31.3	5.4	-14.3	10.9	3.1	2.8	7.2	6.9	6.0	
Growth of imports (US dollar terms, in percent)	35.9	16.3	9.8	-14.1	-32.8	7.6	9.4	5.7	4.9	5.4	6.6	
Current account balance, excluding interest payments 7/	-14.3	-22.2	-10.1	-13.1	3.6	10.2	11.3	10.5	12.0	12.2	11.8	
Net non-debt creating capital inflows	-44.1	-7.3	-28.9	23.0	23.3	14.2	8.5	9.8	3.6	5.9	3.3	

1/ Derived as $[r - g - r(1+g) + ea(1+r)] / (1+g+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)] / (1+g+gr)$ times previous period debt stock. r increases with an appreciating domestic currency ($e > 0$) and rising inflation (GDP deflator).

3/ Projections also reflect the impact of price and exchange rate changes, inflows of extraordinary financing (and Fund repurchases).

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year. This estimate excludes old bank-related asset recovery in 2014, and large one-off projected liquidation of assets abroad, to service lumpy debt payment.

7/ Historical debt and interest data exclude old bank data (based on staff and Central Bank estimates).

Table A2. Iceland: Public Sector Debt Sustainability Framework, 2005–15
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing primary balance 9/
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	
Baseline: Public sector debt 1/	25.4	30.1	29.3	71.7	99.9	115.6	107.8	101.1	94.3	85.2	75.8	0.5
o/w foreign-currency denominated	10.4	16.8	13.3	24.7	38.9	49.4	44.9	44.5	43.4	40.2	36.8	
Change in public sector debt	-9.1	4.7	-0.9	42.4	28.2	15.7	-7.7	-6.7	-6.9	-9.1	-9.4	
Identified debt-creating flows (4+7+12)	-7.6	-8.0	-10.8	28.1	38.6	16.8	-2.4	-4.3	-6.7	-7.0	-7.4	
Primary deficit (including interest income)	-7.1	-8.5	-8.0	-2.8	4.0	0.5	-2.4	-5.7	-7.9	-7.9	-7.7	
Revenue and grants	47.1	48.0	47.7	44.2	39.4	38.9	38.5	39.5	40.4	40.5	40.4	
Primary (noninterest) expenditure	40.0	39.5	39.7	41.4	43.4	39.4	36.0	33.9	32.6	32.6	32.6	
Automatic debt dynamics 2/	-0.6	0.5	-2.8	12.6	7.3	2.7	0.1	1.4	1.2	0.9	0.4	
Contribution from interest rate/growth differential 3/	-1.1	-0.9	-0.6	0.0	7.6	2.7	0.1	1.4	1.2	0.9	0.4	
Of which contribution from real interest rate	1.2	0.1	1.0	0.2	2.8	-0.2	3.3	3.9	2.8	3.7	2.9	
Of which contribution from real GDP growth	-2.3	-1.0	-1.6	-0.3	4.8	2.8	-3.3	-2.5	-1.6	-2.8	-2.5	
Contribution from exchange rate depreciation 4/	0.5	1.4	-2.2	12.6	-0.3	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	18.3	27.3	13.6	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities 5/	0.0	0.0	0.0	0.0	11.8	0.0	0.0	0.0	0.0	0.0	0.0	
Other (capitalization of banks, bilateral loans) 6/	0.0	0.0	0.0	18.3	15.5	13.6	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 7/	-1.4	12.7	9.9	14.3	-10.4	-1.1	-5.4	-2.4	-0.2	-2.1	-2.1	
Public sector debt-to-revenue ratio 1/	53.9	62.8	61.4	162.1	253.2	296.9	280.3	255.7	233.1	210.3	187.7	
Gross financing need 8/	-1.7	-3.3	-2.2	6.4	22.5	27.8	22.8	7.1	7.1	14.1	3.1	
in billions of U.S. dollars	-0.3	-0.6	-0.4	1.1	2.7	3.5	3.1	1.0	1.1	2.2	0.5	
Scenario with key variables at their historical averages 9/						115.6	106.7	100.9	97.2	91.7	86.3	0.1
Scenario with no policy change (constant primary balance) in 2010-2015						115.6	110.8	110.3	112.0	111.5	110.5	0.7
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	7.5	4.6	6.0	1.0	-6.8	-3.0	3.0	2.4	1.7	3.1	3.1	
Average nominal interest rate on public debt (in percent) 10/	7.1	9.7	9.6	12.9	12.3	9.3	7.5	6.6	6.9	6.8	6.2	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.2	0.9	4.0	1.1	3.4	-0.5	3.2	3.9	3.0	4.2	3.7	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-3.1	-12.1	15.9	-48.7	1.0	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	2.8	8.8	5.7	11.9	8.9	9.8	4.3	2.7	3.9	2.6	2.5	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.3	3.2	6.5	5.4	-2.3	-11.9	-5.9	-3.8	-2.2	3.3	3.1	
Primary deficit (including interest income)	-7.1	-8.5	-8.0	-2.8	4.0	0.5	-2.4	-5.7	-7.9	-7.9	-7.7	
Net public sector debt	9.4	7.8	11.0	42.1	67.7	75.6	78.6	74.7	64.5	58.6	51.8	

1/ General government gross debt (including bilateral loans to the central government to support central bank reserves; excludes IMF loans).

Also includes the estimated impact of the guarantee on UK/Dutch IceSave loans, net of asset recovery. It estimates, under given assumptions for asset recovery and on a cash flow basis, the residual obligation for the government and growth thereof due to accruing interest.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r))/(1+g+\pi+g\pi)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ Reflects the estimated "net present value" of the guarantee on UK/Dutch IceSave loans, after asset recovery.

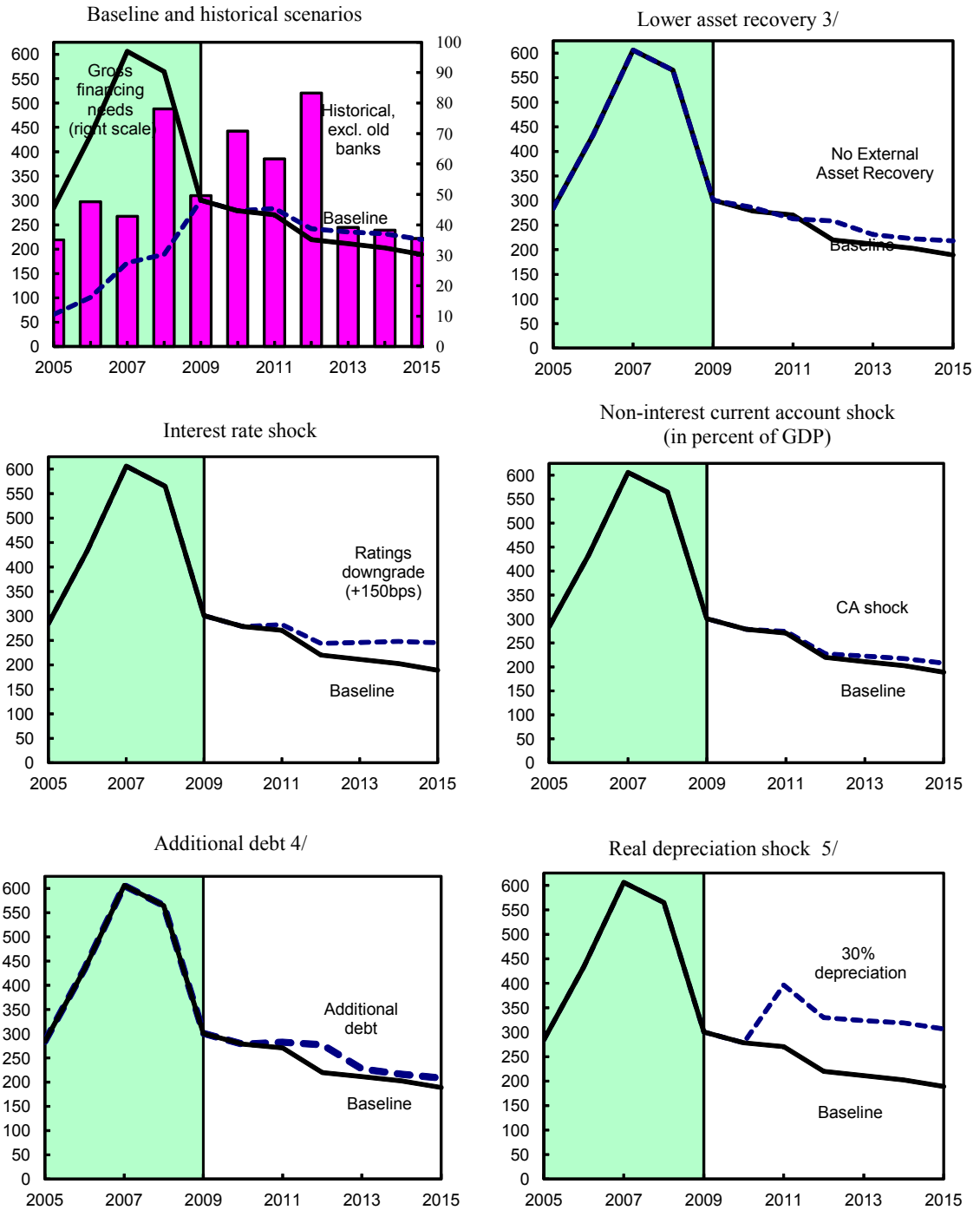
6/ Includes capitalization of new banks, savings banks, and bilateral loans to support CBI reserves.

7/ For projections, this line includes exchange rate changes. In 2009-11, the residual also reflects use of deposits at the central bank and sale of financial assets obtained during the financial crisis.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

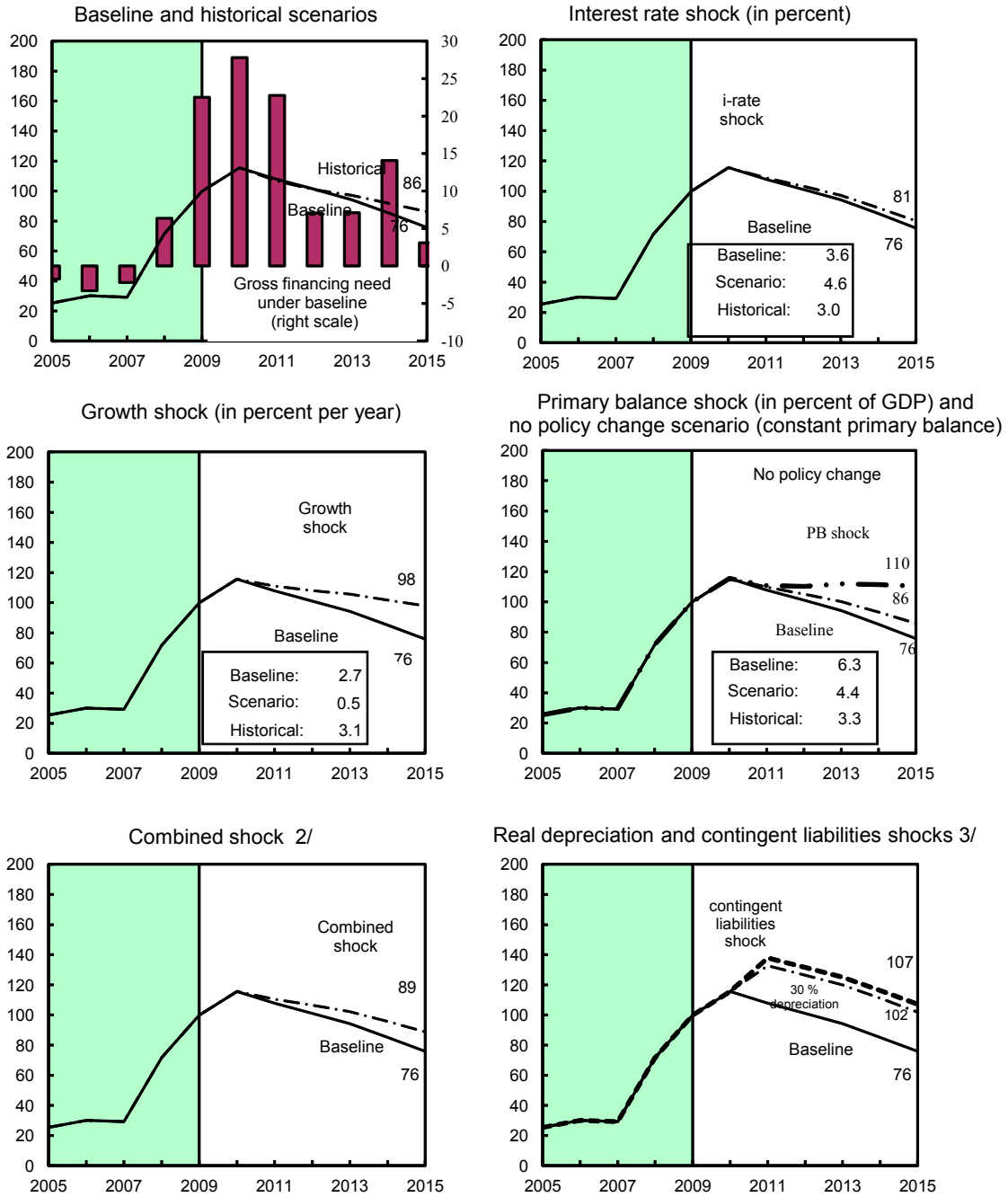
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A1. Iceland: External Debt: Current Baseline Projection 1/ 2/
(in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
 1/ Shaded areas represent preliminary actual data including old banks unless otherwise indicated. Individual shocks are permanent one-half standard deviation shocks.
 2/ GDP is converted into \$ at average exchange rates.
 3/ Lower asset recovery scenario assumes no payout from asset recovery to Icesave loan through 2015
 4/ Assumes 20 percent of GDP increase in external debt in 2011.
 5/ One-time real depreciation of 30 percent occurs in 2011

Figure A2. Iceland: Public Debt Sustainability under Current Projection 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent or 30 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

APPENDIX II. ICELAND: FUND RELATIONS

(As of June 30, 2010)

- I. **Membership Status:** Joined: December 27, 1945; Article VIII
- II. **General Resources Account:**
- | | SDR Million | Percent Quota |
|---------------------------|--------------------|----------------------|
| Quota | 117.60 | 100.00 |
| Fund holdings of currency | 868.95 | 738.91 |
| Reserve position in Fund | 18.65 | 15.86 |
| Holdings Exchange Rate | | |
- III. **SDR Department:**
- | | SDR Million | Percent Allocation |
|---------------------------|--------------------|---------------------------|
| Net cumulative allocation | 112.18 | 100.00 |
| Holdings | 84.86 | 75.64 |
- IV. **Outstanding Purchases and Loans:**
- | | SDR Million | Percent Quota |
|-----------------------|--------------------|----------------------|
| Stand-By Arrangements | 770.00 | 654.76 |
- V. **Latest financial Arrangements:**

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-By	Nov 19, 2008	May 31, 2011	1,400.00	770.00

- VI. **Projected Payments to the Fund** (SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2010	2011	2012	2013	2014
Principal			280.00	358.75	105.00
Charges/Interest	9.74	19.37	16.36	6.84	1.26
Total	9.74	19.37	296.37	365.59	106.26

- VII. **Implementation of HIPC Initiative:** Not applicable
- VIII. **Safeguards Assessment:** The 2009 assessment concluded that the CBI's overall control environment was broadly appropriate for a small central bank, with good controls in the accounting and financial reporting area. The CBI's external and internal audit procedures practices were not found to be in line with international practices, however, and the foreign reserves management area would benefit from development. The authorities have already taken steps to implement safeguard recommendations, notably by appointing an international audit firm under the auspices of the Auditor General to conduct annual external audits of the CBI in

line with international standards, starting with financial year 2009. Internal audit was also outsourced. Work on other recommendations, such as the reserves management guidelines, is in progress.

IX. Article IV Consultation:

Discussions for the 2008 Article IV Consultation were held in Reykjavik during June 23–July 4, 2008. The Staff Report (Country Report No. 08/367) was considered by the Executive Board on September 10, 2008.

Discussions for the 2010 Article IV Consultation were held in Reykjavik during June 14–28, 2010 and July 19–22, 2010. The mission met with Prime Minister Sigurðardóttir, Finance Minister Sigfússon, Economic Affairs Minister Magnússon, Central Bank Governor Guðmundsson, and other senior officials, as well as parliamentarians, CEOs of the new banks and Icelandic corporations, the employers federation and labor unions, representatives of creditors, and academics. The staff team comprised M. Flanagan (head), C. Fernández and W. Maliszewski (EUR); I. Petrova (FAD); L. Cortavarria (MCM); M. Chivakul (SPR). The mission overlapped with a technical assistance mission by MCM. The mission was assisted by F. Rozwadowski and E. Karlsdóttir from the resident representative office. B. Olafsson (OED) attended many meetings.

X. Technical Assistance:

Department	Purpose	Date
MCM	Foreign exchange regulation	November 2008
FAD	Budget framework	January 2009
MCM	Monetary operations	February 2009
MCM	Capital account liberalization	February 2009
LEG	Debt restructuring	February 2009
FAD	Budget framework	May 2009
MCM	Capital account liberalization	June 2009
MCM	Public debt management	August 2009
MCM	Monetary operations	September 2009
STA	Monetary and financial statistics	September 2009
FAD	Cash management	September 2009
MCM	Public debt management	October 2009
MCM	Monetary operations	December 2009
MCM	Capital account liberalization	March 2010
MCM	Reserves build and liquidity management	June 2010
FAD	Fiscal framework issues	August 2010

XI. Resident Representative:

Mr. Franek Rozwadowski assumed the position in March 2009.

APPENDIX III. ICELAND: STATISTICAL ISSUES

Data provision to the Fund is adequate for surveillance purposes. Iceland subscribed to the Special Data Dissemination Standard (SDDS) in 1996, and is in observance of the SDDS specifications for coverage, periodicity, and timeliness, but uses a flexibility option on the timeliness and periodicity for the production index and the producer price index (PPI). The Statistics Department (STA) prepared a data module of the Report on the Observance of Standards and Codes (data ROSC) that was published on November 22, 2005.

Data on a wide range of economic and financial variables are provided to the Fund in a timely manner during and between consultations. In addition to periodic press releases, statistical information is disseminated to the public through a range of monthly, quarterly, and annual publications by three main institutions (The Central Bank of Iceland (CBI), the Ministry of Finance, and Statistics Iceland), and is increasingly available on their internet sites. Provision of electronic data in English has improved substantially in recent years, especially, from Statistics Iceland.

As regards the national accounts data, the authorities shifted to ESA95 in August 2000 and revised the corresponding time series back to 1990. Another revision was carried out in 2002. A breakdown is disseminated by industry back to the beginning of the production approach in 1973. Data on GNP and national income, in current and constant prices, as well as data on net savings for the economy as a whole, are also disseminated. The quarterly data are seasonally adjusted.

The authorities publish Treasury returns on a monthly basis, and quarterly and annual data on the general government balance. Iceland reports government finance statistics in accordance with the *GFSM 2001* framework in the *GFS Yearbook*, and is an up-to-date contributor to the *International Financial Statistics (IFS)*. Balance of payments data deviate from the IMF's *Balance of Payments Manual*, fifth edition (*BPM5*) in certain respects. In particular, the CBI follows the methodology applied by the European Central Bank (ECB) for the calculation of income payable by collective investment institutions (e.g., mutual funds). Unlike the *BPM5*, the ECB's methodology includes portfolio investors' shares of retained earnings in the balance of payments statement. Some other departures are: a) income on external debt is compiled on a due-for-payment basis, including between affiliated enterprises; b) debt between affiliated banks is not identified; c) banking sector loans are not classified separately from currency and deposits; d) in the international investment position, foreign direct investments are valued at book value; e) external debt is valued at face value; f) financial derivatives held by banks are not available as on-balance sheet items; and, g) domestic currency deposits held with banks by nonbank nonresidents are not recorded as part of external debt.

On monetary and financial statistics, the concepts and definitions broadly conform to the guidelines of the *Monetary and Financial Statistics Manual (MFSM)*. Departing from the *MFSM*, monetary aggregates include deposits of the foreign sector and the central government; and the currency-linked and indexed bonds held by nonresidents are classified as domestic instead of foreign liabilities. Classification and sectorization are mostly in line with the *MFSM*, except that, in the accounts of other depository corporations (that is, commercial and savings banks), financial derivatives are off balance sheet and positions of nonfinancial public corporations are included in the government accounts but cannot be identified; and, in the accounts of the CBI, fixed assets are off balance sheet. Several banks do not report at market value loans net of provisions and securities for investment.

Iceland: Table of Common Indicators Required for Surveillance
(As of August 6, 2010)

	Date of latest observation	Date received	Freq. of Data	Freq. of Reporting	Freq. of publication	Memo Items:	
						Data Quality – Methodological soundness	Data Quality – Accuracy and reliability
Exchange Rates	Aug 4, 10	Aug 5, 10	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities	June 2010	July 8, 10	M	M	M		
Reserve/Base Money	June 2010	July 7, 10	M	M	M	LO, O, LO, LO	LO, O, O, O, O
Broad Money	May 2010	July 23, 10	M	M	M		
Central Bank Balance Sheet	June 2010	July 7, 10	M	M	M		
Consolidated Balance Sheet of the Banking System	May 2010	July 23, 10	M	M	M		
Interest Rates	July 15, 08	Aug 5, 10	D	D	D		
Consumer Price Index	July 2010	July 28, 10	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing – General Government	2009	Apr 24, 10	A	A	A	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing– Central Government	Q1, 2010	June 9, 10	A,Q	A,Q	A,Q		
Stocks of Central Government and Central Government-Guaranteed Debt	2009	Apr 17, 10	A	A	A		
External Current Account Balance	Q1, 2010	June 3, 10	Q	Q	Q	O, O, LO, O	LO, O, O, O, O
Exports and Imports of Goods and Services	July 2010	Aug 6, 10	M	M	M		
GDP/GNP	Q1, 2010	June 8, 10	Q	Q	Q	O, LO, O, LO	LO, O, LO, LO, O
Gross External Debt	Q1, 2010	June 8, 10	Q	Q	Q		

INTERNATIONAL MONETARY FUND

ICELAND

**Staff Report for the 2010 Article IV Consultation and Third Review Under the Stand-By Arrangement and Request for Modification of Performance Criteria
Supplementary Information**

Prepared by European Department

Approved by Poul M. Thomsen and James Roaf

September 24, 2010

This supplement provides an update on developments and their implications for the program since the issuance of the Staff report. These developments have helped to reduce policy related risks in several areas, although they do not alter the thrust of the Staff Appraisal.

Financial sector developments

The legal risks overhanging Iceland's financial sector have materially receded. On September 16, the Supreme Court delivered a new ruling relevant for foreign exchange indexed loan contracts, clarifying that loans ruled to be illegal should be recalculated using krona interest rates (rather than by using the interest rate in the original contract). Under this outcome, the recapitalization needed to return banks to the prescribed 16 percent CAR would amount to at most 3 percent of GDP. Private shareholders would be expected to cover about half of this. The actual recapitalization need will likely be lower, depending on how the line is drawn between legal and illegal foreign exchange linked loans. To put an end to the uncertainty, the authorities are presently pursuing a voluntary framework with banks (which would see conversion of certain foreign currency loans into krona denominated loans).

External financing developments

The external financing outlook has improved notably:

- September 17 saw the first bond issuance in international markets by an Icelandic public or public-guaranteed entity since the financial crisis in 2008. Iceland's National Power Company (Landsvirkjun) secured the sale of USD 100 million of a USD-denominated 5-year note to foreign investors at a 6½ percent coupon (slightly

below the program's interest rate baseline). This transaction that signals significantly lower Landsvirkjun's refinancing risk going forward.

- The CBI is set to realize substantial proceeds from the just-concluded sale of FIH Erhvervesbank (the CBI acquired the shares of this Danish former subsidiary of Kaupthing by dint of collateralized lending in the pre-crisis period). The payment consists of an upfront cash payment of \$300 million and an earn-out agreement of up to \$530 million to be paid in early 2015. While the upfront cash payment is lower than the staff's baseline assumption, the expected 2015 payment is considerably higher, and the total medium-term benefit to reserves would be in the order of \$300 million.

In addition, there has been progress towards resolving the Icesave dispute. The Icelandic authorities have informed staff that they, the United Kingdom and the Netherlands have made significant progress in recent weeks towards reaching agreement on terms for reimbursing the United Kingdom and Netherlands for amounts used to cover retail deposits, up to the EU limit at the time, in the "Icesave" branches of an Icelandic bank. The likelihood of continued legal proceedings in this case has now diminished, while the likelihood has risen for a negotiated settlement at an earlier-than-anticipated juncture. This would pave the way for early access to remaining bilateral financing.

Monetary policy developments

The central bank of Iceland has further cut interest rates, bringing the rate corridor down by 75 basis points. Continuing positive developments on the inflation front and stability of the krona underlie the decision. The CBI also noted that with financial stability risks diminishing, gradual capital control liberalization could be put back on the near-term agenda, and this would have implications for monetary policy going forward. This placed some upward pressure on medium and long term bond yields, underscoring the need for the gradualism embedded in the agreed liberalization approach.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
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DEPARTMENT

Public Information Notice (PIN) No. 10/xx
FOR IMMEDIATE RELEASE
[Month, dd, yyyy]

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

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.¹

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

¹ 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/
National Accounts (constant prices)								
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
Selected Indicators								
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
Money and Credit								
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	...	...
Public Finance (in percent of GDP)								
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
Balance of Payments (in percent of GDP)								
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.



Press Release No. 10/367
FOR IMMEDIATE RELEASE
September 29, 2010

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Third Review Under Stand-By Arrangement for Iceland, Concludes 2010 Article IV Consultation

The Executive Board of the International Monetary Fund (IMF) today completed the third review of Iceland's economic performance under a program supported by a Stand-By Arrangement (SBA).

The completion of this review enables the immediate disbursement of an amount equivalent to SDR 105 million, which would bring total disbursements under the program to an amount equivalent to SDR 875 million (about € 997.9 million or US\$ 1.36 billion).

The 33-month SBA was approved on November 19, 2008 (see [Press Release No. 08/296](#)) for an amount equivalent to SDR 1.4 billion (about US\$2.17 billion) and was subsequently extended to August 31, 2011 (see [Press release No 10/156](#)). The arrangement entails exceptional access to IMF resources, amounting to 1,190 percent of Iceland's quota.

A Public Information Notice on the Executive Director's assessment of the 2010 Article IV consultation with Iceland will be released separately.

Following the Executive Board's discussion, Mr. Murilo Portugal, Deputy Managing Director and Chair, stated:

“Iceland has made impressive progress under its Fund-supported program, reflecting the authorities' strong policy implementation and readiness to adapt policies when warranted. While the economy still faces headwinds, a rebound in growth is on the horizon, with the mildly undervalued krona and planned investment projects lending support to economic activity. The downward trend in inflation should continue, supported by the stable krona.

“The authorities have made progress towards restoring the financial system. Recent legal uncertainty about banks' foreign exchange linked loans and their capital has diminished, and a framework is in place to ensure that capital requirements will be met. The revised

framework for household and corporate debt restructuring will be helpful and the relief this provides to borrowers should support the economy.

“There has been considerable progress towards consolidating the fiscal position. The 2011 budget marks a milestone, with the general government projected to return to a primary surplus. Given the robust projected public debt dynamics, there may be scope in future to moderately scale back the targeted adjustment if financial sector contingent liabilities prove contained.

“Rebuilding Iceland’s international reserves is a priority. This will pave the way for capital account liberalization and the country’s reintegration into global financial markets. The careful monetary policy strategy adopted by the central bank, including the newly introduced foreign exchange purchase auctions, is delivering results and should be continued.

“In the medium term, strengthening Iceland’s policy framework will be critical. The authorities have improved budget planning and execution significantly and have legislated a stronger framework for bank regulation and supervision. Important steps ahead include reform of the local government fiscal framework and implementation of the financial sector supervisory reforms.”

**Statement by Per Callesen, Executive Director for Iceland
and Lilja Alfredsdottir, Advisor to Executive Director
September 29, 2010**

Significant progress has been made in Iceland to combat the effects of the collapse of the Icelandic financial sector that took place exactly two years ago this week. Economic activity has stabilized and growth is expected to resume in the second half of 2010. Inflation continues on a downward path and the outlook for a positive balance of payments is favorable. However, numerous challenges remain after a financial crisis that has affected almost every sector of the economy. My authorities broadly agree with staff assessment and wish to thank the Fund and its staff, in particular Mr. Mark Flanagan, for their excellent work in Iceland.

The Fund program has helped to restore confidence and focus our responses to the crisis. Policy implementation is broadly on track, and has met all end-May criteria and the end-June structural benchmark concerning legislation to strengthen the framework for household debt restructuring. The recapitalization of some weak banks, a structural benchmark for end-May that was delayed, can now go ahead after the September Supreme Court ruling.

My authorities are fully committed to going forward with the program with a continued emphasis on i) further restoration of the financial system where a significant element of uncertainty has now been removed after the September Supreme Court ruling on foreign exchange-indexed loans, ii) maintaining exchange rate stability, and containing inflation, iii) corporate and household debt restructuring, iv) taking steps towards capital account liberalization, v) securing public debt sustainability and vi) normalizing relations with international creditors and reviving market confidence in Iceland.

Since the second review, some progress has been made in negotiations with the authorities of the United Kingdom and the Netherlands. The Icelandic authorities will continue to negotiate in good faith to conclude an agreement on the Icesave issue. My authorities have also sought to maintain a constructive dialogue with the creditors of the intervened private banks in accordance with best international practice.

The Supreme Court Ruling

The Supreme Court ruled on September 16th that the lowest interest rates on new non-indexed loans at credit institutions as published by the Central Bank should prevail in the case of illegal foreign exchange indexation clauses in loan contracts. The ruling alleviates substantially the uncertainty resulting from the Supreme Court's June ruling on the illegality of foreign exchange indexation. If the Supreme Court rulings are confined to consumer loans, the cost to the banking sector is expected to be contained with no need for additional capital injection from the Treasury or other shareholders. Even if corporate loans are found to be illegally indexed to foreign currencies, the possible additional capital injection required into the banks remains limited, and far below levels that had been feared if the foreign contractual interest rates had been imposed. The government is now committed to clarifying the legal sphere in light of the verdicts, easing the settlement of claims and thus speeding up debt restructuring, which might otherwise fall victim to longwinded court proceedings. This will be done in cooperation with the financial institutions. Increased clarity will also support the financial restructuring of the savings banks system. The Icelandic State Financial Investments fund will be responsible for the government's stake in these relatively small, but not insignificant, institutions.

The outlook

Growth in 2009 contracted less than expected. While the first half of 2010 was sluggish, partly due to a volcanic eruption that affected tourism, growth in the second half should be more supportive and a positive growth is expected in the first half of 2011. Unemployment, which before the crisis was almost non-existent, stood at 8.7 percent in mid-2010. This level of unemployment is uncharacteristic for the Icelandic society where participation rates have traditionally been very high. The government has introduced several measures to stimulate small enterprise start up and retraining of labor. Lower unemployment levels should be registered when growth resumes next year.

Risks to the outlook are further deleveraging and contraction of demand, if growth in the main export markets weakens. The depreciation of the exchange rate has made the export sector more competitive and exports have been robust as reflected in the trade figures. However, supply constraints that are present in the main export industries, fisheries and primary aluminum production, hinder volume expansion. Despite the firm management of fishing stocks, potential in the fisheries sector is far from being exhausted. Higher profits and prices have been obtained e.g. by increasing processing for human consumption and direct exports to end users. In general, private sector investment will be a key element in promoting growth and for that purpose my authorities will implement policies to provide an environment that encourages investment, in particular foreign direct investment, with due regard for the environmental impact.

Fiscal policy

Execution of the 2010 budget is advancing well, with both expenditures and revenues on target during the first half of the year. The authorities are confident that this will bode well for the 2011 budget, which will be presented to parliament on 1 October. The budget is expected to be passed in December. The passing of the budget will mark an important step in Iceland's path towards recovery as general government finances will be returned to a primary surplus of around half a percent of GDP as a result of the 3.25 percent primary adjustment subscribed in the bill. The improvement is more than four percent of GDP over the 2009 figures. All revenues exceeding targets in 2010 will be saved. The medium-term fiscal path will be set on a firmer footing at the same time as the budget will include 2-year nominal ceilings that will guide policy through 2012 in line with the planned medium-term consolidation plan which aims at a primary balance of six percent after 2012. My authorities are fully committed to a consolidation path that remains in line with the ambitious consolidation programs in the Nordic countries in the early nineties.

Gross general public debt is expected to peak at around 120 percent of GDP this year with gross-external debt reaching 280 percent of GDP. The net international position, however, amounted to -30 percent of GDP in March 2010. The debt situation is actively being addressed, including measures such as the purchase of a Netherlands-based holding company and its assets and through buyback operations of Eurobonds, at discount, from the market. Staff points out that debt dynamics are favorable under the program design and could tolerate moderate reductions in the medium-term fiscal target. Also staff's debt sustainability analysis indicates that external and public debt levels remain sustainable with lower levels registered compared to the second review. Under a plausible scenario, external debt peaked at 300 percent of GDP in 2009, falling to 190 percent of GDP in 2015. To achieve debt targets, my authorities are committed to continue to contain financial sector contingent liabilities and limit the absorption of further private sector losses. A large part of Iceland's external liabilities are a legacy of the activities of multinational corporations with operations mainly in

other countries. Recently one such company was acquired by a German bank, resulting in a significant lowering of external debt.

Monetary policy

The Central Bank has continued to lower interest rates, keeping a close eye on inflation expectations and the exchange rate of the króna. In August the policy rate was lowered by 100 bp and again on 22 September when the Monetary Policy Committee decided to lower the Central Bank's interest rates by 75 bp. The policy rate (the seven-day collateralized lending rate) is now 6.25 percent while the deposit rate (current account rate) is 4.75%. This rate has in effect become the reference rate for bank lending. In a statement following its interest rate decision, the Monetary Policy Committee noted that the capital controls, developments in terms of trade and other factors affecting the current account balance, and the monetary policy stance relative to trading partner countries all continue to support the exchange rate. The Committee underlined that it stands ready to adjust the monetary stance as required to achieve its interim objective of exchange rate stability and ensure that inflation is close to target over the medium term.

The exchange rate has continued to strengthen, amounting to close to 17 percent against the euro from the beginning of the year. At the same time the five year CDS spread for Iceland has dropped from 412 basis points to around 300 basis points. The Central Bank has started to purchase foreign exchange on a regular basis for the purpose of reserve accumulation. This operation does not signal any preferred level for the króna. Initial purchases have been small but additional purchases, preferably via auctions, will be undertaken in the case of large irregular inflows into the foreign exchange market. Foreign exchange reserves will be further strengthened following the completion of the sale of the Danish FIH Erhvervsbank A/S to a consortium of four foreign companies on 18 September. When the transaction is complete, the Central Bank will receive a substantial amount of foreign currency, and will also have the possibility over the medium-term to recover the rest of a 500 million euro loan granted against share collateral in October 2008 to one of the failed Icelandic banks.

Capital account restrictions were imposed in late 2008 to stabilize the currency and contain damaging capital outflows. Enforcement of the controls has become gradually stricter reflected inter alia in the current account and stronger króna. However, ways to circumvent the controls will be found as time goes on and my authorities will continue to lift the controls gradually as soon as conditions permit. The next step would follow conclusion of the third review with lifting of some restrictions related to long term assets.

Inflation has been falling this year and should be well below five percent at year-end, closing on the inflation target soon thereafter. A reasonable outcome of labour market negotiations that are scheduled to take place later this year, will be crucial to anchor inflation expectations and secure more permanent stability of prices and income.

The policy framework

Reforms on banking regulation and financial supervision are on schedule. Among these are organizational reforms of the FME inter alia to enhance on-site inspection and off-site supervision; bank resolution procedures and prudential requirements inter alia to adjust in 2011 to new Basel capital and liquidity requirements and relevant EU directives; and passing this autumn of a draft bill harmonizing the deposit guarantee regime with EU Directives.

Public financial management reforms include a two-stage budget approval process and the 2011 budget will establish a binding two-year nominal ceiling. Amendments to the Local Government Act include two fiscal rules, namely a zero-balance rule requiring corrective measures if a local government is in breach, and a ceiling on the ratio of local government debt and commitments to tax revenues.

External Financing

While access to external financing will not be essential for meeting the debt roll over coming due in 2011 and 2012, it will be fundamental for building up the necessary confidence and will support the preparation of the release of the capital controls. In the event of any shortfalls, we stand ready to consult with the Fund to implement necessary measures to meet program objectives. My authorities will meet the preconditions of some of our bilateral partners to access bilateral program financing. In this regard my authorities reiterate the undertaking contained in their previous and current Letters of Intent to ensure that the United Kingdom and the Netherlands will be reimbursed in respect of deposits of Landsbanki branches in those two countries provided that comprehensive agreements are reached. The Icesave issue has been complicating the recovery for too long and a successful resolution is an important step to regain confidence in the Icelandic economy.