August 2011
IMF Country Report No. 11/263

Iceland: Sixth Review Under the SBA and Proposal for Post-Program Monitoring—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Iceland.

In the context of the Iceland: sixth review under the stand-by arrangement and proposal for post-program monitoring, the following documents have been released and are included in this package:

- The staff report for the Iceland: Sixth Review Under the SBA and Proposal for Post-Program Monitoring, prepared by a staff team of the IMF, following discussions that ended on June 30, 2011, 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 August 16, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff statement of August 22, 2011 updating information on recent developments.

- A Press Release summarizing the views of the Executive Board as expressed during its August 26, 2011 discussion of the staff report that completed the request and/or review.

- A statement by the Executive Director for Iceland.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Iceland*
Technical Memorandum of Understanding*

*Also included in Staff Report

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

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INTERNATIONAL MONETARY FUND

ICELAND

Sixth Review Under the Stand-By Arrangement and Proposal for Post-Program Monitoring

Prepared by the European Department in Consultation with Other Departments

Approved by Poul M. Thomsen and James Roaf

August 16, 2011

- **Stand-By Arrangement:** A SBA in an amount equivalent to SDR 1.4 billion ($2.2 billion, 1190 percent of quota) was approved by the Executive Board on November 19, 2008 (Country Report No. 08/362). A first purchase of SDR 560 million was made following the Board meeting. Second, third, fourth, fifth, and sixth purchases, totaling SDR 560 million, were made following completion of the first, second, third, fourth, and fifth reviews. The seventh and final purchase, equivalent to SDR 280 million, would become available upon completion of the sixth review. The Arrangement expires on August 31, 2011.

- **Status**. The program is on track, and all end-June performance criteria were met.

- **Summary**. Iceland's Fund-supported program has been a success, and program objectives have been met. The economic recovery is tentative. Moderate growth is expected in 2011, but unemployment remains high and inflation is rising on the back of high commodity prices. Program discussions focused on the revised medium-term fiscal consolidation path. The authorities and staff agreed that there was scope to ease the pace of consolidation over the medium term, given the strong fiscal adjustment undertaken to date and the favorable public debt dynamics. The fiscal target for 2011 was also modestly eased. These modifications use up the existing scope for fiscal easing and it will be critical that the revised plan is adhered to. On monetary policy, there has been an appropriate shift to a tightening bias reflecting inflation risks, the fall in real interest rates, and the need to gradually normalize the risk-adjusted policy rate as capital controls are lifted. The initial steps of the capital account liberalization strategy are being implemented as planned. On private sector debt, the pace of restructuring finally appears to be accelerating, but efforts must continue until the process is brought to a close. Recapitalization of Iceland's core banking system has been completed. Work on reducing remaining vulnerabilities and strengthening prudential regulations and supervision is ongoing, and efforts should be sustained. Financing assurances are in place, and Iceland's Nordic partners and Poland have extended their lending facilities until end-2011.

- **Discussions.** See Fund Relations Appendix.

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Attachments

Appendix

I. CONTEXT

1. **The program has delivered its main objectives**.

- The exchange rate has stabilized. After a sharp depreciation at the onset of the crisis, the krona settled at a competitive level, boosting net exports and avoiding a further deterioration in private and public sector balance sheets which would have had a severe adverse impact on domestic demand. Capital controls played a vital role in preventing exchange rate overshooting, and the orderly current account adjustment and incipient return of confidence has enabled the authorities to begin liberalizing the controls.

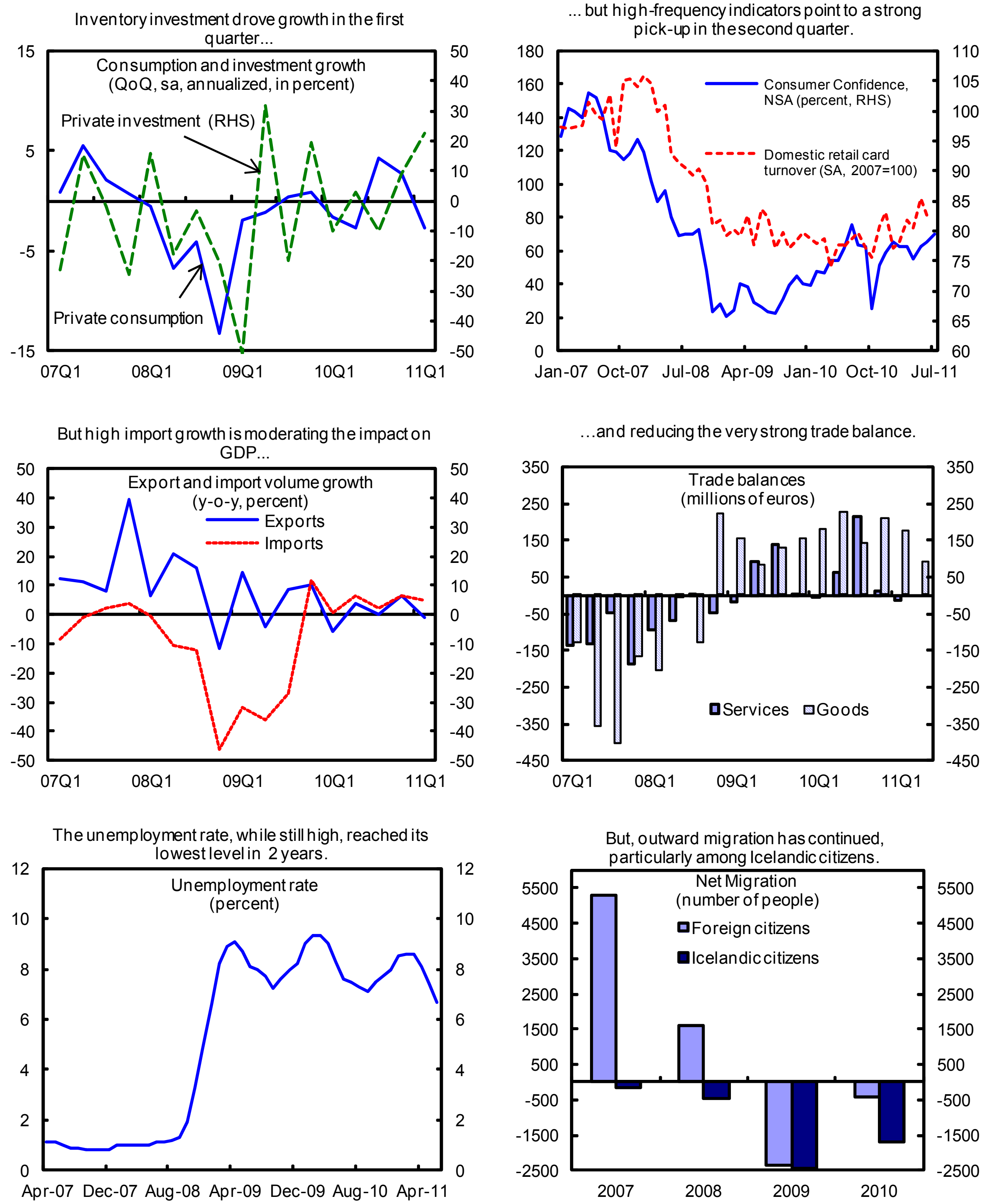
- Significant progress has been made in putting public finances on a sustainable path. The authorities have taken 10 percent of GDP in revenue and expenditure measures, corresponding to a primary balance improvement of 6 percent between 2009 and 2011. This very impressive consolidation program—undertaken in the midst of the deepest recession in Iceland's modern history—has placed the public debt ratio on a declining path and made the authorities' goal of a public debt ratio of 60 percent of GDP over the longer-term achievable.

- A new and significantly smaller banking system has emerged from the crisis, with substantial private sector involvement. The banking system now holds assets of about 200 percent of GDP (one-fifth the size of the system pre-crisis) and is comprised of 14 institutions (23 before the crisis). This downsizing was largely achieved by transferring domestic assets and deposits to new institutions and imposing losses on general unsecured creditors. Work to address legacy vulnerabilities in the financial system (including the high level of nonperforming loans, loan and deposit concentration, and financial imbalances) is progressing. In particular, household and corporate debt restructuring is finally advancing and will help restore bank and private sector balance sheets.

II. RECENT ECONOMIC DEVELOPMENTS

2. **A tentative economic recovery is underway** (Table 1; Figure 1). The economy returned to modest growth in the first quarter of 2011, mainly on account of an increase in inventories of marine products, which will be released as exports over the course of the year. High frequency indicators suggest a strong pickup in the second quarter. Consumption is supported by higher wages, social benefits, and a temporary interest rate subsidy; and investment is being boosted both by projects in the power-intensive sectors and a broad-based pickup in other sectors. However, the positive impact on GDP growth is being moderated by rapid import growth (driven mainly by higher domestic demand). The unemployment rate dropped to 6.7 percent in June from 7.6 percent in the same period last year (and from 7.4 percent in May).

Figure 1. Iceland: Recent Developments in Demand and Labor



Sources: Statistics Iceland; Bloomberg; and IMF staff calculations.

3. **Inflation is rising** (Figure 2). Krona depreciation, higher commodity prices, and hikes in administered prices led to a substantial pickup in the CPI earlier in the year. Although the nominal effective exchange rate has since stabilized, delayed exchange rate pass-through (firms tend to adjust prices with a lag) combined with the effect of wage increases—both direct and through higher expectations—led to a further build up of inflation pressures. In early July, headline inflation approached 5 percent, and measures of core inflation also went up, continuing the trend in the last four months. Survey-based household inflation expectations and the breakeven inflation rate also increased.

4. **Access to international capital markets has been regained and domestic markets have remained broadly stable** (Table 2; Figure 3). The government successfully issued its first post-crisis international sovereign bond in early June—a 5-year, $1 billion, US-dollar denominated bond at a fixed interest rate of just under 5 percent (320 bps over mid-swaps). After a temporary hike, Iceland's CDS spreads have come down to around 260 bps and remain largely unaffected by developments in peripheral Europe. Domestic markets have remained stable. Short-term interest rates have been steady, with no discernable impact from the initial steps in lifting capital controls (offshore krona holdings are concentrated in short-term instruments). The long end of the nominal yield curve appears to have reacted strongly to rising inflation, but real yields have remained low, supported by continued inflows from pension funds and foreign investors locked in by capital controls. Equity prices have picked up, but activity remains restricted to a handful of listed companies.

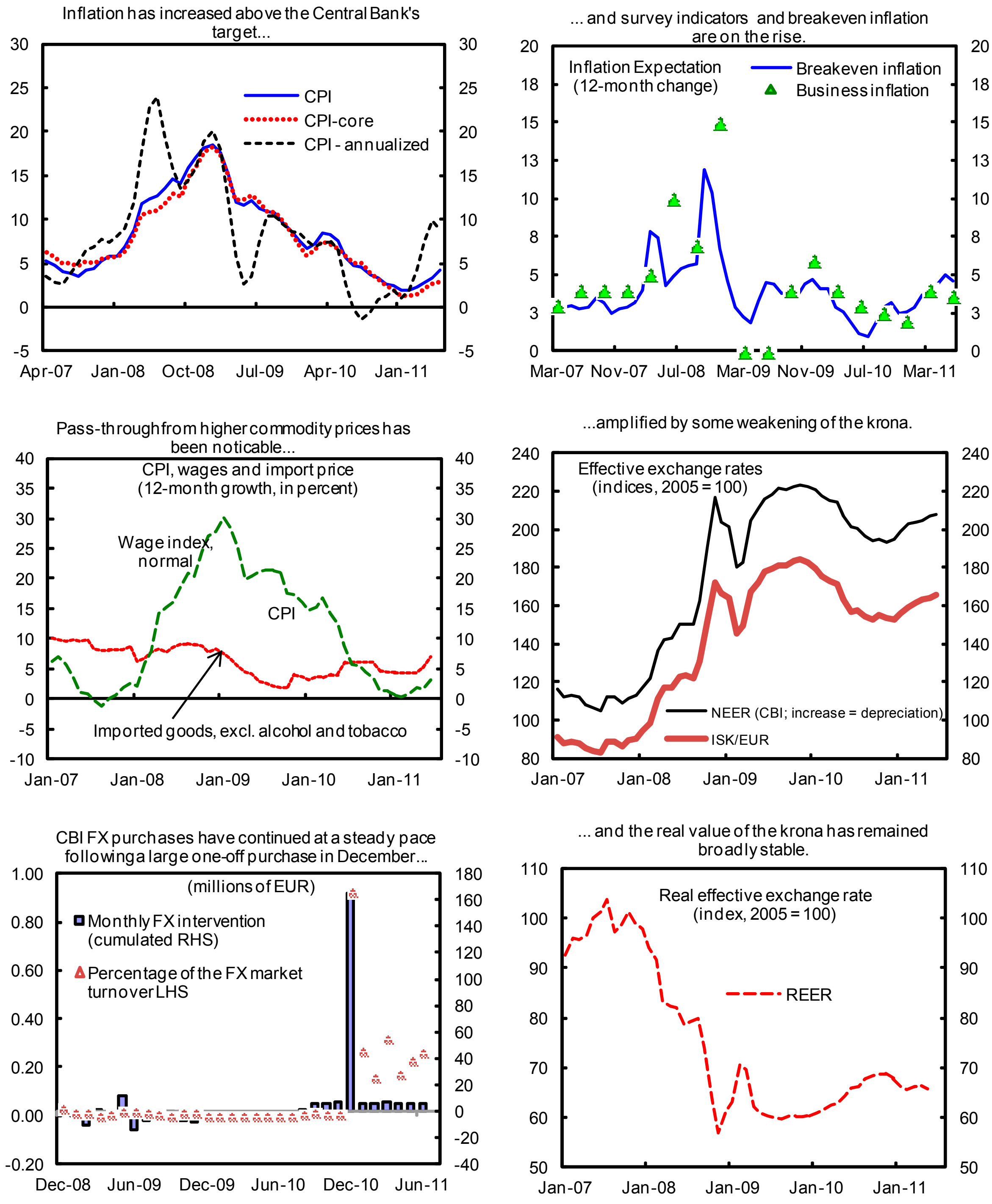
III. OUTLOOK

5. **The outlook is for a moderate expansion, but concerns persist about the sources of medium-term growth** (Table 3).

- For 2011, domestic demand is projected to be stronger than previously projected, as delays in investment projects are expected to be more than offset by robust private consumption. Despite increases in fishing quotas and a strong tourist season, net exports are expected to be weaker on account of brisk import growth.

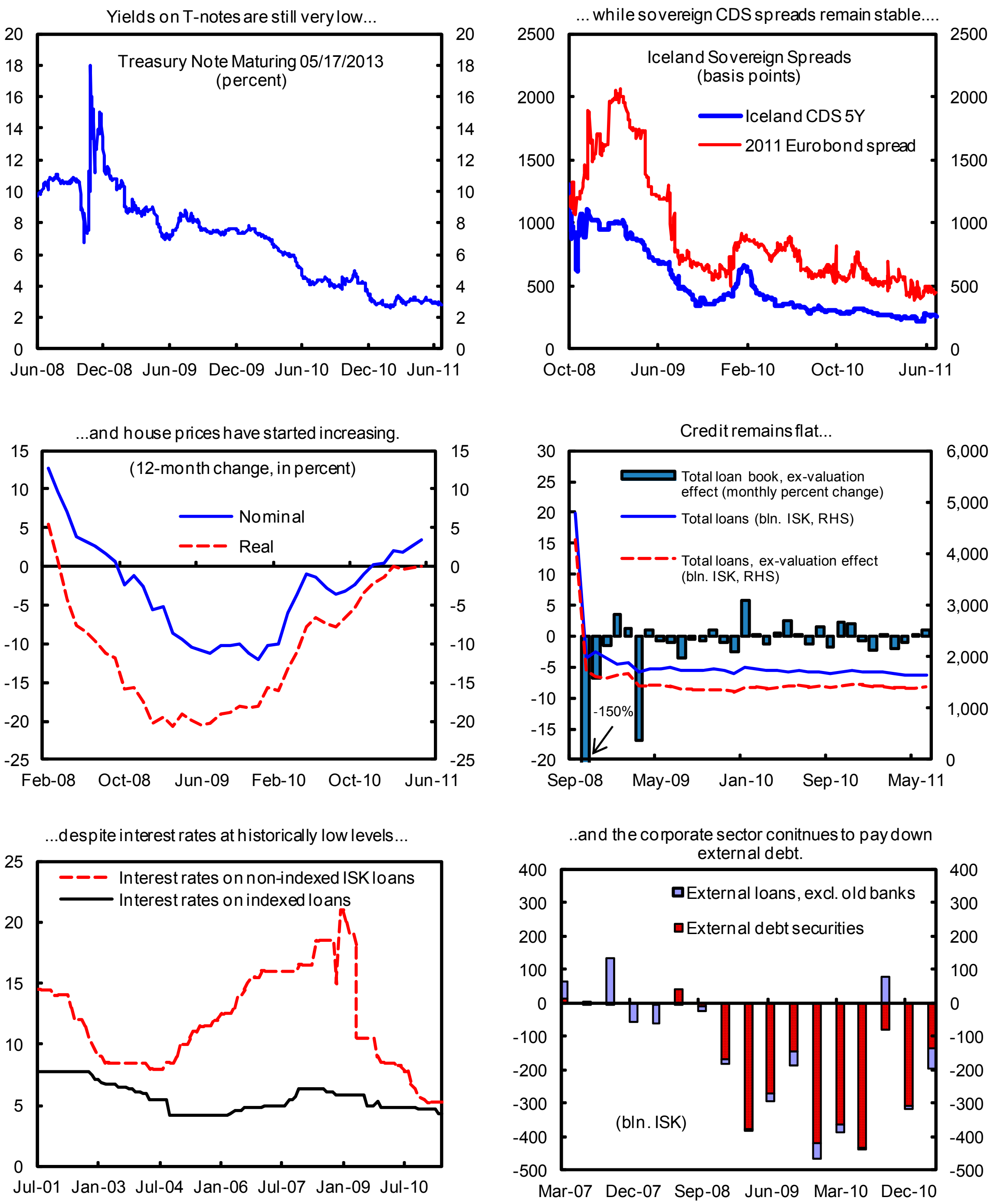
- Over the medium term, moderate growth is projected, led by investment and consumption. However, uncertainty about the sources of growth continues to weigh on prospects. Iceland is endowed with abundant natural resources, but the use of these resources remains an issue of intense public discussion. There has been considerable interest in new investments in power-intensive sectors, but technical and financial obstacles remain a challenge. Lack of clarity on the government's strategy for investment has also increased uncertainty and dampened business confidence. Moreover, the underlying strength of private consumption is clouded due to still high unemployment, the need to rebuild household balance sheets, the temporary nature of the stimulus from household interest subsidies, and rising inflation eroding nominal

Figure 2. Iceland: Price and Exchange Rate Developments



Sources: Central Bank of Iceland; and IMF's International Financial Statistics.

Figure 3. Iceland: Financial and Credit Market Developments



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

wage increases. Risks to the net exports projections stem from uncertainty about the prospects for investment (necessary to overcome supply constraints on the export side), a possibility of excess real exchange rate appreciation on the back of higher inflation, and shocks to external demand and commodity prices. The increased volcanic activity has had a limited impact on growth so far, but also remains a risk.

6. **Inflation is projected to remain above the central bank target until early 2013**. The recent economy-wide wage agreements should help secure stability in the labor market for three years, but have increased near-term inflation pressures in the non-tradable sector. While considerable slack in the economy should limit these pressures, risks are on the upside: the pass-through from wages may be even stronger than projected; and the wage agreement could break down if "opt out" clauses are triggered, possibly leading to higher wage increases going forward.

7. **The balance of payments outlook is largely unchanged from the last review** (Table 4). In line with staff's previous projection, strong current account surpluses, the resumption of access to international capital markets, asset recovery by the old banks, and assumed program and bilateral disbursements are expected to increase reserves in 2011. Accelerated creditor payouts by two of the old banks have made the projected decline in reserves more frontloaded than before, but the expected medium-term reserve coverage is much the same. Two of the old banks are expected to enter composition in 2012, a process that will result in a conversion of external debt liabilities into external equity liabilities as foreign creditors become owners of the banks. The gradual lifting of capital controls and sovereign repayments will continue to drain reserves in the medium term, but the related decline in outstanding short-term debt will keep the reserves-to-short-term-debt ratio above 90 percent. As discussed extensively in past reports, risks to the balance of payments mainly arise from capital account liberalization. At the same time, the current account could worsen more rapidly than projected if import growth continues to be very strong, the export recovery turns out to be short-lived, or the favorable terms-of-trade deteriorate.

8. **Public and external debt ratios are still expected to decline rapidly over the medium term** (Text Table). Gross external debt is projected to reach about 250 percent of GDP at end-2011, with changes relative to the last review reflecting a faster recovery of assets by old banks, an upward revision of short-term external debt, and a revised amortization schedule. In addition, the assumption that two of the old banks enter composition results in a step down in debt in 2012 (see Appendix I). Nonetheless, debt repayments and the release of captive non-resident krona are projected to reduce debt to around 150 percent of GDP by 2016. Gross general government debt is still projected to peak at around 100 percent of GDP in 2011 and decline over the medium term, but the slower fiscal consolidation will reduce the speed of debt reduction. It is now expected to decline to around 80 percent by 2016.

Iceland: Public and External Debt Indictors
(In percent of GDP)

	2010	2011	2016
	Est.	Proj.	Proj.
General Government Debt			
Gross Debt	92.4	100.0	81.1
of which			
Bilateral loans	7.4	14.0	7.2
Bank restructuring debt 1/	16.2	17.4	13.2
Local government debt	8.9	9.1	6.4
Other government bonds	59.9	59.6	54.3
Liquid Assets 2/	29.8	33.5	28.7
Net Debt	62.6	66.5	52.4
External Debt			
Gross Debt	279.0	251.5	147.4
of which			
Public	53.2	66.5	31.7
CBI	19.3	23.3	3.2
General Government	34.0	43.2	28.5
Private	164.7	147.4	113.1
Banks (excluding old Banks)	14.0	3.3	0.9
Other	150.7	144.1	112.2
Old Banks	61.0	37.6	2.6
Net Debt 3/	147.1	141.0	64.1
Memorandum Item			
Short-term Debt at Remaining Maturity	84.4	69.0	12.5

1/ Includes recapitalization of HFF and savings banks, and called guarantees transferred from the Government Guarantee Fund.
2/ Includes government deposits at the CBI, other deposits, and claims on CBI from onlent exchange loans.
3/ Excludes estimated foreign debt security, loan, and currency and deposit assets.

Sources: MoF, CBI and IMF staff estimates.

IV. POLICY DISCUSSIONS

9. **Discussions focused on achievements under the program and the way forward**. The authorities and staff agreed that the program has been successful: program objectives have been met and the economy is gradually recovering. This success was made possible by the authorities' strong policy implementation. Significant progress has been made with fiscal consolidation; the framework for household and corporate debt restructuring has been strengthened and the pace of restructuring is finally picking up; the initial steps of the strategy for lifting capital controls are being implemented as planned; and the banking system has been recapitalized. Nonetheless, the economic recovery remains fragile. Against this background, the authorities' strong track record and significant achievements on fiscal consolidation have created scope to strike a better balance between supporting the recovery and fiscal adjustment. It was therefore agreed that the pace of medium-term fiscal consolidation could be eased but that a primary surplus target of 5 percent of GDP in the

medium term was warranted to ensure a robust decline in the public debt ratio. In other areas, the authorities and staff agreed that it would be critical to continue to implement existing policies and to press ahead with needed reforms, notably in the financial sector.

A. Fiscal Policy

10. **Significant fiscal consolidation has taken place to date, while preserving social objectives**. After a period at the outset of the crises when fiscal adjustment was delayed to let automatic stabilizers operate, the authorities introduced adjustment measures and developed a medium term fiscal consolidation plan. This plan has been implemented, and fiscal consolidation measures have reached nearly 10 percent of GDP in 2009–11. Adjustment took the form of a mix of revenue and expenditure measures, and a primary adjustment of 6 percent of GDP has been achieved in just two years (the primary structural adjustment is of a similar magnitude). Public administration has been restructured and scaled down, cost-reducing reforms in the health and education sectors are underway, and rate increases for all major taxes have supported revenues throughout the downturn. Meanwhile, social benefits have been safeguarded in line with the authorities' objective of preserving the core elements of the Icelandic welfare state.

11. **Fiscal risks associated with financial sector restructuring have been contained** (Text Table)**.** With recapitalization of the banking system essentially complete, fiscal risks have tapered off. While the initial estimates of commercial and central bank gross recapitalization costs (made at the outset of the program in 2008) materialized fully, the net fiscal costs are significantly lower (15 percent of GDP compared with 36 percent of GDP estimated at end-2008). Fiscal costs related to the recapitalization of the HFF and the savings banks, which the government incurred in 2010–11, have also remained below initial estimates.

12. **It was agreed that there was scope to ease the pace of fiscal adjustment in 2011 and over the medium term**. The credibility that the authorities have built up by the adjustment already achieved and the containment of fiscal risks had created this scope. At the same time, it was recognized that even a more moderate pace of adjustment would require a concerted effort, given the upcoming election cycle and the difficulties in undertaking further fiscal consolidation after such a large adjustment has already taken place.

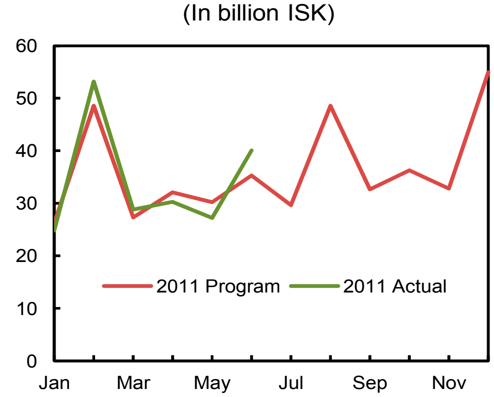
Iceland: Fiscal Costs of Bank Support and Restructuring
(In percent of GDP)

	2008	2009	2010	2011	Total
Write offs 1/	12.9	2.3	3.9	1.3	20.3
Securities lending 2/	6.2	0.0	0.0	0.0	6.2
Central Bank recapitalization	6.7	0.0	0.0	0.0	6.7
Commercial bank recapitalization 3/	0.0	2.3	0.0	0.0	2.3
Recapitalization of the House Financing Fund 4/	0.0	0.0	2.1	0.0	2.1
"Savings Banks" 4/	0.0	0.0	0.0	1.3	1.3
Called guarantees of the State Guarantee Fund 5/	0.0	0.0	1.8	0.0	1.8
Public debt incurred with acquisition of assets	11.4	12.4	0.0	0.0	23.8
Central bank recapitalization	11.4	0.0	0.0	0.0	11.4
Commercial bank recapitalization	0.0	12.4	0.0	0.0	12.4
Gross fiscal cost of bank support and restructuring	24.2	14.7	3.9	1.3	44.1
Net fiscal cost of bank support and restructuring	12.9	2.3	3.9	1.3	20.3

1/ Capital transfers excluding the Icesave-related contingent liability of the government.
2/ Securities lending contracts that failed after the bank collapse.
3/ Retroactive interest paid to recapitalized banks to compensate for recapitalization delays.
4/ For 2011, the figures represent staff's estimate of possible recapitalization costs.
5/ A government guaranteed bonded liability of the Agricultural Fund, which was taken over by one of the old banks prior to the crisis during the privatization of the Fund in 2005-06. The guarantee was called upon the failure of the bank during the crisis.
Sources: Mof; and IMF staff estimates.

13. **For 2011, the authorities and staff agreed to modestly reduce the fiscal target to support the economic recovery** (Tables 5, 6, and 7; LOI ¶5). While the first half of the year shows strong fiscal performance, with robust revenues from major taxes and spending below projections, expenditures are expected to rise sharply in the second half of the year (Figure). The outcome of the wage agreements proved costlier than anticipated (by ¼ percent of GDP), notably on account of the authorities' decision to raise social benefits by more than initially expected. In addition, a more depreciated exchange rate, as well as costs related to the recent volcanic eruption and glacial flooding, reduced the resources available in the contingency fund to finance the wage agreement costs. The authorities and staff therefore agreed to slightly ease the general government primary balance target by ½ percentage point of GDP. Staff cautioned against further expenditure overruns and stressed the need to secure revenues for the financing of the temporary interest subsidy (the latter is expected to be partly financed with proceeds from the capital account liberalization auctions). The authorities underscored their commitment to the revised target, and noted that any excess revenue would be saved. Staff welcomed this commitment, and emphasized that additional measures should be taken, as

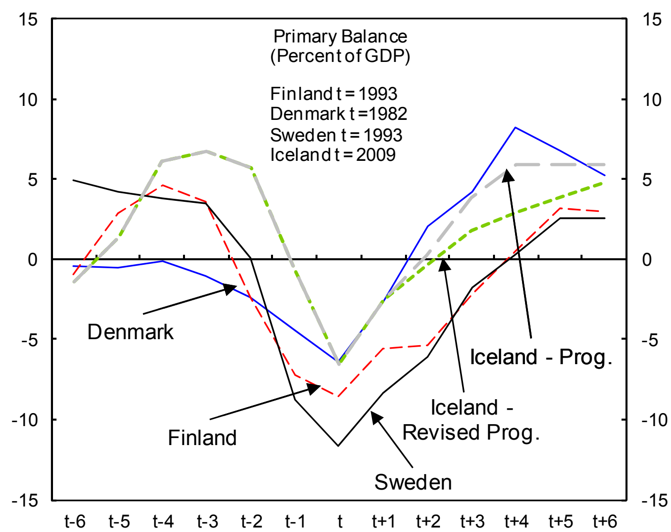
Monthly Primary Revenues in 2011
(In billion ISK)



Sources: MoF and IMF staff estimates.

needed, to avoid any further slippage. With the international bond issuance and the large cash buffer, financing for the remainder of 2011 is largely secured.

14. **The pace of medium-term fiscal consolidation was also moderated** (LOI ¶6). Building on the significant fiscal adjustment to date, the authorities and staff agreed on a revised general government primary balance target of 2 percent of GDP in 2012, 3 percent of GDP in 2013, and 5 percent of GDP in the medium term. The revisions reflect the impact of the wage agreements (which result in higher spending of 1 percent of GDP in 2012 and an additional ½ percent of GDP in 2013) and reduced fiscal measures (including the impact of the modest loosening in 2011). Under this revised path, the cumulative primary balance improvement would still reach nearly 12 percent of GDP by 2016, while the structural adjustment would exceed 10 percent of GDP. The revised medium-term targets would deliver a path that is still in line with the experience of other Nordic countries' consolidation (Figure). Public debt would remain on a steadily declining path, reaching about 80 percent in 2016, and an overall surplus would be reached in 2014 (one year later than previously envisaged). The authorities reiterated their commitment to continuing the fiscal consolidation to ensure debt sustainability, and their intention to publish the revised medium-term plan in the autumn. Staff welcomed this, but nonetheless stressed that the scope for further easing was very limited as domestic and external financing conditions are becoming more challenging, and credibility in international markets is yet to be fully established. Staff also urged the authorities to limit the fiscal costs associated with the wage agreements going forward.



Sources: WEO; Icelandic authorities; and Fund staff estimates.

15. **The authorities are preparing a package of measures to achieve their medium-term goals** (LOI ¶6). Consolidation efforts will be bolstered by the new fiscal framework for local governments (see below), closer coordination between local and central governments, and a planned strengthening of the central government budget framework. While local governments are expected to maintain a balanced primary position in 2012, consolidation efforts should yield primary surpluses of ½ percent of GDP in the medium term. In this context, central government measures amounting to 4½ percent of GDP in 2012–15 will be sufficient to achieve the medium-term fiscal objectives of the general government:

- **Revenue measures in 2012**. The authorities are preparing a package of measures, including increasing environmental and resource taxation, introducing a financial activities tax, and reducing the exemption for voluntary pension contributions. Most of the measures are expected to be permanent (¾ percent of GDP), but some will be phased in with a partial effect in 2012 and the full effect taking place in 2013. To ensure sufficient revenue in 2012, the authorities are expecting one-off receipts from asset sales (¼–½ percent of GDP, including government shares in banks), but are committed to taking additional measures if needed. With the most recent CIT rate increase taking effect in 2012, revenue measures are expected to reach 1½ percent of GDP.

- **Expenditure measures in 2012**. Permanent measures of ½ percent of GDP will build on the ongoing public administration reforms through mergers and efficiency improvements.

- **Measures in 2013–15**. In the next several years, the authorities aim to complete the administrative reforms. These reforms will include cost cutting measures of 1 percent of GDP. The possibility of further permanent revenue measures, particularly in environmental and energy taxation, was also discussed, but mostly one-off revenue measures of 1¾ percent of GDP are currently planned.

16. **Introducing the new local government fiscal framework is critical for implementation of the consolidation plan** (Table 8; LOI ¶7). While tight financing conditions are likely to keep local government operations near balance in 2012, a strong fiscal framework is needed to maintain discipline in the medium term and ensure that heavily indebted local governments are on a sustainable path. The new Local Government Bill (an end-June **structural benchmark**), which provides for such a framework, is now expected to be passed by parliament by end-September 2011 and to take effect while the 2012 local government budgets are being prepared. Moreover, a committee consisting of representatives from key ministries and the local governments has been established to coordinate public finances. The committee's work should be supported by a new reporting system for local government operations, to be introduced in October. Staff reiterated the need to continue monitoring the external and domestic debt maturity profile of local governments and to ensure that the assessment of fiscal risks for the central government takes into account potential payment difficulties of the local governments. The latter risks have recently diminished as many local governments' external obligations have been rolled over into long-term domestic loans.

B. Monetary Policy and Capital Controls

17. **Substantial achievements have been made on the monetary policy framework and operations under the program**. The successful and effective implementation of the capital controls has been a key accomplishment of the CBI. With the controls in place, the krona stabilized and inflation came down. This created scope for the Monetary Policy

Committee (MPC) to significantly reduce policy interest rates, which provided support to the economy and facilitated the restructuring of household and corporate debt. At the institutional level, the creation of the MPC in 2009 increased the transparency and accountability of monetary policy. At the same time, monetary operations were strengthened to manage the disruptions to liquidity management created by the failure of the three large banks. More recently, the adoption of a cautious and stepwise strategy for capital account liberalization has set the stage for a gradual normalization of Icelandic capital markets.

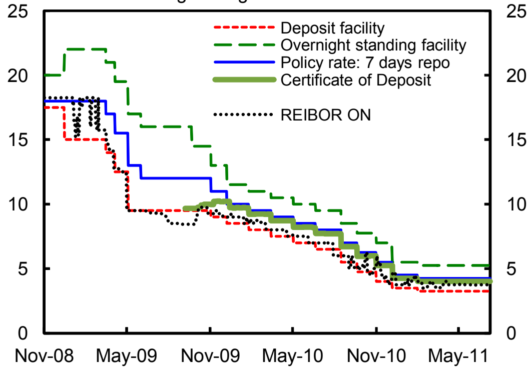
18. **The authorities and staff agreed that monetary policy should stay focused on quelling inflation and preserving exchange rate stability** (Figures 4 and 5; LOI ¶8). Both headline and core inflation have accelerated, as increases in energy, food, and import prices have spread to other components of the price index. As a result, in June, the MPC shifted to a tightening bias, and warned about the impact of the wage agreements on inflation expectations and price stability going forward. The authorities and staff agreed that Iceland's high inflation persistence and loosely anchored inflation expectations underscored the need for vigilance. The CBI also pointed out that uncertainty about the size of the output gap and the effectiveness of traditional monetary policy transmission channels in the post-crisis environment have complicated monetary policy decision making. Nonetheless, the MPC indicated that tighter monetary policy may become warranted in the near term to stem upward drift in inflation expectations. Staff concurred, and warned against the risk of falling behind the curve, emphasizing that an early response to rising inflation expectations would also strengthen monetary policy credibility going forward.

19. **It was agreed that liquidity management was becoming increasingly important**. As the lifting of capital controls may lead to increased pressures on banking system liquidity, the CBI is preparing for higher frequency open-market operations. In addition, with banks looking to expand funding opportunities beyond deposits, the authorities and staff agreed that close monitoring of banks' funding and more active liquidity management would be critical going forward. Regarding foreign exchange operations, the purchases of foreign exchange in weekly auctions will permit further accumulation of non-borrowed reserves.

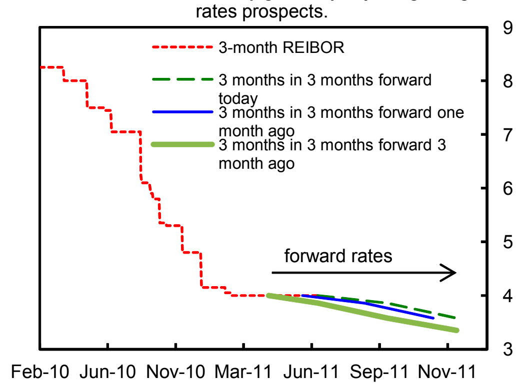
20. **Implementation of the capital account liberalization strategy is proceeding smoothly** (LOI ¶9). The first two rounds of foreign exchange auctions have modestly reduced the overhang of offshore krona while preserving foreign exchange reserves. The auctions were oversubscribed (the bid-to-cover ratios were above 3 in both cases) and led to a notable narrowing of the onshore-offshore spread, with the offshore rate appreciating from around ISK 250/euro in May to ISK 220/euro after the first auction. The authorities expect to open later this year the additional liberalization channels envisaged in their strategy, including allowing krona acquired in the auctions to be invested in a broader range of long-term investment vehicles. They underscored that maintaining reserve adequacy and stability in the financial sector and government bond market will continue to guide the pace of liberalization. Capital controls will be enforced steadily throughout the process, and new circumvention channels addressed as needed in line with the new legislative framework.

Figure 4. Iceland: Monetary Policy Operations and Liquidity Management

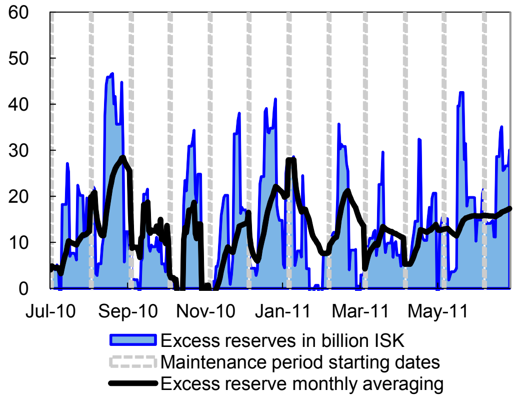
After a protracted phase of monetary easing, the CBI shifted to a tightening bias in June ...



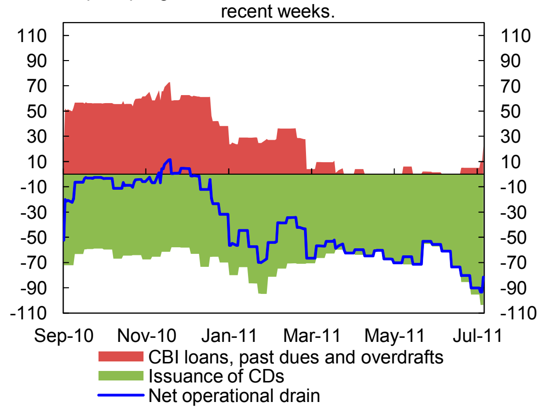
...and forward rates are only gradually adjusting to higher rates prospects.



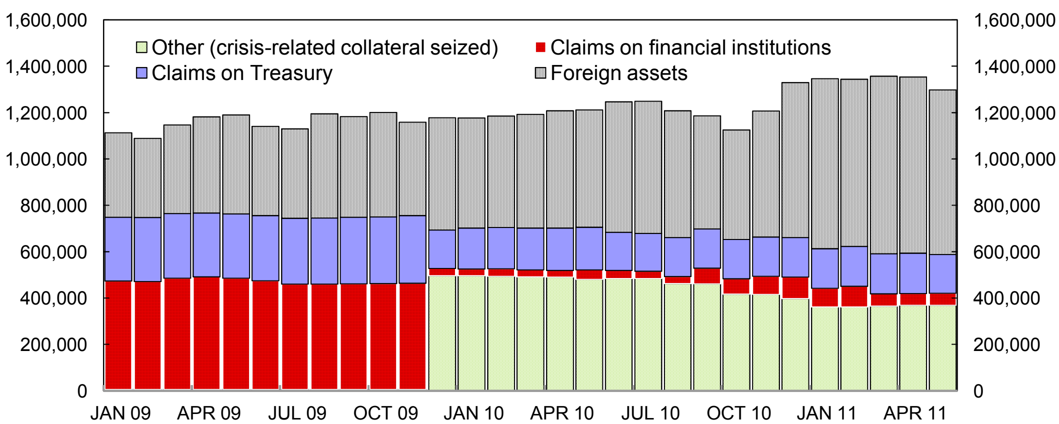
Liquidity has expanded in July ...



...prompting the CBI to increase its stock of CDs in recent weeks.

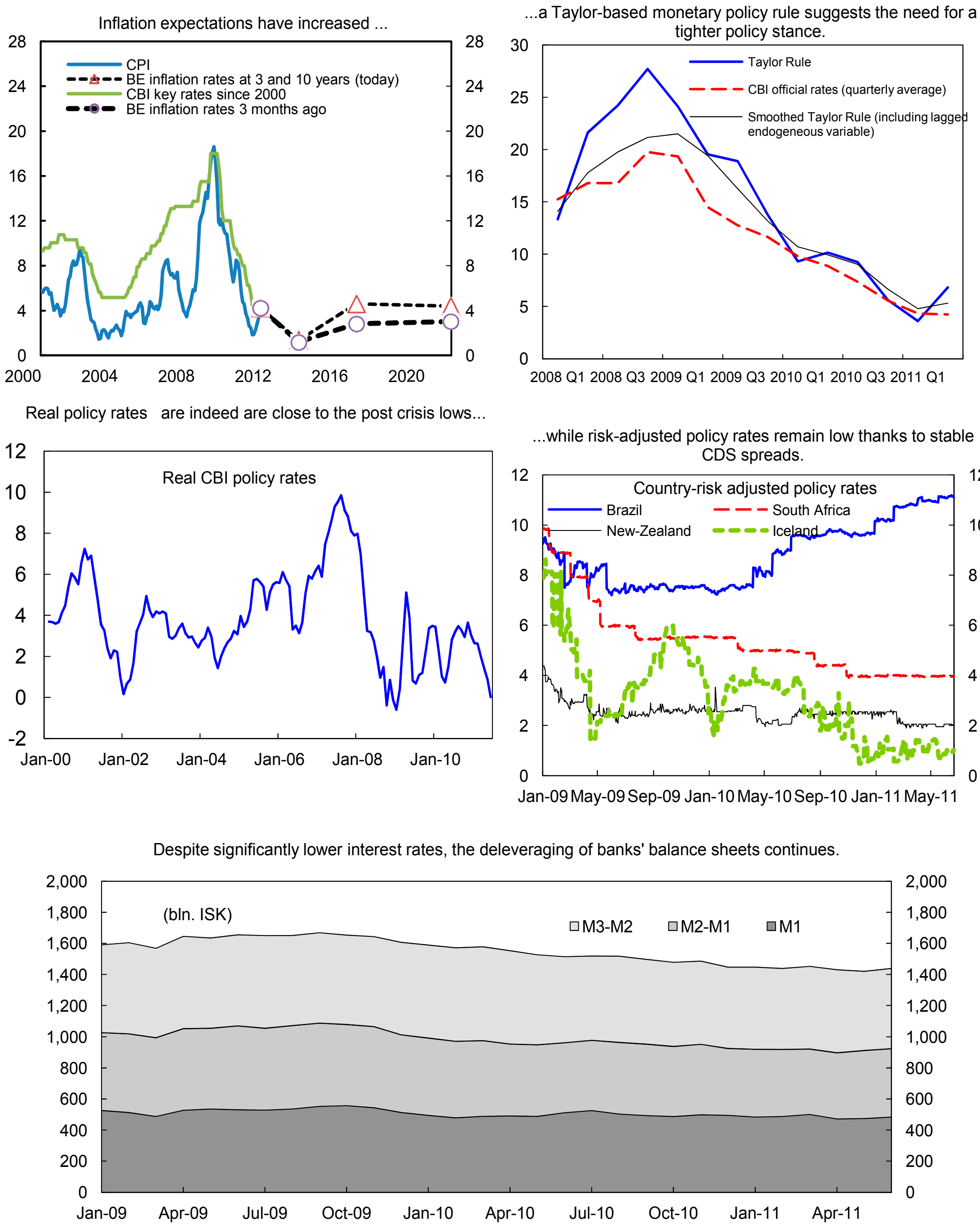


The CBI assets have changed dramatically since the crisis: managing crisis-related assets is a key challenge



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

Figure 5. Iceland: Indicators of Monetary Stance



Sources: Central Bank of Iceland; Bloomberg; Datastream; IMF staff calculations.

21. **Defining a post-capital control monetary framework will be important going forward**. With the lifting of capital controls expected to take some time, however, it was agreed that the discussion of the future monetary policy regime would continue in forthcoming missions, notably the Article IV.

C. Financial Sector Policies

22. **Significant progress has been made under the program in rebuilding the financial sector**. At the outset, Iceland faced a financial crisis of catastrophic proportions: an abrupt loss of confidence, combined with the financial sector's high leverage and dependence on foreign financing, swiftly led to the collapse of nearly the entire financial system. Over time, and after extensive and difficult negotiations with private creditors, the authorities were able to bring core banks and HFF back into solvency with limited net public sector financial support. Important steps have also been taken to address the most urgent supervisory challenges, including management, human resources, legal and regulatory tools. Nonetheless, the process of rebuilding the financial system—in this case practically from scratch—and strengthening the supervisory agency inevitably takes time, and work remains to be done to further reduce vulnerabilities and risks going forward.

23. **Recapitalization of the core financial system is complete** (LOI ¶11). The Icelandic financial system has been significantly restructured and recapitalized (Table).

- For the commercial banks, the FME's Internal Capital Adequacy Assessment Process (ICAAP)—which covered the three largest commercial banks—has concluded that loans are broadly adequately valued, and that all banks meet the minimum required core tier 1 capital of 12 percent (on average the three large commercial banks hold core tier 1 capital of about 20 percent). These results suggest that banks have large buffers to handle unexpected losses arising from credit and market risk going forward, while remaining above the Basel minimums of 3.5 percent common equity tier 1 and 4.5 percent of tier 1 capital (which will be mandatory to all Basel member countries starting in 2013). Furthermore, the most recent Supreme Court ruling on foreign currency-indexed loans of corporations had been partly anticipated by banks.[1] As a result, banks had already increased provisions, and the impact of the ruling on bank capital should therefore be limited. Preliminary analysis by the FME based on the risks scenarios used by the European Banking Authority for its recent stress tests suggests that no commercial banks would fall below the regulatory threshold.

- The restructuring of the largest savings banks is also complete. The mergers of SpKef and Byr with large commercial banks have brought the process of their

[1] On June 9, 2011 the Supreme Court of Iceland upheld a decision of the District Court of Reykjavik that ruled illegal a foreign exchange-indexed loan provided by a commercial bank to a firm.

recapitalization to a close. These mergers, alongside the earlier resolution of other large savings banks, including SPRON and Icebank (a commercial bank related to the savings bank sector), have reduced the size of the savings bank sector to 4 percent of GDP, down from nearly 50 percent of GDP prior to the crisis.

- Private *non*-banks have been recapitalized. All private institutions that rely on market funding now report capital above 8 percent through creditor haircuts, but their full restructuring is yet to be completed. Additional funds may be required to bring HFF's capital up to 5 percent of risk-weighted assets—the decision whether to do so will be made based on an assessment of the impact of the household debt restructuring measures. A tiny state-owned regional development fund may also require additional capital.

Iceland: Size of the Financial Sector, Pre- and Post-Crisis 1/
(In percent of GDP, unless otherwise indicated)

	End-2007		Latest 5/	
	Assets	Number of institutions	Assets	Number of institutions
Banks	985	23	193	14
Commercial Banks	937	5	189	4
Glitnir (2007) / Islandsbanki (current) 3/	225		57	
Kaupthing (2007) / Arion Bank (current)	409		53	
Landsbanki (2007) / Landsbankinn (current)	234		76	
MP bank 2/	-		3	
Straumur bank	50		-	
Icebank	19		-	
Saving banks	48	18	4	10
SPRON	17		-	
Old Byr 3/	14		-	
Sp Kef 4/	7		-	
Other saving banks	10		4	
Nonbanks	82	14	73	9
Housing Financing Fund	46	1	54	1
Other credit undertakings	36	13	19	8
Total	1068	37	266	23

Source: FME, HFF, Bankasýsla, IMF staff calculations
1/ Consolidated accounts
2/ MP bank received its commercial banking license in 2008. It was classified as an investment bank in 2007.
3/ BYR Savings bank went into receivership in July 2010 and "New Byr" was established as a commercial bank. In July 2011, "New Byr" and Islandsbanki announced a merger, pending the approval of the Competition Authority.
4/SpKef was merged with Landsbankinn in March 2011.
5/ End-2010 figures, except for BYR and SpKef whose end-2009 assets are added to Islandsbanki and Landsbankinn, respectively.

24. **Despite this progress, the authorities and staff agreed that further work is needed to address legacy vulnerabilities** (LOI ¶12). The ongoing restructuring of banks' loan portfolios is critical to reduce the high level of NPLs. In this context, it was agreed that

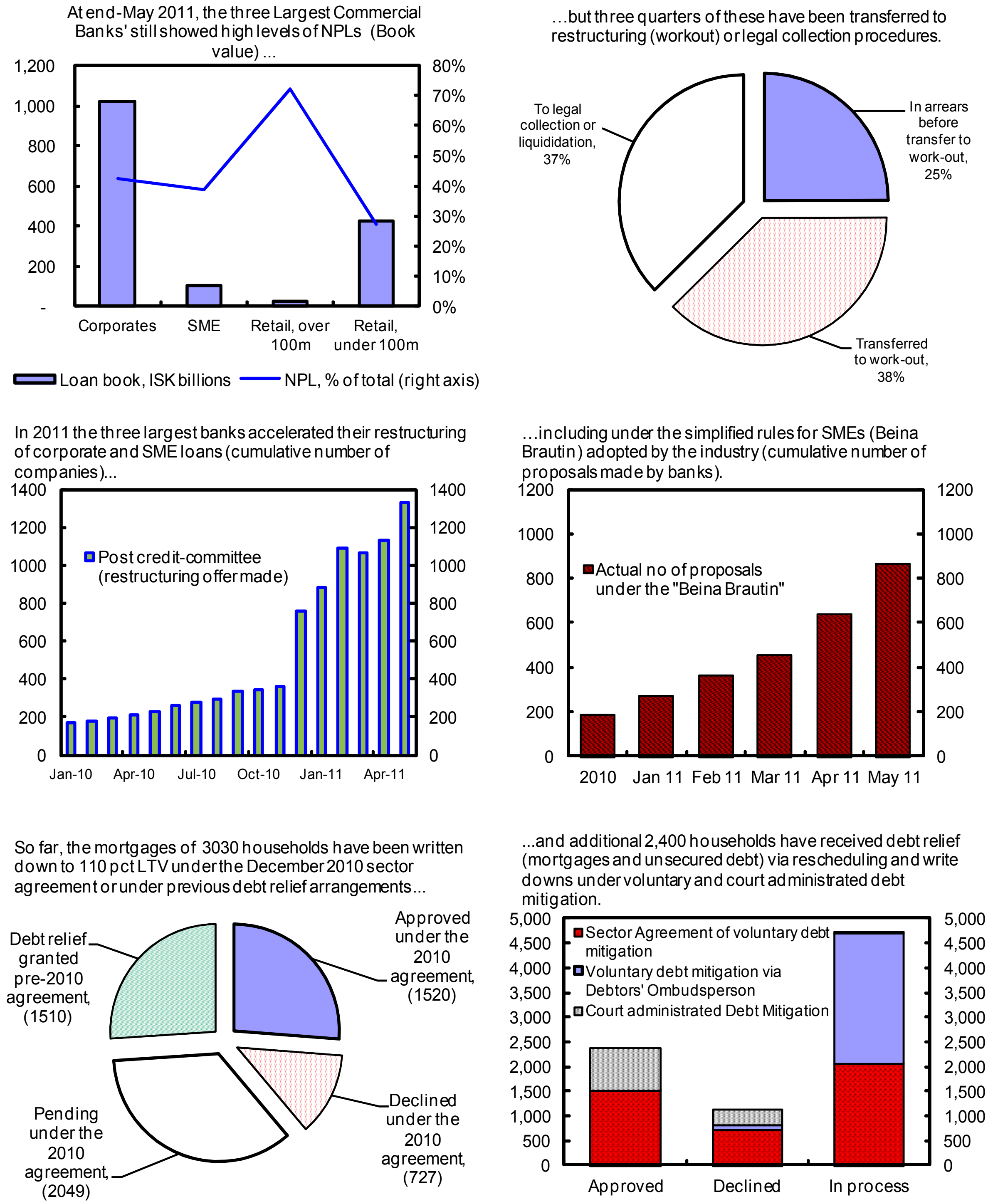
the recent progress in private sector debt restructuring must be reinforced to bring the process to completion as quickly as possible (see section D below). Nonetheless, legacy vulnerabilities may remain for some time. In particular, the conversion of foreign-exchange linked loans to inflation-linked or variable-rate krona loans is likely to increase imbalances associated with inflation indexation. This may create new credit risk challenges that will require proper asset-liability and risk management. These risks will have to be cautiously monitored, and the FME plans to hold regular quarterly meetings with banks to take stock of progress in dealing with them. Additionally, while the remaining small savings banks are reportedly solvent and stable, completing sector consolidation remains a priority.

25. **The authorities and staff agreed that a further strengthening of financial sector supervision is critical** (LOI¶13). The FME is developing an action plan to address the remaining prudential and supervisory gaps identified through a comprehensive assessment of Iceland's compliance with Basel Core Principles for Effective Supervision. This assessment was verified by an independent review by a foreign expert, and resulted in a set of recommendations to strengthen supervisory practices, including risk models, on-site and off-site procedures, disclosure and reporting practices, organization and management, human resources management, training, and IT infrastructure. The authorities are committed to requesting a stand-alone ROSC assessment of Basel Core Principles for Effective Supervision in 2013 to gauge progress made in this area. Staff stressed the need to ensure that FME has both sufficient resources and accountability to fulfill its role. On regulation, the authorities remain committed to updating the existing prudential framework to meet the standard set by EU directives and regulations: new rules on large exposures and additional own funds (hybrid capital), in line with the new Capital Requirement Directive, will be issued. In addition, legislation on deposit insurance, in line with international standards, will permit a gradual phasing-out of the blanket deposit guarantee and pave the way for a normalization of banks' funding strategy. The credit registry was recently established and will allow close monitoring of large exposures to avoid excessive risk concentration going forward. The authorities are preparing a report (to be submitted to parliament in the fall) that will present options for the future role of the financial system, including its size, structure, and supervision. The role of the HFF and its level of capitalization will be considered in the context of this report.

D. Private Sector Debt Restructuring

26. **Welcome progress is being made on private sector debt restructuring** (Figure 6). The authorities and staff agreed that it was critical for the financial sector to press ahead with household and corporate debt restructuring (LOI ¶14). Data collected by the authorities and the banks suggest that tangible progress is finally being made. Nonetheless, the authorities and staff agreed that continued careful monitoring of the restructuring process, and the extent of leverage after restructuring, will be critical to ensure that corporates and households do not remain over-indebted and that only viable firms remain operating. It was agreed that the process should be brought to completion, and further measures were not anticipated.

Figure 6. Iceland: Private Sector Debt Restructuring



Sources: Commercial banks; Debt Restructuring Monitoring Committee; and Debt Ombudsman Office.

- **Corporate debt restructuring**. After a slow start, restructuring of small- and medium-size enterprises (SMEs) and large corporates picked up markedly in May and June. For SMEs, commercial banks are implementing the measures agreed in December 2010, which involve writedowns of debt to the value of the firm, and most eligible SMEs received a restructuring offer by end-May (broadly in line with banks' targets). For large corporates, banks will continue to handle cases individually through specialized debt restructuring units. The three commercial banks expect that corporate debt restructuring will be largely completed by end-2011. Staff welcomed the progress made, and urged that the process be brought to completion as quickly as possible.

- **Household debt restructuring**. The pace of household debt restructuring is also accelerating. The number of applications for debt relief under the measures agreed in December 2010 (involving mortgage writedowns to 110 percent of the property value) had been significantly lower than expected, but shot up in June as the deadline for submitted applications approached. As of mid-July, the Office of the Debtor's Ombudsman had received some 3400 applications for debt mitigation, of which about a third are under formal (voluntary) negotiations. The three commercial banks expect to complete the household debt restructuring process by end-2011.

E. Program Modalities

27. **Iceland's return to international capital markets is a major achievement under the program**. It marked Iceland's first sovereign issue since 2006, and effectively rolled over the central government's major external obligations until mid-2012. The financing of the medium-term balance of payments assumes a continuation of market financing, with the sovereign and major corporations assumed to rollover most obligations to non-official creditors falling due over the medium term (Table 11). As anticipated in past reviews, pressures on the balance of payments will arise from payments associated with the resolution of the old banks and from the lifting of capital controls. While the capital account liberalization is expected to proceed gradually, and the strategy provides considerable flexibility to adjust the pace of liberalization in the face of shocks, augmenting reserves will provide additional buffers. Continued regular FX purchases and drawing the remaining funds available under the program and from bilateral partners will boost reserves. Depending on market conditions, an additional bond issue in the coming months would cement Iceland's return to international capital markets.

28. **Financing assurances are in place**. To date, Iceland has received $50 million from the Faroe Islands and drawn two of the four Nordic loan tranches ($1.2 billion), and one-third of the available funds under its bilateral loan from Poland ($70 million). The Nordic and Polish authorities have agreed to extend the availability of their funds until end-2011, and new loan agreements were finalized in July and August. External debt remains on a downward trajectory,

29. and the baseline balance of payments is sufficiently strong to ensure that Iceland fulfills its obligations to the Fund (Table 12).

30. **Iceland continues to face large risks:**

- Risks associated with policy missequencing, notably with respect to the liberalization of capital controls, remain heightened. As noted in earlier reviews, a too-rapid pace of liberalization could unsettle markets and lead to disorderly depreciation of the krona. Insufficient administrative controls during the liberalization process could also lead to circumvention, effectively speeding up the pace of liberalization and depleting reserves. And residents' pent-up demand for foreign assets could be far greater than the levels currently assumed in the baseline. These risks are mitigated by the authorities' commitment to a gradual and stepwise process for lifting controls, and to ensuring that the controls remain effective during the liberalization process.

- Litigation risks related to the resolution of Icesave and challenges to the Emergency Law remain.

    - On Icesave, the EFTA Surveillance Authority (ESA) issued its reasoned opinion in June, finding that Iceland is in breach of the EU Directive on Deposit Insurance. Given the authorities' longstanding position on the issue, it is likely that the matter will be brought before the EFTA Court. Should the EFTA Court also find Iceland to be in breach of the EU Directive, it remains unclear what the actual sovereign liability would be and on what terms—interest and maturity—Iceland would have to discharge such a liability. These risks are mitigated by the significant asset recovery from Landsbanki's estate, which are estimated to cover 94–99 percent of Icesave deposits. Stress tests suggest that, while fiscal costs would rise substantially in some possible outcomes, public debt would remain on a downward path (Appendix I).

    - As reported previously, risks associated with the Emergency Law have been considerably reduced since ESA's decision of last year, but not eliminated. Iceland's Supreme Court is expected to rule as early as September on some Emergency Law cases initiated by creditors against the failed banks. As noted in previous reports, a decision overturning the Emergency Law would have significant implications for Iceland's public finances.

- External financing risks are growing in importance. Although the successful issuance of the bond in international capital markets has addressed near-term financing issues, Iceland will need to maintain a presence in international capital markets for the foreseeable future. The uncertain external financing environment poses risks going forward. However, program financing, as well as the gradual and carefully calibrated approach to capital account liberalization embedded in the authorities' revised strategy, provide comfort that these risks can be handled.

V. Staff Appraisal

31. **Iceland's Fund-supported program has been a success**. The key program objectives were met: the exchange rate has been stabilized, Iceland's public finances have been put on a sustainable path, and significant progress has been made in rebuilding the financial sector. Policy implementation has been impressive, earning the authorities significant credibility. This paved the way for Iceland's recent bond issuance in international capital markets and the first steps of capital account liberalization.

32. **The recovery is underway, but risks and uncertainty persist**. Consumption and investment are rising, and exports are strong, but delays in investment projects continue to weigh on growth and business confidence. Looking ahead, it will be essential that the authorities provide greater clarity on their growth strategy, and notably the role of investment. On inflation, the outlook has deteriorated and measures of inflation expectations have picked up. Key risks arise from higher than projected pass through of wages into prices, potential krona depreciation, and commodity price shocks.

33. **Fiscal consolidation must continue, but the pace of adjustment can be eased**. Given the significant fiscal effort that has already taken place—10 percent of GDP in fiscal measures and a primary balance improvement of over 6 percent of GDP—there is scope to adjust the balance between supporting the recovery and continued consolidation. The revised medium-term path would still deliver sustainable public debt dynamics, provided that private sector losses are not absorbed by the public sector and contingent liabilities remain in check. The fact that fiscal risks associated with the financial sector restructuring have been contained provides added comfort. For 2011, the modest easing of the target should provide support to the still tentative economic recovery.

34. **It is essential that the revised fiscal path be adhered to**. The scope for easing, beyond what has been agreed, is very limited as financing conditions are becoming more difficult and credibility is yet to be fully established. To ensure that the credibility gains to date are not reversed, the authorities will need to implement fully their revised medium-term fiscal plan. In particular, further slippage in 2011 should be avoided and additional fiscal costs associated with the wage agreements contained. The authorities' strong track record with fiscal consolidation, commitment to the revised path, and desire to further improve the fiscal framework provide comfort in this regard.

35. **The first steps toward capital account liberalization are welcome**. With the success of the first two auctions, the lifting of capital controls is gradually underway in a manner that safeguards reserve adequacy and stability in the government bond market and the financial sector. Still, the authorities must be prepared to slow or stop the liberalization process if the balance of payments is not sufficiently strong to support a further lifting of controls. In this regard, their commitment to comprehensively assess the balance of payments, as well as the stability of the financial sector, before taking major liberalization

steps is welcome. Continued steady enforcement of controls will also be critical. To further boost international reserves, regular foreign exchange purchases should continue and available financing should be drawn. Improvements in liquidity management should also advance.

36. **The shift to a tightening bias in monetary policy is appropriate**. Given the rise in inflation expectations and the need to normalize policy interest rates as capital controls are lifted, monetary policy will need to be gradually tightened. A clear response to rising inflation expectations would strengthen monetary policy credibility going forward.

37. **Private sector debt restructuring is finally advancing, and efforts should be sustained**. The progress in corporate and household debt restructuring is welcome, and the process should now be brought rapidly to completion. Going forward, careful monitoring of the restructuring process will be critical to ensure that corporates and households are not left with excessive leverage and that only viable firms remain operating. The FME should ensure that banks keep sufficient buffers to address unexpected losses arising from the need to revisit unsuccessful restructuring cases.

38. **Welcome progress has been made on financial sector restructuring, but more needs to be done to address remaining vulnerabilities**. Completion of the recapitalization of the core financial system is a milestone in Iceland's emergence from crisis. The FME's ICAAP exercise is also an important step in bolstering confidence that the banking system is well capitalized, and close monitoring of banks' accounting and reporting practices should continue. Nonetheless, vulnerabilities remain and must be addressed. Notably, NPLs must be reduced through debt restructuring and financial imbalances should be handled through careful asset-liability management. Given that corporate and household debt restructuring is expected to be completed in the next year, the 2012 ICAAP exercise, supported by external experts, may help bring the bank restructuring process to a successful end. The process of restructuring and consolidating the remaining private nonbanks and tiny savings banks must also be completed.

39. **Efforts to further strengthen financial sector supervision must continue**. Although major progress has been made in this area, remaining supervisory gaps have been identified and must be addressed. In this regard, the action plan that the FME is developing is most welcome, and it will be critical that the plan is fully implemented and that sufficient resources are provided for this task. The authorities' commitment to an independent assessment of supervisory standards in early 2013 underscores their determination to complete the reforms of banking supervision. Their intention to update existing prudential rules and regulations and to introduce new rules on large exposures and hybrid capital should further strengthen the regulatory framework. The planned legislation on deposit insurance will pave the way for an eventual lifting of the blanket guarantee on deposits and a normalization of bank funding. The CBI and FME should reinforce the recent improvements in cooperation, as this will become increasingly important as the economy fully emerges

from crisis. Fully implementing these measures will be essential to reduce risks and vulnerabilities in the Icelandic financial sector.

40. **On the basis of the progress under the program, staff supports the authorities' request to complete the sixth review**. Iceland's capital controls regime continues to marginally affect the conversion and transfer of a certain component of current payments, giving rise to an exchange restriction. Since it has been imposed for balance of payments purposes, is non-discriminatory and temporary, staff support's the authorities' request for Board approval of the further retention of the measure for 12 months.

41. **Staff recommends that Iceland be brought back to the standard 12-month consultation cycle for Article IV consultations upon expiration of the SBA**. In accordance with Executive Board Decision No. 14747-(10/96), Iceland shall be placed on a 12-month consultation cycle because it currently has an outstanding Fund credit exceeding 200 percent of quota. In light of the amount of the outstanding credit, and given that the authorities have not decided yet to request a successor arrangement from the Fund, the Managing Director also recommends the initiation of post-program monitoring.

Table 1. Iceland: Selected Economic Indicators, 2005–11

	2005	2006	2007	2008	2009	2010	2011	
					Est.	Est.	Prog.	Proj.
(Percentage change unless otherwise noted)								
National Accounts (constant prices)								
Gross domestic product	7.5	4.6	6.0	1.4	-6.9	-3.5	2.3	2.5
Total domestic demand	15.4	9.5	-0.1	-8.5	-20.7	-2.5	3.0	4.2
Private consumption	12.7	3.6	5.6	-7.9	-15.6	-0.2	2.7	3.1
Public consumption	3.5	4.0	4.1	4.6	-1.7	-3.2	-3.9	-1.3
Gross fixed investment	35.7	22.4	-11.1	-19.7	-50.9	-8.1	16.8	17.0
Export of goods and services	7.5	-4.6	17.7	7.0	7.0	1.1	2.5	2.2
Imports of goods and services	29.3	10.4	-0.7	-18.4	-24.0	3.9	3.9	5.4
Output gap 1/	3.0	2.1	3.6	2.2	-2.6	-5.2	-2.5	-2.2
Selected Indicators								
Nominal GDP (bln ISK)	1026.7	1168.6	1308.5	1483.1	1495.3	1539.5	1627.1	1641.6
Unemployment rate 2/	2.1	1.3	1.0	1.6	8.0	8.1	7.5	7.1
Consumer price index	4.0	6.8	5.0	12.4	12.0	5.4	2.8	4.0
Nominal wage index	6.5	9.1	9.3	4.0	0.5	3.1	4.7	6.0
Nominal effective exchange rate 3/	10.4	-10.7	2.7	-40.4	-34.2	-3.0	...	...
Real effective exchange rate (CPI) 3/	13.3	-7.1	5.1	-20.7	-18.4	6.3	...	...
Terms of trade	1.0	3.5	0.1	-9.3	-6.7	5.9	0.0	-0.1
Money and Credit								
Base Money	32.2	27.9	190.7	-31.5	1.3	-19.4	...	-4.2
Deposit money bank credit (end-period)	76.0	44.4	56.6	-28.3	-17.8	-3.4	...	-6.0
of which to residents (end-period)	54.7	33.6	28.3	...	...	...	...	...
Broad money (end-period)	23.2	19.6	56.4	36.3	1.0	-10.0	...	-4.1
CBI policy rate (period average) 4/	10.5	14.1	13.8	15.4	13.7	7.8	...	...
Public Finance (in percent of GDP)								
General government 5/								
Revenue	47.1	48.0	47.7	44.1	41.1	42.3	40.8	41.0
Expenditure	42.2	41.6	42.3	44.6	49.7	47.7	44.2	45.0
Balance	4.9	6.3	5.4	-0.5	-8.6	-5.4	-3.3	-4.0
Primary balance	6.1	6.7	5.7	-0.5	-6.5	-2.5	0.2	-0.4
Balance of Payments (in percent of GDP)								
Current account balance	-16.1	-25.6	-15.7	-28.3	-11.7	-10.2	2.3	2.2
Trade balance	-12.2	-17.5	-10.1	-2.3	8.7	10.6	10.4	9.4
Financial and capital account	13.9	44.0	18.1	-70.2	16.3	15.7	-12.2	-21.0
Net errors and omissions	2.6	-11.1	-1.9	-16.9	-7.3	1.4	0.0	4.8
Gross external debt 6/	284.5	433.5	605.9	564.7	266.2	279.0	240.8	251.5
Central bank reserves (US$ billion)	1.1	2.3	2.6	3.6	3.9	5.8	6.2	6.1

Sources: Statistics Iceland; Central Bank of Iceland; Ministry of Finance; and 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
(Billions of krona, unless otherwise indicated)

	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11 Proj.	Dec-11 Proj.
Central Bank									
Net foreign assets 1/	-175	-188	-158	-163	-176	-115	-95	-94	-93
Assets	496	499	571	496	716	815	879	944	1,139
Liabilities	671	687	729	659	892	930	974	1,037	1,231
Net domestic assets	291	300	245	235	269	191	167	195	183
Net claims on the public sector	-52	8	-29	-38	28	17	21	77	40
Net claims excluding recap bond	-218	-172	-193	-207	-142	-156	-149	-96	-133
Recapitalization bond	165	181	165	169	171	173	170	173	173
Net claims on banks 2/	-25	-58	-60	-10	-24	-55	-82	-102	-77
Others Items, net	368	350	334	283	265	229	228	220	220
Base Money 3/	117	112	88	72	94	76	72	101	90
Currency issued	26	24	26	27	35	32	33	37	38
DMB deposits at the central bank	91	89	62	45	59	44	39	64	52
Banking System									
Net foreign assets	-30	-48	-7	99	86	112	111	125	130
Net domestic assets	1,610	1,602	1,495	1,371	1,326	1,308	1,294	1,289	1,249
Net claims on the central bank	120	147	135	61	73	82	122	166	129
Credit to private sector	1,855	1,904	1,878	1,829	1,791	1,763	1,715	1705	1,695
Credit to government	210	213	216	219	222	225	228	225	225
Other items, net	-574	-662	-734	-739	-760	-762	-770	-807	-800
Domestic deposits	1,581	1,554	1,488	1,470	1,412	1,420	1,406	1,414	1,379
Local currency	1,462	1,433	1,370	1,385	1,329	1,336	1,334	1328	1309
Foreign currency	119	121	118	85	83	84	72	86	70
Consolidated Financial System									
Net foreign assets	-204	-236	-165	-64	-90	-3	16	31	37
Net domestic assets	1,811	1,814	1,679	1,561	1,536	1,455	1,422	1,420	1,380
Net claims on the public sector	158	221	187	181	250	242	249	302	265
Net credit to private sector	1,855	1,904	1,878	1,829	1,791	1,763	1,715	1,705	1,695
Other, net	-202	-311	-386	-449	-505	-550	-542	-587	-580
Broad Money (M3)	1,607	1,578	1,514	1,497	1,447	1,452	1,439	1,451	1,417
Memorandum items:									
Base money (y-o-y percentage change)	1.3	-15.8	-40.0	-55.2	-19.4	-32.3	-17.8	40.2	-4.2
Broad money (y-o-y percentage change)	1.0	0.6	-8.5	-10.2	-10.0	-8.0	-5.0	-3.1	-4.1
Credit to private sector (y-o-y percentage change)	-17.8	3.1	-5.0	-4.6	-3.4	-7.4	-8.7	-6.8	-6.0
Money velocity (GDP/base money)	12.8	13.5	17.4	21.3	16.4	21.0	22.8	16.6	19.1
Broad money velocity (GDP/M3)	0.9	1.0	1.0	1.0	1.1	1.1	1.1	1.2	1.2
Multiplier (M3 / base money)	13.8	14.1	17.3	20.8	15.4	19.1	20.0	14.4	15.7

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.

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

Table 3. Iceland: Medium-Term Projections, 2008–16
(Percent change, unless otherwise indicated)

	2008	2009	2010	2011		2012	2013	2014	2015	2016
		Est.	Est.	Prog.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Percentage change)									
Real economy										
Real GDP	1.4	-6.9	-3.5	2.3	2.5	3.1	2.8	2.8	2.7	3.0
Real domestic demand	-8.5	-20.7	-2.5	3.0	4.2	3.8	4.1	3.6	1.7	2.8
Private consumption	-7.9	-15.6	-0.2	2.7	3.1	3.3	3.3	3.5	3.5	3.3
Public consumption	4.6	-1.7	-3.2	-3.9	-1.3	-1.0	-1.0	0.0	0.2	1.0
Gross fixed investment	-19.7	-50.9	-8.1	16.8	17.0	14.7	13.3	8.4	-1.7	3.3
Net exports 1/	11.3	11.9	-0.7	-0.2	-0.8	-0.1	-0.5	-0.2	1.0	0.5
Exports of goods and services	7.0	7.0	1.1	2.5	2.2	3.7	2.9	2.0	3.9	3.4
Imports of goods and services	-18.4	-24.0	3.9	3.9	5.4	5.2	5.2	3.2	2.3	3.0
Output gap 2/	2.2	-2.6	-5.2	-2.5	-2.2	-0.8	-0.3	0.0	0.0	0.0
Potential output	2.8	-2.3	-0.9	-0.5	-0.6	1.6	2.3	2.5	2.7	3.0
Unemployment rate 3/	1.6	8.0	8.1	7.5	7.1	5.7	4.3	3.5	3.5	3.6
Real wages	-7.5	-10.1	-2.2	1.9	2.0	1.1	1.8	2.3	2.2	2.2
CPI inflation	12.4	12.0	5.4	2.8	4.0	3.7	2.6	2.4	2.5	2.5
CPI inflation (excl. effect of ind. taxes)	12.6	11.4	4.4	2.8	3.7	3.2	2.5	2.5	2.5	2.5
CPI inflation (end of period)	18.1	7.5	2.4	3.3	5.4	2.6	2.5	2.5	2.5	2.5
Nominal ISK/EUR exchange rate	127.0	172.0	162.2	161.1	162.8	165.9	167.1	167.9	166.3	164.5
Real exchange rate (+ appreciation)	-20.7	-18.4	6.3	0.0	0.0	0.0	0.0	0.0	1.0	1.0
Nominal GDP (bln ISK)	1483.1	1495.3	1539.5	1627.1	1641.6	1761.5	1854.2	1953.0	2052.3	2161.3
	(In percent of GDP, unless otherwise indicated)									
Balance of Payments										
Current account	-28.3	-11.7	-10.2	2.3	2.2	2.8	-1.0	-1.5	-1.1	-0.7
Underlying current account 4/	-3.2	6.2	9.9	9.4	9.8	7.1	3.1	2.4	2.7	2.8
Trade balance	-2.3	8.7	10.6	10.4	9.4	9.0	7.5	6.8	7.6	7.7
Net income balance 5/	-25.8	-19.8	-20.3	-7.8	-7.0	-5.9	-8.3	-8.1	-8.5	-8.2
Capital and financial account	-70.2	16.3	15.7	-12.2	-21.0	-16.9	1.4	-2.2	6.6	-0.4
Capital transfer, net	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Direct investment, net	30.4	-18.2	39.3	6.5	4.3	5.0	5.1	4.9	7.1	4.6
Portfolio investment, net	15.7	9.0	2.8	5.0	1.5	66.0	-21.1	-12.9	-13.1	0.4
Other investment, net 6/	-116.2	25.6	-26.3	-23.7	-26.8	-87.8	17.5	5.9	12.6	-5.4
Accumulation of arrears	157.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary financing	6.7	5.6	7.7	15.3	15.8	-2.7	-3.4	-2.8	-2.9	-1.3
Gross external debt 7/	564.7	266.2	279.0	240.8	251.5	187.6	178.0	168.6	158.3	147.4
Underlying gross external debt 8/	…	261.9	258.5	237.6	237.8	177.8	175.4	165.6	157.4	146.7
Net external debt 9/	…	139.7	147.1	147.6	141.0	84.9	85.2	75.6	73.1	64.1
Central bank reserves (US$ billion)	3.6	3.9	5.8	6.2	6.1	3.5	3.0	2.0	2.4	2.0
General government accounts										
Revenue	44.1	41.1	42.3	40.8	41.0	41.3	41.3	41.6	41.7	41.6
Expenditure	44.6	49.7	47.7	44.2	45.0	43.4	42.2	41.4	40.5	39.9
Overall balance	-0.5	-8.6	-5.4	-3.3	-4.0	-2.2	-1.0	0.2	1.2	1.6
Primary balance	-0.5	-6.5	-2.5	0.2	-0.4	1.8	2.9	3.9	4.8	5.0
Primary balance (excl. new road projects)	-0.5	-6.5	-2.5	0.3	-0.3	2.0	3.0	4.1	4.8	5.0
Change in primary balance (excl. new road projects)	-6.3	-6.0	4.0	2.8	2.2	2.3	1.1	1.0	0.7	0.3
Gross debt	70.3	88.2	92.4	100.1	100.0	95.2	94.0	90.6	86.9	81.1
Net Debt	41.7	55.8	62.6	66.0	66.5	64.7	63.0	60.1	56.5	52.4

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

7/ Including old banks before 2009. Old banks' total liabilities are excluded starting from 2009, 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.

8/ Excluding short-term debt that are covered by external assets.

9/ Gross external debt minus debt securities and other investment assets.

Table 4. Iceland: Balance of Payments, 2008–16
(In billions of US dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
			Est.	Proj.	Proj.	Proj.	Proj.	Proj	Proj
Current Account	-4.8	-1.4	-1.3	0.3	0.4	-0.2	-0.2	-0.2	-0.1
Trade Balance	-0.4	1.0	1.3	1.4	1.4	1.2	1.1	1.3	1.4
Balance on Goods	-0.1	0.7	1.0	1.0	1.1	0.9	0.9	1.1	1.2
Merchandise exports f.o.b.	5.3	4.1	4.6	5.4	5.9	6.1	6.3	6.6	6.9
Merchandise imports f.o.b.	-5.4	-3.3	-3.6	-4.4	-4.8	-5.2	-5.4	-5.4	-5.7
Balance on Services	-0.3	0.3	0.4	0.3	0.3	0.3	0.2	0.2	0.2
Exports of services, total	2.1	2.3	2.5	2.9	3.1	3.2	3.3	3.5	3.6
Imports of services, total	-2.4	-2.0	-2.2	-2.6	-2.8	-2.9	-3.1	-3.3	-3.4
Balance on Income 1/	-4.3	-2.4	-2.6	-1.0	-0.9	-1.3	-1.3	-1.4	-1.5
Receipts	0.5	-0.1	-0.4	0.3	0.8	0.5	0.6	0.5	0.5
of which dividends and reinvested earnings	-0.9	-0.5	-0.7	0.1	0.2	0.2	0.3	0.2	0.2
of which interest receipts	1.4	0.4	0.2	0.2	0.2	0.3	0.3	0.3	0.3
Expenditures	-4.8	-2.3	-2.1	-1.3	-1.7	-1.8	-1.9	-1.9	-2.0
of which dividends and reinvested earnings	0.9	0.2	-0.3	-0.5	-0.5	-0.5	-0.4	-0.4	-0.4
of which interest payments	-5.7	-2.6	-1.8	-0.8	-1.2	-1.3	-1.4	-1.5	-1.6
Current transfer, net	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Cap and Finan. Acct	-11.8	2.0	2.0	-3.0	-2.6	0.2	-0.4	1.1	-0.1
Capital transfer, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	-11.8	2.0	2.0	-3.0	-2.6	0.2	-0.3	1.1	-0.1
Direct investment, net	5.1	-2.2	4.9	0.6	0.8	0.8	0.8	1.2	0.8
Portfolio investment, net	2.6	1.1	0.4	0.2	10.0	-3.3	-2.1	-2.2	0.1
Assets	4.9	2.0	0.7	0.1	0.3	-0.1	-0.6	-0.7	-0.7
Liabilities 2/	-2.3	-0.9	-0.3	0.2	9.7	-3.2	-1.5	-1.5	0.8
Net borrowing	-0.4	-0.9	-0.3	0.1	-0.9	0.3	-0.2	0.1	0.9
Equities	-1.8	0.0	0.0	0.1	10.6	-3.5	-1.3	-1.6	-0.1
Other investment, net 3/	-19.6	3.1	-3.3	-3.8	-13.3	2.7	1.0	2.1	-1.0
Assets	-3.1	4.1	-4.8	1.0	0.3	1.0	-0.1	1.2	0.3
Liabilities 2/	-16.5	-1.0	1.5	-4.9	-13.7	1.8	1.1	1.0	-1.2
of which external asset recovery (Landsbanki)	0.0	0.8	0.6	0.5	0.7	0.2	0.2	0.1	0.2
of which other external asset recovery	…	0.2	0.6	1.7	2.3	1.7	1.1	0.5	0.1
of which other asset recovery payments (Landsbanki)	0.0	0.0	0.0	-4.6	-1.3	-0.5	-0.6	-0.6	-0.6
of which other asset recovery payments	0.0	0.0	0.0	0.0	-3.6	0.0	0.0	0.0	0.0
of which old banks foreign deposits	-18.8	…	…	…	…	…	…	---	---
Net errors and omissions	-2.9	-0.9	0.2	0.7	0.0	0.0	0.0	0.0	0.0
Overall Balance	-19.5	-0.3	0.9	-2.0	-2.1	0.1	-0.6	0.9	-0.2
Overall financing	18.7	0.3	-0.9	2.0	2.1	-0.1	0.6	-0.9	0.2
Change in gross reserves ("-" = increase)	-0.9	-0.3	-1.9	-0.3	2.5	0.5	1.1	-0.4	0.4
Accumulation of arrears ("-" = paydown)	18.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing 4/	0.8	0.7	1.0	2.3	-0.4	-0.5	-0.5	-0.5	-0.2
Fund ("+" = net disbursement)	0.8	0.2	0.3	0.8	-0.4	-0.5	-0.4	-0.5	-0.2
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/	0.0	0.5	0.7	1.5	0.0	0.0	-0.1	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)	3.6	3.9	5.8	6.1	3.5	3.0	2.0	2.4	2.0
Level of gross reserves (eop) excluding old bank deposits		2.7	4.2	3.6	1.9	2.1	1.4	1.9	1.5
Memo									
GDP $ bln	16.9	12.1	12.6	14.3	15.2	15.7	16.3	17.0	17.9
Underlying balance of income 6/	-3.5	0.1	0.0	0.0	-0.2	-0.7	-0.7	-0.8	-0.8
Underlying current account balance 6/	-3.2	1.1	1.2	1.3	1.1	0.5	0.4	0.5	0.5
Reserves (months of imports of G&S)	8.0	8.1	9.9	9.6	5.2	4.3	2.7	3.2	2.6
Reserves/S-T debt (residual basis, in percent)	68.0	50.6	72.0	76.4	256.1	231.0	130.1	97.8	94.2
Reserves/S-T debt (residual basis, in percent) 7/	…	41.3	65.1	65.9	214.7	265.9	140.0	95.5	92.2
Reserves (in percent of GDP)	21.1	32.1	46.0	42.2	23.1	19.3	12.2	14.2	11.1
Principal and interest arrears of old banks 2/	3.0	14.8	…	…	…	…	…	…	…

Sources: CBI; and IMF staff estimates.

1/ Actual data include old banks' incomes.

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

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

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

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

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

7/ Excludes resolution committee deposits at the central bank.

Table 5. Iceland: General Government Operations, 2008–16 (GFS modified cash basis, percent of GDP 1/)

	2008	2009	2010	2011		2012	2013	2014	2015	2016
		Est.	Est.	Prog.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Total revenue 2/	**44.1**	**41.1**	**42.3**	**40.8**	**41.0**	**41.3**	**41.3**	**41.6**	**41.7**	**41.6**
Taxes	**33.8**	**30.8**	**31.8**	**30.9**	**31.3**	**31.2**	**31.3**	**31.5**	**31.7**	**31.9**
Taxes on income and profits	17.8	16.0	16.1	15.9	15.9	15.8	15.7	15.7	15.7	15.8
Personal Income Tax	13.2	12.9	12.8	12.8	13.0	12.8	12.8	12.9	12.9	13.1
Corporate Income Tax	1.9	1.8	1.2	1.4	1.3	1.5	1.5	1.5	1.5	1.5
Capital gains tax, rental income	2.7	1.4	1.9	1.7	1.6	1.5	1.5	1.4	1.3	1.2
Taxes on payroll and workforce	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Taxes on property	2.2	2.1	2.3	2.4	2.4	2.3	2.3	2.3	2.3	2.2
Taxes on goods and services	13.1	11.7	12.4	11.7	11.8	12.1	12.2	12.5	12.7	12.8
VAT	9.1	8.0	7.9	7.8	7.8	8.1	8.1	8.2	8.3	8.3
Other taxes on goods and services	4.1	3.7	4.5	3.9	4.0	4.0	4.1	4.3	4.4	4.5
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	0.6	0.4	0.4	0.4	0.4	0.4
Social contributions	**2.8**	**3.1**	**4.2**	**4.0**	**4.0**	**3.6**	**3.5**	**3.4**	**3.4**	**3.4**
Grants	**0.1**	**0.1**	**0.1**	**0.5**	**0.3**	**0.4**	**0.1**	**0.1**	**0.1**	**0.1**
Other revenue	**7.4**	**7.1**	**6.1**	**5.5**	**5.4**	**6.0**	**6.4**	**6.5**	**6.6**	**6.2**
Property income	3.8	3.6	2.6	1.8	1.7	1.8	2.1	2.4	2.5	2.6
o/w Interest income	3.3	3.1	2.2	1.6	1.5	1.5	1.6	1.9	2.0	2.1
Total expenditure 2/ 3/	**44.6**	**49.7**	**47.7**	**44.2**	**45.0**	**43.4**	**42.2**	**41.4**	**40.5**	**39.9**
Current expense 3/	**42.0**	**48.3**	**47.3**	**44.5**	**45.2**	**43.5**	**42.0**	**41.3**	**40.6**	**40.1**
Compensation of employees	14.6	15.0	14.6	13.9	14.2	13.5	13.1	12.8	12.6	12.5
Use of goods and services	11.6	12.5	12.3	11.5	11.7	11.1	10.7	10.5	10.3	10.1
Consumption of fixed capital	1.8	2.1	2.2	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Interest	3.3	5.2	5.1	5.2	5.0	5.5	5.5	5.6	5.6	5.5
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	1.4
Grants	0.2	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Social benefits	6.1	8.2	7.8	7.3	7.5	6.9	6.4	6.2	6.1	6.0
Other expense	2.6	3.0	3.0	2.5	2.5	2.4	2.3	2.3	2.2	2.2
Nonfinancial assets	**2.6**	**1.4**	**0.4**	**-0.3**	**-0.2**	**0.0**	**0.2**	**0.2**	**-0.1**	**-0.1**
Non-financial assets, acquisition	4.5	3.5	2.6	1.8	1.9	2.1	2.3	2.2	2.0	1.9
of which: road construction projects				0.1	0.1	0.2	0.2	0.2	0.0	0.0
Consumption of fixed capital (-)	-1.8	-2.1	-2.2	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1
Net lending/borrowing 3/	**-0.5**	**-8.6**	**-5.4**	**-3.3**	**-4.0**	**-2.2**	**-1.0**	**0.2**	**1.2**	**1.6**
Net lending/borrowing incl. write-offs	**-13.5**	**-10.9**	**-9.0**	**-4.6**	**-6.2**	**-2.2**	**-1.0**	**0.2**	**1.2**	**1.6**
Financial assets, transactions	**21.9**	**7.5**	**2.7**	**-0.3**	**-1.4**	**-0.6**	**2.0**	**1.2**	**1.6**	**0.1**
Currency and deposits	4.2	3.0	6.7	-0.9	-1.8	-0.9	1.8	1.0	1.3	-0.2
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	-5.0	0.0	0.4	0.3	0.3	0.2	0.3	0.3
Liabilities, transactions	**35.4**	**18.4**	**11.7**	**4.3**	**4.7**	**1.5**	**3.0**	**1.0**	**0.4**	**-1.5**
Securities other than shares	10.6	21.0	9.1	4.5	5.8	1.1	0.7	0.2	-0.5	-1.0
Loans	21.4	-3.0	2.4	-0.2	-1.1	0.5	2.3	0.8	0.9	-0.5
Domestic loans	19.0	-4.2	3.4	0.3	0.2	0.0	-0.2	-0.3	-0.3	-0.5
Foreign loans	2.4	1.3	-1.0	-0.4	-1.2	0.4	2.5	1.0	1.2	0.0
Stock of debt 4/										
General government gross debt 4/	70.3	88.2	92.4	100.1	100.0	95.2	94.0	90.6	86.9	81.1
Domestic	45.7	61.1	67.8	69.4	70.0	66.6	64.1	61.2	57.6	53.5
Foreign currency 4/	24.6	27.1	24.5	30.6	30.0	28.6	29.9	29.4	29.3	27.6
of which:										
Bilateral loans to support CBI reserves	0.0	3.1	7.4	13.9	14.0	13.1	12.4	11.3	9.1	7.2
Other	24.6	23.9	17.2	16.7	16.0	15.5	17.4	18.1	20.1	20.4
General government net debt 5/	41.7	55.8	62.6	66.0	66.5	64.7	63.0	60.1	56.5	52.4
Structural Balances 6/										
Structural balance	-1.7	-7.1	-2.4	-0.1	-2.7	-1.7	-0.8	0.2	1.2	1.6
Structural primary balance	-1.7	-5.1	0.3	3.3	0.7	2.2	3.0	3.9	4.8	5.0
Memo Items										
Nominal GDP (billion ISK)	1483	1495	1540	1627	1642	1761	1854	1953	2052	2161
Primary revenue	40.7	37.9	40.0	39.2	39.5	39.8	39.6	39.7	39.8	39.5
Primary expenditure	41.3	44.5	42.5	39.0	39.9	38.0	36.8	35.8	35.0	34.5
Primary balance (excl. interest income)	-0.5	-6.5	-2.5	0.2	-0.4	1.8	2.9	3.9	4.8	5.0
Change in the primary balance	-6.3	-6.0	4.0	2.7	2.1	2.2	1.1	1.0	0.9	0.3
Primary balance (excl. new road projects)	-0.5	-6.5	-2.5	0.3	-0.3	2.0	3.0	4.1	4.8	5.0
Change in the primary balance (excl. new road projects)	-6.3	-6.0	4.0	2.8	2.2	2.3	1.1	1.0	0.7	0.3
New discretionary revenue measures		2.4	2.9	0.7	0.7	1.4	0.6	0.7	0.5	0.0
New discretionary expenditure measures		0.0	-2.6	-1.9	-1.0	-0.6	-0.4	-0.3	-0.2	0.0
New discretionary measures		2.4	5.5	2.6	1.7	1.9	1.0	0.9	0.7	0.0

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

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

2/ Nominal measures have been allocated primarily toward revenue measures in 2012.

3/ Write-offs in 2008 are the result of CBI recapitalization and securities lending contracts that failed after the bank 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 HFF and savings bank recapitalization.

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

Loan from the Norwegian government directly to the CBI is excluded from general government debt. Does not include Fund liabilities.

5/ Gross debt minus liquid assets at the CBI (including assets from bilateral loans 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. The deterioration in 2009 does not reflect the fiscal stance. The difference between 2011 program and projection numbers reflects a change in the calculation methodology.

Table 6. Iceland: Central Government Operations, 2008–16
(GFS modified cash basis, percent of GDP)

	2008	2009	2010	2011		2012	2013	2014	2015	2016
			Est.	Prog.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Cash receipts from operating activities 1/	**30.0**	**27.7**	**30.0**	**28.0**	**28.1**	**28.6**	**28.6**	**28.9**	**29.1**	**28.9**
Tax revenue	23.6	21.3	22.2	21.5	21.9	21.9	21.9	22.1	22.3	22.4
Taxes on income, profits, and capital gains	10.3	9.3	8.9	8.4	8.4	8.3	8.1	8.1	8.0	8.0
Personal income tax	5.9	5.5	5.8	5.3	5.5	5.3	5.2	5.2	5.3	5.3
Corporate income tax	2.0	1.2	1.22	1.4	1.3	1.5	1.5	1.5	1.5	1.5
Other taxes on income and profit	2.4	2.6	1.9	1.7	1.6	1.5	1.5	1.4	1.3	1.2
Taxes on payroll and workforce	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Taxes on property	0.5	0.4	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Taxes on sales and services	12.1	10.8	11.7	11.5	11.6	11.9	12.1	12.3	12.5	12.6
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	0.6	0.4	0.4	0.4	0.4	0.4
Social contributions	2.8	2.8	4.0	4.0	4.0	3.6	3.5	3.4	3.4	3.4
Grants	0.1	0.1	0.1	0.5	0.3	0.4	0.1	0.1	0.1	0.1
Other receipts	3.6	3.5	3.7	2.0	1.9	2.6	3.0	3.2	3.3	3.0
of which:										
Interest income	2.6	2.9	1.8	1.3	1.2	1.2	1.4	1.6	1.7	1.8
Total spending 1/	**30.5**	**36.9**	**34.5**	**30.7**	**31.3**	**30.5**	**29.5**	**28.8**	**28.0**	**27.5**
Cash payments for operating activities	**28.2**	**34.3**	**32.8**	**29.9**	**30.3**	**29.3**	**28.1**	**27.5**	**26.9**	**26.5**
Compensation of employees	8.5	8.6	8.3	7.5	7.6	7.2	7.1	7.1	7.0	7.0
Purchases of goods & services	5.5	6.0	6.2	5.4	5.7	5.3	5.1	4.8	4.6	4.5
Interest 2/	1.9	5.3	4.8	4.3	4.0	4.7	4.8	5.0	5.0	4.9
Transfer payments	12.3	14.4	13.6	12.6	13.1	12.1	11.1	10.6	10.3	10.1
Net cash inflow from operating activities	**-11.2**	**-6.6**	**-2.8**	**-1.9**	**-2.2**	**-0.7**	**0.5**	**1.4**	**2.1**	**2.4**
Investments in NFAs	2.3	2.6	1.7	0.9	1.0	1.2	1.4	1.3	1.1	1.1
*of which: r*oad construction projects				0.1	0.1	0.2	0.2	0.2	0.0	0.0
Overall balance (incl. adjustment to cash)	**-12.6**	**-10.1**	**-4.5**	**-2.7**	**-3.2**	**-1.9**	**-0.9**	**0.1**	**1.0**	**1.3**
Write-offs	13.0	2.3	3.6	1.3	2.2	0.0	0.0	0.0	0.0	0.0
of which:										
Recapitalization related write-offs 3/	11.8	0.0	2.1	0.0	2.2	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
Augmented Balance	-25.6	-12.4	-8.1	-4.0	-5.4	-1.9	-0.9	0.1	1.0	1.3
Memorandum Items:										
Nominal GDP	1,483	1,495	1,540	1,627	1,642	1,761	1,854	1,953	2,052	2,161
Primary revenue	27.4	24.8	28.2	26.7	26.9	27.4	27.2	27.3	27.3	27.0
Primary expenditure	28.6	31.5	29.7	26.4	27.3	25.8	24.7	23.9	23.1	22.6
Primary balance (excl. interest income)	-1.2	-6.7	-1.5	0.3	-0.4	1.6	2.5	3.5	4.3	4.4
Change in primary balance		-5.5	5.2	1.8	1.1	2.0	0.9	0.9	0.8	0.1
Primary balance (excl. new road projects)		-6.7	-1.5	0.4	-0.3	1.8	2.7	3.6	4.3	4.4
Change in the primary balance (excl. new road projects)		-6.7	-1.5	1.9	1.2	2.1	0.9	0.9	0.7	0.1

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

1/ Measures are allocated primarily toward revenue measures in 2012-13.

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

3/ Write-offs in 2008 are the result of CBI recapitalization; write-offs in 2010 reflect recapitalization of the HFF; write-offs in 2011 reflect HFF and savings bank recapitalization.

Table 7. Iceland: Estimated Impact of 2011 Fiscal Measures

Revenue Measures 1/	Nominal Amount (In ISK Billion)	Amount (In Percent of GDP)
Raising CIT and the capital gains tax rates to 20 percent	2.8	0.2
PIT on early withdrawal of private pensions	4.2	0.3
Raising the net wealth and inheritance tax rates	2.5	0.2
Other tax measures 2/	2.4	0.1
Total Revenue Measures	**11.9**	**0.7**

Expenditure Measure 1/	Nominal Amount (In ISK Billion)	Nominal Amount (In Percent of GDP)
Current expenditure	**9.0**	**0.5**
Wages	4.4	0.3
Other current expenditure	4.5	0.3
Transfers	**1.7**	**0.1**
Capital expenditure	**5.9**	**0.4**
Total Expenditure Measures	**16.6**	**1.0**

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

1/ Fiscal measures are relative to 2010. Easing due to the wage agreement reduces the impact of the measures relative to previous estimates.

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

Table 8. Iceland: Reforms of the Fiscal Framework 1/

Weakness Identified	Reforms Proposed	Progress to Date
Strengthening the Central Government Budget Framework		
Medium-term fiscal and budget frameworks do not inform the cabinet's and parliament's policy prioritization discussions; enable spending agencies to prepare long-term budget plans; nor ensure multi-year expenditure discipline and fiscal sustainability.	Prepare a Medium-term Fiscal Strategy setting multi-year fiscal objectives for general government deficit and debt.	2011 Budget included a medium-term fiscal framework for the State Budget based on the aim of attaining a primary surplus by 2011, an overall surplus by 2013 and a reduction in State debt below 60 % of GDP over the long-term.
	Introduce a fixed, two-year nominal ceiling for aggregate State expenditure.	Budget 2011 fixed a two-year nominal expenditure ceiling for aggregate State expenditure.
	Expenditure ceiling should cover the majority of State expenditure and exclude only those items which are fiscally neutral, highly volatile, or sensitive to the economic cycle, or genuinely nondiscretionary.	Expenditure ceiling covers about ¾ of State expenditure. The list of volatile or non-discretionary items excluded from the ceiling is limited to debt interest, pension liabilities, tax write-offs, capital income taxes, unemployment compensation and the Municipal Equalization Fund.
Preparation of the annual budget follows a bottom-up rather than top-down sequence.	Adopt a top-down sequence to the preparation of the budget in which the Cabinet agrees the overall fiscal objectives and budget ceiling before approving ministerial allocations.	2011 Budget discussions in Cabinet followed a top-down sequence.
	Introduce a spring budget orientation debate in which Parliament to allow for legislative scrutiny and endorsement of the Medium-term Fiscal Strategy.	Under consideration for 2013 Budget cycle.
	Adopt a top-down sequence to budget debating and voting of the annual budget in Parliament.	Under consideration for 2013 Budget cycle.
Frequent resort to supplementary budgets to legitimize discretionary spending increases and operational overruns. Budget transparency and discipline further undermined by complex system of carryovers and earmarking of revenue.	Restrict supplementary budgets to exceptional situations.	In 2010, supplementary budgets have not been used to fund new policies and have so far been expenditure neutral.
	Introduce a contingency reserve of at least 1% of State expenditure to cope with unforeseeable, unavoidable and unabsorbable pressures that arise during budget execution.	2010 and 2011 Budgets included a contingency reserve of ISK 5 billion or approximately 1% of State expenditure. Access to the reserve in 2010 was limited to genuine contingencies.
	Abolish borrowing from future appropriations. Fix a quantitative limit on carry-forward of unspent appropriations from one year to the next.	2010 Budget abolished borrowing from future appropriation, limited the amount of unspent appropriation that can be automatically carried over from one year to the next to 4% of turnover, and limited to total stock of carryovers that can be accumulated to 10 % of turnover.
	Reduce earmarking of revenue to specific expenditures.	Under consideration for 2012 Budget.
	More intensive cabinet and parliamentary monitoring of budget execution.	In 2010, Cabinet and the Budget Committee of Parliament began receiving monthly reports on the execution of the State budget.

Table 8. Iceland: Reforms of the Fiscal Framework 1/ (Cont'd)

Strengthening the Local Government Budget Framework		
		A working group with representatives from central and local government recommended in a September 2010 report that several changes be made to the law governing local government to improve municipal finances. A bill implementing the working group's recommendations has been introduced into Parliament. Local governments have agreed to begin adopting some of the proposals on an informal basis before the passage of legislation. The proposals related to the identified weakness are set out below.
Municipalities not subject to firm deficit rule. Many ran deficits in boom years.	Impose a fiscal rule prohibiting municipalities from running operating deficits.	The bill prohibits municipalities from running operating deficits.
Municipalities not subject to limit on their borrowing. Many incurred large debts in foreign currency.	Impose a fiscal rule requiring municipalities keep their debt-to-revenue ratios below 150 percent. Require municipalities whose debt already exceeds 150 percent of revenue to borrow only in local currency, from Municipal Credit Iceland.	The bill requires that debt and commitments be kept below 150 percent of revenues. Municipalities who breach the ceiling are required to enter a negotiated agreement with the MoI. If the agreement proves ineffective, such municipalities could be subject to additional borrowing restrictions.
Municipal revenues extremely volatile.	Require municipalities to satisfy the deficit rule (above) not year by year but over three-year rolling periods.	The bill requires that the deficit rule apply over rolling three-year periods.
Municipal finances not subject to effective central monitoring.	Create a three-tiered approach to financial oversight of municipalities based on the principle of earned autonomy, in which municipalities breaching fiscal rules are subject to increasing monitoring.	The bill allows the MoI to impose monthly monitoring of municipal finances in case a negotiated agreement proves ineffective.
Limited coordination on fiscal matters between local and central government.	Consider creating a new high-level committee in charge of local-central coordination, comprising representatives of central and local government and an independent chair, with subcommittees for monitoring, accounting, and new mandates.	The bill requires that a Cooperation Board of State and Local Governments, consisting of three ministers and three local government representatives, oversee the formal cooperation between the central and the local governments.
Few sanctions for noncompliance with rules short of takeover by central government.	Introduce further sanctions, including some that are relatively mild, such as "naming and shaming" of noncompliant municipalities in public reports.	The bill gives powers to the MoI to subject noncompliant municipalities to a binding adjustment plan, targets for the operating balance, and mandatory spending cuts or revenue increases. If needed, the MoI may deprive the municipal council of financial powers, put the municipality into bankruptcy proceedings, or negotiate a merger with another municipality.

1/ Based on FAD TA recommendations.

Table 9. Iceland: Status of the Financial Sector

	Total assets				Capital adequacy ratio 3/	Status
	end-Dec 2009 2/		end-Dec 2010			
	in billions of ISK	in percent of GDP	in billions of ISK	in percent of GDP	in percent	
Commercial banks 1/	**2592**	**173**	**2919**	**189**	**19.4**	
Landsbankinn	1061	71	1171	76	20.0	Going concern
Arion	757	51	813	53	15.2	Going concern
Islandsbanki	717	48	873	57	22.6	Going concern
MP bank	57	4	62	3	...	Going concern
Byr and SpKef	**243**	**16**	...	...	...	
BYR Sparisjóður	165	11	*Assets consolidated with Islandsbanki figures*		...	In April 22, 2010 the bank was intervened, assets and deposits were transferred to new Byr (a commercial bank). In July 2011, new Byr and Islandsbanki announced a merger, pending approval of the Competition Authority.
Sparisjóður Keflavíkur	78	5	*Assets consolidated with Landsbankinn figures*		...	On April 22, 2010 the bank was intervened, assets and deposits were transferred to new Spkef (a savings bank). Negotiations between creditors and authorities were not successful to keep the bank operating. As a consequence, deposits were transferred to Landsbankinn and the two entities are being merged (FME decision dated March 5, 2011).
Other saving banks	**65**	**4**	**59**	**4**	**4**	2 small saving banks are in a process of consolidation with their parent banks.
Housing Finance Fund (HFF)	**795**	**53**	**836**	**54**	**2**	The HFF recapitalisation law was adopted by parliament in December 2010. A 33 bln ISK capital injection will bring HFF's capital to around 2 percent of risk-weighted assets.

Sources: CBI and FME; and staff calculations.

1/ Figures are adjusted for the subordinated instruments provided by the government under private capitalization.

2/ As of end-June 2010 for Byr and the savings banks.

3/ The Capital Adequacy Ratio is calculated using core tier 1 capital based on end 2010 audited financial accounts (pre-merger with BYR and Sp Kef for Islandsbanki and Landsbankinn).

Table 10. Iceland: Access and Phasing Under the Stand-By Arrangement, 2008–11

	Purchases		
Date Available	SDR mns	Percent of quota	Conditions include
November 2008	560	476.2	Board approval of arrangement
28 October 2009	105	89.3	First review completion and observance of end-December 2008 PCs
15 December 2009	105	89.3	Second review completion and observance of end-October 2009 PCs
15 July 2010	105	89.3	Third review completion and observance of end-May 2010 PCs
25 November 2010	105	89.3	Fourth review completion and observance of end-September 2010 PCs
25 February 2011	140	119.0	Fifth review completion and observance of end-December 2010 PCs
15 July 2011	280	238.0	Sixth review completion and observance of end-June 2011 PCs
Total	1400	1190.4	

Source: IMF staff estimates

Table 11. Iceland: External Financing Requirements and Sources, 2010–16
(In billions of US dollars)

	2010 Prelim	2011 Proj	2012 Proj	2013 Proj	2014 Proj	2015 Proj	2016 Proj
A Gross Requirements	12.3	10.9	7.3	3.1	3.5	3.3	4.1
Current account deficit	1.3	-0.3	-0.4	0.2	0.2	0.2	0.1
Amortization (MLT)	3.1	5.3	4.6	1.5	2.0	2.1	3.0
Official (excl. IMF)	1.9	4.6	3.9	3.7	0.8	0.9	1.9
Private	1.2	0.8	0.7	-2.2	1.2	1.2	1.2
Short-term debt	7.9	5.9	3.2	1.4	1.2	0.9	0.9
B Sources of Financing	11.1	8.0	7.7	3.6	3.9	3.8	4.3
Foreign Direct Investment (net)	4.9	0.6	0.8	0.8	0.8	1.2	0.8
FDI outflows Abroad	2.0	0.1	0.2	-0.1	-0.1	0.4	0.1
FDI inflows to Iceland	3.0	0.5	0.6	0.9	0.9	0.8	0.7
Net inflows of equity and other capital	0.7	0.1	10.9	-3.6	-1.9	-2.3	-0.8
Disbursements (MLT)	3.8	2.6	2.5	0.8	0.8	0.9	1.6
Short-term debt	7.7	3.4	-10.1	3.3	2.4	2.3	1.1
Other net assets	-4.1	1.5	1.1	1.8	0.7	2.0	1.1
Reserves accumulation (-: increase)	-1.9	-0.3	2.5	0.5	1.1	-0.4	0.4
C Financing Gap (A-B)	1.2	2.9	-0.4	-0.5	-0.5	-0.5	-0.2
Errors and omissions	0.2	0.7	0.0	0.0	0.0	0.0	0.0
Accumulation of arrears	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing	1.0	2.3	-0.4	-0.5	-0.5	-0.5	-0.2
Fund	0.3	0.8	-0.4	-0.5	-0.4	-0.5	-0.2
Bilateral (earmarked/ non-cash)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other identified new financing	0.7	1.5	0.0	0.0	-0.1	0.0	0.0
Residual Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: CBI; and IMF staff estimates

Table 12. Iceland: Indicators of Fund Credit, 2008–16
(In millions of SDR)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Existing and prospective Fund credit									
Disbursements	560	105	210	525	0	0	0	0	0
Stock	560	665	875	1400	1120	761	512	171	0
Obligations	0	13	18	19	321	389	268	350	172
Principal (repurchases)	0	0	0	0	280	359	249	341	171
Charges and interest	0	13	18	19	41	30	19	8	1
Stock of existing and prospective Fund credit									
In percent of quota	476	565	744	1190	952	647	436	145	0
In percent of GDP	5.1	8.6	10.7	15.6	11.7	7.7	5.0	1.6	0
In percent of exports of G&S	11.5	16.3	18.9	26.8	19.9	13.0	8.5	2.7	0
In percent of gross reserves	24.3	26.9	23.2	37.0	50.8	39.7	40.8	11.2	0
Obligations to the Fund from existing and prospective Fund arrangements									
In percent of quota	0.0	11.1	15.2	16.6	272.9	330.7	227.9	297.3	146.6
In percent of GDP	0.0	0.2	0.2	0.2	3.4	3.9	2.6	3.2	1.5
In percent of exports of G&S	0.0	0.3	0.4	0.4	5.7	6.6	4.4	5.5	2.6
In percent of gross reserves	0.0	0.5	0.5	0.5	14.6	20.3	21.4	22.8	13.7

Sources: IMF staff estimates; and projections

ATTACHMENT I. LETTER OF INTENT

Reykjavík, August 16, 2011

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Ms. Lagarde:

1. **Our economic program has underpinned Iceland's emergence from crisis and the recovery underway**. Growth is resuming, and we have made significant achievements under the program. Public finances have been put on a sustainable footing, the exchange rate has stabilized, and the financial sector has been rebuilt. While the unemployment rate remains unacceptably high, the measures that we have put in place to facilitate job retraining and skill upgrading should help spur job creation by reducing skill mismatch. The recent issuance of an international sovereign bond marks a key milestone in our emergence from crisis and is a critical step toward the normalization of external financing. Looking ahead, we intend to press on with our policy agenda. Our key policy challenges are an orderly and gradual lifting of capital controls, the development of a post-capital controls monetary framework, completion of the fiscal consolidation with the aim of reducing public debt to a prudent level, and a further strengthening of financial sector supervision and regulation. We continue to attach high priority to accelerating private sector debt restructuring, as we believe that this will be critical to a sustainable recovery and job creation. Our policy plans in these areas are elaborated in this letter. Although the Stand-by Arrangement is ending, we will keep our close policy dialogue with the Fund and will consult with it from time to time in accordance with the Fund's policies on post-program consultations.

2. **Policy implementation under the program remains broadly on track**. All end-June and continuous performance criteria have been met (Table 1). We continue to make progress on the structural benchmark on the fiscal framework for local governments, and the relevant legislation is in parliament and is expected to be passed in September 2011 (Table 2). On this basis, and on the basis of the policies defined in this letter, we request completion of the sixth review under the Stand-By Arrangement.

The outlook

3. **We continue to expect a gradual recovery to take hold this year**.

- Growth is expected to reach 2½ percent in 2011, and unemployment is set to decline. But risks to growth remain tilted to the downside. Prospects for investment are still uncertain, while still high unemployment and the need to restore balance sheets continue to weigh on private consumption.

- We expect headline inflation to rise to around 4 percent this year on average due to the krona depreciation, wage increases, the pick-up in house prices, and rising commodity prices, before returning to the central bank's target of 2½ percent by early 2013. Risks to the inflation outlook emanate mainly from rising inflation expectations and higher pass through of wages into prices than expected in the baseline.

- The evolution of the balance of payments is supporting the lifting of capital controls. The current account surplus, the recent international sovereign bond issuance, the realization of program financing, and disbursements from bilateral partners are expected to further increase reserves to about $6 billion at end-2011, or around 75 percent of short-term external debt.

4. **Public and external debt ratios should both decline rapidly over the medium term**. Gross external debt is projected to reach about 250 percent of GDP at end-2011, but we project that debt repayments, the release of captive non-resident krona holdings in line with our capital account liberalization strategy, and ongoing asset recovery will reduce it to around 150 percent of GDP by 2016. We expect general government debt to peak at around 100 percent of GDP in 2011 before declining over the medium term, reaching about 80 percent of GDP in 2016.

Securing fiscal sustainability while supporting growth

5. **We have slightly eased our fiscal target for 2011 to support the economic recovery**. In the first half of the year, revenue performance remained robust and spending contained, enabling us to meet our end-June target, despite cost increases due to exchange rate and interest rate fluctuations. Financial institutions and profits from foreign exchange auctions are expected to deliver sufficient revenue to cover the temporary interest subsidy. At the same time, as part of the wage agreements with social partners, we increased social benefits more than previously planned, to support the recovery and help shield our most vulnerable citizens, and raised public sector wages in line with the general labor market. To accommodate this, we have eased our fiscal target (general government primary balance) for 2011 by ½ percentage point of GDP. Despite these expenditure increases, we expect to end the year with a primary deficit of ¼ percent of GDP, coming close to obtaining a balanced primary position and representing an improvement of over 2 percent of GDP compared with 2010. We are actively seeking ways to reduce the primary deficit by containing expenditure. Moreover, if revenue is stronger than expected in the second half of 2011, we will save any excess.

6. **We aim to present a revised medium-term fiscal consolidation plan for 2012–2015 by end-September with a goal to strike a better balance between growth and**

continued adjustment. With the output gap expected to remain in the near term, and given the track record established by the strong front-loaded fiscal consolidation to date, we intend to ease the medium-term fiscal path to support economic activity. We remain committed to achieving the key goals in our initial medium-term fiscal plan, while moderating the pace of adjustment. Specifically, we plan to reach an overall fiscal surplus in 2014 (instead of 2013 as originally planned) and to reduce gross debt to 60 percent of GDP in the long-term. We believe that these goals are achievable with an improvement of the general government primary balance to 2 percent of GDP in 2012 and 5 percent of GDP by year 2016. We intend to take measures sufficient to reach these targets. To this end, as a first step, we are preparing a package of new measures amounting to 1¾ percent of GDP in 2012, of which two-thirds will be permanent:

- Permanent measures will make up over half of the adjustment on the revenue side in 2012. We are preparing a wide range of measures, including increasing environmental and resource taxation, introducing a financial activities tax, and changes related to the taxation of individual pension funds. To further strengthen the permanent revenue base the net wealth tax will be reviewed and extended over the medium term and the carbon tax will be made permanent. Asset sales will provide additional temporary revenues. In 2012 the ISFI will submit proposals for divestment of shares in financial institutions during 2012–15. We will, in early 2012, assess the prospects of reaching our revenue targets from assets sales. If revenue targets from asset sales cannot be attained, we will introduce further revenue measures within the fiscal year 2012 to ensure that overall revenue targets are met.

- Permanent measures on the expenditure side will make up the remainder of the 2012 adjustment, to be achieved, inter alia, through the ongoing public administration reforms, mergers of institutions, and efficiency improvements.

- Additional permanent measures are planned for 2013 through 2015, primarily on the expenditure side, with asset sales providing additional revenue each year.

7. **We are finalizing the new fiscal framework for local governments**. We expect that the new Local Government Bill will be passed by parliament by end September 2011 (**structural benchmark**), and we have begun preparing regulations that will clarify the implementation of the bill. Therefore, local governments will need to align their operations and finances with the new fiscal framework as they prepare the 2012 budgets. To this end, we have established a committee consisting of key Ministries and representatives from Municipalities to coordinate public finances. As many local governments' external obligations have been rolled over into long-term domestic loans, their repayment profile has significantly improved and contingent liabilities for the central government have diminished. We continue to monitor local governments' fiscal consolidation process and debt maturity profile. The new reporting system of local government operations will be introduced in October 2011.

Monetary policy and capital controls

8. **Monetary policy will remain focused on inflation and preserving exchange rate stability**. In its June meeting, the MPC raised concerns about impact of the wage agreements on price stability and inflation expectations. To reduce the risk that long-term inflation expectations drift upwards, it indicated that tighter monetary policy may become warranted in the near term. To improve monetary policy implementation, the CBI will continue to strengthen liquidity management, particularly as the lifting of capital controls may lead to increased pressures on banking system liquidity. Purchases of foreign exchange in weekly auctions will permit further accumulation of non-borrowed reserves.

9. **We are implementing our strategy for lifting capital controls**. The first auction of foreign currency to holders of offshore krona went smoothly and led to a significant narrowing of the onshore-offshore exchange rate spread. The "second leg" of this auction, involving the sale of long-term krona-denominated government securities to holders of foreign exchange held abroad, was oversubscribed and achieved our objective of reducing the overhang of offshore krona while preserving foreign exchange reserves. The first leg of the second auction achieved similar levels and resulted in a marginal tightening of the offshore rate. The second leg of this auction is scheduled for August. In line with our strategy, we are also preparing liberalization channels that will allow krona acquired in the auctions to be invested in a broader range of long-term investment vehicles. We will adjust the pace of the liberalization process to maintain reserve adequacy and stability in the financial sector and the government bond market. Enforcement of capital controls will be maintained throughout the liberalization process, and any legislative changes will leave the CBI with flexibility to address any new channels of circumvention that may arise as the controls are gradually lifted. The Fund has in the past approved the temporary retention of a measure in the capital controls regime that gives rise to a restriction since it marginally affects the conversion and transfer of some interest on bonds. Given our strategy to lift such controls, we expect that this measure will be eliminated as soon as circumstances permit. Accordingly, we request temporary Board approval of further retention of the above-mentioned measure.

10. **Looking ahead, a key priority will be to design a post-capital controls monetary framework**. The new framework must take into account the need to manage large external shocks, volatile capital flows, and risks arising from the financial sector. This suggests that macroprudential tools will be a critical component. Our consultations with stakeholders are ongoing, notably with respect to assessing the relative merits of different future monetary regimes and the most appropriate institutional set-up of a new macroprudential framework.

Restoring the financial sector to health

11. **We have completed the recapitalization of the deposit taking institutions.** Concrete steps have been taken to ensure proper capitalization of banks.

- **Bank's capital adequacy has been confirmed.** The FME has concluded its annual review of the three large commercial banks' Internal Capital Adequacy Assessment Process (ICAAP) and confirmed that they hold sufficient buffers to address credit and market risks. Their core tier 1 capital remains above the 12 percent minimum currently required by the FME. This review has included a focused examination of the banks' audited loan portfolio (with the participation of local consultants) to ensure that loan valuations, after provisions and taking into account the discount at which they were purchased from the old banks, reflect their expected fair recovery value. In addition, the FME has determined that the impact of the June 2011 Supreme Court ruling regarding foreign exchange-indexed corporate loans on banks' capital is expected to be limited. Moreover, the FME's high level assessment of banks' capacity to absorb losses under plausible scenarios (based on the European Banking Authority's criteria) produced no undercapitalization events.

- **Recapitalization of the savings banks has been completed.** In July, new Byr's assets and deposits were sold to a commercial bank. The proceeds from the sale of the state´s shares cover nearly all of the capital previously injected into New Byr. On SpKef, discussions are ongoing with a commercial bank on determining the size of our obligations under the blanket guarantee. We intend to present to parliament in October a bill authorizing the Ministry of Finance to meet these obligations. We have, through the Central Bank´s Holding Company injected new capital into five savings banks, thereby enabling them to meet FME capital adequacy requirements. With these steps, we have completed the recapitalization of the savings banks.

- **Recapitalizing non-deposit taking institutions is near completion.** All remaining private finance companies hold capital above 8 percent of risk-weighted assets. A decision as to whether, and if so to what extent, to recapitalize Byggdastofnun (a small regional fund) will be made on the basis of the recommendations of a working group, which was presented in May.

12. **We will press ahead with the further strengthening of commercial banks, the banking system, and reforms to HFF and the savings banks**.

- **We attach high priority to ensuring that remaining legacy vulnerabilities in commercial banks are addressed**. While the banks' valuation of their assets at significantly below face value provides them with reasonable buffers to address financial risks, we will continue to closely monitor banks progress in reducing the still high level of non-performing loans and remaining imbalances. To this end, beginning in September 2011, the FME will meet quarterly with each individual institution to take stock of progress made in cleaning up their balance sheets and to agree on targets to reduce remaining legacy vulnerabilities.

- **Identifying policy issues concerning the future of the financial system is critical**. The Ministry of Economic Affairs is preparing a report, to be delivered to Althingi during its autumn session, on the future of the financial system and its supervision. The report will be the basis for new legislation and analyze the present legal framework, international obligations and the financial institutions in light of the size of Iceland and the complexity of its economy. The aim is to identify decisions that will need to be taken on the future of the system, on strengthening financial sector supervision, and on enhancing financial stability.

- **Reform of the Housing Finance Fund (HFF)**. We are in the process of assessing HFF's capital needs in light of anticipated write-downs associated with the measures agreed in December 2010. Based on our assessment, additional funds may have to be injected in order to increase the capital of HFF to the regulatory minimum. Further steps towards reforming HFF will be taken based on the work on the future of the financial system (see previous bullet).

- **Consolidating the remaining savings banks.** For the remaining eight small savings banks, the Icelandic State Financial Investment Company (which holds the government's shares in the three of these banks that are majority state owned) is exploring, together with the five privately held savings banks, options to strengthen their medium-term viability through consolidation (group merger or incorporation into the commercial banks). Meanwhile, the FME will closely monitor these institutions to ensure that viability issues are addressed in a timely fashion.

13. **Strengthening prudential rules and supervision will remain key priorities**.

- **The FME will continue to further strengthen its prudential framework in line with EU** directives **and regulations**. In September, it will issue rules on large exposures and additional own funds (hybrid capital) in accordance with the revised Capital Requirements Directive. The FME also intends to update measures to combat money laundering and terrorist financing in October.

- **The credit registry is operational**. The FME, in collaboration with the CBI, has completed and made operational a database to closely monitor and identify credit concentration and large exposures (currently set at ISK 300 million) of banks' related and non-related economic groups.

- **Bank reporting is being harmonized**. In mid-July, the FME completed, in coordination with the banking industry, a standardized form on banks' loan portfolios. By mid September the banks will submit the first fully harmonized reports. This report will facilitate the monitoring of progress on household and corporate debt restructuring. The FME also regularly assesses the consistency across banks of income recognition from asset recovery and restructured loans.

- **Filling supervisory gaps**. The FME has completed a two and a half-year plan to address supervisory gaps identified by an internationally recognized supervision expert. The plan includes actions on risk model supervision, on-site and off-site procedures, disclosure and reporting practices, organization and management, human resources management, training, and IT infrastructure, benchmarked against supervisory practices in an advanced European country. During 2013, we will request that the IMF undertake an independent assessment under a stand-alone Report on the Observance of Standards and Codes (ROSC) against Basel Core Principles for Effective Banking Supervision. We are committed to providing the FME with sufficient resources to ensure that it can successfully perform its duties.

- **Deposit insurance.** A bill is pending in parliament on revising deposit insurance legislation in line with recently introduced changes in European legislation. The proposed legislation aims to help restore confidence in the banking system and pave the way for an eventual orderly and gradual lifting of the blanket guarantee on deposits. We have also recently amended the existing legislation with an interim provision that secures payments of premiums for this year. Progress has also been made in identifying the remaining legal loopholes in the regulation of the banking industry, and coordination between the CBI and FME has been strengthened. We plan to complete and formalize our proposals as part of the discussions on the future of the banking system (see ¶12). A longer-term objective will be to improve the existing legal framework for bank resolution in line with the EU timetable.

Completing private sector debt restructuring

14. **Corporate and household debt restructuring is advancing**. Data on debt restructuring compiled by the FME, the banks, and the Debtors Ombudsman shows progress. Banks have made restructuring proposals to nearly all eligible SMEs under the measures agreed in December 2010, and they are aiming to complete the restructuring of most large corporations by end-2011. Household debt restructuring is progressing steadily and banks expect to complete this process by end-2011. The granting of automatic protection from creditors upon applying to the Debtors Ombudsman ended as scheduled at end-June as did the deadline for applying for the household debt measures agreed in December 2010.

External financing

15. **We have secured adequate external financing**. Our Nordic and Polish bilateral partners have completed the extension until end-December 2011of the availability of financing under their arrangements, and we intend to draw on this funding if a financing gap arises. Our international sovereign bond issuance meets the central government's rollover requirements for 2011 and 2012. Nonetheless, depending on conditions in the international market, we may undertake an additional issue in coming months.

16. **We still attach high importance to resolving the Icesave issue**. The law authorizing the Minister of Finance to confirm the agreements reached between the Icelandic Government a, respectively, the Dutch and U.K. authorities on the Icesave issue was revoked following a national referendum in April last. We had negotiated these agreements in spite of our view that the reimbursement of the Icesave deposit payout is not a sovereign obligation and that Iceland´s deposit guarantee scheme was set up in full compliance with the respective European directives. This is still our view. Consequently, it is likely that the dispute regarding the deposit guarantees will be settled through legal channels. We are ready to fully engage in such a process. We have already affirmed that should a competent court come to the conclusion that Iceland has a sovereign obligation stemming from the Icesave deposits, we will honor that obligation.

Yours sincerely,

/s/
Jóhanna Sigurðardóttir
Prime Minister

/s/
Steingrímur Sigfússon
Minister of Finance

/s/
Már Guðmundsson
Governor of the Central Bank of Iceland

/s/
Árni Páll Árnason
Minister of Economic Affairs

Table 1. Iceland: Quantitative Performance Criteria and Indicative Targets 1/

	Performance Criteria													
	Oct. 09 Prog.	Oct. 09 Actual	Dec. 09 Prog.	Dec. 09 Actual	May 10 Prog.	May 10 Actual	Sep 10 Prog.	Sep 10 Actual	Dec 10 Prog.	Dec 10 Actual	Mar 11 Prog.	Mar 11 Actual	Jun 11 Prog.	Jun 11 Actual
														(In billions of Króna)
1. Floor on the change in the central government net financial balance 2/	-175	-139.5	-200	-166.7	-55	-48.4	-140	-82.9	-150	-121	-40	-11.9	-80	-55.4
2. Ceiling on the change in net domestic assets of the Central Bank of Iceland 3/	20	34	42.6	30.3	65	16.3	40	1.1	40	-15	35	-29	13.5	-40
3. Ceiling on the change in the net domestic claims of the Central Bank of Iceland to the central government (Indicative targets)	70	8.6	70	13.8	80	19.5	80	9.6	80	41.6	70	-14	70	-7
														(In millions of U.S. dollars)
4. Floor on the change in net international reserves of the Central Bank of Iceland 4/	-425	-278	-475	-319	-325	-122.9	-530	68	-580	812	-592	369	-460	904
5. Ceiling on the level of contracting or guaranteeing of new medium and long term external debt by central government 5/	3500	54.5	3500	486.6	2500	0	2500	1486	2500	1486	2000	0	2500	1000
6. Ceiling on the stock of central government short-term external debt 6/	1400	0	1400	0	750	0	750	22	750	22	700	0	700	0
7. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors 6/	0	0	0	0	0	0	0	0	0	0	0	0	0	0

1/ Cumulatively from the beginning of each year (unless otherwise indicated).
2/ The net financial balance excludes the capital injection cost of bank and central bank recapitalization and excludes the increase in debt from guaranteeing the repayment of depositors in foreign branches of Icelandic banks, as well as the increase in central government debt due to on lending to finance road construction related to the Suðurlandsvegur, Vesturlandsvegur, Vadlaheidargong, and Reykjanesbraut road projects (the latter up to a maximum of ISK 6 billion).
3/ Excluding changes due to central bank recapitalization bond.
4/ (-) indicates decrease. NIR is defined as the difference of gross foreign assets and foreign liabilities (including all foreign currency deposits and other liabilities of financial institutions and the general government at the CBI; from September 2010, the definition excludes foreign currency deposits of the general government at the CBI, as specified in the TMU. NIR adjuster is specified in the TMU.
5/ Excludes IMF and excludes official bilateral loans for deposit insurance. Short term external debt has an original maturity of up to and including one year. Medium and long-term external debt has an original maturity of more than one year.
6/ Applies on a continuous basis.

Table 2. Iceland: Structural Conditionality

Structural Conditionality	Status
Structural Benchmarks	
Passage of legislation to strengthen the fiscal framework for local governments, covering (i) the fiscal rule to be applied; (ii) restrictions on municipal borrowing; (iii) mechanisms for dealing with revenue volatility; (iv) surveillance modalities; (v) coordination mechanisms; and (vi) sanctions for non-compliance (LOI ¶7). *By end-June 2011.*	Not met/To be passed by end-September.

ATTACHMENT II. TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This memorandum sets out the understandings between the Icelandic authorities and the IMF staff regarding the definitions of quantitative and structural performance criteria, as well as respective reporting requirements for the Stand-By Arrangement (SBA). These performance criteria and indicative targets are reported in Tables 1 and 2.

2. The exchange rate for the purposes of the program is set at 113.9 Icelandic króna per U.S. dollar. The corresponding cross exchange rates are provided in Table 3.

Central Government

3. **Definition:** For the purposes of the program, the government includes the central government, which includes government entities of group "A" as defined in the Government Financial Reporting Act No.88/1997.

4. **Supporting material:** The Ministry of Finance (MoF) will provide to the IMF detailed information on monthly revenues and expenditures both on a cash and accrual basis, domestic and foreign debt redemptions, new domestic and foreign debt issuance, change in the domestic and foreign cash balances of the central government at the central bank of Iceland, all other sources of financing including capital transactions, and arrears of the central government. Data will be provided within 30 days.

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

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

5. **Definition:** The net financial balance of the central government will be measured from the financing side at current exchange rates, and will be defined after contributions to the government employee's pension fund. The net financial balance will be defined as the negative of the sum of (i) net domestic financing and (ii) net external financing.

- **Net domestic financing** (NDF) is defined as the change in the stock of the net domestic debt of the central government. Domestic central government debt consists of ISK-denominated debt financed by the banking system (the Central Bank of Iceland (CBI) and commercial banks) and non-bank financial institutions to the central government. It consists of treasury bills, government bonds, promissory notes and other domestic debt instruments issued by the government, including any interest arrears, and loans and advances to the central government by the commercial banks, including any interest arrears. Net domestic central government debt is calculated as the gross debt plus proceeds from the sale of financial assets (including, but not limited to, government, government-backed, or other bonds obtained during the central bank recapitalization process, and as a result of failed securities lending) or proceeds from privatization, minus ISK-denominated government deposits with the central bank of Iceland and commercial banks. ISK-denominated government deposits at the central bank of Iceland include the deposits in the treasury current account, government institution current accounts and other time deposits. Domestic debt will be valued at the nominal price for T-notes. For T-bonds and other loans, both of which are indexed, the nominal value of the debt will be adjusted by the consumer price inflation.

- **Net external financing** is defined as the total of foreign currency denominated financing disbursed to the central government minus the net accumulation of foreign currency deposits at the CBI and at commercial banks, plus accrued interest from the Icesave-related debt, net change in external arrears, minus amortization paid. Amortization includes all external debt-related payments of principal by the central government. Disbursements and amortization will be valued at the exchange rate at the time of the transaction. Net accumulation of foreign currency deposits is defined as the sum of daily change in the stock of foreign currency deposits at the CBI and at commercial banks in foreign currency, valued at the current daily exchange rate. Accrued interest on Icesave-related debt will be calculated based on the average monthly value of the outstanding stock of Icesave-related debt. The stock of outstanding Icesave-related debt will be calculated as sum of the outstanding loans and the accrued interest from the previous period minus the amount paid out from recovered assets. The stock of Icesave-related debt will be calculated in the currency of the loan agreements (sterling and euro). Accrued interest will be converted to krona at the current (monthly average) exchange rate.

6. **Adjustment mechanism**:

- For the purposes of the program, the net financial balance will exclude any debt issuance for the purposes of bank restructuring and central bank recapitalization. It will; however, include the accrued interest on inflation indexed debts related to central bank and bank recapitalization. Net domestic financing will exclude the retro-active accrued interest on the bank capitalization bonds from October 8, 2008 to October 8, 2009.

- For the purposes of the program, the net financial balance will exclude central government debt issuance for on-lending to finance road construction related to the Suðurlandsvegur, Vesturlandsvegur, Vadlaheidargong, and Reykjanesbraut projects. Such adjustment should not exceed ISK 6 billion in 2011.

7. **Supporting Material:**

- Data on domestic bank and nonbank financing will be provided to the IMF by the Central Bank of Iceland and the Financial Management Department of the MoF within three weeks after the end of the month. This will include data on redemptions of domestic central government liabilities and data on the cash balances in domestic currency of the MoF at the Central Bank of Iceland and in commercial banks.

- Data on net external financing (disbursement, net change in external arrears and amortization) as well as other external borrowing will be provided to the IMF monthly by the Financial Management Unit at the MoF within three weeks of the end of each month. Data on the fx cash balances of the MoF at the Central Bank of Iceland and in commercial banks will be reported daily.

- Data on central government debt issuance for on-lending to finance road construction related to the Suðurlandsvegur, Vesturlandsvegur, Vadlaheidargong, and Reykjanesbraut projects will be provided to the IMF monthly by the MoF.

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

8. **Definition:** Net international reserves (NIR) of the Central Bank of Iceland (CBI) are defined as the U.S. dollar value of reserve assets minus reserve-related liabilities of the CBI.

- **Reserve assets** are defined consistently with SDDS as readily available claims on nonresidents denominated in foreign convertible currencies. They include the CBI's holdings of monetary gold, SDRs, foreign currency cash, foreign currency securities, deposits abroad, and the country's reserve position at the Fund. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered, claims on residents, precious metals other than gold, assets in nonconvertible currencies, and illiquid assets.

- **Reserve-related** are defined consistently with SDDS as all fx liabilities to residents and nonresidents, including commitments to sell foreign exchange arising from derivatives, and all credit outstanding and SDR allocation from the Fund. Foreign currency deposits and other liabilities of financial institutions (both active and in the process of winding up) will be included in reserve-related liabilities. General government fx liabilities at the CBI will not be included in reserve-related liabilities.

- **For program monitoring purposes**, the stock of reserve assets and reserve-related liabilities of the CBI shall be valued at program exchange rates as described on paragraph 2 above. The stock of NIR amounted to $1,511 million as of December 31, 2010 (at the program exchange rate).

9. **Adjustment mechanism:**

- The NIR floor will be adjusted upward at the program exchange rate by the cumulative amount of Nordic disbursements since December 31, 2010. For every one dollar of disbursements, the NIR floor for each period will be adjusted upward by

0.5 dollars. Nordic disbursements are defined as external disbursements from Denmark, Finland and Sweden to the Government of Iceland, and from Norway to the CBI.

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

C. Ceiling on Net Domestic Assets

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

- **Net credit to the central government** is defined in criteria D.

- **Net credit to the private sector** is defined as the difference between credit to the private sector and liabilities of the private sector to the CBI. Credit to the private sector is defined as the sum of CBI lending to banks and other financial institutions (through its overnight and weekly collateral facilities and any other instruments to which the CBI would extend credit to the private sector) and other assets. Liabilities of the private sector to the CBI is defined as the sum of current account balances of the banks and other financial institutions at the CBI, central bank CDs in issuance and other liabilities.

- **Other items net** are defined as the sum of capital contributions, revaluation accounts and retained earnings. Performance against the NDA target will be measured at program exchange rates.

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

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

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

- **Deposits of the central government** at the CBI in domestic currency include the sum of deposits in the treasury current account, government institution current accounts and other time deposits.

- **Adjustment**. For the purpose of the program, the net credit of the CBI to the central government will exclude any debt issuance for the purposes of recapitalizing the CBI.

- **Supporting material:** The CBI will provide the IMF with data on central bank lending to the central government and central government deposits at the central bank, on a daily basis with a lag of no more than 10 days.

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

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

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

- **Loans**. That is, advances of money to an obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements).

- **Suppliers' credits.** That is, contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided.

- **Leases**. That is, arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the leaser retains the title to the property. For the purpose of the program, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property.

- **Arrears, penalties, and judicially awarded damages** arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt."

- **Adjustments**. (i) Previously contracted debt that has been rescheduled will be excluded from the definition of "new debt" for the purposes of this performance criterion; (ii) excluded from the limits are purchases from the IMF Stand-By Arrangement and bilateral official loans extended and earmarked for payments on foreign deposit guarantees; (iii) changes in the stock of nonresident holding of medium and long-term debt in krona will also be excluded from definition of new debt; and (iv) arrears arising from intervened banks will be excluded.

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

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

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

15. **Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors.** This performance criterion applies on a continuous basis. External payment arrears consist of external debt service obligations (principal and interest) falling due after

October 20, 2008, and that have not been paid at the time due, taking into account the grace periods specified in contractual agreements. Data will be provided on a monthly basis with a lag of no more than 20 days.

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

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

Table 3. Program Exchange Rates

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

APPENDIX I. DEBT SUSTAINABILITY ANALYSIS

1. **External and public debt is on a sustainable path, but risks remain** (Tables A1–A2; Figures A1–A2).

A. External DSA

2. **The baseline external debt path takes into account the following assumptions**:

- Available data on the three old banks' asset recovery up to March 2011 suggest that recovery has continued to be somewhat faster than previously anticipated. These recoveries are reflected in external debt because these assets are recorded as liabilities to nonresidents until they can be paid out to creditors. The time at which each of the old banks are assumed to make their first payments out of recovered assets to external creditors has been revised in this review, and now is as follows: one old banks is expected to start making payments paying in 2011, while the other two old bank are expected to start in 2012.

- The treatment of potential liabilities related to Icesave deposits remains as it did in the last review, with the dispute to be settled through legal channels. As before, the United Kingdom and the Netherlands are treated as priority claimants on the Landsbanki estate. This treatment recognizes external debt in the same way as that arising from asset recovery from the other old banks—the debt accrues over time as assets are recovered (see ¶3).

- Two of the old banks indicated the possibility—particularly given the recent amendments to the Financial Undertakings Act—that their creditors may choose resolution through composition (through which they become companies owned by their creditors) rather that liquidation. Given this, we have assumed that these two old banks become companies controlled by their shareholders in 2012, and so the asset recovery that has been treated as an external obligation (debt) of the old bank becomes part of Iceland’s equity liabilities. The impact of this is to remove the assets recovered from the external debt from 2012.

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

- Underlying this DSA, external borrowings by the central government (aside from that from bilateral creditors) and its enterprises are assumed to be rolled over. The remaining Nordic tranches are assumed to be drawn in the second half of 2011. As before, the central government is assumed to issue bonds to cover (on average 30 percent) of the CBI’s external debt that falls due over 2012–16. Local municipalities are assumed to only partially roll over their debt, with an average rollover rate of around 30 percent assumed over 2011–16.

- As before, external debt declines with the implementation of the authorities' capital control strategy during 2011 and 2012, as captive non-resident krona holdings are assumed to exit and be only partially offset by new inflows. The DSA also assumes that, as part of the strategy to liberalize the capital controls, the government issues \$0.4 billion worth of Eurobonds in exchange for krona-denominated government securities held by non-residents.

3. **As in past reviews, the external debt path is expected to decline substantially over the medium term.** External debt is estimated at almost 290 percent of GDP in 2010, and is expected to fall to around 150 percent of GDP by 2016. Around 20 percent of the 2010 debt stock (around 60 percent of GDP) reflects external liabilities to nonresidents (i.e., foreign creditors) associated with asset recovery of the old banks, although this declines as liabilities are paid and the old banks go through composition. Until ongoing litigation is resolved, assets recovered by the old banks cannot be paid out to creditors. Over time, on a net basis, however, most of the liabilities that remain as debt should be matched by the assets recovered externally. Debt covered by these recovered external assets has no implications on the net external stocks or flows.

4. **The external debt path is contingent on the eventual outcome of the Icesave dispute**. Litigation surrounding the Icesave claim poses risks to the baseline. Scenarios considered in this DSA are: (i) Iceland is found by the relevant court to be liable for all (insured and uninsured) Icesave deposits; and (ii) Iceland is found by the relevant court to be liable for insured Icesave deposits. Under both of these scenarios the potential liability is treated as a loan under which the government reimburses the residual amount of covered Icesave deposits after asset distributions plus financing costs. Interest is accrued until after remaining litigation is resolved (assumed to be in 2014), with the accumulated amount becoming an additional obligation of the Iceland. In addition, for comparison, the implications of the December 2010 Icesave agreement for external debt as well as a scenario where insured deposit have super-priority status (i.e., insured deposits would be paid out before uninsured deposits) in the estate of Landsbanki—which would imply that they would be reimbursed in full by end-2012—are also included. 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. Payments from Landsbanki's estate are expected to begin in the second half of 2011.

5. **Stress tests suggest that the downward trajectory remains a robust result.** 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 the debt path remains on a downward trajectory as assets are recovered, claims are settled, and old banks go into composition. An exchange rate depreciation of 30 percent would have the strongest effect, but even under this scenario the debt ratio would resume falling after the initial increase.

B. Public Debt Sustainability

6. **Since the fifth review, a number of assumptions underlying the public debt sustainability analysis have been revised**:

- The 2011 primary balance target has been eased slightly by ½ percentage points of GDP. Given unchanged net interest payments, this leads to an equivalent reduction in the overall balance. Road construction spending is now expected to occur between in 2011–14, reducing the primary balance by about ¼ percent of GDP in 2012–14.

- The medium-term fiscal path has also been modified, with the primary balance gradually reaching 5 percent by 2016. The resulting larger borrowing requirement implies greater interest payments compared to the 5th review projections. Consequently, the overall balance also improves at a slower pace, reaching a small surplus in 2014—instead of 2013—and 1½ percent of GDP by 2016 (instead of 3 percent of GDP).

- A new international bond amounting to 7 percent of GDP with a 5 year maturity and yield of 4.99 was issued in June. The interest rate on the bond is significantly lower than originally projected; the full impact of the lower interest payments will become apparent only in 2012.

- Local governments' debt at end 2010 was revised down by ¼ percent of GDP. One of the municipalities with debt falling due in 2011 is expected to reach an agreement with domestic creditors to rollover its external debt in August.

7. **Public debt is expected to peak at 100 percent of GDP in 2011, but still decline over the medium term**. (Table A2, Figure A2). The downward path will be more gradual than expected in the program largely as a result of the easing of the medium-term fiscal path. The real interest rate/GDP growth differential will help public debt decline faster in 2011–12, but will eventually reverse to around 1 percentage point in the medium term, which is a typical differential rate for advanced economies. Despite the easing of the medium-term fiscal path, the primary balance is still expected to exceed the debt stabilizing balance by 2012 and continue to contribute to debt reduction beyond the projection horizon.

8. **The debt level remains contingent upon the outcome of the Icesave dispute.** The Icesave stress scenarios are slightly modified: (i) it is assumed that interest payments commence no later than 2015; and (ii) the scenarios are simulated using both the currently projected interest rates on long-term euro and UK government bonds and penalty rates that are 300 basis points higher. The asset recovery assumption has been revised and is 94.5 percent based on current exchange rate projections. Other assumptions regarding the scenarios presented previously have been retained.

- In the first set of scenarios, the contingent liability of the government at end 2011 is estimated at 6½ percent of GDP if only insured deposits are covered, and 13¼ 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 9 ¾ percent of GDP for insured deposits and 20 ¾ percent of GDP for all deposits.

- In the second set of scenarios, the contingent outcomes remain more benign (Panel B). In the case in which insured deposits have super-priority in the estate of Landsbanki, the NPV of the potential financing cost obligation of the government would amount to 4¼ percent of GDP at end-2011. Should the most recent agreement take effect, the NPV of the cost to the government would amount to 3¼ percent of GDP at end-2011, assuming payments commence in 2013. This cost could increase to 9 ½ percent of GDP if penalty interest rates are applied.

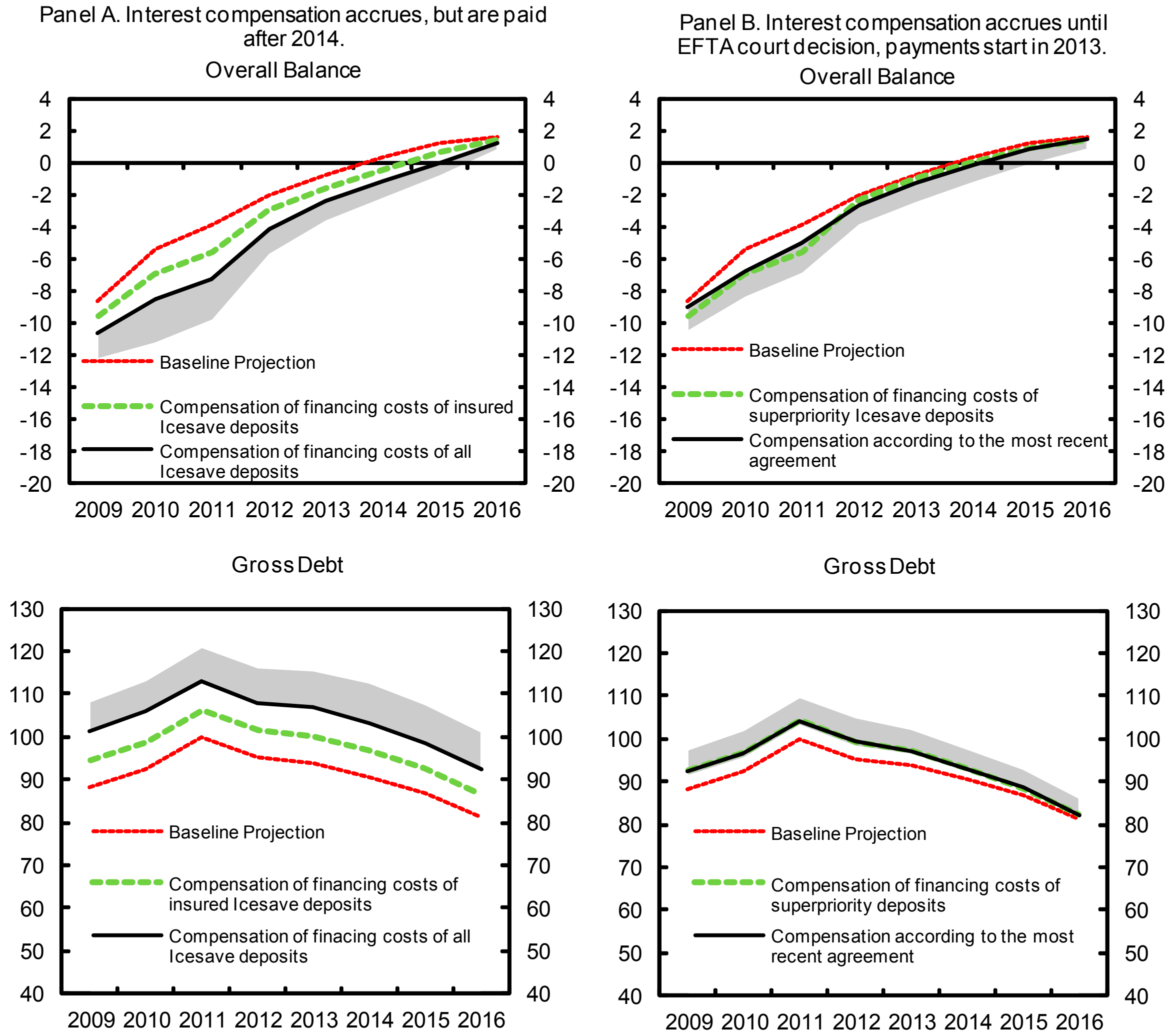
9. **The baseline debt trajectory has become very sensitive to growth shocks and implementation of the fiscal consolidation plan** (Figure A2):

- **Macro shocks.** A standard growth shock would reverse the downward path of public debt and keep it well above 100 percent in the absence of offsetting measures. By bringing debt to 107 percent of GDP in 2016, this scenario has become more onerous than a scenario in which the fiscal consolidation stalls in 2011–16. An interest rate shock and a combined macro shock would flatten the debt path, while a 30-percent depreciation of the exchange rate would raise the debt ratio to 110 percent of GDP in 2012 and leave debt at 97 percent of GDP in 2016.

- **No policy change scenario**. Halting the implementation of the fiscal consolidation program—i.e., maintaining a small primary deficit as in 2011—would reverse the debt path and cause debt to reach 104 percent of GDP in 2016.

- **Contingent liability shock unrelated to the outcome of the Icesave dispute.** While bank and savings bank recapitalization is near completion and fiscal risks have been contained significantly, staff's simulations retain a scenario with a 30 percent contingent liability shock for comparison with previous analysis under the program. Such a shock is expected to raise public debt to 125 percent of GDP (compared to 130 percent in previous simulations). However, due to the softer consolidation path, public debt is expected to decline to 113 percent of GDP in 2016—instead of 106 percent of GDP.

Figure. Icesave Scenarios
(Percent of GDP)



Sources: Ministry of Finance of Iceland; 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.

Table A1. Iceland: External Debt Sustainability Framework Current Baseline, 2006-2016
(In percent of GDP, unless otherwise indicated)

	Actual												
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016		**Debt-stabilizing non-interest current account 6/**
Baseline: External debt (including old banks)	433.5	605.9	564.7										
Baseline: External debt	101.3	171.8	188.4	266.2	279.0	**251.5**	**187.6**	**178.0**	**168.6**	**158.3**	**147.4**		**10.7**
Change in external debt	35.4	70.6	16.5	77.8	12.8	-27.4	-64.0	-9.5	-9.4	-10.3	-10.9	0.0	
Identified external debt-creating flows	31.3	26.8	33.8	37.4	-36.7	-26.7	-104.1	4.8	-4.0	-3.0	-8.9	0.0	
Current account deficit, excluding interest payments	22.2	10.1	12.5	1.5	2.2	-12.6	-15.2	-11.3	-11.0	-11.3	-11.4	-10.7	
Deficit in balance of goods and services	17.5	10.1	2.3	-8.6	-10.7	-9.5	-9.0	-7.5	-6.8	-7.6	-7.7		
Exports	32.1	34.5	44.0	52.8	56.6	58.3	58.9	59.1	58.6	58.8	58.6		
Imports	49.6	44.6	46.4	44.2	46.0	48.8	49.9	51.6	51.8	51.2	50.9		
Net non-debt creating capital inflows (negative)	7.3	28.9	-30.8	7.5	-55.8	-18.4	-93.9	8.8	-0.7	0.3	-5.1	5.6	
Automatic debt dynamics 1/	1.9	-12.2	52.2	28.4	16.8	4.3	5.1	7.2	7.7	8.0	7.6	5.1	
Contribution from nominal interest rate	3.4	6.1	15.9	10.3	8.0	10.5	12.4	12.3	12.6	12.3	12.1	11.9	
Contribution from real GDP growth	-3.0	-4.9	-2.8	18.1	8.9	-6.2	-7.3	-5.1	-4.8	-4.4	-4.5	-4.6	
Contribution from price and exchange rate changes 2/	1.4	-13.4	39.2	44.2	-19.4	...	...	...	...	...	...	-2.2	
Residual, incl. change in gross foreign assets 3/	4.1	43.7	-17.3	40.4	49.5	-0.7	40.1	-14.3	-5.4	-7.3	-2.0	0.0	
External debt-to-exports ratio (in percent)	315.8	498.4	427.9	504.0	492.5	431.8	318.6	301.1	287.7	269.3	251.8		
Gross external financing need (in billions of US dollars) 4/	8.0	8.7	13.5	6.6	9.5	12.9	10.3	8.4	3.8	3.8	4.1		
in percent of GDP	47.6	42.8	80.3	55.0	75.7	90.3	67.7	53.2	23.0	22.4	22.8		
Scenario with key variables at their historical averages 5/						**309.5**	**362.2**	**348.4**	**345.1**	**340.6**	**343.1**		**-6.8**
Key Macroeconomic Assumptions Underlying Baseline												For debt stabilization	
Real GDP growth (in percent)	4.6	6.0	1.4	-6.9	-3.5	2.5	3.1	2.8	2.8	2.7	3.0	2.8	
Nominal external interest rate (in percent)	5.3	7.4	7.6	3.9	3.1	4.3	5.2	6.8	7.3	7.6	8.0	7.3	
Growth of exports (US dollar terms, in percent)	4.5	31.3	5.4	-13.9	11.7	17.0	7.0	4.0	3.0	4.6	4.9		
Growth of imports (US dollar terms, in percent)	16.3	9.8	-14.1	-31.6	8.3	20.8	8.4	7.1	4.4	2.9	4.7		
Current account balance, excluding interest payments 7/	-22.2	-10.1	-12.5	-1.5	-2.2	12.6	15.2	11.3	11.0	11.3	11.4		
Net non-debt creating capital inflows	-7.3	-28.9	30.8	-7.5	55.8	18.4	93.9	-8.8	0.7	-0.3	5.1		

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, w ith r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP grow th 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 w ith an appreciating domestic currency (e > 0) and rising inflation (GDP deflator).

3/ Projections also reflect the impact of price and exchange rate changes, inflow s of extraordinary financing (and Fund repurchases). The large projected residuals in 2011 and 2013 reflect the imapct of large payments by the oldbanks w hich (discretely) reduce external debt w ith an associated simultaneous decline in foreign assets accumulated during the asset recovery phase.

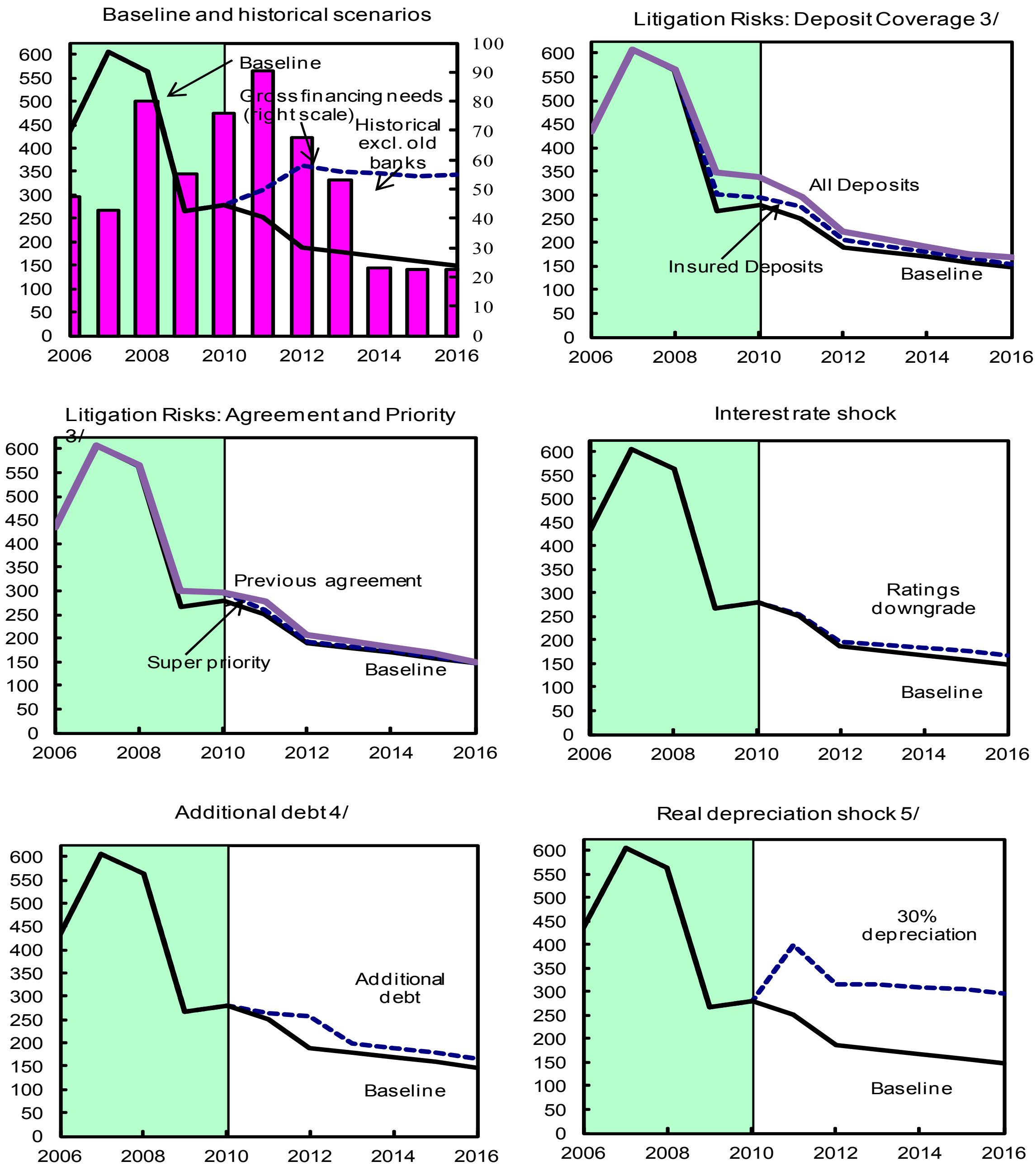
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

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

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

Figure A1. 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 despostis: Compensation for financing all Icesave deposits.
Insured deposits: Compensation for financing costs of insured deposits.
Super priority: Compensation for financing costs of super-priority deposits.
Agreement: Compensation for financing costs according to the most recent Icesave agreement.

4/ Assumes 20 percent of GDP increase in external debt in 2011.
5/ One-time real depreciation of 30 percent occurs in 2011.

Table A2. Iceland: Public Sector Debt Sustainability Framework, 2006–16
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	30.1	29.1	70.3	88.2	92.4	**100.0**	**95.2**	**94.0**	**90.6**	**86.9**	**81.1**	**1.0**
o/w foreign-currency denominated	16.8	13.3	24.6	27.1	24.5	30.0	28.6	29.9	29.4	29.3	27.6	
Change in public sector debt	4.7	-1.0	41.2	17.9	4.2	7.6	-4.8	-1.2	-3.4	-3.7	-5.8	
Identified debt-creating flows (4+7+12)	-8.0	-10.8	27.9	17.4	7.0	5.2	-4.7	-3.8	-4.9	-5.6	-6.0	
Primary deficit (including interest income)	-8.5	-8.0	-2.8	3.4	0.3	-1.1	-3.3	-4.5	-5.8	-6.8	-7.1	
Revenue and grants	48.0	47.7	44.1	41.1	42.3	41.0	41.3	41.3	41.6	41.7	41.6	
Primary (noninterest) expenditure	39.5	39.7	41.3	44.5	42.5	39.9	38.0	36.8	35.8	35.0	34.5	
Automatic debt dynamics 2/	0.5	-2.8	12.5	4.4	2.3	-0.7	-1.4	0.7	0.8	1.2	1.1	
Contribution from interest rate/growth differential 3/	-0.9	-0.6	-0.1	4.6	2.6	-0.7	-1.4	0.7	0.8	1.2	1.1	
Of which contribution from real interest rate	0.1	1.0	0.3	-0.2	-0.4	1.5	1.5	3.3	3.4	3.5	3.6	
Of which contribution from real GDP growth	-1.0	-1.6	-0.4	4.8	3.0	-2.2	-2.9	-2.5	-2.5	-2.3	-2.5	
Contribution from exchange rate depreciation 4/	1.4	-2.2	12.6	-0.3	-0.3	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	18.2	9.6	4.4	7.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities 5/	0.0	0.0	0.0	6.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (capitalization of banks, bilateral loans) 6/	0.0	0.0	18.2	3.1	4.4	7.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 7/	12.7	9.8	13.3	0.5	-2.8	2.4	-0.1	2.6	1.6	1.9	0.2	
Public sector debt-to-revenue ratio 1/	62.8	61.1	159.5	214.6	218.6	243.9	230.7	227.8	217.8	208.2	195.1	
Gross financing need 8/	-0.4	0.6	13.1	26.2	25.5	20.0	11.8	10.2	9.6	7.4	14.5	
in billions of U.S. dollars	-0.1	0.1	2.2	3.2	3.2	2.9	1.8	1.6	1.6	1.3	2.6	
Scenario with key variables at their historical averages 9/						**100.0**	**96.7**	**96.2**	**94.7**	**93.5**	**90.7**	**-0.3**
Scenario with no policy change (constant primary balance) in 2011-2016						**100.0**	**97.4**	**99.6**	**101.0**	**103.1**	**103.5**	**1.3**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.6	6.0	1.4	-6.9	-3.5	2.5	3.1	2.8	2.8	2.7	3.0	
Average nominal interest rate on public debt (in percent) 10/	9.7	9.6	13.0	7.5	6.0	5.8	5.8	6.1	6.3	6.4	6.6	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.9	4.0	1.2	-0.8	-0.7	1.8	1.7	3.7	3.8	4.1	4.4	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-12.1	15.9	-48.7	1.0	1.1	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	8.8	5.7	11.8	8.3	6.7	4.0	4.1	2.4	2.5	2.3	2.2	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.2	6.5	5.4	0.3	-7.6	-3.8	-1.9	-0.5	0.2	0.3	1.5	
Primary deficit (including interest income)	-8.5	-8.0	-2.8	3.4	0.3	-1.1	-3.3	-4.5	-5.8	-6.8	-7.1	
Net public sector debt	7.8	10.8	41.7	55.8	62.6	66.5	64.7	63.0	60.1	56.5	52.4	

1/ General government gross debt (including bilateral loans to the central government to support central bank reserves; excludes IMF loans).
Also includes the estimated impact of the guarantee on UK/Dutch IceSave loans, net of asset recovery. It estimates, under given assumptions for asset recovery and on a cash flow basis, the residual obligation for the government and growth thereof due to accruing interest.

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

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

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

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

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

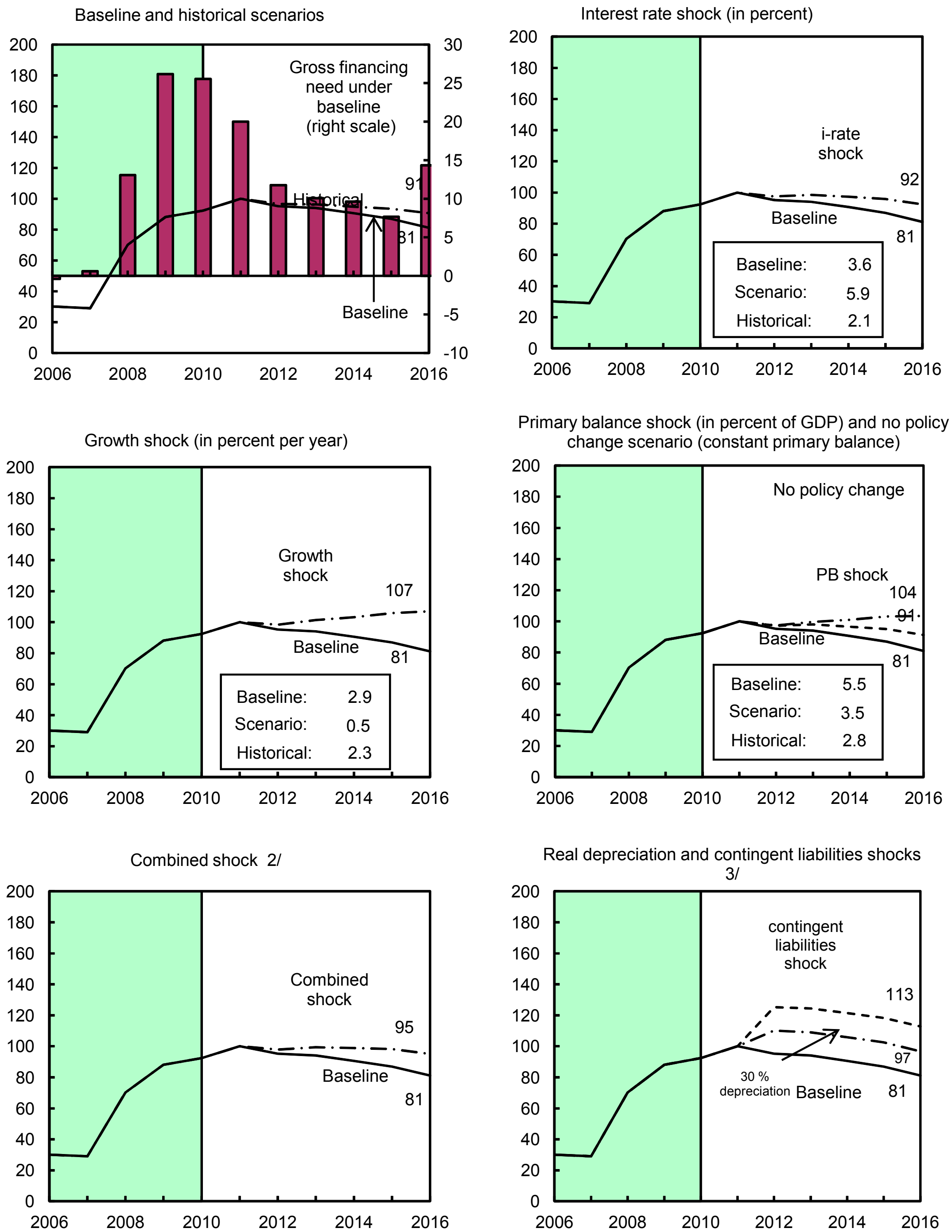
7/ For projections, this line includes exchange rate changes. In 2009-11, the residual also reflects use of deposits at the central bank and sale of financial assets obtained during the financial crisis.

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

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

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

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



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent or 30 percent of GDP shock to contingent liabilities occur in 2012, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

INTERNATIONAL MONETARY FUND

ICELAND

Sixth Review Under the Stand-By Arrangement and Proposal for Post-Program Monitoring

Informational Annex

Prepared by the European Department

August 16, 2011

Content | Page

ICELAND: FUND RELATIONS
(As of July 31, 2011)

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

II. **General Resources Account:**	**SDR Million**	**Percent Quota**
Quota	117.60	100.00
Fund holdings of currency	1,218.92	1,036.50
Reserve Tranche Position	18.69	15.89

III. **SDR Department:**	**SDR Million**	**Percent Allocation**
Net cumulative allocation	112.18	100.00
Holdings	200.64	178.85

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent Quota**
Stand-By Arrangements	1,120.00	952.38

V. **Latest financial Arrangements:**

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-By	Nov 19, 2008	Aug 31, 2011	1,400.00	1,120.00

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

	Forthcoming				
	2011	2012	2013	2014	2015
Principal		280.00	358.75	214.38	201.25
Charges/Interest	16.24	30.98	20.17	9.18	3.10
Total	16.24	310.98	378.92	223.56	204.35

VII. **Implementation of HIPC Initiative:** Not applicable

VIII. **Exchange Rate Arrangements**: The Icelandic krona is floating effective October 2008. Iceland has accepted Article VIII, Sections 2(a), 3, and 4 obligations, but maintains an exchange restriction arising from limitations imposed on the conversion and transfer of interest on bonds (whose transfer the FX rules apportion depending on the period of the holding), whose retention has been approved by the Executive Board (Decision No. 14745-(10/96), adopted September 29, 2010). In addition, Iceland has in place measures that constitute exchange restrictions imposed for security reasons related to financial transactions based on UN Security Council Resolutions. Exchange restrictions arising from the rationing of foreign exchange in respect of certain imports were in place at the time of approval of the Stand-By arrangement, but they were lifted in November 2008. The restriction arising from the limitations on the transfer of the indexed portion of amortized principal on bonds that was in place at the time of the first review under the Stand-By Arrangement was lifted on October 31, 2009.

IX. **Safeguards Assessment:** The 2009 assessment concluded that the CBI's overall control environment was broadly appropriate for a small central bank, with good controls in the accounting and financial reporting area. The CBI's external and internal audit procedures practices were not found to be in line with international practices, however, and the foreign reserves management area would benefit from development. The authorities have already taken steps to implement safeguard recommendations, notably by appointing an international audit firm under the auspices of the Auditor General to conduct annual external audits of the CBI in line with international standards, starting with financial year 2009. Internal audit was also outsourced. Work on other recommendations, such as the reserves management guidelines, is in progress.

X. **Last Article IV Consultation:**

Discussions for the 2010 Article IV Consultation were held in Reykjavik during June 14–28, 2010 and July 19–22, 2010. The Staff Report (country report No. 10/176) was considered by the Executive Board on September 29, 2010. Article IV consultations with Iceland are currently held on a 24-month cycle.

XI. **Sixth Review Mission:**

Discussions were held during June 21–30. The mission met with Prime Minister Sigurðardóttir, Finance Minister Sigfússon, Economic Affairs Minister Árnason, Central Bank Governor Guðmundsson, and other senior officials, as well as parliamentarians, CEOs of the new banks and Icelandic corporations, the employers' federation and labor unions, and academics. The staff team comprised J. Kozack (head), A. Chailloux and W. Maliszewski (EUR); I. Petrova (FAD); L. Cortavarria (MCM); N. Porter (SPR) and K.Christopherson Puh (LEG). The mission was assisted by F. Rozwadowski and E. Karlsdóttir from the resident representative office. L. Alfredsdottir (OED) attended many meetings.

XII. **Technical Assistance:**

Department	Purpose	Date
MCM	Foreign exchange regulation	November 2008
FAD	Budget framework	January 2009
MCM	Monetary operations	February 2009
MCM	Capital account liberalization	February 2009
LEG	Debt restructuring	February 2009
FAD	Budget framework	May 2009
MCM	Capital account liberalization	June 2009
MCM	Public debt management	August 2009

MCM	Monetary operations	September 2009
STA	Monetary and financial statistics	September 2009
FAD	Cash management	September 2009
MCM	Public debt management	October 2009
MCM	Monetary operations	December 2009
MCM	Capital account liberalization	March 2010
MCM	Reserves building and liquidity management	June 2010
MCM	Public debt management	July 2010
FAD	Fiscal framework issues	August 2010
MCM	Capital Control Liberalization	November 2010
MCM	Liquidity management	March 2011
FAD	Tax policy	March 2011
STA	External Sector Statistics	April 2011

XIII. **Resident Representative:**
Mr. Franek Rozwadowski assumed the position in March 2009.

Statement by the Staff Representative on Iceland
Executive Board Meeting
August 26, 2011

This staff statement provides an update on developments and their implications for the program since the issuance of the Staff Report. These developments do not alter the thrust of the Staff Appraisal.

The Monetary Policy Committee (MPC) of the Central Bank of Iceland (CBI) raised policy interest rates by 25 bps on August 16. The move is in line with the policy shift towards a tightening bias announced at the previous MPC meeting, and follows the rise in headline and core inflation in recent months. The decision reflects the MPC's concerns about inflation expectations becoming entrenched at levels above target and potential pressure on the krona. Despite the announced shift towards the tightening bias, the interest rate decision was largely unexpected by markets, and interest rates increased markedly across the yield curve (by around 50 bps).

To date, Iceland has been largely unaffected by the recent turmoil in international financial markets. The onshore exchange rate has remained stable, domestic financial markets remain calm (the recent increase in interest rate seems attributable to the MPC decision), and CDS spreads have remained broadly unchanged. Nonetheless, risks to Iceland's recovery have increased, particularly if global growth slows, financing for investment projects becomes more difficult, or commodity prices decline markedly.

The global turmoil has, however, had an impact on the most recent auction under the authorities' capital account liberalization strategy. As discussed in the previous staff report, the initial step of the strategy entails the CBI selling foreign currency to offshore krona holders (the "first leg" auction) and then repurchasing foreign currency in exchange for krona (the "second leg" auction) in order to preserve reserves. Following a successful first leg auction in mid-July, the CBI conducted a second leg auction to repurchase Euros in exchange for krona in mid-August. The coverage of the second leg auction was very limited, as bids represented only about 5 percent the offered amount (all offers were accepted at the price of 210 krona per Euro). The turbulence in global markets and investor risk aversion appear to have played a key role in the low auction coverage. In particular, the Icelandic pension funds (which hold large foreign assets and were key participants in the previous set of auctions) were reportedly reluctant to divest foreign assets at a time of significant market volatility. As noted in the previous staff report, the authorities' capital account liberalization strategy is flexible and is designed to adjust the pace of liberalization in response to adverse domestic or global developments.

Press Release No.11/316
FOR IMMEDIATE RELEASE
August 26, 2011

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Sixth and Final Review Under the Stand-By Arrangement for Iceland

The Executive Board of the International Monetary Fund (IMF) today completed the sixth and final review of Iceland's economic performance under a program supported by a Stand-By Arrangement (SBA). The completion of this review enables the immediate disbursement of an amount equivalent to SDR 280 million (about €312.4 million, or US$450.6 million), which would bring total disbursements under the program to an amount equivalent to SDR 1,400 million (about €1.56 billion or US$2.25 billion).

This is the last review under the SBA, which will expire on August 31. Owing to strong implementation by the authorities, the Fund-supported program has been successfully completed. The objectives have been met and the country is on the road to recovery.
The authorities and staff agreed to ease the pace of fiscal consolidation, given the strong fiscal adjustment to date, the favorable public debt dynamics, and the need to support the recovery. The fiscal target for 2011 was also modestly eased. It is now critical that the revised plan is implemented.

The Central Bank has appropriately raised policy rates, reflecting inflation risks going forward, the fall in real interest rates, and the need for a gradual normalization as capital controls are lifted. The initial steps of the capital account liberalization strategy are being implemented. The pace of restructuring private debt finally appears to be accelerating, but efforts must continue until the end of the process. Recapitalization of Iceland's core banking system has been completed. Work on reducing remaining vulnerabilities and strengthening prudential regulations and supervision is ongoing, and efforts should be sustained. Financing assurances are in place, and Iceland's Nordic and Polish partners have extended their lending facilities until end-2011.

Of course, challenges remain. While moderate growth is expected in 2011, unemployment remains high and inflation is rising on the back of high commodity prices. And strong policy implementation will continue to be essential to fully restore confidence and underpin the recovery.

After the expiration of the SBA, Iceland and the IMF will continue to maintain a constructive policy dialogue. In accordance with Fund policy, Post-Program Monitoring[1] (PPM) will now be initiated.

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

Following the Executive Board's discussion, Ms. Nemat Shafik, Deputy Managing Director and Acting Chair, stated:

"Iceland has successfully completed its Fund-supported program. Key objectives have been met: public finances are on a sustainable path, the exchange rate has stabilized, and the financial sector has been restructured. Strong policy implementation has underpinned this success.

"Remaining uncertainties and risks, including from the external environment, are weighing on the recovery. Further delays to investment projects and an acceleration of inflation may weaken current prospects. Improved prospects for investment would support Iceland's recovery and bolster confidence.

"Fiscal adjustment must continue, but there is some scope to ease the pace of consolidation on account of the significant fiscal effort to date and strong track record. The revised fiscal path would still deliver sustainable debt dynamics, while providing near-term support to the economy. However, it will be critical that the authorities fully implement the new path to ensure that credibility gains are not eroded.

"The first steps of the capital control liberalization strategy are being implemented. Liberalization should proceed gradually and flexibly, while maintaining stability in the government bond market and financial sector and ensuring an adequate level of reserves. Effective enforcement of the capital controls will be essential.

"The tightening bias in monetary policy is appropriate. The rise in inflation expectations and the risks of second round effects from higher wages call for vigilance.

[1] The central objective of PPM is to provide for closer monitoring of the policies of members that have substantial Fund credit outstanding following the expiration of their arrangements. Under PPM, members undertake more frequent formal consultation with the Fund than is the case under surveillance, with a particular focus on macroeconomic and structural policies that have a bearing on external viability.

"Recapitalization of the core financial system marks an important milestone in Iceland's emergence from crisis. Progress in private sector debt restructuring is welcome. However, a further strengthening of financial sector supervision is needed. Addressing remaining vulnerabilities, as well as gaps in the legal, regulatory, and supervisory framework, will be essential going forward. Fully implementing the agreed reforms will be critical to reduce risks and vulnerabilities in Iceland's financial sector."

Statement by Benny Andersen, Executive Director for Iceland
And Lilja Alfredsdottir, Advisor to Executive Director
August 26, 2011

This is the 6th and final review of the Stand-By Arrangement that was approved by the Executive Board on November 19, 2008 and expires on August 31, 2011. At this juncture, our authorities are pleased to confirm that the cooperation with the Fund has been exemplary, and has provided key support in the authorities' efforts to rebuild the economy after the severe banking and currency crisis in the autumn of 2008.

All end-June performance criteria have been met, and the program is on track. More importantly, the three main objectives of the SBA have been achieved, namely stabilising the exchange rate, placing fiscal policy on a sustainable path, and reconstructing the financial system. However, the authorities realise that despite the success of the program, a number of challenges still remain in the area of fiscal and monetary policy, and significant work is still needed to foster economic growth, reduce unemployment, and enhance the competitiveness of the Icelandic economy.

Fiscal policy

Fiscal consolidation equivalent to about 10 percent of GDP has been achieved between 2009 and 2011. The fiscal target for 2011 was lowered slightly, or by about ½ percent of GDP, to accommodate public sector wage increases in line with the general labour market agreement and to strengthen the social safety net. The revenue side has performed largely as planned. Given contained support from economic growth in 2011, and some one-time unplanned outlays to the Housing Financing Fund and small savings banks, the authorities find it more realistic to aim for an overall fiscal surplus in 2014 instead of 2013. However, the key goal of the medium-term fiscal plan is a gradual reduction of gross debt to 60 percent of GDP.

Continuing towards the goal of an overall positive balance in 2014, with both revenue and expenditure measures in 2012, requires substantial political effort, as most low-hanging fruits have already been picked. Several special taxes will be introduced or increased, such as environmental and resource taxes/levies, as well as financial activities taxes. Asset sales are also being considered. Permanent measures on the expenditure side will mainly include public administration savings. The passage of the new Local Government Bill as expected in September will have an important impact on local government finances in 2012. There is significant scope for savings in local government administration and generally increased fiscal discipline at the local government level. The greatest risk to further progress in fiscal consolidation can probably be found in weaker economic activity, as revenue is sensitive to growth in consumption and investment.

Monetary policy

The focus of monetary policy will remain on containing inflation and exchange rate stability. Following the policy shift towards a tightening bias announced in its meeting in July, the Monetary Policy Committee (MPC) decided to raise CBI's interest rate by 0.25 percentage points in its meeting on August 17. The reasons cited are a deteriorating inflation outlook for the coming two years, longer-term inflation expectations well in excess of the target, and indications that domestic demand and employment will grow more strongly in 2011 than previously projected. Headline inflation was 5 percent in July, fuelled mainly by rising house prices and imported goods prices. Contractual wage rises are also expected to increase inflation in the coming months. The MPC expects inflation to return to target only in the latter half of 2013. Investigations into post-capital control monetary policy options are underway in the Central Bank and the Government is considering available policy options that could serve Iceland either outside or inside the EU.

Capital Controls

Capital controls have now been in place since 2008. The authorities are well aware that keeping such controls longer than necessary might provide a sense of comfort and false security against policy mistakes. The capital account liberalisation strategy initially aims to reduce the overhang of offshore króna holdings while preserving the sizable foreign exchange reserve buffer. The first foreign exchange auctions have been oversubscribed at an acceptable bid rate. The second leg, where foreign exchange owners are offered long-term government bonds, was successful the first time, but participation was very low in the second auction, presumably due to the effect of global market unrest on investor sentiment. The implementation of the strategy will be adjusted in an effort to make it more effective and broaden participation to other investors than pension funds, which were the principal buyers in the first round.

Debt Restructuring

Household and private sector debt restructuring is moving forward. Our authorities agree that this is a very important step towards supporting economic activity. Eligible SMEs have obtained restructuring proposals for implementation, and restructuring of most large corporations will be completed by end-2011. Recapitalisation of deposit-taking institutions, savings banks and non-deposit taking institutions, as well as a planned reform of the HFF and strengthening of financial supervision and prudential rules, has prepared the financial system to fulfil its role as a pillar of economic growth and prosperity.

Financial Sector

Significant progress has been made in rebuilding the financial system, which has largely been restructured and recapitalized. Through the Internal Capital Adequacy Assessment Process (ICAAP), the Financial Supervisory Authority (FME) has concluded that the three largest commercial banks exceed the minimum required core tier one capital of 12 percent by about 8% on average. Thus, the three large commercial banks have large buffers to meet unexpected future losses stemming from market and credit risk. Despite this distinct progress, further work is needed to accelerate the restructuring of banks' loan portfolios and reduce the high level of NPLs. To that end, FME has introduced a variety of measures and is monitoring the restructuring progress on a regular basis.

Important steps have been taken to address supervisory challenges and FME has been enlarged and strengthened considerably. FME is developing an action plan to address the remaining prudential and supervisory gaps identified through a comprehensive assessment of Iceland's compliance with Basel Core Principles for Effective Supervision. Moreover, the existing prudential framework has been strengthened and is being updated to meet the standard set by EU directives and regulations.

Outlook and risks

In the August *Monetary Bulletin,* the CBI presented a new economic growth projection. Growth for this year is forecast to be stronger than in its April forecast of 2.8 percent but weaker for 2012 due to a front-loaded 2011 increase in private consumption and an outlook for less-than-expected investment in energy-intensive industries. Thus some of the growth envisaged in 2012 has now shifted to 2013. While unemployment has been reduced to just under 7 percent, the job-generating capacity of the economy is still below par. Also, there has been some loss of skilled labour to the neighbouring countries. FDI will be essential to further growth, and the authorities intend to promote investment in productive activities as much as possible. Iceland still offers sustainable energy resources, geographical space, and skilled labour in many fields.

Staff rightly mentions several risks to the outlook, and our authorities are prepared to respond to these risks if they appear likely to materialise. Much depends on developments in the global economy, especially as regards refinancing and terms of trade.

The task ahead will probably not be made easier by the uncertainties that cloud the global economy. In the initial program documents, IMF staff described what Iceland faced nearly three years ago as the perfect storm. Our ship is certainly more seaworthy now than in 2008, but the extended headwinds might slow down the recovery process.

We are optimistic, however, that the main difficulties are now behind us and the Icelandic economy can look towards the future with confidence. We are appreciative of the successful relationship with the Fund and look forward to a continuation in this cooperation in the future. Finally, we would like to express our gratitude to the bilateral lenders of the program, namely: Denmark, Faroe Islands, Finland, Norway, Poland and Sweden.