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ICELAND

SECOND POST-PROGRAM MONITORING DISCUSSIONS

November 2012

In the context of the Second Post-Program Monitoring Discussions with Iceland, the following documents have been released and are included in this package:

- **Staff Report** for the Second Post-Program Monitoring Discussions, prepared by a staff team of the IMF, following discussions that ended on September 28, 2012, 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 24, 2012. 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.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its November 12, 2012 discussion of the staff report that concluded the Second Post-Program Monitoring Discussiosn.
- **Statement by the Executive Director** for Iceland.

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

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ICELAND

SECOND POST-PROGRAM MONITORING DISCUSSIONS

October 24, 2012

KEY ISSUES

Context: Iceland's recovery is taking root and is expected to continue, but downside risks prevail. While the external position is sound, it is vulnerable to the lifting of capital controls before conditions are right. Public debt is on a downward trajectory, and fiscal consolidation is broadly on track, although implementation risks are high. Financial conditions have improved, but inflation remains elevated, and banks are burdened by legacy vulnerabilities.

Capital controls: Appropriately sequenced and paced capital account liberalization will help maintain a strong external position. One precondition for liberalization is reducing the overhang of liquid offshore krona. This process needs to be accelerated by improving incentives for offshore krona holders to exit via the channels in the authorities' capital account liberalization strategy.

Fiscal policy: Adhering to the authorities' medium-term fiscal consolidation path is key to maintaining market confidence. This will require taking some additional measures and preparing contingency plans to address implementation risks.

Monetary policy: Bringing inflation down to the central banks' target will require further policy tightening, underpinned by more effective bank liquidity management.

Financial sector policy: Safeguarding financial stability calls for addressing the remaining liquidity, foreign currency, and provisioning risks through heightened financial supervision.

Approved By
Ajai Chopra and James Roaf

Ms. Zakharova (Head), Mr. Chailloux, Mr. Gregory, and Ms. Bordon (all EUR), Mr. Belhocine (FAD), and Ms. Bi (SPR) visited Reykjavik during September 18–28. The mission met with senior government, central bank and financial supervision officials, members of parliament, representatives from the trade unions and business community, and academics. Mr. Rozwadowski, Ms. Karlsdóttir, and Mr. Hjalmarsson (resident representative's office), and Ms. Boranova and Ms. Ilagan (EUR) assisted the mission. Ms. Alfredsdottir (OED) participated in some of the policy discussions.

CONTENTS

ANNEXES

RECENT DEVELOPMENTS AND OUTLOOK

Iceland's recovery is taking root amid declining unemployment but high inflation. The outlook is upbeat, although downside risks prevail.

A. A demand-driven recovery

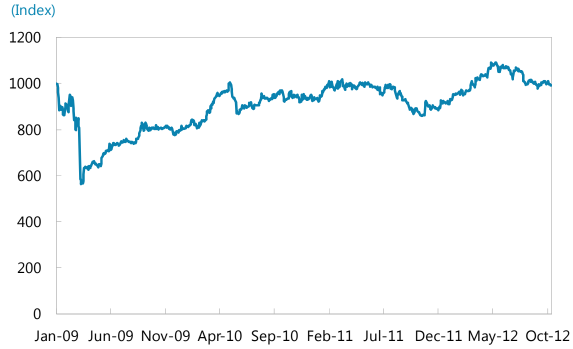
1. Growth has strengthened on the back of robust domestic demand. Following a deep recession, the economy expanded by 2.6 percent in 2011 and 2.4 percent (year on year) in the first half of 2012. The output gap, which averaged around 3 percent in the last three years, is essentially closed. Private consumption increased by 4 percent in the first half of the year, bolstered by rising consumer confidence, continuing early pension withdrawals, and declining household debt. Investment also rose, supported by capacity expansion in the aluminum sector. Strong imports dampened the contribution of net exports to growth (Figure 1).

2. Unemployment has declined. The seasonally adjusted unemployment rate declined to 6 percent in September from a peak of 9.2 percent in September 2010. Net emigration was below ½ percent of the population in 2011, down from 1½ percent in 2009. However, long-term unemployment—one fifth of total unemployment—remains an issue.

3. Inflation has been slow to come down and inflation expectations remain high. Inflation eased from 6.4 percent in March to 4.3 percent in September—helped by an appreciating krona and declining petroleum prices—but remained well above the Central Bank of Iceland's (CBI) target of 2½ percent. Survey-based measures of households' one-year-ahead inflation expectations remain high at 5.6 percent in the third quarter and breakeven inflation (5-year ahead) was at 4.7 percent in August (Figure 2). The increase in the wage index was more than 9 percent (year-on-year) at end-2011 and wages have risen another 3.7 percent since the beginning of 2012, putting further pressure on prices.

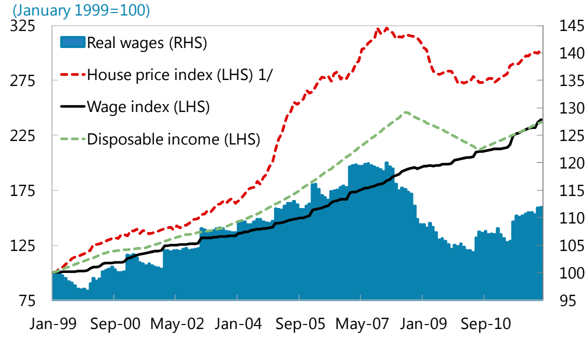
4. Financial sector conditions have continued to improve. Despite negligible credit growth, banks are well-capitalized, liquid, and profitable. Two of the three large banks have issued covered bonds, diversifying and lengthening the maturity of funding. The stock market index climbed by 11 percent in the year up to September 2012 on the back of positive quarterly corporate earnings. Real estate prices are rising in line with disposable income.

Stock Market Index, 2 January 2009 - 11 October 2012
(Index)



Sources: Nasdaq OMX Iceland Exchange.

Greater Reykjavík house prices, wage index, and disposable income per capita, January 1999–March 2012
(January 1999=100)



1/Greater Reykjavík house price index.
Sources: Registers Iceland; Statistics Iceland.

5. Progress in household and corporate debt restructuring continues. At end-August 2012, household debt amounted to around 109 percent of GDP, down from a peak of 132 percent of GDP in 2009. At end-June 2012, corporate debt amounted to 183 percent of GDP, down from a peak of 360 percent of GDP at end-March 2008. Banks expect to finalize the bulk of corporate debt restructuring by end-2012, though full completion will not occur until end-2013. Case-by-case household debt restructuring continues steadily at the banks, but progress is slow elsewhere under the legal framework of the Debtors' Ombudsman, in part reflecting the complexity of the process.[1]

6. The underlying external position remains sound. A surge in imports weakened the trade balance in the first half of the year, but exports were solid, buttressed by another banner year for tourism. However, the developments in the current account were offset by strong capital inflows, including foreign direct investment in energy-intensive sectors. As a result, gross international reserves remained at a comfortable level, above 100 percent of short-term debt.

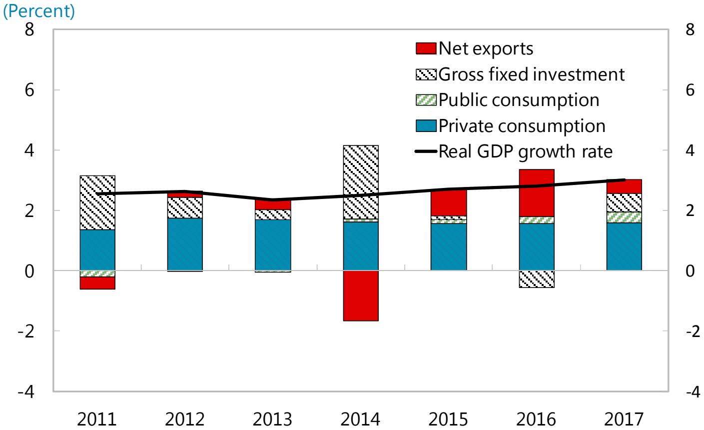
7. External debt dynamics have improved. In May and October 2012, Landsbanki's partial payment to priority creditors (with total payment in 2011–12 amounting to 50 percent of priority claims) reduced external debt by 14 percent of GDP. Also in May, Iceland confirmed its renewed access to capital markets by successfully placing a one billion USD-denominated 10-year bond at a fixed rate of 6 percent. The proceeds, together with some $580 million in reserves, were used to prepay Iceland's nearer-term obligations to the IMF and Nordic partners. As a result, outstanding credit to the Fund was reduced to SDR 582 million (495 percent of quota). While the recourse to market borrowing to prepay official loans has increased interest costs, it also lengthened the maturity of public debt and established a benchmark for private external debt issuance.

B. Outlook and risks

8. Staff and the authorities shared the view that the prospect is for continued expansion, declining inflation, and a strengthening external position. The staff's baseline remains broadly the same as that presented at the time of the April 2012 Article IV consultation, with the main exception being that it is now assumed that capital controls will remain in place through 2015 because of the limited progress made so far in reducing the stock of offshore krona.[2]

Contributions to Growth, 2011–17

(Percent)



Sources: Statistics Iceland; and IMF staff estimates.

[1] Box 3.2 of the April 2012 World Economic Outlook presents further details on household debt restructuring.

[2] The baseline scenario assumes that the current legislative authorization for capital controls, which expires at end-2013, will be extended.

- Growth, which turned positive in 2011, is expected to remain steady at 2.6 percent in 2012, as delays in investment in the energy-intensive sector are offset by better-than-expected export performance. Subsequently, growth will moderate until 2015, when exports from energy-intensive investments come on line, supporting a faster economic expansion.

- Inflation has declined slower than anticipated this year, contributing to a real exchange rate appreciation, and is expected to converge more gradually to the CBI target of 2½ percent by mid-2015, assuming continued monetary tightening.

- Public and external debt ratios, though still high, are projected to continue declining, even under stress scenarios, although the public debt trajectory is sensitive to a growth shock (Annex I).

- The capital account is expected to be dominated by the lifting of capital controls: to avoid undue pressure on the balance of payments and the exchange rate, the authorities' strategy envisages a phased lifting of controls, with the speed of liberalization calibrated by the strength of the balance of payments outlook, reserve adequacy, and the need to safeguard financial stability. Staff's baseline scenario assumes that offshore krona holdings are largely released by end-2015 and that some easing of capital controls starts from 2016. Onshore krona holders then rebalance their portfolios toward foreign assets gradually enough not to destabilize the balance of payments. Starting in 2016, large foreign currency payments by the old banks' estates to foreign creditors are assumed to flow out gradually and be partially offset by government borrowing, helping to keep reserves at comfortable levels. Temporary inflationary pressures that may arise from the exchange rate volatility during the lifting of controls are expected to be contained by an appropriate monetary policy response.

9. There was broad agreement that risks to this outlook are tilted to the downside:

- **Euro area crisis.** An intensification of the crisis and an associated economic downturn would reduce exports and foreign direct investment, with negative effects on growth and employment. Heightened risk aversion abroad could undermine Iceland's newly achieved market access. The direct impact on banks would be mitigated by capital controls and banks' mainly local funding, but a growth slowdown would likely increase nonperforming loans (NPLs).

- **Capital account liberalization.** In the unlikely event that capital controls are lifted prematurely—before significantly reducing the liquid overhang of offshore krona—disorderly capital outflows could ensue and the krona could come under pressure. This would fuel inflation and—with most loans indexed to the CPI—increase private sector debt, with adverse implications for growth and lenders' balance sheets. Figure 3 illustrates the potential impact of a premature lifting of controls on the balance of payments. Disorderly exit of the large stock of liquid offshore krona, combined with resident capital flight, would put significant pressure on reserves. Market access could be less than under the baseline. And payouts by the old banks from their liquid domestic assets could come sooner than in the baseline. These risks could be mutually reinforcing (by undermining confidence), giving rise to substantial financing needs in the coming years. The authorities viewed the possibility of a premature lifting of capital controls as a distant tail risk.

- **Fiscal consolidation.** A significant setback in fiscal consolidation could undermine investor confidence and market access. While fiscal slippages during 2011-12 were partly reversed in the draft 2013 budget, that budget may run into political headwinds against the backdrop of looming parliamentary elections in April 2013.

- **Inflation.** Persistent high inflation could further fuel inflation expectations and trigger wage-price spirals detrimental to growth.

- **Delays in investment in the energy intensive sector.** Protracted and widespread delays in investments, owing to technical, financing, and political constraints, would reduce growth and could impact confidence in the economy.

MANAGING RISKS TO PROMOTE EXTERNAL STABILITY AND GROWTH

10. Discussions focused on policies promoting external viability and sustainable growth. Well sequenced and paced capital account liberalization is needed to remove capital market distortions without disrupting the external position in the near term. Continued fiscal consolidation, in line with the authorities' medium-term objectives, should keep public debt on a sustainable path and help sustain market access, which is critical to the lifting of capital controls. Further monetary tightening—underpinned by more effective liquidity management—is called for to bring down inflation and prepare for the liberalization of the capital account. And intrusive financial supervision should reduce financial sector vulnerabilities and help safeguard financial stability as capital controls are lifted.

A. Orderly capital account liberalization

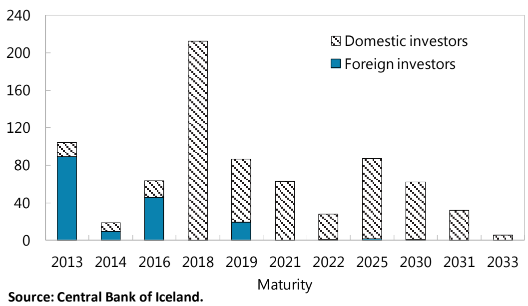
Progress in reducing the still-high stock of liquid offshore krona—an important precondition for lifting capital controls—has been slow. Incentives now need to be strengthened for offshore krona holders to participate in the central bank's liberalization strategy.

Background

11. The authorities' capital account liberalization strategy consists of two phases. In phase one, liquid offshore kronas are to be released via auctions, conversions of short-term krona-denominated assets into long-term Eurobonds, and an exit levy. In phase two, restrictions on capital account transactions are to be lifted gradually. Preconditions for phase two include a sufficient reduction in the stock of offshore krona, sound public finances, access to international financial markets, and a strong financial sector. Legislative authority for the controls expires at end-2013.

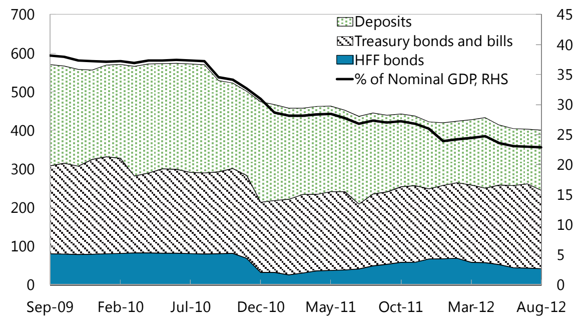
12. Since the liberalization strategy was introduced, there has been limited progress in reducing the stock of liquid offshore kronas. Only the auction channel has been opened so far and after more than a year it has released only a modest amount of locked in kronas–about 4.5 percent of GDP. The modest progress likely reflects the reluctance of domestic investors to offload already underweighted non-krona assets, limited inward foreign investment, and weakened incentives to participate in the auctions as the legislative deadline for lifting capital controls approaches (Annex II). Moreover, the progress was partly offset by coupon payments on offshore kronas and krona released from the estates of old banks, with the result that offshore krona holdings remain high at 23 percent of GDP.

Holdings of Government Securities by Residency and Maturity as of August 2012 1/
(Billions of krona)



Source: Central Bank of Iceland.
1/ Includes bonds and bills as well as securities lending from the issuer to the primary dealers.

Holdings of Offshore Krona
(Billions of krona)



Sources: Central Bank of Iceland; and IMF staff calculations.

Policy Discussion

13. Staff discussed how to accelerate the reduction of the stock of liquid offshore kronas. Staff encouraged the authorities to review experience with the auctions channel with a view to introducing measures to encourage greater participation—including by clarifying that the conditions under which liquid offshore kronas are allowed to exit will become less favorable over time.

14. In this context, staff also advocated removing the reference in legislation to a terminal date for the controls. This would help strengthen offshore krona holders' incentive to participate in auctions or Eurobond conversions since that incentive would weaken as the deadline approached. It will also reduce the probability of a deadline-driven liberalization before the preconditions for an orderly process were in place and provide time to prepare for the second phase of the strategy.

15. Once incentives are in place, staff recommended opening the next channels envisaged in the strategy—bond swaps and an exit tax. The objective of the swaps (of short-term krona-denominated assets into long-term euro-denominated bonds) would be to reduce the stock of offshore krona significantly before introducing an exit tax and ultimately lifting the controls. Since participation in the exit tax channel would immediately impact the balance of payments, the exit tax would need to be designed to ensure maximum participation in the auctions and the bond swaps channels.

16. The bond swaps need to be designed carefully in the context of a broader review of capital controls. The design should take account of their impact on the balance of payments and the exchange rate. For example, the maturity of the euro bonds needs to be sufficiently long to distribute the pressure on the balance of payments over a number of years. The design should also address sovereign debt management issues arising from replacing short-term krona debt with long-term foreign-currency debt. More broadly, foreign exchange controls should be revised as necessary to prevent circumvention via bond swaps.

17. The authorities were aware of the risks of premature liberalization, and indicated they would take staff's recommendations under consideration. There was broad consensus that a premature liberalization could lead to severe disruption and given current conditions it would be difficult to liberalize safely before the end-2013 deadline in the current legislation. It was seen as unlikely that any post-election government would maintain the end-2013 deadline if that would put Iceland's exchange rate or financial stability at risk. The authorities shared staff's view that strengthening incentives for holders of liquid offshore krona to participate in the liberalization strategy would be important for accelerating progress.

B. Staying on the path of fiscal consolidation

Fiscal adjustment is broadly on track. The 2013 budget offsets more than half of the past fiscal slippages, but faces political headwinds, raising implementation risks. These risks would need to be addressed through adequate contingency planning.

Background

18. Fiscal consolidation is broadly on track. The authorities are maintaining the targets set in their medium-term plan: a balanced overall position in 2014 and a primary surplus of 5 percent of GDP in 2016. While the proposed 2012 supplementary budget has an overall deficit about ½ percentage points of GDP higher than under the plan—reflecting higher interest costs and pension-related spending—the draft 2013 budget offsets more than half of the slippage, bringing the 2014 target within reach. In the proposed 2013 budget, revenue increases—from higher VAT on hotel, social insurance contributions, asset sales, and the fish levy (Box 1)—and expenditure cuts will more than offset new social spending and government investment.

19. However, implementation risks are high. Key measures—increasing social insurance contributions and VAT on hotels—will likely face difficulties in parliament in the run up to the elections, while preparations for asset sales have been slow. In addition, the HFF's recapitalization needs may turn out higher than expected. Finally, pressures to increase spending will likely mount ahead of the elections.

20. Plans are underway to strengthen the fiscal framework. The draft organic budget law, which the government plans to introduce in Parliament in November, should improve procedures for budget preparation and execution, broaden the coverage of fiscal reporting, and increase government accountability to parliament.

Policy Discussion

21. Staff argued that additional measures are needed to address risks and reach the medium-term targets. Reaching the targets will safeguard debt sustainability and support continued market access—both critical to the successful lifting of capital controls—while also providing a buffer for automatic stabilizers to operate should external conditions deteriorate. For the 2013 budget, additional measures amounting to 0.2 percent of GDP would put the overall balance firmly on track for a balanced position in 2014. Any additional revenues should be used to ensure these targets are met, or to address potential weaknesses in the budget, rather than spent. Adequate contingency plans should also be prepared to mitigate implementation risks. For these purposes, consideration could be given to reducing agricultural subsidies, better targeting social transfers, and raising the lowest VAT rate (with offsetting subsidies to the most vulnerable groups). The new organic budget law will help underpin fiscal discipline in the medium term and its timely passage will ensure that relevant provisions come into effect with the post-election government.

22. The authorities affirmed their commitment to staying on track with fiscal consolidation. They considered that continued fiscal discipline is crucial for maintaining market confidence and for putting public finances firmly on a sustainable footing. They shared staff's concerns about the risks to the 2013 budget, but hoped that higher-than-budgeted revenues, including from extra dividend receipts (see also paragraph 32), could mitigate these risks. Nevertheless, they acknowledged that there will be pressures to use such revenues for additional spending.

Box 1. The New Fisheries Laws

The legal framework for the Icelandic fisheries sector is undergoing a major reform. A first bill, on fisheries' resource fees, was adopted in June and a second, on the framework of utilization rights in the sector, will be further debated in Parliament in the fall.

The act on resource fees aims to enhance the taxation of the fisheries' sector. Through it, the government intends to collect some of the resource rent associated with Iceland's fishing stocks. The annual government revenue take is estimated at about 0.8 percent of GDP. The government intends to use the revenue to support its fiscal consolidation plans and to reinvest a portion of the proceeds into programs aimed at fostering economic diversification and promoting investment and employment.

The pending bill on fisheries management rights aims to restructure the quota system. The existing system of Individual Transferable Quotas (ITQ) allows each fishing entity to own a share of the total allowable catch.[1] The initial distribution of ITQs, in the early 1990s, is widely perceived as unfair since they were allocated gratis, on the basis of fishing vessels' average catches during the preceding three years. In contrast with the existing legislation, which does not specify the term of ITQs, the new bill would define a 20 year term. It would also split the quotas into two groups, one operating as an ITQ system and the other providing utilization rights to the government which can be rented out for social and regional development objectives. Moreover, every time quota shares are transferred, 3 percent of the transferred shares will revert to the government.

[1] For further details see Haraldsson, G. and D. Carey (2011) "Ensuring a Sustainable and Efficient Fishery in Iceland", *OECD Economics Department Working Papers*, No. 891, OECD Publishing.

C. Tightening monetary policy to bring down inflation

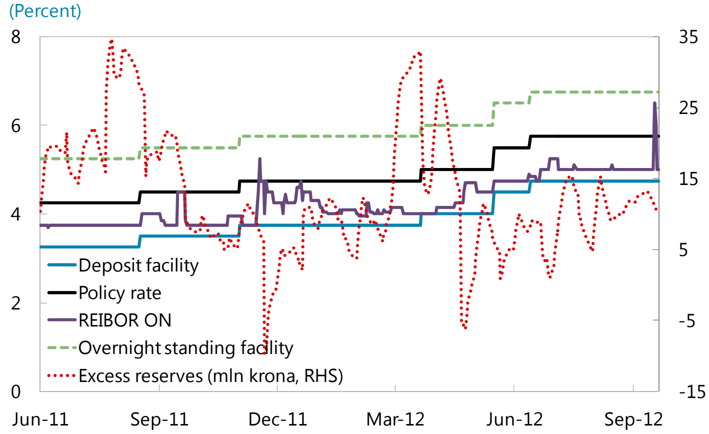
Continued high inflation expectations and a rapidly closing output gap indicate the need for further monetary tightening to bring inflation down to the central bank's target and to normalize monetary policy in preparation for the lifting of capital controls.

Background

23. The central bank accelerated the pace of monetary tightening in early 2012, but has since paused. After falling behind the curve in 2011, the Central Bank of Iceland (CBI) hiked policy rates three times by a cumulative 100 basis points in 2012, to 5.75 percent, bringing real official rates into positive territory (Figure 4). At the same time, the Monetary Policy Committee (MPC) signaled a shift toward a more hawkish stance, emphasizing the need to curtail monetary accommodation against the backdrop of high inflation and a narrowing output gap. However, more recently the tightening cycle was put on hold, with the MPC citing an improved inflation outlook and uncertain near-term exchange rate prospects.

24. The monetary transmission mechanism remains weak. Monetary transmission has been weak since the crisis with banks holding large excess reserves. The CBI has increased issuance of its certificates of deposit (CDs), but interbank market interest rates still hover at the bottom of the policy interest rate corridor.

Excess Reserves and the Interbank Rate
(Percent)

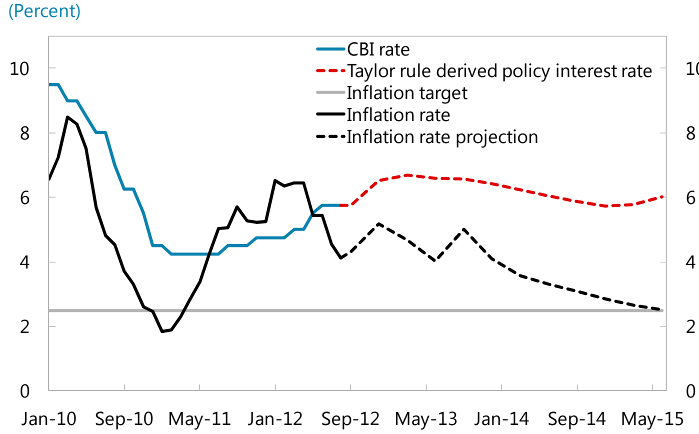


Source: Central Bank of Iceland.

Policy Discussion

25. Staff argued that further monetary tightening will be needed to bring inflation down to the CBI's target in the medium term. Model-based estimates suggest that the policy rate should increase by as much as 100 basis points over the coming months to bring inflation down to target by mid-2015. Achieving the inflation target would strengthen the credibility of the central bank, helping to anchor inflation expectations and forestall second round effects, in particular through wage increases. Continued tightening will be needed to normalize monetary policy in

Inflation and Monetary Policy
(Percent)



Sources: Central Bank of Iceland; and IMF staff calculations and projections.

preparation for when the capital account is liberalized, and to further enhance the CBI's policy credibility.

26. A more consistent management of liquidity would strengthen the effectiveness of monetary policy. The effectiveness of the interest rate channel can be increased by monitoring banks' excess reserves, adjusting the stock of CDs accordingly, and steering short-term money market rates toward the center of the policy interest rate corridor. Episodes of low excess reserves in the banking system suggest that banks are ready to manage liquidity more proactively through the interbank market.

27. While preferring to keep nominal rates on hold at the current juncture, the authorities emphasized that they have maintained a tightening bias. They agreed that there would be a need for monetary tightening to support future capital account liberalization. Despite a relatively weak transmission mechanism, liquidity management has become more active. CD issuance has become more proactive while other measures—such as changes to the remuneration of banks' excess reserves—are also being considered.

D. Reducing vulnerabilities in the financial sector

Bank's balance sheets have strengthened, but risks still need to be addressed. Although progress has been made, legacy vulnerabilities remain, including a reliance on deposits locked in by capital controls, large asset-liability mismatches, and loan and deposit concentration. Risk mitigation calls for maintaining large capital buffers determined through periodic supervisory reviews.

Background

28. Despite an unfavorable Supreme Court ruling in February 2012, banks' financial conditions have continued to improve. Estimated losses resulting from the Supreme Court ruling on the recalculation of illegal foreign exchange-indexed loans were booked in 2011. Nonetheless, the three largest banks' average Capital Adequacy Ratio remains high (22–24 percent at end-June 2012). Likewise, and despite negligible credit growth, their average return on equity also remains high (12–19 percent in the first half of 2012), supported by a comfortable margin between inflation-indexed assets and low-interest, non-indexed deposits. NPL ratios are well below the post-crisis high of 18 percent (on a facility default basis) but have stabilized at a still high 10 percent (42 percent and 19 percent, respectively, on a cross default basis) (Figure 5). Banks are meeting all statutory liquidity requirements and preparations are underway to phase-in the Basle III liquidity standards in 2013.

29. Nevertheless, significant risks remain. First, banks' reliance on captive deposits makes them vulnerable to the lifting of capital controls (liquidity risk). Second, deposit and credit concentration remain high. Third, while the banking system's net open foreign exchange position is positive, it will turn negative when Landsbanki's large unhedged foreign currency denominated contingent bond is issued next year. Fourth, the excess of inflation-indexed assets over non-indexed liabilities has increased, making banks more vulnerable to an unanticipated decline in inflation. There is also still uncertainty in the face of further Supreme Court rulings on foreign exchange-indexed loans. Finally, the HFF's financial position has been steadily deteriorating owing to a large negative carry on its balance sheet.

Policy Discussion

30. Staff emphasized that safeguarding financial sector stability requires addressing the remaining risks. The recent requirement for banks to submit contingency plans to deal with liquidity pressures, and the FME's commitment to follow up, is welcome. The foreign currency risk associated with the Landsbanki bonds underscores the need for banks to gain market access. Risks associated with growing indexation imbalances should be reflected in banks' capital requirements, creating a buffer and strengthening the incentive to contain the imbalances. Regarding restructured loans, conservative provisioning and income recognition policies, would ensure that capital gains arising from the restructuring, and hence also bank profitability, do not reflect overly optimistic expectations of loan performance.

31. Maintaining adequate equity buffers would enhance banks' ability to absorb unexpected losses. This is particularly important in light of the above-mentioned risks, heightened external risks, and the prospect of capital account liberalization. Given the uncertainty about restructured loan valuations and the potential deterioration of credit quality if the exchange rate depreciates, it is important to ensure that banks continue maintaining adequate capital buffers through strict periodic capital reviews. In this vein, now that bank commitments not to distribute dividends have expired, the authorities should use prudential measures to ensure banks remain sufficiently capitalized. These measures should be defined by the Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP), conducted under the Basel Pillar II exercise. An early assessment of the HFF's capital adequacy should also be undertaken through these processes. Finally, maintaining a strong, independent, and adequately resourced Financial Supervisory Authority (FME) is essential for effective financial sector oversight.

32. The authorities agreed that while the banking system was well capitalized and liquid, legacy risks still needed to be addressed. The FME is in the final stages of the 2012 ICAAP/SREP process. While the FME is not averse to dividend payments in principle—viewing them as a sign of financial soundness and of the progress that the banks have made—the SREPs have focused on ensuring that the banks continue to maintain adequate capital buffers. Having recently assumed responsibility for regulating the HFF, the FME intends to conduct an assessment of its capital adequacy through the ICAAP process.

POST-PROGRAM MONITORING

33. Iceland remains in a good position to repay the Fund. The baseline balance of payments outlook is similar to that at the time of the 2012 Article IV consultation. External debt is projected to stay on a downward trajectory. Reserves (net of old banks' deposits) are expected to remain above 100 percent of short-term debt over the medium term, despite the second pre-payment (in June) of Iceland's Nordic and Fund obligations. While the pre-payment lowered reserves and raised interest costs, it also lengthened the average duration of the public debt, reducing near-term rollover risk.

34. A number of risks remain, although some have diminished since the 2012 Article IV consultation.

- **Capital account liberalization**. The lifting of capital controls continues to pose substantial risks. A premature or disorderly lifting of controls or their unintended weakening, could give rise to large outflows, causing a disruptive depreciation of the krona or a sizeable loss of reserves. A higher-than-anticipated demand by residents for foreign assets as capital controls are lifted could also weaken the balance of payments.

- **Market access**. Government's capacity to borrow abroad to ease the balance of payments pressure as capital controls are lifted could be smaller than assumed under the baseline, particularly if the external environment deteriorates or if market confidence in Iceland falters.

- **Litigation risks.** Risks from the Icesave litigation are unchanged from the 2012 Article IV staff report. Expected asset recovery from the Landsbanki estate continues to exceed priority claims, including all Icesave deposits. However, if the relevant courts find the Icesave deposits to be a sovereign obligation and impose interest charges, the costs that would fall on the state could be large (Annex I).

35. Continued strong policy implementation would help mitigate these risks. Implementation of the policies identified during the Stand-By Arrangement and discussed above will be important for maintaining market confidence going forward. Particularly important are a conditions based and well sequenced capital account liberalization with appropriate incentives and safeguards. Building buffers through continued non-borrowed reserve accumulation and further Eurobond issuances, if conditions permit, would also be welcome.

STAFF APPRAISAL

36. The recovery is taking root and is expected to continue. The strong growth performance in 2011 looks set to be repeated in 2012 and sustained over the medium term. The output gap is closing, unemployment has declined, and inflation, though still high, should converge toward the Central Bank's target of 2½ percent in the medium term, if monetary tightening resumes. Public and external debt ratios are on a downward path and financial sector conditions are improving.

37. Risks to the outlook are tilted to the downside. Externally, an intensification of the euro area crisis could harm exports, growth, and market access. The main domestic risk would materialize if capital controls were lifted before the necessary conditions were in place. This would destabilize the krona, fueling inflation and increasing private sector debt, with spillovers to the banking sector.

38. Capital account liberalization should continue to be conditions based. These preconditions include a significant reduction of the "overhang" of liquid offshore krona, sound public finances, a strong balance of payments—including access to international financial markets—and healthy capital and liquidity buffers in the banks. Incentives to participate in the strategy need to be strengthened, however, as progress in reducing the stock of liquid offshore krona—a key precondition for liberalization—has been slow. Key steps will be to curtail expectations that capital controls will be lifted soon, including by removing a reference in legislation to a terminal date for the controls and to clarify that the conditions under which liquid offshore kronas are allowed to exit will become less favorable over time. Once incentives are in place, the authorities could open the next channels envisaged in their strategy—bond swaps and an exit tax. These channels should be designed with a view to managing their impact on the exchange rate, sovereign debt management, and bank liquidity.

39. Fiscal consolidation is broadly on track, but contingency planning is needed to address implementation risks. The draft 2013 budget offsets more than half of the past fiscal slippages, bringing the authorities' target of a balanced overall position in 2014 within reach. However, expenditure pressures remain high in the run-up to the elections, and key proposed revenue measures face political headwinds. Measures therefore need to be identified to address risks and achieve fiscal targets. Moreover, any additional revenues should be used to address potential weaknesses in the budget rather than spent.

40. The government's plans to strengthen the fiscal framework are welcome. The draft organic budget law will improve budget procedures, broaden the coverage of fiscal reporting, and increase government accountability to parliament. Early passage of the law would ensure that important provisions come into effect with the post-election government.

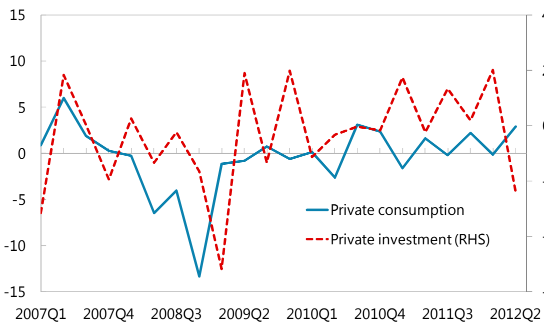
41. Further monetary tightening is needed. The recent decline in inflation has been driven by seasonal factors and, with the output gap closing, the policy stance is still accommodative. Continued tightening is needed to reach the central bank's inflation target and normalize monetary conditions in advance of capital account liberalization.

42. Banks' balance sheets have strengthened, but risks still need to be addressed. The three largest banks are profitable and well-capitalized but nonperforming loan ratios are still high, though well below their post-crisis peak. Although progress has been made, legacy risks remain, including a reliance on deposits locked in by capital controls, asset-liability mismatches, and loan and deposit concentration. There is also still uncertainty in the face of Supreme Court rulings on foreign exchange-indexed loans. To help manage these risks it will be important to maintain large equity buffers determined through periodic supervisory reviews. An early assessment of the HFF's capital adequacy should be undertaken through the ICAAP process. Maintaining a strong, independent, and adequately resourced Financial Supervisory Authority (FME) is also essential for effective financial sector oversight.

Figure 1. Iceland: Recent Developments in Demand and Labor

Domestic demand was a key driver of growth...

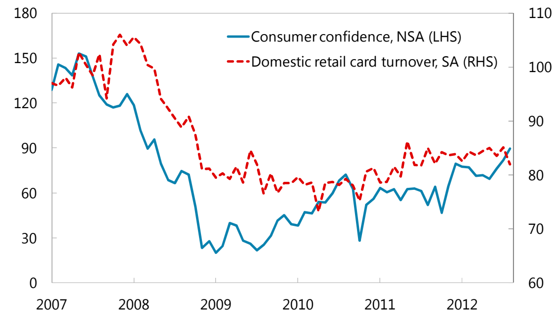
Consumption and Investment Growth
(Quarter-on-quarter percentage chage, SA, annualized)



Sources: Statistics Iceland; and IMF staff calculations.

...supported by improving consumer confidence.

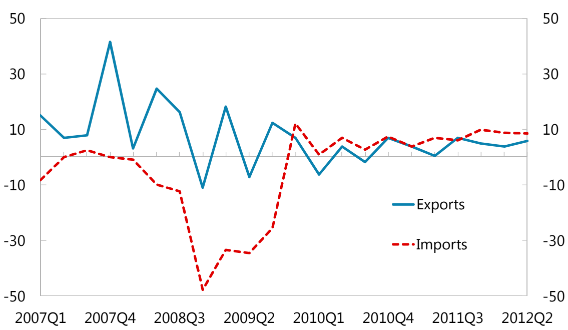
High Frequency Indicators
(Percent) (Index, 2007=100)



Source: Statistics Iceland.

Imports continue to grow rapidly...

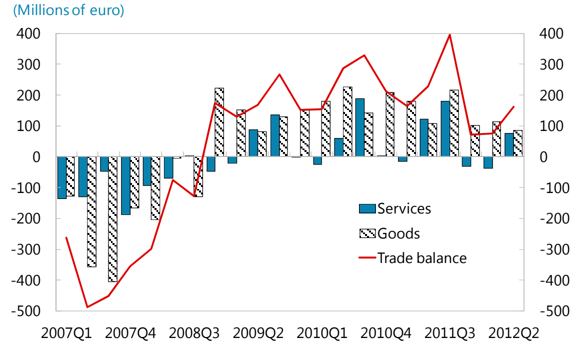
Export and Import Volume Growth
(Year-on -year percentage chage)



Sources: Statistics Iceland; and IMF staff calculations.

...denting the trade surplus.

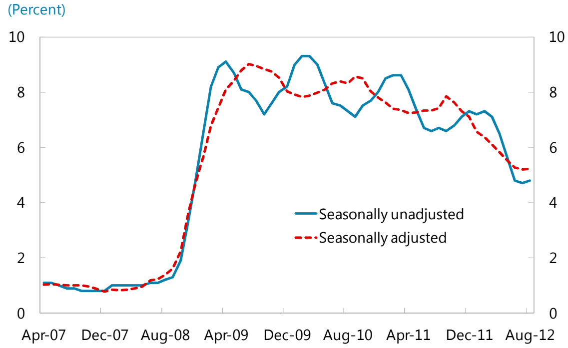
Trade Balance
(Millions of euro)



Sources: Statistics Iceland.

The unemployment rate is trending down...

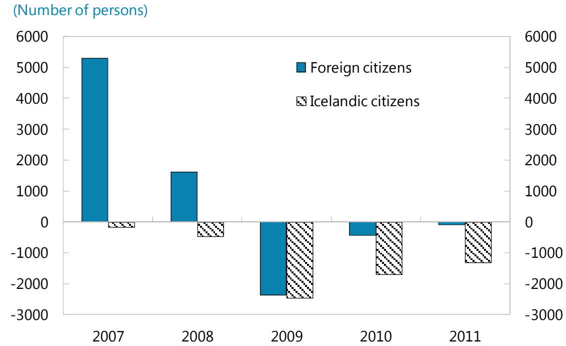
Unemployment Rate
(Percent)



Sources: Department of Labor; and Haver Analytics.

...and outward migration has slowed.

Net Migration
(Number of persons)

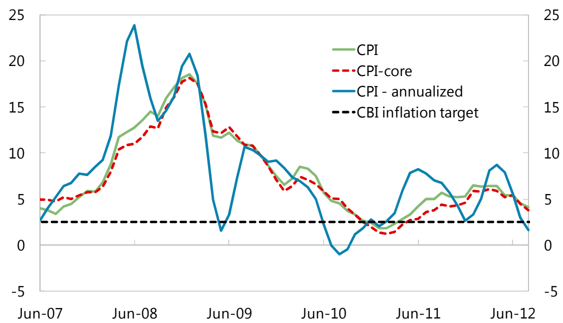


Source: Statistics Iceland.

Figure 2. Iceland: Price and Exchange Rate Developments

Inflation remains above the CBI's 2½ percent target...

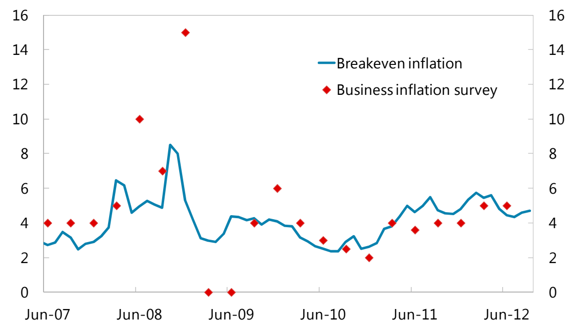
Inflation Rates
(Percent)



Sources: Central Bank of Iceland; and Statistics Iceland.

...and inflation expectations remain high.

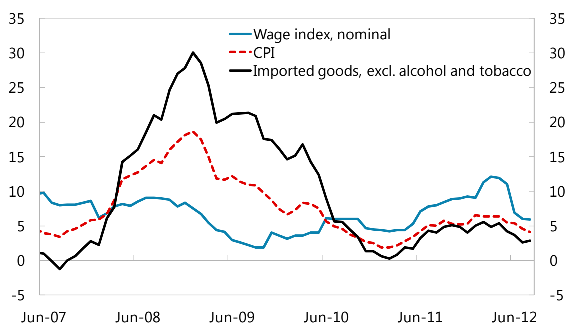
Inflation Expectations
(12-month percentage change)



Source: Central Bank of Iceland.

Declining wages and commodity prices helped ease inflation...

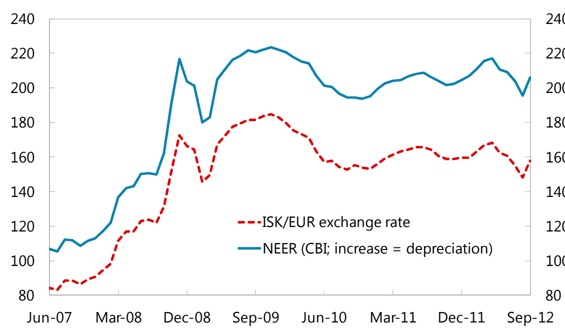
CPI, Wages and Import Prices
(Percent, 12-month growth)



Source: Statistics Iceland.

...supported by an appreciating exchange rate.

Effective Exchange Rates
(Indices, 2005=100)



Source: Central Bank of Iceland.

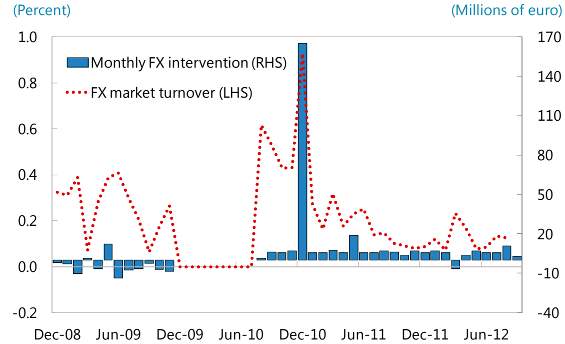
The real value of the krona has remained broadly stable.

Real Effective Exchange Rate
(Index, 2005=100)

Source: IMF's INS database.

CBI FX purchases have continued at a steady pace.

Foreign Exchange Transactions
(Percent) (Millions of euro)



Sources: Central Bank of Iceland; and IMF staff calculations.

Figure 3. Iceland: Reserve Adequacy Under the Premature Lifting of Capital Controls 1/2/

Disorderly exit of liquid offshore kronas with resident capital flight would give rise to sizeable financing needs...

...with lack of market access having a similar impact.

The financial needs will be even larger if, in addition to the above shocks, the old bank estates pay out liquid assets recovered.

Source: IMF staff calculations and projections.

1/ All shock scenarios assume that capital controls are lifted prematurely in 2013 and all outstanding offshore kronas (23 percent of GDP) flow out in 2014. Additional assumptions underpinning each shock scenarios are:

Resident flight: Resident capital outflows are 8 percent of the broad money during 2014–15 and double the size assumed in the baseline during 2016-18. This assumption is consistent with the cross-country observations in *Assessing Reserve Adequacy*.

Partial access: During 2013–17, 25 percent of projected baseline new external borrowing is not possible. This assumption is broadly in line with the usual rollover assumptions in tail risk scenarios (see *The Fund's Mandate—The Future Financing Role: Reform Proposals*).

Combined shock: In addition to all the above shocks, all liquid assets recovered by old bank estates are paid out in 2014.

2/ Negative reserves indicate financing need.

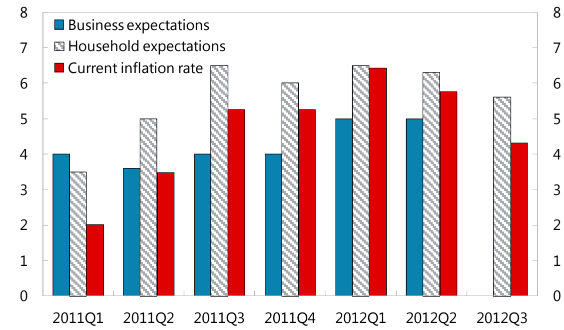
Figure 4. Iceland: Monetary Policy

Inflation expectations remain high.....

...suggesting the need for a tighter policy stance.

Business and Household Inflation Expectations

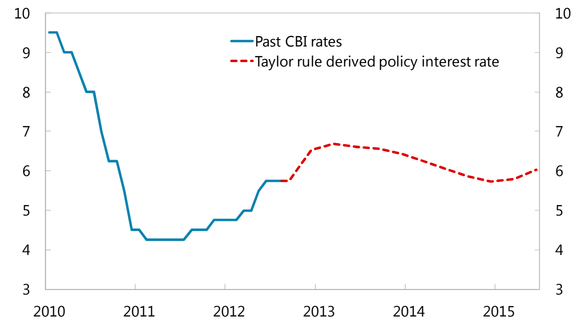
(Percent)



Source: Central Bank of Iceland.

Policy Interest Rate

(Percent)



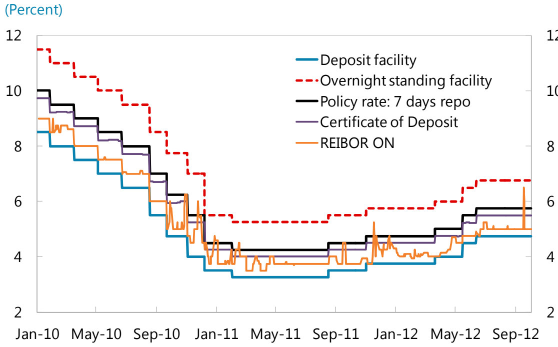
Sources: Central Bank of Iceland; and IMF staff calculations.

Monetary tightening is underway...

...and real policy rates are beginning to turn positive.

Policy and Interbank Rates

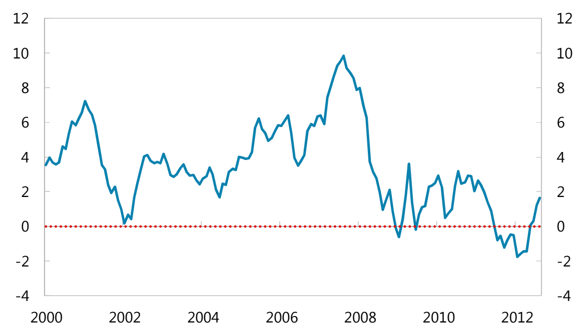
(Percent)



Source: Central Bank of Iceland.

Real CBI Policy Rate

(Percent)



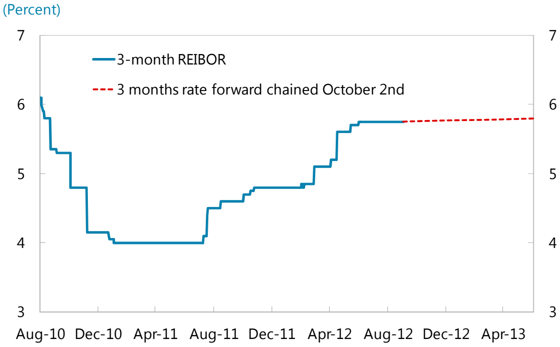
Sources: Central Bank of Iceland.

Yet forward rates are not pricing in further rate increases...

...and the risk-adjusted policy rate remains relatively low.

REIBOR and Forward Rates

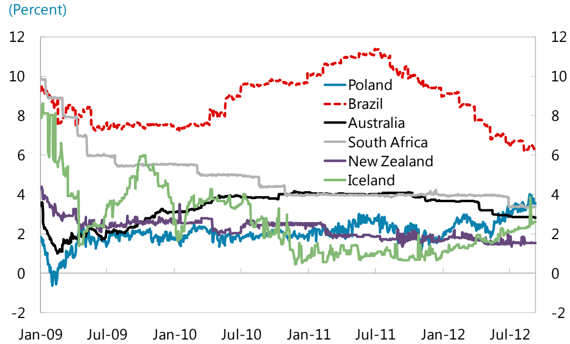
(Percent)



Sources: Cental bank of Iceland; and IMF staff calculations.

Risk-adjusted Market Rates

(Percent)



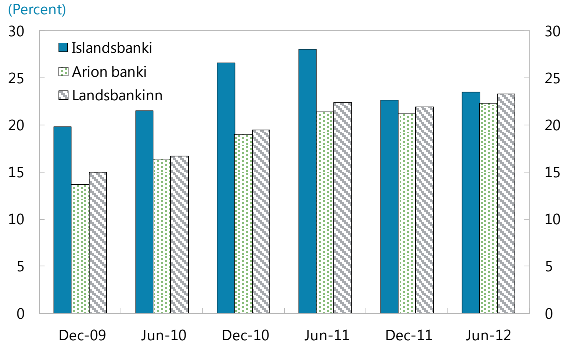
Sources: National Authorities; Thomson Reuters; and IMF staff calculations.

Figure 5. Iceland: Financial Sector Development

Capital buffers remain high...

Capital Adequacy Ratios of Commercial Banks

(Percent)

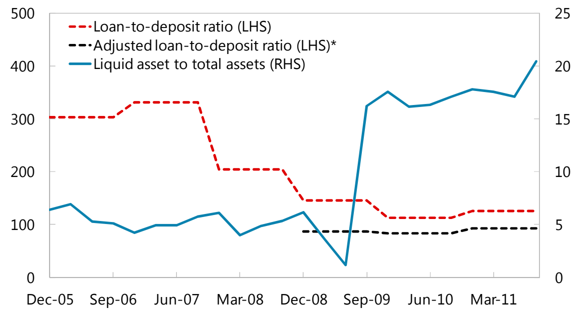


Sources: Central Bank of Iceland.

....while banks' leverage remains low and liquidity high...

Banks' Leverage and Liquidity

(Percent)



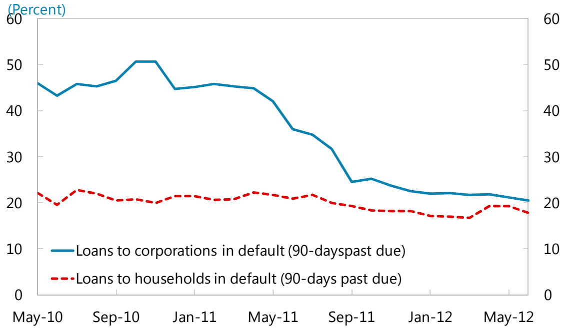
Sources: Central Bank of Iceland; and Financial Supervisory Authority.

* Including 'captive liabilities' under the capital control.

NPLs are gradually declining...

Loans to corporations and households in default 1/

(Percent)



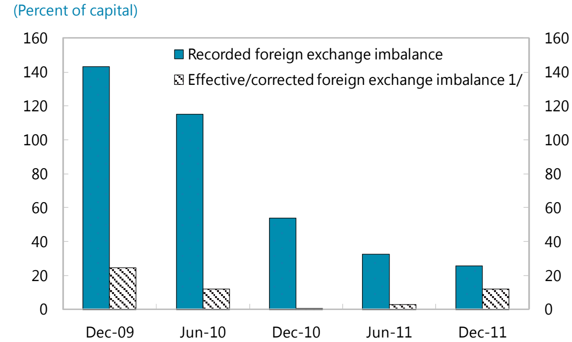
Sources: Central Bank of Iceland.

1/ If a single loan is overdue for more than 90 days the entire credit position of the borrower is considered nonperforming.

...and net open positions in fx remain positive.

Exchange Rate Imbalance

(Percent of capital)



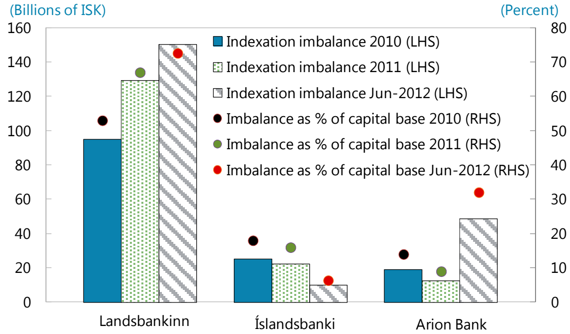
Source: Central Bank of Iceland.

1/ Excluding foreign exchange loans taken by borrowers with income in krona.

However, indexation imbalances are rising...

Indexation imbalances of the three largest commerical banks 1/

(Billions of ISK) (Percent)



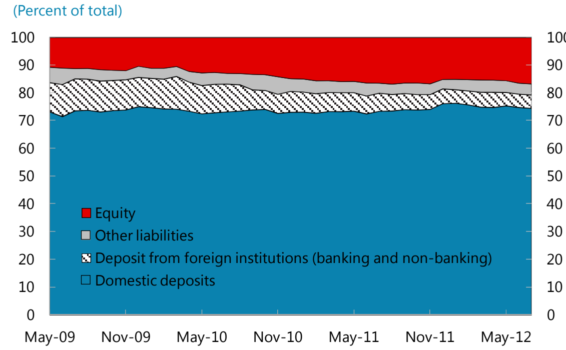
Source: Central Bank of Iceland.

1/ Indexation imbalance reflects the difference between CPI-indexed assets and liabilities.

...and banks continue to rely on deposits for funding.

Banks Funding

(Percent of total)



Source: Central Bank of Iceland.

Table 1. Iceland: Selected Economic Indicators, 2006–13

	2006	2007	2008	2009	2010	2011	2012 Proj.	2013 Proj.
	(Percentage change, unless otherwise indicated)							
National Accounts (constant prices)								
Gross domestic product	4.7	6.0	1.2	-6.6	-4.0	2.6	2.6	2.3
Total domestic demand	9.1	0.0	-8.6	-20.3	-2.2	3.0	3.2	2.4
Private consumption	3.6	5.7	-7.8	-15.0	0.0	2.7	3.4	3.3
Public consumption	4.0	4.1	4.6	-1.7	-3.4	-0.9	0.0	-0.2
Gross fixed investment	24.4	-12.2	-20.4	-51.4	-8.6	12.8	8.4	3.0
Export of goods and services	-4.6	17.7	7.0	7.0	0.6	4.1	4.9	4.0
Imports of goods and services	11.3	-1.5	-18.4	-24.0	4.5	6.8	5.9	4.3
Output gap 1/	2.0	3.7	2.3	-2.0	-4.8	-2.3	-0.4	0.4
Selected Indicators								
Nominal GDP (bln ISK)	1,168.6	1,308.5	1,480.3	1,497.6	1,536.5	1,626.3	1,731.4	1,855.1
Unemployment rate 2/	1.3	1.0	1.6	8.0	8.1	7.4	6.1	5.7
Consumer price index	6.8	5.0	12.4	12.0	5.4	4.0	5.4	4.5
Nominal wage index	9.1	9.3	4.3	2.0	2.6	6.1	7.5	5.9
Nominal effective exchange rate 3/	-11.8	2.5	-40.4	-34.2	2.9	-0.1	...	...
Real effective exchange rate 3/	-7.1	6.0	-20.7	-18.7	6.4	0.9	0.5	0.7
Terms of trade	3.4	0.2	-9.3	-6.7	6.0	-1.8	-1.8	1.7
Money and Credit								
Base Money	27.9	190.7	-31.5	1.3	-19.4	-20.7	14.1	...
Deposit money bank credit (end-period)	44.4	56.6	-28.3	-17.8	-3.5	0.9	0.0	...
of which to residents (end-period)	33.6	28.3	...	...	...	...	...	...
Broad money (end-period)	19.6	56.4	36.3	1.2	-9.9	7.1	-4.9	...
CBI policy rate (period average) 4/	14.1	13.8	15.4	13.7	7.8	4.4	...	...
	(Percent of GDP, unless otherwise indicated)							
Public Finance								
General government 5/								
Revenue	48.0	47.7	44.1	41.0	41.5	41.9	42.6	42.7
Expenditure	41.6	42.3	44.7	49.6	47.9	46.7	45.3	43.9
Balance	6.3	5.4	-0.5	-8.6	-6.4	-4.8	-2.7	-1.2
Primary balance	6.7	5.7	-0.5	-6.5	-2.7	-0.8	1.2	2.6
Balance of Payments								
Current account balance	-25.6	-15.7	-28.4	-11.6	-8.4	-6.3	-2.4	-0.3
Trade balance	-17.5	-10.1	-2.3	8.6	10.1	8.6	7.1	7.9
Financial and capital account	43.3	18.1	-66.9	-30.7	48.1	14.7	-1.3	-3.5
Net errors and omissions	-11.0	-1.0	-19.5	36.2	-31.2	-1.1	0.0	0.0
Gross external debt 6/	433.5	605.9	564.7	267.5	290.7	251.6	223.6	208.1
Central bank reserves (US$ billion)	2.3	2.6	3.6	3.5	5.6	8.7	6.2	5.7

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

1/ Staff estimates. Actual minus potential output, in percent of potential output.
2/ In percent of labor force.
3/ A positive (negative) sign indicates an appreciation (depreciation).
4/ Data prior to 2007 refers to annual rate of return. 2007 and on, refers to nominal interest rate.
5/ National accounts basis.
6/ Including face value of old banks debt before 2009. Related interest transactions are not included from Q4 2008 on.

Table 2. Iceland: Money and Banking

(Billion of Krona, unless otherwise indicated)

	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
Central Bank													
Net foreign assets 1/	-175	-189	-158	-163	-177	-116	-73	-42	90	-39	-37	-34	-27
Assets	496	499	571	496	715	766	831	917	1,052	982	856	848	851
Liabilities	671	688	729	659	892	882	904	959	962	1,022	893	882	878
Net domestic assets	291	301	245	235	271	192	145	113	-16	123	113	116	112
Net claims on the public sector	-52	8	-29	-38	28	17	21	75	47	31	33	17	98
Net claims excluding recap bond	-218	-172	-193	-207	-142	-156	-149	-97	-145	-163	-164	-178	-99
Recapitalization bond	165	181	165	169	171	173	170	172	192	194	197	195	197
Net claims on banks 2/	-25	-58	-60	-10	-19	-55	-104	-170	-244	-90	-94	-74	-153
Others Items, net	369	350	334	283	262	231	228	209	182	183	174	173	167
Base Money 3/	117	111	88	72	94	76	72	71	74	83	76	74	85
Currency issued	26	24	26	27	35	32	33	34	39	37	37	39	39
DMB deposits at the central bank	91	88	62	45	59	44	39	37	35	47	39	35	46
Banking System													
Net foreign assets	-24	-41	-2	102	77	108	117	145	205	219	156	247	170
Net domestic assets	1,607	1,597	1,493	1,371	1,338	1,310	1,291	1,402	1,308	1,259	1,317	1,359	1,267
Net claims on the central bank	120	147	135	62	76	96	122	176	121	134	131	109	199
Credit to private sector	1,849	1,897	1,866	1,817	1,785	1,762	1,735	1,715	1,801	1,808	1,817	1,785	1,801
Credit to government	210	213	216	219	222	225	228	230	233	236	239	235	245
Other items, net	-572	-660	-724	-727	-745	-773	-794	-719	-848	-920	-870	-770	-978
Domestic deposits	1,583	1,556	1,490	1,472	1,414	1,418	1,408	1,547	1,513	1,478	1,472	1,559	1,436
Local currency	1,464	1,435	1,372	1,387	1,327	1,333	1,335	1,445	1,438	1,387	1,385	1,516	1,350
Foreign currency	119	121	118	85	87	84	72	102	74	91	88	43	86
Consolidated Financial System													
Net foreign assets	-199	-230	-160	-61	-101	-8	43	103	295	180	119	213	143
Net domestic assets	1,808	1,810	1,676	1,561	1,550	1,458	1,397	1,478	1,257	1,335	1,391	1,440	1,333
Net claims on the public sector	158	221	187	181	250	242	249	305	280	267	272	252	343
Net credit to private sector	1,849	1,897	1,866	1,817	1,785	1,762	1,735	1,715	1,801	1,808	1,817	1,785	1,801
Other, net	-199	-309	-377	-437	-486	-546	-588	-541	-824	-741	-697	-597	-811
Broad Money (M3)	1,609	1,580	1,516	1,499	1,449	1,450	1,440	1,581	1,552	1,515	1,510	1,503	1,476
Memorandum items:													
Base money (y-o-y percentage change)	1.3	-16.3	-40.0	-55.2	-19.4	-31.9	-17.8	-1.0	-20.7	10.0	5.4	3.7	14.1
Broad money (y-o-y percentage change)	1.2	0.7	-8.5	-10.2	-9.9	-8.2	-5.0	5.5	7.1	4.5	4.8	-5.0	-4.9
Credit to private sector	-17.8	4.4	-5.3	-4.9	-3.5	-7.1	-7.0	-5.6	0.9	2.7	4.7	4.1	0.0
Money velocity (GDP/base money)	12.8	13.6	17.5	21.3	16.4	21.1	22.6	22.5	21.8	19.9	22.1	22.7	20.4
Broad money velocity (GDP/M3)	0.9	1.0	1.0	1.0	1.1	1.1	1.1	1.1	1.0	1.1	1.1	1.0	1.2
Multiplier (M3 / base money)	13.8	14.2	17.3	20.8	15.4	19.1	20.0	22.2	20.8	18.1	19.9	22.2	17.4

Sources: Central Bank of Iceland; and Fund staff estimates.

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

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

3/ Base money includes currency in circulation (ex cash in vault) and DMBs deposits at the central bank in krona.

Table 3. Iceland: Medium-Term Projections, 2009–17

	2009	2010	2011	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.
				(Percentage change)					
Real economy									
Real GDP	-6.6	-4.0	2.6	2.6	2.3	2.5	2.7	2.8	3.0
Real domestic demand	-20.3	-2.2	3.0	3.2	2.4	5.8	1.9	1.1	3.0
Private consumption	-15.0	0.0	2.7	3.4	3.3	3.1	3.0	3.0	3.0
Public consumption	-1.7	-3.4	-0.9	0.0	-0.2	0.5	0.5	1.0	1.8
Gross fixed investment	-51.4	-8.6	12.8	8.4	3.0	25.1	0.4	-5.3	4.9
Net exports 1/	11.9	-1.1	-0.4	0.2	0.4	-1.7	0.9	1.6	0.4
Exports of goods and services	7.0	0.6	4.1	4.9	4.0	3.8	4.6	4.9	4.2
Imports of goods and services	-24.0	4.5	6.8	5.9	4.3	9.5	3.5	2.2	4.3
Output gap 2/	-2.0	-4.8	-2.3	-0.4	0.4	0.3	0.1	0.0	0.0
Potential output	-2.7	-1.2	0.3	0.5	1.4	2.6	2.9	2.9	3.0
Unemployment rate 3/	8.0	8.1	7.4	6.1	5.7	4.9	4.5	4.2	4.0
Real wages	-8.9	-2.6	2.1	2.0	1.4	2.4	2.1	2.1	2.1
CPI inflation	12.0	5.4	4.0	5.4	4.5	3.2	2.5	2.5	2.5
CPI inflation (excl. effect of ind. taxes)	11.4	4.4	3.8	5.3	4.4	3.2	2.5	2.5	2.5
CPI inflation (end of period)	7.5	2.5	5.3	4.9	3.8	2.8	2.4	2.5	2.5
Nominal ISK/EUR exchange rate	172.0	161.7	161.0	...	...	...	...	...	...
Real exchange rate (+ appreciation)	-18.7	6.4	0.9	0.5	0.7	-0.3	-0.7	-0.7	1.0
Terms of trade	-6.7	6.0	-1.8	-1.8	1.7	0.6	-0.5	-0.8	-0.1
Nominal GDP (bln ISK)	1497.6	1536.5	1626.3	1731.4	1855.1	1969.0	2071.3	2177.0	2294.8
				(Percent of GDP, unless otherwise indicated)					
Balance of Payments									
Current account	-11.6	-8.4	-6.3	-2.4	-0.3	-2.9	-2.8	-2.7	-2.6
Underlying current account 4/	8.8	8.3	5.9	4.0	5.2	2.4	2.3	2.3	2.2
Trade balance	8.6	10.1	8.6	7.1	7.9	5.4	6.0	7.2	7.2
Net income balance 5/	-19.6	-17.9	-14.4	-8.9	-7.6	-7.8	-8.2	-9.3	-9.2
Capital and financial account	-30.7	48.1	14.7	-1.3	-3.5	4.8	8.7	-10.3	-1.8
Capital transfer, net	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment, net	-18.2	21.8	8.3	5.1	2.5	4.9	3.3	1.3	1.2
Portfolio investment, net	0.6	-8.1	-5.2	7.3	5.7	3.0	1.7	2.5	-3.0
Other investment, net	-13.0	34.4	11.6	-13.8	-11.8	-3.1	3.6	-14.1	-0.1
Accumulation of arrears	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary financing	5.5	8.3	14.8	-14.3	0.0	0.0	-3.4	-1.6	0.0
Gross external debt 6/	267.5	290.7	251.6	223.6	208.1	188.8	179.6	163.4	157.2
Underlying gross external debt 7/	263.2	272.2	227.2	207.8	200.8	187.9	178.9	163.4	157.2
Net external debt 8/	158.9	182.7	170.2	153.8	146.9	135.2	131.4	112.8	104.4
Central bank reserves (US$ billion)	3.5	5.6	8.7	6.2	5.7	6.0	6.3	4.1	3.4
General government accounts									
Revenue	41.0	41.5	41.9	42.6	42.7	42.4	42.8	42.2	42.0
Expenditure	49.6	47.9	46.7	45.3	43.9	42.6	41.7	41.3	41.0
Overall balance	-8.6	-6.4	-4.8	-2.7	-1.2	-0.2	1.1	1.0	1.0
Primary balance	-6.5	-2.7	-0.8	1.2	2.6	3.7	4.4	4.8	4.8
Primary balance (excl. new road projects)	-6.5	-2.7	-0.8	1.2	2.7	3.9	5.1	4.8	4.8
Change in primary balance (excl. new road projects)	-6.0	3.8	1.9	2.0	1.6	1.2	1.2	-0.3	0.0
Gross debt	88.0	92.7	99.5	94.6	90.3	86.5	83.7	78.4	76.7
Net Debt	55.7	62.7	66.8	67.1	65.1	62.6	59.5	56.4	52.9

Sources: CBI; and IMF staff estimates.

1/ Contributions to growth.
2/ In percent of potential output
3/ In percent of labor force.
4/ Excludes old banks transactions and accrued interest payments on intra-company debt held by a large multinational.
5/ Includes interest payments due from the financial sector and income receipts to the financial sector.
6/ Excluding old banks' total liabilities, but external debt includes TIF's deposit liabilities, and accumulated recovered assets from both external and domestic sources before being paid out to foreign creditors. Once recovered, these assets are recorded as short-term debt.
7/ Excluding short-term debt that are covered by external assets.
8/ Gross external debt minus debt securities and other investment assets.

Table 4. Iceland: Balance of Payments, 2009–17

(U.S. Dollar billions)

	2009	2010	2011	2012	2013	2014	2015	2016	2017
				Proj.	Proj.	Proj.	Proj	Proj	Proj
Current Account	-1.4	-1.1	-0.9	-0.3	0.0	-0.4	-0.4	-0.4	-0.4
Trade Balance	1.0	1.3	1.2	1.0	1.1	0.8	0.9	1.1	1.2
Balance on Goods	0.7	1.0	0.8	0.7	0.5	0.1	0.2	0.2	0.3
Merchandise exports f.o.b.	4.1	4.6	5.3	5.1	5.1	5.4	5.8	6.2	6.6
Merchandise imports f.o.b.	-3.3	-3.6	-4.5	-4.4	-4.6	-5.2	-5.6	-6.0	-6.4
Balance on Services	0.3	0.3	0.4	0.3	0.6	0.6	0.7	0.9	0.9
Exports of services, total	2.3	2.5	3.0	3.0	3.3	3.5	3.7	3.9	4.2
Imports of services, total	-2.0	-2.2	-2.6	-2.7	-2.7	-2.9	-3.0	-3.0	-3.3
Balance on Income 1/	-2.4	-2.3	-2.0	-1.2	-1.1	-1.1	-1.2	-1.4	-1.5
Receipts	0.8	0.5	1.1	0.5	0.5	0.5	0.5	0.5	0.5
of which dividends and reinvested earnings	0.4	0.2	0.8	0.2	0.2	0.2	0.2	0.2	0.3
of which interest receipts	0.4	0.3	0.3	0.2	0.2	0.3	0.3	0.2	0.2
Expenditures	-3.1	-2.7	-3.1	-1.7	-1.6	-1.6	-1.8	-1.9	-2.0
of which dividends and reinvested earnings	-0.6	-0.9	-1.0	-0.3	-0.2	-0.2	-0.1	-0.1	-0.1
of which interest payments	-2.5	-1.8	-2.1	-1.4	-1.3	-1.5	-1.6	-1.8	-1.9
Current transfer, net	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Cap and Finan. Acct	-3.7	6.0	2.1	-0.2	-0.5	0.7	1.3	-1.6	-0.3
Capital transfer, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	-3.7	6.0	2.1	-0.2	-0.5	0.7	1.3	-1.6	-0.3
Direct investment, net	-2.2	2.7	1.2	0.7	0.4	0.7	0.5	0.2	0.2
Portfolio investment, net	0.1	-1.0	-0.7	1.0	0.8	0.4	0.2	0.4	-0.5
Assets	1.0	0.2	-0.9	0.1	-0.1	-0.1	0.0	-0.5	-0.7
Liabilities 2/	-0.9	-1.2	0.2	0.9	0.9	0.6	0.2	0.9	0.2
Net borrowing	-0.8	-1.3	0.2	-0.5	0.8	0.5	0.1	0.8	0.1
Equities	-0.1	0.0	0.0	1.4	0.1	0.1	0.1	0.1	0.1
Other investment, net 3/	-1.6	4.3	1.6	-1.9	-1.6	-0.5	0.5	-2.2	0.0
Assets	-1.0	2.4	4.1	1.0	0.8	0.7	0.0	-0.2	-0.2
Liabilities 2/	-0.6	1.9	-2.5	-2.9	-2.4	-1.1	0.5	-2.0	0.2
of which external asset recovery (Landsbanki)	0.8	0.6	0.7	0.9	0.2	0.1	0.4	0.0	0.0
of which other external asset recovery	0.2	0.6	1.7	2.1	1.3	1.0	0.4	0.3	0.0
of which other asset recovery payments (Landsbanki)	0.0	0.0	-1.7	-1.1	-0.2	-0.1	-0.5	0.0	-0.1
of which other asset recovery payments	0.0	0.0	-0.6	-1.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	4.4	-3.9	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance	-0.7	1.1	1.0	-0.5	-0.5	0.3	0.9	-2.0	-0.7
Overall financing	0.7	-1.1	-1.0	0.5	0.5	-0.3	-0.9	2.0	0.7
Change in gross reserves ("-" = increase)	0.1	-2.1	-3.1	2.4	0.5	-0.3	-0.4	2.3	0.7
Accumulation of arrears ("-" = paydown)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing 4/	0.7	1.0	2.1	-1.9	0.0	0.0	-0.5	-0.3	0.0
Fund ("+" = net disbursement)	0.2	0.3	0.9	-1.3	0.0	0.0	-0.5	-0.3	0.0
Bilateral (earmarked/ non-cash)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other identified new financing 5/	0.5	0.7	1.2	-0.6	0.0	0.0	0.0	0.0	0.0
Financing Gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Level of gross reserves (eop)	3.5	5.6	8.7	6.2	5.7	6.0	6.3	4.1	3.4
Level of gross reserves (eop) excluding old bank deposits	2.2	4.0	6.0	3.3	3.5	4.0	4.7	3.6	3.1
Memo									
GDP $ bln	12.1	12.6	14.0	13.6	13.9	14.5	15.0	15.4	16.3
Underlying balance of income 6/	0.1	-0.2	-0.3	-0.3	-0.3	-0.4	-0.5	-0.7	-0.7
Underlying current account balance 6/	1.1	1.0	0.8	0.5	0.7	0.3	0.3	0.3	0.4
Reserves (months of imports of G&S)	7.1	9.4	14.6	10.2	8.4	8.3	8.4	5.0	4.6
Reserves/S-T debt (residual basis, in percent)	45.1	64.8	119.7	191.2	226.4	308.7	246.2	226.9	146.3
Reserves/S-T debt (residual basis, in percent) 7/	34.7	56.7	131.4	111.6	158.9	256.3	209.1	241.8	150.8
Reserves (in percent of GDP)	28.7	44.4	61.8	45.8	40.8	41.1	42.3	26.4	20.5
Principal and interest arrears of old banks 2/	14.8	...	...	...	...	...	...	...	...

Sources: CBI; and IMF staff estimates.

1/ Actual data include old banks' incomes.

2/ Unlike in the 2012 Article IV staff report, where claims on Kaupthing and Glitnir are assumed to be transformed into equity, these claims are now assumed to remain as debt (see Annex I.A. for details).

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

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

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

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

7/ Excludes resolution committee deposits at the central bank.

Table 5. Iceland: General Government Operations, 2008–17

(GFS, modified cash, percent of GDP 1/)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
					Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Total revenue	**44.1**	**41.0**	**41.5**	**42.0**	**42.6**	**42.7**	**42.4**	**42.8**	**42.2**	**42.0**
Taxes	**33.8**	**30.7**	**30.9**	**32.0**	**32.5**	**32.2**	**32.2**	**32.6**	**32.0**	**32.1**
Taxes on income and profits	17.8	16.0	15.6	16.6	16.8	16.2	16.3	16.3	16.4	16.6
Personal Income Tax	13.2	12.8	12.8	13.4	13.6	13.4	13.4	13.5	13.6	13.8
Corporate Income Tax	1.9	1.8	1.0	1.9	1.9	1.7	1.7	1.7	1.7	1.7
Capital gains tax, rental income	2.7	1.4	1.8	1.3	1.2	1.1	1.1	1.1	1.1	1.1
Taxes on payroll and workforce	0.2	0.2	0.2	0.2	0.3	0.5	0.5	0.5	0.5	0.5
Taxes on property	2.2	2.1	2.3	2.3	2.5	2.6	2.6	2.2	2.1	2.1
Taxes on goods and services	13.2	11.7	12.0	12.1	12.0	12.1	12.1	12.1	12.1	12.1
VAT	9.1	8.0	8.0	7.6	8.0	8.0	8.0	8.0	8.1	8.1
Other taxes on goods and services	4.1	3.6	4.0	4.5	4.1	4.1	4.1	4.1	4.0	4.0
Taxes on international trade	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Other taxes	0.1	0.4	0.4	0.4	0.5	0.4	0.4	1.0	0.4	0.4
Social contributions	**2.8**	**3.1**	**4.1**	**4.1**	**3.8**	**3.8**	**3.8**	**3.9**	**3.9**	**3.9**
Grants	**0.1**	**0.1**	**0.2**	**0.2**	**0.2**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**
Other revenue	**7.4**	**7.1**	**6.3**	**5.7**	**6.1**	**6.6**	**6.2**	**6.2**	**6.2**	**5.8**
Property income	3.9	3.6	2.6	2.0	2.4	2.2	1.9	1.9	1.9	1.9
o/w Interest income	3.3	3.1	2.1	1.7	1.6	1.6	1.3	1.3	1.2	1.2
Total expenditure	**44.7**	**49.6**	**47.9**	**46.7**	**45.3**	**43.9**	**42.6**	**41.7**	**41.3**	**41.0**
Current expense	**42.1**	**48.2**	**47.1**	**47.1**	**45.6**	**44.1**	**42.9**	**42.0**	**41.5**	**41.2**
Compensation of employees	14.6	15.0	14.8	14.5	14.4	13.9	13.6	13.3	13.1	13.0
Use of goods and services	11.6	12.5	12.2	11.7	11.6	11.2	10.8	10.6	10.5	10.5
Consumption of fixed capital	1.8	2.1	2.2	2.2	2.1	2.1	2.1	2.1	2.1	2.0
Interest	3.3	5.2	5.8	5.7	5.4	5.3	5.2	5.2	5.1	5.1
o/w Interest on IceSave guarantee	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Subsidies	1.8	1.9	1.8	1.7	1.7	1.6	1.5	1.5	1.5	1.5
Grants	0.2	0.4	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2
Social benefits	6.1	8.1	7.9	8.5	7.7	7.3	7.1	6.9	6.9	6.9
Other expense	2.6	3.0	2.3	2.4	2.4	2.4	2.2	2.1	2.1	2.1
Nonfinancial assets	**2.6**	**1.4**	**0.7**	**-0.3**	**-0.4**	**-0.2**	**-0.2**	**-0.3**	**-0.3**	**-0.2**
Non-financial assets, acquisition	4.5	3.5	2.9	1.8	1.8	1.9	1.9	1.8	1.8	1.8
of which: road construction projects				0.0	0.0	0.2	0.1	0.1	0.0	0.0
Consumption of fixed capital (-)	-1.8	-2.1	-2.2	-2.2	-2.1	-2.1	-2.1	-2.1	-2.1	-2.0
Net lending/borrowing (augmented) 2/	**-0.5**	**-8.6**	**-6.4**	**-4.8**	**-2.7**	**-1.2**	**-0.2**	**0.5**	**1.0**	**1.0**
Net lending/borrowing 3/	**-13.5**	**-10.9**	**-10.3**	**-6.0**	**-3.5**	**-1.6**	**-0.6**	**0.7**	**0.6**	**1.0**
Financial assets, transactions	**21.9**	**5.2**	**2.2**	**-1.3**	**-2.9**	**-0.7**	**0.1**	**1.6**	**-0.7**	**3.1**
Currency and deposits	4.2	3.0	7.2	-2.0	-3.3	-0.9	-0.1	1.3	-1.0	2.8
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	14.4	-7.7	-6.0	0.7	0.3	0.3	0.2	0.3	0.3	0.3
Shares and other equities	0.2	9.3	2.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	3.2	0.6	-1.8	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities, transactions	**35.4**	**16.1**	**12.5**	**4.4**	**0.6**	**0.6**	**0.3**	**0.5**	**-1.6**	**2.2**
Securities other than shares	10.6	21.9	6.6	4.4	2.8	1.0	0.6	-0.2	-1.0	2.6
Loans	21.5	-6.2	3.9	-0.3	-2.2	-0.5	-0.3	0.7	-0.6	-0.4
Domestic loans	19.1	-7.5	1.7	0.6	-0.2	-0.1	-0.3	-0.5	-0.6	-0.4
Foreign loans	2.4	1.3	2.2	-0.9	-1.9	-0.4	0.0	1.1	0.0	0.0
Insurance technical reserves	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts payable	3.2	0.2	2.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Stock of debt										
General government gross debt	70.4	88.0	92.7	99.5	94.6	90.3	86.5	83.7	78.4	76.7
Domestic	45.8	61.0	68.1	69.8	68.6	60.5	52.8	50.1	46.6	46.5
Foreign currency 4/	24.6	27.0	24.6	29.6	26.1	29.8	33.6	33.6	31.8	30.2
of which:										
Bilateral loans to support CBI reserves	0.0	3.1	7.4	13.8	5.9	5.5	5.1	4.8	4.6	4.4
Other	24.6	23.9	17.2	15.8	20.2	24.3	28.5	28.7	27.2	25.8
General government net debt 5/	41.8	55.7	62.7	66.8	67.1	65.1	62.6	59.5	56.4	52.9
Structural Balances 6/										
Structural balance	-4.6	-7.5	-3.6	-3.6	-2.5	-1.5	-0.4	0.4	0.9	0.9
Structural primary balance	-4.6	-5.4	0.0	0.3	1.3	2.3	3.5	4.2	4.7	4.7
Memo Items										
Nominal GDP (billion ISK)	1480	1498	1537	1626	1731	1855	1969	2071	2177	2295
Primary revenue	40.8	37.9	39.4	40.2	41.0	41.1	41.2	40.9	41.0	40.8
Primary expenditure	41.3	44.4	42.1	41.0	39.8	38.5	37.4	36.6	36.2	36.0
Primary balance	-0.5	-6.5	-2.7	-0.8	1.2	2.6	3.7	4.4	4.8	4.8

Sources: IceStat; Ministry of Finance; and IMF staff estimates.

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

2/ Excludes write-offs recorded as capital transfers and revenues from the exit tax. Write-offs in 2008 are the result of CBI recapitalization and securities lending contracts that failed following the banks' collapse. Write-offs in 2009 reflect the retroactive interest paid to new banks to compensate for late capitalization. Write-offs in 2010 reflect called guarantees of the State Guarantee Fund and HFF recapitalization. Write-offs in 2011 reflect recapitalization of the savings bank and does not include the state's revaluation of its equity holdings in the Regional Development Institute and the NSA Ventures since these are valuation changes recorded in the balance sheet of the government. Write-offs in 2012 reflect the recapitalization of the HFF.

3/ Excludes asset sales.

4/ Includes bilateral loans and international bond issuance to support foreign currency reserves at the Central Bank of Iceland (CBI). The loan from the Norwegian government directly to the CBI is excluded from general government debt. Does not include Fund liabilities.

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

6/ In percent of potential GDP. Structural estimates for 2008-2009 account for the impact of the asset bust price cycle.

Table 6. Iceland: Central Government Operations, 2008–17

(GFS modified cash basis, percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
					Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Cash receipts from operating activities	**30.0**	**27.7**	**30.1**	**28.9**	**29.3**	**29.5**	**29.3**	**29.7**	**29.0**	**28.8**
Tax revenue	23.6	21.3	22.3	22.3	22.8	22.5	22.5	22.8	22.2	22.3
Taxes on income, profits, and capital gains	10.3	9.3	9.0	9.1	8.9	8.4	8.4	8.4	8.4	8.6
Personal income tax	5.9	5.5	5.8	5.7	5.8	5.6	5.6	5.6	5.6	5.7
Corporate income tax	2.0	1.2	1.2	1.9	1.9	1.7	1.7	1.7	1.7	1.7
Other taxes on income and profit	2.4	2.6	1.9	1.6	1.2	1.1	1.1	1.1	1.1	1.1
Taxes on payroll and workforce	0.1	0.2	0.2	0.2	0.3	0.5	0.5	0.5	0.5	0.5
Taxes on property	0.5	0.4	0.6	0.7	0.8	0.8	0.8	0.4	0.4	0.4
Taxes on sales and services	12.1	10.8	11.7	11.5	11.9	12.0	12.0	12.0	12.0	11.9
Taxes on international trade and transactions	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Other tax revenue	0.1	0.4	0.4	0.4	0.5	0.4	0.4	1.0	0.4	0.4
Social contributions	2.8	2.8	4.0	4.1	3.8	3.8	3.8	3.9	3.9	3.9
Grants	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Other receipts	3.6	3.5	3.7	2.5	2.6	3.1	2.9	2.9	2.8	2.5
Of which:										
Interest income	2.6	2.9	1.8	1.2	1.3	1.3	1.0	1.0	1.0	1.0
Total spending	**30.5**	**36.8**	**34.6**	**32.5**	**31.8**	**30.8**	**29.8**	**29.0**	**28.7**	**27.9**
Cash payments for operating activities	**28.3**	**34.3**	**32.9**	**31.5**	**31.0**	**29.9**	**28.9**	**28.1**	**27.9**	**27.1**
Compensation of employees	8.5	8.6	8.3	8.0	7.7	7.4	7.4	7.4	7.5	7.6
Purchases of goods & services	5.5	6.0	6.2	5.6	5.8	5.4	5.1	4.8	4.7	4.5
Interest 1/	1.9	5.3	4.8	4.0	4.6	4.9	4.7	4.7	4.6	4.3
Transfer payments	12.3	14.4	13.6	13.9	12.9	12.2	11.7	11.2	11.0	10.7
Net cash inflow from operating activities	**-11.2**	**-6.6**	**-2.8**	**-2.5**	**-1.6**	**-0.4**	**0.4**	**0.9**	**1.1**	**1.7**
Investments in NFAs	2.3	2.5	1.7	1.0	0.8	0.9	0.9	0.9	0.8	0.8
Of which: road construction projects	0.0	0.0	0.0	0.0	0.0	0.2	0.1	0.1	0.0	0.0
Augmented balance (incl. adjustment to cash) 2/	**-12.6**	**-10.0**	**-4.5**	**-3.5**	**-2.4**	**-1.3**	**-0.5**	**0.0**	**0.3**	**0.9**
Write-offs	13.0	2.3	3.6	1.2	0.9	0.0	0.0	0.0	0.0	0.0
Of which:										
Recapitalization related write-offs	11.8	0.0	2.1	1.2	0.9	0.0	0.0	0.0	0.0	0.0
Securities lending related write-offs	1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Guarantees	0.0	0.5	1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Retro-active interest on bank capitalization	0.0	1.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance 3/	**-25.6**	**-12.3**	**-8.1**	**-4.7**	**-3.3**	**-1.7**	**-0.9**	**0.3**	**0.0**	**0.9**
Memorandum Items:										
Nominal GDP	1,480	1,498	1,537	1,626	1,731	1,855	1,969	2,071	2,177	2,295
Primary revenue	27.4	24.8	28.2	27.7	28.0	28.2	28.3	28.0	28.0	27.8
Primary expenditure	28.7	31.5	29.7	28.5	27.2	25.9	25.0	24.3	24.1	23.6
Primary balance	-1.2	-6.7	-1.5	-0.8	0.8	2.3	3.2	3.6	3.9	4.1

Sources: IceStat; Ministry of Finance; and IMF staff estimates.

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

2/ Excludes write-offs recorded as capital transfers and revenues from the exit tax. Write-offs in 2008 are the result of CBI recapitalization and securities lending contracts that failed following the banks' collapse. Write-offs in 2009 reflect the retroactive interest paid to new banks to compensate for late capitalization. Write-offs in 2010 reflect called guarantees of the State Guarantee Fund and HFF recapitalization. Write-offs in 2011 reflect recapitalization of the savings bank and does not include the state's revaluation of its equity holdings in the Regional Development Institute and the NSA Ventures since these are valuation changes recorded in the balance sheet of the government. Write-offs in 2012 reflect the recapitalization of the HFF.

3/ Excludes asset sales.

Table 7. Iceland: Indicators of Fund Credit, 2008–16

(Millions of SDR)

	2008	2009	2010	2011	2012	2013	2014	2015
Existing and prospective Fund credit								
Disbursements	560	105	210	525	0	0	0	0
Stock	560	665	875	1400	582	512	512	171
Obligations	0	13	18	29	844	81	10	348
Principal (repurchases)	0	0	0	0	818	70	0	341
Charges and interest	0	13	18	29	26	11	10	6
Stock of existing and prospective Fund credit								
In percent of quota	476	565	744	1190	495	435	435	145
In percent of GDP	5	9	11	15	6	6	5	2
In percent of exports of G&S	11.5	16.3	19.0	26.0	10.9	9.2	8.7	2.7
In percent of gross reserves	24.3	26.9	23.2	24.9	13.2	18.5	20.2	7.2
Obligations to the Fund from existing and prospective Fund arrangements								
In percent of quota	0.0	11.1	15.2	25.0	718.0	68.7	8.5	295.7
In percent of GDP	0.0	0.2	0.2	0.3	9.5	0.9	0.1	3.5
In percent of exports of G&S	0.0	0.3	0.4	0.6	15.9	1.5	0.2	5.5
In percent of gross reserves	0.0	0.5	0.5	0.5	19.3	2.9	0.4	14.6

Source: IMF staff estimates and projections.

Table 8. Iceland: Financial Soundness Indicators (in percent, unless otherwise indicated)

	2009	2010	2011
Capital adequacy			
Total regulatory capital to risk-weighted assets	12.6	19.3	24.3
Tier I regulatory capital to risk-weighted assets	11.8	17.4	21.9
Capital to assets	13.4	16.1	17.4
Asset composition 1/			
Sectoral distribution of loans to total loans (percent of total)			
Business credit	45.9	44.7	42.3
Industry (excluding energy sector)	8.8	7.3	6.7
Energy Sector	0.4	0.4	0.4
Agriculture (including fisheries)	6.3	5.8	6.1
Construction	4.4	3.5	2.9
Transport and communication	0.5	1.1	1.5
Trade/commerce	25.5	26.7	24.7
Consumer credit (trade and services)	8.3	8.3	8.4
Mortgage credit	32.1	33.6	33.8
Loan portfolio to GDP	187.7	184.1	174.3
Total asset to GDP	250.8	234.6	233.8
Asset quality			
Nonperforming loans (billions of kronur)	241.4	319.7	244.8
Non-performing loans (percent of book value) 2/	42.0	40.0	23.0
Provisions to non-performing loans (book value)	82.0	48.0	50.0
Asset liability management 1/			
CPI-indexed assets to total assets	34.1	35.0	36.8
FX-indexed assets to total assets	47.0	42.9	31.8
CPI-indexed liabilities to total assets	32.1	32.7	33.7
FX-indexed liabilities to total assets	26.0	25.3	28.1
Earnings and profitability 3/			
ROA (profits to period average assets)	-0.3	2.4	3.0
ROE (profits to period average equity)	-4.4	18.7	16.0
Interest margin to gross income	61.3	36.4	55.8
Net interest margin	...	3.1	2.5
Cost to assets	...	2.2	1.8
Liquidity 4/			
Liquid assets to total assets	18.0	18.0	20.0
Liquid assets to total short-term liabilities	195.0	210.1	201.4
Loan-to-deposit ratio (non-interbank liabilities only)	113.0	126.0	126.0
Liquid assets to foreign exchange liabilities to nonresidents	938.0	6857.0	6591.0
Foreign exchange liabilities to nonresidents to total liabilities	4.2	0.6	0.6
Sensitivity to market risk			
Gross open positions in foreign exchange to capital	605.3	417.4	346.7
Net open position in FX to capital	174.4	107.7	21.4

Source: Central Bank of Iceland; FME

1/ Including the three major deposit money banks and the Housing Finance Fund (hereafter HFF).

2/ Cross-default criteria for NPLs: If one single loan is overdue for more than 90 days, the entire credit position of the borrower is nonperforming.

3/ For 2011 based on non-audited financial statements Q3 or Q4, 3 largest banks, excluding HFF.

4/ For all Deposit Money Banks (DMBs), does not include HFF.

Annex I. Debt Sustainability Analysis

1. External and public debt are on sustainable paths, but risks remain elevated (Annex Tables 1–2; Annex Figures 2–3). Although both external and public debt are projected to decline in the medium term, overcoming the large debt overhang remains a challenge.

A. External Debt Sustainability Analysis

2. The underlying assumptions for the baseline external debt path are largely the same as in the 2012 Article IV staff report, with the following updates:

- The three old banks' asset recovery has been faster than previously anticipated. This increases debt because recoveries are only treated as liabilities to nonresidents from the date on which they are recovered. Debt decreases in future years when recovered assets are paid out to creditors.

- For the most part, the time at which each of the old banks is assumed to make its first payments of recovered assets to external creditors is in line with that in the 2012 Article IV staff report. The exception is that the estate of old Landsbanki made payments to creditors in December 2011, May 2012 and October 2012, with the total amounting to 50 percent of priority claims.

- As in the 2012 Article IV staff report, it is assumed that the Icesave dispute will be settled through legal channels. As before, the United Kingdom and the Netherlands are treated as priority claimants on the Landsbanki estate. As with debt arising from asset recovery from the other old banks, the Icesave debt is treated as accruing as assets are recovered (see ¶3).

- As before, it is assumed that two of the old banks will be resolved through composition rather than liquidation. Unlike in the 2012 Article IV staff report, where the external debt of the old banks is assumed to be transformed into equity, this debt is now assumed to remain as debt. This treatment reflects uncertainty around this issue and the possibility that the old banks may issue bonds rather than equity shares to creditors post composition. As a result, the current DSA projects somewhat higher external debt from 2012 onwards than the DSA in the 2012 Article IV consultation report.

- The prospective sale of a large (resident) multinational to a nonresident company creates uncertainty as to whether the multinational's external debt remains Icelandic debt. In light of the uncertainty, this debt is still treated as Icelandic debt, with part of it assumed to be transformed into equity, resulting in a reduction in the external debt by end-2012. If the multinational's external debt is excluded, gross external debt in 2012 will decline by about 56 percent of GDP.

- Interest rates for *new* borrowing throughout the projection period are assumed to be somewhat lower than in the last DSA, reflecting reduced global funding costs.

- External borrowing by the central government (aside from that from bilateral official creditors) and public enterprises are assumed to be rolled over. As before, the central government is assumed to issue additional bonds to cover (on average 30 percent) of the CBI's external debt that falls due between 2012–16. Local municipalities are assumed to only partially roll over their debt, with an average rollover rate of around 40 percent assumed over the next two years. Corporations under financial stress are assumed to be unable to roll over external debt.

- In a departure from the DSA in the 2012 Article IV report, the easing of capital controls is assumed to start in 2016 rather than 2014. Therefore, external debt declines with the implementation of the authorities' capital account liberalization strategy during 2012-15, as captive non-resident krona holdings are assumed to exit. The DSA also assumes that, as part of the strategy to liberalize the capital controls, the government issues two Eurobonds, each at a value of $0.8 billion, in 2013 and 2014 to exchange for krona-denominated government securities held by nonresidents. This operation will not affect the level of external debt, but will increase the government's foreign exchange exposure.

3. External debt is expected to decline substantially over the medium term. External debt is estimated at 252 percent of GDP in 2011, and is expected to fall to around 157 percent of GDP by 2017. Around one-third of the 2011 debt stock reflects external liabilities to nonresidents captured by the capital controls and expected payments to foreign creditors associated with asset recovery of the old banks, although this declines as offshore kronas exit and old banks' liabilities are paid.

4. The external debt path is contingent on the eventual outcome of the Icesave litigation. The EFTA Court ruling on the Icesave dispute, expected before the end of the year, will determine whether an infringement occurred, but will not define what financial obligation, if any, would ensue. This could be resolved through further litigation in relevant courts, if the parties do not reach agreement otherwise. Outcomes favorable to Iceland could imply small or no payments for Iceland while unfavorable rulings could produce higher costs. The DSA therefore considers three alternative scenarios: (i) Iceland is liable for the total deposit claims; (ii) Iceland is liable for the insured Icesave deposits which account for about half of the total Icesave deposits; and (iii) Iceland agrees to the terms of the December 2010 Icesave agreement. In each scenario, the potential liability is treated as a loan to Iceland covering the difference between asset distributions by the Landsbanki estate and the sum of Icesave deposits and financing costs. Interest is accrued until after remaining potential litigation is resolved (assumed to be in 2014), with the accumulated amount becoming an additional obligation of Iceland. Each of these scenarios is treated the same way as in the Public DSA, and would involve an upward revision of the debt path, with coverage of both the insured and uninsured deposits having the largest impact.

5. Stress tests suggest that the downward trajectory is robust. Standard shocks would not disturb the downward trajectory of the external debt ratio. Realization of any of the litigation risk scenarios would result in higher debt throughout the medium term, although in each case the debt ratio would be declining as assets were recovered and claims settled. The historical scenario (an exchange rate depreciation of 30 percent) would have the strongest effect, but even in these scenarios the debt ratio would decline after the initial increase.

B. Public Debt Sustainability Analysis

6. Iceland's public debt sustainability analysis (DSA) is based on the following underlying assumptions:

- The outturn in 2012 is expected to be close to the last Article IV projections. The proposed 2012 supplementary budget implies a primary balance about ½ percent of GDP higher than the authorities' target. The overall deficit is expected at 2¾ percent of GDP.
- The 2013 budget proposal eliminates about 0.3 percent of past slippages and targets a primary balance of 2.6 percent of GDP. Over the medium term, the primary balance is expected to reach about 4¾ percent of GDP in 2016, an improvement of ¼ percent of GDP compared to the latest DSA projections. Nevertheless, the primary balance will still fall slightly short by 0.2 percent of GDP of the 5 percent of GDP target in 2016. The overall deficit will not close until 2015, a year after the authorities' objective, and the overall balance will reach 1 percent of GDP in 2016.
- HFF recapitalization amounting to about ¾ percent of GDP is assumed to take place in 2012.

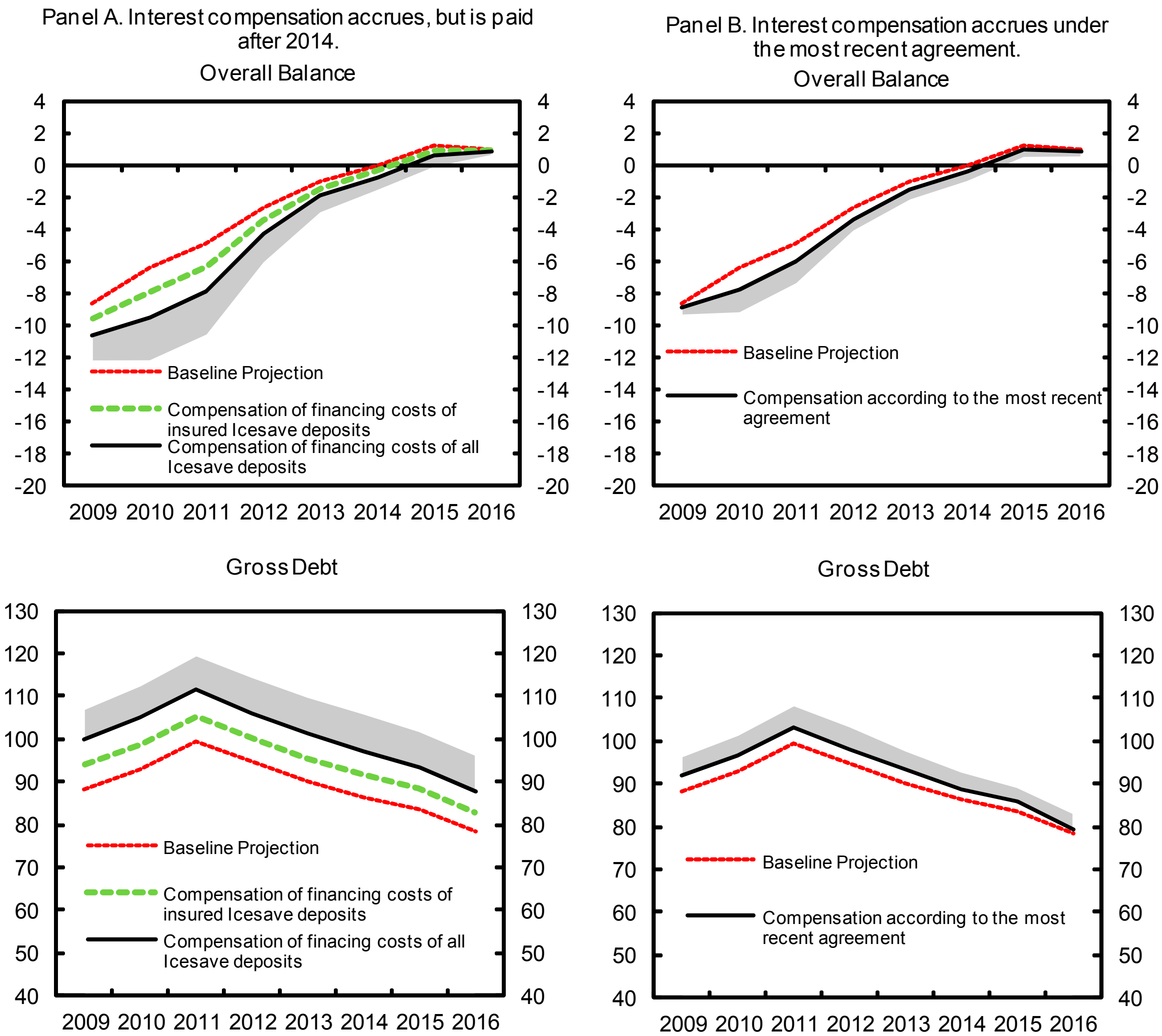
7. General government debt is estimated at 99½ percent of GDP in 2011 (Annex Table 2, Annex Figure 3). Because of the prepayment of a portion of the Nordic loans, the debt-to-GDP ratio is expected to be lower by 2.7 percent of GDP in 2012 relative to the last Article IV estimate. In light of this, and given the improved primary balance profile, the debt-to-GDP ratio will be lower by 5 percent of GDP in the medium-term compared to the last Article IV. As a result, the overall declining debt path remains unchanged compared to the previous DSA. The primary balance will still exceed the debt stabilizing balance and is expected to do so throughout the forecasting period.

8. The baseline debt trajectory is very sensitive to growth shocks (Annex Figure 3). A standard growth shock would reverse the downward path of public debt and keep it well above 100 percent of GDP in the absence of offsetting measures. An interest rate shock, a combined macro shock, and an interruption of the fiscal consolidation would flatten the debt path and would stabilize debt around 95 percent of GDP. A 30-percent depreciation of the exchange rate would raise the debt ratio to 103 percent of GDP in 2013 and leave debt at 90 percent of GDP in 2017.

9. The outcome of the Icesave dispute continues to weigh on the potential debt path (Annex Figure 1). The underlying assumptions regarding the estimates remain broadly as in the previous assessment, and the results are similar. The contingent liability of the government at end-2011 is estimated at 5¾ percent of GDP if only insured deposits are covered, and 12 percent of GDP if insured plus uninsured deposits are covered (Panel A). Applying penalty rates would increase the estimated contingent liability at end-2011 to 9½ percent of GDP for insured deposits and 19¾ percent of GDP for all deposits. Should the most recent agreement take effect (Panel B), the NPV of the cost to the government would amount to 3½ percent of GDP at end-2011, assuming payments commence in 2013. This cost could increase to 8¾ percent of GDP if penalty interest rates are applied.

10. Finally, contingent liability shocks unrelated to the outcome of the Icesave dispute could have substantial effects. A 30 percent contingent liability shock could raise public debt above 120 percent of GDP in 2013. Under this scenario, in the medium term, public debt is expected to decline to 108 percent of GDP.

Annex Figure 1. Icesave Scenarios
(Percent of GDP)



Sources: Country authorities; and IMF staff estimates.

Note: Lines show estimates based on projected interest rates on long-term euro and UK government bonds. Shaded areas indicate additional impact of using penalty rates.

Annex Table 1. Iceland: External Debt Sustainability Framework Current Baseline, 2007-2017

(In percent of GDP, unless otherwise indicated)

		Actual												
		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017		**Debt-stabilizing non-interest current account 6/**
	Baseline: External debt (including old banks)	605.9	564.7											
1	**Baseline: External debt**	171.8	188.7	267.5	290.7	251.6	**223.6**	**208.1**	**188.8**	**179.6**	**163.4**	**157.2**		**3.8**
2	Change in external debt	70.6	16.9	78.8	23.1	-39.1	-28.0	-15.5	-19.3	-9.3	-16.1	-6.2	0.0	
3	Identified external debt-creating flows	35.0	34.2	42.8	-23.0	-23.0	-41.5	-15.2	-10.8	-12.5	-5.6	-3.7	0.0	
4	Current account deficit, excluding interest payments	9.6	12.5	1.4	0.4	-3.9	-8.1	-9.1	-7.3	-7.9	-8.8	-8.8	-3.8	
5	Deficit in balance of goods and services	10.1	2.3	-8.6	-10.1	-8.6	-7.1	-7.9	-5.4	-6.0	-7.2	-7.2		
6	Exports	34.5	44.1	52.7	56.5	59.3	59.6	60.2	61.5	63.6	65.9	66.5		
7	Imports	44.6	46.4	44.2	46.4	50.8	52.5	52.3	56.1	57.7	58.7	59.3		
8	Net non-debt creating capital inflows (negative)	37.6	-30.9	13.9	-41.7	-22.7	-37.1	-10.4	-8.7	-10.4	-3.4	-1.7	0.1	
9	Automatic debt dynamics 1/	-12.2	52.6	27.5	18.3	3.6	3.7	4.3	5.2	5.8	6.6	6.7	3.7	
10	Contribution from nominal interest rate	6.1	15.9	10.3	8.0	10.2	10.5	9.4	10.2	10.8	11.5	11.4	11.1	
11	Contribution from real GDP growth	-5.0	-2.5	17.3	10.3	-6.7	-6.8	-5.1	-5.0	-5.0	-4.9	-4.7	-4.5	
12	Contribution from price and exchange rate changes 2/	-13.4	39.2	44.4	-20.1	-23.3	...	...	...	...	...	...	-2.8	
13	Residual, incl. change in gross foreign assets 3/	35.5	-17.3	36.1	46.1	-16.0	13.5	-0.3	-8.5	3.3	-10.6	-2.5	0.0	
	External debt-to-exports ratio (in percent)	498.4	427.9	507.3	514.3	424.1	374.9	345.7	307.1	282.3	247.9	236.6		
	Gross external financing need (in billions of US dollars) 4/	8.6	13.5	6.6	9.3	13.5	14.1	8.2	6.0	5.0	6.1	2.8		
	in percent of GDP	42.3	80.4	54.7	74.3	96.5	104.2	59.0	41.1	33.7	39.8	17.0		
	Scenario with key variables at their historical averages 5/					**251.6**	**248.9**	**247.8**	**241.3**	**243.5**	**233.5**	**233.9**		**-7.3**
	Key Macroeconomic Assumptions Underlying Baseline												For debt stabilization	
	Real GDP growth (in percent)	6.0	1.2	-6.6	-4.0	2.6	2.6	2.3	2.5	2.7	2.8	3.0	3.0	
	Nominal external interest rate (in percent)	7.4	7.6	3.9	3.1	3.9	4.0	4.3	5.1	5.9	6.6	7.4	7.4	
	Growth of exports (US dollar terms, in percent)	31.3	5.4	-13.9	11.2	17.0	-2.6	3.7	6.2	6.8	7.0	6.6		
	Growth of imports (US dollar terms, in percent)	9.8	-14.1	-31.6	9.0	22.0	0.2	2.3	11.4	6.2	5.2	6.8		
	Current account balance, excluding interest payments 7/	-9.6	-12.5	-1.4	-0.4	3.9	8.1	9.1	7.3	7.9	8.8	8.8		
	Net non-debt creating capital inflows	-37.6	30.9	-13.9	41.7	22.7	37.1	10.4	8.7	10.4	3.4	1.7		

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

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

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

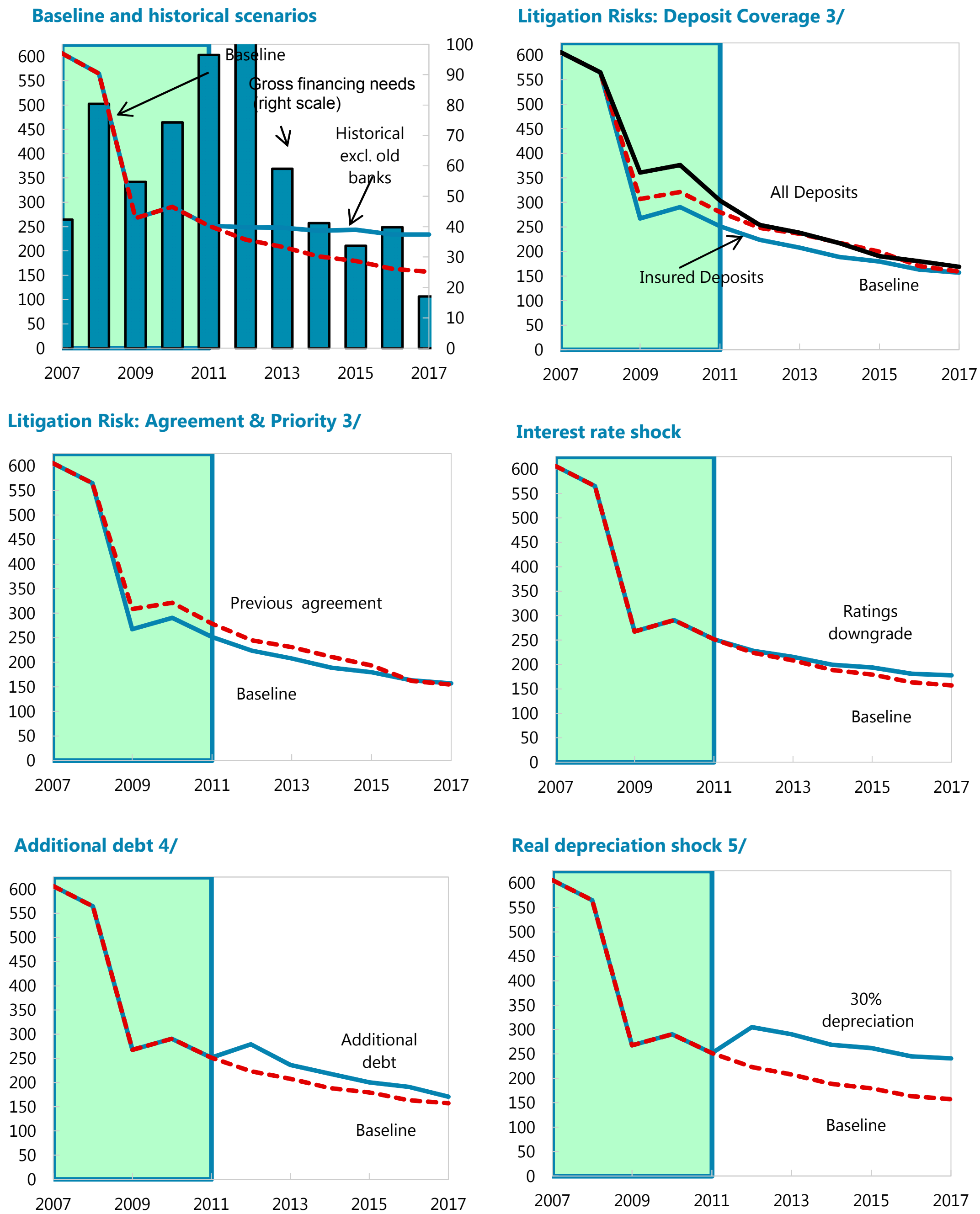
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year. This estimate excludes old bank-related asset recovery in 2017, and large one-off projected liquidation of assets abroad, to service lumpy debt payment.

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

Annex Figure 2. Iceland: External Debt: Current Baseline Projection 1/ 2/
(Percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent preliminary actual data including old banks unless otherwise indicated. Except for the interst rate shock, the Individual shocks are permanent one-half standard deviation shocks. The interest rate shock is a one standard deviation shock.
2/ GDP is converted into $ at average exchange rates.
3/ Litigation risks are assumed as follows:
All depostis: Compensation for financing all Icesave deposits.
Insured deposits: Compensation for financing costs of insured deposits.
Agreement: Compensation for financing costs according to the most recent Icesave agreement.
4/ Assumes 20 percent of GDP increase in external debt in 2012.
5/ One-time real depreciation of 30 percent occurs in 2012.

Annex Table 2. Iceland: Public Sector Debt Sustainability Framework, 2007–17

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	29.1	70.4	88.0	92.7	99.5	**94.6**	**90.3**	**86.5**	**83.7**	**78.4**	**76.7**	**0.9**
o/w foreign-currency denominated	13.3	24.6	27.0	24.6	29.6	26.1	29.8	33.6	33.6	31.8	30.2	
Change in public sector debt	-1.0	41.3	17.6	4.7	6.8	-4.8	-4.3	-3.8	-2.8	-5.3	-1.7	
Identified debt-creating flows (4+7+12)	-10.8	28.0	25.4	11.9	6.5	-2.5	-5.1	-5.1	-4.3	-5.0	-5.0	
Primary deficit (including interest income)	-8.0	-2.8	3.4	0.6	-0.9	-2.8	-4.1	-5.0	-6.3	-6.0	-6.0	
Revenue and grants	47.7	44.1	41.0	41.5	41.9	42.6	42.7	42.4	42.8	42.2	42.0	
Primary (noninterest) expenditure	39.7	41.3	44.4	42.1	41.0	39.8	38.5	37.4	36.6	36.2	36.0	
Automatic debt dynamics 2/	-2.8	12.6	4.1	3.2	-0.6	-0.6	-1.0	0.0	0.9	1.0	1.1	
Contribution from interest rate/growth differential 3/	-0.6	0.0	4.4	3.5	0.6	-0.6	-1.0	0.0	0.9	1.0	1.1	
Of which contribution from real interest rate	1.0	0.3	-0.2	0.1	2.8	1.9	1.1	2.1	3.1	3.3	3.3	
Of which contribution from real GDP growth	-1.6	-0.3	4.6	3.4	-2.2	-2.5	-2.1	-2.1	-2.2	-2.2	-2.2	
Contribution from exchange rate depreciation 4/	-2.2	12.6	-0.3	-0.3	-1.2	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	18.2	17.9	8.1	8.0	0.9	0.0	0.0	1.1	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities 5/	0.0	0.0	0.0	1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (capitalization of banks, support of international reserves) 6/	0.0	18.2	17.9	6.6	8.0	0.9	0.0	0.0	1.1	0.0	0.0	
Residual, including asset changes (2-3) 7/	9.8	13.3	-7.8	-7.2	0.3	-2.3	0.8	1.2	1.5	-0.3	3.2	
Public sector debt-to-revenue ratio 1/	61.1	159.5	214.6	223.5	237.6	222.1	211.5	203.7	195.4	185.6	182.5	
Gross financing need 8/	0.6	13.1	27.6	27.6	23.9	19.6	8.9	6.6	4.9	12.4	2.4	
in billions of U.S. dollars	0.1	2.2	3.3	3.5	3.3	2.7	1.2	1.0	0.7	1.9	0.4	
Scenario with key variables at their historical averages 9/						**94.6**	**92.9**	**91.8**	**92.0**	**89.3**	**90.2**	**0.1**
Scenario with no policy change (constant primary balance) in 2012-2017						**94.6**	**91.7**	**90.1**	**90.9**	**89.0**	**90.7**	**1.1**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	6.0	1.2	-6.6	-4.0	2.6	2.6	2.3	2.5	2.7	2.8	3.0	
Average nominal interest rate on public debt (in percent) 10/	9.6	13.0	7.5	6.7	6.5	5.8	6.0	6.1	6.3	6.4	6.8	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.0	1.2	-0.8	-0.2	3.3	2.1	1.4	2.6	3.9	4.2	4.5	
Nominal appreciation (increase in US dollar value of local currency, in percent)	15.9	-48.7	1.0	1.1	5.3	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	5.7	11.8	8.3	6.9	3.2	3.7	4.7	3.6	2.4	2.2	2.3	
Growth of real primary spending (deflated by GDP deflator, in percent)	6.5	5.4	0.3	-9.0	-0.1	-0.3	-0.9	-0.5	0.3	1.8	2.4	
Primary deficit (including interest income)	-8.0	-2.8	3.4	0.6	-0.9	-2.8	-4.1	-5.0	-6.3	-6.0	-6.0	
Net public sector debt	10.8	41.8	55.7	62.7	66.8	67.1	65.1	62.6	59.5	56.4	52.9	

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

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

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

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

5/ Reflects called guarantees of the State Guarantee Fund.

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

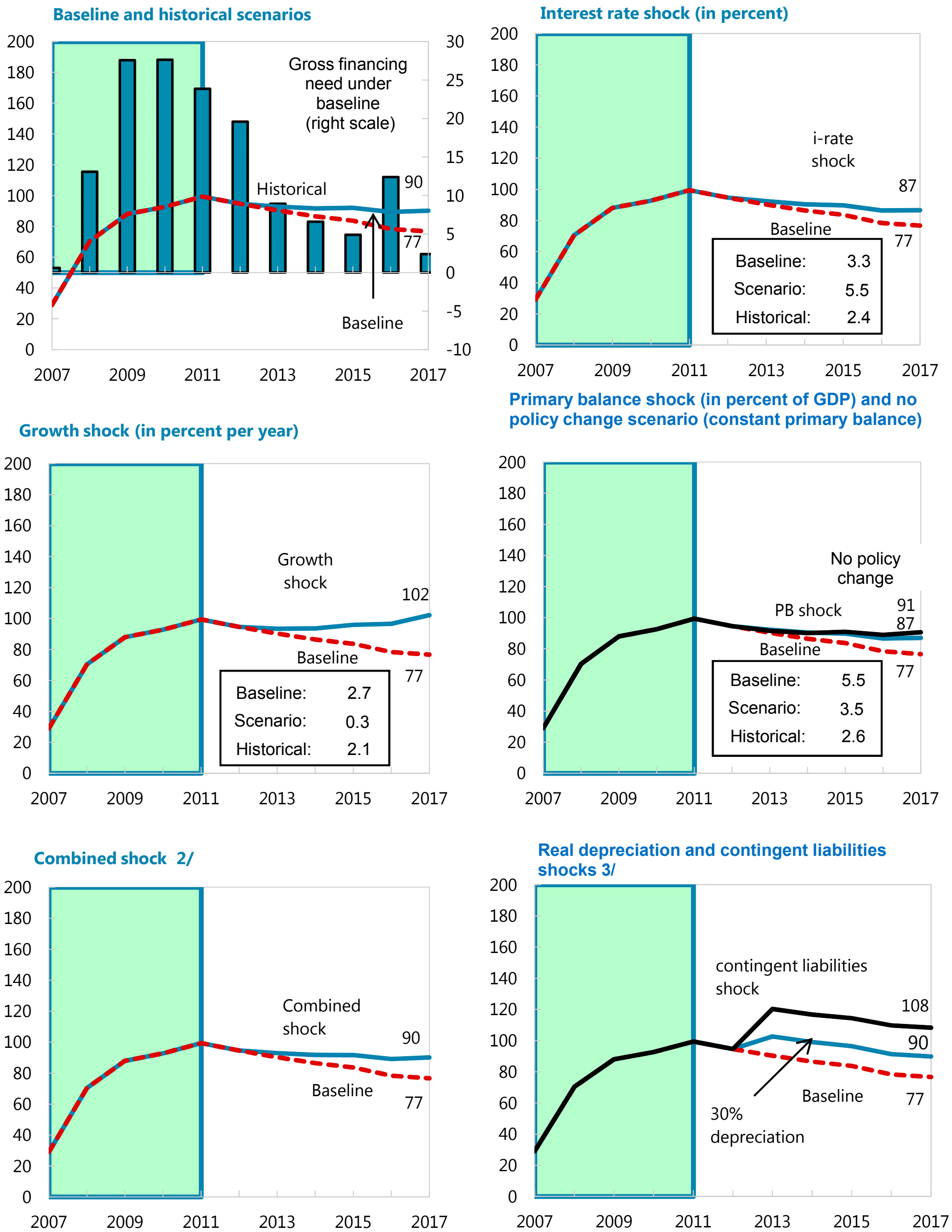
7/ For projections, this line includes exchange rate changes. In 2009-17, the residual also reflects use of deposits at the central bank and sale of financial assets obtained during the financial crisis.

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

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

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

Annex Figure 3. Iceland: Public Debt Sustainability under Current Projection 1/
(Public debt in percent of GDP)



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

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

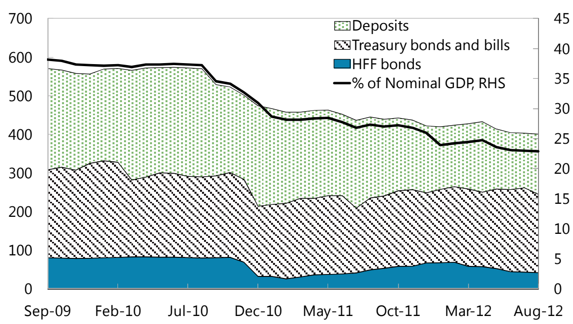
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent or 30 percent of GDP shock to contingent liabilities occur in 2013, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Annex II. Capital Account Liberalization: Strategy and Risks

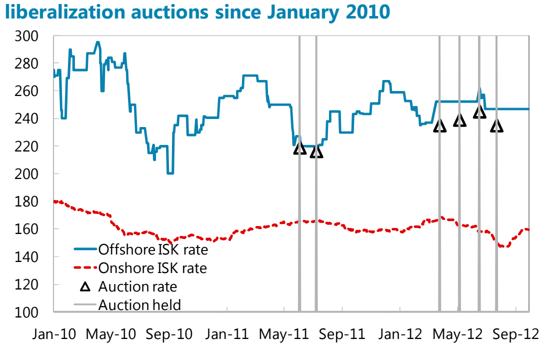
Iceland´s capital controls, introduced at the height of the 2008 crisis, played a key role in stabilizing the exchange rate and supporting the recovery. The challenge today is to remove the controls without depleting foreign exchange reserves or disrupting the foreign exchange market. Considerable progress has been made in meeting the macroeconomic conditions necessary to lift capital controls, including putting government finances on a sustainable trajectory, cleaning up financial sector balance sheets, and regaining access to international capital markets. However, liberalization is made more difficult by a large (23 percent of GDP) stock of liquid "offshore krona" trapped behind the capital control, a stock that will increase significantly when the estates of the failed old banks are wound up.

Holdings of Offshore Krona
(Billions of krona)



Sources: Central Bank of Iceland; and IMF staff calculations.

EUR/ISK domestic and offshore rate and capital control liberalization auctions since January 2010



Sources: Reuters; and Central Bank of Iceland.

A. Potential Balance of Payments Pressures

The principal risk associated with liberalization is large and disorderly outflows. Potential drains fall into three broad categories:

- ***Liquid offshore kronas (about 23 percent of GDP)***. These consist mainly of assets locked in when the capital controls were imposed. They are held as Treasury and Housing Fund bonds and bank deposits (see chart), and only modest progress has been made in terms of releasing them since the liberalization strategy was introduced in March 2011.

- ***The estates of old banks (about 30-40 percent of GDP, with part of them liquid)***. Legislation passed in March 2012 has subjected old banks' recovered assets to capital controls, eliminating the risk that krona payouts to creditors would trigger unpredictable balance of payments outflows (Box 1). Instead, these sums will be given the same treatment as liquid offshore kronas.

- ***Resident outflows***. The amount of resident outflows will depend in large degree on the credibility of the liberalization strategy, including its handling of the overhang. Since controls will have been in place for some time since the crisis when they are lifted, it is likely that there will be outflows related to portfolio rebalancing, particularly since some institutions have been induced to sell already underweighted non-krona assets.

Box 1. Offshore Krona and the Resolution of the Failed Banks

The failure of Iceland's three largest banks in October 2008 led to the creation of new ongoing banks and defunct estates engaged in asset recovery and winding-up procedures ("old banks").[1] The new banks were created out of deposits in Icelandic branches of the pre-collapse banks and most of their domestic assets. The assets in the estates under winding up are now being recovered. Priority claims have begun to be paid, and the rest are slated to go to composition later this year.

The domestic assets that will be used to compensate creditors comprise a number of financial instruments. In addition to cash, loans and securities, two of the old banks hold equity stakes in new banks amounting to around ISK 226 billion, while the third holds a compensation bond (issued by a new bank) that is currently valued at around ISK 304 billion (after the prepayment of ISK 73 billion in June 2012), to be paid between 2015 and 2018.

While winding up procedures will ensure that there is no imbalance between the total assets and liabilities of the three failed banks, there will be an imbalance, between their *foreign* assets (about ISK 1.9 trillion) and *foreign* liabilities (about ISK 2.4-2.6 trillion, with uncertainties on the exact share of foreign claims). This implies a net negative position of around ISK 0.5-0.7 trillion or 30-40 percent of GDP (see Figure A1).

The failed bank estates' net negative foreign position represents a large potential drain on the balance of payments. To mitigate the risks of large unpredictable outflows, the authorities amended the *Foreign Exchange Act* in March 2012, withdrawing an exemption from controls that was previously awarded to payments by the estates. Consequently krona released by the estates are now subject to capital controls so the central bank will be able to regulate the extent and timing of the associated balance of payments drain. Effectively, these sums will be added to the stock of offshore kronas, though not all of them are liquid and volatile.

1/ A detailed background to the failure and resolution process is presented in Appendix 1 of the Staff Report of the 2012 Iceland Article IV.

B. Risks During the Liberalization Process

A liberalization in which outflows lead to a weaker krona or pressure on reserves, could create stress in several sectors of the economy:

- ***Inflation***. Given the strength of pass-through in Iceland,[1] a depreciation of the krona would likely cause a rapid rise in prices, possibly triggering a wage-price-exchange rate spiral.

[1] Benes J., A. Chailloux, and N. Porter, 2012, "Strengthening the Monetary Policy Framework in Iceland," Chapter II in Iceland—Selected Issues, IMF Country Report No. 12/90, pp. 20-38.

- ***Households***. A weaker krona could lower real household incomes and add to the debt burden for those with CPI-indexed mortages (around 80 percent of all mortgages).

- ***Banks***. Liberalization could create funding pressures for domestic banks if portfolio rebalancing by krona holders resulted in substantial outflows from the banking sector. Inflation could also increase credit risks owing to a loss of competitiveness and, as mentioned above, increased debt burden for households.

- ***Government***. Possible outflows are likely to put pressure on government funding.

C. The Strategy for Lifting Controls—Progress to Date

To address the overhang of liquid offshore krona ahead of complete liberalization, the authorities' strategy, adopted in March 2011, has two phases. In phase one, exit channels are opened for offshore kronas in order to reduce or eliminate the overhang. In phase two, which can begin when the overhang has been sufficiently reduced, restrictions on capital account transactions are to be gradually eliminated. At present, implementation is in phase one.

Phase one has three main stages corresponding to different exit channels for offshore kronas: auctions of foreign exchange; swaps of short-term krona-denominated assets for long-term foreign currency-denominated assets; and an exit tax. The first stage (the only one initiated so far) consists of matched pairs of auctions: in one auction, residents and nonresidents wishing to make eligible long-term real or financial investments in Iceland sell euros to the central bank for kronas; in the other, owners of locked-in "offshore kronas" use these to buy euros from the central bank. Matching the quantities in a pair of auctions allows offshore kronas to exit with no immediate impact on foreign exchange reserves.

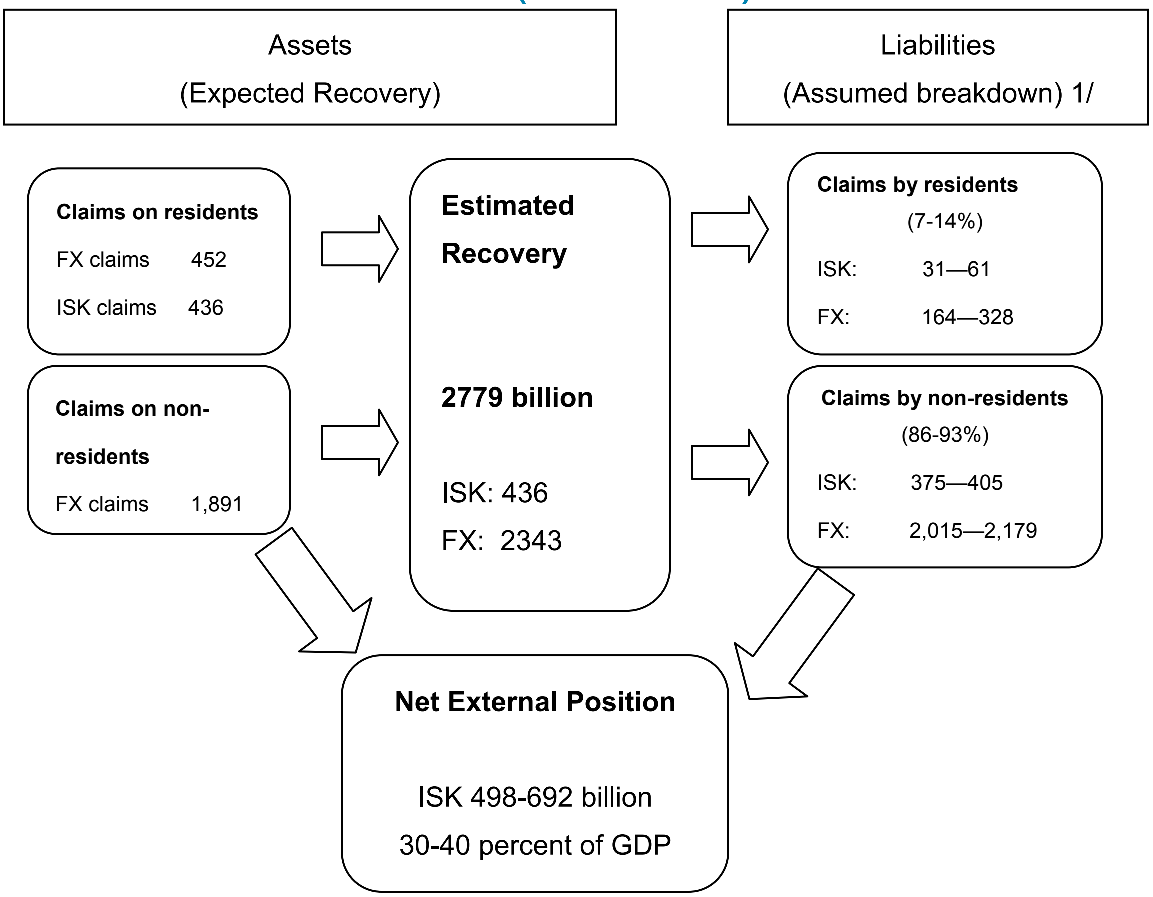
Ten paired auctions have been executed, with operational modalities evolving over time. The auctions have been modest in size—cumulating to 4.5 percent of GDP—and their effect on the overhang has been largely offset by coupon payments on Treasury and HFF bonds and, to a small extent so far, krona payments by old bank estates. Consequently, the stock of liquid offshore krona has not declined significantly since the auctions were initiated in March 2011 (see chart)[2].

There appear to be several reasons for the slow uptake. First, domestic investors were reluctant to offload already underweighted non-krona assets, especially at a time when prices on international equity markets were depressed. Second, on the other side of the market, leveraged players holding a large fraction of offshore krona have bid erratically, resulting in dispersed bid arrays and unpredictable price-discovery. Third, there has been limited interest to date in purchasing kronas for use in eligible investments. Finally, the interest in the auctions had likely been weakened by the

[2] The decline prior to the adoption of the strategy is mainly the result of a one-time transaction with the Central Bank of Luxembourg (the so called "Avens deal").

approaching expiration of the legislative authorization for capital controls, with offshore krona holders anticipating leaving with full value of their krona after a relatively short wait.

Annex Figure 1. Assets and Liabilities of the Old Bank Estates
(In billions of ISK)



1/ Uncertainties remain on the exact breakdown. The share of nonresident claims is estimated to be between 86 and 93 percent of total liabilities.
Source: Central Bank of Iceland

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

IMF Executive Board Concludes Second Post-Program Monitoring Discussion with Iceland

On November 12th, 2012 the Executive Board of the International Monetary Fund (IMF) concluded the Second Post-Program Monitoring Discussion with Iceland.[1]

Background

Iceland's recovery is taking root. The economy expanded by 2.6 percent in 2011 and 2.4 percent in the first half of 2012, on the back of robust domestic demand. Against the backdrop of a narrowing output gap, unemployment has declined to 6 percent in September, down from a peak of 9.2 percent in September 2010.

Capital account liberalization has proceeded slower than expected. Modest amounts of offshore krona have been released through the channels opened up by the authorities' liberalization strategy. But the stock of liquid offshore krona remains high at 23 percent of GDP and could rise significantly as the estates of "old banks" are wound up.

Fiscal consolidation is broadly on track, but implementation risks are high. While the proposed 2012 supplementary budget has an overall deficit about ½ percentage point of GDP higher than under the medium-term plan, the draft 2013 budget offsets part of the past slippages, making the 2014 target of a balanced overall position within reach. However, expenditure pressures remain high in the run-up to the elections, and key proposed revenue measures face political headwinds.

Inflation eased from 6.4 percent in March to 4.3 percent in September, but remains well above the central bank's target of 2½ percent. The central bank increased policy interest rates by a

[1] Post-Program Monitoring provides for more frequent consultations between the Fund and members whose arrangement has expired but that continue to have Fund credit outstanding, with a particular focus on policies that have a bearing on external viability. There is a presumption that members whose credit outstanding exceeds 200 percent of quota would engage in Post-Program Monitoring.

cumulative 100 basis points in the first half of 2012 and has since paused.

Banks are well capitalized, profitable, and liquid. Nevertheless, although progress has been made, significant legacy risks remain. In particular, banks remain reliant on locked-in deposits resulting from capital controls, nonperforming loan ratios have stabilized at still-high levels, and indexation imbalances have increased.

In June, Iceland confirmed its renewed access to capital markets by successfully placing a one billion USD-denominated 10-year bond. The proceeds from this issuance, together with some reserves, were used to prepay most of Iceland's 2013 and 2014 obligations to the IMF, as well as to their Nordic partners. Reserves remain at comfortable levels, with the ratio of gross reserves to short-term debt projected to remain well above 100 percent over the medium term.

The outlook is for a continued moderate economic expansion, declining inflation, and a strengthening external position. However, downside risks prevail, including from a lifting of capital controls before conditions are right and a potential intensification of the euro area crisis.

Executive Board Assessment

Directors welcomed the ongoing recovery and renewed access to capital markets, and the prospect for continued expansion, declining inflation and debt, and a strengthening external position, which has enabled prepayment of Iceland's nearer-term obligations to the IMF and Nordic partners. However, they noted that downside risks are high due to both external and domestic vulnerabilities, and underscored the importance of continued strong policy implementation to mitigate these risks and to promote external viability and sustainable growth.

Directors cautioned against premature and disorderly capital account liberalization, and concurred that it should continue to be conditions-based. However, they noted the limited progress in reducing the large stock of liquid offshore krona—a pre-condition for lifting the controls. They urged the authorities to strengthen incentives for locked-in offshore krona holders to participate in the capital account liberalization strategy, including by amending legislation so as to remove the terminal date for the controls and by making it clear that the conditions under which liquid offshore kronas are allowed to exit will become less favorable over time.

Directors commended the progress made in fiscal consolidation, noting that it is broadly on track. However, they observed that implementation risks are rising in the run-up to the elections and revenue measures are facing political headwinds. Directors urged the authorities to mitigate risks by preparing contingency plans. Directors also welcomed the government's plans to strengthen the fiscal framework through the organic budget law, and encouraged early passage of the law.

While welcoming the recent monetary tightening bias, Directors viewed the policy stance as still accommodative. They agreed that further monetary tightening is needed to bring inflation back to target and to normalize monetary conditions in advance of capital account liberalization. However, the pace of tightening should be tailored to the pace of the economic recovery, and the monetary transmission mechanism needs to be improved.

Directors encouraged the authorities to address remaining vulnerabilities in the financial sector, even as banks' balance sheets have strengthened. They noted banks' dependence on locked-in deposits, high deposit and credit concentration, asset-liability mismatches, and the deteriorating financial position of the Housing Finance Fund. To manage these risks, they underscored the importance of strengthening financial supervision and maintaining large equity buffers determined through periodic supervisory reviews.

Iceland: Selected Economic Indicators, 2006–13

	2006	2007	2008	2009	2010	2011	2012 Proj.	2013 Proj.
	(Percentage change, unless otherwise indicated)							
National Accounts (constant prices)								
Gross domestic product	4.7	6.0	1.2	-6.6	-4.0	2.6	2.6	2.3
Total domestic demand	9.1	0.0	-8.6	-20.3	-2.2	3.0	3.2	2.4
Private consumption	3.6	5.7	-7.8	-15.0	0.0	2.7	3.4	3.3
Public consumption	4.0	4.1	4.6	-1.7	-3.4	-0.9	0.0	-0.2
Gross fixed investment	24.4	-12.2	-20.4	-51.4	-8.6	12.8	8.4	3.0
Export of goods and services	-4.6	17.7	7.0	7.0	0.6	4.1	4.9	4.0
Imports of goods and services	11.3	-1.5	-18.4	-24.0	4.5	6.8	5.9	4.3
Output gap 1/	2.0	3.7	2.3	-2.0	-4.8	-2.3	-0.4	0.4
Selected Indicators								
Nominal GDP (bln ISK)	1,168.6	1,308.5	1,480.3	1,497.6	1,536.5	1,626.3	1,731.4	1,855.1
Unemployment rate 2/	1.3	1.0	1.6	8.0	8.1	7.4	6.1	5.7
Consumer price index	6.8	5.0	12.4	12.0	5.4	4.0	5.4	4.5
Nominal wage index	9.1	9.3	4.3	2.0	2.6	6.1	7.5	5.9
Nominal effective exchange rate 3/	-11.8	2.5	-40.4	-34.2	2.9	-0.1	…	…
Real effective exchange rate 3/	-7.1	6.0	-20.7	-18.7	6.4	0.9	0.5	0.7
Terms of trade	3.4	0.2	-9.3	-6.7	6.0	-1.8	-1.8	1.7
Money and Credit								
Base Money	27.9	190.7	-31.5	1.3	-19.4	-20.7	14.1	…
Deposit money bank credit (end-period)	44.4	56.6	-28.3	-17.8	-3.5	0.9	0.0	…
of which to residents (end-period)	33.6	28.3	…	…	…	…	…	…
Broad money (end-period)	19.6	56.4	36.3	1.2	-9.9	7.1	-4.9	…
CBI policy rate (period average) 4/	14.1	13.8	15.4	13.7	7.8	4.4	…	…
	(Percent of GDP, unless otherwise indicated)							
Public Finance								
General government 5/								
Revenue	48.0	47.7	44.1	41.0	41.5	41.9	42.6	42.7
Expenditure	41.6	42.3	44.7	49.6	47.9	46.7	45.3	43.9
Balance	6.3	5.4	-0.5	-8.6	-6.4	-4.8	-2.7	-1.2
Primary balance	6.7	5.7	-0.5	-6.5	-2.7	-0.8	1.2	2.6
Balance of Payments								
Current account balance	-25.6	-15.7	-28.4	-11.6	-8.4	-6.3	-2.4	-0.3
Trade balance	-17.5	-10.1	-2.3	8.6	10.1	8.6	7.1	7.9
Financial and capital account	43.3	18.1	-66.9	-30.7	48.1	14.7	-1.3	-3.5
Net errors and omissions	-11.0	-1.0	-19.5	36.2	-31.2	-1.1	0.0	0.0
Gross external debt 6/	433.5	605.9	564.7	267.5	290.7	251.6	223.6	208.1
Central bank reserves (US$ billion)	2.3	2.6	3.6	3.5	5.6	8.7	6.2	5.7

Sources: Statistics Iceland; Central Bank of Iceland; Ministry of Finance; and IMF staff estimates.
1/ Staff estimates. Actual minus potential output, in percent of potential output.
2/ In percent of labor force.
3/ A positive (negative) sign indicates an appreciation (depreciation).
4/ Data prior to 2007 refers to annual rate of return. 2007 and on, refers to nominal interest rate.
5/ National accounts basis.
6/ Including face value of old banks debt before 2009. Related interest transactions are not included from Q4 2008 on.

Statement by Benny Andersen, Executive Director for Iceland
and Lilja Alfredsdottir, Advisor to Executive Director
November 12, 2012

The Icelandic authorities wish to thank staff for constructive and informative discussions during the visit in September. Significant progress has been made since the 2008 crisis, and the prospects for the economy continue to improve. Nevertheless, the authorities are fully aware that risks are tilted to the downside, and they acknowledge challenges, especially due to the uncertain external environment. Our authorities broadly agree with the staff assessment and most of the recommendations.

Economic Prospects

Statistics Iceland recently published its new economic forecast, which is generally in line with previous forecasts. GDP is projected to grow by 2.7 percent in 2012 and 2.5 percent in 2013. The balance on goods and services trade will be positive while the headline current account balance will continue to be negative in 2012 and 2013. Terms of trade could deteriorate in 2013.

Exports are expected to grow by 5 percent in 2012, but slightly less growth is projected for 2013. Marine export volumes are expected to increase by up to 9 percent this year over 2011, although 3 percent deterioration is estimated for 2013. However, export performance remains subject to conditions in Iceland's main trading partner countries.

The labor market is improving, and the unemployment rate is projected to continue on a downward path from the projected 5.7 percent in 2012. However, some emigration to the common labor market in the Nordic countries is continuing, as the real wage differential remains significant. To prevent such "backwash" effects from faster-growing regions, it is essential to create more highly paid jobs in a wide spectrum of industries. The authorities have presented a medium-term strategy that aims to stimulate investment in a number of industries as well as providing an attractive environment for FDI.

Public Finances

The 2013 budget continues to follow the medium-term path set out in the last review of the IMF program. Fiscal consolidation will continue until a surplus is achieved that places public debt on a downward slope. A positive overall balance is targeted in 2014, as is a primary surplus of 5 percent of GDP in 2016. While overall budget consolidation over this term has been considerable by any standard, a primary objective has been to protect the most vulnerable groups in society.

In the proposed supplementary budget for 2012, the Treasury balance will improve by about 4 percent of GDP, from -5.5 percent of GDP in 2011 to about -1.5 percent in 2012, slightly below the 4.3 point improvement written into the 2012 budget. Judging from two 2012 quarters of data available from municipalities, their overall balance could improve by as much as ½ percent of GDP, with a similar improvement in their primary balance. Accordingly the general government balance could improve somewhat more than in staff projections.
The 2013 budget proposal will offset at least half of the slight 2012 slippages. A Treasury primary surplus of 3.2 percent in 2013 is within reach. Even though 2013 is an election year, our authorities remain determined do their utmost to ensure that the medium-term fiscal plan is adhered to. If the Housing Financing Fund (HFF) requires more capital or other

implementation problems emerge, the authorities stand prepared to respond appropriately. We believe that there is a profound understanding in society of the absolute necessity to deliver on the fiscal side, as abolition of capital controls and future economic progress are predicated on sound fiscal policies.

Monetary Policy

The stance of monetary policy has been tightened significantly in the recent period. The nominal policy rate was increased by a total of 0.75 percentage points in May and June. These hikes along with falling inflation have swung the real policy rate during a short period from being significantly negative to being positive. At the same time inflation has fallen to 4.2 percent in October and signs have indicated that the economic recovery is somewhat weaker than expected, although continuing. However, the recent weakening of the exchange rate will probably deteriorate inflation prospects in coming months. Staff recommends further monetary tightening in the near term. The authorities agree that the real stance of monetary policy will have to be tightened further in the coming period, provided that the recovery stays on course. However, the speed of that tightening is an open question to be assessed in each meeting of the Monetary Policy Committee (MPC). Furthermore, the degree to which real tightening will require nominal tightening will depend on inflation prospects, with recent developments and the weakening of the exchange making an increase in the nominal policy rate more likely in the near term. Balancing these considerations the MPC decided to keep interest rates unchanged at its October meeting, citing indications of weaker growth in domestic demand, slow recovery in the labor market, and lower projected inflation. The MPC will announce its next decision on November 14th along with the release of a new economic forecast.

The Financial Sector

While the Icelandic banks are solid by most measures, we agree with staff that significant risks remain in the financial sector. As regards banks' reliance on captive deposits and deposit and credit concentration, this risk should be reduced as we move further from the crisis, capital control liberalization progresses, and the equity market recovers. The contingent Landsbanki bond remains a bump in the road, but negotiations for its extension are well underway. Recent Supreme Court rulings on exchange rate-linked loans have diminished the potential negative shock to the banks by a considerable amount (ISK 40 bn.). The Housing Financing Fund (HFF) probably represents the greatest uncertainty. The results of a capital adequacy assessment are awaited, but in the present legal environment it will only be indicative for the HFF, as neither the authorities nor the FME has the statutory authority to require that the HFF maintain minimum capital adequacy. The authorities stand ready to review the structure of the HFF, including meeting the necessary capital requirements or other implementation problems. Work has recently been commissioned on a draft bill of law on mortgage credit pertaining to residential housing which – if approved – will strengthen prudential requirements made to service providers in this market and create a level playing-field for all service providers of residential mortgage credit.

Capital Controls

The capital liberalization strategy is being implemented broadly as planned. The currency auctions held so far have by no means been unsuccessful. The participation in the actions has been mainly restricted by the volume of new investment opportunities. It should be stressed, however, that the purpose of this first step in Phase I of the strategy was to unwind the most unstable part of the foreign króna (ISK) holdings and to facilitate investment. In the coming year the Central Bank (CB) and relevant authorities will aim to clarify the sunset character of the auctions, including the conditions under which liquid krónur (ISK) will be allowed to exit once the auctions process draws to a close. This includes the terms of bond swaps and the exit tax. Further measures will also have to be taken to ensure the orderly unwinding of the estate of the old banks, which were brought under the auspices of the capital controls legislation in March this year. They entail significant net liability of the Icelandic economy which in the absence of an orderly process could lead to destabilizing outflows. Before controls are abolished certain prudential rules need also to be in place, as explained in a recent CB report. The authorities agree that it will most probably be too risky to abolish the controls in 2013. However, they think it is premature to decide now on a new time limit and continue to stress the conditions based aspect of the strategy, which can in principle work in both directions.

Finally, as always has been the case, the Icelandic authorities will consent to the publication of this paper on the second post-program monitoring discussions.