July 15, 2009

Memorandum

Recipient: Parliamentary Budget Committee

Sender: Central Bank of Iceland, Governor of the Central Bank of Iceland

Re: Written statement from the Central Bank of Iceland on the Icesave agreements and information on the debt service burden of foreign loans

The Parliamentary Budget Committee requested a written statement from the Central Bank of Iceland on the Icesave agreements and information on the debt service burden of foreign loans. The request was received by the Bank on July 6, 2009. The Central Bank of Iceland has compiled an opinion, which is divided into two sections: a discussion of Iceland's external debt position and a legal opinion on the Government guarantee of the Depositors' and Investors' Guarantee Fund's (DIGF) obligations.

I. External liabilities

An assessment of the debt service burden of the loan agreements that have been signed with the British and Dutch in order to fulfil Iceland's prospective obligations due to the Icesave accounts centres on two factors:

1. The Treasury's ability to generate revenues and reduce expenditures so as to be able to tolerate the interest burden of the agreements.
2. The economy's ability to generate a sufficient trade surplus to pay the interest and instalments during the repayment period of the loans, without a substantial depreciation of the króna.

An assessment of these two key factors is subject to considerable uncertainty. One uncertainty concerns the recovery ratio for Landsbanki assets, which are assumed to cover the bulk of the Depositors' and Investors' Guarantee Fund's (DIGF) obligations. There is also considerable uncertainty about developments in GDP growth, which will affect the Treasury's revenue-generating capacity, and about export revenues, which will affect the size of the trade surplus, and therefore the effect of an increased debt service burden on the exchange rate of the króna. The exchange rate of the króna in and of itself also affects the debt service burden as a proportion of GDP in króna terms. All of these uncertainties are highly dependent on global economic developments, which themselves are still very uncertain. It should be stressed that decisions related to economic policy will also make a substantial impact on developments in GDP growth during the loan period under discussion.

The Icesave debt

In evaluating the Icesave agreements, it is assumed that, by year-end 2015, all of the old Landsbanki's foreign assets will have been sold and the debt falling on the Icelandic Government as a result of the agreements will total 340 b.kr., based on a 75% recovery ratio. The present value of this amount, assuming 5.55% interest, is 240 billion krónur, the equivalent of 17% of the estimated gross domestic product (GDP) for the year 2009. This amount is to be paid over a period of 8 years; that is, 30 billion krónur per year, or 2.1% of estimated GDP for 2009.

Because of the how late in the contract period the Icesave payments begin, the principal will have accrued substantial interest by that time. It is assumed that the first payment, in 2016, will amount to nearly 3.1% of GDP for that year; however, that proportion is estimated to fall rapidly, both because accrued interest will decline as the outstanding amount owed declines, and because it is assumed that GDP will rise. In the final year, 2023, it is assumed that the payment will total 1.4% of GDP for that year. If the payments on the Icesave debt were to begin earlier, the interest on the debt would be less, but in that instance, the Treasury would presumably have to borrow more money elsewhere in order to pay all of its obligations.

The impact of the Icesave agreements on the national economy

The overall consequences of the Icesave agreements for the position of the general economy are even more difficult to assess than their impact on the Treasury. The economy's total balance sheet is very large, even excluding the assets and liabilities of the old banks. In this context, it is necessary to bear in mind that the flow of foreign exchange revenues to pay the interest and principal on private sector debt is determined not only by the nation's export revenues, but also on the returns on privately owned foreign assets. These factors are subject to enormous uncertainty. Therefore, it is actually best to exclude the private sector from an assessment of debt sustainability once the Icesave obligations have been added. As far as the private sector is concerned, one of two things could happen: the firm in question manages to generate revenues, export revenues or returns on investment, in order to defray the cost of interest and principal, which means that the firm in question is sustainable; or the firm becomes insolvent, and its assets are allocated towards its liabilities, which are then written off. As long as the Treasury avoids taking on the burdens of the private sector, private sector debt will not have a lasting effect on the sustainability of the nation's debt. Instability related to the re-financing of private sector debt could be considerable, however.

Direct liabilities of Icelandic residents were estimated at 2,100 billion krónur at the end of March 2009.[1] This amounts to just over 140%

1. There is reason to draw attention to the fact that these liabilities are much less than those included in the Central Bank's official figures, which can be found on the Bank's website. According to those figures, liabilities are estimated at 13,059 b.kr. as of end-March. The liabilities (and assets) of the old banks and other firms that have succumbed to the banking crisis are included in the official figures, in accordance with IMF rules on the calculation of such figures. However, it is clear that these figures do not give an accurate picture of the current debt position. The figures on debt position in this memorandum reflect the Central Bank's assessment of what debts will remain when the estates of the old banks and other insolvent firms have been settled. That assessment has been prepared in consultation with IMF experts.

of estimated GDP for 2009. These figures include some loans that have been taken to strengthen the foreign exchange reserves, but they do not include the Icesave obligations. Neither is non-residents' equity in Icelandic firms included, nor are loans from non-residents to Icelandic companies owned by them (that is, "debt to affiliated enterprises" and "debt to direct investors"). At end-March 2009, these items were estimated at nearly 600 b.kr., or 40% of estimated GDP for 2009.[2]

Further foreign borrowings are planned for 2009 and 2010 in order to strengthen the foreign exchange reserves, and these loans must be repaid beginning in 2011.

Offsetting these debts are some assets. Table 1 specifies the assets that are considered secure. These are the Central Bank's foreign exchange reserves, the Central Bank's collateral in FIH in Denmark, a share in the proceeds of the sale of old Landsbanki's assets according to the Icesave agreement, and the pension funds' foreign assets. Without doubt, parties residing in Iceland own other assets abroad, but information on the value of those assets varies greatly. Table 1 uses the precautionary approach of specifying only those assets that are considered virtually secure.

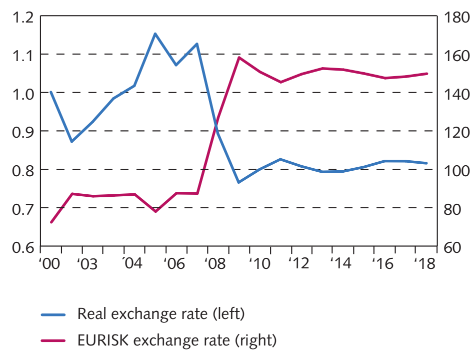
The obligations due to Icesave are denominated in foreign currency; therefore, the exchange rate used is an important determinant of the amount in krónur. For the present report, it was decided to use the Central Bank forecast appearing in *Monetary Bulletin* 2009/2. That forecast assumes that the exchange rate of the euro will average 158 kr. in 2009. This is much lower than the current exchange rate, which is 180 kr., and lower than the exchange rate at the beginning of June (175 kr.), when the agreement was signed. However, it is not far from the average exchange rate of the euro during the first six-and-a-half months of 2009, which was just under 164 kr. Using the exchange rate provided for in the Central Bank's forecasts guarantees consistency between the exchange rate assumptions in the Icesave assessment and the price assumptions in the figures on GDP and exports that are appropriate for use as references. If the exchange rate of the króna remains as low as it is at present, it can be assumed that price levels in Iceland will adapt to it and will therefore be correspondingly higher.

Figure 1 shows the Central Bank's forecast the EURISK exchange rate until 2015. The forecasted real exchange rate is also shown.

As can be seen, it is projected that the real exchange rate will be about 0.8 during the period. It fluctuated around 1.0 for a long while before the banks collapsed, when a current account deficit and debt accumulation characterised the Icelandic economy.

Table 1 gives an extrapolation of Icelandic residents' assets and liabilities until 2018. The extrapolation is based on the assumptions in the Central Bank's macroeconomic forecast, which assumes a significant trade surplus in coming years. It is assumed that the principal amount of debt owed to non-residents in krónur will be unchanged from its March 31, 2009 value, but that the owners will transfer the interest on this debt out of the country. Interest income on the foreign

Chart 1
Real exchange rate and EURISK exchange rate 2000-2018



Source: Central Bank of Iceland.

2. Appendix 3 provides a summary of Iceland's international investment position (IIP) and explains the various concepts and data used in this memorandum.

Table 1. External assets and liabilities

Unit: ISK billions	*31/3 2009*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*	*2017*	*2018*
Foreign assets:	1,009	1,625	1,857	1,689	1,752	1,755	1,710	1,728	1,613	1,608	1,632
Icesave assets (75% recovered)	,	376	322	269	250	221	110	89	0	0	0
Foreign exchange balance at year-end (calculated)	429	673	986	845	956	956	996	1,018	966	922	904
Other foreign assets (FIH)	82	81	74	74	0	0	0	0	0	0	0
Foreign assets of other parties (pension funds)	498	496	476	501	547	578	603	621	647	686	728
External debt, public sector:	767	1,520	1,718	1,502	1,456	1,240	1,151	998	899	812	724
Icesave debt	,	575	527	530	522	427	419	342	301	261	220
Foreign debt due to foreign reserves	406	584	836	617	576	454	374	299	241	194	147
Other foreign debt in foreign currency	59	59	54	54	56	56	56	55	54	55	55
Central Bank foreign debt, excl. foreign reserves (ISK)	97	97	97	97	97	97	97	97	97	97	97
Other public sector debt (ISK)	206	206	206	206	206	206	206	206	206	206	206
State-owned firms and private entities:	1,322	1,312	1,235	1,238	1,270	1,276	1,270	1,254	1,248	1,256	1,265
Non-residents' FX assets	896	886	809	812	844	850	844	828	822	830	839
Non-residents' ISK assets	426	426	426	426	426	426	426	426	426	426	426
Total liabilities in foreign currency	1,361	2,104	2,225	2,012	1,997	1,788	1,694	1,524	1,418	1,339	1,261
Total liabilities in ISK	728	728	728	728	728	728	728	728	728	728	728
Foreign liabilities, total	2,089	2,832	2,953	2,740	2,725	2,516	2,422	2,252	2,146	2,067	1,989
Net debt (in excess of specified assets)	1,080	1,207	1,096	1,051	973	761	711	524	533	460	357

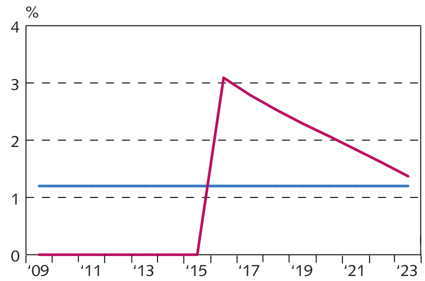
Source: Central Bank of Iceland.

Table 2. Foreign currency payment flows

Unit: ISK billions	*31/3 2009*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*	*2017*	*2018*
Export – import	-43	154	135	151	189	222	200	167	135	134	141
Net interest income (excl. pension funds and dividends)	.	-103	-105	-94	-100	-92	-87	-80	-75	-90	-86
-" – as a proportion of export – import (%)	.	68,3	69,9	66	48,8	39	40,2	44,8	66,5	64,3	46,2
Instalments on Icesave bond	.	0	0	0	0	0	0	0	-43	-43	-43
Borrowings and asset sales (net)	.	195	272	-192	14	-135	-79	-71	-54	-49	-50
Foreign exch. reserves, year-end balance	429	673	986	845	956	956	996	1,018	966	922	904
GDP (for reference)	1,465	1,427	1,414	1,466	1,543	1,643	1,746	1,870	1,998	2,141	2,289

Source: Central Bank of Iceland.

Chart 2
Icesave payments as % of GDP for the year



Fixed percentage
Icesave payments

Source: Central Bank of Iceland.

exchange reserves and repayments of known loans that have been taken or will be taken in the near future to strengthen the reserves are estimated. Also estimated are interest expenses on other public- and private-sector loans in foreign currency. No incoming or outgoing dividend payments are assumed. It is assumed that the pension funds' external assets will continue to be invested abroad, and that neither principal nor interest nor dividends will be repatriated to Iceland. It is also assumed that it will be possible to re-finance firms' foreign debt and public sector debt other than that incurred to fund the foreign exchange reserves. The second-last line in Table 1 shows that, based on these assumptions, the Icelandic economy's external liabilities will be slightly less in króna terms at the end of 2018 than they were at the end of March 2009. During this period, liabilities as a proportion of GDP decline from 143% to 87%, and the assets that are listed in Table 1 rise from 69% to 71% of GDP.

Table 2 shows how supply and demand for foreign currency are expected to develop. The figures on the difference between exports and imports are based on the Central Bank's macroeconomic forecast.

That forecast assumes a sizeable surplus for a protracted period of time.[3] It also assumes that the real exchange rate will remain very low for a prolonged period. Since the macroeconomic forecast was prepared, the real exchange rate has been rather lower than the forecast assumed.

It is assumed that payments made on the Icesave obligations include interest. No further borrowings or instalment payments are assumed, other than those already negotiated in order to strengthen the foreign reserves. No asset sales are assumed except for FIH, which the Central Bank is assumed to sell in 2012.

The second-last line in Table 2 shows that, based on the premises in the extrapolated calculations, there is ample margin in the foreign exchange reserves for the entire period.

Appendix 3 provides an account of the net external position of the Icelandic economy, excluding the old banks and companies in moratorium. That appendix suggests that the net external position is acceptable. It should be noted, however, that the asset side requires further examination; therefore, these should be regarded as preliminary figures.

Below are several figures that show the variables from Tables 1 and 2 as a proportion of GDP. Figure 2 shows the estimated percentage of payments according to the Icesave agreement. The red line shows the estimated percentage based on estimates of the debt service burden according to the agreement. The blue line shows the percentage of GDP that must be put aside in order to cover payments, given that the percentage remains fixed from 2009-2023. During that 15-year period, it would be necessary to set aside nearly 1.2% of GDP per year.

Figure 3 shows the debt as a proportion of GDP. The blue line shows the percentage of the total debt, which peaks at 210% in 2010. It is appropriate to reiterate that this proportion is rather lower than it would otherwise be because the debt owed by foreign-owned Icelandic firms to parent companies or investors abroad is not included, nor is the equity in these firms.

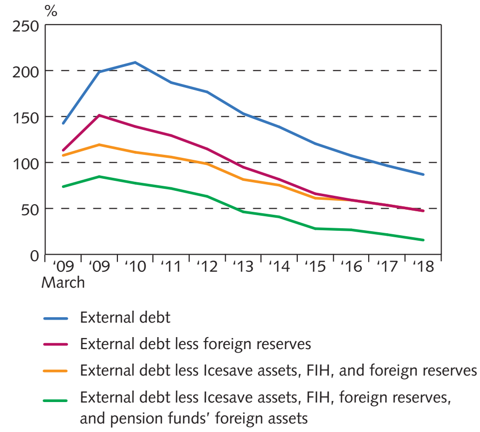
Other lines in the figure show the proportion of the total debt less some of the assets specified in Table 1.

Figure 4 shows the variables in Table 2 as a proportion of GDP. The purple line shows exports less imports; the red line shows net interest income (excluding income from assets held by pension funds or other residents, and excluding dividends on non-residents' direct investment in Iceland); the yellow line shows net borrowings and asset sales, as is assumed above; and the green line shows the foreign exchange balance at year-end.

The discussion above assumes that the sale of Landsbanki assets will yield an amount equivalent to 75% of the present value of the Icesave loan. Figure 5 states how Icesave payments will change if the asset recovery ratio differs from the 75% assumed above.

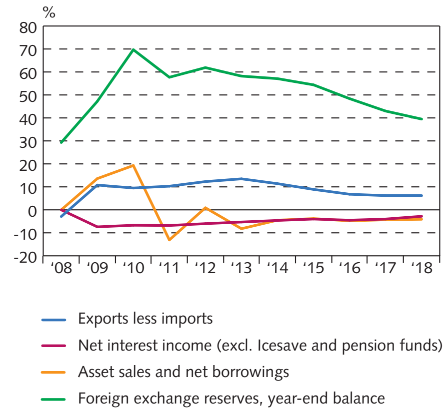
3. The forecast assumes that exports will contract by about 3% this year, remain virtually unchanged in 2010, and then grow by nearly 3% from that time onwards. The forecast assumes the expansion of the Straumsvík aluminium smelter and the construction of a new smelter at Helguvík. Imports are estimated to contract by 36% in 2009 and then grow thereafter, but at a slightly more rapid pace than exports. It is assumed that exports will exceed imports during the period, due to a low real exchange rate.

Chart 3
Year-end position as % of GDP for the year



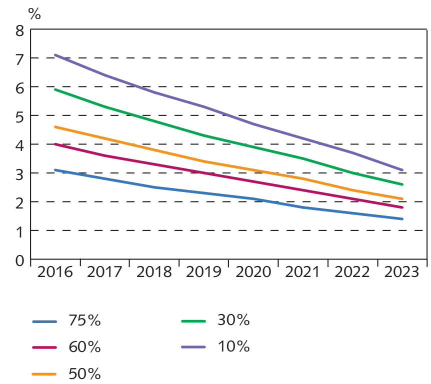
Source: Central Bank of Iceland.

Chart 4
Percentage of GDP 2008-2018



Source: Central Bank of Iceland.

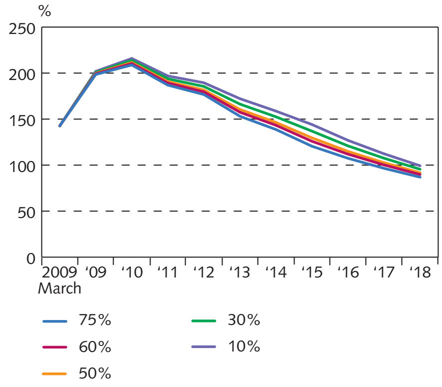
Chart 5
Icesave payments as % of GDP based on various recovery ratios for Landsbanki assets



Source: Central Bank of Iceland.

Chart 6

External debt as % of GDP based on various recovery ratios for Landsbanki assets



Source: Central Bank of Iceland.

Chart 7

Foreign exchange reserves at end of period as % of GDP based on various recovery ratios for Landsbanki assets

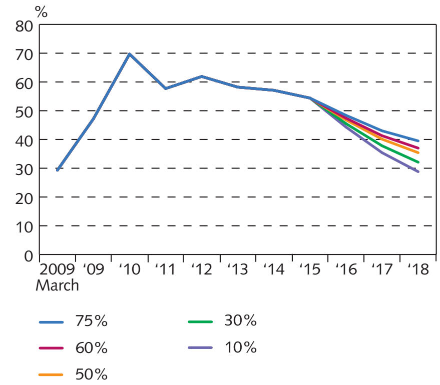
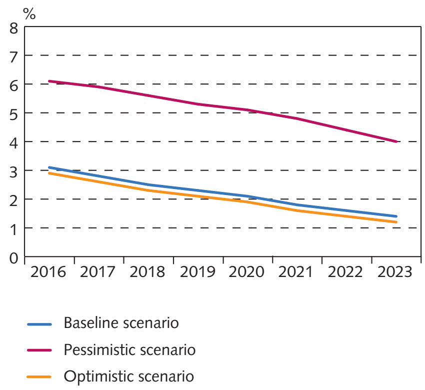


Chart 8

Icesave payments as % of GDP for the year



Source: Central Bank of Iceland.

Figure 6 shows how the debt position changes, and Figure 7 shows how the foreign exchange reserves will develop in these instances. In all instances, the figures show the variable concerned as a percentage of GDP.

In this discussion, the recovery ratio is based on the sum of nominal payments without any discounting of later payment. Due to the interest, it would be more appropriate to use the present value of the repayments as a reference. The estimated distribution of repayments is such that, if a 75% recovery ratio is assumed, the present value of the repayments, at 5.55% interest, equals 60% of the principal of the loan today, or 322 b.kr. Because of the interest, it matters not only how high the total amount is, but also when it accrues. If the recovery ratio is 75% of the total amount but the payment is received in a lump sum at the end of the period – that is, in 2015 – the present value of that payment is 51% of the principal of the loan today, or 222 b.kr.

The timing of the repayments could also make an impact if the principal of the Icesave loan is a priority claim but the interest it accrues is not. Therefore, two repayment profiles that have the same present value could lead to different loan balances in 2015. This can only happen if the recovery is high enough to cover the entire value of the principal; that is, if the recovery ratio is at least 70%, and probably somewhat higher.

The discussion above is based on the Central Bank's macroeconomic forecast from *Monetary Bulletin* 2009/2. For comparison, the outcome has been calculated based on less advantageous developments than the Bank's forecast allow for, and on more advantageous developments.

- The more pessimistic scenario assumes the following: GDP growth will be zero during the period 2010-2123; the sale of Landsbanki assets will yield 50%; the Treasury will have to assume unforeseen foreign-denominated obligations amounting to 500 b.kr. in 2009; due to global economic developments, Iceland's terms of trade will deteriorate by 5% in comparison with the Bank's forecast; and deflation in the UK will strengthen the pound sterling by 2% annually against the króna. Obviously, this is an extremely pessimistic example.
- The other alternative scenario is more optimistic. It assumes that GDP growth will be 1% greater than in the baseline scenario; that the recovery ratio of Landsbanki assets will be 75%, as in the baseline example; and that global economic developments will result in a 5% improvement in Iceland's terms of trade over and above the Bank's forecast.

Figure 8 shows developments in Icesave repayments as a percentage of GDP according to these three scenarios.[4]

4. It is appropriate to mention that neither scenario explains the reason for the changes assumed. This is important because, when such events occur – for example, those that could cause GDP growth, which has long averaged over 3%, to drop to zero for several years – the economy sustains a shock to which it gradually adapts after a period of imbalance. In spite of this, the more pessimistic scenario should give some idea of the tolerance level of the Icelandic economy. Although calculations show that the debt situation would not be unsustainable under these difficult circumstances, it is nonetheless very important that Government leaders take necessary ameliorative measures in due time; for example, that they seek all possible ways to enhance GDP growth and employment.

Figure 9 shows developments in total debt as a proportion of GDP.

Figure 10 shows developments in the foreign exchange reserves as a proportion of GDP, according to the three scenarios.

It is noteworthy that, in spite of the fact that conditions in the most pessimistic scenario are extremely adverse, the foreign exchange reserves will not be depleted until year-end 2018. It is appropriate to repeat that, in these examples, it is assumed that the debt currently being undertaken by the Treasury in order to strengthen the foreign exchange reserves will be repaid as planned. No further borrowings in order to fortify the foreign exchange reserves are assumed during the period. It is also assumed that the Icesave obligations will be paid. Furthermore, it is assumed that loans will be taken in order finance payments on other public sector debt and all private sector debt. This means that, if the difference between exports and imports is sufficient to pay the interest on foreign debt and to remit these specified payments, the foreign exchange reserves will grow correspondingly. In the more pessimistic scenario, net foreign exchange outflows will be large enough that, given these assumptions, the foreign exchange reserves will be exhausted by 2018.

Figures 11 shows that the debt burden less the foreign exchange reserves remains very high throughout the period but declines significantly from its 2009 peak during the period. This result implies that the Icesave debt burden is not unsustainable, even in the event of developments as adverse as those presented here.

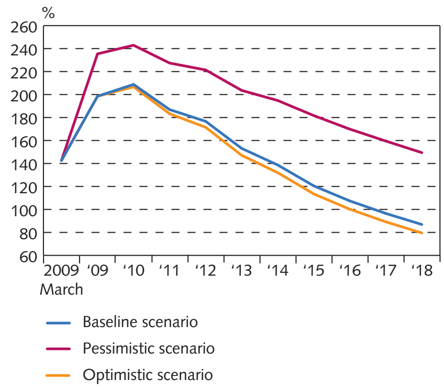
The debt ratio rises somewhat at the end of the period, when Icesave payments begin, but it does not rise as high as in 2009. The reason for the increase can be seen in Figure 12.

Figures 13 illustrates the net external position, or international investment position (IIP), at year-end, as a proportion of GDP. The blue bars are the official figures for 1995-2008.

The Statistics Department of the Central Bank has published estimates showing that the old banks were the largest contributors to Iceland's negative IIP at year-end 2008. If their assets and liabilities are excluded, the IIP drops from -322% of GDP to -33% of GDP. It

Chart 9

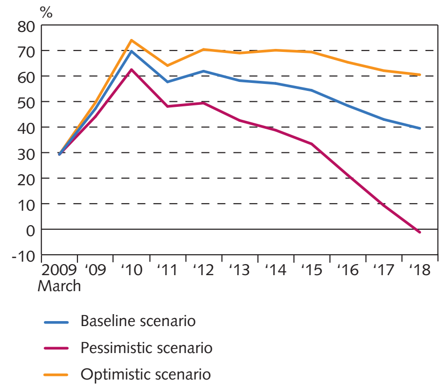
Total external debt as % of GDP



Source: Central Bank of Iceland.

Chart 10

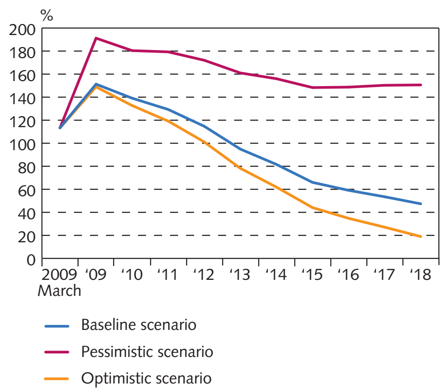
Foreign exchange reserves at year-end as % of GDP



Source: Central Bank of Iceland.

Chart 11

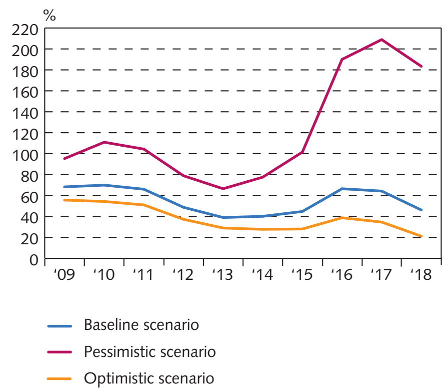
Total external debt less foreign exchange reserves as % of GDP



Source: Central Bank of Iceland.

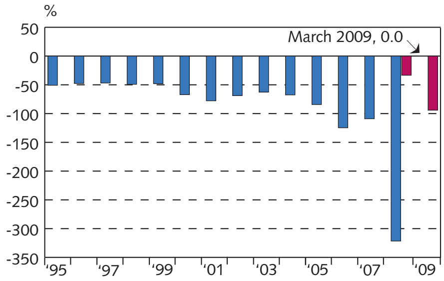
Chart 12

Net interest payments as % of the difference between exports and imports



Source: Central Bank of Iceland.

Chart 13
International investment position as % of GDP 1995-2008 and estimated position in March 2009



Source: Central Bank of Iceland.

is appropriate to mention that, because of the weakness of the króna at year-end 2008, external assets and liabilities become very high as a proportion of GDP measured at the average price for the year if they are converted at that low exchange rate. As a result, the -322% figure probably represents an exaggerated view of Iceland's IIP at year-end 2008. It is likely that the "right figure" lies somewhere between -322% and -33%, which the red bar shows for 2008.

The last blue bar, for March 2009, shows the Central Bank's official estimate of the IIP excluding the assets and liabilities of the old banks and other firms that have succumbed to the banking crisis. At present, the estimate assumes that the IIP is positive by a few million krónur, which translates to 0.0% of GDP for 2009. If the estimated Icesave obligation is included, that figure becomes -17%.

Another way to calculate Iceland's net position is to include only the assets that can be considered secure, as is done in Table 1. Using these figures and adding the Icesave obligations and the asset value of the interest rate differential on the loans that have been taken to strengthen the foreign exchange reserves yields an estimate of the lower limit of Iceland's IIP at year-end 2009. The resulting figure is -94%. Based on these assumptions, it is likely that the net external position at the end of 2009 lies between -17% and -94%.

It should be noted, however, that these figures are extremely uncertain. Nonetheless, they give a clear indication of the overall trend in the IIP over the period 1995-2009.

Position of the Treasury and Central Bank of Iceland

It is clear that the domestic and foreign liabilities of the Treasury and the Central Bank have increased in the wake of the banking crisis.

Table 3. Assets and liabilities of the Treasury and Central Bank of Iceland. Preliminary estimate.

Unit: ISK billions	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*
Assets						
Appropriated collateral securities	175.7	110.7	111.0	111.0	111.0	111.0
Current accounts, net	79.5	73.3	73.3	73.3	73.3	73.3
Equities, ownership shares, and initial capital	197.8	583.7	584.0	584.0	584.0	584.0
Icesave assets (75% recovered)	0.0	376.0	322.0	269.0	250.0	221.0
Central Bank FX balance	429.3	586.7	826.9	616.5	595.9	548.6
Other foreign assets (FIH)	81.5	80.7	73.6	73.9	.	.
Total domestic	453.0	767.7	768.3	768.3	768.3	768.3
Total foreign	510.8	1,043.4	1,222.6	959.4	845.9	769.6
Total	963.8	1,811.1	1,990.9	1,727.7	1,614.2	1,537.9
Liabilities						
Treasury domestic debt[1]	343.7	471.2	521.0	533.0	575.0	535.0
Central Bank, lost collateral loan claims	270.0	297.5	302.0	308.0	316.0	323.0
Borrowings for capital contribution to banks	0.0	385.0	385.0	385.0	385.0	385.0
Icesave debt	.	575.0	527.0	530.0	522.0	427.0
Foreign debt due to foreign reserves	406.9	584.5	835.6	617.0	576.1	454.3
Total domestic	613.7	1,153.7	1,208.0	1,226.0	1,276.0	1,243.0
Non-residents' ISK assets	302.0	302.0	302.0	302.0	302.0	302.0
Total foreign	406.9	1,159.5	1,362.6	1,147.0	1,098.1	881.3
Total, in ISK billions	1,020.6	2,313.2	2,570.6	2,373.0	2,374.1	2,124.3
Net position of Treasury and Central Bank	-56.7	-502.1	-579.8	-645.3	-760.0	-586.4

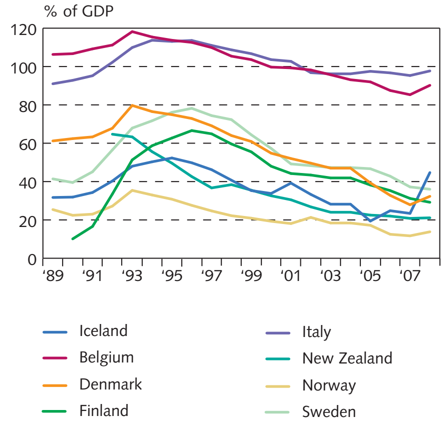
1. Treasury bonds, Treasury notes, Treasury bills, and other obligations.

Offsetting this, however, is the fact that assets have increased, due in part to the strengthening of the foreign exchange reserves. The total assets of the Treasury and the Central Bank amount to 1,840 b.kr. for the year 2009, and liabilities amount to 2,418 b.kr. The net position is therefore negative by 580 b.kr., or roughly 40% of GDP.

The Treasury's debt position in comparison with other countries has been rather strong in recent years, as can be seen in Figure 14. As a result, there was some margin to take on certain obligations in the wake of the banking crisis. Nonetheless, the net position of the Treasury and the Central Bank deteriorated from 2008 to 2009, and yet it is much better than the total debt position based on the assets offsetting, for example, the Treasury's capital contribution to the banks. The Central Bank intends to develop the consolidated balance sheet of the Treasury and the Central Bank more fully, and to include the municipalities as well.

Chart 14

Net debt of various countries 1989-2008 as % of GDP



Source: OECD.

The Icesave debt and possible revenue generation

It is possible to pay the Icesave obligations in various ways. For example, the Central Bank has analysed the amount by which value-added tax would have to be raised in order to finance the Icesave debt. The Central Bank uses the following assumptions:

- GDP growth, private consumption growth, and exchange rates will be in line with the forecast published in *Monetary Bulletin* 2009/2.
- The recovery ratio for Landsbanki assets will be 75%.
- The value-added tax brackets will be raised by the proportion as is shown in Table 4.
- It will be possible to invest the proceeds from the VAT hike at 6% interest.

The results of the calculations[5] reveal that it would be necessary to raise value-added tax so that the accumulated returns on the tax hike would equal the Icesave debt. It should be noted that the Central Bank is not recommending this option; it is merely presenting it as an example.

Table 4. Possible increase in value-added tax

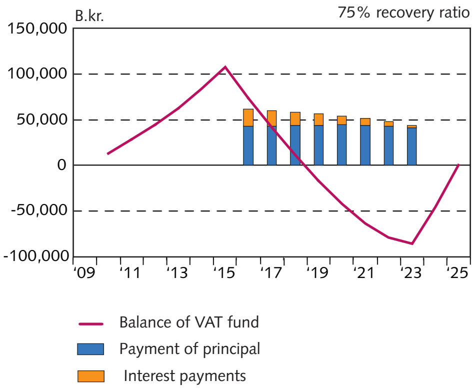
From	*To*	*By*
7%	7.88%	0.88 percentage points
24.50%	27.57%	3.07 percentage points

The calculations assume that the nominal value of private consumption constitutes the entire tax base. Figures on the tax base and forecasts of its development were obtained from the Central Bank of Iceland's Quarterly Macroeconomic Model (QMM).

5. These calculations do not assume that a VAT hike would lead to a rise in price levels and a drop in real disposable income and would thereby affect aggregate demand and employment as well. The macroeconomic forecast in *Monetary Bulletin* 2009/2, which is used as a basis for them, assumes tax increases and public expenditure cuts, so that public sector performance will be in line with Government estimates. These tax increases reduce private consumption and revenues from value-added tax in the forecast for coming years.

Chart 15

Annual amortisation and interest on outstanding balance of Icesave loans and balance of hypothetical VAT fund



Source: Central Bank of Iceland.

Figure 15 shows annual payments (instalments and interest) on the balance of the Icesave loan (based on a 75% recovery ratio on Landsbanki assets) and the balance of a dedicated VAT fund that would earn income on supplemental value-added tax, as is assumed in Table 4, which would be invested at 6% interest and would be used to remit payments on the Icesave loan.

It is clear that economic policy decisions in coming years will determine the extent to which the Icesave obligations will be a burden to future generations. If emphasis is placed on GDP growth, economic shocks must strike the economy in order for the Icesave obligations alone to render the Treasury unable to fulfil its foreign commitments.

Rating agencies' and financial institutions' views on the Icesave agreement

Throughout the years, the Central Bank of Iceland has interacted extensively with credit rating agencies and with the financial institutions that have been the Treasury's principal lenders.

From the outset, the Treasury has always fulfilled its payment obligations and has had excellent credit ratings – in some instances, the highest available. However, the Treasury is now at the outer edge of the investment grade classification, with a negative outlook. As a consequence, it would take very little to push the Treasury's ratings down into speculative grade.

The rating agencies have been informed of the substance of the agreements from the beginning. Teleconferences have been held between the three agencies and various Icelandic officials, including the Ministry of Finance, the negotiating committee, the Landsbanki resolution committee, the IMF's representatives in Iceland, and the Central Bank.

The rating agencies have not given concrete indications of how the agreement could affect the Treasury's credit rating, as their employees are not authorised to give such indications. Decisions to change ratings take place within the ratings committees of the agencies in question, either at regular meetings or at extraordinary meetings due to specific events.

Appendix 6 contains an analysis from Moody's, dated June 15, 2009, stating that the agency considers it positive to reduce uncertainty about Iceland's debt position, even though some uncertainty remains concerning such factors as recovery ratios. It is also stated that Moody's considers Iceland's debt burden manageable, even with the Icesave agreements. Fitch Ratings analyst Paul Rawkins has also been positive about the elimination of uncertainty in this matter. His opinion was covered in the Icelandic media on June 23, 2009.

Furthermore, it can be expected that this decision would make a positive impact on the progress of the economic programme of the Government and the IMF; for example, it will enhance the likelihood that the First Review will take place according to the current schedule and that the loan will be disbursed as planned. It can also be expected that the general response to the resolution of the Treasury's deposit insurance dispute will be positive. These factors will tend to support Iceland's credit ratings.

However, with the Icesave agreement, the Treasury takes on substantial, irrevocable obligations, and there is little or no likelihood that future events will decrease or increase those obligations.

The debt position and debt service burden are the factors of greatest importance to the rating agencies. The agencies will probably examine these factors in their entirety. An analysis like the one in this document will also be presented to them.

However, it is also worth mentioning that rating agencies have given the Treasury very high ratings because they consider the governmental system effective and efficient. In this context, it should be noted that Moody's last analysis, dated January 23, 2009, states that the governmental system is one of the most important factors considered by the agency.

It has also emerged that the repayment period and interest rate on the loan are more beneficial than originally assumed, as it had previously been stated that other terms had been offered.

Finally, it should be noted that discussions with foreign investment banks have indicated that the Treasury could possibly approach the markets by year-end if the recovery programme proceeds according to plan.

II. Legal opinion

The comments below pertain to legal aspects of the loan agreement between the Depositors' and Investors' Guarantee Fund (DIGF) and the Icelandic Government, on the one hand, and the British and Dutch governments, on the other (the Icesave agreements). It should be noted that most of the comments in this opinion apply to circumstances that could arise in the unlikely event that the Icelandic Treasury cannot fulfil its obligations; cf. the IMF's review of debt sustainability, which is mentioned in this statement. The factors that make the greatest impact on the estimated present value of debt obligations are the length of the repayment period, the sequencing of payments, prepayment provisions, asset recovery ratio, and prioritisation of claims. As a result, it is necessary to examine legal comments from the standpoint of the Bank's considered opinion that it is unlikely that the Icelandic Government will be unable to fulfil its obligations according to the agreement, and that rejecting a State guarantee could have severe consequences for financial system reconstruction and economic recovery.

According to the agreement between the Ministry of Finance and Central Bank of Iceland on Treasury debt management, the most recent version of which is dated September 4, 2007, the Central Bank administers debt management, Government guarantees, and relending, as well as other tasks assigned to the Minister of Finance pursuant to the Act on Government Debt Management, no. 43/1990. The agreement stipulates that the Central Bank shall administer Government guarantees and assess the risk to the Treasury as a result of such guarantees.

The Icesave agreements were signed on June 5, 2009; however, the Central Bank's attorneys have not previously issued an opinion on either the Government guarantee or the Icesave agreements.

a. The agreements fall under civil law

The explanation[6] has been given that the agreements are conventional loan agreements that fall under the rules of civil law. There is no doubt that the agreements fall under the scope of civil law, but the assertion that they are conventional loan agreements is doubtful because their content is not of the type generally found in conventional loan agreements or business contracts. With the agreements, the Icelandic Government is assuming liability, concerning which there is legal uncertainty about the scope of EU law, for the Depositors' and Investors' Guarantee Fund (DIGF), which is a civil party. The Treasury is assuming unspecified liability as the guarantor for a loan, including interest and expenses, as it is necessary to revoke the Act on Government Guarantees, no. 121/1997, with the exception of Article 5 of that Act;[7] cf. Article 2 of the bill of legislation. The State is placed in the position of a civil party to a contractual agreement that protects the position of the lender over and above the borrower. The fact that the Icelandic Government should assume liability for the DIGF's payments to depositors need not have led to the State's being relegated to the position of a civil party to a contractual agreement. It would have been desirable that the Icelandic Government's status as an international entity had been better protected.

It cannot be seen that the agreement includes any reference to the agreed Brussels guidelines of November 14, 2008. The exposition accompanying the legislative bill states that the purpose of those guidelines is to guarantee a balance between parties to a dispute. First of all, the guidelines imply that the EU Directive on deposit insurance schemes has been incorporated into legislation on the European Economic Area in accordance with the EEA Agreement, and that it therefore applies in Iceland in the same way that it applies in EU Member States. Second, it was emphasised that the parties would take into consideration "the difficult and unprecedented situation Iceland faces, and the pressing need to determine measures that enable Iceland to reconstruct its economy and financial system." Third, it was emphasised in particular that the organs of the EU and EEA would continue to participate in the negotiation process, which would take place in consultation with them. They would therefore act as some sort of intermediary if the need should arise.

Because the agreements fall under civil law and under the British legal system and jurisdiction, the question of whether the agreements can be interpreted in terms of the Brussels guidelines depends on British law. The Central Bank doubts that such an interpretation would be considered by the British courts, as no reference is made to the guidelines in the agreements themselves.

Because the agreements fall under civil law, an EU/international resolution of the legal uncertainty that reigns because of the flaws in the deposit insurance scheme would be separate from the Govern-

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6. See, for example, the discussion on the website www.island.is, which is the Government's information portal.
7. Article 5 of Act no. 121/1997. The article discusses the Government Guarantee Fund's loss provisioning account due to guarantees granted. At any time, the loss provisioning account shall give a realistic view of the estimated write-offs of all of the Fund's guarantees.

ment's fulfilment of the Icesave agreement. There are clear distinctions between international law and civil law, and handling the resolution of the Icesave dispute in the manner done with these loan agreements severs the connection between them.

If the Icelandic Government wishes to attempt to review the agreements, Articles 13 and 16 (of the UK agreement)[8] must be considered. According to Article 13, the agreement may not be amended, supplemented, or waived without a written agreement between the parties. The authorisation to review the agreement can be found in Article 16, which discusses changes in circumstances. That Article states: "The article applies in the event that the IMF's most recent Article IV Consultation on Iceland's position reveals that its debt sustainability has diminished markedly in comparison with the Fund's assessment as of November 19, 2008."

Article 16.2 states as follows:

> "The Lender agrees that, if this paragraph 16 applies and Iceland so requests, it will meet with Iceland to discuss the situation and consider whether, and, if so, how, this Agreement should be amended to reflect the relevant change in circumstances."

The Icelandic Government does not appear to have an explicit right, according to Article 16, to have the agreement reviewed and re-drafted. In the exposition accompanying the bill of legislation, it is stated, however, that the Icelandic authorities take the view that, if the review clause in the agreements is invoked due to substantial changes in Iceland's debt sustainability, the British and the Dutch are obliged, on the basis of the agreed guidelines that were approved in Brussels in November 2008, to give full consideration to the difficult and unprecedented situation Iceland faces, and to the pressing need to enable Iceland to reconstruct its economy and financial system. As is stated above, the agreements contain no reference to the agreed guidelines; therefore, it is entirely unsure whether the counterparties would agree with this interpretation by the Icelandic authorities.

If the Icelandic Government should wish to review the agreements due to possible resolution, within the EU, of the legal and/or political disagreement about the extent of Government liability for deposit insurance schemes implemented on the basis of EU directives, such a review does not appear to be permissible under the agreement. Iceland would therefore have to seek special agreements with Holland and the UK on this point.

b. A few comments on the agreement

The following discussion touches briefly on the main points relating to a few of the contractual provisions. Due to a very heavy work load, the Bank's attorneys have been unable to study the agreement in depth or carry out comparative research, as would have been desirable.

8. This memorandum refers to the agreement with the United Kingdom, but the agreement with Holland is virtually identical to it.

1. Interest

The entry into force of Act no. 44/2009,[9] on April 22, 2009, is the equivalent of the date of decree in the sense of the Act on Bankruptcy. This date is important as regards interest and expense, as interest and expense on claims occurring after April 22, 2009, will become residual claims; that is, they are last in order of priority.

2. Repayment of the loan amount

The exposition states that it was assumed that the Icelandic Government was able to tolerate the liability represented by the agreements. If the courts should conclude that the priority assigned to deposits with the emergency legislation[10] is unconstitutional, this would be extremely damaging. The Government Attorney has issued the opinion that, before the Icelandic courts, the emergency legislation is not in contravention of the Constitution in this respect. In this context, it is worth pondering what Article 6.9. in the agreement means, and what its purpose is.

> "**Treatment of Landsbanki creditors**
>
> Iceland will not take any action which would result in the creditors (or any class of them) of Landsbanki (including, for the avoidance of doubt, the creditors (or any class of them) of Landsbanki London) being treated in a manner contrary to generally accepted international or European principles of treatment of the creditors in an international winding-up."

The provision is broad and unclear. If it is put to the test, it will be the role of the British courts to interpret it because of the provisions of Article 17 of the agreement, which states that "this agreement and any matter, claim or dispute arising out of or in connection with it, whether contractual or non-contractual, shall be governed by, and construed in accordance with, the laws of England." With reference to Article 17, the question arises whether the British Government could invoke this provision in legal proceedings against Landsbanki's resolution committee/winding-up committee, or even against the Icelandic Government, before the courts of England. The provision does not make it clear to what "generally accepted international or European principles of treatment of the creditors in an international winding-up" the agreement refers. In the Central Bank's opinion, it would be preferable that Article 6.9. were more explicit. It should be mentioned, however, that the agreement does not authorise third parties to use it as the basis for any rights or entitlement, and this diminishes the risk in the provision.

3. Landsbanki's asset portfolio

The Landsbanki asset portfolio, the proceeds of which are to be allocated towards depositors' claims, is clouded in uncertainty, not only in terms of figures, but also in a legal sense. It can be expected that creditors will make every attempt to recover funds from the Landsbanki estate. Neither has it been made clear how heavily encumbered the

9. Act no. 44/2009 amends the Act on Financial Undertakings, no. 161/2002.

10. Act no. 125/2008.

Landsbanki portfolio might be, as claims secured by liens take precedence over priority claims. It is important to eliminate uncertainty about the legal status of the assets as soon as possible.

4. Payments in seven years' time / Government guarantee

Seven years after the agreement is signed, the DIGF shall begin to repay the remainder of the principal. Payment will be remitted in thirty-two quarterly instalments. If the DIGF cannot fulfil its obligation to pay, the Government guarantee according to Article 6 of the agreement will be activated. The Icelandic Government guarantees, irrevocably and unconditionally, vis-à-vis the lender, the due and punctual performance by the DIGF of all of its obligations. According to Article 6.2.(b) of the agreement, the Icelandic Government will undertake to pay the loan as if it were the principal obligor; that is, it assumes the role of guarantor.

5. Comparable and equitable treatment

Article 7.1. of the agreement discusses "comparability of treatment." The provision reads as follows:

> "If the Guarantee Fund or Iceland enters into any financing arrangement or treaty (other than the Dutch Loan Agreement) with any financier (including, without limitation, any state, international organisation or private entity) for the purpose of financing any claims of any depositors of an Icelandic bank, and, under the relevant financing arrangement or treaty (taken as a whole) that financier enjoys an overall more favourable treatment than the Lender under this Agreement or the benefit of any security, then the Guarantee Fund and Iceland shall grant the Lender the same favourable treatment or the benefit of similar security (and the Guarantee Fund and Iceland shall execute any documentation necessary or desirable in order to do so)."

This article guarantees the present lenders the same rights and contractual terms as potential future lenders involved in financing depositors' claims on Icelandic banks, if those subsequent terms are more advantageous to the lender. This means that, if the DIGF or the Icelandic Government concludes agreements concerning payments to depositors, with parties other than the British and the Dutch, and those agreements are more advantageous to the lender than the present agreements, as regards either terms or collateral, the DIGF and the Icelandic Government must grant the British and the Dutch the same terms.

If that provision is put to the test, it could result in an amendment to the terms set forth in the loan agreement.

In the definition in Article 7.2.1., a distinction is made between Landsbanki depositors and those whose deposits were transferred to NBI. The definition could indicate that these two groups of depositors may be handled in different ways.

6. Call provisions

Circumstances other than non-payment of the loan amount could result in the termination of the agreement due to non-performance. So-called termination events are covered in Article 12 of the agreement.

In Article 12.1.5 stipulates that, if external indebtedness undertaken by Iceland (in excess of 10 million pounds sterling) is declared due and payable because the obligation concerned is not paid on the due date, the loan may be called in. A definition of external indebtedness can be found in Article 1.1: *„External Indebtedness means any present or future borrowing, debt or other obligation, whether actual or contingent...“* This definition therefore appears to cover obligations for which the Government is a guarantor. The Government is a guarantor for the obligations of Landsvirkjun and the Institute of Regional Development, for example; that is, claims will not fall on the State until exhaustive attempts have been made to obtain payment from those parties. But according to the agreement, this loan, and therefore all of the Government's foreign loans, could be called in if these State undertakings do not pay their obligations when they fall due.

In previous foreign loan agreements, the State has attempted to narrow the definition of the obligations that could result in the termination of other Government loans. It would have been better had the article made it clear whether a narrower definition applies.

According to Article 12.1.8., the loan may be terminated if the Government's payment obligations under the agreement cease to rank at least as high as its present or future external indebtedness. This applies to all such obligations unless the law stipulates otherwise on the date of the agreement.

In the Icelandic Government's previous loan agreements, it has been conventional to exempt collateral liens and those instances where assets are purchased with encumbrances, or where the purchase price is financed with a loan secured by a lien in the asset concerned.

7. Applicable legislation

In both agreements is a provision stating which law and which jurisdiction shall apply to the resolution of disputes. It is conventional in international loan agreements that, in the event of a dispute, either the law of the country extending the loan shall apply, or British law shall apply. This is because of London's status as an international financial centre. It is noteworthy that Article 17.1. stipulates that the laws of England apply not only to disputes arising from the agreement, but also that *"any matter, claim or dispute arising out of or in connection with it, whether contractual or non-contractual, shall be governed by, and construed in accordance with, the laws of England."*

It is striking that the applicable laws should extend as well to "non-contractual" matters, because the norm is that the following wording is considered to suffice: *"This Agreement is governed by, and shall be construed in accordance with, English law."*

8. Jurisdiction

Article 17.2.1. stipulates that disputes, which are defined in the same broad terms as in Article 17.1, shall fall under the jurisdiction of the English courts. Article 17.2.3. contains a preferential provision for the sole benefit of the lender. According to that provision, the lender may, due to a dispute, initiate legal proceedings before other courts with jurisdiction. Particularly noticeable is the last sentence of that provision, which states as follows: *"To the extent allowed by law, the Lender may take concurrent proceedings in any number of jurisdictions."*

9. Waiver of sovereign immunity

It is a fundamental principle of international law that a state shall enjoy immunity from the jurisdiction of other states. The rule is based on the fundamental idea that states are formally equal international entities and that such sovereign entities cannot have jurisdiction over one another.

As is stated at the beginning of this memorandum, the Icesave agreements fall under civil law; therefore, the fundamental principle of international law – on sovereign immunity – is not unequivocally applicable. It is very common in loan agreements between nations that immunity rights are waived because, without such a waiver, it would not be possible to initiate legal proceedings or prosecute a case before the agreed courts. In the exposition accompanying the legislative bill, the EMTN programme is used as an example, and in recent years, most of the Treasury's foreign loans have been taken on the basis of that agreement. The provision in the EMTN agreement reads as follows:

> "In respect of any proceedings, the Issuer irrevocably consents generally to the giving of any relief and the issue of any process in connection with such proceedings including, without limitation, the making, enforcement or execution against any assets whatsoever of any order or judgement made or given in any such proceedings with the exception of real property and buildings and the contents thereof owned by the Ministry of Foreign Affairs and situated outside Iceland and assets necessary for the proper functioning of the Republic of Iceland as a sovereign power."

It is noteworthy that the waiver of immunity in Article 18 of the present agreement is much broader than the above. For purposes of comparison, it is included below:

> "Each of the Guarantee Fund and Iceland consents generally to the issue of any process in connection with any Dispute and to the giving of any type of relief or remedy against it, including the making, enforcement or execution against any of its property or assets (regardless of its or their use or intended use) of any order or judgment. If either the Guarantee Fund or Iceland or any of their respective property or assets is or are entitled in any jurisdiction to any immunity from service of process or of other documents relating to any Dispute, or to any immunity from jurisdiction, suit, judgment, execution, attachment (whether before judgment, in aid of execution or otherwise) or other legal process, this is irrevocably waived to the fullest extent permitted by the law of that jurisdiction. Each of the Guarantee Fund and Iceland also irrevocably agree not to claim any such immunity for themselves or their respective property or assets."

According to the last sentence of the Article, the DIGF and the Icelandic Government relinquish irrevocably the right to claim immunity; that is, to determine whether such immunity exists, either for themselves or for their property or assets.

If the waiver of immunity is put to the test, the British State Immunity Act of 1978 (SIA) will be invoked in order to resolve the dispute. According to that Act, a government can waive immunity in a very broad manner, with written approval. Thus it is clear that the British courts have full jurisdiction to rule on any dispute or default resulting from the agreement. British legal procedure would also apply to the appropriation of the Icelandic Government's assets in British jurisdiction. It should be noted that the Central Bank of Iceland is considered an independent legal entity according to the SIA and, as such, the Bank and its assets enjoy immunity. However, it should be pointed out that, in spite of the SIA, the British Government invoked its anti-terrorist legislation against the Central Bank and froze its assets for a period of time in October 2008.

If a court judgment is rendered, the enforcement of that judgment will take place in the jurisdiction where the assets concerned are located. Possible appropriation of the Icelandic Government's assets in Iceland, on the basis of a court judgment, is subject to Icelandic legal procedure in all respects. In Icelandic enforcement proceedings, the State does not enjoy any particular immunity over and above other convicted party. Therefore, there is no particular statutory barrier to appropriation of the State's assets, except that Article 40 of the Constitution could prevent such execution against real property and the right of use of such property. That Articles states that "*Nor may … any real estate belonging to the State or the use thereof sold or in any other way disposed of, except by authority in law.*" If the agreement takes effect, an amendment to Icelandic legislation – for example, an amendment exempting State assets from enforcement – could be interpreted as a termination event; cf. Article 12.1.11., which reads as follows:

> "A Change of Icelandic Law occurs which has or would have a material adverse effect on the ability of the Guarantee Fund or Iceland to perform their respective payment or other obligations under the Finance Documents to which they are a party."

Legal opinion diverges on how broadly a state can, in international law, waive sovereign immunity as regards appropriation of its assets. It is clear that a state can waive immunity as regards those assets that fall under civil law and those used for commercial purposes. In international law, however, there is greater doubt about the right to appropriate assets necessary for the proper functioning of the state as a sovereign power. In this context, it should be pointed out that, if an attempt is made to appropriate State assets in Icelandic jurisdiction, it is unclear whether the interpretation or general principles of international law would apply, as the Icelandic legal system is based on the concept of dualism, which means that legal authority according to international law is not binding until it has been incorporated into Icelandic law.

Furthermore, it is clear that the Icelandic Government will enjoy immunity according to the 1961 Vienna Convention on Diplomatic Relations. Diplomats and assets that are necessary for embassy operations are protected from interference or enforcement, either by the state concerned or by others. The Vienna Convention has been ratified all over the world and was incorporated into Icelandic law with Act no. 16/1971.

Appendix 1.

Long-term foreign borrowings (including intended borrowings) by the Treasury and the Central Bank of Iceland. July 2009.

	Interest rate	*Payment due date*	*Currency*	*Total amount*
EMTN (bond)	4.375%	30.9.2009	EUR	150
EMTN (bond)	3.750%	1.12.2011	EUR	1000
EMTN (bond)	5.375%	10.4.2012	EUR	250
EMTN (bond)	4.375%	10.3.2014	USD	200
Bonds	14.500%	31.1.2016	GBP	30
Syndicated loan	(LIBOR+) 0.900%	22.9.2011	EUR	300
IMF SBA[1]	5.250%	31.12.2015	SDR	1400
IMF Bilateral	(3M Euribor+) 2.750%	1.12.2020	USD	3250

1. Loan not concluded in full. It is planned that the largest portion of the loans will be in euros. Disbursements will be in line with the IMF programme.

Appendix 2.

Icesave obligations (all amounts in millions, in the currency concerned).

	Based on 75% recovery							
	Pounds sterling (GBP)		*Euros (EUR)*		*Total (ISK)*		*Exchange rate assumptions*	
	Principal (beginning of year)	*Payments*	*Principal (beginning of year)*	*Payments*	*Principal (beginning of year)*	*Payments*	*ISK/GBP*	*ISK/EUR*
2009	2,350	220	1,329	125	627,268	66,112	177.46	158.18
2010	2,260	237	1,278	134	574,841	71,237	169.09	150.72
2011	2,148	169	1,215	96	527,002	50,843	163.09	145.37
2012	2,098	186	1,186	105	529,612	55,967	167.82	149.59
2013	2,028	475	1,147	268	521,898	142,473	171.08	152.49
2014	1,666	102	942	57	427,014	30,539	170.39	151.88
2015	1,657	373	937	211	418,965	111,920	168.11	149.85
2016	1,376	248	778	140	342,469	61,816	165.47	147.49
2017	1,204	239	681	135	301,266	59,758	166.36	148.28
2018	1,032	229	584	130	260,857	57,954	168.05	149.79
2019	860	220	486	124	219,877	56,178	169.98	151.51
2020	688	210	389	119	177,213	54,139	171.25	152.64
2021	516	201	292	113	132,075	51,355	170.17	151.68
2022	344	191	195	108	85,834	47,681	165.89	147.86
2023	172	182	97	103	41,096	43,377	158.85	141.59

Appendix 3.

Net international investment position,[1] estimate.

ISK millions, end of period:	*ISK*	*USD*
Total assets	2,811,347	22,978
Direct investment abroad	1,131,154	9,245
Portfolio assets	1,093,390	8,937
Financial derivatives	75,099	614
Other investment, assets	46,091	377
Reserves	384,072	3,139
Total liabilities	2,811,066	22,976
Direct investment in Iceland	590,314	4,825
thereof equity capital	306,785	2,507
thereof debt to affiliated enterprises	283,529	2,317
Portfolio liabilities	946,972	7,740
Financial derivatives	75,099	614
Other investment, liabilities	1,198,682	9,717
International investment position	281	2
Total debt in the external debt overview[2]	2,504,281	20,468
Total debt used in this memorandum[3]	2,088,825	17,073
Exchange rate: ISK/USD	122.35	

1. The old commercial banks, holding companies and other companies that are in a moratorium are excluded. It should be mentioned that this table has not been published and the Statistics Department of the Central Bank is working on improving data collection on the asset side.
2. The difference between “total liabilities” in the summaries of IIP and in the summaries of total external debt is the item “own capital,” under the item “direct investment in Iceland.” Equity is generally not included with debt.
3. The difference between total external liabilities in this memorandum and total external liabilities in official Central Bank figures is mainly the item “loans from related parties,” under “direct investment in Iceland.” This item refers to loans from foreign parent companies to their subsidiaries in Iceland. It was also decided to omit the swap agreements that were not included in the foreign exchange reserves.

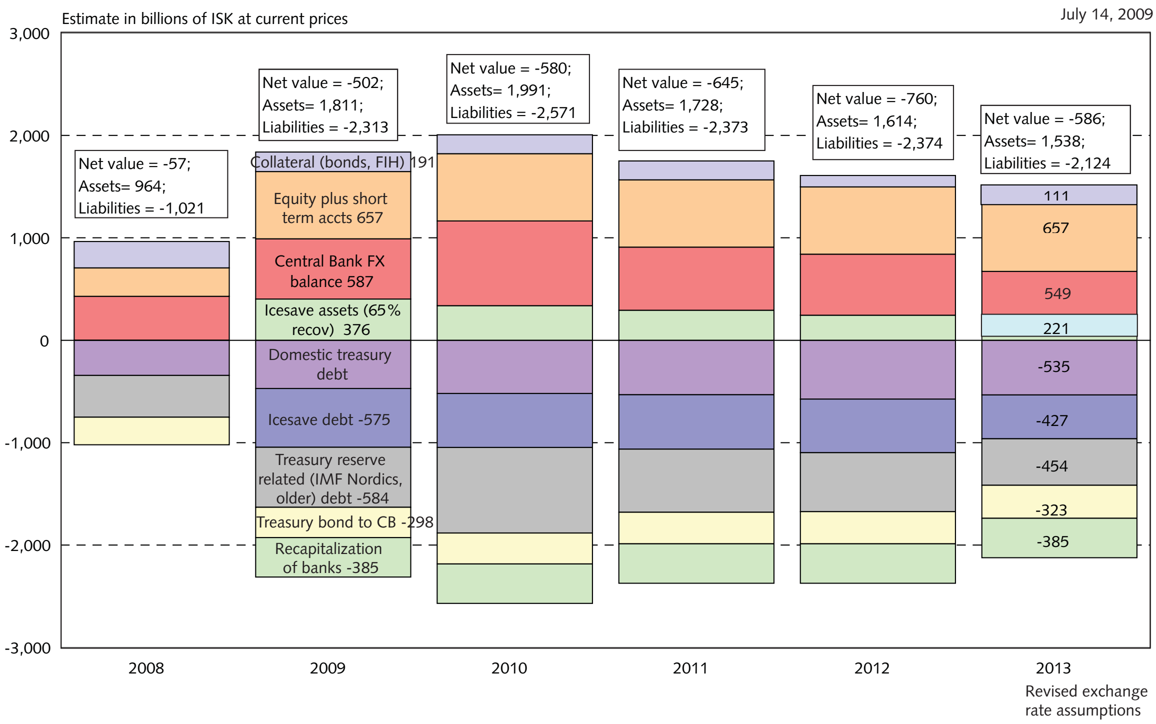
Appendix 4.

Assets and liabilities as % of GDP.

	2008	*2009*	*2010*	*2011*	*2012*	*2013*
GDP	1,464,000	1,427,173	1,414,337	1,465,712	1,542,820	1,642,815
Total assets/GDP, %	65.83	126.90	140.76	117.87	104.63	93.61
Total liabilities/GDP, %	69.71	162.08	181.76	161.90	153.88	129.31
Domestic assets/GDP, %	30.94	53.79	54.32	52.42	49.80	46.77
Foreign assets/GDP, %	34.89	73.11	86.44	65.46	54.83	46.84
Domestic liabilities/GDP, %	41.92	80.84	85.41	83.65	82.71	75.66
Foreign liabilities/GDP, %		81.24	96.35	78.26	71.18	53.65
Net debt position						
Treasury and Central Bank %	-4	-35	-41	-44	-49	-36

Appendix 5.

Consolidated balance sheet of the Treasury and the Central Bank



Appendix 6.

Moody's Weekly Credit Outlook, June 15, by Kenneth Orchard, Moody's senoir analyst on Iceland.

Icesave Agreement Brings Some Clarity to Icelandic Debt Picture

On June 5, the Icelandic government signed an agreement with the British and Dutch governments resolving the Icesave dispute. Although there is still uncertainty about the Icelandic government's fiscal position, the Icesave agreement brings some welcome clarity to the public debt picture. The agreement supports our view that the Icelandic government's long term debt burden will be manageable, thereby underpinning our Baa1 rating. The negative outlook on the rating remains appropriate, however, in light of the still-fragile economic and financial situation.

The collapse of Landsbanki in October 2008 left the Icelandic depositors' and investors' private guarantee fund with a significant liability from internet deposits collected by the bank in the UK and Netherlands. Although the British and Dutch governments initially paid out compensation to depositors, the Icelandic government was forced at the time to assume ultimate responsibility for the deposit insurance. The gross liability emanating from the Icesave reimbursement is 40%-50% of Iceland's annual GDP (depending upon assumptions used for the exchange rate and GDP), but the government hopes to recoup at least 75% of the amount by liquidating Landsbanki's assets over the next 5-10 years.

The Icesave agreement set some key parameters for the liability, particularly the interest rate and maturity. The loan will accrue interest at 5.55% per annum and will have a 15-year term with a 7-year grace period. This will provide the government with some much needed time to realize value from Landsbanki's assets and get its own fiscal house in order. Because the Icesave liability is the largest portion of the government's gross debt, at about 44% of the total in 2009, the Icesave agreement brings some much needed clarity to the public debt picture.

In addition to the Icesave liability, the Icelandic government's debt is increasing significantly. This is largely due to significant budget deficits, the need to recapitalise the banking system and foreign borrowing – from the IMF, Nordic countries and others – to support the currency.

Exhibit 1: Icelandic Government Debt

Exhibit 1 shows gross and net government debt as a percentage of GDP. Gross debt/GDP is estimated to peak this year at about 144%, while net debt/GDP, which incorporates the equity the government will hold in the banking system and liquid assets, is estimated to reach about 95%. The ratios are then expected to decline over the next few years, with net debt/GDP stabilizing at approximately 55% in 2013.

In relation to the negative outlook on the rating, we are currently monitoring three developments:

1. fiscal consolidation, which is desperately needed to get the budget deficit under control over the next few years;
2. banking sector restructuring, which holds the key to jump-starting private sector activity;
3. the level of the currency (the Icelandic krona).
   14 June 15, 2009 Moody's Weekly Credit Outlook Moody's Weekly Credit Outlook

Fiscal policy slippage, extra costs associated with the banking sector resuscitation, and/or a weak currency could all cause debt/GDP to stabilise at a higher level than forecast. Progress on fiscal consolidation and banking sector restructuring is expected over the next six weeks before the next review of the IMF programme is finalised in late July. The currency issue, on the other hand, seems likely to remain tentative for some time. The krona has been gradually weakening over the past couple of months, despite tough capital controls, high (albeit declining) interest rates, and a trade surplus. However, there is some optimism that a decision to pursue EU membership, which could eventually lead to adoption of the euro, will reduce anxiety about Iceland's currency regime and boost local's confidence in the krona.