Iceland: Staff Report for First Review under Stand-By Arrangement and Requests for Extension of the Arrangement, Waivers of Nonobservance of Performance Criteria, and Rephasing of Access

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on October 20, 2009, with the officials of Iceland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 20, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff statement.
- A Press Release.
- A statement by the Executive Director for Iceland.

The document(s) listed below will be separately released.

Letter of Intent sent to the IMF by the authorities of Iceland\* Memorandum of Economic and Financial Policies by the authorities of Iceland\* Technical Memorandum of Understanding\*

\*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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#### INTERNATIONAL MONETARY FUND

#### **ICELAND**

# First Review Under the Stand-By Arrangement and Requests for Extension of the Arrangement, Waivers of Nonobservance of Performance Criteria, and Rephasing of Access

Prepared by the European Department in Consultation with Other Departments

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October 20, 2009

- Stand-By Arrangement: A 24-month SBA in the amount of SDR 1.4 billion (\$2.1 billion, 1190 percent of quota) was approved by the Executive Board (Country Report No. 08/362) on November 19, 2008, and a first purchase of SDR 560 million was made following the Board meeting. As required under the Emergency Financing Mechanism, the Staff Report for the Interim Review (Country Report No. 09/52) was issued on December 24, 2008. The second purchase, subject to the completion of this first review, amounts to SDR 105 million. It is proposed that the remainder of the program be extended and rephased to account for delays to date. The Nordic countries and Poland have also committed to provide funds to cover the financing gap under the program.
- **Summary**: Post-crisis dynamics have to date followed the expected pattern: a sharp drop in GDP, rapid decline in inflation, shift of the current account to balance, and gradual stabilization of currency and financial markets. Policy implementation has been subject to considerable delay, not least due to the protracted political fallout of the crisis, but also reflecting administrative bottlenecks. Several program quantitative and structural targets were missed. Meanwhile, better information became available about corporate sector external debt, and the division of banking sector debt between domestic and external creditors, which indicated that total external debt was considerably higher. It is expected to peak at about 310 percent of GDP in 2009 (but with Iceland's high external assets offering a significant offset from the perspective of Iceland's international investment position). The discussions focused on recalibrating policies to ensure robust reductions in debt, and putting financial sector reforms back on track. The authorities and staff agreed that a faster pace of fiscal adjustment and more gradual pace of capital account liberalization would be key towards preserving stability and sustainability. Strategies in both areas were approved and, in the case of the fiscal plan, after consultations with social partners. The authorities felt that rapid resolution of financial sector problems would be crucial to reviving the economy. Two of the three new banks have now been recapitalized, and some progress has been made towards a better framework for private sector debt restructuring. Finally, the authorities recognized that balance sheet exposures meant that currency stability would have to remain the key objective of monetary policy. To this end, interest rate policy has been adapted to evolving foreign exchange market conditions.
- **Discussions.** See Fund Relations
- **Publication**. The Icelandic authorities intend to allow the publication of the Staff Report.

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#### I. Introduction

- 1. Iceland's late-2008 economic and financial crisis was followed by a period of protracted political fallout. In late January the ruling coalition government collapsed and was replaced by an interim coalition of the Social Democratic Alliance (SDA) and Left-Green Movement (LGM). The senior management of the Central Bank of Iceland (CBI) was replaced: an interim governor was appointed (followed eventually by a new Governor in August), and a Monetary Policy Committee was set up (with two out of five members external to the CBI). Managers at the Icelandic Financial Supervisory Authority (FME), Prime Ministry and line ministries were also shuffled and in some cases replaced.
- 2. The end-April election ushered in political stability, and a renewed focus on solving Iceland's economic problems. The SDA-LGM coalition government now holds a majority in parliament. It has laid out plans, consistent with the IMF-supported program's objectives, to address Iceland's challenges, and it has sought and received the support of social partners including labor unions, summarized in a stability pact. After a period of intense debate, on July 17, 2009 Iceland also applied for accession to the EU. However, the timeline for negotiations is still unclear and the issue remains very sensitive within Iceland.
- 3. The drawn-out political crisis stalled policy implementation, but the new government implemented a number of actions to bring the program back on track (LOI ¶2). Quantitative targets for end-December covering net international reserves (NIR) and the net financial balance of the central government were missed (Table 1), but subsequent indicative targets have been largely met and cumulatively policies are on course. Financial sector and fiscal consolidation objectives are being met. Bank recapitalization was delayed, but two of three large banks have now been recapitalized. The fiscal consolidation plan was delayed, also by administrative bottlenecks in Iceland's small institutions, but has since been completed along with other structural actions (Table 2). Finally, in support of the program's exchange rate stability objective, the authorities have specified a strategy for capital account liberalization and adapted interest rate policy as needed.

#### II. RECENT ECONOMIC DEVELOPMENTS

- 4. The post-crisis dynamics of the real economy are taking shape (Table 3; Figure 1):
- GDP has tumbled, although preliminary first half numbers show a less-thananticipated decline of 5½ percent year-over-year. A sharp drop in domestic demand has fallen largely on imports. Within domestic demand, consumption has been smoother than expected, supported by fiscal policy and debt rescheduling, while investment has been more volatile, reflecting severe credit constraints. The slowdown

- is raising spare capacity, and the unemployment rate has already reached 9 percent on a seasonally-adjusted basis.
- Inflation has fallen rapidly, but the rate of decline has slowed of late. The 12-month rate has fallen from about 18 percent at end-2008 to just under 11 percent in September 2009. Inflation expectations, inferred from the yields on inflation indexed bonds, have remained low at around 3–4 percent. The broad stability of the exchange rate in 2009 has helped, although pass-through from recent weakness has slowed downward momentum. Second-round effects from high inflation have been avoided, reflecting cautious wage agreements between union and employer groups.
- The current account deficit has shrunken dramatically, to about 2 percent of period GDP during the first half of 2009. The trade balance has shifted into surplus. Imports, particularly durable goods and capital equipment, have compressed even more rapidly than expected, reflecting weak domestic demand. But the deterioration of the global economy since program inception has reduced exports, forestalling an even larger trade balance improvement. Strongly negative net interest receipts—a reflection of Iceland's external debt burden—have dragged the overall current account into deficit.
- 5. Financial markets have broadly stabilized, but risk remains elevated, and trade remains thin (Figures 2 and 3):
- The exchange rate now sits around end-2008 levels, but has endured wide swings. Since the opening of the interbank FX market in early December 2008, the onshore rate has remained around or above post-crisis lows of 180 krona per euro. After reaching a high of 140 krona per euro in February, the rate has weakened as interest rates have been reduced, capital control circumvention increased (due to light enforcement), and as lumpy interest payment outflows through June dwarfed the market. The offshore rate has been volatile with a recent spread around 10-30 krona above the onshore rate. The real effective exchange rate has now depreciated by almost 40 percent since early 2008.
- Interest rates have fallen dramatically on krona debt, but the risk premium on external debt remains elevated. A 600-basis point reduction in the CBI policy rate and a widening of the interest rate corridor around the policy rate has provided the system with ample liquidity. The overnight interbank rate has thus fallen from 18½ percent at end-2008 to 8½ percent at present, but interbank trade has been dormant since all of the major banks are holding excess balances at the CBI (Table 4). The yield on treasury bills has also fallen substantially, and the slope of the yield curve has turned positive. A CDS spread of about 400 bps signals a still elevated risk premium.

• Trade in asset markets remains extremely thin. Equity prices have stabilized but under conditions of very low trading. Housing prices, which have risen sharply since 2000, continue to drift downwards, and have fallen by about 10 percent in nominal terms in the last 12 months. A vicious downward circle, driven by a flood of resale housing supply, has been avoided to date via a standstill on foreclosures, debt rescheduling, and growing use of house swaps.

#### 6. The crisis has put balance sheets in every sector under severe stress:

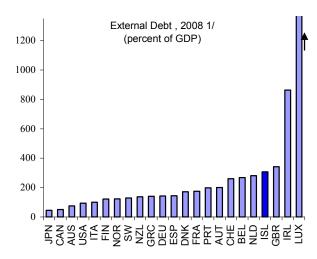
- In the **corporate sector**, which is heavily exposed to FX-linked debt, over 20 percent of the largest corporations are now in debt moratorium or under liquidation procedures. Corporate bankruptcies have risen substantially since the beginning of 2009 and are up 20 percent year-on-year. Banks' internal assessments suggest that two-thirds of loans will require some form of restructuring, including partial write off. (Figure 4).
- The household sector, which is heavily exposed to real estate as an asset, and to inflation-indexed and FX mortgage liabilities, has been shielded to date by a standstill on foreclosures and by various debt restructuring measures. Nonetheless, about 20 percent of households currently have negative equity in their properties, and many others would encounter negative equity if property prices continue to fall. Moreover, about 20 percent of households have a very high ratio of debt service to disposable income.
- In the banking sector, reported non-performing loans have risen sharply, to 15—17 percent of total loans, while asset valuation work has painted a bleak picture of asset quality in the new banks, suggesting a need for additional mark downs up to a total of 50–60 percent. Mark downs during the recap process will reduce credit risk substantially in the new banks, but they will still face significant imbalances, including FX open positions as high as 300 percent of their estimated capital needs. The imbalances give rise to a large negative interest rate spread when the exchange rate is stable or appreciating and this threatens banks' cash flow and profitability. Finally, the collateral damage of the crisis for the remainder of the financial system has been enormous: virtually the entire savings bank sector, along with the largest investment bank, has required government intervention (Table 5).
- The general government debt stock is expected to increase to about 125 percent of GDP in 2009 on a gross basis (90 percent of GDP on a net basis, excluding, *inter alia*, loans transiting through the government to the central bank to help build up reserves) (Table 6). Central bank recapitalization costs have been larger than expected (at 18½ percent of GDP), but this has been offset by lower-than-expected bank recapitalization costs, and by lower Icesave-related deposit insurance obligations (the obligation falls on the deposit insurance fund, which will amortize out of asset

recovery, with the government of Iceland liable only for any shortfall after seven years, and for interest capitalized over the seven years). Gross financing needs are high, the average maturity of central government debt is below three years, and the maturity profile is very lumpy, with maturities concentrated in a few years only, and half the non-indexed domestic Treasury bonds set to mature before 2011 (Figure 5). In addition, state guarantees amount to a very large 85 percent of GDP. These are concentrated in the mortgage finance firm (the Housing Financing Fund, or HFF) and Landsvirkjun (the public power company). These companies have substantial assets, report regularly on an IFRS basis, and are actively engaged in risk management, but are exposed to aspects of Iceland's crisis (housing, in the case of the HFF), and to aspects of the global crisis (aluminum prices, in the case of Landsvirkjun).

## 7. A clearer picture of Iceland's net international position (excluding the three large failed banks) has emerged:

• The stock of gross **external debt** appears significantly higher than earlier estimated (Box 1), but in-line with levels in other advanced economies. The additional external debt amounts to 92 percent of 2009 GDP, and pushes the projected end-2009 stock to

about 310 percent of GDP. The upward revisions largely relate to private sector debt (higher by 98 percent of 2009 GDP), which reflects a better understanding of the allocation of banking sector liabilities between residents and non-residents, and new information about the debt of Icelandic multinationals. Public external debt has been revised down by 7 percent of GDP, largely due to updated estimates of deposit insurance liabilities. High external debt ratios are common for advanced economies with high levels of global



Source: IFS, Haver, WEO, World Bank JEDH database, staff estimates. 1/ Iceland debt data is for 2009.

integration, but Iceland's post crisis debt levels do place it among the most indebted.

• The stock of gross **external assets** is estimated to be about 134 percent of GDP at end-2008. Beyond Iceland's international reserves, this figure includes assets held by Iceland's fully-funded pension schemes, and assets of Icelandic multinationals.

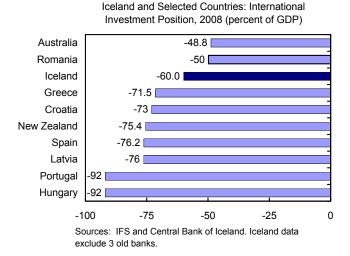
#### Box 1: Revised Estimates of the Stock of External Debt

A clearer picture has emerged of Iceland's post-crisis underlying external debt. Better information about the fallout of the financial collapse and about complex transactions entered into by Icelandic multinationals suggests that the underlying stock is about \$10.9 billion (92 percent of 2009 GDP) higher than initially understood. The main reasons for the upward revision are as follows:

- Public Sector and Deposit Insurance Fund (-\$0.8 billion; -7 percent of GDP):
- Foreign deposit insurance liabilities are now understood to be \$2.6 billion lower than originally projected (\$5.6 versus \$8.2 billion). Some deposits abroad were subsequently paid through asset recovery (e.g. Germany), and the original program made a very conservative assumption about the amount of deposits covered by insurance.
- Nonresident holdings of krona denominated public sector debt were \$1.9 billion larger than initially understood. The extra debt was divided among central bank CDs, general government bonds, and Euroclear/Clearstream settlement accounts absorbed by the CBI.
- Banking Sector (\$5 billion; 42 percent of GDP).
- In the original program, it was assumed that the *whole* of the external debt of the banking sector would be tackled and resolved or written down in the bankruptcy process. However, new information suggests that: (i) the external creditors of the old banks will recover some \$1.5 billion via the new-to-old bank compensation instruments (that is, for assets transferred in excess of liabilities); and (ii) external creditors could recover some \$1.3 billion from savings and investment banks now in bankruptcy.
- In addition, non-resident deposits in domestic branches of Iceland's banks are now incorporated into the estimate of external debt. This amounts to \$2.2 billion (\$1.6 billion in krona and \$0.6 billion in FX deposits).
- Other Private sector (\$6.7 billion; 56 percent of GDP). Information has become available about a very large 2007 debt transaction between an Icelandic multinational and a Luxembourg-based holding company. Estimates have also been adjusted for \$1.2 billion in write downs expected in the wake of the bankruptcy of several large holding companies.

There are some remaining margins of uncertainty about the external debt data, but these go in both directions. One source of uncertainty is the ultimate size of the new-to-old bank compensation instrument in New Landsbanki. In general, Icelandic corporations' international transactions remain a tangled web: there could be more unreported debt transactions with companies abroad, but it is also possible that there is some round tripping in the data—krona debt that is really held by foreign subsidiaries of resident corporations. Finally, it is possible that write downs of private sector debt may be larger than expected.

international investment
position (including non-debt
assets and liabilities) is
estimated to be about 60 percent of GDP,
comparable to many countries
in or in proximity to the EU,
and not out-of-line with
advanced country comparators.
In essence, Iceland's very high
level of integration with the
global economy has magnified
both sides of its balance sheet

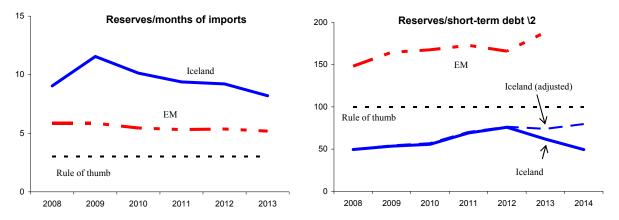


#### III. POLICY DISCUSSIONS

- 8. The authorities and staff agreed that program objectives remain appropriate. Balance sheet exposures called for continued focus of monetary policy on exchange rate stability, while actions were needed to restore the financial sector to health and to preserve fiscal sustainability. In support of these principal objectives, and in light of better information about private sector balance sheet distress, it was felt that increased emphasis should be given to establishing an efficient framework for private sector debt restructuring. It was agreed that at some point the program would need to ponder Iceland's post-crisis monetary framework, but the present juncture would be premature, and the focus should remain on measures to address Iceland's immediate post-crisis challenges.
- 9. It was agreed, however, that policies needed to be recalibrated to adjust for the higher-than-expected external debt level (MEFP ¶2). Much of the additional debt relates to one Icelandic multinational and is thought to be a self-liquidating problem. However, even excluding this, the other additional external debt and debt service raised problems with sustainability under original program policies and assumptions. Bilateral loan agreements with the Dutch, U.K. and Nordics embodied better terms than the program's conservative assumptions, and will help to address the issue. Endogenous macro adjustments are also likely to help; for instance a slightly less appreciated real exchange rate may lead to a stronger current account. However, full endogenous adjustment through the real exchange rate would magnify private sector sustainability issues (given balance sheet exposures). Thus securing a robust policy framework required some policy adjustments, including a more gradual path for capital account liberalization, and a more rapid pace of fiscal adjustment.

#### A. Macroeconomic Framework

- 10. Under the revised policy framework, macroeconomic outcomes are not expected to differ greatly from original program projections (Tables 7–8; Figure 6):
- GDP is projected to be slightly lower both in the near and medium term. From the demand side, tighter fiscal policy and real effective exchange rate adjustments would shift the composition of growth, leading to lower domestic demand and a stronger external sector. Within domestic demand, investment projections have been adjusted downwards on the outlook for FDI, especially in the energy and aluminum sectors; while consumption projections have been smoothed, reflecting experience to date. The authorities and staff expect growth to bottom in the first half of 2010.
- **CPI Inflation** is expected to be slightly higher in 2009, reaching about 7 percent, due to higher consumption taxes and recent exchange rate movements. However, as pass-through from the recent bout of currency weakness dissipates, base effects from late-2008 diminish, and unit labor costs improve (reflecting the recently agreed stability pact with social partners), inflation rates should approach program targets.
- The current account is expected to be slightly below program projections. The trade balance would improve over the medium-term as weaker domestic demand and a less appreciated exchange rate reduce imports (exports should also respond, but with less vigor due to supply constraints in key industries). The better trade balance partially offsets the higher debt service implied by revised external debt statistics.
- The capital and financial account is weaker than under the program in 2009–10, reflecting lower projected FDI in the energy-intensive sector and higher amortization payments on the revised debt stock. This is partly offset by a more gradual pace of liberalization of capital outflows. The level of gross reserves is lower than under the program in the medium term. Nevertheless, the level of coverage appears adequate in the short term (with capital controls in place, import coverage is the appropriate metric); and converges on an adequate level of short-term debt coverage in the medium term (i.e. as capital controls are lifted).



Source: WEO, staff estimates. EM (emerging markets) and OECD data are medians.

- \2 Short-term debt is on residual maturity basis. Adjusted measure for Iceland excludes a large multinational (which has offsetting assets and liabilities).
- 11. The revised macroeconomic projections are broadly in line with experience in past banking-cum-capital account crises (Figure 7). In Iceland, however, the higher initial macroeconomic imbalances and debt burden suggest a slightly stronger contraction in domestic demand and a stronger adjustment in trade balance than in a typical crisis case.
- 12. Iceland's very high public and external debt is a matter for concern, but staff analysis suggests that debt will decline under the macroeconomic baseline (Appendix I):
- Gross **external debt** is expected to remain very high and to peak at about 310 percent of GDP in 2009 (excluding amounts in old banks set to be settled in the bankruptcy process). However, it is expected to decline continuously thereafter under the program baseline (Table A1). Both sides of Iceland's balance sheet are expected to shrink through stock adjustments: (i) external asset recovery in old Landsbanki is expected to cover about 75 percent of external deposit insurance liabilities; and (ii) Iceland's globally integrated corporations are projected to go through an extended period of balance sheet repair, involving write-offs, debt-equity swaps, and realization of foreign assets (the Appendix presents the case study of one company, which alone represents 70 percent of GDP in external debt). Overall Iceland's net international position should improve, aided further by improved flows; that is, increased national savings reflected in improved current account dynamics. Indeed, by 2014 the current account balance is projected to be comfortably above the debt stabilizing deficit level, and IIP improvements should continue.
- Iceland's **public debt** is also expected to remain very high, peaking at about 136 percent of GDP in 2010. However, thereafter it also declines under reasonable assumptions, assisted by the now faster pace of fiscal consolidation (Table A2). By 2014, the public surplus is expected to be comfortably above the (deficit) level that would stabilize debt, suggesting that if policies were maintained beyond 2014, the downward trend in debt would continue.

- 13. Analysis of the potential impact of shocks gives comfort that the debt reduction path is robust, provided that the program is strictly implemented (Figures A1 and A2):
- Standard shocks, which capture key individual risks for Iceland, do not upset the declining path for gross external and public debt ratios. Debt continues to decline in the face of: higher interest rates (e.g. due to a sovereign downgrade); a lower current account balance (e.g. due to terms of trade shocks affecting the resource-intensive export base); and higher contingent liabilities (either through the financial sector or through outstanding public guarantees). An exchange rate shock does initially raise external debt considerably, but all else equal debt begins to decline again (and the strengthened program framework for private debt restructuring would be expected to curtail indirect impacts on growth through balance sheet channels). The response to shocks in each case is similar to that shown in the original program, and the dynamics reflect the fact that the non-interest current account balance and primary government deficit are comfortably above their debt-stabilizing levels.
- Under a tailored alternative downside scenario—to capture multiple correlated shocks—debt declines are preserved, provided the fiscal targets are achieved. The tailored scenario assumes weaker FDI (delay of an anticipated aluminum project), a 300 bps increase in the risk premium, and lower growth (by 1½ percent per year on average). The debt ratios still fall back beneath initial values in this scenario assuming that fiscal deficit targets are met (which would require identification of additional measures).
- The external debt would not be sustainable under a historical scenario, while the public debt would not be sustainable under a no policy change scenario. The odds are extremely low that Iceland will anytime soon realize the elastic capital flows at the core of the 2003–07 episode, but this underscores the need to move ahead with envisioned reforms to financial sector supervision and regulation. For public debt, it is clear that double digit public deficits cannot be maintained, and full implementation of the program would correct this.
- 14. A high level of external assets, Iceland's funded pension plans, and potential upside on bank resolution outcomes and FDI, offer additional comfort about the high level of external and public debt:
- Large external assets indicate that the resources exist for a substantial de-leveraging of the economy (beyond the one multinational case considered). It also suggests substantial upside, relative to staff's conservative projections, for the income account of the balance of payments and the ability of Iceland to service its high debts.

- Iceland's high level of public debt is not further compounded by extensive unfunded public pension liabilities, as in many other OECD countries. The fully-funded pension schemes in Iceland imply that there are no hidden fiscal adjustment needs.
- Regarding bank resolution, program assumptions are conservative, and upside is possible. The debt sustainability estimates assume that the government recapitalizes and owns the banks until at least the end of the projection period, whereas the deals reached for two banks suggest early creditor ownership (instead of compensation via debt issuance) is a possible outcome. At the same time, asset recovery in Landsbanki is assumed to be in the bottom half of the range recently identified by auditors (75 to 95 percent of the deposit liability).
- In addition, a stronger output recovery based on higher FDI is a possibility, and would improve debt dynamics. The authorities are working toward realizing such an outcome, and acknowledged the need to boost the perception of Iceland as an attractive destination for foreign investment. It was agreed, however, that it would be prudent to reflect upside in the program only if and when it became more certain.

#### **B.** Monetary and Exchange Rate Policy

- 15. The authorities and staff agreed that the program's monetary strategy—the focus on stabilizing the exchange rate within a flexible regime—remains appropriate (MEFP ¶3). Concerns about balance sheet exposures remained paramount, and concerns about containing pass-through had been underscored by the recent bout of exchange rate weakness. These concerns were unlikely to lift soon, although down the road the envisaged targeted corporate and household debt restructuring could eventually help with the balance sheet issue. Many in Iceland advocate euro adoption as a quick fix for Iceland's problems, but the authorities recognized that this route, if selected, would take years to implement.
- 16. It was agreed that both capital controls and firm interest rate policy would continue to be needed to maintain exchange rate stability. The existence of large nonresident krona holdings (amounting to some \$5 billion, or 40 percent of GDP), and the propensity of residents to invest abroad, suggest that without capital controls, outflows could be very large. This rules out rapid capital account liberalization. However, even with capital controls in place the level of interest rates remains a crucial consideration toward exchange rate stability. There are current account flows which give a margin of choice between FX and krona assets (for example, interest payments, which may be reinvested; and export proceeds, which may be kept in either FX or krona). And of course it is difficult to eliminate all channels for circumventing the controls, but possible to influence the opportunity cost of this with interest rates. It was agreed that a tightening of the administration of controls, and clarification of the path for control liberalization (in particular to emphasize that it would only be done in a gradual manner consistent with stability), would be essential to help take some of the pressure off of interest rate policy.

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- 17 The authorities' priority has been to use policy space to cut interest rates, but an initial round of aggressive cuts has given way to a pause and shift to a tightening bias. Lower inflation and a broadly stable krona provided space for the Monetary Policy Council (MPC) to cut interest rates beginning in early-March. In total rates were reduced by some 600 basis points by early-June, a pace much faster than IMF staff advocated. This rapid policy loosening, and a weaker than expected balance of payments (including due to capital controls leakages), produced a sharper-than-expected depreciation of the krona, despite some intervention. After reviewing the outlook and balance of risks, the MPC elected to pause with rate reductions and signal that it stands ready to increase rates if necessary. Going forward, the authorities perceived that new monetary policy space would hinge on greater clarity about fiscal policy, the balance of payments outlook and bank restructuring, all of which could help lower the risk premium on krona assets and appreciate the krona. In this instance, they expected a more cautious approach to rate reductions. They also recognized that the level of rates would have to be coordinated with steps toward capital account liberalization: the risk-adjusted rate of return will have to be attractive enough to limit outflows as liberalization proceeds.
- 18. The authorities have approved and published a plan for a gradual liberalization of capital controls (MEFP ¶5).¹ The authorities and staff agreed that full liberalization as soon as possible must be the aim. The authorities were initially inclined to push aggressively forward, but in light of the balance of payments outlook and the need to preserve currency stability, it was agreed that the liberalization would be done in stages, as preconditions are met (Table 9):
- From international experience with liberalization, key **preconditions** include credible macroeconomic stabilization policies (to reduce country and exchange rate risk); attractive returns (to give an incentive to remain in the krona); strong reserves and a good outlook for the balance of payments (to limit any near-term volatility after each step); greater financial system stability and adequate supervision (otherwise risks of financial and currency stability could be magnified); and fiscal stability (confidence that the government will be able to continue to issue and rollover debt in adequate volumes and at sustainable interest rates).
- The agreed **sequencing** would focus first on freeing all new non-FDI inward investment in foreign currency (FDI is already free of controls, but experience suggests that benefits will accrue faster once other complementary flows are liberalized). In the second stage, accounts and assets of a long maturity that had been in the holder's possession for some time would be gradually released by raising thresholds and by selectively lifting controls on transactions. In a final stage, krona assets or accounts most likely to depart the country upon liberalization—those of

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<sup>&</sup>lt;sup>1</sup> See http://www.sedlabanki.is/?PageID=287&NewsID=2196

shorter maturity—would be released. The authorities indicated that they may use auctions of FX-convertible bonds during the final stage to calibrate the speed of the release (with the amount of the bids and the difference between the face value and bids providing an indication of sentiment). The use of krona in international transactions would be curtailed throughout the liberalization process to limit opportunities for circumvention.

- Regarding the **timing**, it was felt that the liberalization could begin late in 2009, with release of controls on new inward investment. However, with the many uncertainties it was agreed that it made little sense to define an explicit timetable for the other stages: these would proceed as preconditions fell into place, and at a pace that the market could digest.
- Gradual liberalization of the controls will be combined with a tightening of their administration. Controls typically lose effectiveness over time as ways are found to circumvent them. The authorities felt that the light enforcement to date was a key reason for widespread violation of the controls. To address this they have set up monitoring and investigation units dedicated to enforcement. Going forward, each step taken toward liberalization will multiply opportunities for circumvention, requiring that administration be strengthened in parallel. The authorities and staff agreed that if it proved necessary for effective administration, assets at the greatest risk of flight could be ring-fenced in the CBI (where they would earn a market return).
- 19. While current payments are generally transferable in Iceland, the capital control regime does give rise to exchange restrictions subject to Fund jurisdiction under Article VIII. The regime marginally affects the conversion and transfer of two components of current payments, as defined by the IMF: interest on bonds (the transfer of which the FX rules apportion depending on the period of the holding) and the indexed portion of amortized principal on bonds. It was agreed that these exchange restrictions were needed for BOP reasons, and that they were non-discriminatory. The objective to liberalize controls and the newly specified strategy to this end made it clear that they were of a temporary nature.
- 20. Improvements in monetary operations have been implemented, and these will also help achieve monetary policy objectives (MEFP ¶6). The authorities felt that they needed to strengthen the CBI's ability to control liquidity and to implement interest rate strategy effectively. Limits were thus placed on the volume of short-term open-market operation lending, and the CBI's CD issuance strategy was adjusted (6 month CDs have been replaced with 28-day bills that are auctioned weekly, with the total volume geared to absorb the estimated surplus liquidity).

#### C. Financial Sector Policies

21. The authorities and staff agreed that financial system restructuring ought to remain driven by three key imperatives (MEFP ¶7). First, the latest data on public and external debt underscored the need not to further absorb creditors' losses, whether through direct use of public resources or the use of the public balance sheet to assume risks. Second, the need to strengthen commercial relations between the new banks and international creditors, and to mitigate the risk of potential litigation, meant that it remained imperative to aim for fair and equitable treatment of creditors, in line with applicable law. Third, since further delays in restructuring would slow Iceland's return to economic growth, delay capital account liberalization, and prolong uncertainty about debt sustainability and exchange rate stability, it was important to move the financial sector restructuring process along as quickly as feasible. To facilitate progress, the authorities overhauled their management of the process, and hired an advisor, Hawkpoint (MEFP ¶8).

# 22. The full establishment of the new banks proved to be more complex than expected, but a way forward was found (MEFP $\P 9$ ):

- It proved impossible to obtain a point valuation for the assets transferred from the old to the new banks. The high level of post-crisis uncertainty made it difficult to achieve agreement on assumptions and methodology. Two separate estimates were ultimately developed, and the range so-defined served as a basis for negotiations (Box 2). With this as backdrop, a consensus emerged that the problem could be mitigated by designing the compensation instrument to support a range of valuations. The originally envisioned debt instrument would be complemented by a second instrument with a variable return, with the whole package enabling creditors to participate in asset upside/downside.
- The process for negotiating compensation was delayed by the desire of the old banks' Resolution Committees (RCs) to consult with creditors before reaching an agreement with the government on the terms of such compensation; and by the desire of creditors to have access to more information before ratifying any RC settlement proposal. To move forward in a fair and equitable manner, the authorities (i) made information more widely available in mid July to creditors (it had been available to RCs and their financial advisors since May); (ii) allowed additional time—to early-September— to finalize banks' opening balance sheets (that is, to agree on valuation and bond compensation); (iii) allowed even more time for Landsbanki (where there are greater complexities) to finish negotiations about the valuation and the precise parameters of the compensation package; (iv) allowed time for RCs to consult with creditors about any agreement; and (v) allowed selected creditors to observe and participate directly in the negotiations.

#### Box 2: Valuation of the New Banks' Assets

Two estimates for the valuation of transferred assets were developed, which together imply a wide overall valuation range:

- **1.** The Report of the Independent Accounting Firm (Deloitte, with subsequent assessment by Oliver Wyman). This was produced at the behest of the FME, in line with the original program strategy:
- The valuation methodology assumed that the new banks would continue to operate as fully capitalized domestic Icelandic banks with no requirements to divest their assets or settle their liabilities on a distressed basis. However, the methodology could not be agreed with creditor representatives, who objected *inter alia* to non-IFRS elements inherent in this approach, and the use of a discounted cash flow method (which would have a significant impairment effect on loan value, given high interest rates).
- Deloitte ultimately produced a range for the valuation instead of a point estimate, reflecting the uncertainty about Iceland's and most individual borrowers' medium-term outlook.
- 2. New banks' management assessment (in the process of being examined on the basis of IFRS by their independent auditors). The banks opening balance sheets had to be audited on the basis of IFRS to determine recapitalization needs.
- In this approach, loan value incorporates new elements relative to Deloitte's methodology, including an assessment of asset deterioration after March 15, 2009 (i.e. after completion of the Deloitte report), lack of FX funding, a higher ISK interest rate, revised collateral valuation criteria, off balance sheet items, and a longer horizon to restructure loans (given assumptions about a more challenging macroeconomic outlook).
- The results suggest an average markdown of 62 percent.
- The compensation packages for Old Kaupthing and Old Glitnir have now been agreed. In each case a "base" valuation was first settled, close to the low end of the valuation range, to provide the basis for a fixed compensation instrument. Upside was then handled in the case of New Kaupthing by ring-fencing and tracking returns on the 40 largest loans (with a settlement in three years, based on excess returns, up to a cap); and in the case of Glitnir by two contingent bonds (which vest in 2-3 years, and pay out according to a measure of excess profits, again up to a cap). In both cases, if all instruments pay out up to their caps, the implied valuation is towards the middle of the overall valuation range. For both new banks, the government also agreed to allow the old banks to acquire a majority interest. They would purchase the government's stake via cash, swap of their compensation bonds, or injection of other suitably high quality assets. The potential acquisitions remain subject to creditor ratification, and the approval of the FME (for instance, as regards governance and the ownership

structure). In essence, if creditors still believe the agreed valuation/compensation is too low, they can recapitalize and assume ownership of the assets.

- Negotiations concerning the Landsbanki compensation package still continue:
  - The authorities have agreed in principle with the RC to work towards bond compensation. Further equity-based compensation would be discussed through mid-November. The authorities acknowledged that while there are reasonable prospects for reaching agreement with the RC, there are perhaps insurmountable hurdles to full creditor agreement in the Landsbanki case. The problem revolves around the depositor preference introduced in the emergency law: asset recovery is not expected to fully cover deposits, leaving other creditors with nothing. Legal challenges to depositor preference are likely from these other affected creditors.
  - In the event that an agreement on compensation cannot be reached, the authorities reserved the right to put in place a package. Old Landsbanki would in this instance be given a debt instrument and an equity option exercisable over the government's shareholding (subject to the government earning a return on its investment above its cost of funds). Provided that the total compensation has some grounding in an agreed (or otherwise independent) assessment of valuation, this could be considered a fair outcome. Independent arbitration over valuation had been weighed as an option, but some drawbacks have been identified, principally the inability to bind underlying creditors, and the likely difficulty in agreeing terms.
- The approach to **recapitalization** was refined. It was agreed that higher tier 1 capital than envisioned in the program—12 versus 10 percent—would be needed to account for credit and liquidity risks and to provide a buffer to absorb losses. Due to the smaller size of bank balance sheets (as determined during the valuation process), the total initial injection by the government would amount to 277 billion krona, or 19 percent of GDP. If the old banks later acquire a majority equity interest in two of the banks, as is the aim, the government injection would be reduced to 200 billion krona (part of which would likely be tier 2 capital). In either case this would be much less than the 385 billion krona envisioned in the program. The recapitalization for New Kaupthing and Islandsbanki was completed by end-August and for New Landsbanki is proposed as a new program **structural benchmark** for end-November.
- 23. Recapitalization of the banks still leaves the difficult challenge of operationally restructuring them (MEFP ¶10). Overall, the three new banks will amount to a much-more-manageable 150 percent of GDP. The largest new bank, New Landsbanki, will comprise 63 percent of 2009 GDP. But the new system has to be strengthened:

- It was agreed that a stronger **governance framework** was required to ensure that restructuring proceeds. An agency has thus been established to hold the government's bank shares. This is expected to help insulate government-owned banks from political pressure, while leveraging the experience of banking experts toward implementing prudent lending, cost reduction policies, and transparent competition. The authorities noted that the agency is not designed to micro-manage, but will have leverage through its approval of banks' business plans, and by being the vehicle through which the government injects any new capital (staff recommended that it hold in reserve enough "contingent" capital to cover a possible decline of 2½–5 percent in banks' CAR). This framework was successfully utilized during the Norwegian banking crisis in the early 1990s. If the old banks (and their creditors) were to become the largest shareholders in two of the three banks, the role of this agency would have a more limited scope.
- The key near-term operational issue would be to address **balance sheet problems.**Liquidity indicators for the new banks appear reasonable (15–30 percent of total deposits), but risks could arise in the context of capital control liberalization (deposit euroization or flight), and the banks also continue to have some illiquid assets (mainly claims on failed savings banks). Moreover, they face an excess of FX assets over liabilities, and interest rate and maturity gaps. It was agreed that problems could be reduced dramatically by denominating any compensation bond to old banks in FX, and by accepting FX subordinated debt in lieu of equity during the recap. Banks' business plans envisage that remaining imbalances will be handled over time within the debt restructuring process, by *inter alia* providing appropriate and targeted incentives for the gradual and voluntary conversion of foreign currency loans into krona loans over 2–3 years (the authorities rejected forced conversions, an approach advocated by some).

Balance Sheet of the Three Major Banks 1/ (in ISK billions, unless otherwise stated)

·	New Landsbanki 2/	New Kaupthing	Islandsbanki	Total
Total assets	929	624	639	2,193
(in percent of GDP)	63	43	44	150
of which:				
compensation instruments from the old bank		38		38
private sector loans	557	336	494	1,387
Total liabilities and equity	929	624	639	2,193
Total liabilities: of which:	809	547	576	1,931
compensation instruments to old banks	208		52	260
Equity	121	78	63	261
Government capitalization	140	72	65	277
Operating profit / loss	-19	5	-2	-17
Memorandum items (in percent):				
Tangible equity to total assets	13	12	10	12
Capital adequacy ratio (CAR)	12	13	12	12

Source: Ministry of Finance, FME, Hawkpoint, and New banks' preliminary business plans.

- 24. **Stabilizing the remainder of the financial system has proven to be an equally difficult challenge (MEFP ¶12).** The authorities had put in place, in late 2008, a program to inject up to 20 percent of an institution's end-2007 capital, provided that this brought the capital adequacy ratio to 12 percent. Subsequent audits revealed that very few institutions would qualify, and that several were deeply insolvent. The authorities have in each case allowed the affected institution and its creditors time to restructure debts, in some cases with multiple deadline extensions. The work is nearing completion:
- Three problem institutions were intervened in March-April. Action was taken after concerns grew about these institutions' liquidity position and about possible asset stripping by managers and related parties, and following failed efforts between the banks and their creditors to find a solution which did not require the government to partially socialize private losses. The authorities protected depositors—deposits and a matching amount of assets were transferred to New Kaupthing and Islandsbanki—and the system remained stable.
- Some remaining savings banks also face significant capital shortfalls. In the last two months, these banks have been engaging in negotiations with their creditors. Proposals have recently been submitted to the FME, and these are being evaluated for technical feasibility, before the FME communicates its opinion back to them. The authorities indicated that, before they would inject any capital, they would need to be assured that the proposals would insulate the government from existing credit losses and liquidity risk.

<sup>1/</sup> As of end-December, 2008.

<sup>2/</sup> Agreement on recaptalization and compensation instrument of New Landsbanki has not been reached. Numbers shown in New Landsabanki refer to preliminary estimates.

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Some other very small savings banks are either sound or will be recapitalized with government participation by end-November, after a full evaluation by the FME and CBI of their audited financial statements and business plans. Addressing remaining problems in savings banks, including those presently facing deep capital shortfalls, was proposed as a new **structural benchmark** for end-November.

### 25. A review of supervision practice has revealed notable deficiencies, and the authorities are determined to correct these (MEFP ¶14):

- A external banking expert published a report in March 2009 (meeting a program **structural performance criteria**). The report noted many problems, including inadequate liquidity stress tests; insufficient definitions of related parties; an excessive concentration of loans to holding companies (that invested in shares or other venture capital); indirect risks through cross-financing of bank shares; and inadequate fit-and-proper rules for owners and managers.
- The authorities were determined to implement the recommendations in the report to strengthen banking supervision. Actions would be taken to enhance the FME's supervisory capacity by means of more specialization within the authority and more resources allocated to onsite inspection. The authorities were also preparing legislation to: strengthen supervisory powers of the FME (in particular its ability to strictly regulate large exposures and connected lending); create a national credit registry (to allow proper and timely identification of significant risk exposures); and improve the deposit insurance system. Given the importance of strengthening confidence in the system, the introduction of such legislation has been proposed as a **structural benchmark** for end-December 2009.

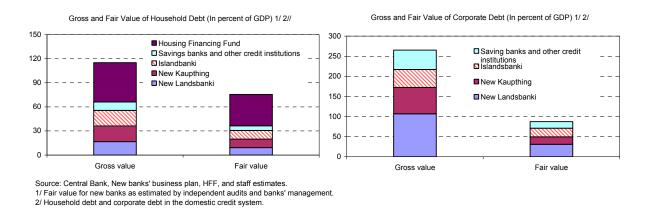
#### D. Private Sector Debt Restructuring

26. The authorities and staff agreed that establishing a framework for targeted private sector debt restructuring was an important objective for the program (MEFP ¶15). This would complement efforts to revive the financial sector and facilitate new bank lending, diminishing the credit constraints now holding back investment and growth. There were good reasons to further avoid delay. A large number of companies are already in distress, with high leverage and heavy FX exposure, and even the expected rebound of the krona could not be counted on to revive them. Moreover, there was a growing risk of contagion from distressed companies to healthy and viable companies through trade credit channels; of dissipation of assets by corporate managers; and of a vicious circle in residential housing involving negative equity, forced sales, and further price declines.

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<sup>&</sup>lt;sup>2</sup> Report on Banking Regulations and Supervision in Iceland: past, present and future <a href="http://eng.forsaetisraduneyti.is/media/frettir/KaarloJannari">http://eng.forsaetisraduneyti.is/media/frettir/KaarloJannari</a> 2009.pdf.

27. A number of key principles will guide the restructuring approach. The authorities acknowledged the importance of safeguarding credit discipline and of distinguishing between viable debtors (who can be rehabilitated) and non-viable debtors (whose rapid exit should be arranged through credible and efficient liquidation and bankruptcy procedures). For these reasons, they have rejected calls for across-the-board debt relief. The authorities recognized that there would be no room for further fiscal assistance. However, they noted that the compensation agreement between the new and old banks will provide the new banks with a margin to fund restructuring: the difference between the face value and new book value of their loans (text figure). This would be used judiciously, with representatives of old banks monitoring the process. The program discussions revolved around defining an approach to restructuring that would rely principally on market-based voluntary workouts, underpinned by measures to strengthen the legal framework that supports debt restructuring. International experience suggested that with good execution the process could be complete in 18–24 months.



# 28. For household debt restructuring, it was agreed that the time had come to move away from emergency post-crisis measures towards a framework (MEFP ¶16).

Emergency measures had helped to prevent a housing market meltdown, but could not be sustained. Thus the temporary freeze on payments of foreign-denominated mortgage loans was lifted in late-April 2009, and the freeze on foreclosures will be allowed to expire in October. In their place voluntary mortgage workouts would be used (based on existing Housing Finance Fund approaches), and for more distressed households, a framework for rescheduling was specified (text table). In support of debt workouts, specific amendments were introduced to the insolvency law, and a more comprehensive review of the household insolvency regime has now been completed (reforms will be proposed by end November). The cross-sectional data on households suggests that only a subset of households are under negative equity in their properties and/or with high multiples of debt services to income, and would need measures beyond voluntary workouts. But with loans already marked down on banks' books the incidence of the restructuring would not fall on the government. The challenge, going forward, will be to monitor progress, consolidate various measures into a

coherent framework, assess whether the framework is providing adequate relief, and efficiently administer the system in the event of a surge in applications for rescheduling.

	Housing Financing Fund (HFF)	Banks and other non- banks		
I. Voluntary Workouts	ruliu (HFF)	baliks		
For mortgage and other debts				
Payment suspension (installments and interest), extending maturity, partial payment plan	Available	Available		
Refinancing defaulted payments	Available	To be introduced		
Voluntary conversion of FX-indexed loans to ISK denominated loans	n.a.	Available		
For mortgage debt only				
Payment smoothing based on May 2008 level and mortgage payment adjustment index (for ISK-indexed or FX-indexed loans)	Available	Available		
II. Legal framework for the most distressed households (mortga	ge debt only)			
Temporary Mitigation of Residential Mortgage Payments' under the legislation (temporary debt relief based on repayment capacity granted by district court if other voluntary workouts are insufficient.)	Available			
III. Insolvency framework  Amendments to expedite court approval of rehabilitation agreements between debtors and unsecured creditors	Introduced to the	ne insolvency law		
Review the existing insolvency regime to determine whether to integrate debt counseling services and to include secured creditors in an individual's rehabilitation proceedings	Proposed reforms by end-October 2009			

Source: Central Bank of Iceland, Icelandic authorities, Housing Financing Fund and major banks.

## 29. For corporate debt restructuring, it will take more time to put a full framework into place (MEFP ¶17):

• Bank-led **voluntary restructuring**, based broadly on the London approach, was deemed viable (the authorities report that an independent external expert found that banks had the capacity to do this). The broad outline of the framework was understood (text figure), but it would take some additional time and technical assistance to finalize the details. The authorities and staff agreed that an asset management company (AMC) could also become necessary. It would serve as a safety valve if bank-led restructuring proved insufficient to restructure debts of the largest and most economically significant firms. It would provide for synergies on debt and operational restructuring. Legislation enabling establishment of an AMC has been passed. The prospective AMC would be established with clear objectives and aligned incentives in governance and asset disposal, consistent with international best practice.

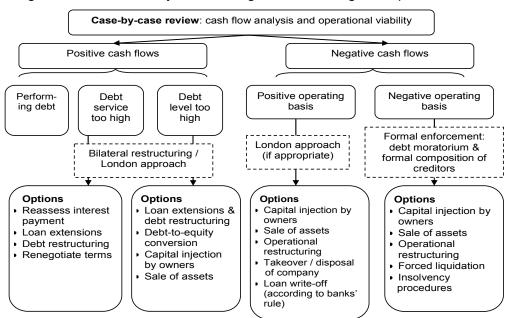


Figure: Bank-led Voluntary Restructuring Process for Largest Corporate Loans

• The authorities recognized that out-of-court workouts operate more effectively in the shadow of an efficient and credible **legal and institutional insolvency framework**. Accordingly, the government has undertaken a comprehensive review of the corporate insolvency regime. The review has focused on promoting out-of-court rehabilitation agreements between creditors and viable corporate debtors and facilitating the rapid and efficient liquidation for nonviable firms. It has also assessed other critical features of the bankruptcy regime (e.g. incorporating a liquidity test for initiation of insolvency proceedings and including secured creditors in agreed restructuring plans). The authorities will submit to Parliament by end-November key proposals for reforms.

#### E. Fiscal Policy

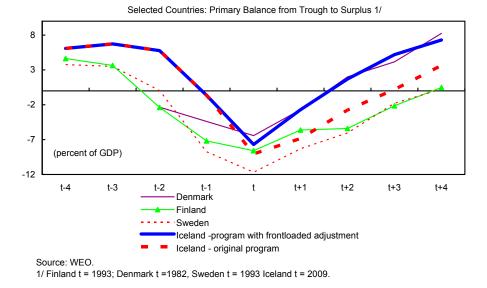
30. The authorities and staff agreed that the fiscal consolidation phase of the program had to be brought forward, and the pace of adjustment increased (MEFP ¶18). The original program targeted full operation of automatic stabilizers in 2009, and

improvement of the structural primary fiscal balance by about  $2\frac{1}{2}$  percent of GDP per annum thereafter. Earlier action on fiscal consolidation would underpin better external and public debt dynamics, contain the fiscal financing challenge as capital controls are gradually lifted, help promote a better fiscal-monetary policy mix in the near-term, and put policy in a better position to manage risks from legal and public-enterprise-related contingent liabilities. The authorities stressed their political resolve to tackle the fiscal challenge, and the strong support from social partners for a faster pace. They made progress toward medium term consolidation the top item in their 100-day post-election agenda.

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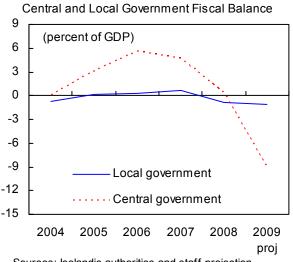
- 31. Measures have been taken to contain the 2009 fiscal deficit (MEFP ¶19). The authorities reported that revenues had contracted more than earlier envisaged, due to sharply changed consumption patterns, while the budget had also been affected by rising outlays for unemployment benefits, and higher interest on inflation-indexed debt. To help offset this, the government introduced increases in excises and social security contributions, surtaxes on high incomes, operational spending cuts, better means-testing of social benefits, and cuts in public investment. The measures amount to 2 percent of GDP, and would be sufficient to keep to the program's original fiscal deficit target. The revenue changes will bring the tax system more in line with other Nordic countries, while expenditure savings focus on recent areas of high spending growth while protecting vulnerable citizens.
- 32. The medium-term consolidation plan, embodying a faster pace of adjustment, was approved by the Cabinet in July (MEFP ¶20).<sup>3</sup> The plan, which was a structural benchmark for end-December 2008, was discussed extensively with social partners, which the authorities stressed would lend greater credibility to it. Key details are as follows:
- The authorities targeted an improvement of the structural primary balance of 3½ percent of GDP in 2010, and 3 percent of GDP per annum in 2011–12. This is at the very upper end of the program range. The overall scale of the adjustment is ambitious, but the pace would be similar to that seen during the Nordic consolidations in the 1980–2000 period, providing reassurance about feasibility (in light of their similar socio-economic characteristics and the similar overall macro context). Going forward, the authorities and staff agreed to shift the focus of program targets to the primary balance, which would avoid difficulties in measuring potential GDP and elasticities, which are subject to great uncertainty in the aftermath of the crisis. By this metric, the targeted adjustment in 2010 would be 5½ percent of GDP.

<sup>3</sup> See <a href="http://www.ministryoffinance.is/publications/measures20092013/">http://www.ministryoffinance.is/publications/measures20092013/</a>



• The plan commits the central government to the targets, but acknowledges a need to coordinate with local governments to ensure a fair division of general government adjustment. Local

governments undertake about onequarter of general government spending, and now run a deficit of just over one percent of GDP. They have not been a major source of fiscal instability in the past, but do tend to run procyclical policies. Looking towards Iceland's recovery, avoidance of this would help reduce the burden of adjustment on the central government. The authorities noted that representatives of local governments had endorsed the



Sources: Icelandic authorities and staff projection.

stability pact, and the fiscal targets therein, providing a good basis for cooperation moving forward. To strengthen the fiscal-federal framework, it was agreed that renewed consideration would be given to introducing local government borrowing limits.

• To realize the adjustment, the authorities envision a broadly balanced mix of measures (Table 10). They wished to preserve the basic model of the Nordic welfare state. In total, about two-thirds of the necessary measures have been identified by the authorities in consultation with their social partners. This is enough to cover adjustment needs in 2010–11. The measures are discussed in detail in the plan:

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- Revenue measures, which will dominate in the near term, will involve every major tax. The measures aim for fairer burden sharing, and to bring tax rates to levels seen previously in Iceland and in countries with a similar size of government (Figure 8).
- ➤ Spending cuts will fall on all budget categories. Cuts to current spending will be delegated to line managers (who have been given guidance on the types of wage and operational adjustments to make). Cuts to investment spending would bring the ratio relative to GDP back down to that of previous years (and special attention has been given to targeting the cuts to avoid stalled projects). Cuts to transfer programs will focus on introducing greater means-testing to ensure protection of the most vulnerable.
- ➤ Work continues toward identifying remaining measures for the outer years, with a focus on further adjustment to transfer programs to ensure that they are better means-tested. The staff and authorities agreed that these could be elaborated in more detail in early 2010.

The intended approach—large upfront increases in direct taxes and cuts in public investment, later switching to items such as welfare transfers that require more time to implement—is in line with other OECD consolidations which had a high probability of being continued.<sup>4</sup> Staff analysis suggests that the envisioned tax increases would have only small impacts on inflation, given the large output gap and coordination with social partners on wage settlements (upward pressure on wages—a key problem in past unsuccessful country consolidation episodes—is not expected).

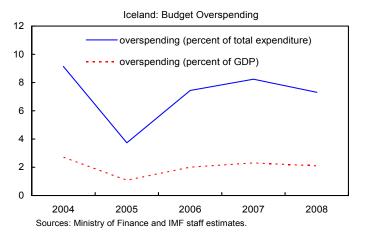
- 33. The 2010 budget marks the first implementation of the fiscal consolidation plan (MEFP  $\P21$ ). The authorities explained that lingering cyclical impacts on revenues implied that a greater effort would be needed to attain their goal of a  $5\frac{1}{2}$  percent of GDP improvement in the primary general government deficit. Of the  $6\frac{1}{2}$  percent of GDP in needed measures, some  $4\frac{1}{4}$  percent of GDP would come through the revenue side (including better harmonization of the personal income tax with taxation of investment income, as well as some further increase in excise and environmental taxes, and changes to VAT brackets); while  $2\frac{1}{4}$  percent of GDP in primary spending cuts would be needed (spread across the targeted categories, with emphasis on right-sizing the public investment program).
- 34. It was agreed that addressing public debt management challenges would be a priority (MEFP ¶22). The deficit for 2009 is expected to be fully financed given the pool of capital locked in by capital controls, the capital available through the funded pension system, and government current account deposits in the central bank (about 11 percent of GDP in

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<sup>&</sup>lt;sup>4</sup> Guichard, S. et al. (2007), 'What Promotes Fiscal Consolidation: OECD Country Experiences", OECD Economics Department Working Papers, No. 553, OECD Publishing.

mid-2009). However, as capital controls are lifted, and the government must compete more vigorously for funds, pressures could increase. The authorities felt that they needed to

develop a more detailed plan to raise the average maturity of the debt, to smooth the maturity profile, to address management of contingent liabilities, and to optimize cash management (an adequate level of deposits is needed to absorb budgetary shocks, and to act as a form of collateral to those buying debt). In light of these challenges, the authorities requested technical assistance to help them



formulate a detailed debt management plan. The plan, which would be built on the new medium-term fiscal framework, would become a new program **structural benchmark** for end-December.

35. In support of the fiscal consolidation effort, the authorities have started to address key weaknesses in their budget framework (MEFP ¶23). A recent technical assistance mission from the IMF's Fiscal Affairs Department highlighted problems with spending overruns that are legitimized ex-post, a complex system of carry-overs, and the insufficient integration of the medium-term budget framework with the annual budget and policy priorities. The authorities emphasized that they can no longer afford budget slippages in light of the consolidation need. The cabinet has already approved a number of measures to strengthen within-year budget control, and has also approved a medium-term budgeting framework featuring multi-year nominal expenditure ceilings (now being implemented with the 2010 budget).

#### F. Program Modalities and Safeguards Assessment

### 36. To address program delays and Iceland's evolving challenges, the program has been modified in several ways:

• Extension and rephasing. Following the delay in completing the first review, the authorities request an extension of the program to end-May 2011. Key program objectives will take longer than anticipated to realize. Financial sector restructuring has already required an extra 6 months (and the accompanying private sector debt restructuring will take some time); while preserving exchange rate stability will likely remain a focus for some time, depending on the pace of capital control liberalization.

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

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

Source: IMF staff estimates

- Program performance will continue to be monitored by quarterly reviews, but modification to the program's quantitative conditionality is proposed. The performance criteria on the change in net credit of the CBI to the private sector and the change in net credit of the CBI to the general government would be dropped. In their place, a new performance criterion would be introduced on the change in net domestic assets of the CBI (this will essentially allow the CBI more discretion in managing liquidity). Since government deposits at the CBI remain an important component of the debt management strategy, the ceiling on net credit of the CBI to the general government will be kept as an indicative target. All PCs have been quantitatively specified through end-2009 (MEFP Table 1 and TMU).
- New structural conditionality has been added in support of program objectives (MEFP Table 2, and MEFP ¶9, 10, 14, and 22):
  - Recapitalization of New Landsbanki and completion of the program of savings bank recapitalization (proposed structural benchmarks for end-November) will bring the initial stage of bank restructuring to completion, help to more fully establish the banking system, and set the stage for needed operational and loan restructuring. These outcomes are crucial towards restarting credit and supporting economic recovery.
  - Introduction of legislation to parliament to clarify powers given to the supervisory agency, create a national credit registry, improve the deposit insurance system, and address prudential regulations on large exposures and connected lending (a proposed structural benchmark for end-December) will help secure a stronger regulatory and supervisory framework for the financial sector going forward, and strengthen confidence in the system.
  - Approval by the Ministry of Finance of a medium-term public debt management plan (a proposed structural benchmark for end-December) will

<sup>1/</sup> Reflects a rephasing of purchases and the extension of arrangement requested in the LOI/MEFP.

prepare for the challenge of smoothly financing high near-term deficits and managing contingent liabilities, both of which will help ensure that fiscal sustainability is also supported from the financing side.

37. Iceland's financing gap remains broadly the same, but is distributed differently over the program period (Table 11). Higher estimates of external debt and debt service *ceterus paribus* raise the gap, but program refinements including faster fiscal adjustment and a more gradual capital account liberalization both reduce and redistribute the gap, including into 2011.

Iceland: Financing Needs, 2008-11 (in billions of US dollars)

	Original program 1/				Current projection				
	2008	2009	2010	2011	2008	2009	2010	2011	
Overall balance	-18.5	-2.0	0.1	0.1	-18.7	-0.3	-2.6	-0.3	
Financing	18.5	2.0	-0.1	-0.1	18.7	0.3	2.6	0.3	
Reduction in reserves	-3.0	0.6	-0.7	-0.1	-0.9	-1.4	0.4	0.0	
Accumulation of arrears	10.3	0.0	0.0	0.0	18.8	-5.6	0.0	0.0	
Extraordinary Financing	11.2	1.4	0.6	0.0	8.0	7.3	2.2	0.3	
Fund	8.0	0.6	0.6	0.0	0.8	0.3	0.7	0.3	
Bilateral (earmarked / non-cash)	8.2	0.0			0.0	5.6	0.0	0.0	
Other identified new financing					0.0	1.4	1.5	0.0	
Residual financing gap	2.2	8.0			0.0	0.0	0.0	0.0	

Source: Central Bank of Iceland, Fund staff estimates and calculations.

#### 38. Financing assurances are in place (MEFP ¶24):

- The terms and conditions of Nordic loans, amounting to \$2.5 billion, have been finalized. Their disbursement has been linked to resolution of the Icesave dispute with the U.K. and Netherlands over deposit insurance liabilities. After protracted discussions, the three governments have reached an agreement on this, and the authorities expect parliamentary approval of the deal by the time of the next review. The resulting short delay in disbursement of the Nordic loans can be accommodated within the program.
- A loan from the Faroe Islands (\$50 million) has already disbursed, and a loan from Poland has been agreed (\$200 million), and will disburse alongside the next 3 program reviews. A \$500 million loan originally committed by Russia is no longer expected, but the \$250 million in over-financing in the original program, an expected macro-stabilization loan from the EU (\$150 million), and use of an existing repo facility with the BIS (\$700 million, of which \$214 million is outstanding) will more than offset this.
- The exchange restrictions that capital controls have introduced have not led to any arrears. A financing assurances review under the Fund's lending into arrears policy is thus not required (¶19)

<sup>1/</sup> Original program as in Request for Stand-By Arrangement, November 15, 2008 (EBS/08/124).

The extraordinary financing from the Fund and bilaterals provides room for adjustment, and helps bring the ratio of gross reserves-to-short-term debt (on a residual maturity basis) to about 70 percent by 2011, up from 50 percent at end-2008 (including debt subject to capital controls). To support reserves, the authorities and staff agreed that it would be appropriate to use the SDR allocation to increase them.

39. Staff believes that the modified program puts Iceland in a position to fulfill its obligations to the Fund in a timely manner despite higher debt. Fund credit outstanding would peak in 2011 at 52 percent of Iceland's gross reserves (compared to 38 percent in the original program). Peak payments would be in 2012–14 at a still manageable 10 to 16 percent of gross reserves. The gradual pace of capital account liberalization, geared to the level of reserves, offers some comfort that payments can be met, even if the external financing environment remains weak for a number of years. The past pattern of import compression in Iceland in response to shocks—reflecting consensus of the government, labor and business towards demand reduction policies and competitiveness-improving wage policies—offers comfort about an ability to handle export price shocks despite high debt-service to export ratios.

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	306	420	210	0	0	0	0
Stock 1/	560	866	1286	1496	1216	752	371	135
Obligations	0	5	14	18	297	477	388	239
Principal (repurchases)	0	0	0	0	280	464	381	236
Charges and interest	0	5	14	18	17	13	7	3
Stock of existing and prospective Fund	credit							
In percent of quota	476	736	1093	1272	1034	639	316	115
In percent of GDP	5.1	11.4	15.8	17.3	13.3	7.8	3.6	1.3
In percent of exports of G&S	11.6	23.5	31.7	34.8	26.4	15.6	7.3	2.5
In percent of gross reserves	24.3	27.4	43.9	50.9	38.9	25.0	11.8	4.3
Obligations to the Fund from existing and prospective Fund arrangements								
In percent of quota	0	4	12	16	253	405	330	203
In percent of GDP	0.0	0.1	0.2	0.2	3.3	5.0	3.8	2.2
In percent of exports of G&S	0.0	0.1	0.3	0.4	6.5	9.9	7.7	4.5
In percent of gross reserves	0.0	0.2	0.5	0.6	9.5	15.9	12.4	7.6

Source: IMF staff estimates and projections.

# 40. There are large risks, but strict implementation of the program and specific elements of program design would help to mitigate them:

• Most prominently, higher-than-expected net external debt liabilities could arise through financial sector resolution (including due to poor asset recovery). The authorities emphasized that agreements with creditors of two banks—their aim—

<sup>1/</sup> End of period. Assumes use of new general SDR allocation, in 4Q09.

- would reduce risks of litigation. Regarding asset recovery, the program makes somewhat conservative assumptions to help avoid surprises, and the debt remains sustainable in an extreme no asset recovery scenario.
- Inadequate government debt management in the face of a rapid and premature liberalization of the capital account could create a fiscal financing crisis. On the debt side, problems could arise through the substantial stock of contingent liabilities or via the lumpy debt maturity structure. The articulation of consistent debt management and capital control liberalization plans will help to guard against this.
- 41. **Nonetheless, mitigating other large risks would require enormous policy efforts**. Litigation over depositor preference is a key risk (this was introduced on the eve of the crisis and gives depositors first claim to recovery during bank resolution). While it would likely take years to play out in court, a full award against the government could add some \$5 billion or about 40 percent of GDP to public and external debt. This would present a great challenge to both public and external debt sustainability. In theory, this could be addressed by government asset sales or an even tighter fiscal stance, although public support for such a strategy is far from a certainty.
- 42. **Discussions about the Safeguards Assessment led to an agreement on modifications to the CBI's external audit arrangements (MEFP ¶25).** The authorities indicated that the current procedures were working reasonably well. These involve an annual audit overseen by the Auditor General of Iceland, conducted by the well-regarded independent body, the National Audit Bureau (NAB), and then reviewed by parliament and made public. Nonetheless, they have modified their arrangements to bring them more into line with international standards (most central banks leverage the experience of private sector auditors). Thus, the authorities have appointed 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.

#### IV. STAFF APPRAISAL

- 43. The crisis is taking the expected toll on the macroeconomy, but some positive signs are emerging. Measured by growth and unemployment, 2009 will be a difficult year. However, the imbalances that marked Iceland's unsustainable boom—high inflation and an enormous current account deficit—have rapidly unwound. Financial markets have also stabilized and the exchange rate is holding around post-crisis lows.
- 44. **Timely policy implementation has proven difficult, and is a major challenge going forward.** Iceland's political crisis contributed to delays, but so did administrative bottlenecks within Iceland's small institutions. Going forward, the complex program is likely to continue to challenge Iceland's administrative capacity. In this situation determined and full political support for the program is essential.

- 45. **The program has been brought back on track.** The new government is committed to program objectives. Targets for reserves, the fiscal balance and credit are all now cumulatively on course, and key actions have been taken to advance bank restructuring, review the financial sector supervision framework, and approve a medium-term fiscal consolidation plan. The staff supports the authorities' request for waivers for nonobservance of the performance criteria covering the central government net financial balance and net international reserves and as of end-December 2008; and covering the recapitalization of banks by end-February 2009.
- 46. **Upward revisions to external debt numbers underscore the scale of Iceland's challenge, and call for stronger policies going forward.** A high level of external assets offers some comfort about the level of debt, but maintaining a robust downward path for debt requires stronger policies. The agreed combination of more rapid fiscal adjustment, more gradual capital control liberalization, and an enhanced focus on private sector debt restructuring should suffice. Determined and timely policy implementation will be needed going forward.
- 47. The central bank must keep its focus on preserving currency stability. Balance sheet exposures remain a deep concern, and recent currency weakness underscores the risks of inflation pass-through. Against this backdrop, the staff believes that the CBI has been too aggressive at times in reducing interest rates. Sharp and destabilizing interest rate reductions, of the sort undertaken in May, must be avoided. The tightening bias adopted by the CBI in July remains appropriate for now. Looking forward, as financial sector restructuring and fiscal consolidation improve confidence, room could open up to cautiously loosen policy.
- 48. Capital controls remain an essential feature of the policy mix, and must be removed gradually as preconditions are satisfied. Prospective capital outflows remain too large to address through interest rate policy alone, and too large for a rapid release. The removal of controls can be initiated as balance of payments developments permit and once financial sector stability is solidified. Against this backdrop the staff has been concerned about measures advocated by the CBI to accelerate the pace of liberalization. The government and central bank must scale back expectations about rapid removal, and with liberalization set to be very gradual, focus on tightening the administration of controls. The strategy now agreed marks a turn in the right direction.
- 49. The capital controls give rise to a restriction subject to IMF jurisdiction under Article VIII. In light of the circumstances, including that the exchange restrictions are imposed for balance of payments reasons, non-discriminatory and temporary, staff supports the authorities request for the temporary approval of these measures, as well as their request for a waiver of the continuous performance criterion on the non-introduction of exchange restrictions during the period of the arrangement.

- 50. Progress with financial system restructuring has been slow, but important milestones are now being reached. Disagreement on process between the authorities and creditors along with technical complexity have substantially delayed bank recapitalization and discussions on compensation. These difficulties have now been largely overcome, and recent negotiations have produced agreements with creditor representatives for Kaupthing and Glitnir. Focus must now turn to bringing Landsbanki discussions to a conclusion, to allow recapitalization by end-November.
- 51. However, much remains to be done to fully stabilize the financial sector. The focus must begin to shift to operationally restructuring the new banks and resolving remaining undercapitalized savings banks. Supervision needs to be overhauled in line with recommendations made by the independent expert, to ensure that the practices that led to Iceland's financial crisis cannot recur.
- 52. An efficient framework is needed for targeted private sector debt restructuring. Alleviating distress in a targeted manner will complement financial sector restructuring efforts, and help revive the economy. In light of binding fiscal constraints, the focus should be on market-based voluntary workouts, underpinned by measures to strengthen the legal and insolvency framework.
- 53. The accelerated pace of fiscal consolidation is crucial to program success. It will help underpin better debt dynamics and limit financing risks. The medium-term consolidation plan is welcome, and work must continue to identify remaining needed measures for outer years, in consultation with the government's social partners. The plan must also be complemented with a full strategy to manage public debt, and by implementation of actions to improve budget management and the fiscal federal framework.
- 54. The stronger policy commitments made by the authorities are needed to help mitigate risks, which are considerable. Navigating the restructuring of government, financial sector, and private non-financial sector balance sheets in the present global environment presents risks of litigation, fiscal financing failures, and delay-driven loss of confidence. All of these could fundamentally disturb the downward path for Iceland's debt. Program design contains these risks by an appropriate pace and sequencing of capital account liberalization, coordinated debt management and capital control liberalization plans, and by the negotiated approach to settling creditor claims.
- 55. Implementation of the IMF-supported program represents the best opportunity for Iceland to extricate itself from high debt and a deep post-crisis recession. Staff support the authorities' request for completion of the first review under the Stand-By Arrangement, the extension of the arrangement, and the corresponding rephasing.

...leading to a turnaround in the trade Demand appears to be dropping... balance. 20 160 60 40 Trade in goods 15 (billions of ISK) 10 120 20 5 40 0 -5 80 Groceries turnover -10 20 Payment card turnover -15 40 -20 -20 Trade balance (RHS) Gallup confidence - · Exports -25 index (RHS) Imports -30 06Q1 06Q4 07Q3 08Q2 09Q1 Jan-06 Nov-06 Sep-07 Jul-08 May-09 The soaring unemployment rate... ...is depressing real wages. 10 10 20.0 20 Unemployment rate Real and nominal wages 15.0 15 (percent) (12-month growth, in percent) 8 8 10.0 10 6 6 5.0 5 0.0 0 4 -5.0 -5 Wage index, nominal 2 2 -10.0 -10 Real wages (CPI deflated) 0 -15.0 -15 Jul-08 Jul-08 Jan-06 Nov-06 Sep-07 May-09 Jan-06 Nov-06 Sep-07 May-09 Inflation has fallen sharply since late 2008... ...and inflation expectations are coming down. 25 25 20 20 (12-month growth, in percent, qoq annualized CPI inflation (12-month change, in percent) growth, in percent) 20 20 15 15 Breakeven inflation CPI **Business inflation** 15 15 CPI-core CPI - annualized 10 10 10 10 5 5 5 5 Jan-06 Sep-07 May-09 Nov-06 Jul-08 Jan-06 Nov-06 Sep-07 Jul-08

Source: Iceland Statistics; Bloomberg; and IMF.

Figure 1. Iceland: Recent Economic Developments

The exchange rate remains just above late-2008 ...and the offshore-onshore spread has narrowed. 275 275 400 400 Onshore, Krona/Euro Icelandic Krona per Euro 250 250 Narrow exchange rate index 350 350 Offshore, Krona/Euro 225 225 300 300 200 200 250 250 175 175 200 200 150 150 150 150 125 125 100 100 100 100 Jun-08 Jun-09 Jun-08 Oct-08 Jun-09 Oct-08 Feb-09 Oct-09 Feb-09 Oct-09 ...and is intervening less in the domestic forex The central bank has considerbly lowered its market amid low turnover. policy rate... 25 0.6 0.6 25 (billions of USD) (percent) 20 20 ■ Turnover 0.4 0.4 ■CBI net sale 15 15 10 10 0.2 0.2 Current account Overnight loan 5 5 Policy rate (nominal) **ECB Fixed Rate** 0 0 Jul-09 Jun-08 Oct-08 Jun-09 Oct-09 Oct-08 Jan-09 Apr-09 Feb-09

Figure 2. Iceland: Monetary and Exchange Rate Developments

Source: Central Bank of Iceland.

Figure 3. Iceland: Financial and Asset Markets Developments

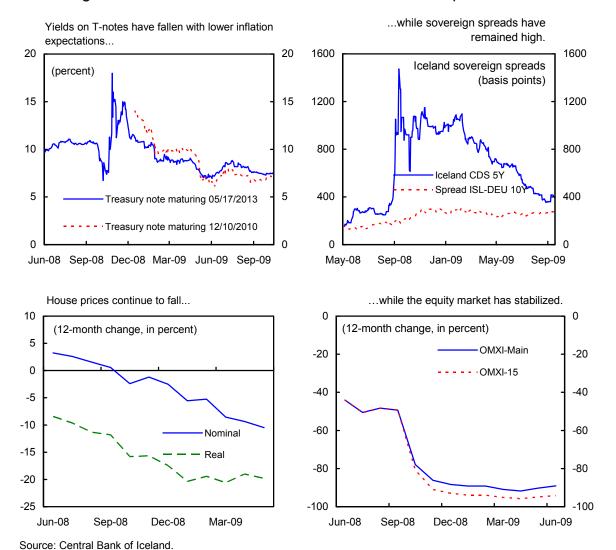
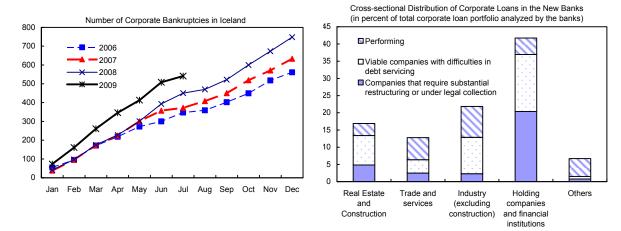


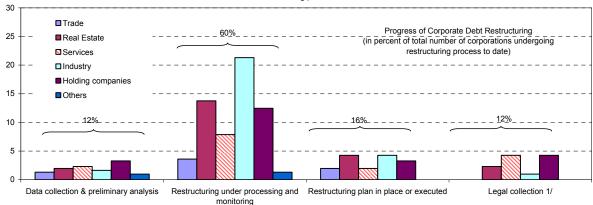
Figure 4. Iceland: Developments in Household and Corporate Sectors

Corporate bankiruptcies are rising fast...

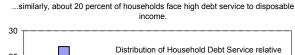
...and many companies are having difficulties in debt servicing.

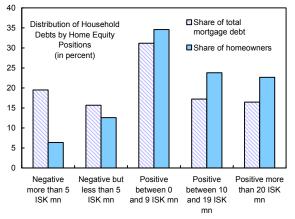


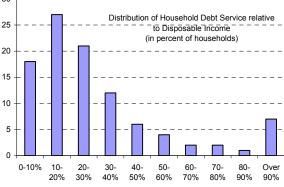
Most companies undergoing debt restructuring are under processing and monitoring, with many have put in place or executed their restructuring plans



About 20 percent of homeowners have large negative equity...



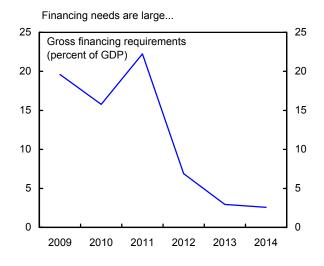


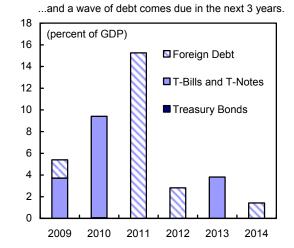


Source: CBI, New Banks, IceStat and staff estimates.

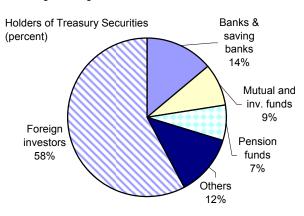
1/ Legal collection includes bankruptcy proceedings, moratorium, and formal legal foreclosure.

Figure 5. Iceland: Fiscal Financing and Debt Management

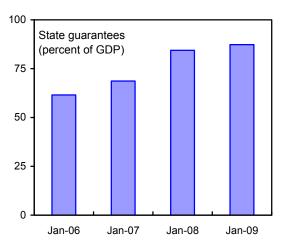




Non-resident investors locked-in by capital controls have large holdings.



There are risks from sizeable contingent liabilities.



Source: Central Bank of Iceland and Bloomberg.

Figure 6. Iceland: Macroeconomic Outlook Compared to the Original Program, 2007-2014

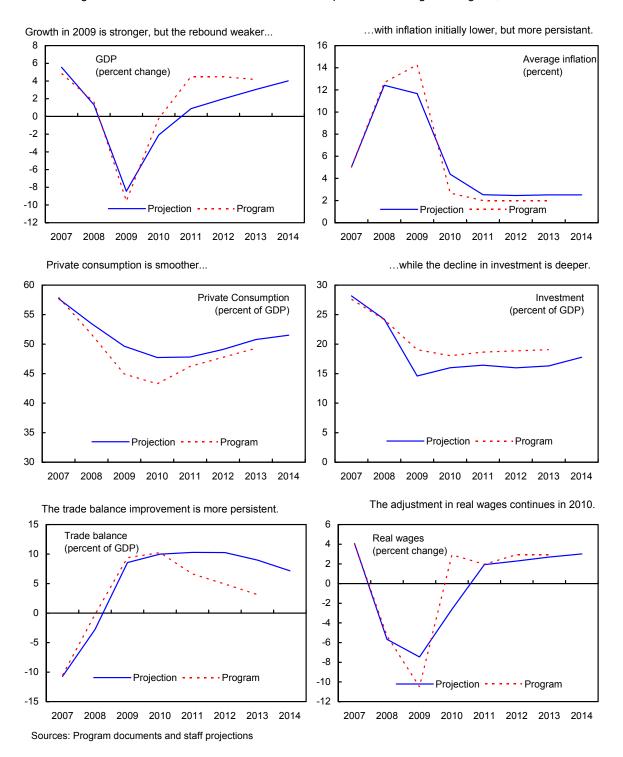
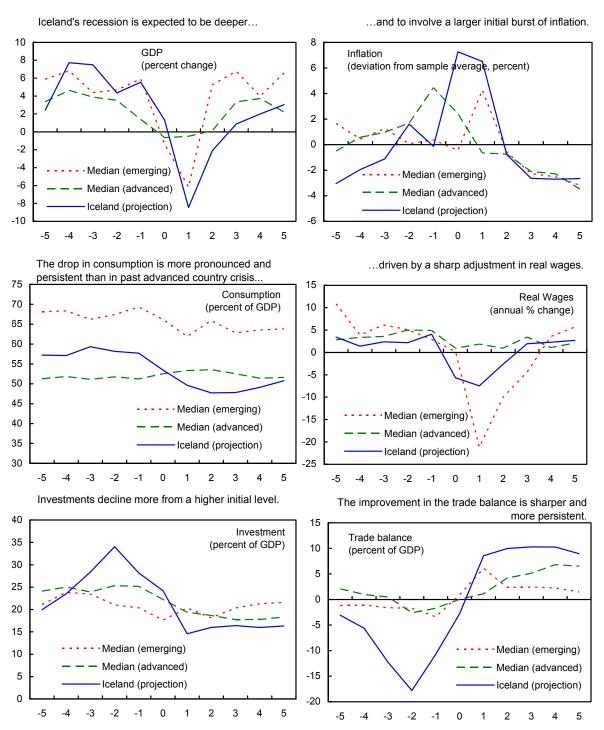


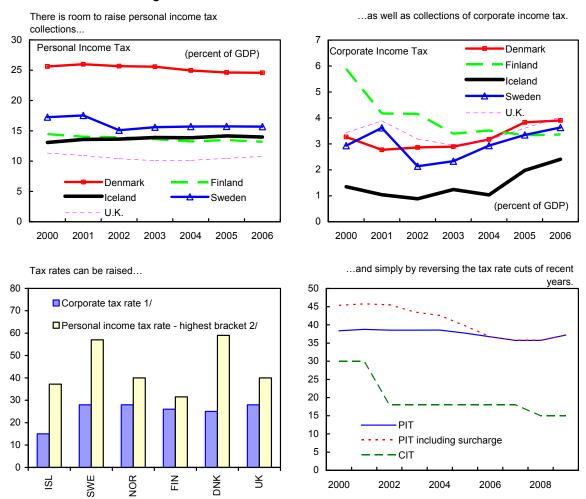
Figure 7. Iceland: Macroeconomic Outlook Compared to Previous Crises



Sources: WEO and staff projections.

Notes: Crisis year = 0. Advanced crisis countries include Finland, Norway, Sweden and Spain. Emerging crisis countries include Argentina, Chile, Ecuador, Indonesia, Korea, Malaysia, Mexico, Philippines, Thailand, Turkey and Uruguay. Dates of the crisis defined as in Laeven and Valencia (2008) (2008 for Iceland).

Figure 8. Iceland: Tax Collections and Tax Rates



Source: IMF (FAD databases).

1/ Based on information in 2007: Sweden, Finland, Belgium; Based on information in 2008: Norway, Denmark, U.K..

2/ Based on information in 2007: Sweden, Norway, Belgium; Based on information in 2008: Finland, Denmark, U.K..

Table 1. Iceland Quantitative Performance Criteria Under the 2008–09 Economic Program.

	Perform Crite			Indicativ	e Targets		Prior A	Action	Performar	nce Criteria
	Dec 08 Program Dec 08 1/ Actual		Mar 09 Ceiling/Floor 2/	Mar 09 Actual	Jun 09 Ceiling/Floor 3/	Jun 09 Actual	Sep 15 Ceiling 4/ 5/	Sep 15 Actual	Oct 09 Ceiling/Floor 5/	Dec 09 Ceiling/Floor 5/
					(In billions	of Króna)				
1. Floor on the change in the central government net financial balance 6/	-12	-117	-55	1.7	-55	-51			-175	-200
2. Ceiling on the change in net domestic assets of the Central Bank of Iceland 7/									20	20
3. Ceiling on the change in net credit of the Central Bank of Iceland to the private sector	25	2.1	50	28.9	50	-27.5				
4. Ceiling on the change in the domestic claims of the Central Bank of Iceland to the central government ( <i>indicative target for end-October and end-December</i> )	25	7.8	25	-31.1	25	41.4			70	70
					(In millions of	f U.S. dolla	rs)			
5. Floor on the change in net international reserves of the Central Bank of Iceland 7/ 8/	-500	-543	-500	-70	-500	-28.9	-96.6	-82.9		
6. Ceiling on the level of contracting or guaranteeing of new medium and long term external debt by central government 9/	4000	0	4075	54.5	4150	54.5			3500	3500
7. Ceiling on the stock of central government short-term external debt 9/	650	137.0	650	189.4	650	281.8			1400	1500
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 10/ 11/	0	0	0	0	0	0			0	0

<sup>1/</sup> From October 22, 2008 to December 31, 2008 (unless otherwise indicated).

<sup>2/</sup> From January 1, 2009 to March 31, 2009.

<sup>3/</sup> From April 1, 2009 to June 30, 2009.

<sup>4/</sup> Prior action for the first review. Defined as NIR, cumulative from January 1, 2009.

<sup>5/</sup> Cumulatively from January 1, 2009 (unless otherwise indicated).

<sup>6/</sup> Dec 08 target defined from Oct 1 2008 to Dec 31 2008. At end-Sep 08, the central government net financial balance was króna 4.28 billion, after contributions to the government employees pension fund. 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.

<sup>7/</sup> Excluding changes due to central bank recapitalization bond and adding back the effect of the transfer of collateral from the CBI to the government as described in the Technical Memorandum of Understanding.

<sup>8/ (-)</sup> indicates decrease. NIR is 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). Excludes new SDR allocation.

<sup>9/</sup> 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.

<sup>10/</sup> Applies on a continuous basis.

<sup>11/</sup> On October 20 the central government had no arrears to multilateral and official bilateral creditors

Table 2. Iceland Structural Conditionality Under the 2008–09 Economic Program

	Structural Conditionality	Status
Prior actions	s for the First Review	
•	Implementation of monetary policy towards the currency stability objective, and in line with reserve targets.	• Done
•	Approval by cabinet of a strategy to phase out capital controls.	• Done
•	Approval by cabinet of a medium-term fiscal consolidation plan.	• Done
•	Recapitalize New Kaupthing and Islandsbanki, using tradable government bonds issued on market terms, to raise the capital adequacy ratio to at least 12 percent.	• Done
Structural P	erformance Criteria	
•	A capital injection into the three new banks, made using tradable government bonds issued on market terms, to raise the capital adequacy ratio to at least 10 percent. <i>By end-February 2009</i> .	Not observed (see prior action and new structural benchmark)
•	An experienced banking supervisor to provide an assessment (to be published) of the regulatory framework and supervisory practice, including the framework of rules on liquidity management, connected lending, large exposures, cross-ownership, and the "fit and proper" status of owners and managers, and propose needed changes. <i>By end-March 2009.</i>	• Done
Structural B	enchmarks	
•	Develop a strategy for asset recoveries. By end-November 2008.	Done.
•	Prepare plans to embark on medium-term fiscal consolidation. By end-2008.	Implemented with delay (see prior
•	FME to review the business plans of each of the new banks. By January 15, 2009.	action)
•	International Auditing Firm to conduct valuations of the old and new banks using a methodology in	Done.
	accordance with international best practice. Complete by end-January 2009.	Done.
•	Improve the medium term fiscal framework. By end-June 2009.	Implemented with delay in mid-July.
New Structu	ıral Benchmarks	
•	A capital injection into New Landsbanki, using tradable government bonds issued on market terms, to raise the capital adequacy ratio to at least 12 percent. [By end-November, 2009]	
•	Completion of the program of savings bank recapitalization, meeting FME and Ministry of Finance requirements. [By end-November, 2009]	
•	Approval of legislation to address deficiencies in bank regulatory framework and supervisory practice. [By end-December 2009]	
•	Approval by cabinet of a medium-term public debt management plan [By end-December 2009].	

Table 3. Iceland: Selected Economic Indicators 2005-09

	2005	2006	2007	200	8	20	009
				Prog.	Est.	Prog.	Adj. Prog.
	(Percentage change unle	ss otherwi	se noted)				
National Accounts (constant prices)							
Gross domestic product	7.5	4.3	5.6	1.6	1.3	-9.6	-8.5
Total domestic demand	15.8	8.8	-0.1	-9.1	-8.7	-19.7	
Private consumption	12.7	3.6	5.6	-8.7	-7.8	-23.7	-17.0
Public consumption	3.5	4.0	4.1	3.2	4.6	2.9	-0.1
Gross fixed investment	35.7	21.6	-12.2	-19.7	-20.4	-33.6	
Export of goods and services	7.5	-4.6	17.7	12.1	7.1	1.9	
Imports of goods and services	29.3	10.4	-0.7	-15.2	-18.3	-23.1	-30.5
Output gap 1/	2.4	3.2	5.5	4.6	2.2	-5.4	-3.2
Selected Indicators							
Nominal GDP (bln ISK)	1,026.7	1,168.2	1,301.4	1,490.1	1,476.5	1,495.1	1,472.5
Central bank gross reserves (bln ISK)	67.3	167.8	162.8	686.5	429.3	562.7	617.5
Unemployment rate 2/	2.1	1.3	1.0	1.4	1.6	5.7	8.6
Real disposable income per capita	6.6	-2.0	5.4				
Consumer price index	4.0	6.8	5.0	12.7	12.4	14.3	11.7
Nominal wage index	6.5	9.1	9.3	6.7	6.1	2.3	3.3
Nominal effective exchange rate 3/	10.4	-10.7	2.7	-40.8	-40.4	-18.4	-34.2
Real effective exchange rate (CPI) 3/	12.7	-6.8	5.7	-22.9	-20.7	-5.6	-18.0
Terms of trade	1.0	3.5	0.1	-1.4	-6.1	-7.7	-8.5
Money and Credit							
Base Money	23.1	25.4	182.0	83.3	-21.6		24.4
Deposit money bank credit (end-period)	76.0	44.4	56.6				
of which to residents (end-period)	54.7	33.6	28.3				
Broad money (end-period)	23.2	19.4	56.6		36.3		
CBI policy rate (period average) 4/	10.5	14.1	13.8		15.4		
Public Finance (in percent of GDP)							
General government 5/							
Revenue	47.1	48.0	47.9	43.8	44.3	40.0	38.4
Expenditure	42.2	41.7	42.5	44.0	44.8	53.5	
Balance	4.9	6.3	5.4	-0.2	-0.5	-13.5	
Structural balance 6/	2.9	3.6	1.3	-3.4	-2.1	-8.7	
Balance of Payments (in percent of GDP)							
Current account balance	-16.1	-25.6	-19.9	-10.7	-35.8	1.0	-3.5
Trade balance	-10.1	-25.0	-19.9	0.1	-2.3	10.3	
Financial and capital account	13.9	44.0	-10.1	-102.1	-2.3 78.6	-15.7	
Net errors and omissions	2.6	-11.1	32.9	2.5	-33.4	0.0	
Gross external debt 7/	284.4	433.5	566.2	670.2	192.9	159.5	
Central bank gross reserves (in months	204.4	400.0	300.2	070.2	192.9	159.5	300.9
of imports of goods and services)	1.8	3.5	3.4	11.0	7.5	9.9	12.7
	1.0	5.5	5.4	11.0	1.5	9.8	12.1

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

<sup>1/</sup> Staff estimates. Actual minus potential output, in percent of potential output.

<sup>2/</sup> In percent of labor force.

<sup>3/</sup> A positive (negative) sign indicates an appreciation (depreciation).

<sup>4/</sup> Data prior to 2007 refers to annual rate of return. 2007 and on, refers to nominal interest rate.

<sup>5/</sup> National accounts basis.

<sup>6/</sup> In percent of potential GDP.

<sup>7/</sup> Including old banks before 2007 and in 2008 program.

Table 4. Iceland: Money and Banking (In billion of Krona, unless otherwise noted)

	Sep-08	Oct-08 Est. 1/	Dec-08 Est.	Mar-09 Est.	Jun-09 Est.	Sep-09 Est.	Oct-09 Proj	Dec-09
Central Bank								
Net foreign assets 2/	123	-21	-96	-98	-112	-138	-143	-158
Assets	308	382	429	383	384	435	430	415
Liabilities	185	403	526	480	496	573	573	573
Net domestic assets	72	242	228	256	257	309	309	315
Net claims on the public sector	-197	-180	39	20	63	82	92	112
Net claims excluding recap bond	-197	-180	-231	-259	-218	-205	-195	-175
Recapitalization bond	0	0	270	279	282	287	287	287
Net claims on banks 3/	378	587	299	396	385	410	400	386
Others, net	-109	-164	-110	-160	-191	-183	-183	-183
Base Money 4/	166	124	132	158	146	171	166	164
Currency issued	16	26	24	22	24	25	24	24
DMB deposits at the central bank	150	98	107	136	122	146	142	140
Banking System								
Net foreign assets	-2,842	-269	-295	-197	-207	-190	-190	-190
Net domestic assets	4,256	1,442	1,382	1,867	2,041	2,035	2,035	2,035
Net claims on the central bank	-378	-587	-299	-396	-385	-410	-400	-386
Credit to private sector	5,297	2,546	2,501	2,271	2,220	1,777	1,777	1,777
Credit to government				45	46	50	50	50
Other items, net	-663	-516	-820	-53	160	618	608	594
Domestic deposits	1,413	1,174	1,087	1,669	1,834	1,845	1,845	1,845
Local currency	1,267	979	909	1,501	1,637	1,647	1,647	1,647
Foreign currency	146	195	178	168	198	198	198	198
Consolidated Financial System								
Net foreign assets	-2,719	-289	-391	-295	-318	-328	-333	-348
Net domestic assets	4,145	1,958	2,068	2,082	2,231	2,237	2,227	2,212
Net claims on the public sector 5/	-197	-180	39	65	109	132	142	162
Net credit to private sector	5,297	2,546	2,501	2,271	2,220	1,777	1,777	1,777
Other, net	-955	-407	-472	-255	-99	327	307	272
Broad Money (M3)	1,426	1,668	1,676	1,787	1,913	1,909	1,894	1,864
Memorandum items:								
Base money (y-o-y percentage change)	50	37	-22	-3	100	3	34	24
Broad money (y-o-y percentage change)	22	44	36	28	38	34	14	8
Credit to private sector (y-o-y percentage change)	68	-19	-28	-46	-49	-66	-30	-29
Money velocity (GDP/base money)	8.6	11.6	11.2	9.5	10.4	9.0	9.0	9.0
Broad money velocity (GDP/M3)	1.0	0.9	0.9	0.8	0.8	0.8	0.8	0.8
Multiplier (M3 / base money)	8.6	13.4	12.7	11.3	13.1	11.1	11.4	11.4

Sources: Central Bank of Iceland; and Fund staff estimates

<sup>1/</sup> Estimates using balance sheet data as of Oct. 15 for the 3 new banks. As balance sheets of the new banks have not been finalized, the items under the banking system and consolidated financial system remain estimates for all periods after October 2008. Estimates of the new banks' balance sheets were updated periodically.

<sup>2/</sup> NFA is defined by the TMU. In particular, foreign liabilities include fx deposits of DMBs and government.

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

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

<sup>5/</sup> 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 oustanding government bonds held by the banks.

Table 5. Status of the Financial Sector in Iceland

		position as of er 2008) 2/	Post-	crisis 2/	Status
	(in ISK millions)	(in percent of GDP)	(in ISK millions)	(in percent of GDP)	
A. Total assets in the commercial banks 1/					
Old banks					
Landsbanki	4,524,162	309	1,743,000	121	Moratorium
Glitnir	3,684,458	251	2,370,600	165	Moratorium
Kaupthing	4,843,616	331	2,937,000	205	Moratorium
New banks					
New Landsbanki			929,369	63	Capitalization in progress
Islandsbanki			624,305	43	Capitalization completed
New Kaupthing			638,857	44	Capitalization completed
3. Total assets in the saving banks					
Icebank	331,764	23	188,211	13	Moratorium
SPRON	275,148	19	226,075	16	Moratorium
BYR sparisjóður	247,329	17	253,209	18	Capitalization plan under consideration
Sparisjóður Keflavíkur	100,178	7	100,806	7	Capitalization plan under consideration
Sparisjóður Mýrasýslu (SPM)	44,536	3	35,514	2	Merged into New Kaupthing
Other saving banks	74,101	5	53,282	4	Pending recapitalization
C. Total assets in investment bank					
Straumur	768,951	52	660,275	46	Moratorium
D. Total assets in other credit undertakings 3/	658,245	45	609,739	42	

Source: Central Bank of Iceland and FME, Iceland.

<sup>1/</sup> Numbers for the old banks under moratorium in post-crisis, as reported previously in the Briefing paper under First Review of SBA.

Numbers for new banks under post-crisis are preliminary estimates.

2/ Financial positions under post-crisis for saving banks as of March 17, 2009 provided by FME, for investment bank Straumur as of end-Jan 2009, and for other credit undertakings as of end-Dec 2008.

3/ Exclude the balance sheet of the Housing Financing Fund (HFF).

Table 6. General Government Operations 2007-2014 (GFS, modified cash, percent of GDP 1/)

	2007	2008		2009		2010	2011	2012	2013	2014
		Prog.	Est.	Prog.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj
Total revenue 2/	47.9	43.8	44.3	40.0	38.4	40.5	43.1	44.5	45.4	44.5
Taxes	37.6	33.4	33.9	30.0	29.7	32.6	35.0	36.3	37.6	36.8
Taxes on income and profits	18.5	16.4	17.8	14.7	15.8	16.8	18.7	19.5	19.8	19.3
Personal Income Tax	13.8	12.6	13.1	12.4	12.5	14.4	16.0	16.4	16.7	16.2
Corporate Income Tax	2.5	1.7	2.0	1.3	0.9	1.0	1.2	1.6	1.6	1.6
Capital gains tax, rental income	2.2	2.1	2.4	1.1	2.4	1.4	1.4	1.4	1.4	1.4
Taxes on payroll and workforce	0.0	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Taxes on property	2.4	2.1	2.2	1.9	1.7	1.5	1.7	1.7	1.7	1.7
Taxes on goods and services	16.1	14.4	13.2	12.9	11.4	13.3	13.8	14.3	15.2	14.9
VAT	10.1	9.4	8.6	8.4	7.2	7.6	7.9	8.3	9.2	8.9
	5.5	5.0	4.6	4.5	4.2	5.7	7.9 5.8	6.0	6.0	6.0
Other taxes on goods and services	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3		
Taxes on international trade							0.3		0.3 0.6	0.3
Other taxes	0.1	0.1	0.1	0.1	0.5	0.6		0.6		0.6
Social contributions	3.1	2.8	2.8	2.8	2.9	3.2	3.1	3.2	2.8	2.8
Grants	0.1	0.0	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Other revenue	7.1	7.6	7.4	7.3	5.7	4.6	4.9	4.8	4.9	4.8
o/w Interest income	2.3	2.5	3.1	2.2	3.4	2.5	3.0	3.0	3.0	2.9
Discretionary revenue measures 2/	0.0	0.0	0.0	0.0	1.4	5.6	6.6	7.2	7.1	5.9
Total expenditure 2/ 3/	42.5	44.0	44.8	53.5	52.7	51.4	49.9	47.1	44.7	43.3
Current expense 3/	40.0	40.7	42.2	49.8	51.1	50.9	50.0	47.5	45.0	43.4
Compensation of employees	14.9	16.2	14.6	17.3	15.9	15.5	15.1	14.6	14.1	13.5
Use of goods and services	10.9	9.5	11.6	10.8	12.5	12.1	11.7	11.4	11.1	11.4
Consumption of fixed capital	1.8	1.5	1.8	1.7	1.9	1.9	1.9	1.9	1.9	1.8
Interest 9/	2.6	2.1	3.4	7.3	9.5	10.7	11.4	10.6	9.6	8.7
Subsidies	1.8	1.6	1.9	1.6	2.0	1.9	1.7	1.6	1.6	1.5
Grants	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.2
Social benefits	5.8	6.9	6.1	8.0	6.8	6.4	5.9	5.2	4.6	4.4
Other expense	2.2	2.6	2.6	2.9	2.4	2.2	2.1	2.0	1.9	1.8
Nonfinancial assets	2.5	3.3	2.6	3.7	1.6	0.5	-0.1	-0.4	-0.3	-0.1
Non-financial assets, acquisition	4.2	4.8	4.5	5.4	3.5	2.4	1.7	1.5	1.6	1.7
Consumption of fixed capital (-)	-1.8	-1.5	-1.8	-1.7	-1.9	-1.9	-1.9	-1.9	-1.9	-1.8
Discretionary expenditure measures 2/	0.0	0.0	0.0	0.0	-0.6	-2.9	-4.4	-5.2	-5.3	-4.0
Net lending/borrowing 3/	5.4	-0.2	-0.5	-13.5	-14.4	-10.9	-6.8	-2.6	0.7	1.2
Net lending/borrowing incl. write-offs	5.4	-28.3	-13.6	-23.5	-34.2	-10.9	-6.8	-2.6	0.7	1.2
Stock of debt 4/										
General government gross debt 4/	28.7	108.9	70.0	108.6	125.2	136.0	135.1	131.7	124.7	114.7
Domestic	15.3	43.7	46.1	60.4	76.4	78.2	79.6	77.5	71.9	65.8
Foreign currency 4/ of which:	13.4	65.2	23.9	48.2	48.8	57.8	55.5	54.2	52.8	48.9
Bilateral loans to support CBI reserves	0.0	0.0	0.0	0.0	8.2	17.2	16.6	15.6	14.9	12.4
Net present value of depositor guarantees 5/	0.0	47.0	0.0	32.8	17.2	19.5	20.9	21.7	22.0	21.9
Other	13.4	18.2	23.9	15.4	23.3	21.1	18.0	16.9	15.9	14.6
General government net debt 6/	10.3	90.6	41.3	97.0	89.5	97.6	101.6	100.4	95.0	88.5
Structural Balances 7/										
Structural balance	1.3	-3.4	-2.1	-8.7	-10.2	-8.1	-5.4	-1.7	1.6	1.2
Structural primary balance	2.2	-3. <del>4</del> -3.8	-2.1 -1.3	-0.7 -3.9	-10.2	-0.1 -0.2	-5. <del>4</del> 2.8	5.8	8.0	6.9
Structural primary balance	2.2	-3.0	-1.3	-3.9	-3.1	-0.2	2.0	5.0	6.0	0.8
Memo Items	4.004	4 100	4 4=0	4 105	4 4=0	4 =00	4	4 0 4 5	4 =00	400
Nominal GDP (billion ISK)	1,301	1,490	1,476	1,495	1,472	1,520	1,573	1,642	1,732	1,845
Primary balance (excl. interest income) 3/	5.8	-0.6	-0.3	-8.5	-8.3	-2.7	1.6	5.1	7.2	6.9
Change in structural primary balance/fiscal impuls	-2.2	-5.6	-3.5	-0.1	-2.4	3.6	3.0	3.0	2.2	-1.1
Government guaranteed debt 8/	62.5	_ =	84.4	_ =		_ :-				
Change in the primary balance 3/	-1.0	-6.4	-6.1	-7.9	-8.0	5.6	4.4	3.5	2.1	-0.3
Write-off claims on banks 10/	0.0	28.1	13.0	10.0	19.9	0.0	0.0	0.0	0.0	0.0

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

<sup>1/</sup> Historical data are semi-accrual; projections are modified cash. Data are presented in GFS format, with program columns converted from national accounts to GFS. As a result, depreciation is no longer counted as capital revenue, and aggregate revenue and expenditure ratios are adjusted accordingly.

<sup>2/</sup> Measures needed have been reflected about equally divided between tax and expenditure measures, except in 2009 where revenue measures are expected to dominate. Measures are counted cumulatively from 2009 onward.

<sup>3/</sup> 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), which under the original program were assumed to be direct CBI liabilities.

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

<sup>5/</sup> For the program column this reflects the outstanding value of the UK/Dutch IceSave loan.

<sup>6/</sup> Gross debt minus liquid assets at the CBI (including liquid assets from bilateral loans to support CBI reserves).

<sup>7/</sup> In percent of potential GDP.

<sup>8/</sup> State guarantees only. Excludes guarantee on IceSave loans.

<sup>9/</sup> Includes interest accrued on depositor guaranteed loans.

<sup>10/</sup> For 2009, retroactive interest paid to new banks to compensate for delayed capitalization is treated as a write-off claim.

Table 7. Iceland: Medium-Term Projections, 2007–14 (Percentage change, unless otherwise indicated)

	2007	200	18	20	009	2010	2011	2012	2013	2014
		Prog.	Est.	Prog.	Adj. Prog.	Proj.	Proj.	Proj.	Proj.	Proj.
		(F	Percentage	change)						
Real economy			_							
Real GDP	5.6	1.6	1.3	-9.6	-8.5	-2.1	0.9	2.0	3.0	4.0
Real domestic demand	-0.1	-9.1	-8.7	-19.7	-20.7	-1.5	0.4	1.9	4.3	5.8
Private consumption	5.6	-8.7	-7.8	-23.7	-17.0	-4.5	0.9	4.7	6.5	5.5
Public consumption	4.1	3.2	4.6	2.9	-0.1	-1.6	-3.3	-2.5	-1.0	1.2
Gross fixed investment	-12.2	-19.7	-20.4	-33.6	-50.6	11.7	5.3	-0.1	5.7	13.8
Net exports 1/	6.2	11.7	11.4	10.0	11.2	0.4	0.5	0.3	-0.7	-1.1
Exports of goods and services	17.7	12.1	7.1	1.9	-1.5	1.0	2.7	4.9	3.0	2.7
Imports of goods and services	-0.7	-15.2	-18.3	-23.1	-30.5	0.0	2.3	6.0	6.5	7.0
Output gap 2/	5.5	4.6	2.2	-5.4	-3.2	-2.7	-1.7	-1.3	-0.8	0.2
Potential output	3.8		2.3		-2.4	-2.6	-0.2	1.6	2.5	3.0
Unemployment rate 3/	1.0	1.4	1.6	5.7	8.6	10.6	8.5	7.0	5.5	4.0
Real wages	4.1	-6.0	-5.7	-12.0	-7.5	-2.6	1.9	2.3	2.7	3.0
CPI inflation	5.0	12.7	12.4	14.3	11.7	4.4	2.5	2.5	2.5	2.5
CPI inflation (end of period)	5.9	20.5	18.1	4.5	7.0	2.5	2.5	2.5	2.5	2.5
	(In perc	ent of GDF	, unless of	therwise i	ndicated)					
Balance of Payments										
Current account	-19.9	-10.7	-35.8	1.0	-3.5	-2.0	-3.2	-3.0	-3.0	-3.6
Trade balance	-10.1	0.1	-2.3	10.3	8.6	10.0	10.3	10.3	9.0	7.2
Net income balance 4/	-9.5	-10.5	-33.3	-9.0	-11.6	-11.6	-13.1	-12.8	-11.6	-10.4
Capital and financial account	-12.5	-102.1	78.6	-15.7	6.8	-18.2	8.0	8.1	6.5	8.6
Capital transfer, net	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Direct investment, net	-63.6	-4.4	49.8	2.0	8.4	5.5	5.2	3.3	2.6	10.0
Portfolio investment, net	-34.0	11.6	1.8	-9.8	-6.6	-7.2	-4.8	-0.3	-1.1	0.0
Other investment, net 5/	85.3	-109.1	27.0	-7.7	5.1	-16.4	0.5	5.1	5.1	-1.4
Accumulation of arrears	0.0	61.3	158.5	0.0	-47.2	0.0	0.0	0.0	0.0	0.0
Extraordinary financing	0.0	66.7	6.8	10.5	61.8	16.9	2.4	-3.0	-4.8	-3.6
Gross external debt 5/ 6/	566.2	670.2	192.9	159.5	306.9	295.5	272.7	254.3	235.1	210.6
Central bank reserves (US\$ billion)	2.6	5.6	3.6	5.0	4.9	4.6	4.6	4.9	4.7	4.9
General government accounts										
Revenue	47.9	43.8	44.3	40.0		40.5	43.1	44.5	45.4	44.5
Expenditure	42.5	44.0	44.8	53.5	52.7	51.4	49.9	47.1	44.7	43.3
Overall balance	5.4	-0.2	-0.5	-13.5	-14.4	-10.9	-6.8	-2.6	0.7	1.2
Structural balance 7/	1.3	-3.4	-2.1	-8.7	-10.2	-8.1	-5.4	-1.7	1.6	1.2
Gross debt	28.7	108.9	70.0	108.6	125.2	136.0	135.1	131.7	124.7	114.7
Net Debt	10.3	90.6	41.3	97.0	89.5	97.6	101.6	100.4	95.0	88.5

Sources: CBI; and IMF staff estimates.

<sup>1/</sup> Contributions to growth.

<sup>2/</sup> In percent of potential output

<sup>3/</sup> In percent of labor force.

<sup>4</sup>/ Includes interest payments due from the financial sector and income receipts to the financial sector.

<sup>5/</sup> Includes possible arrears accumulated by the financial sector.

<sup>6/</sup> Including old banks before 2007 and in 2008 program.

<sup>7/</sup> In percent of potential GDP.

Table 8: Iceland: Balance of Payments, 2007–2014

		(U.S. D	ollar billior	าร)						
	2007	2008	2008	2009	2009	2010	2011	2012	2013	2014
	Prel.	Prog.	Prel.	Prog.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Current Account	-4.0	-1.8	-6.3	0.1	-0.4	-0.3	-0.4	-0.4	-0.4	-0.6
Trade Balance	-2.1	0.0	-0.4	1.4	1.0	1.3	1.4	1.4	1.3	1.1
Balance on Goods	-1.4	0.2	-0.1	0.9	0.9	0.9	0.9	1.0	0.9	0.8
Merchandise exports f.o.b.	4.8	5.8	5.3	4.9	3.8	4.2	4.4	4.8	5.0	5.1
Merchandise imports f.o.b.	-6.2	-5.6	-5.4	-4.1	-2.9	-3.3	-3.5	-3.7	-4.0	-4.4
Balance on Services	-0.7	-0.1	-0.3	0.5	0.1	0.3	0.5	0.4	0.4	0.4
Exports of services, total	2.3	2.7	2.1	2.6	1.9	2.1	2.3	2.4	2.5	2.7
Imports of services, total	-3.0	-2.8	-2.4	-2.0	-1.8	-1.8	-1.8	-2.0	-2.2	-2.3
Balance on Income 1/ 2/	-1.9	-1.8	-5.9	-1.2	-1.4	-1.5	-1.8	-1.8	-1.7	-1.7
Receipts	3.6	3.9	-2.4	0.3	0.1	0.4	0.5	0.6	0.6	0.7
of which dividends and reinvested earnings	1.5		-4.2		-0.1	0.1	0.2	0.3	0.4	0.4
of which interest receipts	2.2		1.8		0.1	0.2	0.2	0.3	0.3	0.3
Expenditures	-5.6	-5.6	-3.4	-1.5	-1.5	-1.8	-2.3	-2.4	-2.4	-2.4
of which dividends and reinvested earnings	-1.1		1.6		0.0	-0.1	-0.1	-0.2	-0.2	-0.3
of which interest payments	-4.4		-5.0		-1.5	-1.8	-2.2	-2.3	-2.2	-2.1
Current transfer, net	-0.1	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Cap and Finan. Acct	-2.7	-17.1	-6.8	-2.1	0.7	-2.3	0.1	1.1	1.0	1.4
Capital transfer, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	-2.5	-17.1	-6.8	-2.1	0.7	-2.3	0.1	1.2	1.0	1.4
Direct investment, net 1/	-12.9	-0.7	8.4	0.3	1.0	0.7	0.7	0.5	0.4	1.6
Portfolio investment, net	-6.9	1.9	0.3	-1.3	-0.8	-0.9	-0.6	0.0	-0.2	0.0
Assets	-7.6	0.1	1.4	-1.3	0.1	-0.2	-0.5	-0.2	-0.2	-0.3
Liabilities 2/	0.7	1.9	-1.1	0.0	-0.9	-0.7	-0.1	0.2	0.1	0.3
Net borrowing		2.5	0.7	1.5	-0.8	-0.7	-0.2	0.0	-0.2	-0.1
Equities	0.2	0.3	-1.7	0.0	0.0	0.0	0.1	0.2	0.3	0.3
Other investment, net	17.3	-18.3	-15.5	-1.0	0.5	-2.1	0.1	0.7	0.8	-0.2
Assets	-16.8	-3.0	-0.9	1.1	0.8	-0.2	0.7	0.8	0.4	0.4
of which asset recovery				2.1	0.4	0.1	1.0	0.8	0.4	0.3
Liabilities 2/	34.1	-15.4	-14.6	-2.1	-0.4	-1.8	-0.6	-0.1	0.3	-0.7
of which deposit insurance loans		0.0	0.0	-2.1	0.0	-1.5	-1.0	-0.8	-0.4	-0.3
of which old banks foreign deposits		-15.8	-18.8							
of which general and special SDR allocations					0.1					
Net errors and omissions	0.4	0.4	-5.6	0.0	-0.6	0.0	0.0	0.0	0.0	0.0
Overall Balance	-6.1	-18.5	-18.7	-2.0	-0.3	-2.6	-0.3	0.7	0.5	0.8
Overall financing	6.1	18.5	18.7	2.0	0.3	2.6	0.3	-0.7	-0.5	-0.8
Change in gross reserves ("-" = increase)	6.1	-3.0	-0.9	0.6	-1.4	0.4	0.0	-0.3	0.2	-0.2
Accumulation of arrears ("-" = paydown)	0.0	10.3	18.8	0.0	-5.6	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing 3/	0.0	11.2	0.8	1.4	7.3	2.2	0.3	-0.4	-0.7	-0.6
Fund ("+" = net disbursement)	0.0	0.8	0.8	0.6	0.3	0.7	0.3	-0.4	-0.7	-0.6
Bilateral (earmarked/ non-cash)	0.0	8.2	0.0	0.0	5.6	0.0	0.0	0.0	0.0	0.0
Other identified new financing	0.0	2.2	0.0	0.8	1.4	1.5	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	0.0
Level of Gross reserves (eop) 4/	2.6	5.6	3.6	5.0	4.9	4.6	4.6	4.9	4.7	4.9
Memo	2.0	0.0	0.0	0.0					•••	
GDP \$ bln	20.3	16.9	16.8	13.4	11.9	12.6	13.4	14.1	14.9	15.9
Non-FDI assets (from IIP)/S-T debt (residual basis) 5/	20.3	10.9	85%		88%	96%	122%	134%	113%	88%
excluding large multinational 5/			85%		90%	98%	122%	132%	131%	136%
Reserves/S-T debt (residual basis)			50%		54%	57%	71%	79%	65%	51%
excluding large multinational 6/			50%		55%	58%	72%	80%	78%	82%
Reserves (months of imports of G&S)	4.0	11.0	9.0	9.9	11.7	10.3	9.6	9.5	8.3	8.4
Reserves (% GDP)	13%	33%	21%	37%	42%	36%	34%	34%	31%	31%
Arrears of old banks 2/		2.7	2.5		5.7					

Sources: CBI; and IMF staff estimates.

<sup>1/</sup> The 2008 balance on income data reported by the central bank include large losses (under dividends and reinvested earnings) in Iceland and abroad, a large portion of which (up to 15 percent of GDP, net) may be misclassified capital losses. Consistent with standard BOP treatment, offsetting entries for these losses appear under FDI in the financial account. 2/ Principal and interest transactions related to old banks are not included from 4Q08 on (scheduled payments for 4Q08 and 1H09 are shown as memo items under "Arrears of old banks"). Original program projections for 2009 forward also did not include old bank-related projections, but included 4Q08 payments.

<sup>3/</sup> Debt service payments on extraordinary financing appear in the financial account, except for Fund repurchases. Payments of non-lcesave related deposit claims (and associated external asset recovery) not shown.

<sup>4/</sup> Includes repos with BIS (USD380 as of end-2008).

 $<sup>\</sup>ensuremath{\mathsf{5}}\xspace$  Projections assume 3 percent annual growth of non-official reserve assets.

<sup>6/</sup> A multinational with significant but offsetting international assets and liabilities.

Table 9. Capital Control Liberalization Strategy in International Perspective.

Step	Preconditions	International experience
Liberalization of inward investments in foreign currency	Credible macroeconomic stabilization policies.	The sequencing loosely follows the
<ul> <li>Limitations on the use of krona for international transactions.</li> </ul>	<ul> <li>Strong reserves and a good outlook for the balance of payments</li> </ul>	standard capital account liberalization methodology successfully implemented by many countries, including more recently
Leveraged derivative transactions remain controlled.	Sound banking sector. adequate supervision.	the Central and Eastern European
	Attractive returns.	countries. Adjustments have been made to ensure that Iceland's obligations under
	Investor-friendly FDI policies	the EEA agreement concerning the nondiscriminatory treatment of residents and nonresidents are respected. Hence
	T	the capital outflow liberalization is based on krona asset types.
Preparations for liberalizing outflows	The split must be based on potential outflows	• •
<ul> <li>Categorization of accounts, asset classes and transactions into (i) those that can be liberalized; and (ii) those that will remain blocked</li> </ul>	resulting from the liberalization of the account, assets class or transaction and the possibility of effective administration.	<ul> <li>A number of countries have maintained separate blocked accounts. For example, Hungary did not allow the conversion of</li> </ul>
Leveraged derivative transactions to remain controlled		certain forint proceeds of nonresidents during a significant part of the
3. Lifting controls on the accounts, asset classes and	Confidence in the domestic banking sector.	liberalization procedure. South Africa maintains blocked accounts for certain
transactions that can be liberalized in the near term.	Comfortable reserves level.	nonresidents. <i>Russia</i> also maintained a
<ul> <li>Transferability of krona assets and accounts up to a certain ceiling to be gradually increased or for certain transactions in a sequenced manner.</li> </ul>	<ul> <li>Efficient administration to ensure that blocked accounts remain nontransferable and circumvention contained.</li> </ul>	one-year mandatory waiting period for the conversion of the proceeds from nonresidents' investments in treasury bills. These proceeds had to be deposited in
4. Lifting controls on blocked accounts	Completion of the third stage	special accounts and could be used only
Gradual lifting in accordance with available surplus	Comfortable reserves level	to purchase certain government and corporate securities. Finally, <i>Malaysia</i>
reserves	<ul> <li>Determination of the method to be used for releasing blocked krona assets or krona balances on blocked accounts.</li> </ul>	blocked the transferability of nonresidents' proceeds from certain assets for one year. Maintaining blocked account for residents requires additional administrative measures to minimize circumvention.

Table 10. Measures implemented in 2009 and proposed for 2010 budget (percent of GDP) 1/

	2009	2010
Tax measures		
Income Taxes		
Introduction of second PIT bracket	0.14	
Reform of PIT system (e.g. inclusion of investment income)	0.00	2.56
Surtax on capital income	0.02	
Enhanced frequency of capital income collections	0.68	0.00
Social security contributions	0.33	0.78
Taxes on goods and services		
VAT (changes in brackets and/or tax base)	0.00	0.51
Excise taxes		
Alcohol	0.05	0.14
Tobacco	0.03	0.07
Sweets	0.05	0.13
Environmental and natural resource taxes		
Petrol tax	0.08	0.19
Diesel tax	0.02	0.06
Other excise taxes	0.00	0.03
Carbon/energy tax	0.00	1.05
Expenditure measures		
Savings on wages (incl. by nominal freezes) and operating expenditures (incl. identified by managers) 3/	0.12	0.94
Transfers		
Reform in health sector (incl. regarding procurement of drugs, co-payments, specialist services)	0.03	0.17
Improve meanstesting for child-related benefits and reducing universal benefit system	0.00	0.09
Improve meanstesting for old age and disability benefits	0.12	0.24
Halting automatic indexation of social benefits		
Other 4/	0.05	0.23
Maintenance and capital investment		
Road construction and maintenance	0.24	0.54
Other construction	0.06	0.12

Source: Ministry of Finance and staff projections.

<sup>1/</sup> Cumulative effect. Measures have been implemented in mid-2009 and therefore do not reflect a full year yield.

Full year yields are included in 2010 where relevant.

<sup>2/</sup> In addition, enhancing frequency of collection of capital gains tax could yield an additional ISK 10 billion.

<sup>3/</sup> In 2010: 10 percent on general administrative costs, 7 percent on educational spending and 5 percent on welfare-related spending.

 $<sup>{\</sup>it 4/ Includes \ cuts \ in \ operational \ spending \ classified \ under \ transfers, \ reductions \ in \ legal \ expenses,}$ 

cuts in fees to religious and non-religious organizations.

Table 11. Iceland: External Financing Requirement and Sources, 2009–14 (In billions of US dollars)

	2009	2010	2011	2012	2013	2014
	Proj	Proj	Proj	Proj	Proj	Proj
A Gross Requirements	8.2	9.4	8.5	6.4	5.8	7.1
Current account deficit	0.4	0.3	0.4	0.4	0.4	0.6
Amortization (MLT)	2.6	4.4	3.7	1.8	1.1	2.4
Official (excl. IMF)	8.0	0.6	1.9	0.4	0.2	0.4
Deposit insurance loans	0.0	1.5	1.0	8.0	0.4	0.3
Private	1.9	2.3	0.8	0.6	0.5	1.7
Short-term debt	5.1	4.7	4.3	4.2	4.2	4.2
B Sources of Financing	7.1	7.2	8.1	6.9	6.5	7.7
Foreign Direct Investment (net)	1.0	0.7	0.7	0.5	0.4	1.6
FDI outflows Abroad	0.6	0.2	0.1	0.0	-0.1	1.1
FDI inflows to Iceland	0.5	0.5	0.6	0.5	0.4	0.5
Net inflows of equity and other capital	0.0	-0.2	-0.4	-0.1	0.0	0.1
Asset recovery (of old bank foreign assets)	0.4	0.1	1.0	8.0	0.4	0.3
Disbursements (MLT)	1.7	2.2	2.9	1.7	1.3	1.6
Disbursements (ST)	4.7	4.4	4.2	4.3	4.2	4.2
Other net assets	0.6	-0.3	-0.3	0.0	0.0	0.1
Reserves accumulation (-: increase)	-1.4	0.4	0.0	-0.3	0.2	-0.2
C Financing Gap (A-B)	1.1	2.2	0.3	-0.4	-0.7	-0.6
Errors and omissions	-0.6	0.0	0.0	0.0	0.0	0.0
Accumulation of arrears	-5.6	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing	7.3	2.2	0.3	-0.4	-0.7	-0.6
Fund	0.3	0.7	0.3	-0.4	-0.7	-0.6
Bilateral (earmarked/ non-cash)	5.6	0.0	0.0	0.0	0.0	0.0
Other identified new financing	1.4	1.5	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.

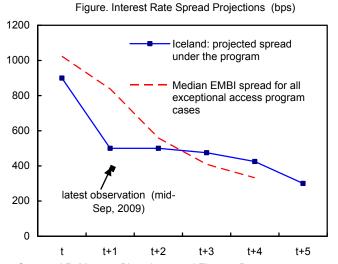
#### APPENDIX I. DEBT SUSTAINABILITY ANALYSIS

1. This appendix analyzes external and public debt sustainability in detail. The discussion encompasses the assumptions used, the baseline projection, and a detailed discussion of a variety of shock scenarios. To anticipate, while the level of both external and public debt is expected to remain high in the medium term, in both cases the debt should remain on a downward trajectory under the baseline. The results are robust to standard and tailored shocks, provided that there is strict program implementation.

## A. External Debt Sustainability

- 2. The assumptions behind the analysis have been modified compared to the original program to reflect developments:
- The **external debt stock** has been revised upwards. Box 1 in the Staff Report outlines the main reasons for the revisions. Essentially more information is available about how the collapse of the banking system has affected both the level of debt and its allocation between non-residents and residents, and more information is available about corporate external debt.
- The **path for interest rates** has been updated to reflect market developments and

agreements with creditors. Rates on market debt are initially high, in line with the present high nominal rates (reflecting inflation, risk premia and the monetary policy stance), but they gradually fall over the medium term as the situation improves. A gradual decline in the external risk premium from an average level of 900 bps in 2009 to 300 bps in 2014 is in line with developments in past crisis cases. However, the overall level of interest rates does not decline by this amount due to projected increases in world interest rates. Interest



Source: J.P. Morgan, Bloomberg, and Finance Department 1/ Crisis year = t. EMBIG spreads are defined as the EMBIG yields net of the adjusted SDR rate of charge. The dotted line is the median for all exceptional access cases since 1995 (including under the SRF), subject to data availability.

rates on ISK instruments broadly reflect interest parity (in line with gradual lifting of capital controls). Regarding official bilateral debt, the final terms on the Nordic bilateral and the Icesave loans are incorporated, lowering interest rates on these loans compared to the original program.

- Capital outflow projections have been refined to reflect the expected sequence and gradual pace of capital control liberalization. Regarding the second-stage release (longer terms assets), it is assumed that there are some portfolio reallocations towards foreign assets as capital controls are lifted. Regarding the third stage (short-term assets), debt is assumed to be almost fully rolled (with an exception made for some circumvention of controls). Liberalization steps in this third stage are assumed to induce outflows.
- **Disbursements of official bilateral loans** have been shifted in line with agreements reached with creditors. The U.K./Dutch loans to cover deposit insurance liabilities of the deposit insurance fund (under an Icelandic government guarantee) are assumed to be disbursed in 2009. Projected to be \$8.2 billion under the original program, these loans will actually amount to \$5.8 billion at current exchange rates. The \$2.4 billion in loans from Nordic partner countries are assumed disbursed in four tranches in 2009–10 (versus in 2008 under the original program). Other bilateral loans committed under the program, but not yet fully agreed, are assumed disbursed in 2010.
- 3. Under the program baseline scenario, Iceland's external debt declines continuously over the forecast horizon (Table A1 and Figure A1). A major driver of the initial upward and then downward movements is the \$5.8 billion Icesave loan in 2009, which is mostly paid down by asset recovery. A second key influence is the expected process of deleveraging by Icelandic multinationals (see Box A.1 for a case study). Other key drivers include: write-downs or recovery through FX assets for some corporate and financial sector debt now in bankruptcy (reducing nominal amounts by about 70 percent of what is outstanding); current account dynamics; and some appreciation of the nominal exchange rate over the medium term. Iceland's external debt burden, however, will remain very high by international standards. By end period, the actual non-interest current account balance (9½ percent of GDP) is well above the debt-stabilizing level (-4.7 percent of GDP, which reflects FDI inflows and macroeconomic fundamentals), suggesting that external debt reductions would continue in the medium term.

# Box A.1. Corporate De-leveraging and External Debt in Iceland: A Case Study

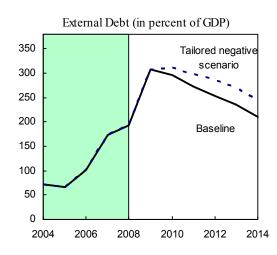
Just one Icelandic multinational accounts for more than one-fifth of Iceland's total external debt (some 70 percent of GDP). This multinational has over 95 percent of its employees and revenues outside of Iceland. The recorded value of its foreign assets in Iceland's IIP is a fraction of what the company estimates is their current book value.

For Iceland's DSA, this one extremely large loan is assumed to be either serviced from assets held abroad or restructured. That is, the firm is expected to de-leverage. This is consistent with its stated intentions. If instead the large loan were to be rolled over to a more permanent basis, the rate of reduction in Iceland's external debt would be much slower. However, in this instance the company would have to have sufficient cash flow to cover the debt service obligations. Fully accounting for this in the income account—there is little evidence of such cash flow at the moment—would help underpin a better current account, which would help offset the slowdown in debt reduction.

- 4. A number of standard and tailored shock scenarios show that the declining path for gross external debt is robust. The response is similar to those shown in the original program, albeit from a higher level:
- **Asset recovery shock.** Past experience with banking crises suggests that asset recovery can be extremely low. Assuming no asset recovery (to put a floor on the downside risk) would slow the reduction in the debt ratio, but not stop it.
- Interest rate shock. The recent history for emerging market countries suggests that a downgrade to Baa3 is a possibility given the higher debt numbers. This would imply a roughly 100 basis point risk premium above Iceland's current Baa1 rating. This would slow, but not stop the downward trajectory for debt.
- Exchange rate shock. While the current level of real exchange rate is at a historical low, a new bout of pessimism in global financial markets or a significant terms of trade shock could lead to another steep depreciation of the krona. The exchange rate shock—a depreciation of 30 percent—would lift external debt to extremely high levels. All else equal, the downward trajectory for debt would resume given the substantial margin between the debt-stabilizing and projected non-interest current account balance. The scenario perhaps overstates the impact, however, since it

ignores a feedback from exchange rate depreciation to the economy. The enhanced debt restructuring component of the program would reduce the negative balance sheet effect on growth, while the trade channel would underpin better growth and debt dynamics. At the same time, nominal GDP would likely expand significantly, and with much external debt denominated in krona, debt ratios would thus decline.

- **Current account shock.** Iceland's export base is dominated by resource-intensive industries vulnerable to changes in international prices. Significant terms-of-trade shocks have led to a sizable volatility in the non-interest current account deficit in the past. A permanent deterioration in the non-interest current account by 5 percent of GDP would slow, but would not prevent the reduction in the external debt ratio, in light of the large expected excess of the projected current account over the debt-stabilizing current account.
- Additional debt. Some data uncertainty remains, given the tangled web of external debt transactions that Icelandic corporations were engaged in. At the same time, the government faces some litigation risks related to bank restructuring that could lift external debt. For a small net shock to external debt—20 percent of GDP—and assuming no feedback onto interest rates, the external debt ratio jumps, but it remains on a downward path.
- The historical shock scenario does lead to problematic debt dynamics, but is not thought likely. The collapse of Iceland's banking system was a permanent shock, and it is very unlikely that Iceland will soon again experience the elastic capital flows that underpinned the 2003–07 episode. In any event the program targets an improvement in supervision and regulation, to ensure that such an episode cannot be repeated.
- suggests that results are robust. The tailored scenario includes a feedback to the macroeconomic variables and provides a more thorough presentation of the impact of an adverse shock on the economy than the combined DSA shock (which treats events as independent). The scenario is based on weaker global financial conditions and weaker aluminum FDI (due either to global or domestic developments). FDI is assumed to be cumulatively around \$1.5 billion lower over the medium term compared to the baseline projection (illustrating a significant delay or a cancellation of the planned expansion of the



Helgavik aluminum smelter). Interest rates are 300 basis points higher to reflect a higher risk premium (600 bps instead of 300 bps at end-period), and the exchange rate depreciates

slightly compared to the baseline. The shock dampens consumption and investment growth, and GDP growth is about 1½ percent lower over the medium term. The debt ratio still falls under this scenario, but remains very high at about 245 percent of GDP at the end of the projection period.

6. Iceland's high foreign assets provide comfort that the high level of external debt can be managed. According to current central bank estimates, Iceland's gross foreign assets as of end-June 2009 (excluding old banks) are about 181 percent of GDP. Assets may indeed be under-recorded. The high asset number reflects the holdings of corporations and individuals abroad, the investments of Iceland's fully-funded pension schemes (\$4 billion), and the \$3.6 billion in gross reserves at the central bank. The foreign assets of the private sector are largely invested in equity in the U.K., the Nordic countries, Luxembourg and the Netherlands and are exposed to the global downturn. However, in principle they should earn significant returns over the medium term, offering a substantial offset to Iceland's high debt service, and potentially providing the resources for a more substantial-than-envisioned private sector de-leveraging.

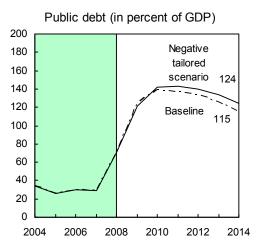
# **B.** Public Debt Sustainability

- 7. The assumptions have been modified relative to the original program:
- **Interest rate assumptions** have been revised in the same manner as assumed in the external debt sustainability analysis.
- **Public debt** now incorporates:
  - The outcome of the central bank recapitalization (18½ percent of GDP versus 10 percent expected in the program).
  - Debt to be issued as part of savings bank recapitalization (1½ percent of GDP).
  - Debt arising due to the Icesave agreement. The agreement foresees amortization via recovery of assets for the first seven years, with interest accruing and being capitalized for outstanding balances. Present auditor estimates suggest a residual government liability of between 5 and 25 percent of the initial obligation (10 percent of 2014 GDP at the high end of this range). The expected pace of asset recovery (a peak is expected in 2010–11) suggests that perhaps 8½ percent of the 2014 GDP could be added to this balance due to accrued capitalized interest. The residual liability is now recognized upfront, instead of including the gross liability as was done under the initial program.
  - Debt to be issued to recapitalize the 3 new banks (the estimate has been lowered to ISK 277 ISK billion (19 percent of GDP) from ISK 385 billion).

- 8. Under the program baseline scenario, Iceland's public debt declines slowly but continuously over the medium term (Table A2, Figure A2). The key factors behind the decline include: the fiscal adjustment (now stronger than initially programmed); valuation changes (as the real effective exchange rate recovers slightly); and the gradually improving real interest rate/GDP growth differential. The pace of the decline is relatively slow, and the stock even rises slightly in the interim, due to further disbursement of bilateral loans, and large deficits. By end-period, however, the actual primary balance (10 percent of GDP) is well above the debt-stabilizing level (1 percent of GDP), suggesting that debt reductions will continue beyond the shown time frame.
- 9. Key shocks would not jeopardize public debt sustainability:
- Standard shocks raise the debt level, but do not affect the downward dynamics. In particular, an interest rate shock (driven by a sovereign downgrade as discussed above), a primary balance shock (for instance due to a temporary slippage in the implementation of the consolidation plan) and macroeconomic shocks (to growth and the exchange rate) do not jeopardize public debt sustainability. This is due to the robustness of the consolidation path, which builds in a sufficient margin between the debt-stabilizing and actual primary balance.
- A contingent liabilities shock can be handled without adverse impacts for sustainability. A contingent liability shock of 20 percent of GDP is assumed, which could capture a significant realization of public sector liabilities (e.g. arising from public power companies, the HFF, or liabilities arising via the structure of the financial settlement with creditors, or due to delays in financial sector restructuring and a need for inject capital into the new banks). The debt ratio continues to decline, again due to the margin between the debt stabilizing primary balance and the actual primary balance.
- The no policy change scenario is unsustainable, but the program aims to avoid this. No policy change would entail a continuation of public deficits at present double digit levels, but the government has of course explicitly committed to adjustment, and has already begun to take measures to this end.

10. The tailored downside scenario shows sustainability can be preserved provided that the authorities stick to their fiscal deficit targets.

With consolidation measures as in the baseline, the tailored scenario would produce a slightly slower adjustment in the primary balance. The slower adjustment combined with a more depreciated exchange rate leaves the public debt ratio at about 125 percent of GDP at end period, not far from where it began. However, if deficit targets are maintained, the debt dynamics are more favorable.



11. **Iceland's funded pension system is a key comfort when considering medium term fiscal sustainability**. Iceland does not have the same aging related fiscal problem that other countries have. Iceland's funded pension system has assets, based on end-2008 data, in excess of 100 percent of GDP, among the very highest of OECD countries. The pension sector is generally sound: (i) actuarial evaluations are done every year and if they show that the net present value of future liabilities exceeds future assets, the pension funds are obliged by law to cut member rights;

(ii) the sector is strictly regulated, including entry requirements, general requirements for operating (covering size, risk, internal auditing and funding); and (iii) guidelines for investment policies are based on risk diversification. Comparisons of Iceland's gross public debt ratio to ratios in countries with public pension systems that are not fully funded need to be interpreted accordingly.

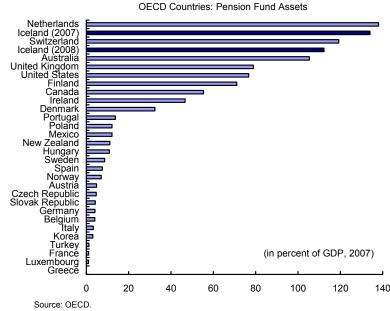


Table A1. Iceland: External Debt Sustainability Framework Current Baseline, 2004-2014

(In percent of GDP, unless otherwise indicated)

		Actual 7/					Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014		Debt-stabilizin
													non-interest
Basalinas Futamal dalat	70.4	05.0	404.0	470.0	400.0	200.0	205 5	070.7	0540	0054	210.6		current account
Baseline: External debt	72.4	65.9	101.3	172.8	192.9	306.9	295.5	272.7	254.3	235.1	210.6	1	-4.7
Change in external debt	-10.7	-6.5	35.4	71.5	20.1	114.0	-11.4	-22.8	-18.4	-19.2	-24.5	0.0	
dentified external debt-creating flows (4+8+9)	19.4	46.5	31.3	78.2	33.7	-11.5	3.0	-10.8	-11.5	-10.6	-18.6	0.0	
Current account deficit, excluding interest payments	8.0	14.3	22.2	13.7	24.5	-9.3	-12.0	-13.0	-13.0	-11.6	-9.5	4.7	
Deficit in balance of goods and services	5.5	12.2	17.5	10.1	2.3	-8.7	-10.0	-10.3	-10.3	-9.0	-7.2		
Exports	34.1	31.4	32.1	34.7	44.2	48.3	50.0	49.8	50.6	50.3	49.4		
Imports	39.6	43.6	49.6	44.8	46.5	39.7	40.0	39.5	40.3	41.3	42.2		
Net non-debt creating capital inflows (negative)	23.8	44.1	7.3	76.2	-40.1	-38.1	-5.0	-11.5	-9.3	-6.3	-13.3	-3.8	
Automatic debt dynamics 1/	-12.4	-11.9	1.9	-11.8	49.2	36.0	20.1	13.7	10.8	7.2	4.3	-0.9	
Contribution from nominal interest rate	1.9	1.8	3.4	6.2	12.9	12.8	14.0	16.2	16.0	14.6	13.1	11.8	
Contribution from real GDP growth	-5.3	-4.4	-2.8	-4.6	-2.8	23.2	6.0	-2.5	-5.2	-7.3	-8.9	-8.0	
Contribution from price and exchange rate changes 2/	-8.9	-9.4	1.3	-13.3	39.1							-4.7	
Residual, incl. change in gross foreign assets (2-3) 3/	-30.1	-52.9	4.1	-6.7	-13.5	125.5	-14.5	-12.0	-6.9	-8.6	-5.9	0.0	
External debt-to-exports ratio (in percent)	212.2	209.6	315.8	498.4	436.3	634.8	591.2	547.6	502.6	467.6	426.4		
Gross external financing need (in billions of US dollars) 4/	4.1	5.7	8.0	9.5	15.0	7.6	9.4	8.5	6.9	6.6	7.8	i	
in percent of GDP	30.9	35.1	47.6	46.6	89.6	63.9	74.1	63.2	48.6	44.1	49.0		
Scenario with key variables at their historical averages 5/						306.9	329.0	343.2	355.8	363.6	373.1		0.3
												For debt	
Key Macroeconomic Assumptions Underlying Baseline												stabilization	
Real GDP growth (in percent)	7.7	7.4	4.4	5.6	1.3	-8.5	-2.1	0.9	2.0	3.0	4.0	4.0	
Nominal external interest rate (in percent)	2.7	3.1	5.3	7.4	6.2	4.7	4.9	5.8	6.2	6.0	5.9	5.9	
Growth of exports (US dollar terms, in percent)	20.0	13.7	4.5	31.3	5.4	-22.7	10.0	5.9	7.0	4.8	4.5	i	
Growth of imports (US dollar terms, in percent)	28.3	35.9	16.3	9.8	-14.3	-39.6	7.3	5.0	7.6	7.9	8.8	i	
Current account balance, excluding interest payments	-8.0	-14.3	-22.2	-13.7	-24.5	9.3	12.0	13.0	13.0	11.6	9.5	i	
Net non-debt creating capital inflows	-23.8	-44.1	-7.3	-76.2	40.1	38.1	5.0	11.5	9.3	6.3	13.3	i	

 $<sup>1/ \</sup> Derived \ as \ [r-g-\rho(1+g)+\epsilon\alpha(1+r)]/(1+g+\rho+g\rho) \ times \ previous \ period \ debt \ stock, \ with \ r=nominal \ effective interest rate on external debt; \ \rho=change \ in \ domestic GDP \ deflator \ in US \ dollar \ terms, \ g=real \ GDP \ growth \ rate, \ g=real \$ 

 $<sup>\</sup>varepsilon$  = nominal appreciation (increase in dollar value of domestic currency), and  $\alpha$  = share of domestic-currency denominated debt in total external debt.

<sup>2/</sup> The contribution from price and exchange rate changes is defined as  $[-p(1+g) + \epsilon \alpha(1+r)]/(1+g+p+gp)$  times previous period debt stock,  $\rho$  increases with an appreciating domestic currency  $(\epsilon > 0)$  and rising inflation (based on GDP deflator).

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

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

<sup>5/</sup> 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.

<sup>6/</sup> 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.

<sup>7/</sup> Historical debt and interest data exclude old bank data (based on staff and Central Bank estimates). These figures are higher than under the original program because: (1) the original program excluded the entire banking sector, whereas only old banks are excluded now; (2) the proportion of the debt stock denominated in local currency was revised downwards; (3) external debt data has been revised upwards. Payments and obligations relating to non-locasive related deposit claims (and associated external asset recovery) not included.

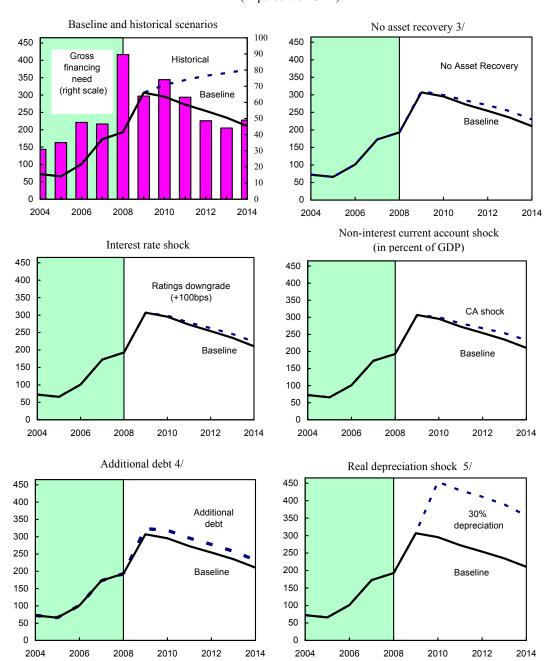


Figure A1. Iceland: External Debt Sustainability: Current Baseline Projection 1/2/ (in percent of GDP)

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. Historical debt data under the revised framework is higher than the original program because: (1) original program excluded the entire banking sector, whereas only old banks are excluded now; and (2) external debt data was revised upwards.

<sup>2/</sup> GDP is converted into \$ at average exchange rates.

<sup>3/</sup> No asset recovery scenario excludes the effects of the baseline projection of \$3.4bn in asset recovery from external sources over the forecast horizon.

<sup>4/</sup> Assumes upper end of estimates for external debt emanating from old bank restructuring (+\$2.4bn).

<sup>5/</sup> One-time real depreciation of 30 percent occurs in 2010.

Table A2. Iceland: Public Sector Debt Sustainability Framework, 2004-2014 (In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Debt-stabilizi
												primary
												balance 9/
Baseline: Public sector debt 1/	34.5	25.4	30.1	28.7	70.0	125.2	136.0	135.1	131.7	124.7	114.7	1.0
o/w foreign-currency denominated	17.9	10.4	16.8	13.4	23.9	48.8	57.8	55.5	54.2	52.8	48.9	
Change in public sector debt	-6.4	-9.1	4.7	-1.4	41.3	55.2	10.8	-0.9	-3.3	-7.0	-10.0	
Identified debt-creating flows (4+7+12)	-6.9	-7.6	-8.0	-10.7	28.0	60.3	16.3	2.2	-3.2	-7.5	-8.8	
Primary deficit (including interest income)	-2.5	-7.1	-8.5	-8.0	-2.8	4.9	0.2	-4.6	-8.0	-10.3	-9.8	
Revenue and grants	44.1	47.1	48.0	47.9	44.3	38.4	40.5	43.1	44.5	45.4	44.5	
Primary (noninterest) expenditure	41.6	40.0	39.5	39.9	41.5	43.3	40.8	38.5	36.5	35.2	34.6	
Automatic debt dynamics 2/	-4.5	-0.6	0.5	-2.6	12.5	9.7	6.8	6.8	4.9	2.7	1.0	
Contribution from interest rate/growth differential 3/	-1.4	-1.1	-0.9	-0.5	-0.1	9.7	6.8	6.8	4.9	2.7	1.0	
Of which contribution from real interest rate	1.4	1.3	0.1	1.0	0.3	3.7	4.2	8.0	7.5	6.5	5.7	
Of which contribution from real GDP growth	-2.9	-2.3	-1.0	-1.5	-0.3	5.9	2.5	-1.2	-2.6	-3.8	-4.7	
Contribution from exchange rate depreciation 4/	-3.1	0.5	1.4	-2.2	12.6							
Other identified debt-creating flows	0.0	0.0	0.0	0.0	18.3	45.7	9.3	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 10/	0.0	0.0	0.0	0.0	0.0	17.2	0.0	0.0	0.0	0.0	0.0	
Other (capitalization of the new banks and bilateral loans) 11/	0.0	0.0	0.0	0.0	18.3	28.5	9.3	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	0.6	-1.4	12.8	9.2	13.3	-5.1	-5.5	-3.1	-0.2	0.5	-1.2	
Public sector debt-to-revenue ratio 1/	78.2	53.9	62.8	59.9	158.2	326.2	335.4	313.1	295.8	274.6	257.9	
Gross financing need 6/	3.6	-2.0	-3.7	-2.6	5.4	24.3	22.1	28.0	11.7	7.2	6.0	
in billions of U.S. dollars	0.5	-0.3	-0.6	-0.5	0.9	2.9	2.8	3.8	1.7	1.1	1.0	
Scenario with key variables at their historical averages 7/ Scenario with no policy change (constant primary balance) in 2009-2014						125.2 125.2	123.2 152.5	115.1 161.7	109.7 172.2	104.8 181.1	98.5 186.3	-1.0 1.6
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	7.7	7.5	4.3	5.6	1.3	-8.5	-2.1	0.9	2.0	3.0	4.0	
Average nominal interest rate on public debt (in percent) 8/	6.6	7.1	9.7	9.6	13.3	13.5	8.8	8.7	8.2	7.6	7.4	
Average real interest rate (nominal rate minus change in GDP deflator, in percent	4.1	4.2	0.6	4.1	1.3	4.5	3.4	6.1	5.8	5.3	5.0	
Nominal appreciation (increase in US dollar value of local currency, in percent)	16.3	-3.1	-12.1	15.9	-48.7							
Inflation rate (GDP deflator, in percent)	2.5	2.8	9.0	5.5	12.0	8.9	5.4	2.6	2.4	2.4	2.4	
Growth of real primary spending (deflated by GDP deflator, in percent)	4.6	3.3	3.0	6.6	5.3	-4.4	-7.7	-4.7	-3.3	-0.7	2.4	
Primary deficit (including interest income)	-2.5	-7.1	-8.5	-8.0	-2.8	4.9	0.2	-4.6	-8.0	-10.3	-9.8	

<sup>1/</sup> General government gross debt (including bilateral loans to the central government to support central bank reserves which were excluded under the original program).

Also includes the estimated net present value of the guarantee on UK/Dutch IceSave loans, net of asset recovery.

<sup>2/</sup> Derived as  $[(r - \pi(1+g) - g + \alpha \epsilon(1+r)]/(1+g+\pi+g\pi)$  times previous period debt ratio, with r = interest rate;  $\pi =$  growth rate of GDP deflator; g = real GDP growth rate;  $\alpha =$  share of foreign-currency

denominated debt; and  $\varepsilon$  = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

<sup>3/</sup> 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.

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

<sup>5/</sup> For projections, this line includes exchange rate changes. In 2009-11, the residual also reflects use of deposits at the central bank.

<sup>6/</sup> Defined as general government deficit, plus amortization of medium and long-term general government debt, plus short-term debt at end of previous period.

<sup>7/</sup> The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

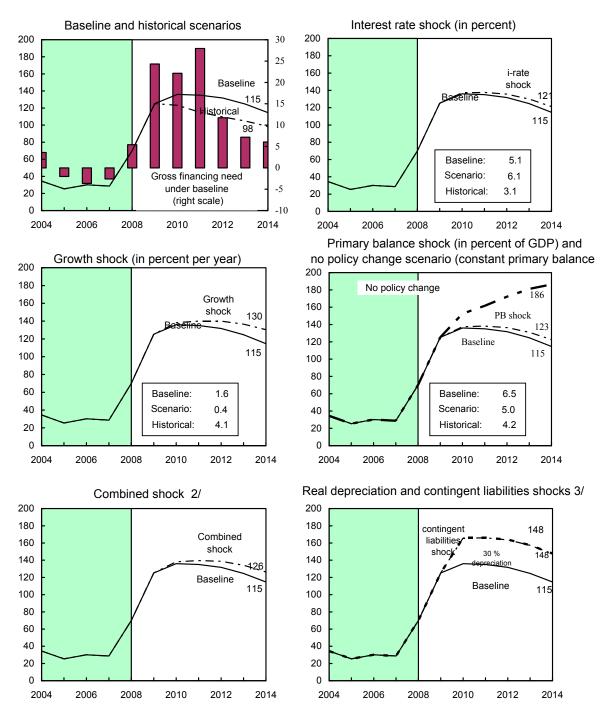
<sup>8/</sup> Derived as nominal interest expenditure divided by previous period debt stock.

<sup>9/</sup> 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.

<sup>10/</sup> Reflects the estimated net present value of the guarantee on UK/Dutch IceSave loans, after asset recovery.

<sup>11/</sup> Includes capitalization of new banks, and asset accummulation from bilateral loans.

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



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

<sup>1/</sup> 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.

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

<sup>3/</sup> One-time real depreciation of 30 percent and 20 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).

#### ATTACHMENT I. LETTER OF INTENT

Reykjavik, October 20, 2009

Mr. Dominique Strauss-Kahn Managing Director International Monetary Fund

Washington, D.C., 20431 U.S.A.

Dear Mr. Strauss-Kahn:

- 1. In the attached Memorandum of Economic and Financial Policies (MEFP), we describe progress towards meeting the objectives laid out in our Stand-By Arrangement. As defined in the original program Letter of Intent of November 15, 2008, policies were to be oriented towards stabilizing the currency, restoring the financial system to health, and securing medium-term fiscal sustainability.
- 2. Our implementation of policies has been delayed, but we are now on track to meet program objectives. We request waivers for nonobservance of performance criteria covering the end-December 2008 central government net financial balance and net international reserves, the end-February 2009 recapitalization of banks, and the continuous obligation to refrain from imposing or intensifying exchange restrictions. As described in the MEFP, we have implemented prior actions to bring policies back on course. In particular, reserves have been kept above an appropriate floor as of end-August (with monetary policy used to preserve currency stability); a plan for gradual capital account liberalization, consistent with currency stability going forward) has been approved; two of the three large banks have been recapitalized; and our fiscal consolidation plan has been approved. The status of all program measures is described in Tables 1–2 of the MEFP.
- 3. On this basis, we request completion of the first review under the Stand-By Arrangement. We also request the second purchase under this arrangement in an aggregate total amount of SDR 105 million.
- 4. In light of the delays in the first review, we also request that the arrangement be extended to end-May 2011 and purchases rephased. We request that ceilings and floors for the quantitative performance criteria under the arrangement be established for October 31, 2009, and for December 31, 2009, with quarterly reviews, as set out in the attached Technical Memorandum of Understanding (TMU). The second review will take place after December 15, 2009. We also request that the performance criteria on the change in net credit of the CBI to the general government be dropped and in their place, a new performance criterion be introduced

on the change in net domestic assets of the CBI. Since government deposits at the CBI remain an important component of the debt management strategy, we request that the ceiling on net credit of the CBI to the general government be kept as an indicative target. As detailed below, we propose three new structural benchmarks against which to measure progress towards key fiscal and financial sector objectives (MEFP Table 2). The TMU explains how program targets are measured.

5. We believe that the policies set forth in the Letter of Intent of November 15, 2008 and in the attached MEFP are adequate to achieve 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.

Very truly yours,

/s/ /s/

Johanna Sigurdardottir Prime Minister Steingrímur J. Sigfússon Minister of Finance

/<sub>S</sub>/

Már Guðmundsson Governor of the Central Bank of Iceland

#### ATTACHMENT II. ICELAND—MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

- 1. The sharp adjustment of Iceland's economy to the 2008 crisis continues, but some positive signs are beginning to emerge. The contraction in economic activity has to date proved less severe-than-expected, largely because a sharper-than-expected drop in domestic demand has fallen on imports. Regarding demand, business investment has been weaker-than-expected, and there is some uncertainty about when large projects in the aluminum and energy sector will be initiated. However, a broadly stable krona has contributed to falling inflation. The end-2008 year-on-year rate of 18 percent came in below the program projection, and the year-on-year rate has now dropped to about 11 percent. Moreover, we continue to foresee that economic activity will stabilize in 2010.
- 2. Our external financing needs remain broadly as anticipated in the program. Exports will be lower than expected in 2009–10 due to slower global growth, but the sharper-than-expected contraction in domestic demand should bring imports down as well. For the capital account, there may be delays in aluminum sector FDI, but the planned gradual phase out of capital controls should reduce the amount of capital outflows and offset this. An examination of newly available external debt data for end-2008 has led to an upward revision in the external debt stock and medium-term debt service, but the stronger policies outlined in this letter are expected to compensate for this.

# **Monetary Policy**

- 3. Monetary policy will continue to be guided by the objective of maintaining a stable krona, within a flexible exchange rate regime. While from a long term perspective, we perceive the krona to be undervalued, there remain high risks in the present that absent a firm monetary policy (involving both capital controls and interest rates), sharp capital outflows could lead to an overshooting depreciation. This would strain household and corporate balance sheets, and through this channel create unacceptable risks to inflation and growth.
- 4. An appropriate level for interest rates remains essential for krona stability. Capital controls have helped to take the pressure off of policy rates, but nonetheless since it is very difficult to eliminate all capital control circumvention, relatively high interest rates have also been necessary to stabilize the exchange rate. Beginning in March, with the krona well above its all time lows and our international reserves stable, we were able to reduce the policy rate in steps. We will continue to monitor the stability of both the currency and our level of reserves as indicators for future policy actions, and stand ready to tighten policy if necessary. Achievement of our reserve targets, without compromising currency stability, will be a **prior action** for the review. Looking forward, the comprehensive policy package that we have put in place, including external financing assurances, fiscal commitments and tangible progress in financial sector restructuring is expected to support krona appreciation

and reserve accumulation. This would in turn create room for gradual reductions in the policy rate, and for gradual lifting of capital controls.

- 5. We have designed a strategy to phase out capital controls over the medium term. It has been approved by cabinet (a **prior action** for the review) and has the following features:
  - The lifting of controls can begin once key preconditions are in place. In particular, we need to: (i) fully implement our macroeconomic stabilization package; (ii) establish a strong, well-managed and adequately supervised financial sector that will be able to withstand unpredictable capital flows once controls are lifted; (iii) implement and operate an efficient liquidity management framework; and (iv) accumulate adequate reserves (so that we can support exchange rate stability and banking system liquidity if necessary). We expect these conditions to be in place in late 2009.
  - The strategy will distinguish accounts, asset classes and transactions to be liberalized
    early in the process from others which will remain controlled for a longer period of
    time. These latter "blocked accounts" will comprise those where there is a large
    potential for outflows, and where early liberalization might undermine effective
    administration of the system.
  - The lifting of controls will be sequenced. Once liberalization starts, controls on all foreign exchange capital inflows can be removed in a relatively short time frame. In a second stage, controls on outflows from non-blocked accounts, asset classes and transactions will be gradually liberalized, consistent with the balance of payments outlook and improvements in confidence in the domestic banking sector. In the final stage, blocked accounts will be gradually released. This stage will only commence once the others are complete, and once we have available surplus reserves (to help contain any exchange rate volatility). The use of krona for international transactions will remain controlled until the final stage of liberalization.
  - Controls on outflows from blocked accounts, when they are lifted, will be lifted either through a gradual increase in thresholds or through targeted auctions of FXconvertible bonds.
  - Since the controls cannot immediately be lifted and must be kept effective, the strategy also provides for stronger administration. In particular, we have strengthened regular reporting by banks and other participants in foreign exchange transactions, established a dedicated monitoring unit in the CBI, and set up a special investigation unit in the FME. The latter two units are sharing information and working together to intensify surveillance and ensure compliance under a formal agreement between the

- CBI and the FME signed in June. We expect this tightening of administration to help loosen constraints on our interest rate policy.
- The strategy will be refined and revised based on the experience from early phases of the plan. We will continuously review the design of the controls to ensure that they are functioning with minimum administrative burden while containing circumvention. The CBI indeed stands ready to tighten administration of "blocked" accounts if the situation requires.
- While current payments are generally transferable, the capital control regime marginally affects the conversion and transfer of two components of current payments, as defined by the IMF: interest on bonds (whose transfer the FX rules apportion depending on the period of the holding) and the indexed portion of amortized principal on bonds. To the extent that these measures give rise to exchange restrictions, we request IMF temporary approval and waiver of the nonobservance of the performance criterion under the Stand-by Arrangement.
- 6. **Monetary operations have been strengthened in support of our strategy**. The CBI has defined an intervention strategy that sets indicative levels for acceptable exchange rate volatility and targets for net foreign exchange accumulation consistent with the program NIR target. Domestic liquidity management has also been tightened. We have enhanced control of the volume of open market operations from July 1, and have established a program of weekly CD issuance (28-day CDs will be used to mop up liquidity and thus make the CB interest rate corridor more relevant).

#### **Financial Sector Policies**

- 7. Our financial sector strategy will continue to be guided by several principles. First, it is crucial, from a macroeconomic perspective, to have a sound banking system as soon as possible. Second, while we remain committed to protecting domestic deposits, we have no fiscal capacity to absorb any further private sector losses from the banking crisis, whether this be through direct use of government resources, or an indirect use of the government's balance sheet to assume risk. Third, there must be a fair, equitable, and non-discriminatory treatment of depositors and creditors in line with applicable law.
- 8. We have strengthened the oversight of the restructuring of the financial system. An Executive Committee, with a mandate from the Prime Minister, Minister of Finance and Minister of Business Affairs and the Central Bank, will continue to oversee the overall financial sector restructuring. A special committee was set up with participation of the Ministry of Finance, Ministry of Business Affairs, and the Prime Minister's Office to manage the process of recapitalizating the three new banks. Reputable financial advisors were retained to discuss compensation instruments. We have publicly clarified to all stakeholders these new lines of responsibility and decision-making.

- 9. Recapitalization of the three new banks (that were established after the collapse of the old banks) is a key objective. We have made much progress, but a few more steps will be required to bring the process to a conclusion:
  - The valuation of the assets transferred from the old banks to the new banks was concluded in April. This produced, for each bank, an estimated range of asset value under a given set of assumptions. This valuation exercise was an important means of gathering information and a helpful input into negotiations with creditors.
  - To underpin fair and transparent discussions on compensation payable to the old banks and on the potential structure of a compensation instrument, we completed the exchange of information with the Resolution Committees of the old banks (RCs). We have also ensured full access by the RCs to the independent report on valuation of the assets, and to banks' business plans. Finally, we have met and shared information with representatives of the old bank creditor groups (in addition to the information that these parties have received through the RCs).
  - The period for discussions had to be time-bound, but with enough flexibility to allow creditors to process information and to consider alternative options. Discussions began in April and accelerated in early June after the RCs gained access to the new banks' business plans and to the independent report on valuation. Extensions were granted in mid-July and mid-August at the request of creditor representatives.
  - The instruments of compensation have been, and will continue to be, designed to account for the uncertainty about asset valuation in a fair manner. They may in each case comprise a fixed debt component and a component for which the return will vary with economic outcomes. We have already reached such agreements with the Kaupthing and Glitnir RCs. We aim for an agreement with the Landsbanki RC by mid-November.
  - Islandsbanki and New Kaupthing have been recapitalized (**prior action** for the review) after a preliminary audit of their opening balance sheets (on the basis of IFRS), and an accounting of the compensation instrument. The capital adequacy ratio (including capital requirements to cover market and operational risk) has in each new bank been brought to 12 percent, by means of an injection of tradable government bonds. We expect Landsbanki to be recapitalized to the same capital adequacy ratio, again using tradable government bonds. We propose that this recapitalization of New Landsbanki be a **structural benchmark** for end-November.

## 10. The process of operationally restructuring the new banks has commenced:

• We have developed a plan to address their financial imbalances. Banks' excess of FX assets over liabilities exposes them to large potential losses in the event of currency

volatility. Eliminating this excess will take time, and as discussed above, capital requirements will be set to help mitigate any problems that arise. We expect the solution to vary by bank. We expect to employ some combination of an FX compensation instrument; FX-subordinated debt (as part of recapitalization); review of lending and deposit rates; and voluntary debt conversion (consistent with the restructuring strategy laid out below) in each bank.

- The three new banks have submitted to the FME revised business plans for the next three years (business plans were submitted to and reviewed by the FME in mid-January 2009, meeting a program **structural benchmark**). These plans are based on the program macroeconomic scenario, and cover the staffing needs, organizational structure and the kind of services they will be offering their customers in the future. They include quarterly targets to gradually eliminate financial imbalances (consistent with the bank-by-bank plan in the bullet above), restructure loans, and bring the system into line with best international practices.
- As part of the governance framework for the new banks, we have set up an agency to be the depository of bank shares held by the treasury. The agency will be operational by end-October 2009. It will be responsible, through a board composed of well-trained and fit and proper banking experts, for negotiating agreements with banks to restructure their operations to achieve and maintain profitability, and more generally to ensure prudent conduct of their operations. The agency will also be responsible for maintaining the level of bank capitalization in full compliance with regulatory requirements, and approving capital increases to sustain asset growth.
- 11. **The three old banks are now in winding up proceedings.** The ultimate recovery of creditors is to be determined in accordance with the legal ranking of secured creditors, depositors, and unsecured creditors, under the applicable insolvency law. Separately, a special prosecutor's office has been established to investigate and prosecute possible criminal offenses in the past management of the old banks. We are committed to providing this office with adequate resources to carry out its functions.
- 12. We are taking action to secure the remainder of the financial system. A number of domestic savings banks and an investment bank suffered from the collapse of the three old banks, and from the aftermath of domestic and international financial turbulence. We had to intervene in several of these institutions in March 2009, after creditors and owners were unable to find a satisfactory solution to solvency and/or liquidity problems (despite repeated deadline extensions). Deposits were transferred to other financial institutions. For remaining saving banks we have a program in place which allows us to inject capital to bring viable institutions up to a capital adequacy ratio of 12 percent of their risk-weighted assets. The public contribution is limited to 20 percent of end-2007 capital. To qualify, their business plans and the fit and proper status of senior managers and directors must first be subjected to thorough scrutiny by the FME, and the Ministry of Finance must be satisfied that their

business plans do not shift risk or losses onto the public sector. We expect this program to be complete no later than November 30, at which point all operating savings banks will be fully capitalized. We propose completion by this date as a **structural benchmark**.

- 13. The government has adopted a statement of its intentions as owner of financial institutions during the reconstruction of the financial system. The principal objectives are to ensure the provision of banking services throughout the country while promoting the development of a sound, trusted and profitable financial system, thereby contributing to economic growth. Other objectives are to strengthen competition, enhance efficiency and encourage transparency in the financial sector. We plan to reduce government holdings of bank equity as market conditions permit.
- 14. We are also taking action to improve our regulatory and supervisory practices. An international expert has concluded and published a review (meeting a program structural performance criterion), and we plan to implement the key recommendations:
  - We intend to introduce legislation into parliament covering the powers given to the supervisory agency; the creation of a national credit registry (to allow identification and monitoring of large exposures); improvements in the deposit insurance system; and prudential regulations on large exposures and connected lending. We propose that the introduction of this legislation become a **structural benchmark** for end-December.
  - The FME will place emphasis in its annual work plan on higher onsite inspection frequency, by means of more specialization within the authority and more resources allocated to onsite inspection. To bolster its investigative capacity, the FME is in the process of establishing a forensic accounting unit with a specialized staff to uncover and prevent financial fraud and wrongdoing, support prosecution efforts, and play a proactive role in risk reduction. It formally began operating in August.
  - We also intend to introduce a bank insolvency bill of law to provide a predictable framework for bank resolution.

#### **Debt Restructuring**

15. Targeted household and corporate debt restructuring are important complements to our financial sector restructuring strategy going forward. Addressing non-performing loans and those at risk of becoming non-performing will be crucial to facilitate prompt economic recovery. In designing and refining policies in this area we will be guided by several principles, including the need to: target our interventions to those truly in need (and in line with fiscal and financial sector capacity); preserve the payment culture and avoid strategic loan defaults; maximize asset recovery; and facilitate market distinctions between rehabilitation of viable borrowers and the efficient exit from the economy of non-viable borrowers.

# 16. For the household sector, we have already put in place several measures and a key focus now will be the household insolvency regime.

- Targeted measures to assist distressed household debtors have included: (i) the law on "Temporary Mitigation of Residential Mortgage Payments" that provides for the extension of maturities of moderate mortgage loans if voluntary restructuring is not sufficient; and (ii) amendment of the insolvency law to facilitate agreements between individual debtors and their unsecured creditors. With these laws now in place, we have lifted the informal freeze on mortgage loans payments and we will allow the standstill on foreclosures to expire, beginning at end-October with full phase out by end-January 2010.
- We are studying household income and debt data to determine whether these
  initiatives should be adjusted. We will also develop guidelines consistent with
  international best practices to support and promote voluntary and expedited debt
  restructurings in the household sector, which will ensure that a coherent and
  consistent strategy is implemented across financial institutions, taking account of
  existing measures.
- In addition, we have reviewed the household insolvency regime to determine whether
  further legal reforms are required including whether to integrate debt counseling
  services into the insolvency law process and to include secured creditors in an
  individual's rehabilitation proceedings. The Ministry of Justice has issued a report
  containing the key recommendations for reform and will submit a bill to Parliament
  in November 2009

# 17. For the corporate sector, voluntary and insolvency law-based tools, along with an asset management company (AMC) will be needed to address debt distress:

- We will work with the banks to facilitate voluntary corporate debt workouts. We will jointly revisit with the banks their existing guidelines on out-of-court restructurings. In line with best international practice, these would cover: voluntary stay of payments and enforcement actions; provision of new financing; and information flows from debtor to creditors. The guidelines will lay out the minimum criteria under which loan terms can be changed (if necessary), including the conditions to be applied to debtors when loans are restructured. The process is expected to accelerate once suitable guidelines are in place and changes in the corporate insolvency regime have been passed.
- The Ministry of Justice has issued a report containing the key recommendations for corporate insolvency regime reform and the corresponding proposals for amendments will be submitted to Parliament in November 2009. The review focuses on the following areas: (i) incorporating a liquidity test for initiation of insolvency

- proceedings; (ii) expediting court approval of restructuring plans concluded between viable firms and a requisite majority of creditors; (iii) including secured creditors in agreed restructuring plans, (iv) facilitating new financing during a firm's rehabilitation by clarifying the priority ranking of such financing; (v) introducing the subordination of related-party claims in insolvency proceedings, where warranted; (vi) strengthening procedures for the efficient liquidation of non-viable firms; and (vii) addressing coordination between Icelandic and foreign courts on cross-border insolvencies.
- A law has been passed by parliament in July 2009 enabling us to establish an AMC. The AMC would ensure that the pace of bank-led restructuring for the targeted group of large firms is sufficient. The AMC would be designed to manage assets without necessarily owning them and allow us to leverage expertise and promote synergies (in the latter case through proxies to restructure firms that are common customers of the banks). The AMC would focus on debt and operational restructuring of large viable firms. It would be placed under professional management, which would be tasked to maximize asset recovery.

## **Fiscal Policy**

- 18. Our fiscal strategy remains to consolidate towards a sustainable fiscal position, and to cushion the public in the near-term from the sharpest impacts of the crisis. Fiscal consolidation is necessary to achieve a sustainable debt position, contain our financing requirements, and provide support for gradual and sequenced monetary and capital controls relaxation. But it should be done at an appropriate pace that avoids exacerbating the crisis, and allows us to preserve the key elements of a Nordic welfare state model.
- 19. In line with our overall fiscal strategy, we have allowed a sharp increase in the deficit in 2009, but we will now begin to take measures to limit this increase. The 2009 budget fully accommodated the estimated automatic effects of the crisis on revenues and expenditures, but these effects have since grown significantly. With the severe financial turbulence now behind us, and having had time to develop and build consensus around fiscal measures, we will begin to tighten fiscal policy. Overall we are implementing an adjustment of krona 30 billion (2 percent of GDP). On the expenditure side measures include savings in operational spending, cut-backs in capital investment and maintenance, and further means testing of social benefits. Overall, the General Government deficit in 2009 (including accrued interest payments) would be limited to 14.4 percent of GDP, which would be consistent with a Central Government net financial balance (including accrued interest payments) of krona 200 billion. We hope to surpass this target by saving all revenue over performance.
- 20. We have set out a plan for medium-term fiscal consolidation. The plan has been approved by cabinet (a prior action for the review). It has been discussed with social

partners in the context of the June 2009 stability pact and also presented to parliament for discussion. It has several dimensions:

- It establishes a clear objective for fiscal policy. It commits to implement measures that will improve the *general government* primary balance by 5½ percent of GDP in 2010 (including the full year impact of measures taken in 2009); by 4½ percent of GDP in 2011; and by 3½ percent of GDP in 2012 (from an initial level of about 8½ percent of GDP in 2009). The overall deficit of the general government would thus be expected to fall from 14.4 percent of GDP in 2009 to 10.9 percent of GDP in 2010 (including accrued interest), and by 2013 there would be a surplus.
- In order to achieve these targets, we will adjust the net financial balance of the central government. As indicated in the stability pact between government and social partners, central and local governments will cooperate closely in implementing fiscal restraint and on developments in the overall government fiscal balance. We will also better align local authorities' budgets with central government fiscal policy (via stronger balanced budget requirements and firmer borrowing limits).
- It establishes policies towards the needed adjustment, discusses the yield from key measures, and the motivation for the potential policy mix. The measures consist of a mix of revenue adjustments and expenditure cuts:
  - Revenue measures aim to raise the central government primary revenue ratio to at least 32 percent of GDP by 2013, and to achieve a fair distribution of the increased tax burden. They include a revision of the individual and corporate income tax systems, higher consumption taxes, measures to adequately finance unemployment benefits, environmental taxes, and a repeal of certain tax expenditures.
  - Expenditure measures aim to reduce the central government primary spending ratio to about 25 percent of GDP by 2013. They focus on further cuts in operational spending; tighter means testing for social benefits; and significant scaling back of investment spending, which had escalated in recent years. Socially important sectors are to be protected, along with labor intensive investment and maintenance.
- 21. In the context of our budget preparations for fiscal year 2010, we have begun to implement the consolidation plan. In order to meet our target to improve the general government primary balance by  $5\frac{1}{2}$  percent of GDP, we anticipate that we will need to raise the primary revenue ratio of the general government by  $3\frac{1}{4}$  percent of GDP, and reduce general government primary spending by  $2\frac{1}{2}$  percent of GDP, compared with the projected 2009 outturns (central government accrual-based primary spending would then amount to krona 456 billion). New revenue measures include reforming the personal income

tax system including by harmonizing it with the taxation of investment income, as well as some further increase in excise and environmental taxes, and further changes to the VAT system. New expenditure measures include reductions in the wage bill, cuts in current expenditures, improving the targeting of social benefits, and further scaling back of investment and maintenance expenditures.

- 22. We are developing a strategy to ensure smooth financing of high near-term deficits, and to contain risks from contingent liabilities. This public debt strategy will be aimed at lengthening the maturity profile of krona debt, smoothing the profile of external debt repayments, preserving adequate levels of government deposits, and limiting risks from contingent liabilities. This plan will be fine-tuned with technical assistance on debt and cash management, including by the IMF. We propose that approval of the plan by the Ministry of Finance be a **structural benchmark** for end-December 2009.
- 23. **Measures have been elaborated to improve the fiscal framework and public financial management** (meeting an end-June **structural benchmark**). The aim is to support fiscal consolidation efforts by limiting within-year expenditure drift (a negative characteristic of recent budget implementation). As articulated in our fiscal consolidation plan, the new policies include a multi-year binding nominal expenditure ceiling (with a limited number of volatile non-discretionary categories outside the ceiling and an escape clause for inflation deviations that would exhaust budget flexibility); a 1–2 percent contingency fund to cope with deviations and unforeseen outlays; restrictions on the scope of the supplementary budget; restrictions on borrowing from future appropriations; elimination of a large amount of accumulated carry-forwards, and limits on recurrent spending carry-forwards.

# **External Financing**

# 24. Almost all of the previously committed bilateral official financing has now been agreed:

- Agreements have been finalized and fully ratified with the Nordic countries and with Poland involving a total of \$2\frac{3}{4}\$ billion in financial assistance. Financing from the Faroe Islands has also been finalized and disbursed.
- Agreements have been finalized with the UK and the Netherlands, at the executive level, to cover deposit insurance in the foreign branches of Landsbanki. We expect the agreements, which should help facilitate access to already committed bilateral financing, to soon be fully ratified. The agreements anticipate that the deposit insurance will be mostly covered by assets recovered from the failed bank, with any residual amount to be covered by a loan guaranteed by the Government of Iceland.

Together with IMF financing, these various loans will help us maintain an adequate level of reserves. While they will add substantially to Iceland's high external debt burden, the terms

are consistent with our near- and medium-term debt servicing capacity. Progress in covering our financing need will continue to be assessed during quarterly program reviews.

# Safeguards

25. We have strengthened external audit provisions for the CBI. The Central Bank safeguards assessment, completed by the IMF, found good controls in accounting and reporting, but suggested modifications to our external audit arrangements. In line with its recommendations the Auditor-General has appointed an international audit firm to conduct on the Auditor-General's behalf the annual external audits of the Central Bank, in accordance with international accounting standards on auditing.

Table 1. Iceland Quantitative Performance Criteria Under the 2008–09 Economic Program.

	Perforr Crite			Indicative	e Targets		Prior A	Action	Performar	nce Criteria
	Dec 08 Program 1/	Dec 08 Actual	Mar 09 Ceiling/Floor 2/	Mar 09 Actual	Jun 09 Ceiling/Floor 3/	Jun 09 Actual	Sep 15 Ceiling 4/5/	Sep 15 Actual	Oct 09 Ceiling/Floor 5/	Dec 09 Ceiling/Floor 5/
					(In billions	of Króna)				
1. Floor on the change in the central government net financial balance 6/	-12	-117	-55	1.7	-55	-51			-175	-200
2. Ceiling on the change in net domestic assets of the Central Bank of Iceland 7/									20	20
3. Ceiling on the change in net credit of the Central Bank of Iceland to the private sector	25	2.1	50	28.9	50	-27.5				
4. Ceiling on the change in the domestic claims of the Central Bank of Iceland to the central government ( <i>indicative target for end-October and end-December</i> )	25	7.8	25	-31.1	25	41.4			70	70
					(In millions of	U.S. dollar	s)			
5. Floor on the change in net international reserves of the Central Bank of Iceland 7/ 8/	-500	-543	-500	-70	-500	-28.9	-96.6	-82.9		
6. Ceiling on the level of contracting or guaranteeing of new medium and long term external debt by central government 9/	4000	0	4075	54.5	4150	54.5			3500	3500
7. Ceiling on the stock of central government short-term external debt 9/	650	137.0	650	189.4	650	281.8			1400	1500
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 10/ 11/	0	0	0	0	0	0			0	0

<sup>1/</sup> From October 22, 2008 to December 31, 2008 (unless otherwise indicated).

<sup>2/</sup> From January 1, 2009 to March 31, 2009.

<sup>3/</sup> From April 1, 2009 to June 30, 2009.

 $<sup>4/\,\</sup>mbox{Prior}$  action for the first review. Defined as NIR, cumulative from January 1, 2009.

<sup>5/</sup> Cumulatively from January 1, 2009 (unless otherwise indicated).

<sup>6/</sup> Dec 08 target defined from Oct 1 2008 to Dec 31 2008. At end-Sep 08, the central government net financial balance was króna 4.28 billion, after contributions to the government employees pension fund. 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.

<sup>7/</sup> Excluding changes due to central bank recapitalization bond and adding back the effect of the transfer of collateral from the CBI to the government as described in the Technical Memorandum of Understanding.

<sup>8/ (-)</sup> indicates decrease. NIR is 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). Excludes new SDR allocation.

<sup>9/</sup> 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.

<sup>10/</sup> Applies on a continuous basis.

<sup>11/</sup> On October 20 the central government had no arrears to multilateral and official bilateral creditors

Table 2. Iceland Structural Conditionality Under the 2008–09 Economic Program

Structura	l Conditionality	Status
Prior actions for the First Review		
<ul> <li>Implementation of monetary policy towa targets.</li> </ul>	rds the currency stability objective, and in line with reserve	• Done
Approval by cabinet of a strategy to pha	se out capital controls.	• Done
<ul> <li>Approval by cabinet of a medium-term fi</li> </ul>	scal consolidation plan.	• Done
<ul> <li>Recapitalize New Kaupthing and Islands terms, to raise the capital adequacy ratio</li> </ul>	sbanki, using tradable government bonds issued on market o to at least 12 percent.	• Done
Structural Performance Criteria		
	nks, made using tradable government bonds issued on acy ratio to at least 10 percent. <i>By end-February 2009</i> .	Not observed (see prior action and new structural benchmark)
framework and supervisory practice, inc connected lending, large exposures, cro managers, and propose needed change	rovide an assessment (to be published) of the regulatory luding the framework of rules on liquidity management, ss-ownership, and the "fit and proper" status of owners and s. By end-March 2009.	• Done
Structural Benchmarks		
Develop a strategy for asset recoveries.	By end-November 2008.	Done.
<ul> <li>Prepare plans to embark on medium-ter</li> </ul>	m fiscal consolidation. By end-2008.	Implemented with delay (see prior action)
FME to review the business plans of each	ch of the new banks. <i>By January 15, 2009.</i>	Done.
<ul> <li>International Auditing Firm to conduct va accordance with international best pract</li> </ul>	aluations of the old and new banks using a methodology in ice. Complete by end-January 2009.	Done.     Implemented with delay in mid-July.
Improve the medium term fiscal framework	ork. By end-June 2009.	implemented with delay in find daily.
New Structural Benchmarks		
	using tradable government bonds issued on market terms, east 12 percent. [By end-November, 2009]	
<ul> <li>Completion of the program of savings be requirements. [By end-November, 2009]</li> </ul>	ank recapitalization, meeting FME and Ministry of Finance	
<ul> <li>Approval of legislation to address deficients practice. [By end-December 2009]</li> </ul>	encies in bank regulatory framework and supervisory	
Approval by cabinet of a medium-term p	ublic debt management plan [By end-December 2009].	

# ATTACHMENT III. TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU) October 20, 2009

- 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.

# **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 employees 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 or government-backed bonds obtained during the central bank

recapitalization process, and as a result of failed securities lending) 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 the value of the difference between outstanding loans and recovered assets. It will be valued at the exchange rate on the day of the assumption of the guarantee and recovered assets will be valued at the exchange rate on the day the sales of assets occurs.
- **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. Net domestic financing will exclude the retro-active accrued interest on the bank capitalization bonds from October 8<sup>th</sup>, 2008 to October 8<sup>th</sup>, 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 and the general government at the CBI will 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 -\$425 million as of October 21, 2008 (at the program exchange rate).
- 8. **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

- 9. **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 is defined as the sum of capital contributions, revaluation accounts and retained earnings. Performance against the NDA target will be measured at program exchange rates.
- 10. **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)

- 11. **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.

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

12. **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 some time 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.
- 13. **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

- 14. **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.
- 15. 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.

Table 3. Program Exchange Rates

Icelandic króna per U.S. dollar 113.9

Icelandic króna per euro 150.5

Icelandic króna per pound 193.6

# INTERNATIONAL MONETARY FUND

# **ICELAND**

# First Review Under the Stand-By Arrangement and Requests for Extension of the Arrangement, Waivers of Nonobservance of Performance Criteria, and Rephasing of Access

Prepared by the European Department in Consultation with Other Departments

Approved by Poul M. Thomsen and Tessa van der Willigen

October 20, 2009

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## **ICELAND: FUND RELATIONS**

(As of September 30, 2009)

I. **Membership Status**: Joined: December 27, 1945; Article VIII

II.	General Resources Account: Quota Fund holdings of currency Reserve position in Fund Holdings Exchange Rate	SDR Million 117.60 658.97 18.63	Percent Quota 100.00 560.35 15.84
III.	SDR Department: Net cumulative allocation Holdings	<b>SDR Million</b> 112.18 97.22	Percent Allocation 100.00 86.66
IV.	Outstanding Purchases and Loans: Stand-By Arrangements	SDR Million 560.00	Percent Quota 476.19
V.	Latest financial Arrangements:		

Type	Date of	Expiration	Amount Approved	Amount Drawn
	Arrangement	Date	(SDR million)	(SDR million)
Stand-By	Nov 19, 2008	Nov 18, 2010	1,400.00	560.00

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

	Forthcoming				
	2009	2010	2011	2012	2013
Principal				280.00	280.00
Charges/Interest	2.70	12.42	12.42	9.38	2.61
Total	2.70	12.42	12.42	289.38	282.61

# VII. Implementation of HIPC Initiative: Not applicable

VIII. Exchange Rate Arrangements: Icelandic krona is floating effective October 2008. Iceland has accepted Article VIII, Sections 2(a), 3, and 4 obligations, but maintains exchange restrictions subject to Fund approval arising from limitations imposed on the conversion and transfer of: (i) interest on bonds (whose transfer the FX rules apportion depending on the period of the holding); and (ii) the indexed portion of amortized principal on bonds. In addition, Iceland has in place measures that constitute exchange restrictions imposed for security reasons related to financial transactions based on UN Security Council Resolutions. Exchange restrictions arising from the rationing of foreign exchange

in respect of certain imports were in place at the time of approval of the Stand-By arrangement, but they were lifted in November 2008.

- IX. Safeguards Assessment: A first-time safeguards assessment of the CBI has been conducted in connection with the current Stand-By Arrangement. The 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. Recommendations were made to strengthen the external audit process, improve the independence of the internal audit function, establish procedures and controls for the data reporting to the Fund, and review and further develop the CBI's foreign reserves management operations. The authorities have already taken steps to implement these 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.
- X. **Last Article IV Consultation:** Discussion 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. Article IV consultations with Iceland are currently held on the 12–month cycle.
- XI. **Discussions for the First Review of the Stand-By Arrangements.** Discussions were held during February 27-March 13, May 19–28, and July 14–17, 2009. The mission met with the Prime Minister, Ms. Sigurdardóttir; the Minister of Finance, Mr. Sigfússon; the Governor of the Central Bank of Iceland, Mr. Øygard; the Minister of Business Affairs, Mr. Magnússon; 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 Mr. Flanagan (head), Ms. Chivakul and Messrs. Maliszewski and Lam (all EUR); Ms. Everaert (FAD); Ms. Christopherson (LEG); Mr. Cortavarria (MCM); and Ms. Stuart and Mr. Dohlman (SPR). The missions overlapped with technical assistance missions by MCM and LEG. The missions were assisted by Mr. Rozwadowski (resident representative). Messrs. Henriksson and Olafsson (OED) attended many meetings.

# XII. 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

# XIII. Resident Representative:

Mr. Franek Rozwadowski assumed the position in March 2009.

# Statement by the Staff Representative on Iceland Executive Board Meeting October 28, 2009

This statement provides information that has become available since the issuance of the staff report. The new information does not alter the thrust of the staff appraisal.

The process of re-establishing the three main banks continues, although hurdles remain to a final Landsbanki deal. Creditor representatives for Glitnir have exercised their option to acquire 95 percent of the shares in Islandsbanki (the successor bank). Meanwhile the Resolution Committee for Old Landsbanki has agreed to the outline of a deal regarding compensation for assets transferred to New Landsbanki. The full compensation package would include a bond, a 20 percent equity stake in the bank, and a contingent bond (with upside capped to limit total compensation). The agreed base compensation is significantly above the estimate on which the bank's business plan was based, and is accordingly under review by the bank's auditors and the FME. While the tentative deal could yet fall through—including due to the results of the auditors' and FME's examination—finalization remains targeted by mid-November. The Islandsbanki acquisition would reduce government debt by 3 percent of GDP relative to program projections; the Landsbanki deal would reduce debt by 1 percent of GDP (with the impact of partial creditor ownership largely offset by the extra capital required to support the larger-than-projected balance sheet).

Parliament has passed legislation establishing a framework for debt restructuring, to be underpinned by agreements among financial institutions on procedures. The framework introduces new generalized and specialized assistance for households. Generalized assistance includes maturity extensions and payment smoothing, to be available to all (on an opt out basis for krona loans, and an opt in basis for fx loans). Specialized assistance includes rules for writing down debts to 110 percent of assets for the most distressed but viable borrowers. The Housing Financing Fund has also been authorized to participate in private sector workouts, and to acquire loan portfolios from commercial banks and to restructure them on flexible terms. For corporations, the law also lays out general considerations that creditors should take into account in voluntary corporate debt restructurings, including equal treatment once rules are set. The framework aims to accelerate restructuring and support private sector demand. Financial institutions have estimated that the potential costs are manageable and can be financed within existing provisions for credit losses. Ongoing review of the implementation of the framework, in particular to ensure that further private sector losses do not migrate to the public sector balance sheet, will be needed under the program.

In accordance with program commitments, the government has now completed a review of the insolvency regime. The authorities have identified a number of revisions to the insolvency regime, including simplification of the process for approval of debtor-creditor agreements, and establishment of a reasonable moratorium on secured debt in the context of

debtor-creditor agreements. However, further review will be necessary to strengthen incentives for out-of-court debt restructurings and accelerating liquidation of non-viable firms (such as the timeliness of court approval of voluntary debtor-creditor agreements), the priority ranking of new financing, and the strengthening of procedures for the efficient exit of nonviable corporations. Work and discussions are continuing with a view to submitting legislation to parliament by end-November.

Press Release No. 09/375 FOR IMMEDIATE RELEASE October 28, 2009 International Monetary Fund Washington, D.C. 20431 USA

# IMF Completes First Review Under Stand-By Arrangement with Iceland, Extends Arrangement, and Approves US\$167.5 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Iceland's economic performance under a program supported by a Stand-By Arrangement (SBA). At the request of Iceland's authorities, the Board also extended the SBA by six months to May 31, 2011 to compensate for delays in program implementation and review, and approved the rephasing of the undisbursed amount over the remainder of the arrangement. The completion of the first review enables the immediate disbursement of SDR 105 million (about US\$167.5 million), bringing total disbursements under the program to SDR 665 million (about US\$1,061.1 million).

In completing the review, the Board approved waivers for the nonobservance of performance criteria related to the central government net financial balance and net international reserves. It also approved waivers for the nonobservance of the structural performance criterion concerning a capital injection into three new banks, and of the continuous performance criterion concerning the imposing or intensification on restrictions on the making of payments and transfers for current international transactions.

The SBA was approved on November 19, 2008 (see <u>Press Release No. 08/296</u>) for SDR 1.4 billion (about US\$2.2 billion). The arrangement entails exceptional access to IMF resources, amounting to 1,190 percent of Iceland's quota.

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

"Iceland's First Review Under the Stand-By Arrangement was completed after being delayed due to several factors, including the change in government, the time required to reach agreement on a policy program with the new authorities, and ongoing negotiations with creditors, which complicated securing from some participating countries the financing needed for the program.

"Iceland's financial crisis has taken a very heavy toll on the economy, even if the decline in output has been less than expected. But there are positive signs now: inflation has come down sharply; the program's main objective, stabilizing the krona, has been met, as have been the financial sector restructuring and fiscal consolidation objectives; and external financing has been secured. With determined and timely policy implementation, the economy could begin to turn the corner in the middle of 2010 and a recovery should follow in the medium term.

"Iceland has emerged from the crisis with high external and public sector debt, higher than understood at the program outset. However, the stronger policies envisioned in the revised program, including more rapid fiscal adjustment, more gradual capital control liberalization, and an enhanced focus on private sector debt restructuring, should suffice to keep debt on a robust and sustainable downward path.

"The focus of monetary policy continues to be on preserving currency stability, within a flexible exchange rate regime, in light of the balance sheet exposures of the private sector. Against this backdrop, progress with financial sector restructuring and fiscal consolidation should improve confidence and open up room for cautious interest rate reductions. Capital controls remain an essential feature of the monetary policy framework, given the scale of potential capital outflows, and in line with the authorities' published plan, should be removed gradually as confidence returns and as balance of payments developments permit.

"The authorities' strengthened medium-term fiscal consolidation plan will help improve debt dynamics and limit financing risks. It will be important to identify remaining measures needed to achieve medium-term targets, in consultation with social partners. In light of Iceland's higher public debt, a full medium-term public debt management strategy needs to be articulated in time for the next fiscal year.

"Resuscitating the financial sector has proven to be a complex challenge, but important milestones have been reached with the recapitalization of New Kaupthing and Islandsbanki. It is important now to conclude the Landsbanki discussions and to finalize the program of savings bank recapitalization. Creditors must be treated fairly and equitably, in line with applicable law, but it also remains imperative for the government not to further absorb losses from the private sector.

"Facilitating voluntary private sector debt restructuring is a key complement to financial sector restructuring efforts and will play an important role in reviving the economy. In light of binding fiscal constraints, the focus should be on targeted voluntary private work-outs, underpinned by measures to strengthen the insolvency regime," Mr. Portugal stated.

# Statement by Jens Olof Henriksson, Executive Director for Iceland and Bjorn Olafsson, Senior Advisor to Executive Director October 28, 2009

The twelve months that have passed since the financial sector collapsed have been eventful and trying for the Icelandic nation. The Icelandic economy appears to be slowly getting back on an even keel as the adjustment process takes hold. My authorities greatly appreciate the efforts and hard work of Fund staff over the course of the past year. They are particularly grateful for the Technical Assistance provided by the Fund. Technical Assistance is one of the important roles of the Fund but is sometimes undervalued. My authorities are also grateful to the countries that have committed bilateral loans in support of the program.

## **Background**

It is difficult to fathom the enormity of the shockwave that struck the Icelandic nation in the last months of 2008. Iceland was seemingly a solid economy, with a high level of education, a strong resource base, fully funded pension scheme and very limited public debt. The economy was deeply integrated into the global economy and participated in the single market of the EU as a member of the European Economic Area.

Iceland's global financial integration was, however, carried to extremes, as was manifested in the outsized financial sector, which had expanded to more than 10 times Iceland's GDP within the space of a few years. At that time, financial integration was a driving force in the global economy. On the surface, Icelandic financial institutions appeared sound, with robust capital ratios and strong ratings; however, their size compared to the economy, leverage and rapidity of the banks' growth had raised concerns. These concerns proved to be justified, and the extreme panic in international markets in September and October 2008, following the collapse of Lehman, proved the banks' undoing.

The downfall of the banks brought on a collapse of the currency and undermined the fiscal position, as the state became saddled with contingent liabilities from the outsized financial sector. At the same time, household and corporate balance sheets were severely affected. Such a shock to a developed economy is probably unprecedented since the establishment of the Bretton Woods institutions.

The financial crisis has had profound effects on all sectors of the economy and the general public. The ensuing uncertainty and confusion created a swell of dissatisfaction among the general public. The authorities responded by repositioning senior civil servants, ousting the governors of the central bank and reforming the governing structure of the bank as well as replacing the board and senior management of the Financial Supervisory Authority. Ultimately the unrest brought the government down. The senior management of the failed banks were dismissed immediately. A number of questions about the causes and consequences of the events that came to a head in October 2008 have yet to be answered. The authorities are determined to get to the heart of the matter and to this end have opened an official inquiry which is due to submit its findings in early 2010.

As is evident from the above, it was not necessarily the size of government, but the magnitude of the problems that initially led to a delay in the review of the program. Most recently, the review has unfortunately been held up pending the resolution of the deposit insurance liability dispute with the UK and the Netherlands. From its inception, the

program has enjoyed strong ownership by the authorities, with widespread support from the general public and all stakeholders. This was reflected in the April parliamentary elections, in which the program was widely considered to be an implicit part of policy. The delay has been most unfortunate and has undermined support for the program among the Icelandic public. Nonetheless, my authorities remain fully committed to the program, as is demonstrated by their policy action.

## Fiscal policy

Fiscal policy is a key pillar of the program. The objective is to achieve a sustainable fiscal position in the coming years. So far in 2009, the position of public finances has deteriorated more than envisaged in the original economic plan of November 2008. While the fiscal policy outcome in 2009 is evolving broadly in line with the envisaged path, the general government deficit is estimated at around 14.4 percent of GDP, according to the staff report, or 0.9 percent of GDP more than in the original report.

While GDP growth is seen to be contracting slightly less in 2009 than expected in the original program, revenues have generally been lower than budgeted while costs have been higher. This reflects higher unemployment than assumed in the budget, which was based on a pre-crisis forecast. The outlook for 2010 has been scaled down with recovery expected to emerge in the second half of the year.

The debt situation has deteriorated slightly more than initially expected. Of greater importance to the budgetary situation, however, is the decision to impute the cost of the interest on the loans from the British and Dutch authorities to compensate depositors in the respective branches of Landsbanki, from 1 January 2009. The increase in debt service is expected to amount to over 2.5 percent of GDP annually. The authorities responded to the situation by going further than the program envisaged and intend to increase the scope of adjustment relative to the original plan, in effect shifting the fiscal surplus targets forward in time by one year in order to stabilize and then reduce the fiscal debt as planned.

In May 2009 and again in June, additional measures to raise revenues and cut costs have been adopted, amounting to around 2.3 percent of GDP in 2009. The increased restriction in 2010 is expected to amount to 1.5 percent of GDP. In cooperation with Fund staff, the authorities have identified several areas of the budgetary framework for reform, at both central and local government levels, in order to ensure that targets for spending cuts are realized. The government has also consulted closely with the social partners over the difficult process of fiscal adjustment in order to build a consensus for the program. The consolidation challenge, which is now well underway, should be seen in the context of Iceland's demonstrated fiscal prudence.

It has proved helpful that the position of public finances at the outset of the crisis was strong after years of fiscal surpluses and payback of government debt. The government has also been able to finance the burgeoning deficit in 2009 on the domestic bond market. As a result, the Treasury still has sizable deposits at the Central Bank of Iceland, estimated at around 13 percent of GDP at end-2009.

The debt dynamics in the aftermath of the financial crisis has represented a challenge. A debt management strategy for the Republic is being constructed in cooperation with the IMF. A technical assistance team has already presented its preliminary findings, and a

follow up mission is currently in Reykjavík. A coherent debt management framework will be in place before the end of the year.

The balance of risks for public finances going forward may now be considered to be tilted to the upside, with the conclusion of several difficult program items at hand, including the restoration of the banking system, the Icesave loan agreement, and the IMF program back on track.

## Monetary policy

The collapse of the Icelandic króna has had devastating effects on highly leveraged private sector balance sheets, as a significant share of private sector debt includes unhedged foreign currency exposures. Hence, exchange rate stability has been the main pillar of the program and the central focus of monetary policy. This has been done, however, within a flexible exchange rate framework in the presence of temporary capital controls.

To that end, interest rates have been kept relatively high and temporary controls on capital movements were introduced to support the currency and prevent potential disorderly capital outflows immediately after the crisis. Emerging slack in the real economy, rising unemployment, declining housing prices and dwindling inflation pressures have reduced the risk of second round effects of price increases stemming from previous depreciation of the króna. The capital controls also give some room for manoeuvre. Hence, the Monetary Policy Committee (MPC) has been able to gradually ease monetary restraint, without jeopardizing exchange rate stability. At the same time, the MPC has taken care to provide sufficiently attractive risk-adjusted returns on krónadenominated assets. For that purpose, and given the fact that ample liquidity in the money market had caused short-term rates in the Banking system to drift below the CBI deposit rate, the MPC decided at its September meeting to issue 28 day CDs to absorb liquidity. This has led to some tightening of the monetary stance.

While some exchange rate depreciation was observed during the process, the MPC has been of the view that the pressure on the króna has mainly been determined by temporary factors, such as interest rate payment outflows to non residents, terms of trade deterioration, and other seasonal trade factors. Rates have remained on hold since May, and the MPC has stated that it stands ready to adjust policy as appropriate should the situation deteriorate. However, in recent months pressure on the króna has been significantly reduced. Consequently the króna has remained broadly stable in effective terms since July with diminishing intervention from the Central Bank.

Monetary policy actions must be coordinated with the eventual removal of the capital controls over the medium term. The aim is to lift the controls as quickly as possible. However, the removals will be sequenced carefully so as not to undermine the króna. Consequently, several key preconditions have been set out, with the first step planned in early November. The Central Bank recently fortified the activities of its Capital Controls Surveillance Unit (CCSU). The aim of the changes was to tighten the administration of the capital controls currently in effect. The CCSU will operate as an independent unit within the Bank, reporting directly to the Governor.

### Private sector debt restructuring

Private sector debt restructuring is a demanding but vital task that will affect the degree of success in underpinning economic recovery, a viable banking system, and social cohesion without jeopardising fiscal sustainability. The restoration of macroeconomic stability and the reconstruction of the banking system have been delayed although both are prerequisites for successful private sector debt restructuring. However, conditions are developing for private sector debt restructuring to begin in earnest. Clearly, circumstances are challenging in light of the indebtedness of the private sector and the large proportion of private sector debt denominated in foreign currency. Furthermore, the public sector is not in a position to take on an increased burden. Nevertheless, the government plays an important role in initiating debt restructuring measures in a situation where banks and private entities face significant co-ordination problems, and the courts are as yet not well prepared for the system-wide scope of bankruptcy.

The government has announced its debt restructuring plans, and financial institutions appear content to participate in them. The measures regarding the household sector are based on a mixture of general and specialized assistance, in addition to changes in official debt mitigation procedures. The general measures involve placing a ceiling on payment smoothing so that the duration of a loan in payment smoothing may be extended by no more than three years. Payment smoothing is intended for mortgages and motor vehicle loans, with the aim of basing payments on the debt service burden as of January 1, 2008, for inflation-linked loans and May 2, 2008, for foreign-denominated loans. Loan payments will develop in line with a so-called modified mortgage payment index. Households for which these general measures do not suffice will be offered special debt mitigation measures in co-operation between borrowers and financial institutions. The specialized debt mitigation measures entail assessing the borrower's long-term capacity to pay and adjusting the debt to that capacity; for example, by deferring a portion of the debt, writing off debt, and possible takeover or sale of pledged assets. Corporate sector debt restructuring is based first and foremost on a creditor-led voluntary restructuring.

#### External debt

The official statistics on Iceland's foreign assets and liabilities compiled by the Central Bank of Iceland still include the assets and liabilities of the old banks that are now in moratorium. Excluding the effect of the old banks, the total foreign liabilities amounted to 225 percent of GDP by the end of June 2009. At the same time, foreign assets amounted to 184 percent and the international investment position was -41 percent of GDP. These figures do not include debt taken on because of the Icesave deposit accounts, nor do they include some additional planned borrowing to expand the foreign exchange reserves. The gross Icesave debt amounts to 50 percent of GDP. Against this liability are Landsbanki assets, most of which are in the UK. The present value of the net debt is estimated at about 15 percent of GDP. Adding this debt and the assets gives a gross debt figure of 306 percent of GDP in 2009 and an international investment position of -56 percent of GDP. This IIP position will deteriorate a bit this year because of the effect of the current account deficit.

According to central bank forecasts the real exchange rate will remain historically low for the next years. This will contribute to a large surplus on the external trade balance. While the income account will be negative, the current account is expected to be below zero this year and close to balance after that. Going forward, current account surpluses, sales of foreign assets (of Landsbanki), repayments of loans taken on to increase the foreign

exchange reserves, will gradually lower the gross debt burden from 300 percent of GDP in 2009-2010 to around 200 percent in 2014.

## Financial sector policies

The Icelandic banking sector was international in scope, but initially the authorities tackled the crisis mostly with their own limited foreign exchange and fiscal resources, with the exception of the Nordic swap arrangements. The IMF program was agreed soon after. Given the magnitude of the impact, it is not surprising that it has taken some time for the government to bring the situation under control. As is mentioned in the staff report, the financial sector has been cut down to size and is now focused on serving the local economy.

My authorities have highlighted three main objectives on the road to financial sector reconstruction. Given the fallout on the fiscal position, it is important not to absorb further creditor losses than the program envisages. At the same time, however, relations between banks and international creditors must be fostered, *inter alia* through equitable and transparent treatment of creditors. It is also evident that the restructuring process needs to be completed so that the authorities can focus on other pressing issues.

My authorities are pleased that compensation packages for all three of the failed major banks have been negotiated in an acceptable manner. The new banks are being recapitalized, and the process of operational restructuring is well underway. Glitnir has on behalf of creditors, acquired 95 percent of Íslandsbanki's share capital. The resolution committee of Kaupthing Bank has until the end of this week to choose between negotiated options. An agreement has been reached on the outline terms for the compensation payable to Landsbanki in return for the transfer of net assets. The deadlines for filing claims are as follows: Landsbanki, October 30; Glitnir, November 29; and Kaupthing, December 30.

In order to address issues concerning the dynamics of the balance sheets of the new banks, the Financial Supervisory Authority will require the banks to hold at tier 1 and tier 2 capital ratios well above the statutory minimum. New agencies; a bank holding agency and an asset management company are being established to administer the government stake in the banks and support corporate restructuring. The issue of capital adequacy in the remaining smaller financial institutions will be addressed in coming weeks.

My authorities are determined to address any deficiencies identified in the financial system by learning from recent events and looking to the future. A special investigative committee is looking into the causes and effects of the crisis and will deliver its report in February 2010. A special prosecutor's office was established to investigate and prosecute all matters concerning past management of financial institutions. The first cases of this nature are intended to be filed before the District Court before the end of the year. Looking forward, it will be necessary to consider the foundations of the remaining financial system, as well as improving regulatory and supervisory practices. Among important matters are improving the deposit insurance system, creating a national credit registry, implementing prudential regulations on large exposures, and addressing the issue of connected lending. The relationship between the Financial Supervisory Authority and the Central Bank will also need to be solidified.