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ICELAND

April 2012

2012 ARTICLE IV CONSULTATION AND FIRST POST-PROGRAM MONITORING DISCUSSION

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2012 Article IV consultation with Iceland, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation and the first post-program monitoring discussion, prepared by a staff team of the IMF, following discussions that ended on March 2, 2012, with the officials of Iceland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 23, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Staff Statement** of April 6, 2012.
- **Informational Annex** prepared bt the IMF.
- **Public Information Notice** (PIN)summarizing the views of the Executive Board as expressed during its April 6, 2012, discussion of the staff report that concluded the ArticleIV consultation.
- **Statement by the Executive Director** for Iceland.

The document listed below has been or will be separately released.

Selected Issues Paper
Ex Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement

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

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March 23, 2012

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION AND FIRST POST-PROGRAM MONITORING DISCUSSION

KEY ISSUES

Context: Iceland is gradually emerging from its severe post-crisis recession. Domestic demand is driving growth and unemployment is declining, but inflation remains high. Imbalances are unwinding, but all sectors of the economy remain highly leveraged. The outlook is for a moderate recovery, but risks emanate from both external and domestic sources.

Fiscal policy: Fiscal consolidation is continuing, but at a slower pace than previously expected. Moderate expenditure overruns materialized in 2011, which will partly spill over to 2012 and the medium term. Thus, a key priority is to put the medium-term fiscal path back on track, which can be achieved with additional fiscal measures of ½ percent of GDP.

Monetary policy: With persistent inflation pressures and expectations consistently above the CBI's target, policy interest rates should rise. Monetary tightening will also be needed to support capital account liberalization.

Capital controls: Lifting the capital controls remains an overarching policy challenge, given the significant locked-in funds. This requires a gradual and cautious approach to liberalization, calibrated to the strength of the balance of payments, reserve adequacy, and the need to safeguard financial stability.

Private sector debt restructuring: Significant progress has been made in restructuring household and corporate debt. But pressure for additional household debt relief, with implications for public finances, remains very high. The high level of public debt severely constrains room for such relief.

Financial sector policy: Additional efforts are needed to further strengthen supervision and reduce banking system vulnerabilities.

Approved By
Ajai Chopra and James Roaf

Ms. Kozack (Head), Mr. Chailloux and Ms. Bordon (all EUR), Mr. Cortavarria (MCM), Ms. Petrova (FAD), and Mr. Porter (SPR) visited Reykjavik from Feb. 21–Mar. 2. The mission met with senior government and central bank officials, members of parliament, representatives from the trade unions and business community, and academics. Mr. Rozwadowski (Resident Representative) assisted the mission. Mr. Andersen and Ms. Alfredsdottir (OED) participated in some of the policy discussions. Iceland is an Article VIII country (Informational Annex: Fund Relations). Data provision is adequate for surveillance (Informational Annex: Statistical Issues).

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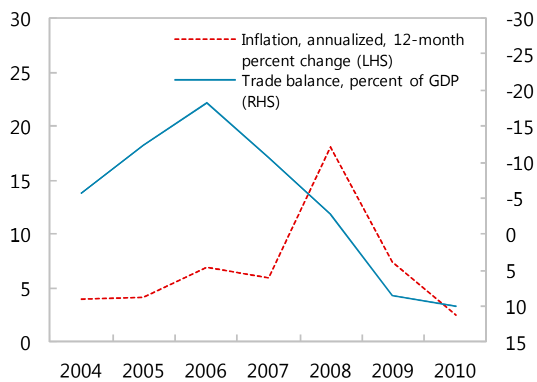
CONTEXT

1. Iceland's crisis and recession were severe, but imbalances have unwound partially. The collapse of the entire financial system in 2008 led to a deep recession, as Iceland's pre-crisis boom turned to a bust. Investment and consumption fell to record low levels as a share of GDP. Depreciation and the sharp decline in domestic demand led to a partial unwinding of macroeconomic imbalances—the underlying current account swung into surplus and inflation declined.

Iceland: Inflation and Trade Balance

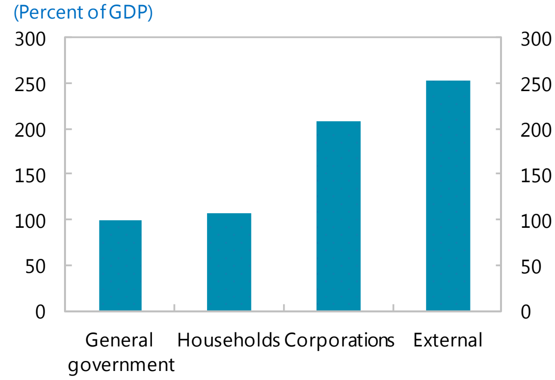


Source: Statistics Iceland.

2. The banking system is now much smaller. The number of commercial and savings banks dropped to 14, from 23 prior the crisis. Assets in the rebuilt system are 200 percent of GDP (900 percent of GDP before the crisis). Two of the three core commercial banks are under majority private ownership.

3. Legacy vulnerabilities remain. Households, corporations, and the government are still highly leveraged. Non-performing loans (NPLs) remain elevated (albeit declining) and banks need to reduce deposit concentration and financial imbalances. The state-owned Housing Finance Fund (HFF) is yet to be restructured and fully recapitalized, and the remaining savings banks need to be consolidated further. Supervision has been improved, but identified weaknesses still need to be fully addressed.

Iceland: Indebtedness at end-2011
(Percent of GDP)



Source: Central Bank of Iceland.

4. The macroeconomic and financial landscape has reflected these adjustments. With imbalances partially unwound and confidence picking up considerably, there are clear signs of recovery: domestic demand is expanding and financial markets are showing signs of life. Nonetheless, high levels of debt will take time to be fully worked out, with macroeconomic consequences: the drag from fiscal consolidation will diminish only gradually, the krona has come under some pressure through deleveraging of foreign currency debt, and banks have yet to shift gears away from loan workout to credit intermediation.

RECENT ECONOMIC DEVELOPMENTS

A. The Economy is Expanding and Inflation has Picked Up

5. The post-crisis recovery is taking hold (Table 1, Figure1). Private consumption (helped by allowances for early withdrawals of pension savings and progress with household debt restructuring) and investment drove growth in 2011, and staff's estimate is now 3.1 percent for the year. Fiscal adjustment continues to be a drag (albeit diminishing) on growth, but its effects on low-income groups have been mitigated by the composition of the measures taken, which in large part aimed at safeguarding the social welfare system (Box 1).

6. Labor market conditions have improved, but long-term unemployment remains a challenge. The unemployment rate fell to about 7¼ percent in February (down from around 8 percent a year ago), after dipping to 6½ percent in the summer on account of seasonal hiring. Nonetheless, long-term unemployment remains high—more than one-third of unemployed individuals have been unemployed for more than 6 months (and one-quarter for more than one year).

7. Inflation pressures have mounted (Figure 2). Headline CPI inflation rose from 1.8 percent (yoy) in January 2011 to 6.3 percent (yoy) a year later, and inflation expectations picked up markedly. Core inflation also rose. The sharp pick-up reflects the very strong pass through of exchange rate developments in Iceland, as well as high commodity prices, wage increases (agreed among the social partners in May 2011, leading to a rise in nominal wages of 6 percent), and alcohol and tobacco tax hikes.

8. In response, the CBI began to tighten monetary policy. The tightening was partially a response to the rise in inflation expectations and partially in recognition of the need to gradually normalize monetary conditions as the capital controls are lifted. Policy interest rates were hiked by 25 bps in August and again in November, bringing the repo rate to 4.75 percent. But monetary policy still remains accommodative as real policy rates are negative.

B. The Trade Balance Remained Strong Amid Mild Krona Depreciation

9. The trade surplus was still high in 2011, supported by exports. Export volumes rose, as fish stocks were plentiful and aluminum production continued at capacity. Iceland had a banner tourism year in 2011, with record arrivals and a tourism season which lasted several months beyond the normal span. Import growth also picked up, reflecting strong domestic demand. The underlying current account (which adjusts for virtual transactions still recorded in the income account), worsened but remained in surplus.

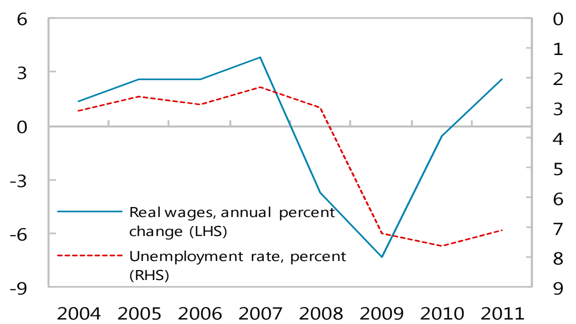
10. But the krona depreciated modestly. This reversed the steady appreciation trend of 2010. Depreciation pressures reflected deleveraging by companies and local governments: external debt was paid down and refinanced in krona (which should ultimately help to reduce currency mismatches). To help stem the associated volatility, the CBI in March intervened in the foreign exchange market for the first time since November 2009, selling euro 12 million.

Box 1. Safeguarding Iceland's Social Welfare System

A key post crisis objective of the Icelandic authorities was to preserve the social welfare system in the face of the fiscal consolidation needed to put public finances on a sustainable path.

With unemployment rising fast and real wages plummeting, it was recognized early on that the social impact of the crisis would be significant. Thus, in designing the fiscal consolidation, the authorities sought to protect vulnerable groups, notably by introducing a more progressive income tax, increasing only the upper VAT rate, and focusing expenditure cuts on areas where efficiency gains could be made—thereby creating space to preserve social benefits.

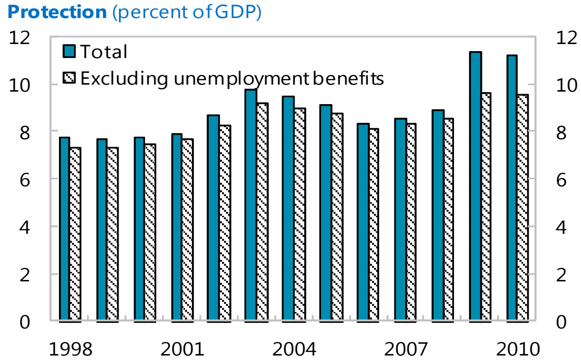
Iceland: Real Wages and Unemployment



Source: Statistics Iceland.

Consequently, when expenditure compression began in 2010, social protection spending continued to rise in percent of GDP, including that unrelated to unemployment benefits.

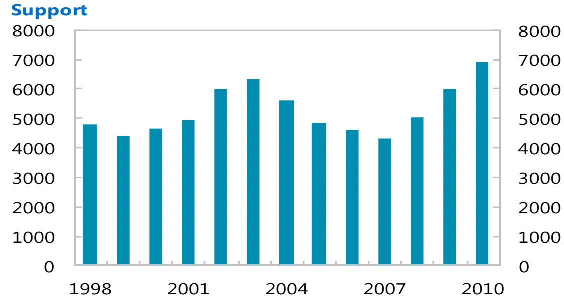
Iceland: General Government Spending on Social Protection (percent of GDP)



Source: Statistics Iceland.

Similarly, the number of households receiving income support from the public sector increased.

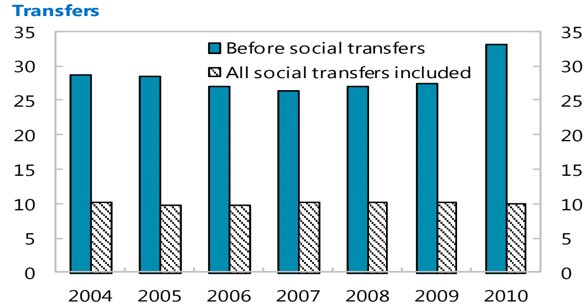
Iceland: Number of Households Receiving Income Support



Source: Statistics Iceland.

And the percentage of households at risk for poverty remained flat on account of social transfers.

Iceland: At-risk-of-poverty Rate Before and After Social Transfers

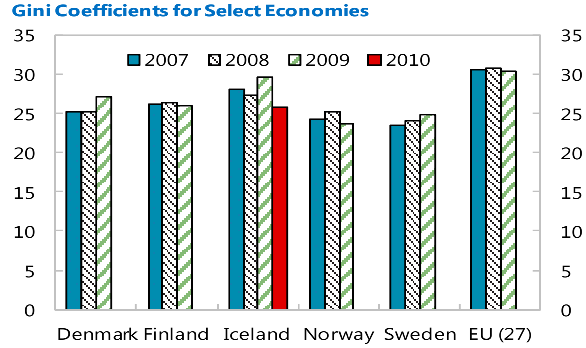


Source: Eurostat.

At the same time, 67 percent of income tax revenue in 2010 was collected from the upper 2 income deciles, compared to 63½ percent prior to the crisis. The tax share of individuals with below-median income declined from 24 percent to 20 percent.

These policies, alongside crisis-related effects (such as reduced income from capital gains), led to a sharp reduction in inequality. Iceland's gini coefficient—which had risen during the boom—fell in 2010 to levels consistent with its Nordic peers.

Gini Coefficients for Select Economies

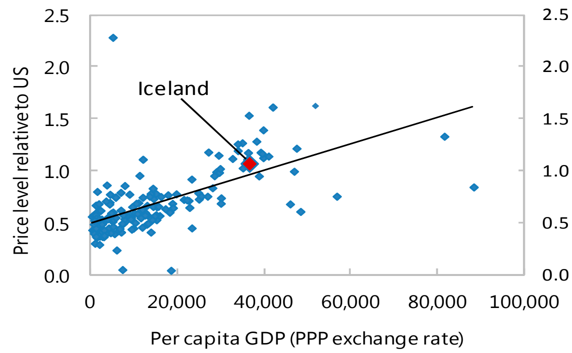


Source: Statistics Iceland.

11. Reserves increased sharply in 2011, but declined after early debt repayments. Gross international reserves stood at $8¾ billion at end-2011 (up from $5¾ billion at end-2010). About one-third of the increase reflected the old banks shifting their foreign currency holdings to the CBI (Appendix II). Gross reserves (excluding old bank deposits) increased from about $4 billion to $6 billion, on account of the drawing of the Nordic loans, the Eurobond issuance in June, and Fund purchases. As part of their asset-liability management, Iceland in March made early repurchases of most of its Fund obligations falling due in 2013 (around 20 percent of the total). Under the terms of Iceland's bilateral loan agreements, this required pari passu early repayments to Iceland's Nordic creditors, but not to Poland or the Faroe Islands. Total repayments to the Fund and the Nordics amounted to around $1 billion.

12. Standard CGER procedures suggest that the krona is moderately undervalued relative to medium term equilibrium. On average, CGER procedures suggest misalignment of around 10 percent—in line with the assessment at the time of the previous Article IV (Box 2). The unchanged degree of misalignment is consistent with the fact that, after about 40 percent real depreciation over 2008–09, the real exchange rate has been broadly stable. Similarly, measures of market share and the trade balance have been broadly flat. Other "rules of thumb", such as purchasing power parity measures, indicate that Iceland's price level is in line with countries with similar income levels.

Price Level vs. Per capita GDP
(PPP basis)



Source: IMF.

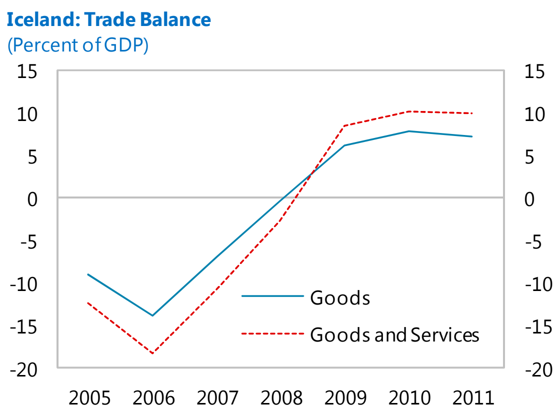
13. However, CGER estimates do not take into account the possible impact of the lifting of capital controls. This would likely increase pressures for depreciation in the near term, given the length of time investors (both domestic and foreign) have been captive. In addition, some domestic entities with limited foreign exchange incomes and scarce access to foreign financing are in the process of repaying external debt, which could exert some pressure on krona over the next year.

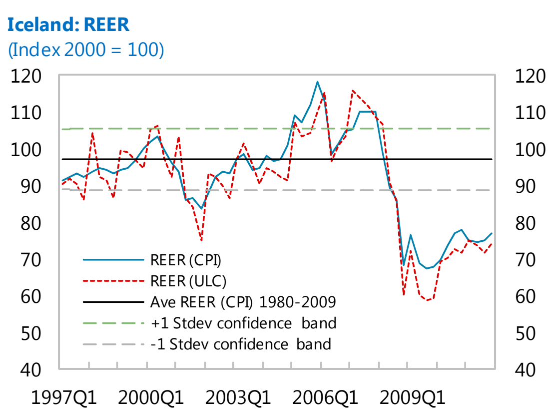
Iceland: CGER Estimates

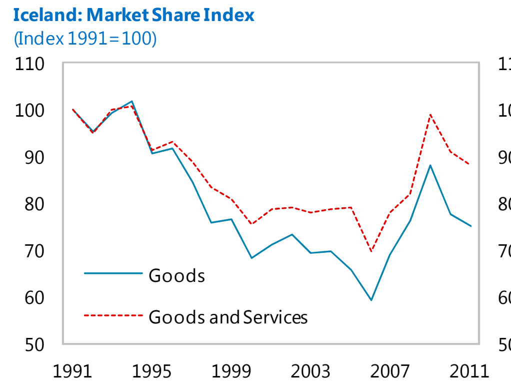
	Real Exchange Rate Assessment (Percent deviation from estimated equilibrium)
Macro Balance Approach (MB)	-5
External Sustainability Approach (ES)	-11
ERER Approach (ER)	-19
Average	-12
Memo items (in percent of GDP):	
Current Account Norm	0.2
NFA-stabilizing Current Account at 2011 level	-1.9

Box 2. Iceland: External Competitiveness

Iceland's competitiveness has improved considerably since the crisis. In the aftermath of the 2008 crisis, the nominal exchange rate depreciated by almost 50 percent in effective terms. The real effective exchange rate also saw a dramatic improvement, although some of the impact was mitigated by a short-lived surge in inflation. Since then, the real effective exchange rate has remained relatively stable around a new, depreciated, mean, and is now only 3–4 percent above its 2010 average level, despite the recent rise in inflation. The relative stability of the real exchange rate is consistent with the significant and sustained post-crisis improvement in the trade balance, and (despite some overshooting) the export market share.







Staff analysis suggests that the krona is moderately undervalued relative to medium-term fundamentals. The three standard CGER methodologies suggest undervaluation in the range of 5–20 percent. The macroeconomic balance (MB) approach suggests the lowest degree of undervaluation, reflecting medium-term fundamentals that are consistent with a largely balanced current account (compared with small projected underlying medium-term surpluses). The external sustainability (ES) approach suggests that Iceland's net foreign assets would be stabilized by a current account deficit of around 1¾ percent of GDP, pointing to a larger undervaluation of around 10 percent. The equilibrium exchange rate (ER) approach suggests the largest degree of misalignment, although this likely reflects Iceland's considerably more appreciated exchange rate in the past (as captured by the country-specific constant). If the constant were close to the average REER seen since 2008, then the degree of undervaluation would be close to 6 percent. The degree of undervaluation implied by the equilibrium REER in the CBI's QMM model is also less than 10 percent (see CBI Working Paper No. 44, 2009).

But other factors point to depreciation pressures in the near term. In particular, the liberalization of Iceland's capital controls could introduce considerable depreciation pressures. The flexible nature of the strategy, which allows the authorities to slow the liberalization if conditions are not supportive, is an important safeguard against excessive exchange rate volatility.

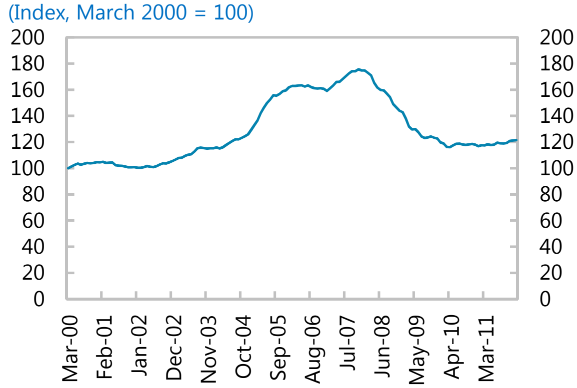
C. Financial Markets Are Showing Signs of Life

14. Government bonds dominate Iceland's financial markets (Figure 3). Despite support from the pool of funds locked in by capital controls, long-term nominal bond rates were volatile in 2011, reflecting inflation developments: the yield curve steepened mid-year but flattened once the CBI began hiking rates, suggesting that monetary transmission—albeit weak—has some traction. CDS spreads fluctuated widely, largely on account of the global turmoil, as did the spread on the June 2011 Eurobond. In November, S&P upgraded Iceland's outlook to stable from negative and, in February, Fitch upgraded Iceland to investment grade.[1]

15. The stock market has become more active. In 2011, turnover nearly tripled relative to 2010 but remains far below pre-crisis levels, and the equity index ended the year roughly unchanged. Several Icelandic companies have announced plans for listing on the stock exchange in 2012. The corporate bond market remains very thin.

16. The housing market staged a comeback. Nominal house prices rose by close to 10 percent in the Reykjavik area (back to their March 2008 level)—a development that should help repair households' balance sheets and support private consumption going forward. Real house prices have stabilized at a level much lower than their pre-crisis peak. But careful attention will need to be paid to house price growth, as the recent pick-up also may reflect the impact of the capital controls.

Real House Price
(Index, March 2000 = 100)



Source: Statistics Iceland.

D. Banks Are Focused on Reducing Non-performing Loans

17. Systemically important banks reported strong profits, capital, and liquidity (Figure 4). High profitability in 2011 (return on assets was about 3 percent) was partly explained by asset recovery, as loans that were purchased from the old banks at a steep discount were restructured and revalued upward. Since the three large commercial banks are not paying dividends, all profits are kept as retained earnings in the equity account. This has pushed banks' capital adequacy ratio to 24 percent on average (22 percent for core tier 1 capital). Liquidity is also high (liquid assets account for one third of total assets).

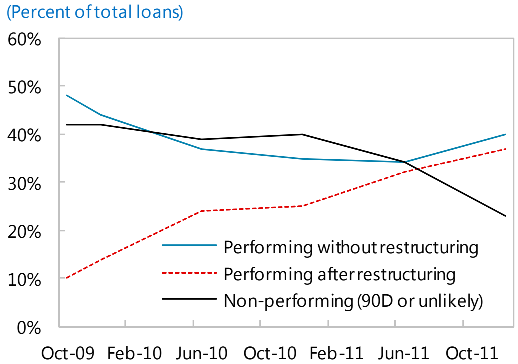
18. However, a Supreme Court ruling on foreign-exchange indexed loans is likely to adversely affect bank capital. In February,

[1] Iceland is now rated investment grade by all three ratings agencies.

Iceland's Supreme Court issued a new ruling on the recalculation of illegal foreign exchange indexed loans (according to an earlier ruling, these loans must be recalculated retroactively in krona). The new ruling appears to imply that the interest rate charged retroactively on these loans should be the contractual (i.e., foreign currency) interest rate rather than the krona interest rate, even though the loans will be denominated in krona. Uncertainty on how to interpret the ruling remains high, and banks and the FME are still assessing the impact. However, banks believe that the impact should be manageable given their significant capital buffers.

19. NPLs have declined sharply, but remain high. Banks reported NPLs of 23 percent at end-2011, down from 40 percent at end-2010. The substantial decline is due to progress in restructuring household and corporate debt.

Performing and Non-performing Loans
(Percent of total loans)



Source: Loan Portfolio Statistic Summary.

20. Despite high liquidity, lending remains sluggish (Table 2). Although some measures of credit have shown increased growth, it is not clear whether this is due to new lending or to debt restructuring and asset revaluation. There is some pick-up in new lending, but it is likely modest.

21. Bank funding is largely deposit-based. For the three large banks, deposits account for 70 percent of liabilities (excluding equity), and the loan-to-deposit ratio is declining. However, high deposit concentration makes banks vulnerable to sudden liquidity shocks. Banks also have a considerable share of non-resident deposits, which may exit once the capital controls are lifted. In an important step toward funding diversification, two of the large commercial initiated covered bond programs.

OUTLOOK AND RISKS

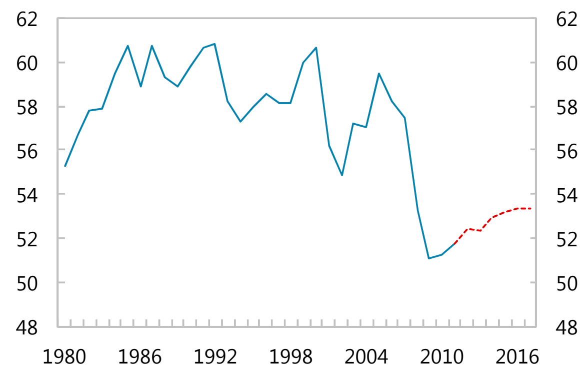
A. The Outlook is for a Moderate Expansion

22. Moderate growth is expected in the near- and medium-terms (Table 3).

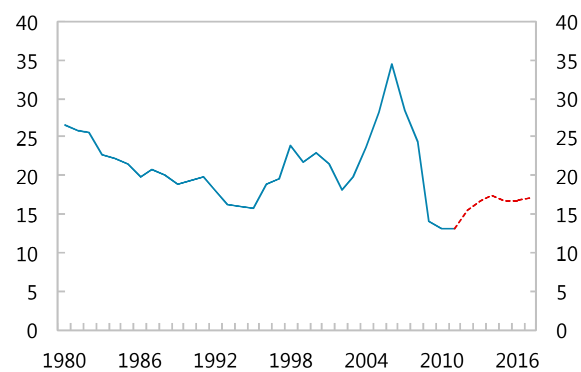
- In 2012, domestic demand is projected to drive growth: some investment projects that had been planned for 2011 have been shifted to 2012, and consumption is expected to continue to recover. Offsetting factors, notably weaker exports on account of lower global growth (particularly tourism, as marine products and aluminum are highly supply-inelastic in the short term) and rising imports, are projected to keep annual GDP growth around 2½ percent.

- Over the medium term, the sources of growth are expected to shift from domestic to external demand. Investment is projected to be the driver of growth through projects in the energy-intensive sector and catch-up in other investment. This should gradually raise the investment-to-GDP ratio. Steady private consumption growth should support the economic expansion and the fiscal drag should diminish as budget consolidation is completed. Net exports will initially make a negative contribution to growth, given the high import component of investment projects, but the contribution should turn positive when the investment phase ends and the associated exports come on stream. The output gap is expected to close in 2013.

Consumption Share in GDP



Investment Share in GDP



23. Inflation should gradually decline. Inflation is expected to peak in the first quarter of 2012 at around 6½–7 percent (yoy). It should gradually decline thereafter, as the effects of the increases in commodity prices and wages fade and as the monetary tightening assumed in staff's baseline (and consistent with recent statements by the Monetary Policy Committee) takes hold. Inflation is projected to reach the CBI's target of 2½ percent in early 2014.

24. The balance of payments may be subject to considerable pressure in the coming years (Table 4). For 2012, staff projects an underlying current account surplus. However, capital outflows are expected to be large on account of Fund repurchases and payments by the estates of the old banks. Over the medium term, moderate underlying current account surpluses should persist as the global economy recovers. The capital account is expected to be dominated by the lifting of controls: under staff's baseline, offshore krona holdings are assumed to be largely released by end-2013, while onshore krona holders are assumed to gradually rebalance their portfolios toward foreign assets in a way that does not destabilize the balance of payments. Payouts by the old banks are assumed to take place in an orderly manner—supported by the recent amendments to the capital account legislation (see Policy Discussions, Section C). Over this same period, external amortization is expected to rise. International reserves are projected to decline in US dollar terms, but indicators of reserve adequacy should return to more comfortable levels because capital account liberalization will reduce short-term external debt (as non-residents exit).

25. Public and external debt ratios are projected to decline rapidly over the medium term, but still be high.

- Gross general government debt (relative to GDP) is projected to decline, starting in 2012 and continuing over the medium term. By 2016, it is expected to reach about 80 percent of GDP. Even with this decline, cash buffers would still cover about two years of gross financing needs.
- Gross external debt is projected to fall rapidly over the medium term, from 250 percent of GDP in 2011 to 150 percent of GDP in 2016. This reflects the decline in external liabilities associated with the liberalization of the capital controls and payments to non-residents by the old banks. The old banks are still assumed to enter into composition in 2012 (wherein the estates of the old banks would become holding companies, with creditors as the shareholders), which would result in a step-down in the external debt ratio as debt is turned into equity (unless bond payouts are preferred to cash, dividend or equity payouts).

26. The authorities broadly agreed with this assessment of the outlook. However, they saw the sources of growth shifted somewhat more toward external, rather than domestic, demand. This implies a higher trade surplus in their forecast, and thus higher reserves. In terms of potential output, the authorities shared staff's assessment that the level of potential output would be permanently lower (relative to pre-boom trend), but that the growth rate could reach 2½–3 percent if investment picked up as projected.

B. Risks Are Both External and Domestic

27. Risks to the outlook are on the downside (Box 3).

- The most significant risk arises from the possibility of a marked deterioration of conditions in Europe, with implications for Iceland through trade (mainly tourism), market access (the government wants to issue another Eurobond in 2012), foreign direct investment, and commodity prices. The banking system should remain relatively sheltered from such a shock, given its minimal reliance on wholesale funding, limited exposure to European sovereign debt, and capital controls (which ban conversion of deposits from krona into foreign currency). Nonetheless, any major shock to the Icelandic economy could adversely affect the banking system through an increase in NPLs.

- On the domestic side, Iceland faces a number of risks. First, possible delays to investment projects in the energy-intensive sector would affect growth immediately (through lower investment) and over the medium term (through lower exports, as new investment is needed to overcome capacity constraints). Second, further wage increases in excess of productivity gains could fuel inflation and erode export competitiveness. Third, deviations from Iceland's strong policy performance in recent years—particularly on the fiscal side—could undermine confidence in its significant achievement to date. Finally, a too-rapid pace of capital account liberalization could affect growth through krona depreciation (which would raise inflation and private sector debt) and/or confidence effects on consumption and investment. Government policies have a critical role to play both in reducing uncertainty about the business climate and in helping to ensure that future wage agreements are not overly generous.

Box 3. Iceland Risk Assessment Matrix

<table>
<tr><th rowspan="2">Nature/Source of Main Threats</th><th colspan="2">Overall Level of Concern</th></tr>
<tr><th>Likelihood of Severe Realization of Threat in the Next 1–3 Years
(high, medium, or low)</th><th>Expected Impact if Threat is Realized
(high, medium, or low)</th></tr>
<tr><td>1. Policy missequencing related to capital account liberalization.</td><td>Medium
• Iceland faces a formidable task in lifting its capital controls.
• An excessively rapid pace of liberalization could result in large outflows.
• Other risks arise from residents' pent-up demand for foreign assets, large old bank transactions, or circumvention of the controls.</td><td>High
• If not managed cautiously, the lifting of controls could lead to a disorderly depreciation of the krona or a significant loss of reserves.
• Currency depreciation would have knock-on effects on public and private sector debt (through currency mismatch and inflation indexation).
• Capital flight could lead to loss of public financing and international market access.</td></tr>
<tr><td>2. Intensification of the eurozone crisis.</td><td>Medium
• The eurozone sovereign debt crisis remains a key global risk.</td><td>Medium
• Icelandic banks have little direct exposure to European sovereign debt or wholesale funding.
• Nonetheless, a sharp deterioration in conditions could adversely affect Iceland through market access, trade, commodity price, and foreign direct investment channels.</td></tr>
<tr><td>3. Substantial publicly-financed writedowns of household debt.</td><td>Medium
• Public pressure for additional writedowns, particularly for CPI-indexed household debt, is mounting.</td><td>High
• A significant portion of CPI-indexed mortgages is held by the state-owned HFF (total assets of 50 percent of GDP), which issues government guaranteed debt.
• The public sector would therefore face a direct fiscal cost, and possible indirect fiscal costs that could arise from the need to recapitalize financial institutions or to write off the asset value of capital injections that have already been made.</td></tr>
<tr><td>4. Litigation risks (Icesave).</td><td>Medium
• In December, the EFTA Surveillance Authority (ESA) referred the Icesave matter to the EFTA Court.
• The EFTA Court could find Iceland in breach of its obligations under EU law with regard to the EU Directive on Deposit Insurance.</td><td>Medium
• The impact of a possible adverse EFTA Court ruling on Iceland is unclear.
• Staff's assessment, based on sensitivity analysis, is that public debt could rise by 6–20 (in the most adverse circumstances) percentage points of GDP.
• Mitigating this risk is the significant asset recovery by Landsbanki, which is now projected to cover 97–100 percent of deposits (depending on the exchange rate used for distribution).</td></tr>
<tr><td>5. Delays in investment in the energy intensive sector, with knock-on effects for growth and other forms of investment.</td><td>High
• Iceland may continue to face delays in jumpstarting investment, driven by technical, financing, and political constraints.
• Delays have already materialized and there is high likelihood that further delays may arise.</td><td>Medium
• Modest delays would have a marginal impact on growth.
• Protracted and widespread delays could have a more severe impact on growth, with effects on confidence.
• Public debt sustainability is very sensitive to growth shocks.</td></tr>
</table>

POLICY DISCUSSIONS

28. Iceland's policy implementation since the crisis has been impressive, and it is critical that momentum not be lost. With significant fiscal adjustment already in train, the size of the banking system reduced dramatically, and the exchange rate stabilized, Iceland's achievements are substantial. Nonetheless, the country still faces a number of challenges—completing the fiscal consolidation, lifting capital controls, devising a post-capital controls monetary policy framework, completing private sector debt restructuring, and continuing with financial sector reforms—that will require sustaining momentum in policymaking, building stronger policy frameworks, and strengthening coordination. These challenges were the focus of the policy discussions.

A. Completing the Fiscal Adjustment

29. Fiscal consolidation is continuing, but more slowly than previously expected (Tables 5 and 6).

- Preliminary data suggest that expenditure overruns (mainly transfers at the central government level) materialized in 2011, increasing the general government primary deficit to 1 percent of GDP (¾ percentage point worse than expected at the time of the last review under the SBA).
- For 2012, the budget passed in December implies a slightly weaker primary balance than originally envisaged (by ¼ percentage point of GDP) on account of higher spending (notably transfers). Moreover, with some of the overspending in 2011 likely to be permanent, the general government primary surplus is now expected to reach 1½ percent of GDP (compared with 2 percent of GDP expected earlier).

30. The authorities and staff agreed that implementation risks are rising. While the deviations in 2011 and the 2012 budget are, in isolation, not cause for great concern, there are risks associated with implementing the 2012 budget. First, new—and politically difficult—legislation still needs to be passed to increase the fishing levy (a revenue measure). Second, asset sales—now expected to generate ¼ percentage point of GDP in temporary revenue—may not materialize to the extent expected. Third, the revenue take from the recently introduced financial activities tax has become more uncertain because its tax base has shifted from employee compensation (fairly predictable) to compensation and profits (less so). And revenue may be reduced on account of the recent Supreme Court ruling, if bank profits are lower. Fourth, there is a risk of further expenditure overruns. Finally, weaknesses in Iceland's budgetary framework provide room for overspending by individual government agencies.

31. The authorities' medium-term objectives are within reach, but only with additional measures.

- Staff projections suggest that the authorities' objectives of a balanced overall position in 2014 and a primary balance of 5 percent of GDP in 2016 would both be missed by ½ percentage point of GDP unless additional measures are taken.

- Staff therefore recommended that the authorities take additional fiscal measures of ½ percentage point of GDP to make up for the slippage in 2012 and put the medium-term fiscal path back on track. The authorities underscored their commitment to fiscal prudence and to their medium-term objectives. However, they also pointed out that implementing the additional measures this year would be difficult. Staff stressed that any further deviations would risk undermining Iceland's significant fiscal achievements to date.
- Staff also urged the authorities to identify contingency measures, particularly on the expenditure side, in case implementation risks materialize. The authorities underscored their commitment to avoiding further slippages, highlighting the recent cabinet-level decision to strengthen fiscal control (individual ministers may not bring new spending proposals to cabinet without an impact assessment from the Ministry of Finance).

32. The authorities and staff agreed that it was important to address weaknesses in Iceland's fiscal framework. Legislation on local governments was passed in October, consistent with Fund TA proposals, and will strengthen control over the finances of the municipalities. Staff strongly endorsed the authorities' intention to submit to parliament legislation for a new organic budget law, in line with Fund TA recommendations. The new law will address weaknesses in Iceland's budgetary framework, including the lack of codified principles for fiscal policy making, fragmentation of the budget process, loopholes in budget execution that allow overspending, and deficiencies in the coverage of fiscal reporting. To underpin the new law, staff recommended that the authorities adopt a procedural fiscal rule, which would require that the government set clear numerical objectives. Staff analysis shows that, given the structure of Iceland's budget, no one fiscal objective will allow for fully counter-cyclical fiscal policy, strong predictability of expenditures (important for planning purposes), and high transparency (important to ensure that the public can hold the government and parliament accountable for fiscal decision making). Thus, the choice of a numerical fiscal objective will inevitably involve tradeoffs between counter-cyclicality, predictability, and transparency. Staff analysis shows that a fiscal objective that limits expenditure growth would be highly transparent and strongly countercyclical. However, such a fiscal objective was found to be associated with a very volatile expenditure path under shocks, which could pose implementation difficulties relative to other possible fiscal objectives (see Selected Issues Paper on Fiscal Policy Objectives under a New Fiscal Rule).

B. Normalizing Monetary Policy

33. The authorities and staff agreed that monetary policy should be gradually tightened (Figures 5 and 6). With inflation and inflation expectations consistently above the central bank's target, and with possible pressures on the krona (pass-through to prices is high) and strong wage growth, policy interest rates should rise. Monetary tightening will also be necessary as the capital account is liberalized.

34. The authorities are still considering options for the post-capital controls

monetary framework. The choice of the future monetary regime remains a matter of intense public debate in Iceland. To help guide the policy discussion, the CBI is preparing a comprehensive review of the pros and cons of different monetary regimes—from retaining inflation targeting to euro adoption.

35. The authorities and staff agreed that the near-term focus should be on strengthening Iceland's existing policy framework. This would include: (i) introducing macroprudential tools (such as tighter loan-to-value ratios and counter-cyclical capital requirements) to help soften the link between capital flows and domestic demand, thus increasing the traction of monetary policy in controlling inflation; and (ii) establishing a clearer and more predictable framework for fiscal policy making (which would help the CBI better adjust monetary policy to the fiscal stance). Indeed, staff analysis suggests that macroprudential tools could help prevent the most negative consequences of a credit bust. At the same time, reducing pass-through and achieving success with standard monetary policy tools is still critical for controlling inflation over the cycle. A more predictable framework for fiscal policy making could also contribute to an improvement in the inflation-output trade-off (see Selected Issues Paper on Strengthening the Monetary Policy Framework in Iceland).

C. Lifting Capital Controls

36. Lifting the capital controls remains a key policy challenge for Iceland. Liquid offshore krona holdings remain large, at around 25 percent of GDP and 40 percent of gross reserves. The challenge has deepened with the global turmoil that began in August 2011, as new capital inflows did not materialize to the extent hoped for.

37. Capital account liberalization has proceeded more slowly than expected. The authorities' strategy for lifting the controls is state-contingent, not time-contingent, and seeks to lift the controls using a series of different methods.[2] The first method of liberalization consists of a "first leg" auction of foreign currency in exchange for offshore krona, followed by a "second leg" auction of krona for foreign currency (at the auction exchange rate, which is more depreciated than the onshore rate). After the failed second-leg auction in August 2011, the CBI halted new auctions and focused on preparing the so-called "FDI route" (which allows FDI inflows through the auction process), in line with its liberalization strategy. In February 2012, the first auction under the FDI route was completed. The CBI bought euro 140 million from investors in exchange for krona investments.

38. The authorities and staff agreed that the capital controls must be lifted gradually. The authorities underscored their commitment to the strategy set out in March 2011 and to a cautious approach, especially given the difficult global environment. In this regard, CBI officials noted the success of the February auction and the announcement of three more similar auctions in the coming months. The authorities are also making more active use of balance of payments

[2] The authorities' capital account liberalization strategy is described in detail in the staff report for the 5th review under the SBA (see http://www.imf.org/external/pubs/cat/longres.aspx?sk=24897.0).

projections—both internally and in wider fora—which staff strongly welcomed. The authorities and staff agreed that this could facilitate the public's understanding of the consequences of a too-rapid liberalization, given Iceland's reserve position. It was agreed that the speed of capital account liberalization will need to be calibrated by the strength of the balance of payments outlook, reserve adequacy, and the need to safeguard financial stability. Given the uncertainty in the global environment and its potential adverse impact on the conditions for liberalization, staff was of the view that additional time may well be needed to lift the capital controls (beyond their expiry in legislation at end-2013).

39. New legislation will help address risks associated with capital account liberalization, but may give rise to new concerns. The new legislation tightens the capital controls by removing the exemption from the controls granted to the estates of the old banks, including for them to pay out the proceeds from asset recovery (which are mainly in foreign currency, but also partly in krona) to foreign creditors. The CBI will now have responsibility for granting exemptions for the old banks. This will help avoid that payouts by the old banks are inconsistent with the strength of Iceland's balance of payments. At the same time, however, as the new legislation marks a significant tightening of the controls, it could increase uncertainty about the future course of liberalization and reduce investor confidence in Iceland, with possible implications for FDI, market access, and financing costs. Staff therefore urged the CBI to publish as soon as possible rules that will clarify the criteria that will guide decisions on exemptions.

40. Enforcing the capital controls remains essential. To this end, Iceland has introduced new exchange restrictions that require approval by the Fund. The restrictions address principal payments and payments on the indexation of principal from holdings of amortizing bonds, which are currently not captured by the controls and which can lead to large balance of payments outflows. Iceland's capital controls regime also continues to marginally affect the conversion and transfer of some interest on bonds, which also gives rise to an exchange restriction. It is envisaged that these restrictions will be removed as part of the liberalization process.

D. Concluding Private Sector Debt Restructuring

41. Private sector debt restructuring continues to advance (Figure 7). Improved data collection and dissemination by the banks has begun to shed light on the amount of debt relief that has been delivered. The measures agreed in December 2010 for both households and SMEs have been implemented at a steady pace. Preliminary data suggest that writeoffs have amounted to nearly ISK 200 billion (12 percent of GDP) for households—most of which is due to recalculation of foreign exchange-indexed debt—and ISK 900 billion (50 percent of GDP) for corporates—about three-quarters of which is for large corporations and the rest for SMEs. Banks report that over 80 percent of household and corporate applications have been processed. Staff welcomed this progress, noting that bringing the process to completion is critical for a full recovery of the Icelandic economy.

42. At the same time, progress with more complex debt restructuring cases remains slow. Comprehensive household debt restructuring for those with more severe debt service problems continues to take much longer than expected. This reflects the complexity of some cases. Moreover, the CPI-indexation of mortgages means that households will continue to face rising loan-to-value ratios unless real house prices continue to rise.

43. Pressure for additional household debt relief remains high, particularly in light of the latest Supreme Court ruling. The ruling—which will likely lead to additional writedowns for holders of foreign-exchange indexed debt—has fueled political pressure for new debt relief for holders of CPI-indexed mortgages (who have not benefitted from court-mandated writedowns). The authorities and staff agreed that fiscal space for additional debt relief was severely constrained. Moreover, staff underscored that across-the-board debt relief would be untargeted and may not provide sufficient relief to households in the most distress.

E. Completing the Restructuring and Strengthening of the Financial Sector

44. The banking system is being gradually strengthened (Tables 7 and 8). Banks' buffers against potential unexpected losses have increased through the retention of profits. NPLs are declining, deposits are increasing, and liquidity is high. Loan portfolios are subject to semi-annual reviews by external auditors, banks are working toward adopting Basel III liquidity ratios, and a recent FME assessment has confirmed that banks have made substantial reforms to their risk management systems.

45. Nonetheless, the authorities and staff agreed that some key legacy vulnerabilities are yet to be fully addressed. The latest Supreme Court ruling has created new uncertainty about banks' asset values, and additional rulings with negative implications for bank capital cannot be excluded. On legacy vulnerabilities, NPLs are still above healthy levels, imbalances will take some time to unwind, and deposit and loan concentration remains a concern.[3] Looking ahead, it will take time before a clear picture emerges about the ability of borrowers to fully service their restructured loans.

46. It was agreed that efforts need to continue to ensure that the restructuring of the banking system is completed. This is essential to help ensure that financial stability is maintained while the capital controls are lifted.

- Since fully addressing the remaining risks and vulnerabilities in the banking system will take some time, banks should continue to maintain high capital buffers. To this end, it will be essential to maintain the ban on dividend payments (and apply it equally to all commercial banks) until vulnerabilities have been sufficiently reduced. The authorities concurred on the need to avoid premature dividend payments.
- Greater transparency on the part of the banks would help boost confidence ahead of the full lifting of capital controls. First,

[3] In Iceland, the definition of NPLs is stricter than in most countries. In particular, if one single loan is overdue for more than 90 days the entire credit position of the borrower is considered non-performing.

(continued)

enhanced disclosure of buffers available would provide greater clarity about banks' ability to absorb unexpected losses. Second, since income recognition policies—notably relating to restructured and non-performing loans—can have a material impact on banks' profits, greater transparency about these policies and their contribution to reported profits would provide comfort that banks' reported financial positions are based on prudent assumptions and policies.

- Improvements in the FME's annual ICAAP exercise can bolster its credibility. Staff urged the authorities to base the 2012 ICAAP exercise on stress scenarios with common assumptions and a focus on tail risks (especially regarding asset quality), supported by an independent asset valuation. Looking farther ahead, staff recommended that the FME design and announce, in coordination with the banks, a strategy to report ICAAP results. The authorities agreed on the need to harmonize the underlying stress scenarios, and to work towards full disclosure of the ICAAP exercise.
- The FME and staff agreed that it would be useful for the banks to prepare periodic updates of contingency plans to deal with unexpected liquidity problems. Staff also urged the authorities to continue to ensure that banks are following prudent policies on income recognition, especially on restructured and past due loans.
- The authorities and staff also agreed that, while solvent and broadly liquid, a small group of non-systemic institutions will likely require further consolidation, given increased competition from the large commercial banks.

47. The restructuring of HFF is yet to be completed. Additional capital injections (estimated at around 1 percent of GDP) are likely to be needed to bring HFF's capital up to its traditional level of 5 percent of risk-weighted assets—the authorities intend to make the necessary injection once HFF has completed the restructuring of its loan portfolio. HFF's broader restructuring (including, for example, its government guarantee) will be addressed in the context of a comprehensive report on the state of Iceland's financial system.

48. A strong, intrusive, and independent supervisory agency is essential to help avoid the build-up of risks that can lead to crisis. In this context, the CBI and FME have put in place a framework to ensure effective coordination. Since last year, as part of its strategy to address identified supervisory gaps, the FME has been implementing a second wave of reforms to its organization and business model. Going forward, additional examiners with credit risk expertise may be needed in the onsite inspection area and the credit risk bureau may need more resources to become a powerful supervisory tool. Staff underscored that preserving the FME's independence, and its capacity and willingness to act, is essential to ensure that the needed strengthening of supervision continues, toward full compliance with Basel Core Principles.

POST PROGRAM MONITORING

49. Iceland's achievements under its Fund-supported program were substantial, and some key lessons can be drawn.[4] First, strong ownership of the program—notably on the fiscal side—was critical for its success. Second, the social impact of crisis can be contained by ensuring that vulnerable groups are protected and that the burden of adjustment falls on those most capable of bearing it. Third, an approach to bank restructuring in which creditors bear part of the initial cost, while retaining upside gains, can help limit the public sector burden. Fourth, in certain circumstances, capital controls can be a useful tool to prevent disorderly balance of payments adjustment.

50. Iceland is in a good position to repay the Fund. The baseline balance of payments is similar to that anticipated during the last program review. Excluding deposits of the old banks, the path for reserves is broadly in line with past projections. Iceland's external debt is expected to remain on a downward path over the medium term. Given this outlook, Iceland's obligations to the Fund remain manageable (Table 9). Reserve adequacy in 2012 and 2013 will be somewhat weaker after the early repayments to the Fund and Iceland's Nordic creditors (compared with no early repayments), although the ratio of gross reserves to short term debt is projected to remain above 100 percent.

51. Nonetheless, Iceland continues to face a number of risks to its balance of payments and public finances (Box 3).

- Risks associated with the liberalization of capital controls remain sizeable (Figure 8). As noted in previous staff reports, an excessively fast pace of liberalization could result in large outflows, possibly triggering a disorderly depreciation of the krona or a significant loss of reserves. Residents' pent-up demand for foreign assets could be far greater than the levels currently assumed in the baseline. Transactions relating to the old and new banks (including asset recovery payouts, dividend payments, and final settlement of the old banks' estates), if not managed cautiously, could also result in larger near-term outflows than assumed in staff's baseline. Any unintended weakening of administrative controls during the liberalization could prompt circumvention, effectively speeding up the pace of liberalization and depleting reserves.

- Litigation risks remain a concern for Iceland, although they have diminished considerably. First, on Icesave, in December the EFTA Surveillance Authority (ESA) referred the matter to the EFTA Court. Should the EFTA Court find Iceland in breach of the EU Directive on Deposit Insurance, it is unclear what the actual sovereign liability would be and on what terms—interest and maturity—Iceland would have to discharge it. These risks are mitigated by the significant asset recovery from Landsbanki's estate, which is estimated to cover more than 100 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). Second, Iceland's

[4] See *Iceland Ex Post Evaluation of Exceptional Access under the 2008 Stand-By Arrangement.*

Supreme Court ruled in October 2011 that the Emergency Law was constitutional, substantially reducing the legal risk stemming from the handling of claims on the failed banks.

52. The authorities and staff agreed that the policies in place could help mitigate these risks.

- Implementation of the macroeconomic and financial policies identified at the end of the SBA will be important for maintaining confidence going forward.
- The authorities' commitment to a gradual and stepwise process for lifting controls, and to ensuring that the controls remain effective during the liberalization process, reduces risks associated with potential policy missequencing. The new legislation also mitigates risks of disorderly balance of payments flows.
- Building buffers through continued non-borrowed reserve accumulation will be important. The authorities also indicated that they are considering issuing another Eurobond, if conditions permit, which is welcome.
- In the event of a significant deterioration in external conditions, staff and the authorities agreed that the flexibility in the capital account liberalization strategy could be used to slow the pace of liberalization.

STAFF APPRAISAL

53. Iceland has achieved much since the crisis, and policy implementation has been impressive. The economy is growing again, public finances are on a sustainable path, and the restructuring of the financial sector is well underway. Nonetheless, considerable challenges remain. Tackling these will require steady policy implementation, increased coordination, and stronger policy frameworks.

54. The economic recovery is taking hold. Growth turned positive in 2011, and the outlook is for a moderate expansion over the medium term. The labor market is expected to continue to improve, reducing high unemployment. Inflation should gradually come back to target, reflecting tighter monetary policy.

55. Risks to the outlook emanate from both external and domestic sources. The most significant risk arises from the possibility of a marked deterioration of conditions in Europe, with implications for Iceland through trade, commodity price, and financing channels. On the domestic side, further delays in investment and uncertainty about the legal and business environment could weigh on growth. Deviations from Iceland's recent strong policy performance, particularly on the fiscal front, could undermine confidence.

56. It is essential that fiscal adjustment be completed. The expenditure slippages in 2011 are unfortunate and, alongside the weaker-than-envisaged 2012 budget, have slowed the pace of consolidation. Rising implementation risks for 2012 are also of concern. Nonetheless, additional permanent measures of ½ percent of GDP would bring the authorities' medium-term fiscal objectives within reach. Contingency measures should also be identified in case implementation risks materialize in 2012. This will help ensure that public finances remain on a sustainable path and that the impressive gains to date are not eroded. The authorities' strong stated commitment to their medium-term fiscal plan, alongside recent steps to improve fiscal control, is welcome.

57. Improvements to the fiscal framework are welcome. Passage in September of the Local Government Act is an important step toward strengthening local government finances. The authorities' intention to submit to parliament new legislation on an organic budget law, drawing on Fund technical assistance, is most welcome.

58. Monetary policy should be gradually tightened. With inflation and inflation expectations above the central bank's inflation target, policy interest rates should rise. A tighter monetary stance will also be needed to support the capital account liberalization. On the framework for monetary policymaking, Iceland should focus in the near term on strengthening its existing framework, including through the use of macroprudential tools which can help limit the adverse effects of a turn in the credit cycle.

59. Lifting capital controls is an overarching challenge. With a large amount of locked in non-resident funds and significant pent-up demand by residents for foreign assets, capital account liberalization is one of Iceland's key policy challenges. A gradual approach remains essential. The speed of liberalization will have to be adapted to the strength of the balance of payments outlook, reserve adequacy, and the need to safeguard financial stability. In view of the uncertain global environment, the conditions for lifting the controls may well take additional time (beyond end-2013) to be fully met. To this end, the removal of the exemption on payouts by the estates of the old banks helps mitigate risks of too-rapid liberalization. At the same time, it is essential that policies with respect to the liberalization process are as predictable as possible to help guide investor and public expectations. The CBI should therefore clarify as quickly as possible the way that payouts from the estates of the old banks will be handled, including through new published rules on exemptions.

60. The progress on private sector debt restructuring is welcome, but the prospect of new delays is a concern. Debt restructuring must be brought to completion as soon as possible. To underpin a sustainable recovery, it is essential that households and corporations have greater certainty about their financial positions. The February 2012 Supreme Court ruling has increased uncertainty about how foreign exchange-indexed loans are to be recalculated and may slow the restructuring process. It is essential that further delays be avoided.

61. New calls for across the board write-downs of household debt should be resisted. Such measures would be untargeted and would not fully address the problems of those most in need. Moreover, the high level of public debt severely constrains the room for new measures that are not paid for through a reprioritization of expenditures or new revenue measures. In this regard, it is critical to ensure that Iceland's public finances remain on a sustainable path and that its significant fiscal achievements are not undermined.

62. Progress continues to be made on bank restructuring, but additional efforts are needed to reduce vulnerabilities. NPLs have been reduced significantly; deposits are increasing gradually; and liquidity is high. The semi-annual portfolio reviews by external

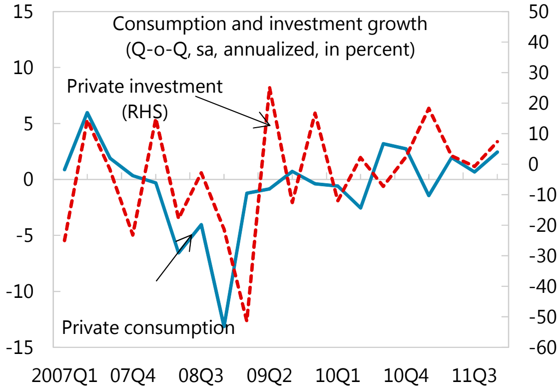
63. auditors should help to build confidence and ensure proper asset valuation. Nonetheless, new risks and legacy vulnerabilities pose challenges. The latest Supreme Court ruling is likely to lead to further writedowns of foreign exchange-indexed loans, adversely affecting banks' loan portfolios and capital positions, but banks expect the effect to be manageable. On legacy vulnerabilities, more needs to be done to further reduce NPLs, lower bank imbalances, and decrease deposit and loan concentration. Dividend payments should therefore be prevented until vulnerabilities have been sufficiently reduced. The FME should continue to closely monitor recently restructured loans and banks' income recognition policies. In other areas, HFF still needs to be fully recapitalized and non-systemic institutions need to be restructured and consolidated.

64. Financial sector supervision must be further strengthened. A strong, intrusive, and independent supervisory agency is essential to guard against the build-up of risks that can lead to crisis. To this end, the framework for effective coordination that CBI and FME have put in place is welcome. It is critical that progress continue to be made in addressing identified supervisory gaps: the reforms to the FME's organization and business model are an important step in this regard. Preserving the FME's independence in both reality and perception, as well as its capacity and willingness to act, is essential to ensure that the needed strengthening of supervision continues.

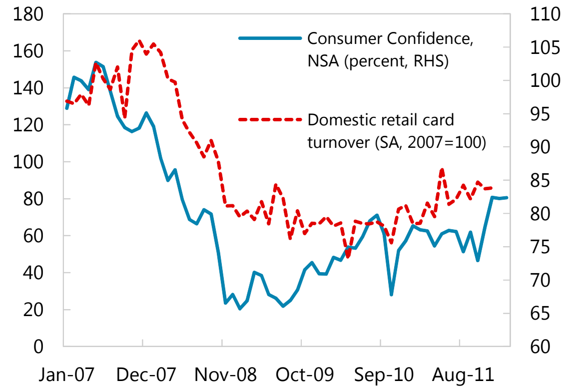
65. Staff proposes to hold the next Article IV consultation on the regular 12-month cycle. Staff supports the authorities' request for Board approval of measures that give rise to exchange restrictions subject to Fund jurisdiction. The measures have been imposed for balance of payments purposes, are non-discriminatory and temporary.

Figure 1. Iceland: Recent Development in Demand and Labor

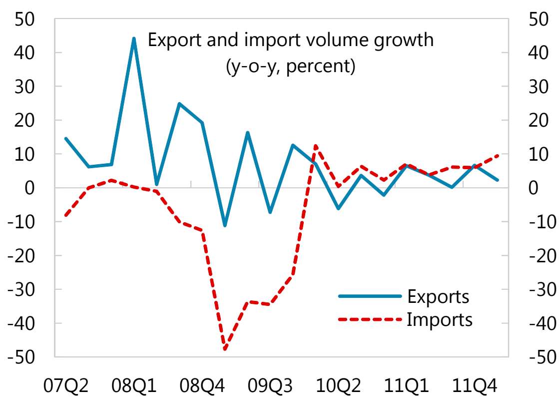
Consumption and investment were key drivers of growth in the second half of 2011...



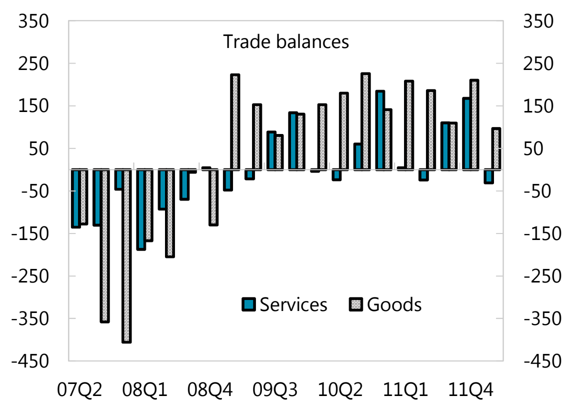
...and high frequency indicators suggest continued strength of consumption going forward.



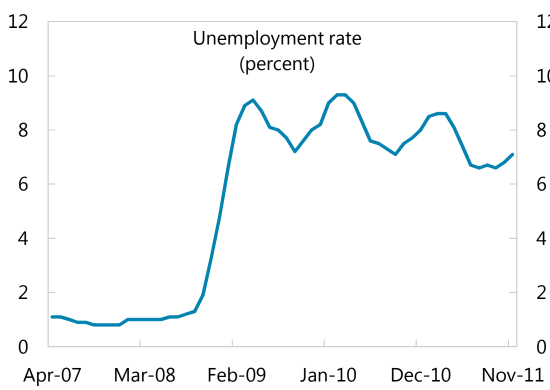
Imports continued to rise...



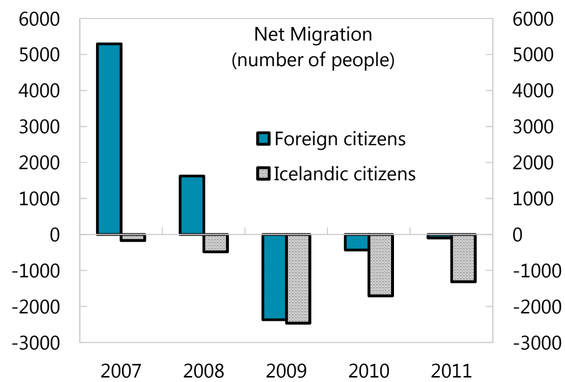
...denting the trade balance.



The unemployment rate is trending down...

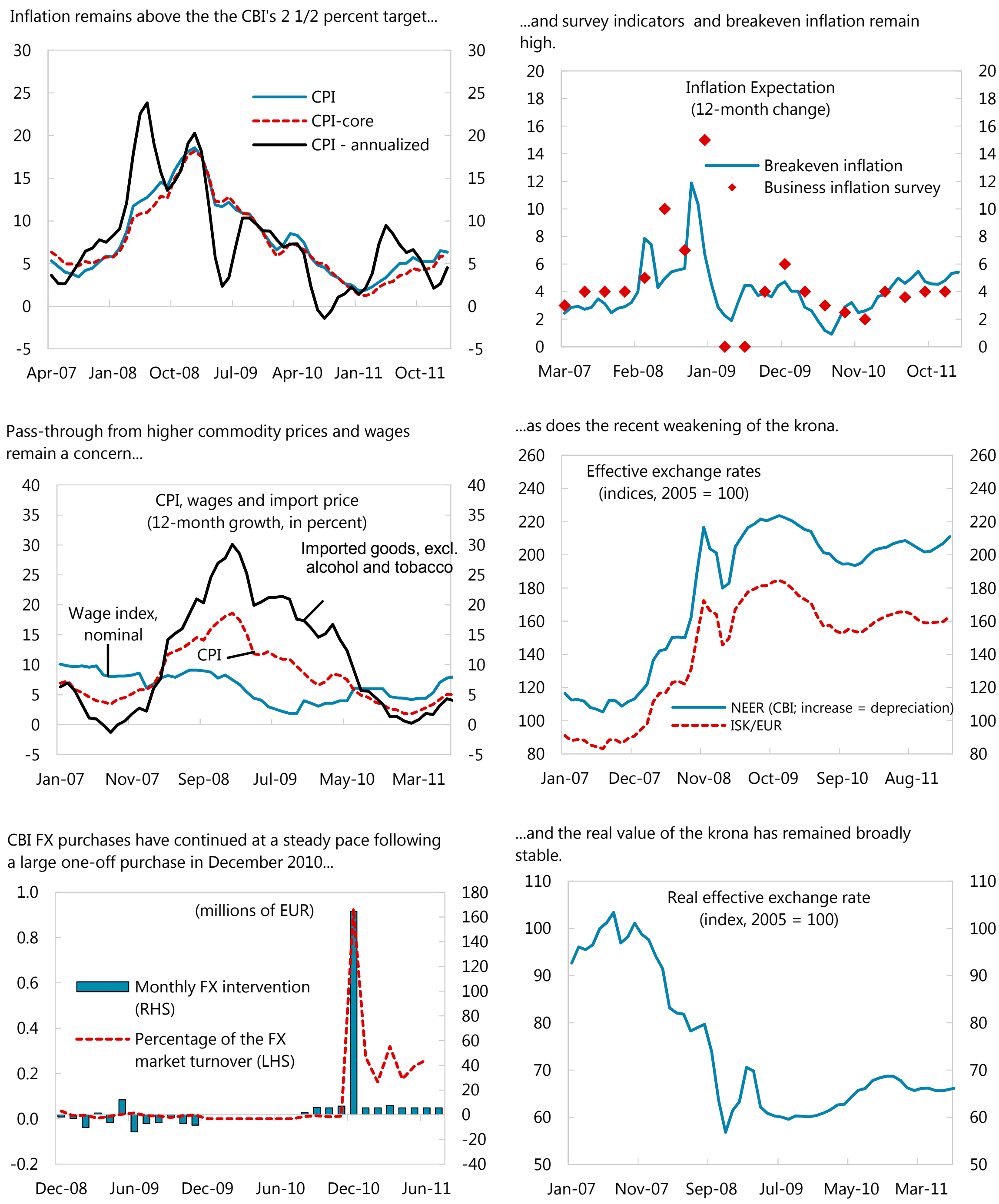


... and outward migration has continued, particularly among Icelandic citizens, but at a slower pace.



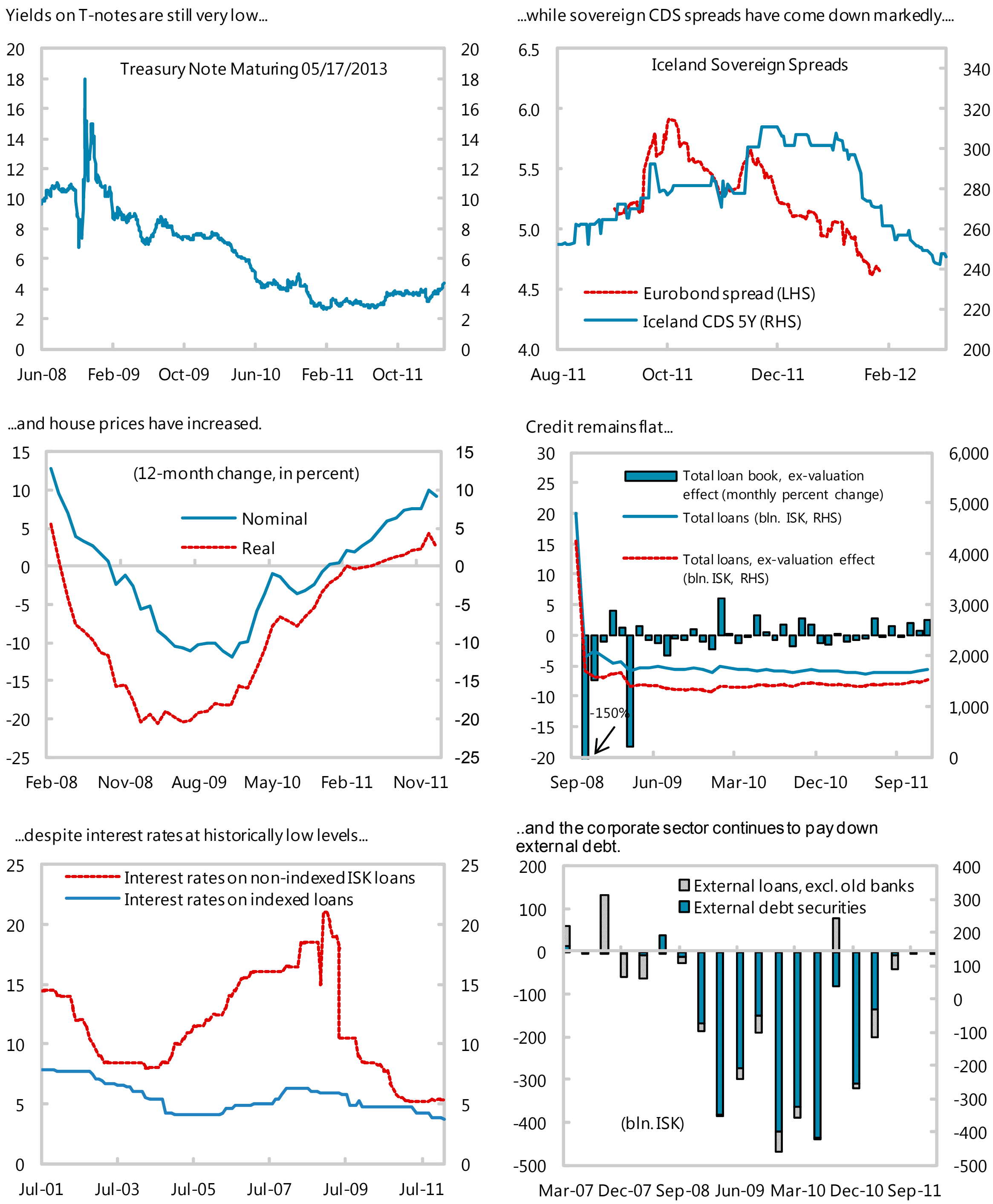
Sources: Bloomberg; Haver Analytics; Statistics Iceland; Bloomberg; and IMF staff calculations.

Figure 2. Iceland: Price and Exchange Rate Developments



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

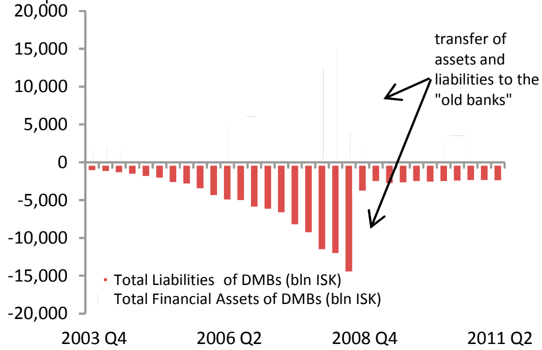
Figure 3. Iceland: Financial and Credit Market Developments



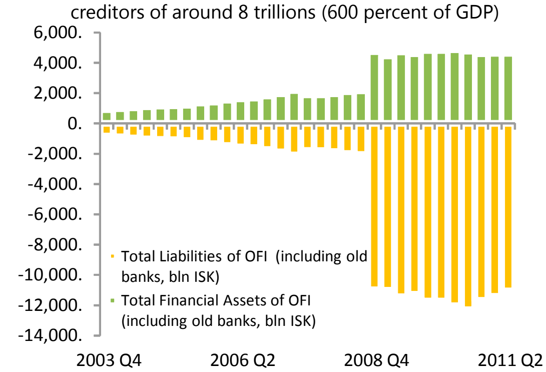
Sources: Central Bank of Iceland; Datastream; and IMF staff calculations.

Figure 4. Iceland: Financial Sector Developments

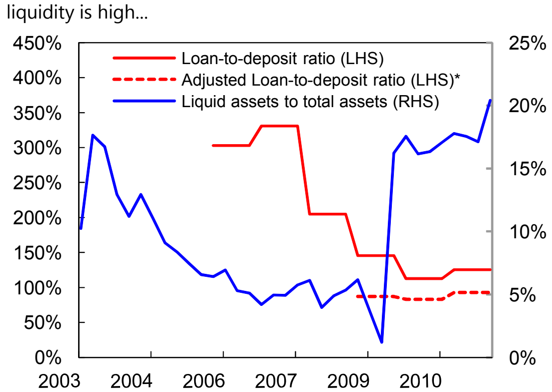
The assets of the new financial sector are a mere fraction of the pre-crisis total...



...as "old banks" estates carry a net liability to overseas creditors of around 8 trillions (600 percent of GDP)

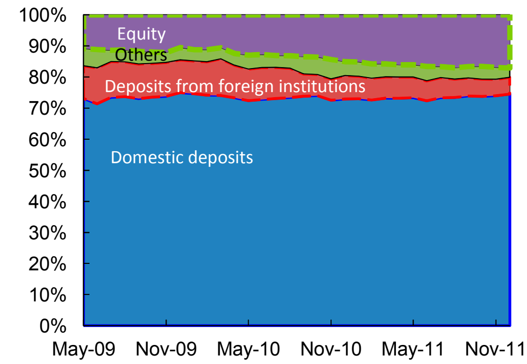


Banks' leverage has sharply decreased since the crisis, and liquidity is high...

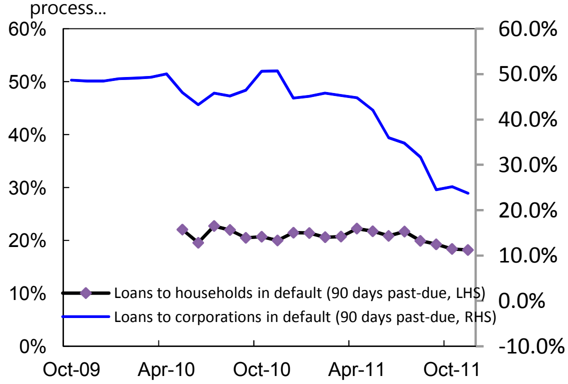


* including "captive liabilities" under the capital control regulation.

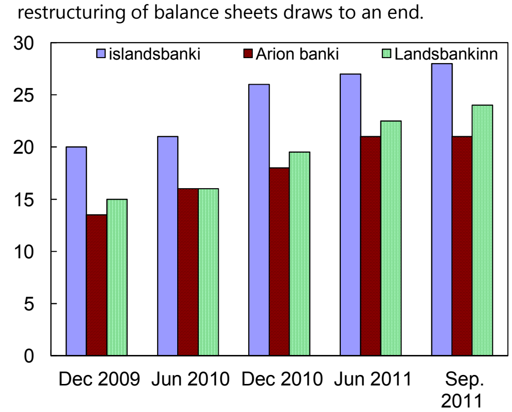
...yet banks' funding shows little diversification and a large reliance on deposits.



NPLs have decreased steadily following the loan restructuring process...



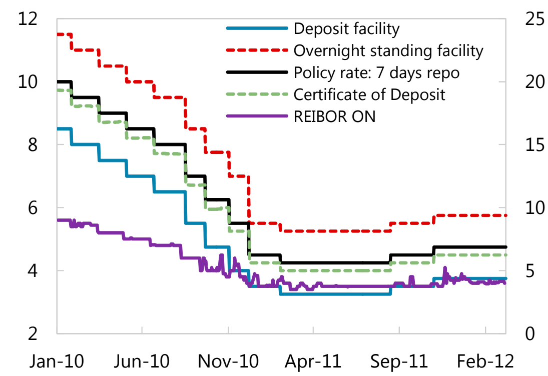
...and banks' capital adequacy (CAR) has improved as the restructuring of balance sheets draws to an end.



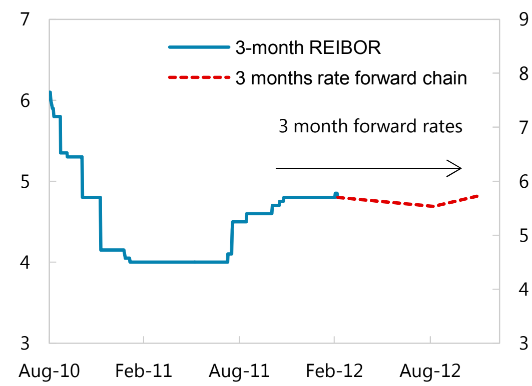
Source: Central Bank of Iceland; FME; and IMF staff calculations.

Figure 5. Iceland: Monetary Policy Operations and Liquidity Management

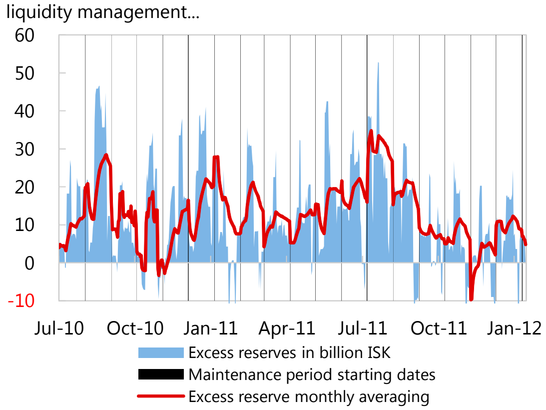
Monetary tightening is underway...



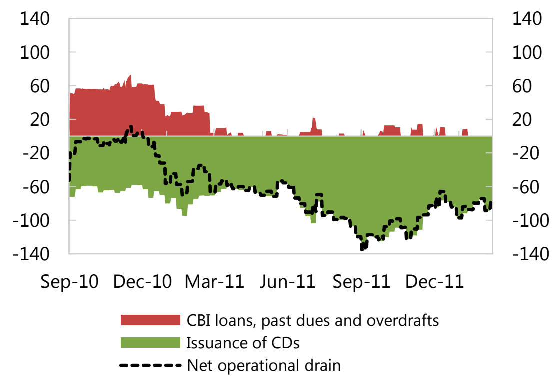
...yet forward rates are not pricing in further rate increases in 2012.



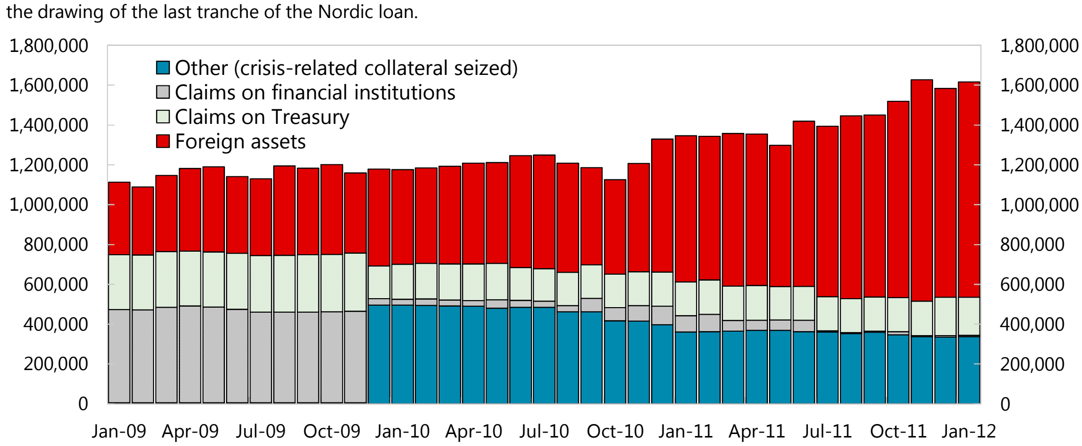
Excess reserves have receded, highlighting a more effective liquidity management...



...underpinned by the record issuance of central Bank CDs in September.

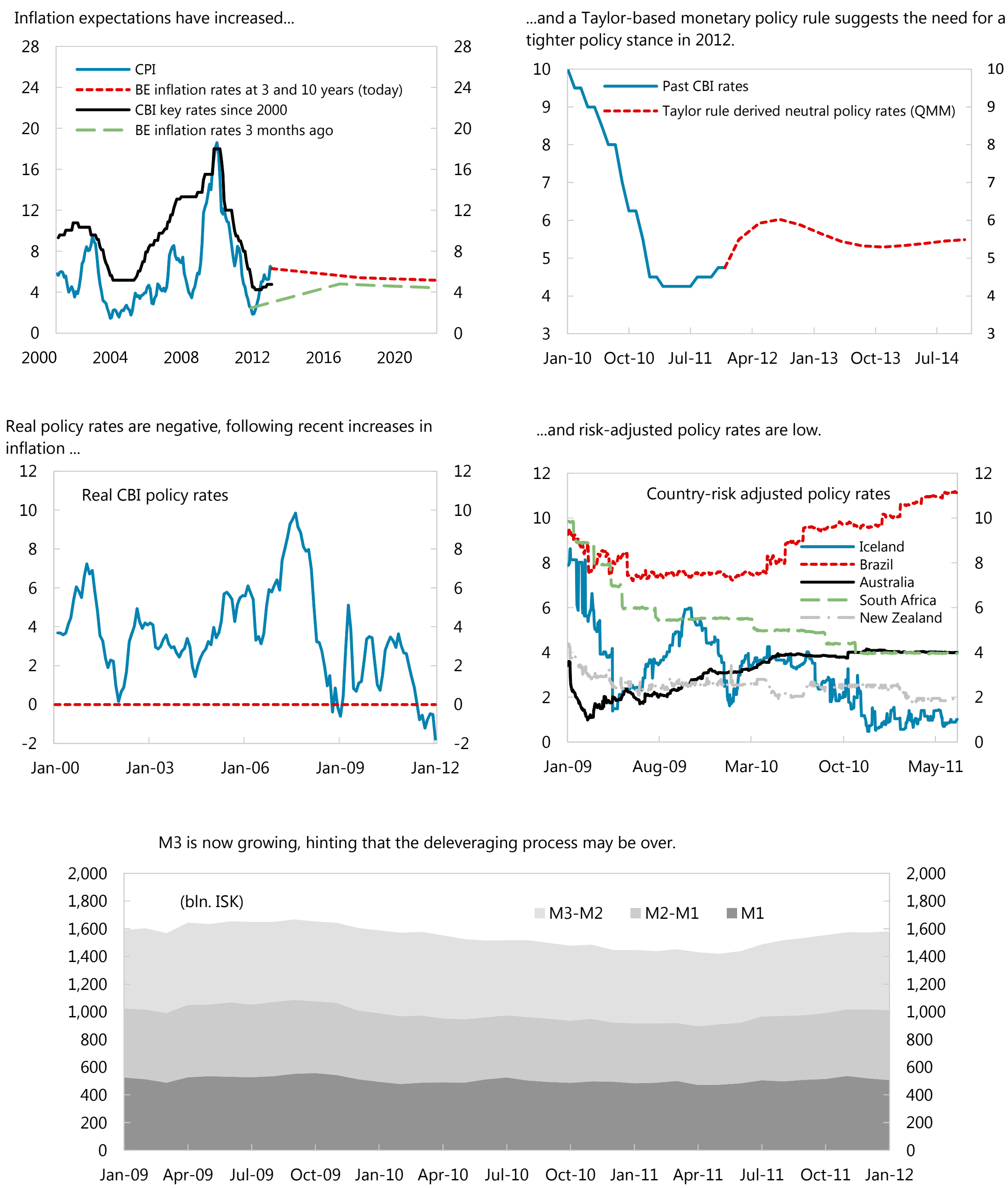


The asset side of the CBI balance sheet shows a substantial increase in gross reserves following completion of the SBA and the drawing of the last tranche of the Nordic loan.



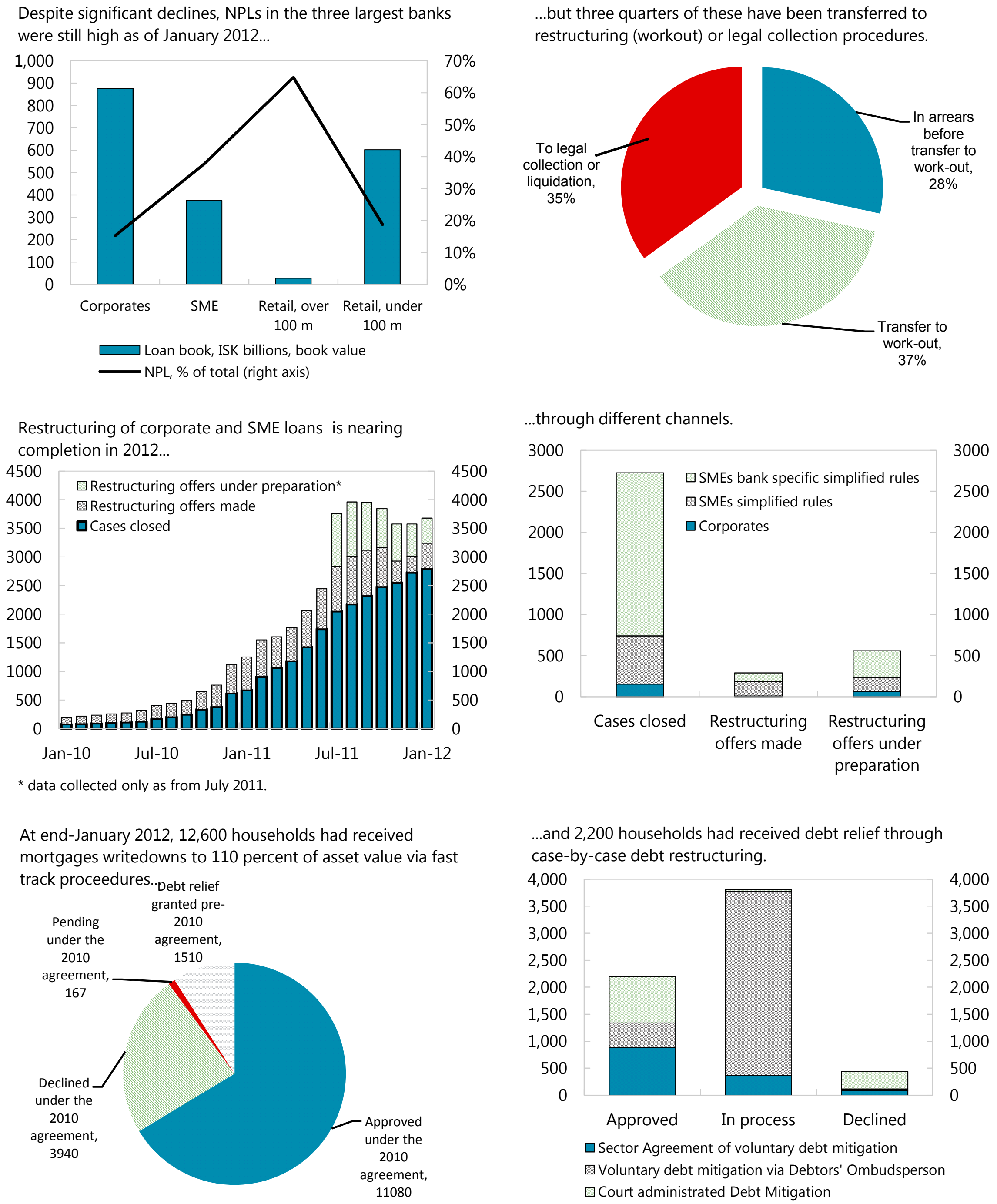
Sources: Central Bank of Iceland; and IMF staff calculations.

Figure 6. Iceland: Indicators of Monetary Stance



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

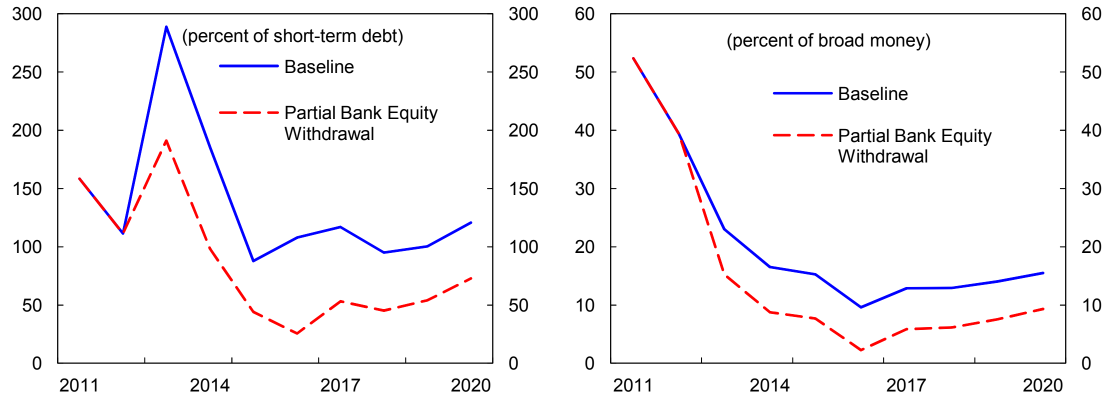
Figure 7. Iceland: Private Sector Debt Restructuring



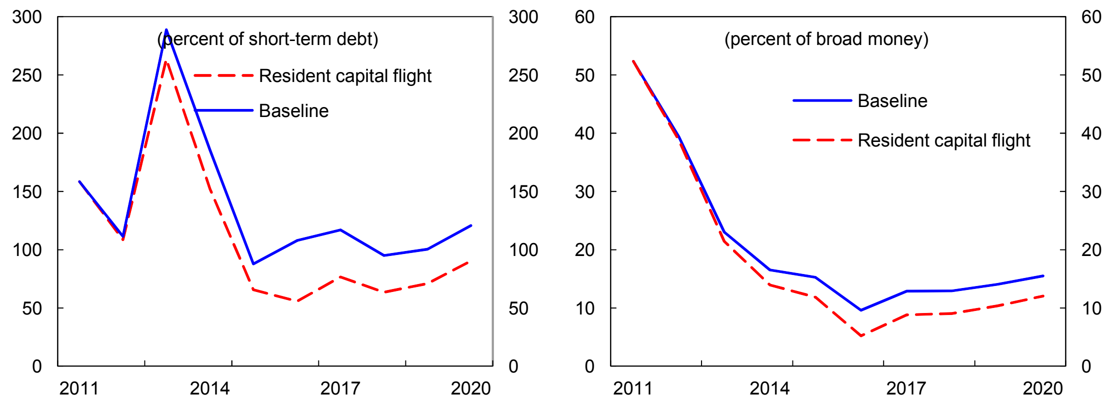
Sources: Debt Ombudsman; Banking Association; and IMF staff calculations.

Figure 8. Iceland: Reserve Adequacy Under Capital Account Liberalization

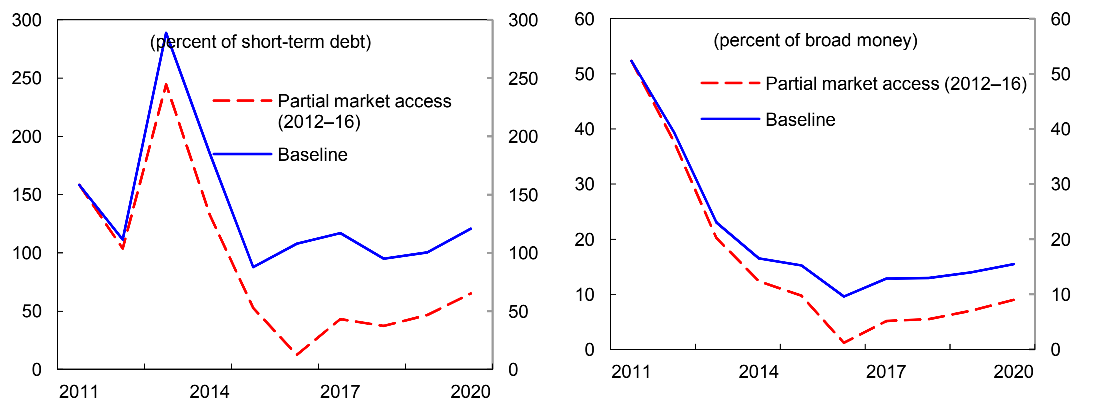
A partial withdrawal of equity capital in the new banks by foreign creditors would persistently dent reserve adequacy.



Resident capital flight would also have a lasting adverse impact on reserve adequacy.



Lack of market access would raise more doubts about Iceland's capacity to lift controls.



Source: IMF staff calculations.
1/ The assumptions underpinning each shock scenarios are:
Equity withdrawal: Post-composition old bank creditors withdraw some equity capital from new banks in 2013.
Resident flight: During 2012-2016 ,residents take an additional 1 percent of broad money overseas.
Partial access: During 2012-2016, 25 percent of projected baseline new external borrowing is not possible.

Table 1. Iceland: Selected Economic Indicators, 2005–12

	2005	2006	2007	2008	2009	2010	2011 Est.	2012 Proj.
	(Percentage change, unless otherwise indicated)							
National Accounts (constant prices)								
Gross domestic product	7.2	4.7	6.0	1.3	-6.8	-4.0	3.1	2.4
Total domestic demand	15.5	9.1	0.0	-8.6	-20.3	-2.3	3.9	3.7
Private consumption	12.7	3.6	5.7	-7.9	-14.9	-0.4	4.0	3.0
Public consumption	3.5	4.0	4.1	4.6	-1.7	-3.4	-0.6	-0.4
Gross fixed investment	34.4	24.4	-12.2	-20.0	-51.6	-8.1	13.4	13.8
Export of goods and services	7.5	-4.6	17.7	7.0	6.6	0.4	3.2	2.9
Imports of goods and services	29.3	11.3	-1.5	-18.4	-24.0	4.0	6.3	5.1
Output gap 1/	2.8	2.0	3.6	2.2	-1.9	-4.5	-1.0	-0.7
Selected Indicators								
Nominal GDP (bln ISK)	1,025.7	1,168.6	1,308.5	1,482.0	1,495.4	1,534.2	1,630.2	1,732.5
Unemployment rate 2/	2.1	1.3	1.0	1.6	8.0	8.1	7.4	6.3
Consumer price index	4.0	6.8	5.0	12.4	12.0	5.4	4.0	4.8
Nominal wage index	6.5	9.1	9.3	4.0	0.5	3.1	5.7	6.0
Nominal effective exchange rate 3/	10.2	-11.8	2.5	-40.4	-34.2	2.9	-0.1	…
Real effective exchange rate 3/	13.3	-7.1	5.1	-20.7	-18.4	6.4	0.9	…
Terms of trade	0.9	3.4	0.2	-9.3	-6.7	6.1	-1.8	-0.7
Money and Credit								
Base Money	32.2	27.9	190.7	-31.5	1.3	-19.4	-20.7	...
Deposit money bank credit (end-period)	76.0	44.4	56.6	-28.3	-17.8	-3.4	3.2	...
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	7.2	...
CBI policy rate (period average) 4/	10.5	14.1	13.8	15.4	13.7	7.8	4.4	...
	(Percent of GDP, unless otherwise indicated)							
Public Finance								
General government 5/								
Revenue	47.1	48.0	47.7	44.1	41.1	41.5	41.7	41.8
Expenditure	42.2	41.6	42.3	44.6	49.7	47.9	46.3	44.6
Balance	4.9	6.3	5.4	-0.5	-8.6	-6.4	-4.6	-2.8
Primary balance	6.1	6.7	5.7	-0.5	-6.5	-2.7	-1.1	1.3
Balance of Payments								
Current account balance	-16.1	-25.6	-15.7	-28.4	-11.8	-8.4	-6.5	-2.8
Trade balance	-12.2	-17.5	-10.1	-2.3	8.4	10.1	8.2	6.6
Financial and capital account	14.0	43.3	18.1	-66.9	-28.2	52.9	15.3	-0.5
Net errors and omissions	2.6	-11.0	-1.0	-19.5	37.3	-37.7	-2.8	0.0
Gross external debt 6/	284.5	433.5	605.9	564.7	266.5	289.7	250.4	207.1
Central bank reserves (US$ billion)	1.1	2.3	2.6	3.6	3.9	5.8	8.7	7.4

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

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

Table 2. Iceland: Money and Banking
(Billion of Krona, unless otherwise indicated)

	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Central Bank											
Net foreign assets 1/	-175	-188	-158	-163	-176	-115	-95	-78	-57	-56	-53
Assets	496	499	571	496	716	815	879	916	1,053	927	919
Liabilities	671	687	729	659	892	930	974	994	1,110	983	972
Net domestic assets	291	300	245	235	269	191	167	149	132	130	127
Net claims on the public sector	-52	8	-29	-38	28	17	21	75	47	-5	-18
Net claims excluding recap bond	-218	-172	-193	-207	-142	-156	-149	-97	-145	-200	-213
Recapitalization bond	165	181	165	169	171	173	170	172	192	195	195
Net claims on banks 2/	-25	-58	-60	-10	-24	-55	-82	-136	-97	-47	-27
Others Items, net	368	350	334	283	265	229	228	210	182	182	173
Base Money 3/	117	112	88	72	94	76	72	71	74	74	74
Currency issued	26	24	26	27	35	32	33	34	39	39	39
DMB deposits at the central bank	91	89	62	45	59	44	39	37	35	35	35
Banking System											
Net foreign assets	-30	-48	-7	99	86	112	111	140	202	220	247
Net domestic assets	1,610	1,602	1,495	1,371	1,326	1,308	1,294	1,359	1,309	1,325	1,312
Net claims on the central bank	120	147	135	61	73	82	122	176	121	82	62
Credit to private sector	1,855	1,904	1,878	1,829	1,791	1,763	1,715	1,725	1,849	1,760	1,785
Credit to government	210	213	216	219	222	225	228	230	233	235	235
Other items, net	-574	-662	-734	-739	-760	-762	-770	-772	-895	-752	-770
Domestic deposits	1,581	1,554	1,488	1,470	1,412	1,420	1,406	1,500	1,511	1,545	1,559
Local currency	1,462	1,433	1,370	1,385	1,329	1,336	1,334	1,416	1,437	1,480	1,516
Foreign currency	119	121	118	85	83	84	72	84	75	65	43
Consolidated Financial System											
Net foreign assets	-204	-236	-165	-64	-90	-3	16	63	145	164	194
Net domestic assets	1,811	1,814	1,679	1,561	1,536	1,455	1,422	1,471	1,405	1,420	1,405
Net claims on the public sector	158	221	187	181	250	242	249	305	280	230	217
Net credit to private sector	1,855	1,904	1,878	1,829	1,791	1,763	1,715	1,725	1,849	1,760	1,785
Other, net	-202	-311	-386	-449	-505	-550	-542	-559	-724	-570	-597
Broad Money (M3)	1,607	1,578	1,514	1,497	1,447	1,452	1,439	1,534	1,551	1,584	1,598
Memorandum items:											
Base money (y-o-y percentage change)	1.3	-15.8	-40.0	-55.2	-19.4	-32.3	-17.8	-0.9	-20.7	-2.6	2.9
Broad money (y-o-y percentage change)	1.0	0.6	-8.5	-10.2	-10.0	-8.0	-5.0	2.5	7.2	9.1	11.1
Credit to private sector	-17.8	3.1	-5.0	-4.6	-3.4	-7.4	-8.7	-5.7	3.2	-0.2	4.1
Money velocity (GDP/base money)	12.8	13.5	17.5	21.2	16.3	21.1	22.7	22.5	21.9	22.4	22.6
Broad money velocity (GDP/M3)	0.9	1.0	1.0	1.0	1.1	1.1	1.1	1.1	1.1	1.0	1.0
Multiplier (M3 / base money)	13.8	14.1	17.3	20.8	15.4	19.1	20.0	21.5	20.8	21.4	21.6

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, 2009–17

	2009	2010	2011 Est.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.
				(Percentage change)					
Real economy									
Real GDP	-6.8	-4.0	3.1	2.4	2.6	2.2	2.6	2.7	2.9
Real domestic demand	-20.3	-2.3	3.9	3.7	3.4	2.9	1.6	2.5	3.0
Private consumption	-14.9	-0.4	4.0	3.0	3.2	3.2	3.2	3.1	3.0
Public consumption	-1.7	-3.4	-0.6	-0.4	-0.6	-0.1	0.4	0.2	1.8
Gross fixed investment	-51.6	-8.1	13.4	13.8	10.7	6.3	-2.1	3.6	4.4
Net exports 1/	11.7	-1.1	-0.7	-0.4	-0.2	-0.1	1.0	0.5	0.3
Exports of goods and services	6.6	0.4	3.2	2.9	2.9	2.9	4.0	3.8	3.6
Imports of goods and services	-24.0	4.0	6.3	5.1	4.2	4.0	2.4	3.5	3.9
Output gap 2/	-1.9	-4.5	-1.0	-0.7	0.0	0.0	0.0	0.0	0.0
Potential output	-2.8	-1.5	-0.1	1.6	1.8	2.2	2.6	2.7	2.9
Unemployment rate 3/	8.0	8.1	7.4	6.3	6.0	5.0	4.4	4.0	4.0
Real wages	-10.3	-2.2	1.6	1.2	1.4	2.2	2.1	2.1	2.1
CPI inflation	12.0	5.4	4.0	4.8	3.5	2.5	2.5	2.5	2.5
CPI inflation (excl. effect of ind. taxes)	11.4	4.4	3.8	4.6	3.5	2.5	2.5	2.5	2.5
CPI inflation (end of period)	7.5	2.4	5.5	4.1	2.9	2.4	2.5	2.5	2.5
Nominal ISK/EUR exchange rate	172.0	161.7	161.0	…	…	…	…	…	…
Real exchange rate (+ appreciation)	-18.4	6.4	0.9	…	…	…	…	…	…
Terms of trade	-6.7	6.1	-1.8	-0.7	1.1	-0.3	0.0	-0.1	0.0
Nominal GDP (bln ISK)	1495.4	1534.2	1630.2	1732.5	1853.4	1941.7	2043.5	2149.2	2266.0
				(Percent of GDP, unless otherwise indicated)					
Balance of Payments									
Current account	-11.8	-8.4	-6.5	-2.8	-1.5	-3.1	-3.1	-3.6	-2.8
Underlying current account 4/	8.7	13.1	5.6	2.3	3.5	2.0	2.0	1.5	2.3
Trade balance	8.4	10.1	8.2	6.6	6.6	6.0	7.0	7.1	7.0
Net income balance 5/	-19.6	-17.9	-14.2	-8.9	-7.7	-8.6	-9.6	-10.3	-9.4
Capital and financial account	-28.2	52.9	15.3	-0.5	-14.5	-1.2	4.2	-6.2	2.3
Capital transfer, net	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment, net	-18.3	21.8	7.9	5.1	5.0	5.5	4.0	4.0	5.3
Portfolio investment, net	3.1	-4.4	-5.6	100.8	-32.6	-20.1	-16.5	-6.9	-4.8
Other investment, net 6/	-13.0	35.5	13.1	-106.4	13.1	13.5	16.7	-3.2	1.9
Accumulation of arrears	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary financing	5.5	8.3	14.6	-6.3	-0.7	-2.5	-3.3	-1.6	0.0
Gross external debt 7/	266.5	289.7	250.4	207.1	175.8	166.6	157.0	147.4	140.7
Underlying gross external debt 8/	262.2	271.3	224.5	191.1	167.3	164.5	157.0	147.4	140.7
Net external debt 9/	160.4	181.9	146.6	189.6	136.1	110.7	88.8	71.6	64.9
Central bank reserves (US$ billion)	3.9	5.8	8.7	7.4	5.0	4.0	3.7	1.8	1.8
General government accounts									
Revenue	41.1	41.5	41.7	41.8	41.2	41.6	41.6	41.3	41.1
Expenditure	49.7	47.9	46.3	44.6	43.0	42.2	41.1	40.4	40.0
Overall balance	-8.6	-6.4	-4.6	-2.8	-1.8	-0.6	0.5	0.9	1.1
Primary balance	-6.5	-2.7	-1.1	1.3	2.3	3.5	4.4	4.6	4.6
Primary balance (excl. new road projects)	-6.5	-2.7	-1.1	1.4	2.4	3.6	4.4	4.6	4.6
Change in primary balance (excl. new road projects)	-6.0	3.8	1.6	2.5	1.0	1.2	0.8	0.2	0.0
Gross debt	88.2	92.8	99.2	97.3	92.4	90.9	87.8	83.0	81.7
Net Debt	55.8	62.8	64.6	66.4	64.6	62.9	59.9	56.7	53.0

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, 2009–17
(U.S. Dollar billions)

	2009	2010	2011	2012	2013	2014	2015	2016	2017
			Est.	Proj.	Proj.	Proj.	Proj	Proj	Proj
Current Account	-1.4	-1.1	-0.9	-0.4	-0.2	-0.5	-0.5	-0.6	-0.5
Trade Balance	1.0	1.3	1.1	0.9	0.9	0.9	1.1	1.1	1.2
Balance on Goods	0.7	1.0	0.8	0.4	0.6	0.5	0.7	0.8	0.9
Merchandise exports f.o.b.	4.1	4.6	5.3	5.0	5.3	5.5	5.9	6.2	6.5
Merchandise imports f.o.b.	-3.3	-3.6	-4.5	-4.5	-4.8	-5.0	-5.2	-5.4	-5.6
Balance on Services	0.3	0.3	0.3	0.5	0.4	0.4	0.4	0.3	0.3
Exports of services, total	2.3	2.5	2.9	2.8	3.0	3.2	3.4	3.6	3.9
Imports of services, total	-2.0	-2.2	-2.6	-2.4	-2.6	-2.8	-3.0	-3.3	-3.6
Balance on Income 1/	-2.4	-2.2	-2.0	-1.2	-1.1	-1.3	-1.5	-1.7	-1.6
Receipts	0.8	0.5	1.0	0.3	0.4	0.3	0.4	0.3	0.5
of which dividends and reinvested earnings	0.4	0.2	0.7	0.2	0.3	0.2	0.2	0.2	0.4
of which interest receipts	0.4	0.2	0.3	0.1	0.1	0.1	0.2	0.1	0.1
Expenditures	-3.1	-2.7	-3.0	-1.5	-1.5	-1.6	-1.9	-2.0	-2.1
of which dividends and reinvested earnings	-0.6	-0.9	-1.0	-0.7	-0.6	-0.6	-0.8	-0.8	-0.8
of which interest payments	-2.5	-1.8	-2.0	-0.8	-0.9	-0.9	-1.1	-1.2	-1.2
Current transfer, net	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Cap and Finan. Acct	-3.4	6.6	2.1	-0.1	-2.1	-0.2	0.6	-1.0	0.4
Capital transfer, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	-3.4	6.6	2.2	-0.1	-2.1	-0.2	0.7	-1.0	0.4
Direct investment, net	-2.2	2.7	1.1	0.7	0.7	0.8	0.6	0.6	0.9
Portfolio investment, net	0.4	-0.5	-0.8	13.7	-4.7	-3.0	-2.5	-1.1	-0.8
Assets	1.3	0.0	-1.0	0.6	-0.2	-0.6	-0.7	-0.7	-1.0
Liabilities 2/	-0.9	-0.5	0.2	13.1	-4.4	-2.4	-1.9	-0.4	0.1
Net borrowing	-0.9	-0.4	0.2	0.9	-1.3	-0.3	-0.1	0.8	0.0
Equities	0.0	-0.1	0.0	12.2	-3.1	-2.1	-1.8	-1.2	0.2
Other investment, net 3/	-1.6	4.5	1.8	-14.5	1.9	2.0	2.6	-0.5	0.3
Assets	-0.9	2.4	4.3	0.5	0.9	0.9	1.1	0.3	0.1
Liabilities 2/	-0.6	2.0	-2.5	-15.0	1.0	1.1	1.5	-0.8	0.2
of which external asset recovery (Landsbanki)	0.8	0.6	0.7	0.9	0.2	0.2	0.1	0.2	0.1
of which other external asset recovery	0.2	0.6	1.9	2.1	1.5	1.1	0.5	0.1	0.0
of which other asset recovery payments (Landsbanki)	0.0	0.0	-1.7	-1.1	-0.2	-0.2	-0.2	-0.2	-0.2
of which other asset recovery payments	0.0	0.0	-0.2	-0.8	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	4.5	-4.7	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance	-0.3	0.9	0.8	-0.4	-2.3	-0.6	0.2	-1.6	-0.1
Overall financing	0.3	-0.9	-0.9	0.4	2.3	0.6	-0.2	1.6	0.1
Change in gross reserves ("-" = increase)	-0.3	-1.9	-2.9	1.3	2.4	1.0	0.3	1.8	0.1
Accumulation of arrears ("-" = paydown)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing 4/	0.7	1.0	2.1	-0.9	-0.1	-0.4	-0.5	-0.3	0.0
Fund ("+" = net disbursement)	0.2	0.3	0.9	-0.9	-0.1	-0.4	-0.5	-0.3	0.0
Bilateral (earmarked/ non-cash)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other identified new financing 5/	0.5	0.7	1.2	0.0	0.0	0.0	0.0	0.0	0.0
Financing Gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Level of gross reserves (eop)	3.9	5.8	8.7	7.4	5.0	4.0	3.7	1.8	1.8
Level of gross reserves (eop) excluding old bank deposits	2.7	4.2	6.0	4.3	2.4	1.8	1.7	1.2	1.6
Memo									
GDP $ bln	12.1	12.6	14.0	13.6	14.3	14.8	15.4	16.1	17.0
Underlying balance of income 6/	0.1	0.4	-0.3	-0.5	-0.4	-0.5	-0.7	-0.8	-0.7
Underlying current account balance 6/	1.0	1.6	0.8	0.3	0.5	0.3	0.3	0.2	0.4
Reserves (months of imports of G&S)	8.0	9.9	15.2	12.0	7.7	5.9	5.1	2.4	2.3
Reserves/S-T debt (residual basis, in percent)	50.6	67.9	133.8	179.2	424.6	334.0	161.2	123.1	111.2
Reserves/S-T debt (residual basis, in percent) 7/	41.3	60.5	157.8	110.5	319.1	227.1	93.9	113.4	112.9
Reserves (in percent of GDP)	32.1	46.2	62.0	54.3	35.0	27.2	23.9	11.4	10.4
Principal and interest arrears of old banks 2/	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, 2008–17 1/
(GFS, modified cash, percent of GDP

	2008	2009	2010 Est.	2011 Est.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.
Total revenue 2/	**44.1**	**41.1**	**41.5**	**41.7**	**41.8**	**41.2**	**41.6**	**41.6**	**41.3**	**41.1**
Taxes	**33.8**	**30.8**	**30.9**	**31.7**	**32.1**	**31.5**	**31.9**	**32.0**	**32.0**	**31.9**
Taxes on income and profits	17.8	16.0	15.6	16.4	16.5	16.1	16.2	16.2	16.2	16.1
Personal Income Tax	13.2	12.9	12.9	13.3	13.2	12.8	13.0	13.0	13.1	13.1
Corporate Income Tax	1.9	1.8	1.0	1.8	2.0	2.0	2.0	2.0	2.0	2.0
Capital gains tax, rental income	2.7	1.4	1.8	1.3	1.4	1.3	1.2	1.2	1.1	1.0
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	2.2	2.4	2.3	2.3	2.2	2.2	2.1
Taxes on goods and services	13.2	11.7	12.0	11.9	12.1	12.2	12.6	12.7	12.7	12.6
VAT 3/	9.1	8.0	8.0	7.8	7.9	8.0	8.1	8.2	8.2	8.1
Other taxes on goods and services	4.1	3.7	4.0	4.1	4.1	4.2	4.4	4.5	4.5	4.5
Taxes on international trade	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.5
Other taxes	0.1	0.4	0.4	0.6	0.5	0.3	0.3	0.3	0.3	0.3
Social contributions	**2.8**	**3.1**	**4.1**	**4.2**	**3.7**	**3.5**	**3.5**	**3.4**	**3.4**	**3.4**
Grants	**0.1**	**0.1**	**0.2**	**0.2**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**
Other revenue	**7.4**	**7.1**	**6.3**	**5.6**	**5.9**	**6.0**	**6.1**	**6.1**	**5.7**	**5.8**
Property income	3.8	3.6	2.6	2.2	2.0	1.9	2.0	2.1	2.2	2.3
o/w Interest income	3.3	3.1	2.1	1.7	1.3	1.2	1.3	1.4	1.5	1.6
Total expenditure 2/	**44.6**	**49.7**	**47.9**	**46.3**	**44.6**	**43.0**	**42.2**	**41.1**	**40.4**	**40.0**
Current expense	**42.0**	**48.3**	**47.2**	**46.2**	**44.8**	**42.8**	**42.1**	**41.2**	**40.5**	**40.0**
Compensation of employees	14.6	15.0	14.8	14.5	14.2	13.6	13.4	13.1	12.8	12.7
Use of goods and services	11.6	12.5	12.2	11.7	11.5	11.0	10.7	10.5	10.3	10.2
Consumption of fixed capital	1.8	2.1	2.2	2.2	2.1	2.1	2.1	2.1	2.1	2.1
Interest	3.3	5.2	5.8	5.2	5.4	5.3	5.4	5.3	5.2	5.1
o/w Interest on IceSave guarantee	…	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Subsidies	1.8	1.9	1.8	1.7	1.6	1.5	1.5	1.4	1.4	1.4
Grants	0.2	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Social benefits	6.1	8.2	7.9	8.3	7.4	6.8	6.6	6.4	6.4	6.3
Other expense	2.6	3.0	2.3	2.4	2.3	2.2	2.1	2.1	2.1	2.1
Nonfinancial assets	**2.6**	**1.4**	**0.7**	**0.1**	**-0.2**	**0.2**	**0.2**	**-0.1**	**-0.1**	**-0.1**
Non-financial assets, acquisition	4.5	3.5	2.9	2.2	2.0	2.3	2.2	2.0	1.9	2.0
of which: road construction projects				0.0	0.1	0.2	0.2	0.0	0.0	0.0
Consumption of fixed capital (-)	-1.8	-2.1	-2.2	-2.2	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1
Net lending/borrowing 4/	**-0.5**	**-8.6**	**-6.4**	**-4.6**	**-2.8**	**-1.8**	**-0.6**	**0.5**	**0.9**	**1.1**
Net lending/borrowing incl. write-offs	**-13.5**	**-10.9**	**-10.3**	**-4.6**	**-4.9**	**-1.8**	**-0.6**	**0.5**	**0.9**	**1.1**
Financial assets, transactions	**21.9**	**5.2**	**2.2**	**-0.6**	**-1.8**	**-1.0**	**1.4**	**1.7**	**0.1**	**4.0**
Currency and deposits	4.2	3.0	7.2	-1.0	-2.1	-1.3	1.1	1.4	-0.2	3.7
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	14.4	-7.7	-6.0	0.4	0.3	0.3	0.2	0.3	0.3	0.3
Shares and other equities	0.2	9.3	2.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	3.2	0.6	-1.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities, transactions	**35.4**	**16.1**	**12.6**	**4.0**	**3.1**	**0.9**	**2.0**	**1.1**	**-0.7**	**2.9**
Securities other than shares	10.6	22.0	6.6	4.1	2.7	1.3	1.0	0.0	-0.4	2.8
Loans	21.4	-6.2	3.9	-0.3	0.5	-0.4	0.9	1.1	-0.4	0.0
Domestic loans	19.0	-7.5	1.7	0.3	0.1	0.0	-0.1	-0.2	-0.4	0.0
Foreign loans	2.4	1.3	2.2	-0.6	0.3	-0.4	1.1	1.3	0.0	0.1
Insurance technical reserves	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts payable	3.2	0.2	2.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Stock of debt 5/										
General government gross debt 5/	70.3	88.2	92.8	99.2	97.3	92.4	90.9	87.8	83.0	81.7
Domestic	45.7	61.1	68.2	69.3	68.3	65.5	63.7	60.7	57.3	57.2
Foreign currency 5/	24.6	27.1	24.6	29.9	29.1	27.0	27.2	27.1	25.7	24.5
of which:										
Bilateral loans to support CBI reserves	0.0	3.1	7.4	13.8	10.8	10.0	9.2	7.1	5.3	3.6
Other	24.6	23.9	17.2	16.1	18.3	16.9	18.0	20.0	20.4	20.8
General government net debt 6/	41.8	55.8	62.8	64.6	66.4	64.6	62.9	59.9	56.7	53.0
Structural Balances 7/										
Structural balance	-4.5	-7.5	-3.7	-4.1	-2.4	-1.9	-0.7	0.5	0.8	1.1
Structural primary balance	-4.5	-5.5	-0.2	-0.6	1.6	2.2	3.4	4.4	4.6	4.6
Memo Items										
Nominal GDP (billion ISK)	1482	1495	1534	1630	1732	1853	1942	2043	2149	2266
Primary revenue	40.8	37.9	39.4	40.0	40.5	40.0	40.3	40.2	39.8	39.5
Primary expenditure	41.3	44.5	42.1	41.1	39.2	37.7	36.8	35.8	35.2	34.9
Primary balance (excl. interest income)	-0.5	-6.5	-2.7	-1.1	1.3	2.3	3.5	4.4	4.6	4.6
Change in the primary balance	-6.3	-6.0	3.8	1.6	2.4	1.0	1.2	0.9	0.2	0.0
Primary balance (excl. new road projects)	-0.5	-6.5	-2.7	-1.1	1.4	2.4	3.6	4.4	4.6	4.6
Change in the primary balance (excl. new road projects)	-6.3	-6.0	3.8	1.6	2.5	1.0	1.2	0.8	0.2	0.0
New discretionary revenue measures		2.4	3.0	0.6	1.4	0.6	0.7	0.5	0.0	0.0
New discretionary expenditure measures		0.0	-2.7	-0.5	-1.5	-0.4	-0.3	-0.2	0.0	0.0
New discretionary measures		2.4	5.7	1.2	3.0	1.0	0.9	0.7	0.0	0.0

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

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

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

3/ Includes Financial Activities Tax introduced in 2012.

4/ 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 2012 reflect HFF and savings bank recapitalization.

5/ Includes bilateral loans and international bond issuance 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.

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

7/ 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.

Table 6. Iceland: Central Government Operations, 2008–17
(GFS modified cash basis, percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
			Est.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Cash receipts from operating activities 1/	**30.0**	**27.7**	**30.1**	**28.7**	**28.8**	**28.4**	**28.8**	**28.9**	**28.5**	**28.4**
Tax revenue	23.6	21.3	22.3	22.5	22.6	22.1	22.5	22.6	22.5	22.4
Taxes on income, profits, and capital gains	10.3	9.3	9.0	9.1	8.8	8.5	8.5	8.4	8.4	8.3
Personal income tax	5.9	5.5	5.8	5.7	5.5	5.3	5.3	5.3	5.3	5.3
Corporate income tax	2.0	1.2	1.2	1.8	2.0	2.0	2.0	2.0	2.0	2.0
Other taxes on income and profit	2.4	2.6	1.9	1.6	1.4	1.3	1.2	1.2	1.1	1.0
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 2/	12.1	10.8	11.8	11.6	11.9	12.0	12.4	12.5	12.5	12.5
Taxes on international trade and transactions	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.5
Other tax revenue	0.1	0.4	0.4	0.5	0.5	0.3	0.3	0.3	0.3	0.3
Social contributions	2.8	2.8	4.0	4.1	3.7	3.5	3.5	3.4	3.4	3.4
Grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other receipts	3.6	3.5	3.7	2.1	2.4	2.6	2.7	2.8	2.4	2.5
of which:										
Interest income	2.6	2.9	1.8	1.2	1.0	0.9	1.0	1.1	1.2	1.3
Total spending 1/	**30.5**	**36.9**	**34.6**	**32.2**	**31.1**	**30.0**	**29.4**	**28.3**	**27.8**	**26.9**
Cash payments for operating activities	**28.2**	**34.3**	**32.9**	**31.2**	**30.3**	**28.9**	**28.3**	**27.4**	**26.9**	**26.1**
Compensation of employees	8.5	8.6	8.3	7.9	7.6	7.3	7.3	7.3	7.2	7.2
Purchases of goods & services	5.5	6.0	6.2	5.5	5.5	5.2	4.9	4.7	4.6	4.4
Interest 3/	1.9	5.3	4.8	4.0	4.5	4.6	4.7	4.6	4.6	4.2
Transfer payments	12.3	14.4	13.6	13.8	12.7	11.9	11.3	10.9	10.6	10.3
Net cash inflow from operating activities	**-11.2**	**-6.6**	**-2.8**	**-2.5**	**-1.4**	**-0.4**	**0.6**	**1.4**	**1.6**	**2.3**
Investments in NFAs	2.3	2.5	1.7	1.0	0.9	1.2	1.1	0.9	0.9	0.9
of which: road construction projects				0.0	0.1	0.2	0.2	0.0	0.0	0.0
Overall balance (incl. adjustment to cash)	**-12.6**	**-10.1**	**-4.5**	**-3.5**	**-2.3**	**-1.6**	**-0.6**	**0.5**	**0.7**	**1.4**
Write-offs	13.0	2.3	3.6	0.0	2.1	0.0	0.0	0.0	0.0	0.0
of which:										
Recapitalization related write-offs 4/	11.8	0.0	2.2	0.0	2.1	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	-3.5	-4.4	-1.6	-0.6	0.5	0.7	1.4
Memorandum Items:										
Nominal GDP	1,482	1,495	1,534	1,630	1,732	1,853	1,942	2,043	2,149	2,266
Primary revenue	27.4	24.8	28.3	27.5	27.8	27.5	27.8	27.7	27.3	27.0
Primary expenditure	28.6	31.5	29.8	28.3	26.6	25.5	24.7	23.7	23.2	22.7
Primary balance (excl. interest income)	-1.2	-6.7	-1.5	-0.8	1.2	2.1	3.1	4.0	4.1	4.3
Change in primary balance		-5.5	5.2	0.7	2.0	0.9	1.1	0.9	0.1	0.3
Primary balance (excl. new road projects)		-6.7	-1.5	-0.8	1.3	2.2	3.3	4.0	4.1	4.3
Change in the primary balance (excl. new road projects)		-6.7	-1.5	0.7	2.1	0.9	1.0	0.7	0.1	0.3

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

1/ Measures are allocated primarily toward revenue measures after 2012.

2/ Includes Financial Activities Tax introduced in 2012.

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

4/ Write-offs in 2008 are the result of CBI recapitalization; write-offs in 2010 reflect recapitalization of the HFF; write-offs in 2012 reflect HFF and savings bank recapitalization.

Table 7. Iceland: Financial Soundness Indicators, 2009–11
(in percent, unless otherwise indicated)

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

Source: Central Bank of Iceland; FME

1/ Including Housing Finance Fund (hereafter HFF).
2/ cross-default criteria for NPLs (see footnote 2 in the text).
3/ For 2011 based on non-audited financial statements Q3 or Q4, 3 largest banks, excluding HFF.
4/ For all Deposit Money Banks (DMBs), does not include HFF.

Table 8. Iceland: Status of the Financial Sector

	Total assets						Capital adequacy ratio end 2011
	end-Dec 2009		end-Dec 2010		end-Dec 2011 2/		
	in billions of ISK	in percent of GDP	in billions of ISK	in percent of GDP	in billions of ISK	in percent of GDP	in percent
Commercial banks 1/	**2592**	**173**	**2804**	**182**	**2677**	**162**	**24**
Landsbankinn	1061	71	1081	70	1124	68	24
Arion	757	51	813	53	823	50	22
Islandsbanki	717	48	683	44	679	41	28
MP bank	57	4	62	4	51	3	21
Saving banks 3/	**143**	**10**	**135**	**9**	**59**	**4**	**13**
Non-Banks 4/	**308**	**21**	**270**	**18**	**231**	**14**	**29**
Housing Finance Fund (HFF) 5/	**795**	**53**	**836**	**54**	**859**	**52**	**2**

Sources: CBI and FME; and IMF staff calculations.

1/ End 2011 data for Landsbankinn and Islandsbanki reflect the impact of their respective mergers with Sp Kef. and Byr in the second half of 2011.

2/ Data as of Q3 2011 for commercial banks assets and CAR, as of end-Q2 2011 for saving banks assets, CAR estimated for Q4 2011

3/ There are now 10 saving banks (versus 18 pre-crisis): Afl sparisjóður, Sparisjóður Bolungarvíkur, Sparisjóður Höfðhverfinga, Sparisjóður Norðfjarðar, Sparisjóður Ólafsfjarðar, Sparisjóður Strandamanna, Sparisjóður Suður-Þingeyinga, Sparisjóður Svarfdæla, Sparisjóður Vestmannaeyja, Sparisjóður Þórshafnar

4/ Data as of Q2 2011, CAR estimated for Q4 2011. Covers leasing companies, credit card companies and other miscellaneous entities.

5/ The HFF recapitalisation law was adopted by parliament in December 2010. A 33 bln ISK capital injection brought HFF's capital to around 2 percent of risk-weighted assets.

Table 9. Iceland: Indicators of Fund Credit, 2008–16
(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	831	761	512	171	0
Obligations	0	13	18	29	598	89	265	348	172
Principal (repurchases)	0	0	0	0	569	70	249	341	171
Charges and interest	0	13	18	29	30	19	16	7	1
Stock of existing and prospective Fund credit									
In percent of quota	476	565	744	1190	707	647	435	145	0
In percent of GDP	5	9	11	15	9	8	5	2	0
In percent of exports of G&S	11.5	16.4	19.1	26.4	16.3	13.9	9.0	2.8	0
In percent of gross reserves	24.3	26.9	23.2	24.9	17.1	23.2	19.4	7.2	0
Obligations to the Fund from existing and prospective Fund arrangements									
In percent of quota	0.0	11.1	15.2	25.0	508.7	75.6	225.7	296.0	146.0
In percent of GDP	0.0	0.2	0.2	0.3	6.7	1.0	2.7	3.5	1.6
In percent of exports of G&S	0.0	0.3	0.4	0.6	11.8	1.6	4.7	5.7	2.7
In percent of gross reserves	0.0	0.5	0.5	0.5	12.3	2.7	10.1	14.7	15.2

Source: IMF staff estimates and projections.

APPENDIX I. DEBT SUSTAINABILITY ANALYSIS

1. External and public debt are on sustainable paths, but risks remain elevated (Tables A1–A2; Figures A1–A2).

A. External Debt Sustainability Analysis (DSA)

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

- Available data on the three old banks' asset recovery up to September 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 estate of old Landsbanki made their first interim payment to creditors in December 2011. Otherwise, the time at which each of the old banks are assumed to make their first payments of recovered assets to external creditors is in line with that in the last review, with initial payments expected in 2012, although the pace of payments is more modest than previously assumed.
- The treatment of potential liabilities related to Icesave deposits remains as it did in the 6th review staff report, 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)
- As before, two of the old banks indicated the possibility that their creditors may choose resolution through composition (through which the estates of the old banks become companies owned by their creditors) rather that liquidation. Given this, these two old banks are assumed to become companies controlled by their shareholders in 2012. As a result, the asset recovery that has been treated as external debt of the old bank is transformed into an equity liability instead. This reduces external debt at end-2012.
- Interest rates for *new* borrowing throughout the projection period are assumed to be somewhat lower than in the last DSA, reflecting reduced global funding costs.
- External borrowing by the central government (aside from that from bilateral creditors) and its enterprises are assumed to be rolled over. As before, the central government is assumed to issue additional bonds to cover (on average 30 percent) of the CBI's external debt that falls due over 2012–16. Local municipalities are assumed to only partially roll over their debt, with an average rollover rate of around 40 percent assumed over the next two years. Corporations under financial stress are assumed to be unable to roll over external debt.
- As before, external debt declines with the implementation of the authorities' capital account liberalization strategy during 2012 and 2013, as captive non-resident krona

(around 25 percent of GDP) 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. **The external debt path is expected to decline substantially over the medium term.** External debt is estimated at 250 percent of GDP in 2011, and is expected to fall to around 140 percent of GDP by 2017. Around one-third of the 2011 debt stock reflects external liabilities to nonresidents caught by the capital controls and expected payments to foreign creditors associated with asset recovery of the old banks, although this declines as liabilities are paid and the old banks go through composition.

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 are also shown. In previous DSA a separate scenario, where insured deposit have super-priority status (i.e., insured deposits would be paid out before uninsured deposits) in the estate of Landsbanki, was included, but a recent Supreme Court decision has made such a scenario redundant. Each of these scenarios is treated the same way as in the Public DSA, and would involve an upward revision of the debt path, with coverage of both the insured and uninsured deposits having the largest impact.

5. **Stress tests suggest that the downward trajectory 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. The historical scenario or 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 Analysis

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

- The 2011 primary balance was weaker by ¾ percent of GDP than previously expected. However, with a slight improvement of the net interest payments relative to the previous DSA, the overall deficit is estimated at 4½ percent of GDP (½ worse than previously expected).

- The 2012 budget adopted by the authorities and current macro assumptions imply that the 2012 primary balance will be slightly eased (by ½ percent of GDP) relative to the target established at the 6th review under the SBA, and the overall deficit is expected at 2¾ percent of GDP.

- Over the medium term, the primary balance is expected to reach 4½ percent of GDP in 2016, unless further measures are implemented to restore the path agreed at the time of the 6th review and bring the primary balance to 5 percent of GDP. This implies that the overall deficit will not close until 2015 and the overall balance will reach ¾ percent of GDP in 2016 rather than 1½ percent of GDP as previously projected.

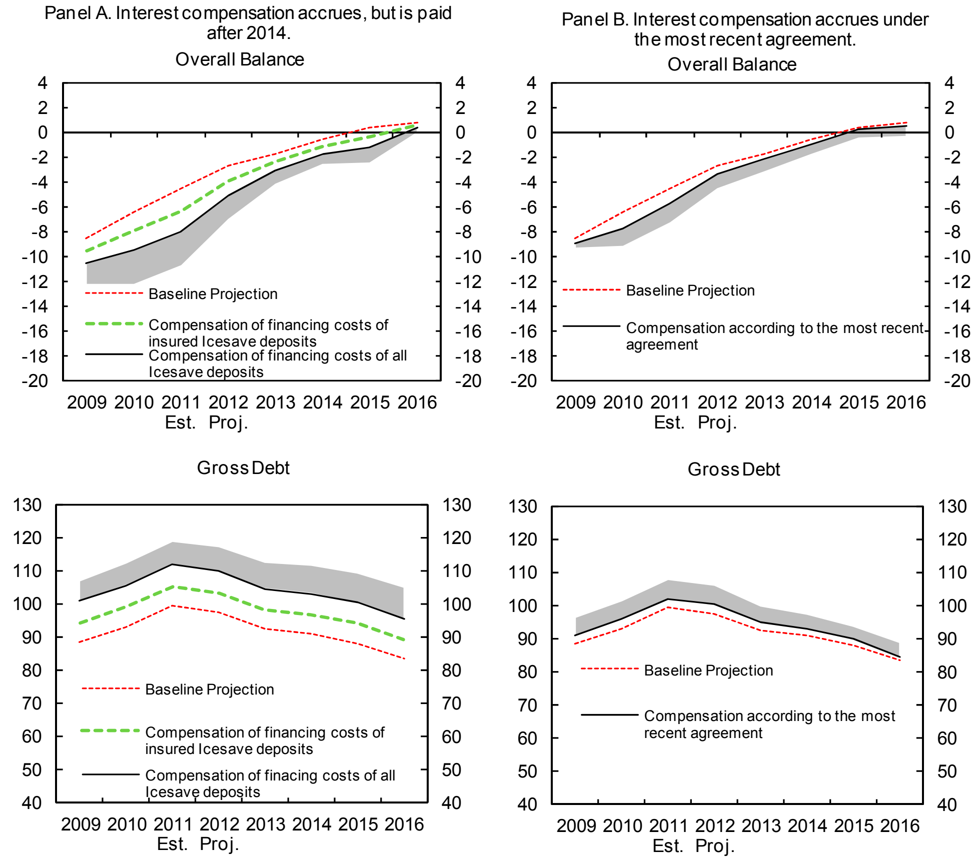
- HFF recapitalization and savings-bank related expenditures amounting to 2 percent of GDP have been postponed until 2012.

7. General government debt is estimated at 99 percent of GDP in 2011. (Table A2, Figure A2). Due to the slight fiscal relaxation in 2012, the debt path is expected to be somewhat flatter than under the previous DSA. Nonetheless, provided no further slippage occurs in the 2012 budget implementation, the primary balance will still exceed the debt stabilizing balance; however, the margin has narrowed relative to previous projections. Low interest rate profile will support favorable debt dynamics in 2012–13, but the real interest rate/GDP growth differential is expected to reverse on average to around 1 percentage point in the medium term.

8. The baseline debt trajectory is very sensitive to growth shocks (Figure A2). A standard growth shock would reverse the downward path of public debt and keep it well above 105 percent in the absence of offsetting measures. An interest rate shock, a combined macro shock, and an interruption of the fiscal consolidation would flatten the debt path. A 30-percent depreciation of the exchange rate would raise the debt ratio to 107 percent of GDP in 2013 and leave debt at 97 percent of GDP in 2017.

9. The outcome of the Icesave dispute continues to weigh on the potential debt path. A recent Supreme Court ruling acknowledged the priority of wholesale deposits. This makes a scenario with an assumption of super-priority of retail deposits redundant. The asset recovery assumption has increased above 100 percent. Other assumptions regarding the estimates remain as in the previous assessment, and the results are broadly similar. The contingent liability of the government at end-2011 is estimated at 6 percent of GDP if *only insured deposits* are covered, and 12½ percent of G*DP if insured plus uninsured* deposits are covered (Panel *A). Applying penalty rates* would increase the estimated contingent liability at end 2011 to 9¼ percent of GDP for insured deposits and 19¼ percent of GDP for all deposits. Should the most recent agreement take effect (Panel *B)*, the NPV of the cost to the government would amount to 3 percent of GDP at end-2011, assuming payments commence in 2013. This cost could increase to 8 ½ percent of GDP if penalty interest rates are applied.

Figure. Icesave Scenarios
(percent of GDP)



Note: Lines show estimates based on pro*jected interest rates* on long-term euro and UK government bonds. Shaded areas indicate additional impact of using penalty rates.
Sources: Country authorities, and staff estimates.

10. Finally, contingent liability shocks unrelated to the outcome of the Icesave dispute could have substantial effects. A 30 percent contingent liability shock could raise public debt above 120 percent of GDP in 2013. In the medium term, public debt is expected to decline to about 115 percent of GDP.

Table A1. Iceland: External; Debt Sustainability Framework Current Baseline,2007–17
(in percent of GDP, unless otherwise indicated)

	Actual												
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017		**Debt-stabilizing non-interest current account 6/**
Baseline: External debt (including old banks)	605.9	564.7											
Baseline: External debt	171.8	189.0	266.5	289.7	250.4	**204.2**	**178.3**	**167.2**	**157.2**	**147.3**	**140.7**		**16.2**
Change in external debt	70.6	17.2	77.5	23.3	-39.3	-46.2	-25.9	-11.1	-10.1	-9.9	-6.6	0.0	
Identified external debt-creating flows	26.8	40.0	41.5	-21.8	-24.2	-122.4	5.5	4.3	4.2	2.3	-8.6	0.0	
Current account deficit, excluding interest payments	10.1	13.1	1.6	0.4	-3.6	-8.2	-9.4	-8.3	-8.7	-8.7	-10.1	-16.2	
Deficit in balance of goods and services	10.1	2.3	-8.4	-10.1	-8.2	-6.6	-6.6	-6.0	-7.0	-7.1	-7.0		
Exports	34.5	44.2	52.6	56.3	58.4	57.1	58.4	59.0	60.2	60.9	61.3		
Imports	44.6	46.5	44.2	46.2	50.2	50.5	51.8	53.0	53.3	53.7	54.3		
Net non-debt creating capital inflows (negative)	28.9	-23.0	12.7	-40.5	-22.8	-118.9	8.6	5.1	5.3	2.8	-6.6	11.4	
Automatic debt dynamics 1/	-12.2	50.0	27.3	18.3	2.2	4.8	6.3	7.6	7.6	8.3	8.2	4.8	
Contribution from nominal interest rate	6.1	12.9	10.3	8.0	10.1	11.0	11.3	11.3	11.8	12.3	12.2	10.6	
Contribution from real GDP growth	-4.9	-2.0	17.0	10.3	-7.9	-6.3	-5.0	-3.7	-4.2	-4.0	-4.0	-3.5	
Contribution from price and exchange rate changes 2/	-13.4	39.1	44.6	-20.0	-23.0	...	...	...	...	...	...	-2.3	
Residual, incl. change in gross foreign assets 3/	43.7	-22.8	35.9	45.1	-15.1	76.2	-31.4	-15.4	-14.2	-12.2	1.9	0.0	
External debt-to-exports ratio (in percent)	498.4	427.9	506.6	514.5	428.9	357.8	305.2	283.5	260.9	242.1	229.6		
Gross external financing need (in billions of US dollars) 4/	8.7	13.1	6.7	9.3	13.5	12.2	9.3	6.5	5.7	5.9	3.6		
in percent of GDP	42.8	78.1	55.0	74.1	95.8	89.3	65.3	44.1	36.8	36.5	21.2		
Scenario with key variables at their historical averages 5/					**250.4**	**307.3**	**280.8**	**267.2**	**255.5**	**246.0**	**249.9**		**-7.8**
Key Macroeconomic Assumptions Underlying Baseline												For debt stabilization	
Real GDP growth (in percent)	6.0	1.0	-6.5	-4.0	3.1	2.4	2.6	2.2	2.6	2.7	2.9	2.2	
Nominal external interest rate (in percent)	7.4	6.2	3.9	3.1	3.9	4.3	5.8	6.5	7.3	8.2	8.8	6.5	
Growth of exports (US dollar terms, in percent)	31.3	5.4	-14.3	11.1	16.0	-5.1	7.5	4.3	6.4	5.6	6.0		
Growth of imports (US dollar terms, in percent)	9.8	-14.1	-31.6	8.6	21.5	-2.4	7.8	5.6	4.8	5.4	6.3		
Current account balance, excluding interest payments 7/	-10.1	-13.1	-1.6	-0.4	3.6	8.2	9.4	8.3	8.7	8.7	10.1		
Net non-debt creating capital inflows	-28.9	23.0	-12.7	40.5	22.8	118.9	-8.6	-5.1	-5.3	-2.8	6.6		

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.

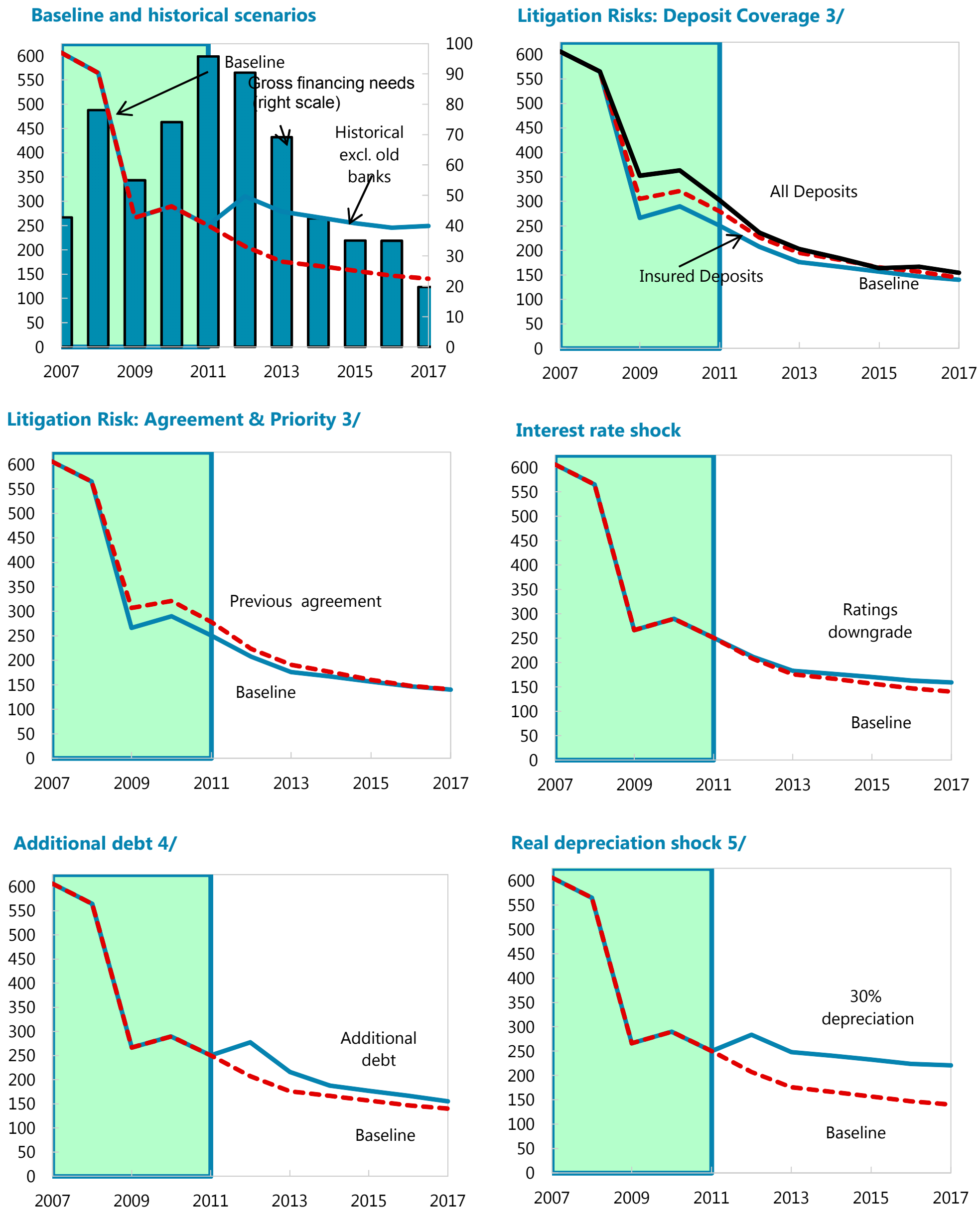
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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 interest rate shock, the Individual shocks are permanent one-half standard deviation shocks. The interest rate shock is a one standard deviation shock.

2/ GDP is converted into $ at average exchange rates.

3/ Litigation risks are assumed as follows:

All depostis: Compensation for financing all Icesave deposits.

Insured deposits: Compensation for financing costs of insured deposits.

Agreement: Compensation for financing costs according to the most recent Icesave agreement.

4/ Assumes 20 percent of GDP increase in external debt in 2012.

5/ One-time real depreciation of 30 percent occurs in 2012.

Table A2. Iceland: Public Sector Debt Sustainability Framework, 2007–17
(in percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	29.1	70.3	88.2	92.8	99.2	**97.3**	**92.4**	**90.9**	**87.8**	**83.0**	**81.7**	**0.9**
o/w foreign-currency denominated	13.3	24.6	27.1	24.6	29.9	29.1	27.0	27.2	27.1	25.7	24.5	
Change in public sector debt	-1.0	41.2	17.8	4.7	6.4	-1.8	-4.9	-1.5	-3.0	-4.9	-1.3	
Identified debt-creating flows (4+7+12)	-10.8	27.9	25.6	11.9	4.7	-0.5	-1.9	-2.5	-3.8	-5.2	-5.3	
Primary deficit (including interest income)	-8.0	-2.8	3.4	0.6	-0.6	-2.6	-3.4	-4.7	-5.8	-6.1	-6.2	
Revenue and grants	47.7	44.1	41.1	41.5	41.7	41.8	41.2	41.6	41.6	41.3	41.1	
Primary (noninterest) expenditure	39.7	41.3	44.5	42.1	41.1	39.2	37.7	36.8	35.8	35.2	34.9	
Automatic debt dynamics 2/	-2.8	12.5	4.3	3.2	-1.5	-0.5	-1.1	1.2	0.7	0.9	0.8	
Contribution from interest rate/growth differential 3/	-0.6	-0.1	4.6	3.5	-0.3	-0.5	-1.1	1.2	0.7	0.9	0.8	
Of which contribution from real interest rate	1.0	0.3	-0.2	0.1	2.4	1.8	1.3	3.1	3.0	3.1	3.1	
Of which contribution from real GDP growth	-1.6	-0.3	4.7	3.5	-2.7	-2.3	-2.4	-1.9	-2.2	-2.2	-2.3	
Contribution from exchange rate depreciation 4/	-2.2	12.6	-0.3	-0.3	-1.2	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	18.2	17.9	8.1	6.8	2.6	2.6	1.1	1.3	0.0	0.1	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities 5/	0.0	0.0	0.0	1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (capitalization of banks, support of international reserves) 6/	0.0	18.2	17.9	6.6	6.8	2.6	2.6	1.1	1.3	0.0	0.1	
Residual, including asset changes (2-3) 7/	9.8	13.3	-7.8	-7.2	1.6	-1.4	-3.0	0.9	0.7	0.3	4.0	
Public sector debt-to-revenue ratio 1/	61.1	159.5	214.6	223.5	237.9	232.8	224.5	218.6	211.1	201.1	198.7	
Gross financing need 8/	0.6	13.1	27.6	27.7	23.6	15.1	9.6	7.5	7.1	13.6	3.5	
in billions of U.S. dollars	0.1	2.2	3.3	3.5	3.3	2.1	1.4	1.1	1.1	2.2	0.6	
Scenario with key variables at their historical averages 9/						**97.3**	**94.4**	**94.0**	**93.6**	**91.4**	**93.1**	**0.2**
Scenario with no policy change (constant primary balance) in 2012-2017						**97.3**	**93.3**	**94.0**	**94.2**	**92.9**	**95.3**	**1.1**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	6.0	1.3	-6.8	-4.0	3.1	2.4	2.6	2.2	2.6	2.7	2.9	
Average nominal interest rate on public debt (in percent) 10/	9.6	13.0	7.5	6.7	5.9	5.8	5.8	6.1	6.1	6.3	6.5	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.0	1.2	-0.8	-0.2	2.8	2.0	1.5	3.5	3.5	3.8	4.0	
Nominal appreciation (increase in US dollar value of local currency, in percent)	15.9	-48.7	1.0	1.1	5.3	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	5.7	11.8	8.3	6.9	3.1	3.8	4.3	2.6	2.6	2.4	2.5	
Growth of real primary spending (deflated by GDP deflator, in percent)	6.5	5.4	0.3	-9.0	0.6	-2.3	-1.3	-0.3	-0.3	0.9	2.1	
Primary deficit (including interest income)	-8.0	-2.8	3.4	0.6	-0.6	-2.6	-3.4	-4.7	-5.8	-6.1	-6.2	
Net public sector debt	10.8	41.8	55.8	62.8	64.6	66.4	64.6	62.9	59.9	56.7	53.0	

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

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 called guarantees of the State Guarantee Fund.

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

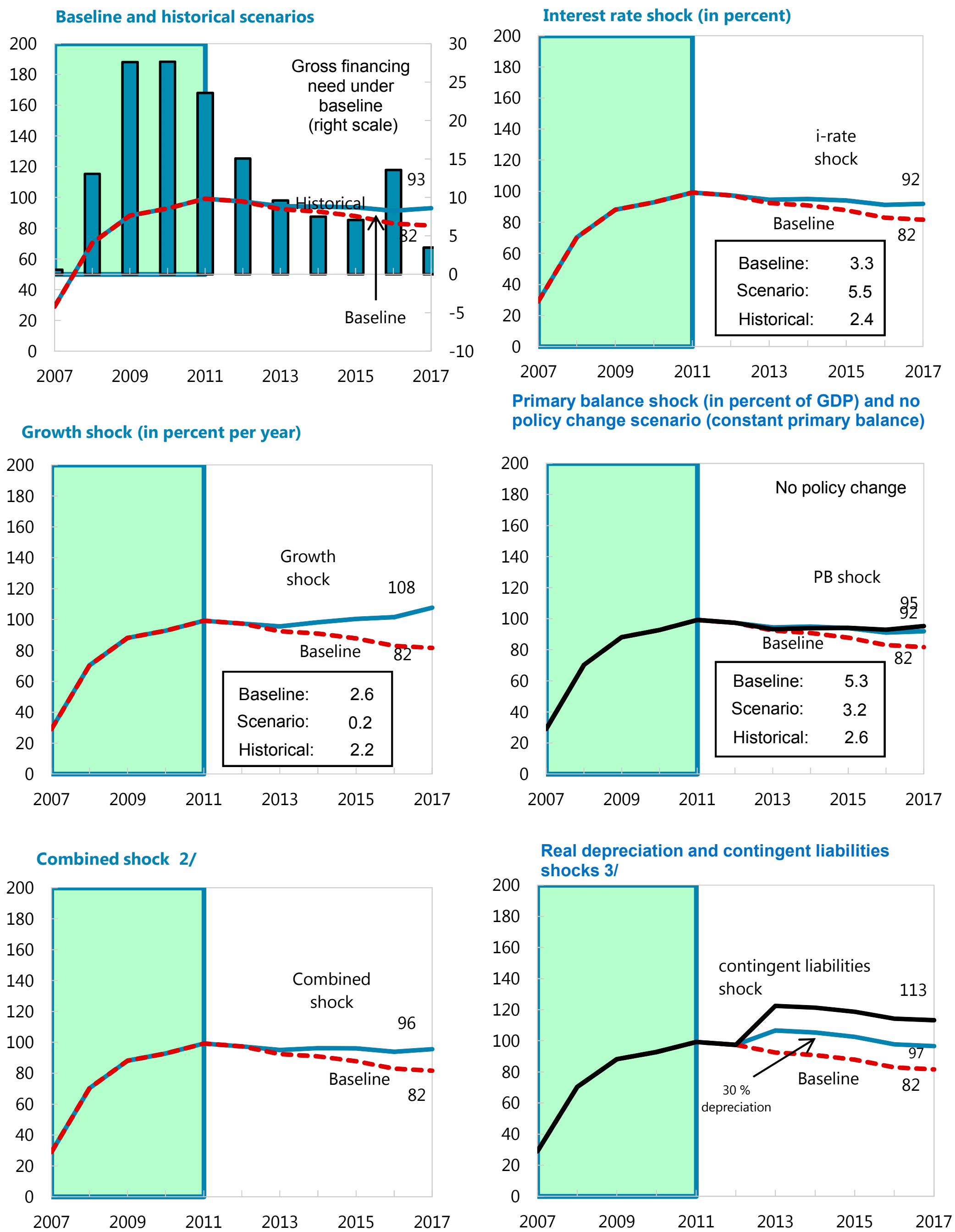
7/ For projections, this line includes exchange rate changes. In 2009-17, the residual also reflects use of deposits at the central bank and sale of financial assets obtained during the financial crisis.

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

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

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

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 2013, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

APPENDIX II. THE RESOLUTION OF ICELAND'S FAILED COMMERCIAL BANKS

In October 2008, Iceland's three largest commercial banks, accounting for 85 percent of the financial system, failed within a single week. The external liabilities of these banks (500 percent of GDP) accounted for most of Iceland's external liabilities. By the end of 2008 each of the three banks was split up into an "old" and a "new" bank where the majority of domestic assets and liabilities of the old banks were transferred to establish the new domestic banks. The old banks are currently undergoing winding up procedures, and in this resolution process is likely that many of the priority claims will be fulfilled, but the use of funds from domestic recovery to cover foreign claims will, over time, put pressure on either reserves or the value of the krona.

Resolution, Winding-up and Creation of the New Banks

Iceland's Emergency Act (Act No.125/2008), passed on October 6, 2008 gave the FME, under extraordinary circumstances, extensive powers to intervene in financial companies. Under this authority Resolution Committees (RCs) were appointed to manage the three largest old banks: Landsbanki on October 7, Glitnir on October 8, and Kaupthing on October 9, 2008. Soon after each bank was granted a moratorium over its obligations, which was, in time, extended up to the 24 month legal limit. An amendment to the Financial Undertakings Act in 2009 clarified that the objective of the moratorium was to ensure that the normal progress of the old bank's winding-up, and that once the moratorium expired, the banks should automatically be regarded as being under winding up procedures. Winding up Boards (WB) were appointed for all three old banks in the first half of 2009, and from this time each old bank's estate was managed jointly by its RC and WB. The RCs manage the old banks' daily operations and assets, while the WBs manage claims (including their recognition and payment) against the old banks' estates. The three old banks all formally entered winding-up procedures on November 22, 2010.

Under the Emergency Act, deposits (including, unusually, wholesale deposits) in the old banks were assigned higher priority than general claims. The deposits in domestic branches and domestic assets of the failed banks were transferred to newly-created domestic banks: New Landsbanki, Arion Banki, and Islandsbanki. After protracted negotiations the differences in the value of the assets and liabilities transferred from Glitnir to Islandsbanki and from Kaupthing to Arion Banki were settled through equity, making the old banks majority owners of the new banks. In the case of Landsbanki, the settlement included some equity (though the state retained a majority share) as well as bonds, including a bond contingent on the performance of certain ring-fenced assets of the new bank. Consequently, asset recovery in the three estates depends on the performance of the new banks.

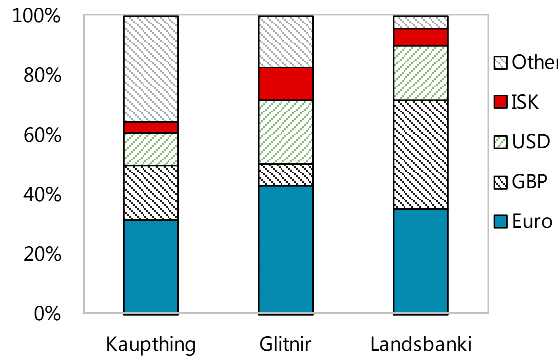
The old banks could emerge from winding-up as companies owned by their creditors. That is, their resolution can end either with liquidation (where recovered funds are paid out to creditors in terms of priority), or with composition (where the old bank becomes a financial holding company with its creditors as shareholders). On June 10, 2011, further amendments to the Financial Undertakings Act made resolution through composition more likely, at least for two of the old banks. These amendments included: the termination of the three RCs at end-2011, a limitation on the ability of the estates to make interim payments to non-priority unsecured creditors ahead of composition, and a revised voting regime for the decision to enter composition. The amendments do not preclude lump-sum payments to priority creditors before composition (with Landsbanki making such a payment in December 2011), or by the new entity after composition to a broader set of creditors.

Financial Position of the Old Banks

Balance sheet. The currently anticipated value of asset recovery should more than cover the reported priority claims on two of the banks, and mostly cover the priority claims on the third. While considerable uncertainty exists over the balance sheets of the old banks, the valuation of their assets is becoming clearer. At end-2010, the fair value of assets was ISK 2.8 trillion (around $24½ billion), an increase during 2010 of around 11½ percent excluding the impact of exchange rate changes. Strong asset recovery continued into 2011 (Table 1). Most of the increase is due to recovered loans, some of which became equity holdings (through seizure of collateral). The currency of old banks' cash holdings largely reflect the currency in which its assets were recovered. As a result, only a small share of cash assets is in krona, while the share of cash deposits maintained in Iceland varies considerably across the three banks. The liabilities of the old banks were fixed in ISK on April 22, 2009 (under the bankruptcy act), but most claims, including priority claims, remain subject to litigation.

Net external impact. The satisfaction of foreign claims with assets recovered domestically will, over time, affect either Iceland's foreign reserve holdings or the value of the krona. While the separation of the old and new banks was intended to leave the

Currency holdings of bank estates
(In billions of ISK, 30 June 2011)



failed banks' estates with only foreign assets and liabilities, the actual partition was not so clean.

At present it seems likely that, for the three old banks, the extent of foreign claims eventually to be paid will be greater than their foreign assets (Table 2). Legitimate domestic claims on all the old banks could be as much as 15 percent of total claims (CBI, 2011), suggesting a value for the payment of foreign claims of around ISK 2½ trillion. With the anticipated recovery from foreign assets around ISK 1¾ trillion, the net foreign liability of the old banks is estimated at around ISK 800 billion. As domestic funds are transferred overseas to settle these claims, there will be pressure on the balance of payments, affecting either reserves or the value of the krona. However there could be some offsetting foreign inflows that mitigate these effects through foreign equity participation in the new banks.

Table 1. The Financial Position of the Old Banks
(In billions of ISK)

	Kaupthing 1/			Glitnir			Old Landsbanki		
	Dec-09	Dec-10	Jun-11	Dec-09	Dec-10	Sep-11	Dec-09	Dec-10	Sep-11
Assets 2/									
Cash and cash equivalent	176	231	319	131	259	306	194	361	484
Loans and claims on credit institutions	53	34	22	89	4	3	18	61	76
Loans to customers	367	279	258	197	143	116	484	277	201
Investments in subsidiaries	27	112	117	289	332	348	14	1	1
Other assets	165	161	173	101	76	74	118	157	176
Subtotal	788	817	889	807	814	847	828	857	938
Net Financial Instruments 3/							344	318	343
Total Assets	788	817	889	807	814	847	1172	1175	1282
Liabilities 4/									
Reported Claims	7316	5502	4710	2973	2791	2761	3427	...	...
Priority	...	548	...	168	154	154	1319	...	...
Memo Item:									
FX valuation impact on asset value 5/		-91	49		-66	35		-123	51

Sources: Central Bank of Iceland (2010); and various creditor's reports of the old banks.

1/ For Kaupthing, the fair value of assets includes some claims for the bank's administrative costs (and other claims) amounting to ISK 26 billion at end-2010, and ISK 0.9 billion as at end-June 2011.

2/ Reported fair value of the assets.

3/ Equity and debt securities issued by New Landsbanki to compensate for transferred domestic assets.

4/ For Kaupthing, the numbers exclude finally rejected claims, and report the maximum priority claim against unpledged assets as estimated by the Winding Up Board. For Glitnir, the estimates are from the Statement of Assets and Liabilities as at 31 December, 2010 (11 March 2011) and 30 September 2011 (17 November 2011). For Landsbanki, the claims reported are those at 22 April, 2009, with priority denoting wholesale and retail deposits.

5/ For Kaupthing, this also includes the impact of asset reclassifications.

Table 2. Net External Position of the Old Banks
(In billions of ISK)

Assets	3,008
Foreign Assets	1,772
Foreign Claims 1/	2,556
Domestic Assets for External Recovery	784

1/ Assuming domestic claims are 15 percent of all claims on average.

INTERNATIONAL MONETARY FUND

ICELAND

March 23, 2012

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION AND FIRST POST-PROGRAM MONITORING DISCUSSION—INFORMATIONAL ANNEX

Prepared By

The European Department
(in consultation with other departments)

CONTENTS

FUND RELATIONS

(As of February 29, 2012)

Membership Status: Iceland became a member of the Fund on December 27, 1945

General Resources Account:

	SDR Million	Percent Quota
Quota	117.60	100.00
Fund holdings of currency (Exchange Rate)	1,428.90	1,215.05
Reserve Tranche Position	18.71	15.91

SDR Department:

	SDR Millions	Percent Allocation
Net cumulative allocations	112.18	100.00
Holdings	383.73	342.05

Outstanding Purchases and Loans:

	SDR Millions	Percent Quota
Stand-by Arrangements	1,330.00	1,130.95

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	1,400.00

Projected Payments to the Fund [1] (SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2012	2013	2014	2015	2016
Principal	210.00	358.75	249.38	341.25	170.63
Charges/ Interest	25.66	25.79	16.12	6.74	1.08
Total	235.66	384.54	265.50	347.99	171.71

Implementation of HIPC Initiative: Not applicable

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section

Implementation of Multilateral Debt Relief Initiative (MDRI): Not applicable

Implementation of Post-Catastrophe Debt Relief (PCDR): Not applicable

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

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.

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 12-month cycle.

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
FAD	Organic Budget Law	October 2011

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

STATISTICAL ISSUES

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

Data on a wide range of economic and financial variables are provided to the Fund in a timely manner during and between consultations. In addition to periodic press releases, statistical information is disseminated to the public through a range of monthly, quarterly, and annual publications by three main institutions (The Central Bank of Iceland (CBI), the Ministry of Finance, and Statistics Iceland), and is increasingly available on their internet sites. Provision of electronic data in English has improved substantially in recent years, especially from Statistics Iceland.
As regards the national accounts data, the authorities shifted to ESA95 in August 2000 and revised the corresponding time series back to 1990. Another revision was carried out in 2002. A breakdown is disseminated by industry back to the beginning of the production approach in 1973. Data on GNP and national income, in current and constant prices, as well as data on net savings for the economy as a whole, are also disseminated. The quarterly data are seasonally adjusted. The authorities publish a Treasury cash flow statement on a monthly basis, quarterly data on the general government operations, and annual data on the general government operations and financial assets and liabilities. Iceland reports government finance statistics in accordance with the GFSM 2001 framework in the GFS Yearbook, and is an up-to-date contributor to the International Financial Statistics (IFS). Balance of payments data deviate from the IMF's Balance of Payments Manual, fifth edition (BPM5) in certain respects. In particular, the CBI follows the methodology applied by the European Central Bank (ECB) for the calculation of income payable by collective investment institutions (e.g., mutual funds).

The CBI made good progress in improving external sector statistics based on 2011 TA mission's recommendations. Particularly, (i) the coverage was expanded by including the data on portfolio investment in equity capital, as well as in securities on secondary market; (ii) data on FDI and on other investment income are compiled in line with balance of payments methodology; (iii) remittances data were improved based on information from money transfer operators; and (iv) the old banks' transactions are recorded broken down by instruments.

On monetary and financial statistics, the concepts and definitions broadly conform to the guidelines of the Monetary and Financial Statistics Manual (MFSM). Departing from the MFSM, M3/Broad Money measure includes deposits of the central government, positions of commercial banks with private nonfinancial corporations include some positions with public nonfinancial corporations, and the latter include some positions with private nonfinancial corporations. Beginning in February 2010, the CBI reports for publication in IFS monetary data for central bank and other depository corporations using the Standardized Report Forms (SRFs).

Iceland: Table of Common Indicators Required for Surveillance

(As of March 15, 2012)

	Date of latest observation	Date received	Freq. of Data	Freq. of Reporting	Freq. of publication	Memo Items: Data Quality – Methodological soundness	Data Quality – Accuracy and reliability
Exchange Rates	Mar. 14, 12	Mar. 15, 12	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities	Feb. 2012	Mar. 8, 12	M	M	M		
Reserve/Base Money	Feb. 2, 12	Mar. 8, 12	M	M	M	LO, O, LO, LO	LO, O, O, O, O
Broad Money	Feb. 2012	Mar. 8, 12	M	M	M		
Central Bank Balance Sheet	Feb. 2012	Mar. 8, 12	M	M	M		
Consolidated Balance Sheet of the Banking System	Jan. 2012	Feb. 24, 12	M	M	M		
Interest Rates	Mar. 14, 12	Mar. 15, 12	D	D	D		
Consumer Price Index	Feb. 2, 12	Feb. 28, 12	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing – General Government	2011	Mar. 9, 12	A	A	A	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing– Central Government	Q4, 2011	Mar. 9, 12	A,Q	A,Q	A,Q		
Stocks of Central Government and Central Government-Guaranteed Debt	Feb. 2012	Mar. 9, 12	M	M	M		
External Current Account Balance	Q4, 2011	Mar. 1, 12	Q	Q	Q	O, O, LO, O	LO, O, O, O, O
Exports and Imports of Goods and Services	Feb. 2012	Mar. 5, 12	M	M	M		
GDP/GNP	Q4, 2011	Mar. 8, 12	Q	Q	Q	O, LO, O, LO	LO, O, LO, LO, O
Gross External Debt	Q4, 2011	Mar. 1, 12	Q	Q	Q		

Statement by the Staff Representative on Iceland
Executive Board Meeting
April 6, 2012

This statement provides an update on developments since the Staff Report was issued. These developments do not alter the thrust of the Staff Appraisal.

On March 21, the Monetary Policy Committee (MPC) raised policy interest rates by 25 bps, in line with the tightening bias identified in the last two meetings and staff's policy advice. The MPC voiced concern about the deterioration in the inflation outlook. The seasonal weakening of the krona, exacerbated by ongoing pressures related to the repayment of external debt, poses a risk to the inflation forecast, given the high exchange rate pass-through to prices in Iceland. Inflation expectations, measured by both breakeven rates and survey data, have also increased.

The Special Prosecutor, in coordination with the CBI's Capital Controls Surveillance Unit, is investigating a fishing company for possible circumvention of the capital controls. Under the capital controls, exporters (including fishing companies) are required to repatriate their export proceeds. Monitoring compliance with this obligation is difficult partly because exporters have subsidiaries overseas, over which the Icelandic authorities' jurisdiction is limited. This investigation is unprecedented and represents an intensification of the authorities' efforts to enforce the capital controls.

The CBI is continuing to implement its capital account liberalization strategy. On March 28, it carried out the second in a sequence of planned auctions intended to match holders of offshore krona wanting to buy foreign exchange with investors willing to bring in foreign currency to invest in government securities or long-term investment projects in Iceland (the so-called "FDI route"). The CBI received bids for a total amount of euro 92.9 million, out of which euro 22.5 million were accepted. The bulk of accepted bids were under the FDI route while only modest amount were allocated to government securities. The variation in bids between this and the previous auction, together with the low acceptance rate for this round, illustrate the challenge in lifting capital controls.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 12/34
FOR IMMEDIATE RELEASE
April 12, 2012

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

IMF Executive Board Concludes 2012 Article IV Consultation with Iceland and Ex Post Evaluation of Exceptional Access Under the 2008 Stand-By Arrangement

The Executive Board of the International Monetary Fund (IMF) concluded the 2012 Article IV consultation with Iceland[1] on April 6, 2012.

Background

Iceland is gradually emerging from its post-crisis recession. The economy expanded by 3 percent in 2011 driven by a broad-based rebound in consumption and a gradual pick-up in investment. Unemployment declined steadily and now stands at around 7 percent. The trade balance continued to post strong surpluses, but the krona nonetheless depreciated—in part reflecting repayments of foreign debt by the private sector. International reserves increased sharply on account of IMF program disbursements, international sovereign bond issuance, and the drawing of bilateral loans. Financial markets became more active, but remained dominated by the government bond market.

The fiscal consolidation initiated in 2009 is continuing, but at a slower pace than previously expected. Expenditure overruns materialized in 2011 and the primary deficit will now reach 1 percent of GDP (compared with ¼ percent of GDP expected previously).

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

Inflation increased in 2011 and now stands well above the central bank's target of 2½ percent. Krona depreciation, wage and commodity price increases pushed inflation up and prompted the central bank to tighten policy twice in 2011. Yet, inflation expectations have remained largely above the target and monetary policy remains accommodative with real policy rates in negative territory.

Regarding the financial sector, banks reported strong profits, high capital, and large liquidity buffers. Although the latest Supreme Court decision will likely have an adverse effect on banks' capital position, banks expect the impact to be manageable. The ongoing restructuring of household and corporate debt has led to a notable decline in Non-Performing Loans (NPLs) from 40 percent in 2010 to 23 percent.

As part of their reserve management strategy, Iceland in March made early repayments of repurchases of most of its Fund obligations falling due in 2013 (around 20 percent of the total). Reserve adequacy in 2012 and 2013 will be somewhat weaker compared with no early repayments, but the ratio of gross reserves to short term debt is projected remain well above 100 percent.[2]

Executive Board Assessment

Directors commended Iceland's emerging recovery and significant achievements in restoring macroeconomic and financial stability. In March, Iceland made an early repayment of part of its obligations under the Stand-By Arrangement. Given the persistence of external as well as domestic risks, strong commitment to prudent policies and focus on addressing remaining challenges will nevertheless remain crucial.

Directors stressed the importance of completing the fiscal consolidation. They called for additional measures to put the medium-term fiscal path back on track, and for contingency measures to guard against implementation risks. They welcomed the authorities' commitment to their medium-term fiscal plan and their efforts to strengthen the fiscal framework.

Directors supported a gradual tightening of monetary policy to help bring down inflation, anchor inflation expectations, and support capital account liberalization. They noted the impact that further wage increases could have on inflation and competitiveness. Regarding the future monetary regime, Directors supported the near-term priority being given to strengthening the existing monetary framework, including through the introduction of macroprudential tools.

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[2] See *Iceland to Repay Early Some Outstanding Obligations to the IMF*, Press Releasse No. 12/84 March 15, 2012 (http://www.imf.org/external/np/sec/pr/2012/pr1284.htm).

Directors underscored that lifting capital controls is a key challenge. They agreed that the pace of liberalization should be guided by the balance of payments outlook, reserve adequacy, and the need to safeguard financial stability, noting that additional time may be needed given continuing global uncertainties. At the same time, risks associated with the prolonged maintenance of controls should be kept in mind. Noting the recent removal of certain exemptions from controls as a way to mitigate risks of rapid liberalization, Directors underscored the need to publish the new rules on exemptions as quickly as possible to help guide investor and public expectations.

Directors welcomed the progress on private sector debt restructuring, and looked forward to the swift completion of the process. They cautioned against additional untargeted household debt relief, which would not fully address the needs of households in greatest distress and strain public finances.

Directors called for further efforts to address the remaining risks and vulnerabilities in the banking system. They welcomed the progress made in strengthening the banking system and reducing nonperforming loans. They underscored the need to continue to address legacy vulnerabilities and to monitor closely how banks recognize income, notably from restructured and nonperforming loans. They considered that dividend payments should continue to be disallowed to ensure that banks maintain high capital buffers while vulnerabilities are still being addressed. Directors encouraged the authorities to further strengthen supervision, including by continuing to address supervisory gaps and preserving the independence of the Financial Supervisory Authority (FME).

Directors agreed with the key findings of the ex post evaluation. They concurred that the program has achieved its objectives, owing to strong ownership and good program design. They noted that the program was flexible and managed risks well, including through bank restructuring that limited the public sector burden and through the use of capital controls. Agreement on a fiscal adjustment consistent with the authorities’ objective of preserving Iceland’s social model was key in easing the social impact of the crisis and fostering program ownership.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for 2012 Article IV Consultation with Iceland and Ex-Post Evaluation of Exceptional Access under the 2008 Stand-By Arrangement is also available.

Iceland: Selected Economic Indicators, 2005–12

	2005	2006	2007	2008	2009	2010	2011 Est.	2012 Proj.
	(Percentage change, unless otherwise indicated)							
National Accounts (constant prices)								
Gross domestic product	7.2	4.7	6.0	1.3	-6.8	-4.0	3.1	2.4
Total domestic demand	15.5	9.1	0.0	-8.6	-20.3	-2.3	3.9	3.7
Private consumption	12.7	3.6	5.7	-7.9	-14.9	-0.4	4.0	3.0
Public consumption	3.5	4.0	4.1	4.6	-1.7	-3.4	-0.6	-0.4
Gross fixed investment	34.4	24.4	-12.2	-20.0	-51.6	-8.1	13.4	13.8
Export of goods and services	7.5	-4.6	17.7	7.0	6.6	0.4	3.2	2.9
Imports of goods and services	29.3	11.3	-1.5	-18.4	-24.0	4.0	6.3	5.1
Output gap 1/	2.8	2.0	3.6	2.2	-1.9	-4.5	-1.0	-0.7
Selected Indicators								
Nominal GDP (bln ISK)	1,025.7	1,168.6	1,308.5	1,482.0	1,495.4	1,534.2	1,630.2	1,732.5
Unemployment rate 2/	2.1	1.3	1.0	1.6	8.0	8.1	7.4	6.3
Consumer price index	4.0	6.8	5.0	12.4	12.0	5.4	4.0	4.8
Nominal wage index	6.5	9.1	9.3	4.0	0.5	3.1	5.7	6.0
Nominal effective exchange rate 3/	10.2	-11.8	2.5	-40.4	-34.2	2.9	-0.1	…
Real effective exchange rate 3/	13.3	-7.1	5.1	-20.7	-18.4	6.4	0.9	…
Terms of trade	0.9	3.4	0.2	-9.3	-6.7	6.1	-1.8	-0.7
Money and Credit								
Base Money	32.2	27.9	190.7	-31.5	1.3	-19.4	-20.7	...
Deposit money bank credit (end-period)	76.0	44.4	56.6	-28.3	-17.8	-3.4	3.2	...
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	7.2	...
CBI policy rate (period average) 4/	10.5	14.1	13.8	15.4	13.7	7.8	4.4	...
	(Percent of GDP, unless otherwise indicated)							
Public Finance								
General government 5/								
Revenue	47.1	48.0	47.7	44.1	41.1	41.5	41.7	41.8
Expenditure	42.2	41.6	42.3	44.6	49.7	47.9	46.3	44.6
Balance	4.9	6.3	5.4	-0.5	-8.6	-6.4	-4.6	-2.8
Primary balance	6.1	6.7	5.7	-0.5	-6.5	-2.7	-1.1	1.3
Balance of Payments								
Current account balance	-16.1	-25.6	-15.7	-28.4	-11.8	-8.4	-6.5	-2.8
Trade balance	-12.2	-17.5	-10.1	-2.3	8.4	10.1	8.2	6.6
Financial and capital account	14.0	43.3	18.1	-66.9	-28.2	52.9	15.3	-0.5
Net errors and omissions	2.6	-11.0	-1.0	-19.5	37.3	-37.7	-2.8	0.0
Gross external debt 6/	284.5	433.5	605.9	564.7	266.5	289.7	250.4	207.1
Central bank reserves (US$ billion)	1.1	2.3	2.6	3.6	3.9	5.8	8.7	7.4

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

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

Statement by Benny Andersen, Executive Director for Iceland
And Lilja Alfredsdottir, Advisor to Executive Director
April 6, 2012

The Icelandic authorities welcome the 2012 Article IV and Ex Post Evaluation reports. The Evaluation report confirms the favorable results of the cooperative effort of the Fund and the Icelandic authorities in combating the 2008 financial crisis. The Selected Issues papers provide very useful analyses on possible fiscal rules and ways to strengthen the present inflation targeting framework.

Our authorities find the staff assessment of the economic situation and outlook in the Article IV report to be realistic. We agree that, at this juncture, many challenges remain and there is no room for complacency. Our authorities intend to go further along the path of fiscal consolidation, and cautious liberalization of capital controls, while at the same time aiming to anchor inflation and inflation expectations, as well as providing support for broad based economic growth and diversification.

Economic Growth

Economic growth measured at 3.1 percent in 2011, mainly driven by private consumption and business investment. Some moderation of consumption growth is expected this year as the effects of temporary policy measures taper off. Public consumption is expected to contract in 2012 but an increase in private sector investment and FDI is expected to offset this. Staff's medium-term growth projections are in line with our assessment.

Staff projects an underlying current account surplus for the year 2012 and that a surplus will persist over the medium term. The trade balance is expected to remain in surplus, but at a lower level this year and be somewhat weaker in the next couple of years due to the high import content of planned investment projects. Similarly, net exports will initially make a negative contribution to growth, but it should turn positive when this investment phase tapers off and the associated exports come on stream. This is broadly in line with our assessment.

Several risks to the growth outlook are discussed by staff. Our authorities agree that the main risk relates to the uncertain outlook in the main trading partner countries in Europe. Slower growth in Europe might depress export prices and limit the growth in tourism as well as constrain market access to new finance. While these risks are difficult to mitigate, there is some scope for trade redirection. Although Icelandic exporters have been quite agile in terms of seeking new markets, it is costly and a severe slowdown in Europe would also have global consequences.

Investment and Natural Resource Management

The role of government policies is to support private sector growth by providing infrastructure and services in addition to a regulatory framework conducive to entrepreneurship and a competitive spirit. A new public investment plan for 2013-2020 is being prepared that aims to coordinate public investment in areas such as transport and regional development. The tax system will be improved to further potential new businesses and strengthen competiveness. A new framework for natural resource utilization is in the final stages. This framework will provide guidance for future utilization and help to resolve environmental issues. New legislation on the management of the fishing resources has been put before the Parliament. This new legislation aims to address the long standing debate on the quota system and distribution of the resource rent. The central proposal is a levy that aims to increase the level of resource rent directed towards public funds in favorable years. Investment in the energy sector includes a medium sized hydropower plant under construction that will supply additional electricity to an aluminum smelter that is being upgraded for increased production of higher value output.

Debt and Unemployment

High private sector indebtedness could put a brake on consumption and investment. Debt restructuring has progressed and uncertainty regarding the treatment of foreign index-linked loans should be reduced over time, once there is greater clarity on how to interpret the recent High Court rulings. However, the private sector debt crisis is not over. More work is needed and our authorities are fully aware that fiscal space for untargeted debt relief is not there.

Unemployment is still unacceptably high. Staff projects the rate to be above four percent in the medium term. This is still a historically high number for Iceland and the goal will be to achieve a better outcome in the near term. The government has introduced several measures to combat unemployment and satisfy demand for specialized workers including a special fund, financed by employers and pension funds, to support education of unemployed people and retraining.

Fiscal Policy

After implementing a fiscal consolidation of over 9 percent of GDP mostly in the two year period 2009-2010, some expenditure overruns in 2011 increased the primary general government deficit to one percent of GDP. Staff estimates that this implies that the 2012 primary surplus will be positive but lower than previously envisaged. Staff proposes additional measures amounting to 1/2 percent of GDP to correct the course in 2012. Despite the observed slippages, our authorities still aim to achieve their medium term objectives: an overall balance in 2014 and a sizable surplus thereafter. Given the uncertainty concerning growth and the external environment, our authorities believe that it would be prudent to closely monitor developments in 2012 and stand ready to support a stronger primary balance in the 2013 budget proposal. Sale of assets and possible higher income from the natural resource tax on fisheries could contribute. The finances of several local governments are being restructured under the auspices of the Ministry of Interior. A new legislation on local government finances will help to lower debt and prevent overruns.

There is always a scope for improvement in the conduct of public finances. The Fund has provided valuable technical assistance to our authorities in particular to prepare for legislation for the new organic budget law. Progress in the legislative area will help our authorities in their resolve to avoid any decisions that undermine the consolidation achievements of recent years. The Selected Issues paper offers analysis on possible fiscal rules for Iceland. There seems to be no clear cut best alternative but staff recommends a procedural fiscal rule with clear numerical objectives. For the next years, the overarching goal of public finances is debt reduction to close in on the 60 percent Maastricht criterion in the period 2016-2019. This goal will set the constraints for public finances in the near term.

Monetary Policy

Inflation and inflation expectations have been stubbornly above the Central Bank's (CBI) target of 2.5 percent. The twelve month rate is now 6.4 percent. At its meeting in March, the Monetary Policy Committee increased the policy rate by 0.25 percent to 5 percent and the Committee has signaled further rate increases as necessary. Recent wage increases were *inter alia* fuelled by high profitability in the tradable sector, due to the low exchange rate, that trickled down to the non-tradable sector through the centralized wage bargaining process in Iceland. The relatively weak ISK and high oil prices have added to inflation pressures due to the rapid pass-through of import prices to domestic consumer prices. The CBI expects the inflation target to be reached in 2014, somewhat later than previously expected.

The Icelandic experience has shown the challenges of an inflation targeting framework when applied in a very small, open and financially integrated economy, in the absence of supplementary policy tools, such as macro-prudential tools to limit destabilizing credit expansion. The Selected Issues paper, on monetary policy analyses the pros and cons of possible additional tools to strengthen the existing inflation targeting framework. Our authorities note the key finding that additional tools are not a substitute for effective monetary policy implementation through the standard interest rate tool. This should also be augmented by the need for supportive fiscal and structural policies.

An important debate on the future monetary regime is taking place in Iceland, including on prospects for EU membership and appropriate strategy for entering the ERM and subsequently adopting the euro. A comprehensive CBI report on alternative exchange rate regimes is expected to be out this spring.

Capital Controls and Amendment to the Act on Foreign Exchange

The capital controls are seen as temporary emergency measures that our authorities will abolish as soon as conditions permit. Lifting the controls is, as staff underlines, a pressing challenge. Two auctions of foreign currency for "off-shore" ISK have been held so far this year and further auctions are planned in the spring. The auction's aim to relieve the pressure from the most distressed ISK holdings, by attracting long-term investors that are willing to hold ISK assets for a minimum period of 5 years. Other measures will follow. Recently the Parliament strengthened the capital controls legislation to prevent loop-holes that turned out to be a more serious problem than previously anticipated, with adverse balance of payments effects. These measures should strengthen confidence in the controls. If controls are to be credible, they must be effectively enforced.

An important measure aimed at preventing serious balance of payments disruptions was a change to the foreign exchange legislation which brought the operations of the winding-up boards of the old banks under the auspices of the legislation. The amended legislation is expected to have limited, if any, effect on payments to priority creditors. Gross payments to non-residents out of the estate of the old banks are equivalent to about half of Iceland's GDP and net payments about 1/3 of GDP. The risk of a disorderly process, e.g. race of the various winding-up boards for the exit, is substantial and was eventually deemed to be unacceptably high. The current legislation provides the CBI with means to better monitor and remove incentives for a disorderly process, e.g. a rush for the exit. In order to facilitate an orderly process, after consulting with the winding-up boards, the CBI will shortly issue regulations that provide general exemptions for the winding-up boards to enable them to pay out the proceeds of asset sales that do not entail balance of payment problems. The aim of the regulation is to create appropriate incentives for the winding-up boards that reduce the risk of co-ordination failure. This will both protect the domestic economy as well as the creditors. Their most valuable domestic assets, including two of the three large commercial banks, are highly sensitive to economic stability.

In March 2012, a prepayment of SDR 289m to the IMF and 366m euros to the Nordic countries was announced. The amount is slightly above 20 percent of funding connected with the SBA. The prepayments aim to lower short term debt and the cost of holding large reserves at the CBI. If conditions permit, further prepayments will be considered.

Financial Sector

All three major banks have now published their 2011 accounts. They have demonstrated their ability to earn moderate profits despite the difficult environment especially as regards the high ratio of NPLs. However, there has been a significant reduction in NPLs as they have been halved to 23 percent and are expected to be lower at the end of 2012. Also, write-offs following the High Court rulings on FX indexed loans were absorbed by the banks and showed up through lower profits in 2011 than was the case in 2010. Our authorities agree with staff that high capital buffers are still needed and dividend payments should be postponed. An important step would be for banks to regain access to foreign capital markets. At least one bank's foreign issuance is advanced in the preparation process. A successful issuance would increase the maneuvering space for the banks and help to create buffers against the holdings of foreign owned deposits in the banks.

Financial supervision has continued to improve mainly through the strengthening of the Financial Supervisory Authority (FME) both in terms of manpower and regulatory tools. Coordination between the CBI and FME has been enhanced and its structure improved. The goal is compliance with Basel Core Principles for Effective Supervision. The banking system is operating within capital controls and a blanket guarantee on deposit insurance that act as shield but also hindrance to robust growth and profitability. Our authorities are considering ways to improve this environment, and a new report on the Future of the Financial System in Iceland has been published by the Ministry of Economic Affairs. This report provides analysis and proposals that serve as a background for discussion and policy making for improved financial sector environment, including the legislative and regulatory framework.