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Iceland: Fifth Review Under the Stand-By Arrangement, and Request for Modification of Performance Criteria and Rephasing of Access—Staff Report; Informational Annex; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Iceland.

In the context of the fifth review under the stand-by arrangement, and request for modification of performance criteria and rephasing of access, the following documents have been released and are included in this package:

- The staff report for the Fifth Review Under the Stand-By Arrangement, and Request for Modification of Performance Criteria and Rephasing of Access, prepared by a staff team of the IMF, following discussions that ended on May 5, 2011, with the officials of Iceland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 19, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff statement of May 27, 2011 updating information on recent developments.

- A Press Release summarizing the views of the Executive Board as expressed during its June 3, 2011 discussion of the staff report that completed the request and/or review.

- A statement by the Executive Director for Iceland.

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

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

*Also included in Staff Report

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

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ICELAND

Fifth Review Under the Stand-By Arrangement, and Request for Modification of Performance Criteria and Rephasing of Access

Prepared by the European Department in Consultation with Other Departments

Approved by Poul M. Thomsen and James Roaf

May 19, 2011

- **Stand-By Arrangement:** A SBA in an amount equivalent to SDR 1.4 billion ($2.1 billion, 1190 percent of quota) was approved by the Executive Board on November 19, 2008 (Country Report No. 08/362). A first purchase of SDR 560 million was made following the Board meeting. Second, third, fourth, and fifth purchases, equivalent to SDR 105 million each, were made following completion of the first, second, third, and fourth reviews. The sixth purchase, equivalent to SDR 140 million, would become available upon completion of the fifth review. The Arrangement is set to expire on August 31, 2011.
- **Status**. The program is on track, and all end-March performance criteria were met. The authorities are requesting a modification of end-June performance criteria and a rephasing of access, combining the last two purchases, on account of the delays in completing recent reviews.
- **Summary**. The economy is gradually recovering. Moderate growth is expected in 2011, but a key challenge is to bring down unemployment, which is still high. Program discussions focused on the authorities' revised strategy for lifting capital controls. The authorities and staff agreed that the lifting of controls should proceed gradually, as conditions permit. The strategy envisages lifting controls in phases. The first phase will release offshore (largely nonresident) krona holdings, with the second phase geared toward liberalizing onshore (largely resident) krona holdings. Fiscal policy is on track and the 2011 target remains achievable, but risks arise from spending pressures contained in the recent three-year wage agreements. On private sector debt restructuring, the measures agreed in December 2010 are accelerating the process of household debt restructuring, but corporate debt restructuring is proceeding more slowly and must be accelerated. Work on financial sector restructuring and strengthening prudential regulations and supervision is ongoing, but efforts should be stepped up. Financing assurances are in place, and Iceland's Nordic partners are in the process of extending their loans until end-2011. Icesave remains unresolved: the Icesave agreement was passed by a substantial majority of the Icelandic parliament in mid-February, but was rejected by referendum on April 9. It will now be decided through legal channels.
- **Discussions.** See Fund Relations Appendix.

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Attachments

Appendix

I. RECENT ECONOMIC DEVELOPMENTS

1. **The post-crisis recovery is underway, but remains fragile** (Table 1; Figures 1 and 2). Exports increased and private domestic demand strengthened in the last quarter of 2010, and the economy stopped contracting on a year-on-year basis for the first time since the crisis. But import growth was particularly strong, turning GDP growth negative on a quarter-on-quarter basis and worsening the contraction to -3.5 percent on an annual basis—an adverse surprise. Short term indicators suggest continued modest growth in domestic demand in the first months of 2011, as investment activity continues to recover on the back of projects in the energy sector. Despite stronger-than-expected imports, the trade balance remained strong on account of a slight weakening of the krona and high commodity prices which kept exports high. Unemployment has declined on a year-on-year basis. The recent rise in commodity prices led to a moderate rise in inflation and inflation expectations in the first quarter of 2011.

2. **The Icesave dispute remains unresolved**. The Icesave agreement was passed by a substantial majority in parliament in February, but rejected in a referendum on April 9. The dispute will now be settled through legal channels (see Section III.F for a discussion of litigation risks).

3. **The exchange rate has remained broadly stable** (Figure 2). The trade-weighted krona depreciated modestly since mid-January because of seasonal fluctuations in the balance of payments, as well as tighter foreign currency positions after the CBI purchased €160 million from banks to reduce their foreign currency imbalances. The CBI has continued its regular weekly foreign exchange purchases (€1.5 million per week). Iceland's CDS spreads have remained around 240 bps.

4. **Financial and capital markets have remained stable, although there has been limited activity outside public and publicly-guaranteed bonds** (Table 2; Figure 3). Given the capital controls, the latter have been the main investment instrument for pension funds and—together with bank deposits—for offshore krona holders locked in by capital controls. This demand has kept yields low, despite the outcome of the Icesave referendum and the threat of sovereign downgrades. Short-term interbank rates and bank lending rates are at historic lows, but credit has remained stagnant as household and corporate deleveraging continues. Corporate bond and equity markets are dormant, although new stock offerings have attracted considerable interest. Iceland recently completed another partial buyback of its Eurobonds falling due in 2011 and 2012, reducing the amount outstanding from €800 million to about €450 million.

5. **Public and external debt ratios have been revised down relative to the last review**. The revisions reflect the fact that the Icesave dispute will not be settled through negotiation, as previously assumed, but through legal channels (Box 1). For gross and net general government debt, the estimated ratios at end-2010 remain broadly unchanged

because the downward revision of the deficit was offset by the lower-than-expected 2010 GDP outturn. Gross external debt estimates for 2010 have been revised down to around 290 percent of GDP, reflecting the revised treatment of the Icesave liability, while net external debt is estimated at around 170 percent of GDP.

Box 1. Treatment of the Icesave Dispute in the Fiscal and External Accounts

The treatment of the Icesave dispute has implications for the fiscal accounts and public debt, as well as the external accounts and external debt.

Previous staff reports included estimates of Icesave-related payments which the government had agreed to making in the context of a negotiated solution with the United Kingdom and the Netherlands. More specifically, the overall fiscal balance included estimates of Icesave interest payments associated with the the government's guarantee of the loan to Iceland's deposit insurance agency and public debt included the net present value of government's estimated costs (interest and principal) under the guarantee, based on the terms of the latest available agreement. The external accounts included the Icesave liability as an external loan from the UK and Dutch governments to Iceland's deposit insurance agency.

Since all sides now agree that the dispute will be settled through legal channels, the potential sovereign obligation is now a *contingent* liability of the Icelandic government.

- For this reason, Icesave-related sums are no longer included in the baseline public debt and fiscal deficit figures. Instead, the contingent liability (and a range of possible terms under which it might be paid) is considered in the public and external debt sustainability analyses (see Appendix I). As a result of this change in treatment, the overall fiscal balance is higher and public debt lower than in previous reports.

- The treatment of Icesave in external debt has also been modified. The estimate of gross external debt is lower than in the last review, reflecting the replacement of the loan to Iceland's deposit insurance agency (associated with a negotiated agreement) with external obligations of the Landsbanki Resolution Committee (associated with asset recovery that will continue to take place). Whereas the loan appeared in external debt immediately, the Resolution Committee obligations accrue *over time* as assets are recovered from Landsbanki's estate.

To facilitate comparability, the table below presents staff's past projections—both including and excluding Icesave payments—and its current projections.

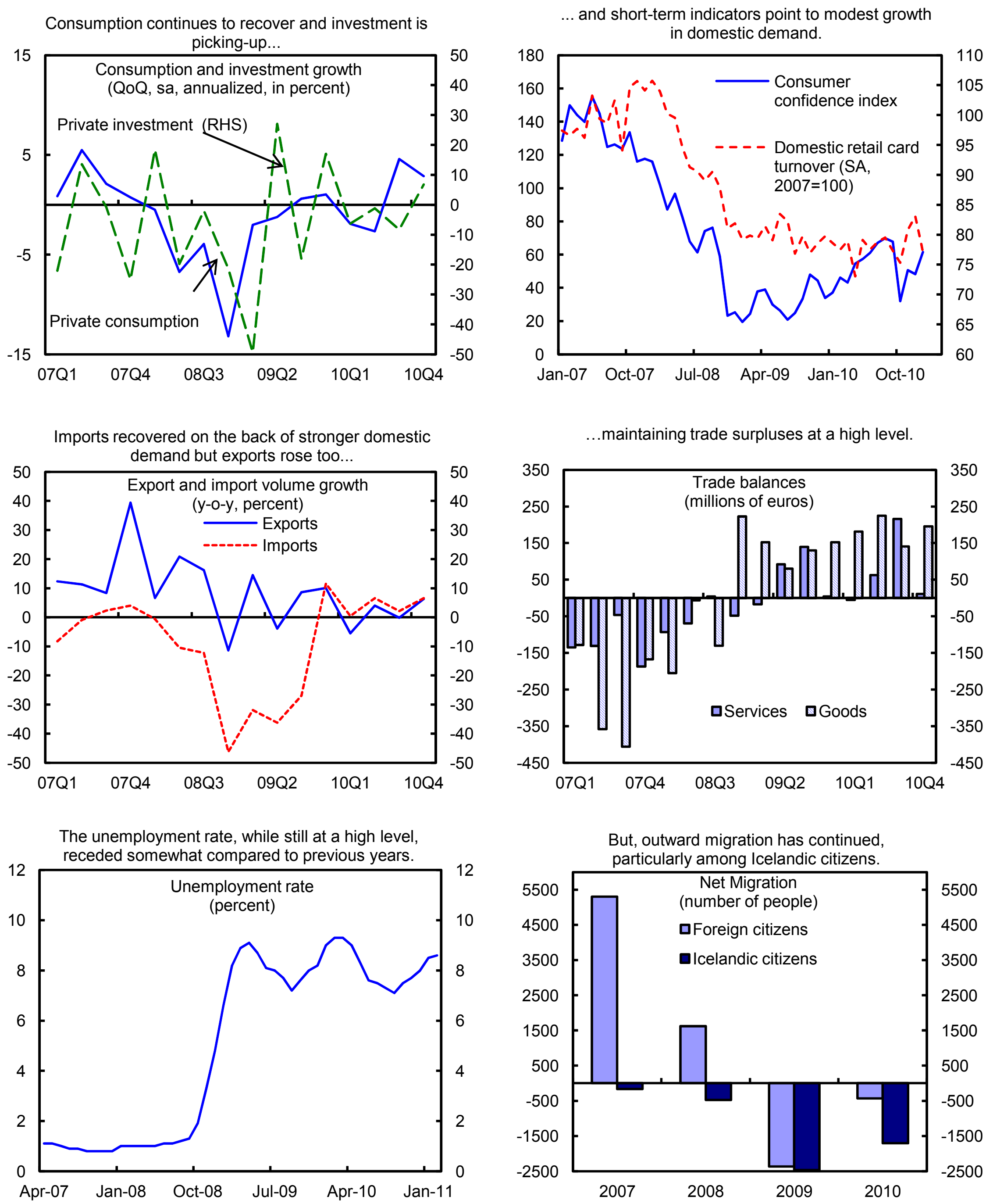
Table. Fiscal and External Sector Projections, 2010-11

(percent of GDP)

	2010			2011		
	4th Rev	4th Rev, Excl. Icesave	Est.	4th Rev	4th Rev, Excl. Icesave	Est.
Overall Balance 1/	-7.1	-5.8	-5.4	-4.9	-3.6	-3.3
Gross Debt	96.3	91.1	92.6	100.5	97.0	100.1
Net Debt	69.0	63.8	63.5	72.0	68.6	66.0
Gross External Debt	333.1	290.2	289.9	267.2	244.2	240.8

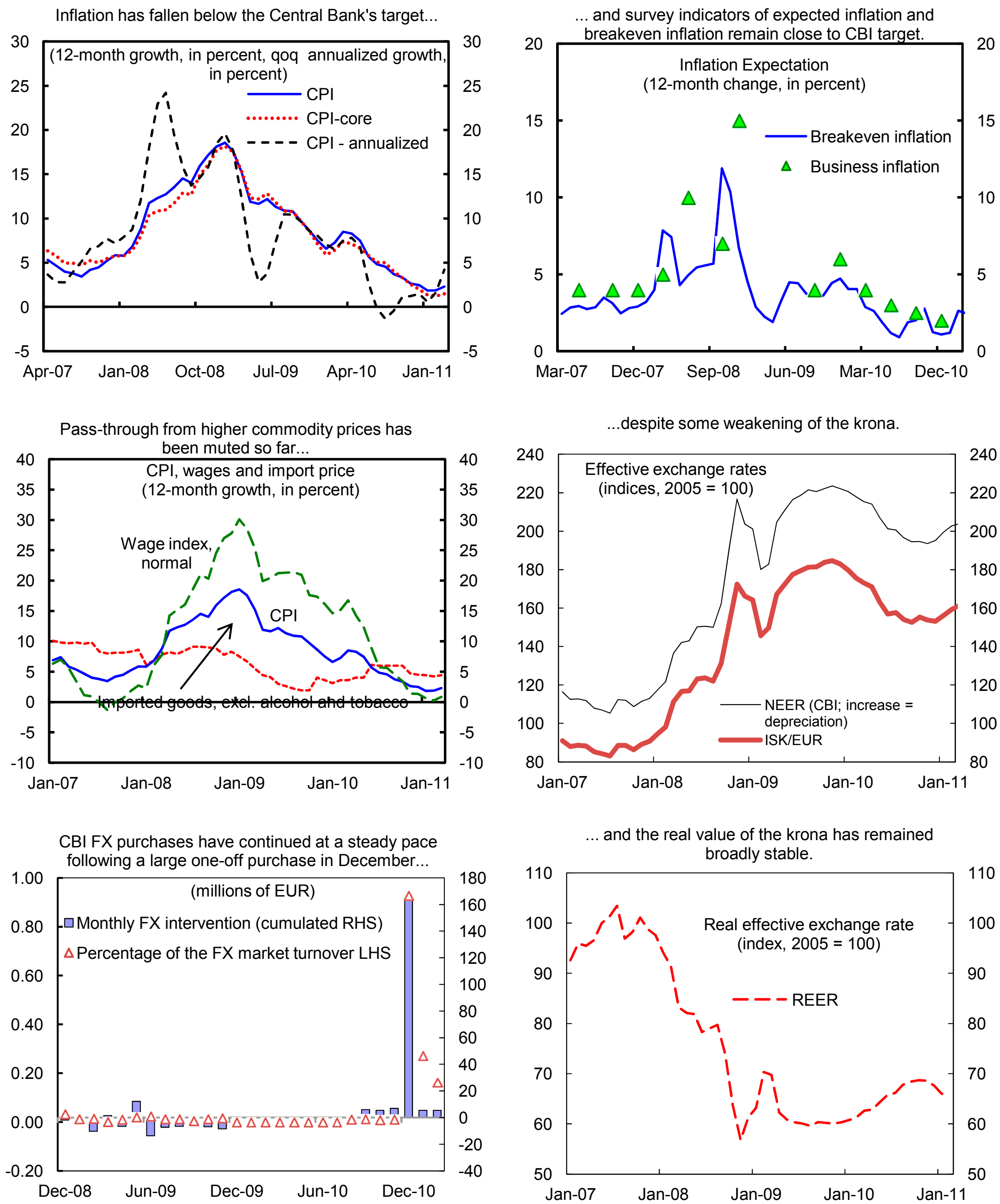
Sources: Ministry of Finance of Iceland, and staff estimates.
1/ Excluding write-offs and road construction projects

Figure 1. Iceland: Recent Developments in Demand and Labor.



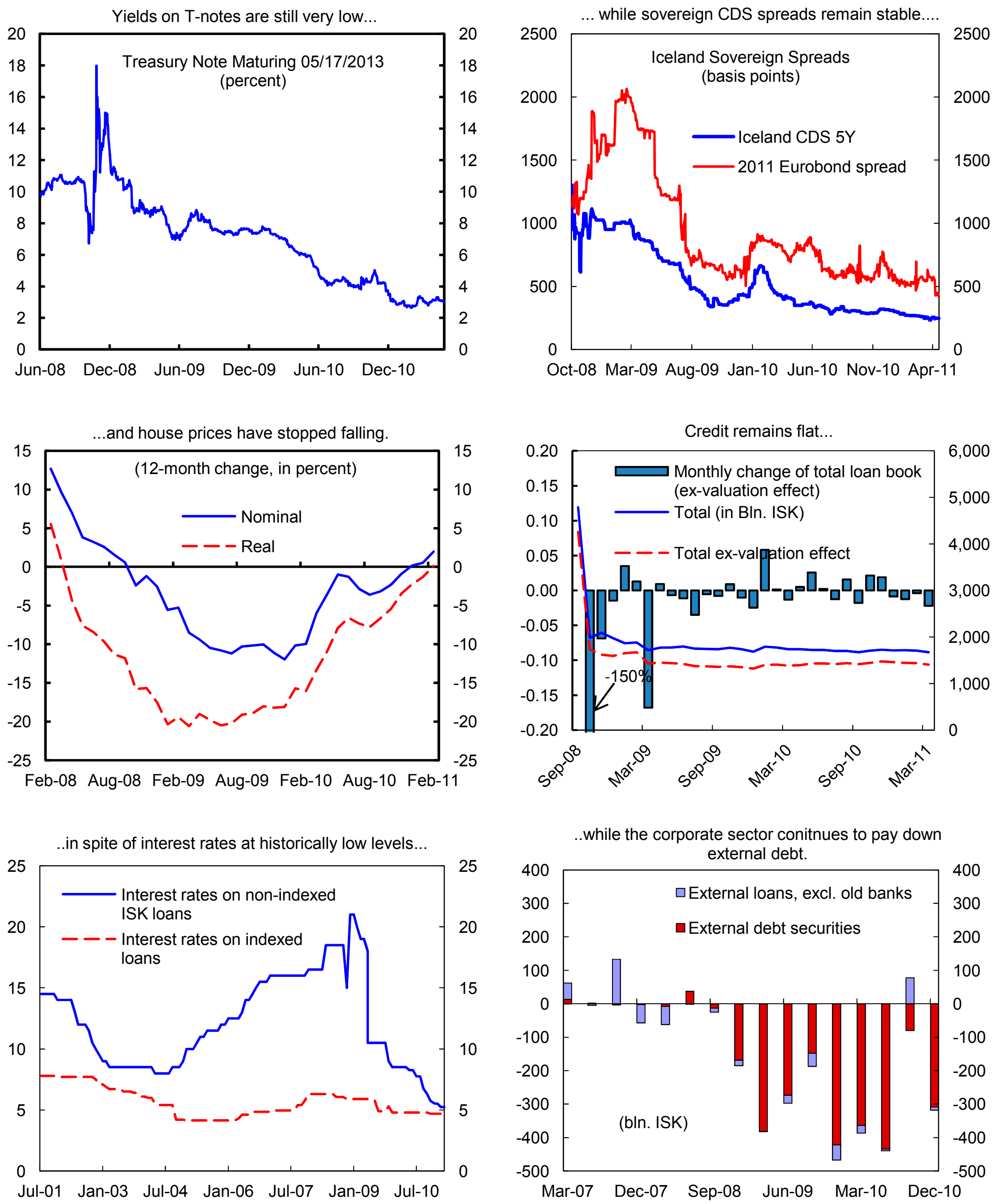
Sources: Statistics Iceland; Bloomberg; and IMF staff calculations.

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.

II. Outlook

6. **The recovery is set to continue in 2011 but risks to the outlook have increased.**

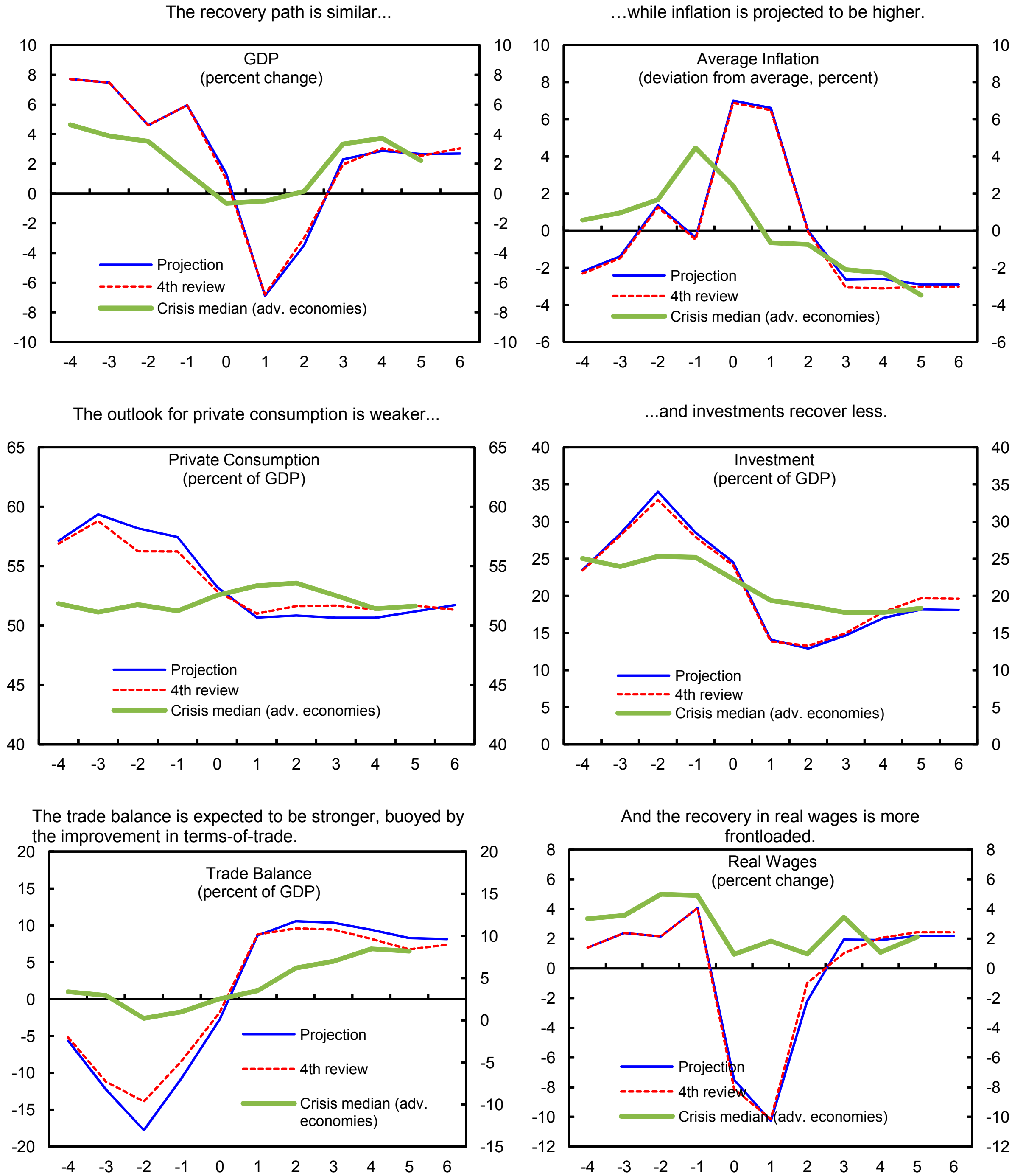
- Growth in 2011 is projected to be 2¼ percent—slightly higher than at the time of the fourth review, but largely reflecting the lower base in 2010 (Table 3; Figure 4). The expansion is still expected to be largely driven by investment, with new investments in energy-intensive sectors offsetting scaled-down plans for road construction. Exports are also projected to be stronger, reflecting better prospects for marine products and tourism. Private consumption is set to recover gradually, receiving a boost from the projected increase in real wages (including strong increases in the tradable sector). Risks to growth are mainly on the downside, and stem from delays in investment projects, slower-than-expected progress in addressing the private sector debt overhang, shocks to external demand and commodity prices, and a possible deterioration in the investment climate. Unemployment is projected to decline as previously expected, helped by active labor market policies (Box 2).

- Headline inflation is projected to be slightly above the central bank's target of 2½ percent in 2011, mainly reflecting the impact of higher commodity prices. The slack in the economy and the broadly stable krona are expected to dampen inflation pressures over time. But risks to the inflation outlook have tilted to the upside: the likelihood of higher imports prices (mainly from higher food and fuel prices and possible exchange rate weakening associated with capital account liberalization measures) has increased and inflation expectations are on the rise. While the three-year wage agreement between the social partners has mitigated risks of very large wage increases in export sectors spreading to nontradables sectors, inflation risks are still heightened as it may be difficult for the nontradable sectors to accommodate even the agreed wage increases in profit margins.[1]

- In 2011, the balance of payments is expected to be supported by a strong underlying current account surplus, the planned resumption of sovereign external borrowing, the realization of program financing, and disbursements from bilateral partners. With gradual steps towards capital account liberalization expected to be financed largely by new capital inflows in 2011, reserves are projected to increase to around $6¼ billion at end-2011.

[1] Agreed wage increases will equal 4.25 percent in 2011, 3.5 percent in 2012, and 3.25 percent in 2013. Low-income earners will receive larger increases.

Figure 4. Iceland: Macroeconomic Outlook Compared to the Fourth Review and Other Crisis Cases



Sources: Program documents and staff projections.
Notes: Crisis year = 0. Advanced crisis countries include Finland, Norway, Sweden and Spain.
Dates of the crisis defined as in Laeven and Valencia (2008) (2008 for Iceland).

Box 2. Tackling Unemployment in Iceland

In the wake of the crisis, Iceland saw an unprecedented increase in unemployment (Figure 5). Job losses were concentrated in the construction sector, which experienced a swift reversal from the pre-crisis housing and investment boom. The official unemployment rate understates the severity of the downturn: outward migration, a rise in part-time employment, and a decrease in the participation rate (including through re-entering educational system) have dampened the rise in the official rate. Nonetheless, unemployment is still at its highest level in recent history, and its structure has become more problematic: unemployment among youth and low-skilled workers is significantly higher than for other groups, and duration is on the rise. The abundance of well-paid unskilled jobs before the crisis led many young people to bypass higher education and enter the labor market at a relatively early age. The result is significant youth unemployment and skill mismatches that require retraining and education.

The authorities' response evolved over time as needs changed.

- In the immediate wake of the crisis, the uptake of existing services was limited by a lack of information about the available services and by stigma, both related to a recent history of near-full employment. Thus, in 2009, the Directorate of Labor focused on expanding registration for unemployment benefits and educating the public about available options.

- As the crisis wore on, the focus shifted to improving services for active job seekers. In late 2009, programs aimed at dealing with youth and long-term unemployment—already recognized as key problems—were introduced and continue to be implemented. These included job retraining, subsidized hiring for trial periods, study programs, subsidized hiring, and volunteer work.

- Additional efforts will be made in 2011. To improve the availability and targeting of education, secondary schools will be opened to anyone under 25 years of age. There will also be increased emphasis on work-related education, and greater cooperation between social partners and the education system.

The authorities' labor market programs have achieved a number of successes. The number of participants surged in 2010 and, while success rates vary, programs providing on-the-job training/apprenticeships or employment in specific projects seem to have increased chances of participants "de-listing" from the unemployment rolls (Table). Although data on the labor market status of de-listed participants are limited, information collected by the Directorate of Labor suggests that about half of unemployed youth found jobs after participating in the programs.

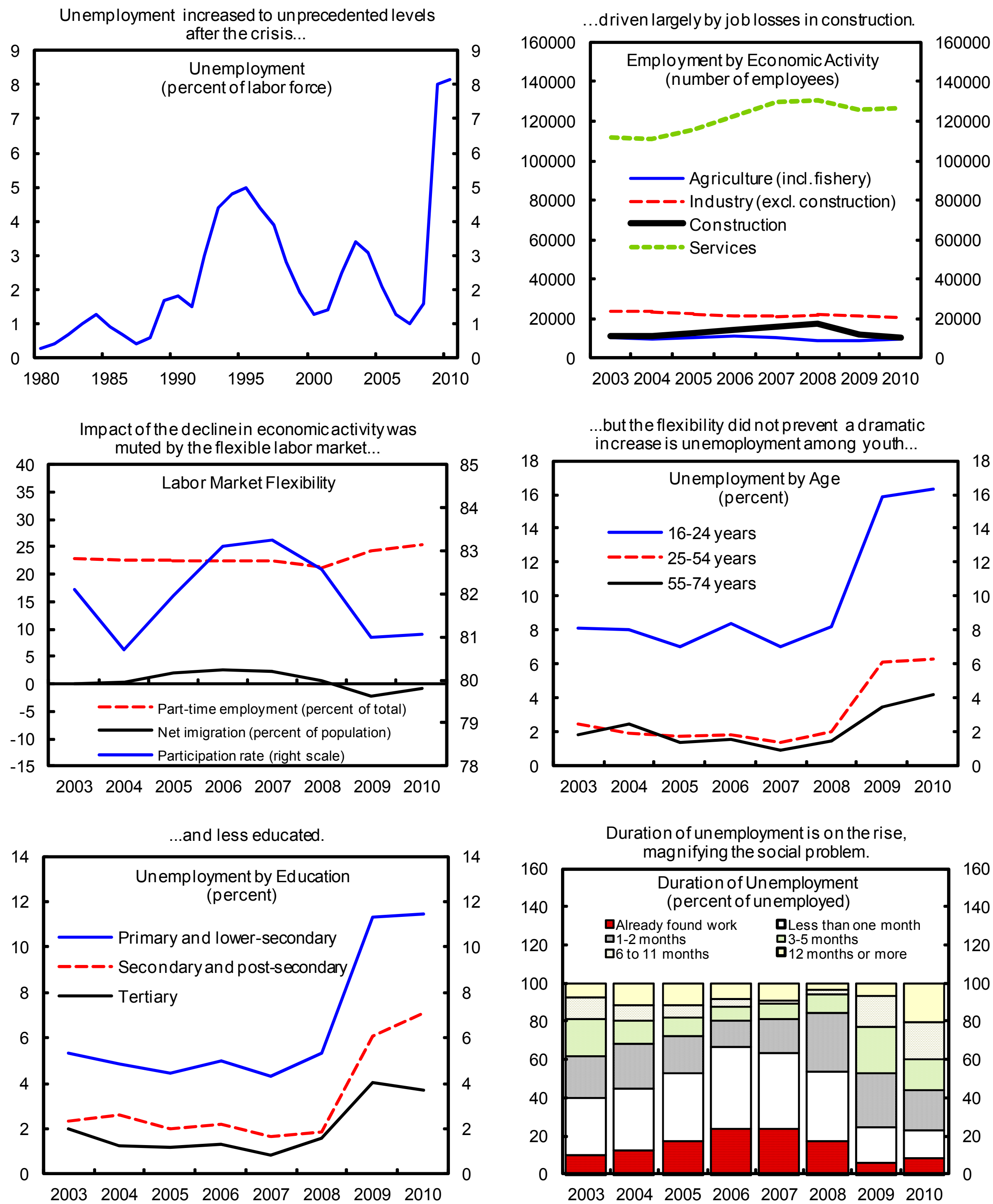
Active labor market measures

	2009	(Jan-Nov)	Delisted from unemployment 3 months after
	(number of persons)		(percent, in 2010)
Basic measures and courses 1/	3712	7806	20-25%
Workshops and recreational clubs	349	1307	30%
Apprenticeships and on-the job training	1883	2023	45-50%
Innovational projects 2/	149	256	60%
Total	**6324**	**12292**	-
Memo item: average number of unemployed	*13075*	*13833*	

1/ Skill, job search, and other development courses, interest area evaluation, and financial consultations.
2/ Basic unemployment benefits may be used to subsidise hirings in companies undertaking innovation projects (evaluated by the Directorate of Labour and Innovation Center Iceland).

Source: Directorate of Labor and Statistics Iceland

Figure 5. Iceland: Labor Market Developments.



Source: Statistics Iceland.

7. **The baseline medium-term balance of payments assumes that capital controls are gradually liberalized, in line with the authorities' strategy** (Table 4). The lifting of controls is assumed to take place in an orderly fashion. Some additional sovereign borrowing in international capital markets would help offset outflows. In addition, a combination of monetary tightening and modest exchange rate depreciation is assumed to limit the size of outflows by residents. Thus, gross reserves are expected to decline, but should remain above 90 percent of short-term debt over the medium term. Risks associated with the lifting of capital controls are discussed in Section III.F.

8. **Both public and external debt ratios are expected to decline rapidly over the medium term**. Gross external debt is projected to amount to about 240 percent of GDP at end-2011, but debt repayments, the release of captive nonresident krona holdings during the planned capital account liberalization, and ongoing asset recovery would reduce it to around 150 percent of GDP by 2016. General government debt is expected to peak at 100 percent of GDP in 2011 after the full disbursement of bilateral loans and the planned strengthening of the central government's cash buffer. Larger projected cash buffers would also lead to a more gradual downward path for the debt ratio in the medium term compared to the fourth review.

Table. Public and External Debt Indicators

	2010	2011	2016
	Est.	Proj.	Proj.
General Government Debt			
Gross Debt	92.6	100.1	71.3
of which			
Bilateral loans	7.4	13.9	7.2
Bank restructuring debt 1/	16.2	17.0	13.1
Local government debt	9.2	9.3	8.3
Other government bonds	59.8	59.8	42.8
Liquid Assets 2/	29.0	34.0	29.5
Net Debt	63.5	66.0	41.8
External Debt			
Gross Debt	289.9	240.8	152.9
of which			
Public	53.2	58.9	30.1
CBI	19.3	25.9	6.8
General Government	34.0	33.1	23.3
Private	173.2	147.8	118.5
Banks (excluding old Banks)	14.0	12.2	9.5
Other	159.2	135.5	109.1
Old Banks	63.5	34.1	4.3
Net Debt 3/	168.4	147.6	77.4
Memorandum Item			
Short-term Debt at Remaining Maturity	87.6	65.4	13.3

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

III. Policy Discussions

9. **With key policies for the remainder of the program period largely in place, discussions focused on the revised strategy for lifting capital controls**. Iceland has made significant progress with fiscal consolidation, strengthening the framework for household and corporate debt restructuring, and restructuring the financial sector. In each of these areas, the authorities and staff agreed that existing measures and policies must continue to be implemented and, in some cases, accelerated. The key remaining policy challenge is an orderly lifting of the capital controls. In this context, it was recognized that Iceland faces a particularly difficult task in releasing the sizeable stock of "locked-in" (largely nonresident) offshore krona at a time when risks to the global economy and financial markets are heightened. It was agreed that controls should be lifted gradually and in a manner that allows the timing of each step to adapt to circumstances. The authorities and staff concurred that, given the risks, a comprehensive assessment of the balance of payments outlook would be undertaken before moving to each next major step in the process.

A. Capital Controls

10. **Iceland faces a formidable task in lifting its capital controls** (Figure 6). Offshore krona holdings held captive by the existing capital controls are large (about 30 percent of GDP), and represent a considerable source of potential pressure on the currency and reserves.[2] Thus, an orderly liberalization of capital controls requires that offshore krona holdings be reduced and that the spread between the offshore and onshore exchange rates be narrowed. At the same time, Iceland's EEA obligations require nondiscriminatory treatment of residents and nonresidents, adding an additional layer of complexity to the liberalization process.

11. **The authorities' revised strategy for lifting capital controls is conditions-based and designed to address Iceland-specific challenges** (LOI ¶15; Box 3). It begins with the release of offshore krona holdings and envisages lifting controls in stages, using a variety of liberalization methods. Once offshore krona holdings have been substantially reduced, (largely resident) onshore krona holdings would be released. In this regard, the strategy is appropriately conditions-based (rather than calendar-driven), as the pace of liberalization would be determined by an assessment of whether specific conditions have been met.

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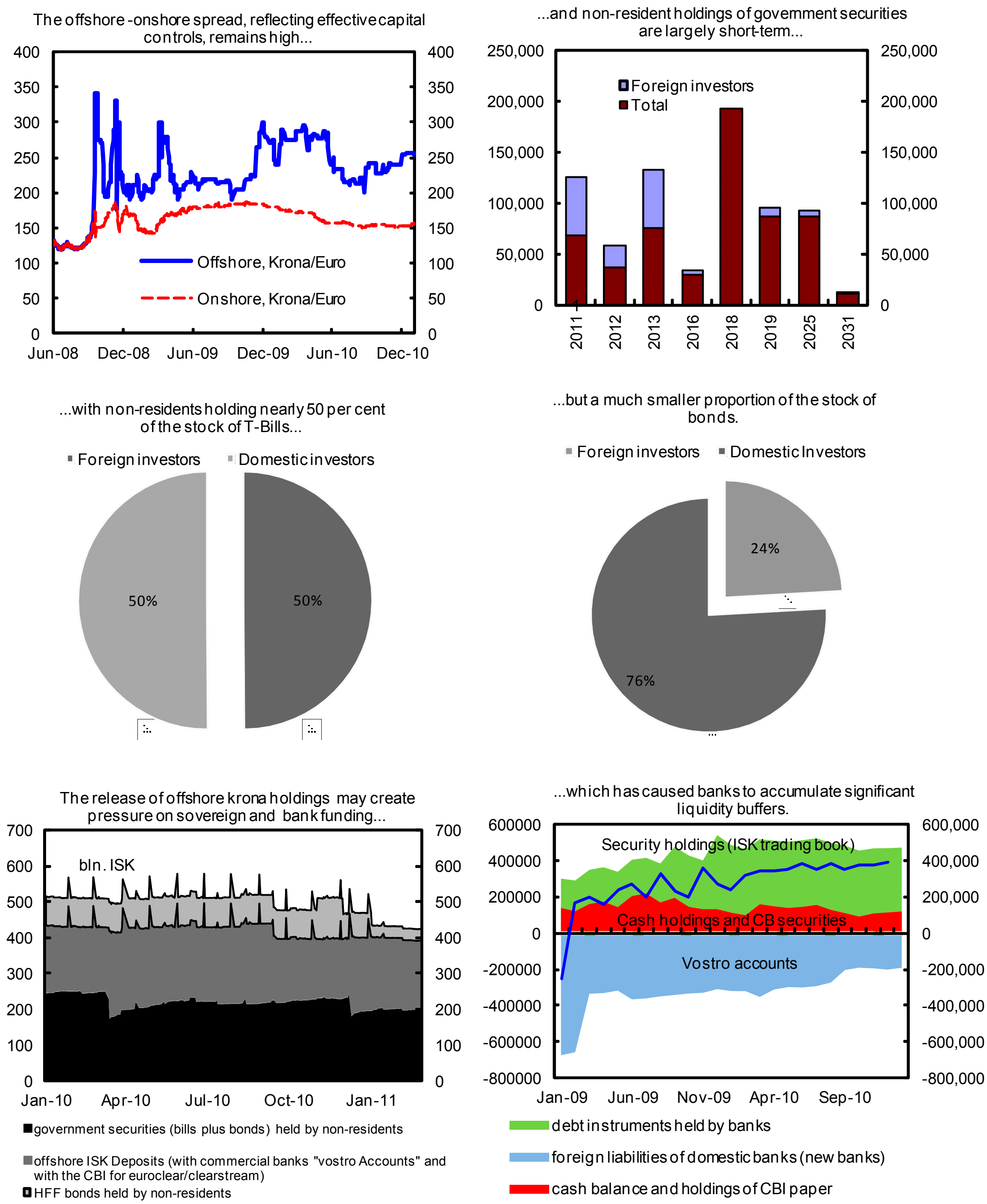
[2] Offshore krona holdings are krona-denominated cash (deposits) or financial assets held in custody of foreign financial institutions by non-residents and residents. The authorities estimate that most of the offshore krona is held by non-residents.

Figure 6. Iceland: Capital Control Liberalization challenges...



Sources: Bloomberg; Central Bank of Iceland; and Datastream.

Box 3. Key Features of Iceland's Revised Strategy for Lifting Capital Controls

Capital controls, which were imposed in November 2008, have helped stabilize the exchange rate, permitted an easing of monetary policy, and reduced sovereign borrowing costs at a time of great uncertainty and financial stress. Nonetheless, in view of their distorting impact and their effect on the business climate, the authorities intend to lift controls as soon as conditions permit.

The authorities have prepared a strategy that is gradual, conditions-based, and involves liberalizing (largely non-resident) offshore krona before (largely resident) onshore krona. A fundamental premise of the overall strategy is that releasing offshore krona will support the lifting controls on onshore krona by narrowing the gap between the offshore and onshore exchange rates and allaying concerns that nonresident outflows could lead to a significant depreciation. Elements of the strategy aim to limit the near-term impact on reserves and government financing while encouraging FDI.

The First Phase: Release of Offshore Krona Holdings

"Tying up" offshore krona. The first step in the strategy aims to move offshore krona holdings (which are currently confined to repoable securities and deposits, and invested largely at the short end) into longer-term investments. Offshore krona holders will be permitted to sell their positions at a discount, while investors willing to take longer-term krona positions or to make qualifying longer-term investments will be permitted to purchase krona at a discount. One method will be auctions in which residents (notably pension funds) holding foreign assets will be allowed to buy krona at CBI-organized auctions for investment in long-term (non-marketable) government securities that will be held in closed-end funds for five years. A second method involves allowing investors to purchase offshore krona at CBI-organized auctions or use their own offshore krona to finance long-term investment. Investments would be structured into closed-end funds (with a five year lock-up period) that would serve as monitoring devices to prevent circumvention. Parties will have to commit to provide 50 percent of their investment in foreign currency to offset the outflows related to the import component of investment projects. Since the government bond market could lose funding when wider investment opportunities become available, the strategy conditions these steps on a robust budget financing framework with a large cash buffer, an extended maturity profile and, preferably, renewed access to international capital markets. To minimize the reserve impact, the auctioned amounts are to be limited and set commensurately with new foreign exchange inflow by long-term investors.

Release of remaining offshore krona. The strategy also aims to release offshore krona that is not "tied up" by the above methods. The release would be effected by: (i) small-scale auctions of foreign currency; (ii) conversions of short term krona-denominated government securities into long-term Eurobonds; and (iii) allowing offshore krona holders who did not take advantage of the other options to sell their krona on payment of an "exit levy". The stipulated preconditions for these steps include government access to international capital markets, sufficient banking sector liquidity to withstand the withdrawal of offshore krona, and adequate reserves.

The Second Phase: Lifting Controls on Onshore Krona Holdings

The strategy does not provide details on how onshore krona would be released, as the authorities believe that the specific methods can be developed over time as the release of offshore krona proceeds. However, the strategy clearly indicates that the release of onshore krona will only begin after a comprehensive assessment of Iceland's medium-term macroeconomic and balance of payments prospects is undertaken. Moreover, it specifies preconditions for the release of onshore krona. These include: (i) a sufficiently strong medium-term balance of payments outlook; (ii) international capital market access for the public sector and financial institutions; (iii) an assessment that the financial sector is able to withstand volatile capital flows; (iv) a significant reduction in non-residents' krona holdings and other highly liquid positions; (v) substantial convergence of the offshore and onshore exchange rates; and (vi) stronger prudential rules. The strategy also states that the post-capital controls monetary framework should be defined before controls on onshore krona holders can be lifted.

12. **The authorities and staff agreed that liberalization should proceed gradually, as preconditions are met** (LOI ¶16). Progress in meeting the preconditions for liberalization has been made in a number of areas: public finances have been put on a sustainable path, the banking sector has been strengthened, and international reserves have risen. At the same time, sovereign access to international capital markets (which would boost international reserves and provide an alternative source of financing for the government) has not yet been achieved and the banking system remains vulnerable to both liquidity and balance sheet shocks. Because there is significant uncertainty about when the preconditions for the full lifting of controls will be met, the authorities are seeking an extension of the legislation on capital controls until end-2015.

13. **The pace of liberalization will be calibrated to safeguard macroeconomic and financial stability**. The authorities and staff agreed that it would be critical to avoid disruptions to the government bond market, the balance of payments, and the banking system as controls are lifted (LOI ¶16). The authorities emphasized that they intend to carefully calibrate the pace of liberalization to external, market, and financial conditions, and that they were prepared to slow (or stop) the pace of liberalization, if needed. In particular, to the extent that the outcome of the Icesave referendum leads to sovereign downgrades and reduces Iceland's access to international capital markets in the coming years, the pace of liberalization would need to be slowed. Recognizing the significant challenges involved, the authorities and staff agreed that a comprehensive assessment of macroeconomic conditions, financial stability, and the adequacy of reserves would be undertaken before each major step in the liberalization process. It was also agreed that strict enforcement of the controls during the liberalization process would be critical. In this regard, staff strongly urged the authorities to ensure that the CBI has sufficient flexibility to quickly respond to leakages that may emerge during the liberalization process, including by ensuring that such flexibility is retained in new legislation on capital controls.

B. Monetary Policy

14. **It was agreed that monetary policy should remain focused on achieving stable inflation and preserving exchange rate stability** (Figures 7 and 8; LOI ¶18 and 19). With inflation expected to be slightly above target and nominal interest rates close to historically low levels, monetary policy has shifted to a neutral bias and policy rates have been kept unchanged in the last two meetings. It was agreed that the stance was appropriate in light of the forthcoming first steps toward lifting capital controls, the uptick in inflation expectations, and the decline in real policy interest rates. The authorities and staff concurred that the MPC would need to remain vigilant in the face of increasing risks to the inflation target.

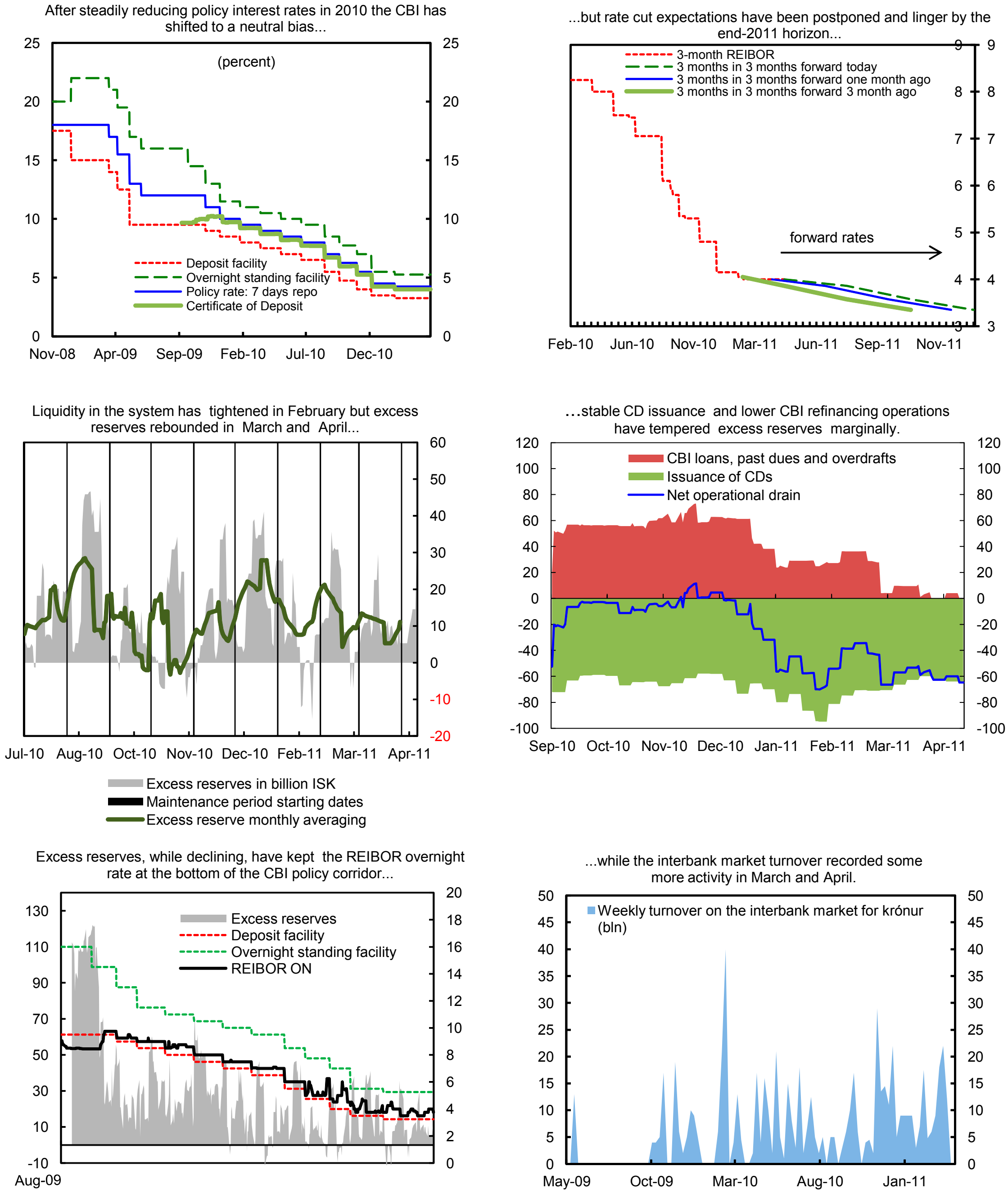
15. **The authorities and staff concurred on the need to improve liquidity management in the coming months (**LOI ¶19**)**. Staff stressed that liquidity management will become increasingly important as capital controls are lifted. Ample liquidity conditions have kept short-term interest rates at the bottom of the CBI's policy corridor. To help

maintain interbank rates around the center of the policy corridor, the authorities intend to improve management of the stock of CDs, strengthen their liquidity forecasting capabilities, and, if needed, to engage in high frequency fine-tuning operations. In addition, it was recognized that the CBI may need to provide liquidity through exceptional operations as capital controls are lifted. In anticipation of this, the CBI has undertaken an evaluation of the availability and distribution of eligible collateral, and, jointly with the FME, an assessment of the banking system's resilience to liquidity shocks.

16. **The authorities reiterated their intention to purchase foreign exchange to increase non-borrowed reserves**. Weekly purchase operations will be scaled up to help meet this goal when conditions permit (LOI ¶20). To ensure that reserves remain sufficient to ensure confidence in the krona during the process of capital controls liberalization, the authorities and staff agreed to use a range of indicators to monitor reserve adequacy.

17. **Work on the contours of a post-program monetary policy framework is underway (**LOI ¶21). The financial crisis has exposed the difficulties of implementing monetary policy in a small open economy like Iceland that is subject to large shocks and volatile capital flows. Because of the risks to financial stability, a strategic foreign exchange intervention and reserve management policy could prove useful in managing large capital flows, while also boosting Iceland's reserves. The authorities underscored that the use of macroprudential tools to help avoid a repeat of the pre-crisis excesses will also be considered. They acknowledged that better coordination of monetary and fiscal policies, and improved institutional arrangements between monetary and supervisory authorities, will be critical to deal with potential challenges to financial stability. Staff stressed that these were areas of weakness that had been exposed by the crisis, and that additional efforts were needed to foster better coordination, particularly if the new monetary framework involved multiple objectives and multiple tools. The authorities are consulting with stakeholders to assess the relative merits of different monetary regimes, including in the context of EU membership discussions. The authorities and staff agreed to continue discussions on the new monetary framework in future missions.

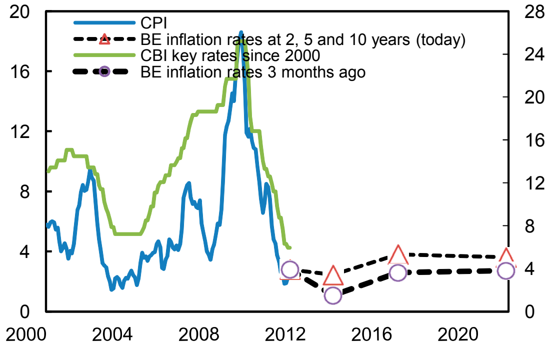
Figure 7. Monetary Policy Operations and Liquidity Management



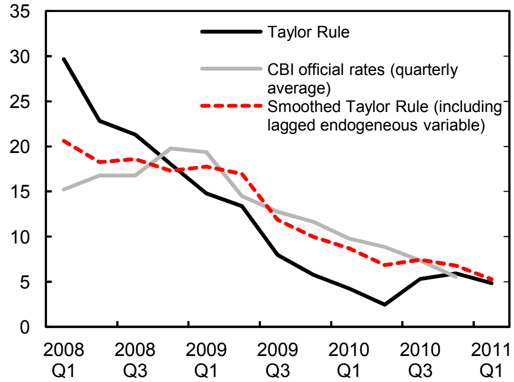
Sources: Central Bank of Iceland; Datastream; and IMF staff calculations.

Figure 8. Iceland: Indicators of Monetary Stance

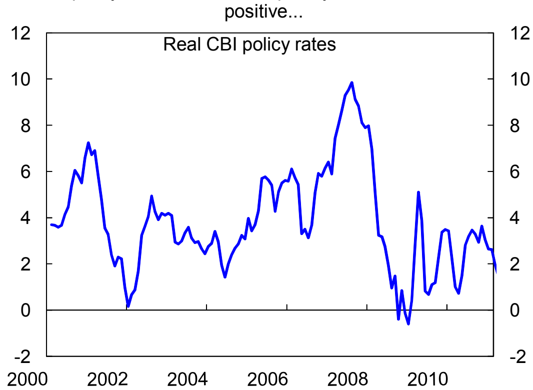
The CBI has shifted its policy bias to neutral, while inflation expectations have bounced back above its 2½% target.



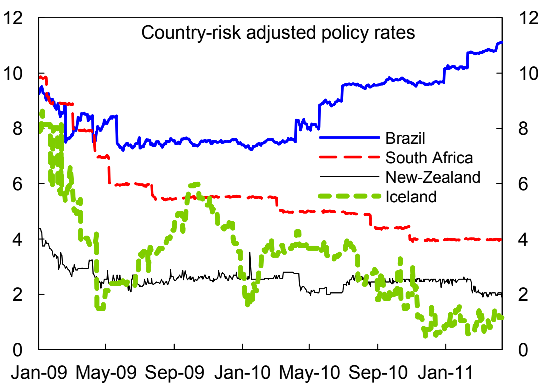
Policy rates are now converging towards a Taylor-based monetary policy rule and a neutral stance.



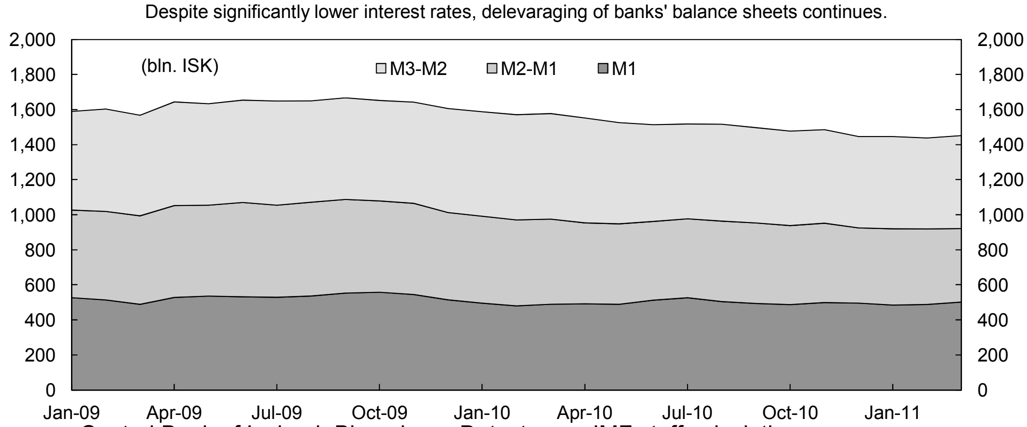
Real policy rates have subsequently declined but remain positive...



...while risk-adjusted policy rates are low.



Despite significantly lower interest rates, delevaraging of banks' balance sheets continues.



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

C. Fiscal Policy

18. **The 2010 fiscal target was met with a small margin** (Tables 5 and 6; Figure 9). On the revenue side, corporate and capital income tax receipts exceeded expectations on account of the conservative projections embedded in the program. Moreover, expenditures were below target at the central government level (¼ percent of GDP), primarily as a result of the more appreciated krona. Thus, despite slippages in local governments' fiscal performance (the primary deficit was ¾ percent of GDP compared with an expected zero), the general government primary deficit of 2½ percent of GDP was within the 2010 target (2¾ percent of GDP), and the overall balance improved by ¼ percent of GDP relative to the fourth review.

19. **The 2011 budget is being implemented, but risks arise from the recent wage agreements**. In the first quarter, revenues and expenditures remained broadly in line with expectations. The authorities intend to levy a special tax on financial institutions to finance the temporary interest subsidy associated with the household debt restructuring measures agreed in December 2010. The general government primary surplus target of ¼ percent of GDP is, therefore, achievable and would deliver an improvement of some 2¾ percent of GDP relative to 2010. However, risks arise from the new 3-year wage agreement, which is expected to increase expenditures by about ½ percent of GDP in 2011. These risks are mitigated by higher expected personal income tax collections and the authorities' willingness to use the contingency fund, whose purpose is to ensure that unexpected price and wage fluctuations do not undermine budget implementation, to ensure that the fiscal target is met. (LOI ¶9). Further slippages of the local governments' primary balance position also pose a risk to the 2011 outcome.

20. **The authorities and staff agreed that improvements to the fiscal framework for local governments were essential** (LOI ¶11). The new framework for local government finances—which requires three-year budgeting with a rolling three-year balanced budget, strict limits on municipal borrowing, and a three-tier system for monitoring municipal finances—was presented to parliament in April (Table 8). Passage of the legislation is expected by June, which will ensure that the framework is made operational for the 2012 budget cycle. The authorities reiterated their commitment to monitoring the financial situation of the local governments, including through the introduction of a new data system for compiling information on the sources and uses of cash on monthly basis. Staff expressed concern about the slippages in local government fiscal performance in 2010 and the recently-announced financial problems at a local-government-owned enterprise, and urged the authorities to begin implementing the new local government framework and monthly cash monitoring as soon as possible.[3]

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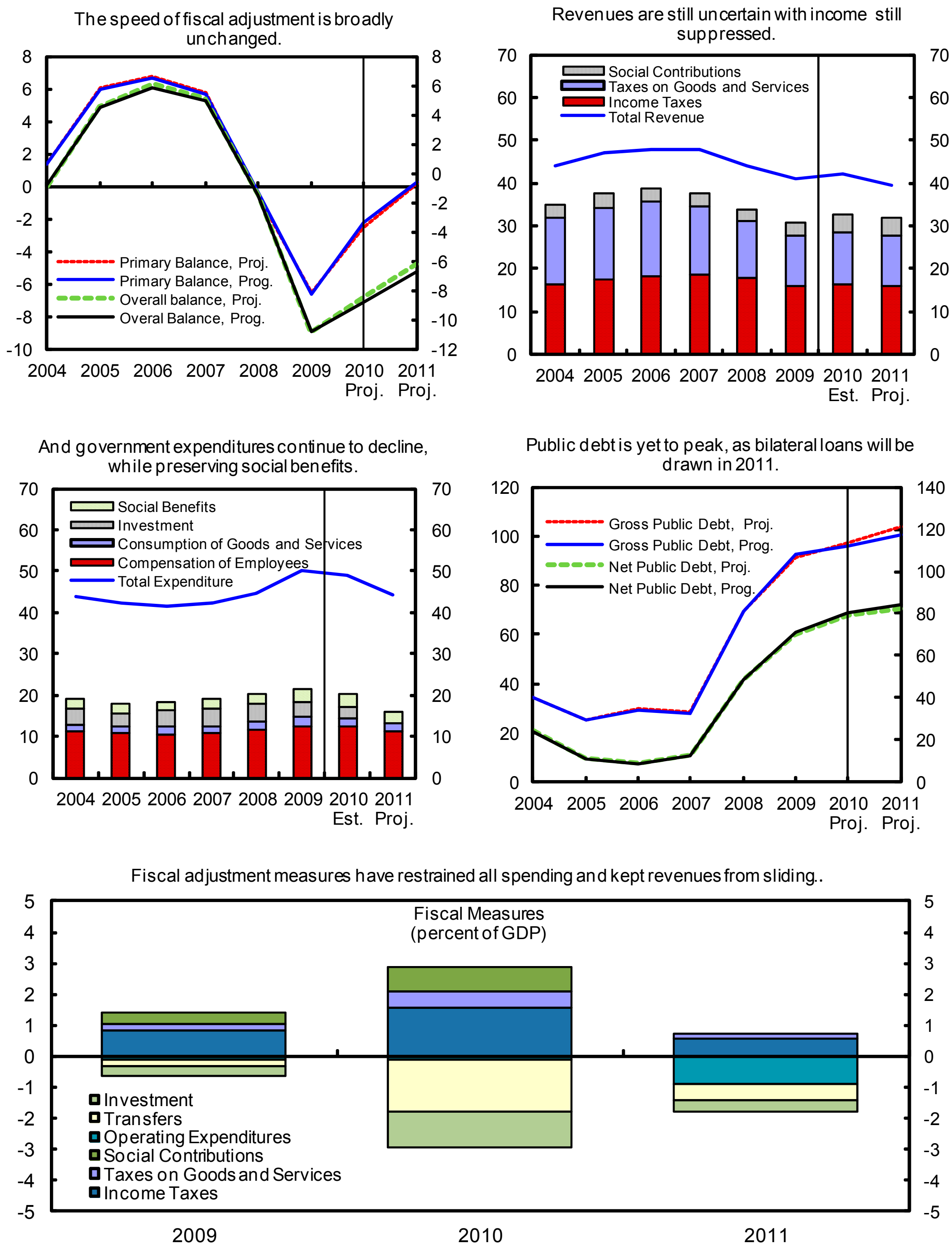
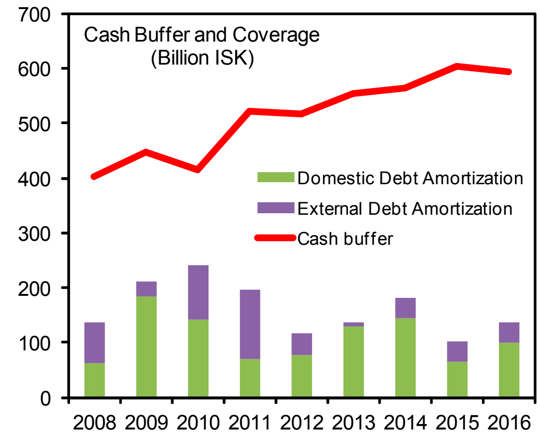
[3] The enterprise in question will receive a long-term loan from its local-government owners in the amount of ISK 12 billion (¾ percent of GDP) and will be required to take measures to strengthen its financial position.

Figure 9. Iceland: Fiscal Performance
(Percent of GDP)



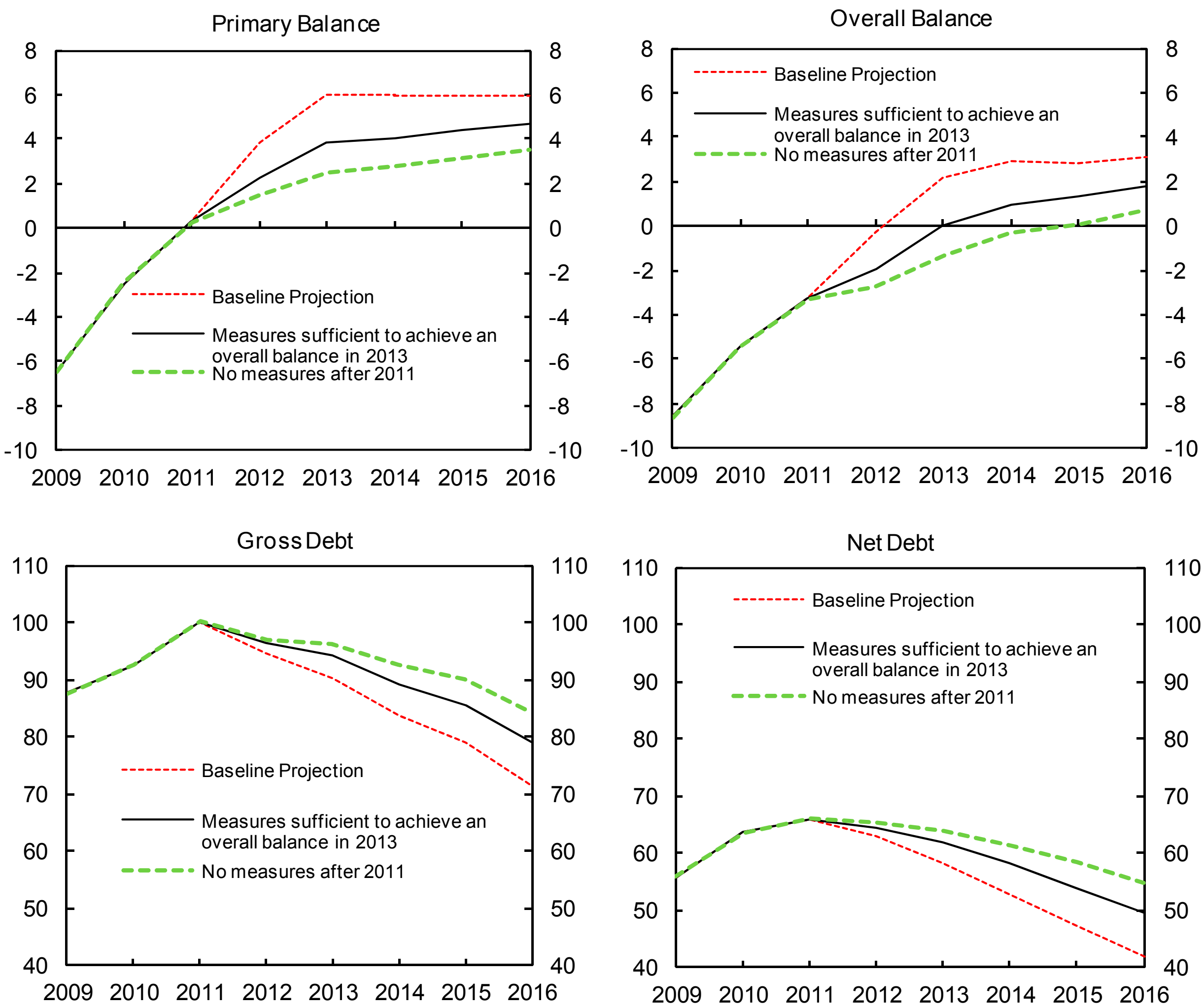
Sources: Ministry of Finance of Iceland; and IMF staff estimates.

21. **Publication of the medium-term debt management strategy marks an important milestone in Iceland's efforts to regain international market access** (LOI ¶12). The strategy, which was published in early February, was received positively by market participants. It lays out the authorities' 2011–14 borrowing strategy and plans for accessing the international capital markets in the coming months. The authorities have also taken steps to secure long-term funding, including through the issuance of a 20-year nominal bond on favorable terms and plans to float additional long-term bonds in line with the revised strategy for capital account liberalization. The recent buyback operation will smooth debt service payments over the next year and modestly reduce interest costs. Recognizing the potential drain on government financing as capital controls are gradually lifted, the authorities have also built up substantial cash buffers which will be drawn down as needed to smooth financing costs.



22. **The authorities and staff agreed to keep Iceland's medium-term fiscal targets under review (**LOI ¶10**)**. The authorities have begun updating their medium-term consolidation plan: the update would take into account changes in the economic environment, the agreement with social partners in the context of the wage round, a revised set of fiscal measures, and the significant progress made to date with fiscal consolidation. The authorities underscored their commitment to reaching an overall surplus in 2013—this commitment was reiterated in their declaration accompanying the wage agreements, which also noted their willingness to work with social partners to achieve this goal. Nonetheless, they acknowledged that this had become more difficult in light of the additional government spending on investment and social protection (including active labor market and education policies) entailed in the new wage agreements. Preliminary estimates suggest that the impact on the primary balance could amount to around 1 percent of GDP per year over 2012–13. Sensitivity analysis suggests that, even with reduced fiscal consolidation measures in 2012–13, public debt would remain on a declining debt path with gross public debt falling below 85 percent of GDP in 2016 (Figure 10). It was agreed that specific fiscal adjustment measures for 2012 and the medium-term fiscal path would be discussed during the next review, in the context of the authorities' planned revisions.

Figure 10. Medium Term Scenarios
(Percent of GDP)



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

D. Financial Sector Policies

23. **Reported bank capitalization remains high, but staff and the authorities agreed that close monitoring was needed to reduce risks of optimistic accounting of asset recovery**. The commercial banks' reported capitalization is above 12 percent of core tier 1 capital (Table 9, LOI ¶22). To ensure that bank capital is reported in a sufficiently prudent way, the FME is currently assessing bank soundness, including the treatment of restructured loans, through its annual Internal Capital Adequacy Assessment Process (ICAAP) exercise. Given the importance of the ICAAP exercise for the health and credibility of the banking system, staff recommended that these assessments should be made more frequently (at least semi-annually) and that banks should prepare stress tests on the basis of macroeconomic scenarios designed by the authorities (which should ultimately be aligned with those used by the European Banking Authority exercise). Staff urged that results of stress tests be made public.

24. **Progress has been made in the recapitalization of the rest of the financial system, but some work remains to be done** (LOI ¶22 and 24). While efforts to complete their recapitalization are underway, a group of savings banks and nonbanks are yet to be fully recapitalized.

- Recapitalization of the savings banks is advancing. Most of the remaining savings banks are in the process of completing their restructuring. Byr's recapitalization is expected to be completed once its 2010 financial statements are finalized. The authorities and staff agreed that the recent merger of SpKef with a commercial bank has resulted in significant consolidation of the savings banks. The next step will involve restructuring the remaining small, largely private savings banks. A working group has been tasked with this work, and its report is expected by end-May. It was agreed that this, alongside SpKef's merger, had met the objective of the end-March **structural benchmark** on a plan to ensure viability of the savings banks.

- In March, the Housing Finance Fund (HFF) received tradable government securities worth ISK 33 billion to bring its capital to about 2 percent of risk-weighted assets. While this is an important step towards enhancing the financial position of HFF, staff urged the authorities to complete the ongoing assessment of HFF's asset quality and, on that basis, to promptly restore its capitalization to at least 5 percent of risk-weighted assets (its pre-crisis level). Staff recommended that, in time, HFF be subject to similar capital requirements as other financial institutions to ensure a level field playing and reduce risks of overly rapid asset growth (the latter could create contingent liabilities for the public sector). Looking forward, the authorities intend to prepare by September a plan on the future structure of HFF, including on how to address its social objectives and what capitalization would be appropriate.

- Leasing and credit card management companies have been restructured without public support. A small commercial bank (3 percent of system assets) was restructured with private capital and without the use of public funds.

25. **The authorities and staff agreed that further progress is needed to address remaining vulnerabilities of the banking system (**LOI ¶23**)**. While banks carry non-performing loans (about 45 percent of total loans) at about half of their nominal value, implying high level of buffers to offset potential losses, there is an elevated risk that delays in debt restructuring will affect asset recovery. Thus, there is an urgent need to bring loans into performing status as soon as possible through effective and speedy workout procedures. In this regard, staff welcomed the new measures for household and corporate debt restructuring and urged their rapid implementation. Other vulnerabilities arise from banks funding (deposits are highly concentrated and largely short-term) and financial gaps (banks' long position in CPI indexed krona will increase).

26. **The authorities are committed to enhancing the legal and regulatory framework** (LOI¶25). The authorities and staff agreed on the need to bring to completion the ongoing regulatory reforms aimed at addressing loopholes that led into the banking crisis, ensuring proper bank reporting, and further improving supervision.

- Tools to closely monitor credit concentration are being put in place, but changes in bank legislation are needed to ensure that shareholders below the 10 percent ownership threshold do not avoid credit limits to related parties. Regulations on large exposures (which became effective in April 2011) and connected lending, and the establishment of a credit risk registry will facilitate the early detection of excessive risk.

- Bank reporting practices on non-performing loans and income recognition related to assets bought at fair value are being harmonized. The authorities and staff agreed that it was essential that banks use similar reporting standards to ensure comparability of financial statements.

- Greater coordination between CBI and FME should pave the way for adoption of Basel III measures, especially on capital, liquidity, and macroprudential tools that aim to strengthen regulation, supervision and risk management of the banking sector.

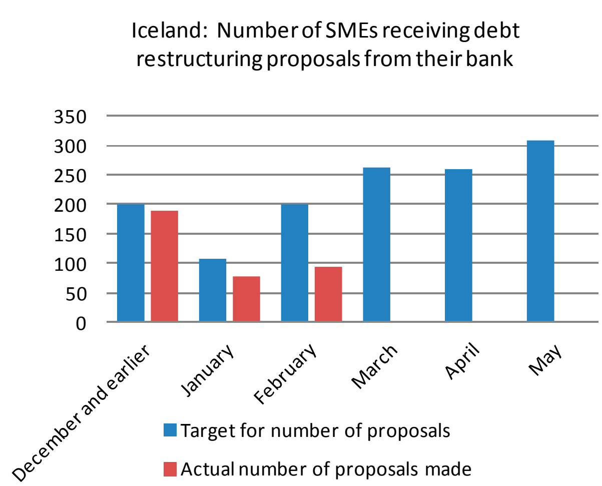
- The legal framework is being reformed to facilitate the resolution of failed institutions, enhance control of banking activities, and improve the role of deposit insurance in bank resolution. Amendments to the deposit insurance law harmonize the current legislation to international best practices, especially regarding premium, funding, and coverage. These reforms are also expected to align the existing legal framework with those of the European Union.

27. **A further strengthening of supervision is needed**. The authorities and staff agreed that, while there has been progress in reforming supervisory practices, a further strengthening of supervision is needed to bring it in line with international best practice. To this end, a report containing recommendations to bring Iceland to full compliance with Basel Core Principles on Effective Supervision and to adopt the best practices in banking supervision has been prepared by an internationally recognized former foreign bank supervisor. These recommendations will be included in the FME's work plan and, as needed, in the draft amendments to the banking law under preparation. Staff underscored that further efforts in this area were critical to reduce risks of another financial crisis in the future.

E. Private Sector Debt Restructuring

28. **The strengthened framework for household and corporate debt restructuring is being implemented, but progress is slow**. The authorities and staff agreed that it was critical to speed up implementation of the new measures (LOI ¶26). In this regard, the authorities plan to improve collection of data on progress in debt restructuring.

- ***Corporate debt restructuring***. Restructuring of small- and medium-size enterprises (SMEs) and large corporates is progressing, but at a slower-than-expected pace. For SMEs, commercial banks are beginning to implement the measures agreed in December 2010, which involve writedowns of SME debt to the value of the firm, but the number of restructuring proposals has fallen short of targets. For large corporates, banks will continue to handle cases individually through specialized debt restructuring units. The three commercial banks expect that corporate debt restructuring will be largely completed by end-2011, and fully completed in 2012. Nonetheless, staff strongly urged the authorities to work with banks to accelerate the process.



- ***Household debt restructuring***. The measures agreed in December 2010 for household debt restructuring—which involve writedowns of mortgages to

110 percent of collateral value, an interest rebate, and an interest subsidy—appear to have spurred debtors and their creditors to begin negotiations. Moreover, the authorities' firm commitment not to take further measures has helped encourage households to enter the debt restructuring process: the Office of the Debtor's Ombudsman has received some 1500 applications for debt mitigation and banks have reported an increased number of applications for debt restructuring. At the same time, delays in recalculating foreign-currency indexed mortgages (in line with the Supreme Court rulings) and in passing legislation to provide HFF with the legal authority to provide its share of debt relief have slowed the process. Even so, the three commercial banks expect to complete the household debt restructuring process by end-2011.

29. **A Supreme Court ruling in February clarified the definition of exchange rate-indexed loans in a way that substantially reduced litigation risks**. The ruling clarifies that exchange rate-indexed mortgages are illegal and should be converted into krona currency loans bearing krona interest rates. The ruling supports the special regime enacted in December 2010 (which allows individuals to convert foreign exchange-indexed mortgages into krona) and thereby significantly reduces litigation risk associated with the December legislation. The FME estimates that the likely impact on banks' capital is negligible, since the court ruling falls within the range of outcomes for which banks have provisioned.

F. Program Modalities

30. **Program monitoring is being adjusted to accommodate the modest delay in completing the fifth review**. The authorities are requesting the rephasing of outstanding amounts committed under the arrangement in order to make the last two purchases available in one single tranche upon completion of one final review (Table 10). This final review, which is expected to take place after July 15, 2011, will assess performance based on end-June 2011 and continuous performance criteria, as well as on relevant benchmarks and indicative targets. The authorities are also requesting modification of the end-June 2011 performance criteria (LOI Table 1 and TMU) and resetting of the structural benchmark on the local government fiscal framework (LOI ¶3 and LOI Table 2).

31. **Iceland has significant external financing needs, which can begin to be met with market funding** (Table 11). The planned bond issuance in international capital markets should cover large external amortizations falling due in late 2011, with subsequent issues expected to cover the smaller amount of amortization due the 2012. However, additional external financing, and higher reserves, will be needed to ensure that capital controls can be lifted in an orderly fashion. Fund and bilateral disbursements, proceeds from asset-liability management transactions, and stepped up foreign exchange interventions have improved Iceland's gross reserve position. Unlocking the full amount of program financing will further raise reserves to nearly 80 percent of short-term debt at end-2011.

32. **Financing assurances are in place**. To date, Iceland has received $50 million from the Faroe Islands, two of the four Nordic loan tranches ($1.2 billion), and one-third of the Polish loans ($70 million). The Nordic authorities have agreed to an extension of the availability of their loans to end-December 2011, but in some cases parliamentary approval is still pending. The Icelandic authorities plan to draw on the remaining amounts as financing gaps require.

33. **The program ensures that Iceland is in a position to fulfill its obligations to the Fund in a timely manner** (Table 12). External debt remains on a downward trajectory. Fund credit outstanding would still peak in 2011 at 35 percent of gross reserves and then rapidly fall. Payments would peak in 2013 at a manageable 23 percent of reserves. The authorities' commitment to a cautious pace of capital account liberalization provides comfort that payments can be met even if the external financing environment is somewhat weaker than envisaged.

34. **There remain large risks, which the program addresses, but they are shifting in importance:**

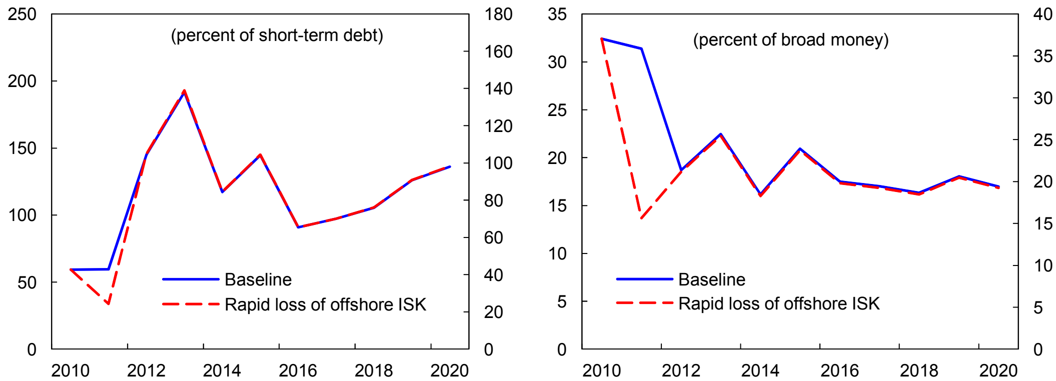
- Risks associated with policy missequencing, notably with respect to the liberalization of capital controls, are heightened given that the liberalization is set to begin soon (Figure 11). More specifically, a too-rapid pace of liberalization could unsettle markets and lead to disorderly depreciation of the krona. Insufficient administrative controls during the liberalization process could also lead to circumvention, effectively speeding up the pace of liberalization. And residents' pent-up demand for foreign assets could be far greater than the levels currently assumed in the baseline. These risks are mitigated by the authorities' commitment to a gradual and stepwise process for lifting controls, and to ensuring that the controls remain effective during the liberalization process.

- Litigation risks have increased. Key risks pertain to the resolution of Icesave and challenges to the Emergency Law.

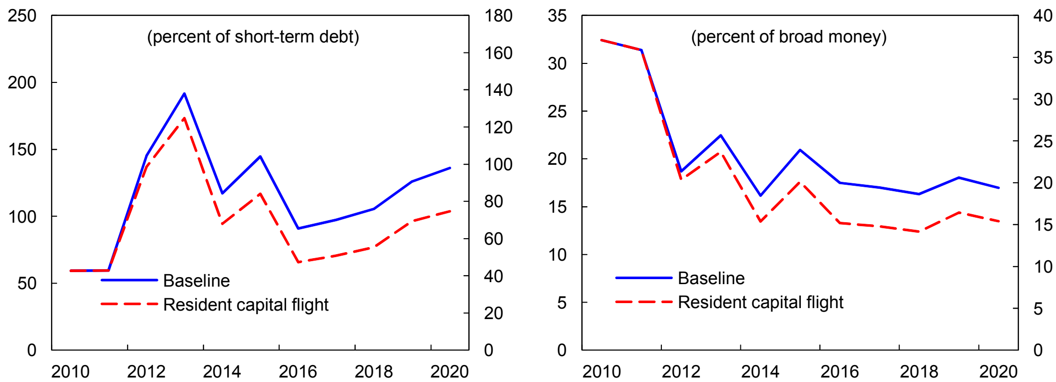
    - The resolution of the Icesave dispute through legal channels increases risks to Iceland. The EFTA Surveillance Authority is expected to issue a reasoned opinion on the matter in the coming months, after which it could be brought before the EFTA Court. Should the EFTA Court find Iceland to be in breach of the EU Directive on Deposit Insurance, and should a sovereign liability be determined, it is unclear on what terms—interest and maturity—Iceland would have to discharge that liability. Additional risks arise from the possibility that Iceland would be required to compensate the UK and Dutch authorities for the full amount of deposits, not just the insured amount. These risks are mitigated by the significant asset recovery from Landsbanki's estate, which are estimated to cover around 90 percent of deposits. Stress tests suggest that, while fiscal costs would rise

Figure 11. Iceland: Reserve Adequacy Under Capital Account Liberalization 1/

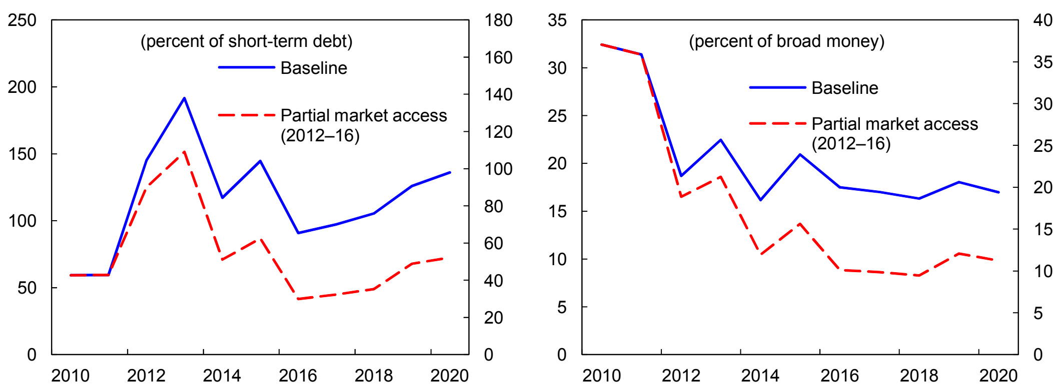
A rapid loss of offshore Krona (possibly through circumvention) would dent reserve adequacy in the near term.



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



...while 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:
Offshore krona loss: All offshore krona assumed to leave in 2012 under the baseline leaves in 2011.
Resident flight: During 2012-2016 residents take an additional 1 percent of broad money overseas.
Partial access: During 2012-2016, 33 percent of projected baseline new external borrowing is not possible.

substantially in some possible outcomes, public debt would remain on a downward path (Appendix I).

- Risks associated with the Emergency Law have been considerably reduced, but not eliminated. The EFTA Surveillance Authority's December 2010 decision on the Emergency Law has eased risks. In the coming months, Iceland's Supreme Court is to render a decision on the Emergency Law in cases initiated by creditors against the failed banks. As noted in previous reports, overturning the Emergency Law would have significant implications for the program.

- External financing risks are growing in importance. With the government poised to take the first steps to lift capital controls and tap international capital markets for the first time since the crisis, the external financing environment is becoming increasingly important for Iceland. A sovereign downgrade could disrupt Iceland's plans to reestablish market access, or limit the amount of financing that can be raised. Program financing, as well as the gradual and carefully calibrated approach to capital account liberalization embedded in the authorities' revised strategy, provide comfort that these risks can be handled.

IV. Staff Appraisal

35. **Iceland's emergence from crisis continues**. The impressive progress in implementing program policies has underpinned the economic stabilization and nascent recovery. Notably, the authorities' strong commitment to these policies has helped deliver key program objectives: the exchange rate has been stabilized and Iceland's public finances have been put onto a sustainable path. This should pave the way for a return to international capital markets and the first steps toward lifting the capital controls.

36. **The recovery is set to continue, but the recent growth setback underscores risks**. Annual growth is still set to turn positive in 2011, but the weak fourth quarter outturn raises concerns about the resilience of the recovery. Delays in investment projects remain a key risk to the growth outlook, while failure to quickly implement the household and corporate debt restructuring measures, lack of progress in reducing unemployment, or shocks to external demand could also slow growth. On inflation, the three-year wage agreement, reached in May (while generous) sets limits on wage push and provides a framework for inflation expectations. Nonetheless, risks have increased on account of increased inflation expectations, wage-cost pressures that could arise in the nontradables sector, pass-through from depreciation pressures that could arise as capital controls are lifted, and commodity price shocks. The authorities' commitment to a gradual pace of capital account liberalization should help mitigate risks of too-rapid depreciation.

37. **The key policy challenge is the lifting of capital controls**. The scale of the challenge is significant—"locked in" offshore krona is equivalent to 30 percent of GDP. This

has required an eclectic approach to lifting the controls—one that relies on several methods of liberalization, beginning with offshore krona holders. The preconditions for beginning to lift controls are largely in place: the economy and the exchange rate have stabilized, reserves have increased, the financial sector—while still vulnerable—has been strengthened considerably, and public finances have been put on a sustainable footing. With the government poised to tap international capital markets for the first time since the crisis, Iceland can begin to lift its capital controls.

38. **The lifting of capital controls must proceed gradually and be underpinned by a sufficiently robust balance of payments outlook**. Staff remains concerned that the lifting of controls may proceed too rapidly, but the approach set out in the authorities' strategy and the proposed extension of capital controls' legislation until end-2015 provide comfort that the pace will be appropriate. The authorities must be prepared to slow, or even stop, the liberalization process if the balance of payments is not deemed to be sufficiently strong to support further liberalization. In this regard, the authorities' commitment to comprehensively assess the macroeconomic and balance of payments outlook, as well as the stability of the financial system, before taking major steps in the liberalization process is welcome, particularly as potential drains may take years to materialize. The CBI's regular foreign exchange purchases will boost reserve adequacy, and Iceland should draw on all available official financing to further increase its reserve buffer. Improvements in liquidity management should continue, as this will become increasingly important in the context of a more open capital account.

39. **There is scope to ease the pace of fiscal adjustment over the medium term**. Such easing would still deliver sustainable public debt dynamics, provided that private sector losses are not absorbed by the public sector and contingent liabilities continue to be contained. The better-than-expected asset recovery of Landsbanki's estate provides comfort that public finances will remain on a sustainable path even if Iceland is found to have a sovereign obligation in the Icesave dispute.

40. **The new measures on household and corporate debt restructuring should be implemented more rapidly**. These measures, alongside the authorities' firm statements that additional debt relief will not be forthcoming, are welcome. It is critical that the measures be swiftly implemented. In this regard, the slower-than-expected progress on corporate debt restructuring is unfortunate and every effort should be made to expedite the process. The authorities' efforts to improve monitoring of progress in debt restructuring is therefore welcome.

41. **Financial sector restructuring should be accelerated and emerging vulnerabilities quickly addressed**. Close monitoring of banks' business and accounting practices is critical for identifying emerging weaknesses and concerns. To this end, the FME's ongoing ICAAP exercise (including its loan valuation review) is most welcome, and its scope should be expanded to ensure that any overstatement of bank capital or income is

promptly corrected. At the same time, recapitalization of the financial system is nearing completion, and the final steps for recapitalizing and restructuring the savings banks and nonbanks must now proceed without further delay. It is critical that work to address banks' remaining vulnerabilities arising from funding and liquidity risks and the high level of non-performing loans advance quickly—accelerating the implementation of the new measures for household and corporate debt restructuring is essential in this regard. New legislation to strengthen the legal and regulatory framework is welcome, and should be enacted soon.

42. **Efforts to strengthen the banking system and supervision must continue**. Further steps to improve supervision and bring it in line with international best practice will be essential if Iceland is to be better prepared to manage another crisis. Remaining gaps in the legal, regulatory, and supervisory framework must be addressed, through legislation if needed. The assessment of Iceland's compliance with the Basel Core Principles on Effective Supervision has identified areas where supervision can be further strengthened and it will be critical that sufficient resources are devoted to this task. Moreover, improved coordination between the CBI, FME, and key government ministries, is needed going forward, particularly as capital controls are lifted and macroprudential rules are put in place.

43. **On the basis of the considerable progress to date, staff supports the authorities' request to complete the fifth review**. Staff recommends the modification of end-June 2011 performance criteria and approval of the authorities' request for the rephasing of access.

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

	2005	2006	2007	2008	2009		2010		2011	
					Prog.	Est.	Prog.	Est. 1/	Prog.	Proj. 1/
	(Percentage change unless otherwise noted)									
National Accounts (constant prices)										
Gross domestic product	7.5	4.6	6.0	1.4	-8.5	-6.9	-3.0	-3.5	2.0	2.3
Total domestic demand	15.4	9.5	-0.1	-8.5	-20.7	-20.7	-1.8	-2.5	2.6	3.0
Private consumption	12.7	3.6	5.6	-7.9	-17.0	-15.6	-0.3	-0.2	3.0	2.7
Public consumption	3.5	4.0	4.1	4.6	-0.1	-1.7	-3.8	-3.2	-4.3	-3.9
Gross fixed investment	35.7	22.4	-11.1	-19.7	-50.6	-50.9	-4.0	-8.1	15.5	16.8
Export of goods and services	7.5	-4.6	17.7	7.0	-1.5	7.0	-0.2	1.1	0.6	2.5
Imports of goods and services	29.3	10.4	-0.7	-18.4	-30.5	-24.0	2.1	3.9	2.1	3.9
Output gap 2/	3.0	2.1	3.6	2.2	-3.2	-2.6	-4.0	-5.2	-2.0	-2.5
Selected Indicators										
Nominal GDP (bln ISK)	1026.7	1168.6	1308.5	1483.1	1472.5	1495.3	1551.4	1539.5	1628.2	1627.1
Unemployment rate 3/	2.1	1.3	1.0	1.6	8.6	8.0	8.3	8.1	7.5	7.5
Consumer price index	4.0	6.8	5.0	12.4	11.7	12.0	5.4	5.4	2.5	2.8
Nominal wage index	6.5	9.1	9.3	4.0	3.3	0.5	4.4	3.1	3.5	4.7
Nominal effective exchange rate 4/	10.4	-10.7	2.7	-40.4	...	-34.2	...	-3.0	...	...
Real effective exchange rate (CPI) 4/	13.3	-7.1	5.1	-20.7	...	-18.4	...	6.3	...	...
Terms of trade	1.0	3.5	0.1	-9.3	-8.5	-6.7	4.1	5.9	1.0	0.0
Money and Credit										
Base Money	32.2	27.9	190.7	-31.5	24.4	1.3	3.6	-19.4	...	...
Deposit money bank credit (end-period)	76.0	44.4	56.6	-28.3	...	-17.8	-5.2	-3.4	...	...
of which to residents (end-period)	54.7	33.6	28.3	...	...	...	...	...	...	...
Broad money (end-period)	23.2	19.6	56.4	36.3	8.3	1.0	-2.5	-10.0	...	...
CBI policy rate (period average) 5/	10.5	14.1	13.8	15.4	...	13.7	...	7.8	...	...
Public Finance (in percent of GDP)										
General government 6/										
Revenue	47.1	48.0	47.7	44.1	38.4	41.1	40.6	42.3	39.6	40.8
Expenditure	42.2	41.6	42.3	44.6	52.7	49.7	47.6	47.7	44.9	44.2
Balance	4.9	6.3	5.4	-0.5	-14.4	-8.6	-7.1	-5.4	-5.3	-3.3
Primary balance	6.1	6.7	5.7	-0.5	-8.3	-6.5	-2.2	-2.5	-0.1	0.2
Balance of Payments (in percent of GDP)										
Current account balance	-16.1	-25.6	-15.7	-28.4	-3.5	-10.4	-4.0	-8.0	1.3	2.3
Trade balance	-12.2	-17.5	-10.1	-2.3	8.6	8.7	9.6	10.6	9.4	10.4
Financial and capital account	13.9	44.0	18.1	-59.8	6.8	-12.2	-14.5	27.5	-9.0	-12.2
Net errors and omissions	2.6	-11.1	-1.9	-28.3	-5.3	25.3	17.6	-12.8	0.0	0.0
Gross external debt 7/	284.5	433.5	605.9	564.7	306.9	267.9	333.1	289.9	267.2	240.8
Central bank reserves (US$ billion)	1.1	2.3	2.6	3.6	4.9	3.9	5.5	5.8	6.0	6.2

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

1/ GDP projections use chain linking to eliminate the statistical discrepancy that arises from aggregating components in constant 2000 prices.
2/ Staff estimates. Actual minus potential output, in percent of potential output.
3/ In percent of labor force.
4/ A positive (negative) sign indicates an appreciation (depreciation).
5/ Data prior to 2007 refers to annual rate of return. 2007 and on, refers to nominal interest rate.
6/ National accounts basis.
7/ Including face value of old banks debt before 2009. Related interest transactions are not included from Q4 2008 on.

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

	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11 Proj.
Central Bank							
Net foreign assets 1/	-175	-188	-158	-163	-176	-115	-113
Assets	496	499	571	496	716	815	876
Liabilities	671	687	729	659	892	930	990
Net domestic assets	291	300	245	235	269	191	191
Net claims on the public sector	-52	8	-29	-38	28	17	31
Net claims excluding recap bond	-218	-172	-193	-207	-142	-156	-142
Recapitalization bond	165	181	165	169	171	173	173
Net claims on banks 2/	-25	-58	-60	-10	-24	-55	-69
Others Items, net	368	350	334	283	265	229	230
Base Money 3/	117	112	88	72	94	76	78
Currency issued	26	24	26	27	35	32	34
DMB deposits at the central bank	91	89	62	45	59	44	44
Banking System							
Net foreign assets	-30	-48	-7	99	86	112	130
Net domestic assets	1,610	1,602	1,495	1,371	1,326	1,308	1,287
Net claims on the central bank	120	147	135	61	73	82	113
Credit to private sector	1,855	1,904	1,878	1,829	1,791	1,763	1,730
Credit to government	210	213	216	219	222	225	224
Other items, net	-574	-662	-734	-739	-760	-762	-780
Domestic deposits	1,581	1,554	1,488	1,470	1,412	1,420	1,417
Local currency	1,462	1,433	1,370	1,385	1,329	1,336	1,335
Foreign currency	119	121	118	85	83	84	82
Consolidated Financial System							
Net foreign assets	-204	-236	-165	-64	-90	-3	17
Net domestic assets	1,811	1,814	1,679	1,561	1,536	1,455	1,435
Net claims on the public sector	158	221	187	181	250	242	255
Net credit to private sector	1,855	1,904	1,878	1,829	1,791	1,763	1,730
Other, net	-202	-311	-386	-449	-505	-550	-550
Broad Money (M3)	1,607	1,578	1,514	1,497	1,447	1,452	1,451
Memorandum items:							
Base money (y-o-y percentage change)	1.3	-15.8	-40.0	-55.2	-19.4	-32.3	-10.9
Broad money (y-o-y percentage change)	1.0	0.6	-8.5	-10.2	-10.0	-8.0	-4.2
Credit to private sector (y-o-y percentage change)	-17.8	3.1	-5.0	-4.6	-3.4	-7.4	-7.9
Money velocity (GDP/base money)	12.8	13.5	17.4	21.3	16.4	20.8	20.6
Broad money velocity (GDP/M3)	0.9	1.0	1.0	1.0	1.0	1.0	1.1
Multiplier (M3 / base money)	13.8	14.1	17.3	20.8	15.4	19.1	18.6

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, 2009–16
(Percent change, unless otherwise indicated)

	2009	2010		2011		2012	2013	2014	2015	2016
		Prog.	Est.	Prog.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Percentage change)									
Real economy										
Real GDP 1/	-6.9	-3.0	-3.5	2.0	2.3	2.9	2.7	2.7	3.0	3.0
Real domestic demand	-20.7	-1.8	-2.5	2.6	3.0	4.2	3.7	2.6	2.8	2.7
Private consumption	-15.6	-0.3	-0.2	3.0	2.7	3.1	3.5	3.5	3.5	3.0
Public consumption	-1.7	-3.8	-3.2	-4.3	-3.9	-2.6	-0.2	1.1	1.3	2.1
Gross fixed investment	-50.9	-4.0	-8.1	15.5	16.8	18.5	9.3	1.8	2.7	2.8
Net exports 2/	11.9	-0.8	-0.7	-0.4	-0.2	-0.5	-0.3	0.4	0.5	0.5
Exports of goods and services	7.0	-0.2	1.1	0.6	2.5	2.3	2.5	3.3	3.3	3.1
Imports of goods and services	-24.0	2.1	3.9	2.1	3.9	4.7	4.4	3.2	3.1	2.6
Output gap 3/	-2.6	-4.0	-5.2	-2.0	-2.5	-1.2	-0.8	-0.3	0.0	0.0
Unemployment rate 4/	8.0	8.3	8.1	7.5	7.5	6.5	4.9	3.9	3.7	3.5
Real wages	-10.1	-1.0	-2.2	1.0	1.9	1.9	2.2	2.2	2.2	2.2
CPI inflation	12.0	5.4	5.4	2.5	2.8	2.8	2.5	2.5	2.5	2.5
CPI inflation (excl. effect of ind. taxes)	11.4	4.4	4.4	2.2	2.8	2.6	2.5	2.5	2.5	2.5
CPI inflation (end of period)	7.5	2.6	2.4	2.4	3.3	2.5	2.5	2.5	2.5	2.5
Nominal GDP (bln ISK)	1495.3	1551.4	1539.5	1628.2	1627.1	1725.4	1813.3	1906.5	2008.7	2116.2
	(In percent of GDP, unless otherwise indicated)									
Balance of Payments										
Current account	-10.4	-4.0	-8.0	1.3	2.3	1.9	-1.2	-1.2	-1.7	-1.2
Underlying current account 5/	7.5	12.4	10.2	8.0	9.4	8.1	4.8	4.4	3.6	3.9
Trade balance	8.7	9.6	10.6	9.4	10.4	9.4	8.3	8.1	8.2	8.3
Net income balance 6/	-18.5	-13.1	-18.1	-7.7	-7.8	-7.3	-9.2	-9.1	-9.7	-9.3
Capital and financial account	-12.2	-14.5	27.5	-9.0	-12.2	-5.9	-12.0	-0.4	7.4	1.0
Capital transfer, net	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Direct investment, net	-18.2	-3.3	9.0	6.8	6.5	5.9	5.3	4.0	6.5	5.4
Portfolio investment, net	4.3	-0.5	2.4	-0.8	5.0	-3.1	1.7	-5.1	-3.5	-4.3
Other investment, net 7/	1.8	-10.7	16.2	-15.0	-23.7	-8.6	-19.0	0.7	4.4	0.0
Accumulation of arrears	0.0	-44.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary financing	5.6	51.3	7.8	11.5	15.3	-2.9	-3.7	-2.4	-3.2	-1.5
Gross external debt 8/	267.9	333.1	289.9	267.2	240.8	217.0	185.4	176.4	164.8	152.9
Underlying gross external debt 9/	263.6	…	271.0	…	237.6	217.0	185.4	176.4	164.8	152.9
Net external debt 10/	148.4	…	168.4	…	147.6	132.7	103.0	94.0	88.5	77.4
Central bank reserves (US$ billion)	3.9	5.5	5.8	6.0	6.2	5.2	2.6	2.0	2.4	2.1
General government accounts										
Revenue	41.1	40.6	42.3	39.6	40.8	42.4	43.2	43.5	43.4	43.3
Expenditure	49.7	47.6	47.7	44.9	44.2	42.9	41.1	40.6	40.6	40.3
Overall balance	-8.6	-7.1	-5.4	-5.3	-3.3	-0.5	2.2	2.9	2.8	3.1
Primary balance	-6.5	-2.2	-2.5	-0.1	0.2	3.7	6.0	6.0	5.9	6.0
Primary balance (excl. new road projects)	-6.5	-2.2	-2.5	0.3	0.3	3.9	6.0	6.0	5.9	6.0
Change in primary balance (excl. new road projects)	-6.0	4.4	4.0	2.5	2.8	3.6	2.1	0.0	0.0	0.0
Gross debt	87.7	96.3	92.6	100.5	100.1	94.6	90.3	83.8	78.9	71.3
Net Debt	55.8	69.0	63.5	72.0	66.0	62.9	58.1	52.7	47.4	42.0

Sources: CBI; and IMF staff estimates.

1/ Projections for 2010 use chain linking to eliminate the statistical discrepancy that arises from aggregating components in constant 2000 prices.

2/ Contributions to growth.

3/ In percent of potential output

4/ In percent of labor force.

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

6/ Includes interest payments due from the financial sector and income receipts to the financial sector.

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

8/ 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.

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

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

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

	2008	2009	2010	2011	2012	2013	2014	2015	2016
	Prel.		Est.	Proj.	Proj.	Proj.	Proj.	Proj	Proj
Current Account	-4.8	-1.3	-1.0	0.3	0.3	-0.2	-0.2	-0.3	-0.2
Trade Balance	-0.4	1.0	1.3	1.4	1.4	1.2	1.3	1.3	1.4
Balance on Goods	-0.1	0.7	1.0	1.0	1.0	0.9	1.0	1.1	1.2
Merchandise exports f.o.b.	5.3	4.1	4.6	5.3	5.5	5.8	6.1	6.4	6.7
Merchandise imports f.o.b.	-5.4	-3.3	-3.6	-4.3	-4.5	-4.9	-5.1	-5.2	-5.5
Balance on Services	-0.3	0.3	0.4	0.5	0.4	0.3	0.3	0.2	0.2
Exports of services, total	2.1	2.3	2.5	2.9	3.0	3.0	3.1	3.2	3.3
Imports of services, total	-2.4	-2.0	-2.2	-2.4	-2.6	-2.7	-2.9	-3.0	-3.1
Balance on Income 1/	-4.3	-2.2	-2.3	-1.1	-1.1	-1.4	-1.4	-1.6	-1.6
Receipts	0.5	-0.1	-0.1	0.3	0.7	0.5	0.6	0.5	0.5
of which dividends and reinvested earnings	-0.9	-0.5	-0.4	0.1	0.2	0.2	0.3	0.2	0.2
of which interest receipts	1.4	0.4	0.2	0.2	0.2	0.3	0.3	0.3	0.3
Expenditures	-4.8	-2.2	-2.2	-1.4	-1.8	-1.9	-2.0	-2.1	-2.1
of which dividends and reinvested earnings	0.9	0.4	-0.3	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
of which interest payments	-5.7	-2.5	-1.8	-0.6	-1.0	-1.1	-1.3	-1.4	-1.4
of which interest payments of old banks	…	-1.8	-1.3						
Current transfer, net	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Cap and Finan. Acct	-9.2	-2.1	3.5	-1.7	-0.9	-1.8	-0.1	1.2	0.2
Capital transfer, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	-9.2	-2.1	3.5	-1.7	-0.8	-1.8	-0.1	1.2	0.2
Direct investment, net	5.1	-2.2	1.1	0.9	0.9	0.8	0.6	1.1	0.9
Portfolio investment, net	2.7	0.5	0.3	0.7	-0.5	0.3	-0.8	-0.6	-0.7
Assets	4.9	1.3	0.7	0.4	0.2	-0.1	-0.6	-0.7	-0.7
Liabilities 2/	-2.3	-0.8	-0.4	0.3	-0.7	0.4	-0.2	0.1	0.0
Net borrowing	-0.4	-0.8	-0.4	0.3	-0.8	0.3	-0.3	0.0	-0.1
Equities	-1.8	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Other investment, net 3/	-17.9	0.2	2.0	-3.3	-1.3	-2.9	0.1	0.7	0.0
Assets	-1.2	1.1	0.4	2.0	0.7	0.0	0.0	1.0	0.1
Liabilities 2/	-16.7	-0.9	1.7	-5.3	-2.0	-2.9	0.1	-0.2	-0.1
of which external asset recovery (Landsbanki)	0.0	0.8	0.6	0.3	0.6	0.2	0.2	0.1	0.2
of which other external asset recovery	…	0.2	0.6	1.3	1.8	1.6	1.3	0.6	0.1
of which deposit insurance loan payments	0.0	0.0	0.0	2.0	-0.6	-0.3	-0.4	-0.4	-0.4
of which other asset recovery payments	0.0	0.0	-0.1	-1.2	-1.9	-4.6	-1.3	-1.6	-0.1
of which old banks foreign deposits	-18.8	…	…	…	…	…	…	---	---
Net errors and omissions	-4.8	3.1	-1.6	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance	-18.8	-0.3	0.8	-1.4	-0.6	-2.0	-0.3	0.9	0.0
Overall financing	18.7	0.3	-0.8	1.7	0.6	2.0	0.3	-0.9	0.0
Change in gross reserves ("-" = increase)	-0.9	-0.3	-1.9	-0.4	1.0	2.5	0.6	-0.4	0.3
Accumulation of arrears ("-" = paydown)	18.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing 4/	0.8	0.7	1.0	2.1	-0.4	-0.5	-0.4	-0.5	-0.3
Fund ("+" = net disbursement)	0.8	0.2	0.3	0.8	-0.4	-0.5	-0.4	-0.5	-0.3
Bilateral (earmarked/ non-cash)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other identified new financing 5/	0.0	0.5	0.7	1.3	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)	3.6	3.9	5.8	6.2	5.2	2.6	2.0	2.4	2.1
Level of gross reserves (eop) excluding old bank deposits		2.7	4.2	3.6	2.0	2.3	1.6	2.2	1.9
Memo									
GDP $ bln	16.9	12.1	12.6	13.8	14.6	15.1	15.7	16.4	17.2
Underlying balance of income 6/	-3.5	0.3	0.0	-0.1	-0.1	-0.5	-0.5	-0.7	-0.7
Underlying current account balance 6/	-3.2	1.3	1.3	1.2	1.2	0.7	0.7	0.6	0.7
Reserves (months of imports of G&S)	8.0	8.0	10.3	10.4	8.2	4.0	2.9	3.3	2.8
Reserves/S-T debt (residual basis, in percent)	68.0	48.1	66.8	71.8	113.8	171.3	113.8	138.8	91.8
Reserves/S-T debt (residual basis, adjusted, in percent) 7/	68.0	94.9	115.2	145.1	121.0	206.8	133.9	163.4	103.6
Reserves/S-T debt (residual basis, in percent) 8/	…	38.8	59.3	59.5	145.1	191.6	117.1	144.6	90.9
Reserves (in percent of GDP)	21.1	32.1	45.9	44.7	35.5	17.4	12.7	14.6	12.2
Principal and interest arrears of old banks 2/	3.0	14.8	…	…	…	…	…	…	…

Sources: CBI; and IMF staff estimates.

1/ Actual data include old banks' incomes.

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

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

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

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

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

7/ Excludes short-term debt blocked by capital controls, and maturing loan with known matching assets.

8/ Excludes resolution committee deposits at the central bank.

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

	2008	2009	2010		2011		2012	2013	2014	2015	2016
		Est.	4th Rev. 8/	Est.	4th Rev.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Total revenue 2/	**44.1**	**41.1**	**40.6**	**42.3**	**39.6**	**40.8**	**42.4**	**43.2**	**43.5**	**43.4**	**43.3**
Taxes	**33.8**	**30.8**	**30.8**	**31.8**	**31.0**	**30.9**	**32.4**	**33.3**	**33.4**	**33.4**	**33.4**
Taxes on income and profits	17.8	16.0	15.7	16.1	15.7	15.9	16.1	16.3	16.3	16.2	16.3
Personal Income Tax	13.2	12.9	12.9	12.8	13.0	12.8	13.1	13.3	13.4	13.4	13.5
Corporate Income Tax	1.9	1.8	1.0	1.3	1.1	1.4	1.4	1.4	1.4	1.4	1.4
Capital gains tax, rental income	2.7	1.4	1.7	1.9	1.6	1.7	1.7	1.6	1.5	1.5	1.4
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	0.2
Taxes on property	2.2	2.1	2.3	2.3	2.3	2.4	2.3	2.3	2.3	2.2	2.2
Taxes on goods and services	13.1	11.7	11.9	12.4	12.1	11.7	13.1	13.9	14.0	14.1	14.1
VAT	9.1	8.0	7.9	7.9	7.9	7.8	8.4	8.5	8.6	8.7	8.7
Other taxes on goods and services	4.1	3.7	4.0	4.5	4.2	3.9	4.6	5.4	5.4	5.4	5.4
Taxes on international trade	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Other taxes	0.1	0.4	0.4	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Social contributions	**2.8**	**3.1**	**4.0**	**4.2**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**	**3.9**	**3.9**
Grants	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.5**	**0.5**	**0.1**	**0.1**	**0.1**	**0.1**
Other revenue	**7.4**	**7.1**	**5.7**	**6.1**	**4.6**	**5.5**	**5.6**	**5.7**	**5.9**	**5.9**	**5.9**
Property income	3.8	3.6	2.4	2.6	2.1	1.8	2.1	2.3	2.5	2.5	2.5
o/w Interest income	3.3	3.1	2.0	2.2	1.7	1.6	1.8	1.9	2.1	2.1	2.1
Total expenditure 2/ 3/	**44.6**	**49.7**	**47.6**	**47.7**	**44.9**	**44.2**	**42.9**	**41.1**	**40.6**	**40.6**	**40.3**
Current expense 3/	**42.0**	**48.3**	**47.2**	**47.3**	**44.8**	**44.5**	**43.2**	**41.5**	**40.6**	**40.3**	**39.8**
Compensation of employees	14.6	15.0	14.0	14.6	13.0	13.9	13.2	12.9	12.8	12.6	12.6
Use of goods and services	11.6	12.5	11.7	12.3	10.8	11.5	10.8	10.4	10.2	10.1	10.0
Consumption of fixed capital	1.8	2.1	2.1	2.2	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Interest	3.3	5.2	6.8	5.1	6.9	5.2	6.0	5.7	5.2	5.2	4.9
o/w Interest on IceSave guarantee	..	0.0	1.2	0.0	1.3	0.0	0.0	0.0	0.0	0.0	0.0
Subsidies	1.8	1.9	1.7	1.8	1.6	1.7	1.6	1.5	1.5	1.4	1.4
Grants	0.2	0.4	0.3	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Social benefits	6.1	8.2	7.5	7.8	7.5	7.3	6.8	6.5	6.3	6.3	6.3
Other expense	2.6	3.0	2.9	3.0	2.6	2.5	2.3	2.2	2.2	2.2	2.2
Nonfinancial assets	**2.6**	**1.4**	**0.5**	**0.4**	**0.1**	**-0.3**	**-0.2**	**-0.5**	**0.0**	**0.3**	**0.4**
Non-financial assets, acquisition	4.5	3.5	2.6	2.6	2.3	1.8	1.9	1.6	2.1	2.4	2.5
of which: road construction projects					0.4	0.1	0.2	0.0	0.0	0.0	0.0
Consumption of fixed capital (-)	-1.8	-2.1	-2.1	-2.2	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1
Net lending/borrowing 3/	**-0.5**	**-8.6**	**-7.1**	**-5.4**	**-5.3**	**-3.3**	**-0.5**	**2.2**	**2.9**	**2.8**	**3.1**
Net lending/borrowing incl. write-offs	**-13.5**	**-10.9**	**-8.6**	**-9.0**	**-5.3**	**-4.6**	**-0.5**	**2.2**	**2.9**	**2.8**	**3.1**
Financial assets, transactions	**21.9**	**7.5**	**-2.0**	**2.7**	**-3.1**	**-0.3**	**0.0**	**1.5**	**0.5**	**1.9**	**-0.5**
Currency and deposits	4.2	3.0	-4.3	6.7	-4.4	-0.9	0.0	1.5	0.5	1.9	-0.5
Securities other than shares	0.0	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	0.0	-5.0	1.3	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities, transactions	**35.4**	**18.4**	**6.6**	**11.7**	**2.2**	**4.3**	**0.5**	**-0.6**	**-2.4**	**-0.9**	**-3.6**
Securities other than shares	10.6	21.0	9.0	9.1	2.3	4.5	-0.2	-3.2	-3.4	-2.3	-3.7
Loans	21.4	-3.0	-2.4	2.4	-0.1	-0.2	0.8	2.6	1.1	1.3	0.1
Domestic loans	19.0	-4.2	0.4	3.4	0.3	0.3	0.3	0.0	0.0	0.1	0.1
Foreign loans	2.4	1.3	-2.8	-1.0	-0.4	-0.4	0.4	2.5	1.0	1.3	0.0
Stock of debt 4/											
General government gross debt 4/	69.7	87.7	96.3	92.6	100.5	100.1	94.6	90.3	83.8	78.9	71.3
Domestic	45.7	61.1	68.4	68.1	68.1	69.4	65.9	59.8	53.9	49.2	43.3
Foreign currency 4/	24.0	26.6	27.8	24.4	32.4	30.6	28.7	30.5	29.9	29.7	28.0
of which:											
Bilateral loans to support CBI reserves	0.0	3.1	7.3	7.4	13.7	13.9	12.9	12.4	11.2	9.0	7.2
'Net present value' of depositor guarantees 5/	0.0	0.0	5.2	0.0	3.5	0.0	0.0	0.0	0.0	0.0	0.0
Other	24.0	23.5	15.3	17.0	15.2	16.7	15.9	18.1	18.7	20.6	20.8
General government net debt 6/	41.7	55.8	69.0	63.5	72.0	66.0	62.9	58.1	52.7	47.4	42.0
Structural Balances 7/											
Structural balance	-2.0	-5.2	0.7	4.0	-3.5	-0.1	0.6	2.5	3.1	2.8	3.1
Structural primary balance	-2.0	-3.2	4.1	6.8	1.6	3.3	4.8	6.3	6.1	5.9	6.0
Memo Items											
Nominal GDP (billion ISK)	1483	1495	1551	1540	1628	1627	1725	1813	1907	2009	2116
Primary revenue	40.7	37.9	38.6	40.0	38.0	39.2	40.7	41.3	41.4	41.3	41.3
Primary expenditure	41.3	44.5	40.8	42.5	38.0	39.0	37.0	35.4	35.4	35.4	35.3
Primary balance (excl. interest income)	-0.5	-6.5	-2.2	-2.5	-0.1	0.2	3.7	6.0	6.0	5.9	6.0
Change in the primary balance	-6.3	-6.0	4.4	4.0	2.1	2.7	3.5	2.3	0.0	0.0	0.0
Primary balance (excl. new road projects)	-0.5	-6.5	-2.2	-2.5	0.3	0.3	3.9	6.0	6.0	5.9	6.0
Change in the primary balance (excl. new road projects)	-6.3	-6.0	4.4	4.0	2.5	2.8	3.6	2.1	0.0	0.0	0.0
New discretionary revenue measures		1.4	2.9	2.9	0.7	0.7	1.7	0.8	0.0	0.0	0.0
New discretionary expenditure measures		-0.6	-3.0	-3.0	-1.6	-1.9	-0.8	-0.3	0.1	0.4	0.4
New discretionary measures		2.0	5.9	5.9	2.3	2.6	2.5	1.0	-0.1	-0.4	-0.4

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

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

2/ Nominal measures have been allocated primarily toward revenue measures in 2012-13.

3/ Excluding write-off claims on banks. Write-offs in 2008 are the result of central bank recapitalization and securities lending contracts that failed after the bank collapse.
Write-offs in 2009 relate to an estimate of the NPV of depositor guarantees (liabilities not recovered by assets) and retroactive interest paid to new banks to compensate for late capitalization.
Write-offs in 2010 reflect called guarantees of the State Guarantee Fund and recapitalization of the House Financing Fund. Write-offs in 2011 reflect savings bank recapitalization.

4/ Includes bilateral loans to support foreign currency reserves at the Central Bank of Iceland (CBI).
Loan from the Norwegian government directly to the CBI is excluded from general government debt. Includes the estimated net present value of the oustanding guarantee, net of asset recovery, on the UK/Dutch IceSave loans to the Icelandic Depositors' and Investors' Guarantee Fund. Does not include Fund liabilities.

5/ NPV of the outstanding IceSave guarantee after asset recovery. It estimates, under given assumptions for asset recovery, the residual obligation for the government and growth thereof due to accruing interest.

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

7/ In percent of potential GDP. Structural estimates for 2009 were normalized to account for the impact of the asset bust price cycle. The deterioration in 2009 does not reflect the fiscal stance.

8/ The 4th Review "Net Lending/Borrowing" has been corrected. The previous publication of the net lending did not include accrued interest on Icesave obligations in 2010.

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

	2008	2009	2010		2011		2012	2013	2014	2015	2016
		Est.	4th Rev	Est.	4th Rev	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Cash receipts from operating activities 1/	**30.0**	**27.7**	**29.4**	**30.0**	**28.0**	**28.0**	**29.8**	**30.6**	**30.7**	**30.6**	**30.5**
Tax revenue	23.6	21.3	21.6	22.2	21.4	21.5	23.1	24.0	24.0	23.9	23.9
Taxes on income, profits, and capital gains	10.3	9.3	8.5	9.0	8.0	8.4	8.6	8.6	8.6	8.5	8.4
Personal income tax	5.9	5.5	5.8	5.8	5.3	5.3	5.6	5.7	5.7	5.6	5.6
Corporate income tax	2.0	1.2	1.0	1.3	1.1	1.4	1.4	1.4	1.4	1.4	1.4
Other taxes on income and profit	2.4	2.6	1.7	1.9	1.6	1.7	1.7	1.6	1.5	1.5	1.4
Taxes on payroll and workforce	0.1	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Taxes on property	0.5	0.4	0.5	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7
Taxes on sales and services	12.1	10.8	11.7	11.7	11.8	11.5	12.9	13.8	13.8	13.9	13.9
Taxes on international trade and transactions	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Other tax revenue	0.1	0.4	0.4	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Social contributions	2.8	2.8	4.0	4.0	4.0	4.0	4.0	4.0	4.0	3.9	3.9
Grants	0.1	0.1	0.1	0.1	0.1	0.5	0.5	0.1	0.1	0.1	0.1
Other receipts	3.6	3.5	3.6	3.7	2.5	2.0	2.3	2.4	2.6	2.6	2.6
of which:											
Interest income	2.6	2.9	1.7	1.8	1.4	1.3	1.5	1.6	1.8	1.8	1.8
Total spending 1/	**30.5**	**36.9**	**34.5**	**34.5**	**32.8**	**30.7**	**29.8**	**28.3**	**27.8**	**27.7**	**27.3**
Cash payments for operating activities	**28.2**	**34.3**	**32.8**	**32.8**	**31.3**	**29.9**	**28.8**	**27.5**	**26.7**	**26.5**	**26.1**
Compensation of employees	8.5	8.6	8.2	8.3	7.5	7.5	7.4	7.3	7.2	7.2	7.1
Purchases of goods & services	5.5	6.0	6.5	6.2	5.8	5.4	4.9	4.8	4.7	4.8	4.8
Interest 2/	1.9	5.3	4.9	4.8	6.1	4.3	5.0	5.1	4.6	4.7	4.4
Transfer payments	12.3	14.4	13.3	13.6	12.0	12.6	11.5	10.4	10.1	9.8	9.8
Net cash inflow from operating activities	**-11.2**	**-6.6**	**-3.4**	**-2.8**	**-3.3**	**-1.9**	**1.0**	**3.1**	**4.0**	**4.1**	**4.4**
Investments in NFAs	2.3	2.6	1.7	1.7	1.4	0.9	1.0	0.8	1.1	1.2	1.2
*of which: r*oad construction projects					0.4	0.1	0.2	0.0	0.0	0.0	0.0
Overall deficit (incl. adjustment to cash)	**-12.6**	**-10.1**	**-5.2**	**-4.5**	**-4.8**	**-2.7**	**0.0**	**2.3**	**2.9**	**2.9**	**3.2**
Memorandum Items:											
Nominal GDP	1,483	1,495	1,551	1,540	1,628	1,627	1,725	1,813	1,907	2,009	2,116
Primary revenue	27.4	24.8	27.7	28.2	26.6	26.7	28.3	29.0	28.9	28.8	28.7
Primary expenditure	28.6	31.5	29.7	29.7	26.7	26.4	24.8	23.2	23.1	23.0	22.9
Primary balance (excl. interest income)	-1.2	-6.7	-2.0	-1.5	-0.1	0.3	3.6	5.8	5.8	5.8	5.8
Change in primary balance		-5.5	4.6	5.3	2.0	1.8	3.2	2.2	0.0	0.0	0.0
Primary balance (excl. new road projects)		-6.7	-2.0	-1.5	0.3	0.4	3.8	5.8	5.8	5.8	5.8
Change in the primary balance (excl. new road projects)		-6.7	-2.0	-1.5	2.3	1.9	3.4	2.0	0.0	0.0	0.0

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

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

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

Table 7. Iceland: Estimated Impact of 2011 Fiscal Measures

Revenue Measures 1/	Nominal Amount (In ISK Billion)	Amount (In Percent of GDP)
Raising CIT and the capital gains tax rates to 20 percent	2.8	0.2
PIT on early withdrawal of private pensions	4.0	0.2
Raising the net wealth and inheritance tax rates	2.5	0.2
Other tax measures 2/	2.4	0.1
Total Revenue Measures	**11.7**	**0.7**
Expenditure Measure 1/	Nominal Amount (In ISK Billion)	Nominal Amount (In Percent of GDP)
Current expenditure	**13.3**	**0.8**
Wages	4.2	0.3
Other current expenditure	9.1	0.6
Transfers	**12.2**	**0.7**
Capital expenditure	**5.8**	**0.4**
Total Expenditure Measures	**31.3**	**1.9**

Sources: Ministry of Finance of Iceland, and staff estimates.
1/ Fiscal measures are relative to 2010.
2/ Other tax measures include raising the CO2 tax, the vehicle tax, the tax on alcohol and tobacco and introducing a bank tax.

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

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

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

1/ Based on FAD TA recommendations.

Table 9. Iceland: Status of the Financial Sector

	Total assets				Capital adequacy ratio 5/	Status
	end-Dec 2009 2/		end-Dec 2010 3/			
	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**	**19.2**	
Landsbankinn	1061	71	1081	70	20.0	Going concern
Arion	757	51	813	53	15.2	Going concern
Islandsbanki	717	48	683	44	22.6	Going concern
MP bank	57	4	62	4	...	Going concern
BYR sparisjóður 4/			165	11	...	In April 22, 2010 the bank was intervened, assets and deposits were transferred to new Byr, a commercial bank. New Byr's recapitalization should be completed soon.
Saving banks 4/	**143**	**21**	**135**	**9**	**3**	
Sparisjóður Keflavíkur	78	5	76	5	2	On April 22, 2010 the bank was intervened, assets and deposits were transferred to "new Spkef", a savings bank. Negotiations between creditors and authorities were not successful to keep the bank operating. As a consequence, deposits were transferred to Landsbankinn and the two entities are being merged (FME decision dated March 5, 2011).
Other saving banks	65	4	59	4	4	4 saving banks have been recapitalized. 2 small saving banks are in a process of consolidation with their parent banks.
Housing Finance Fund (HFF) 5/	**795**	**53**	**836**	**54**	**2**	The HFF recapitalisation law was adopted by parliament in December 2010. A 33 bln ISK capital injection will bring HFF's capital to around 2 percent of risk-weighted assets.

Sources: CBI and FME, and staff calculations.

1/ Numbers for new banks are adjusted for the subordinated instruments provided by the government under private capitalization.
2/ As of end-June 2010 for Byr and the savings banks.
3/ As of end-June 2010 for MP and Byr.
4/ Saving banks total does not include Byr anymore, as Byr h.f. (new Byr") was set-up by the FME on April 23 2010 as a commercial bank.
5/ The Capital Adequacy Ratio is calculated using core tier 1 capital based on end 2010 audited financial accounts.

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

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

Source: IMF staff estimates

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

	2010 Prelim	2011 Proj	2012 Proj	2013 Proj	2014 Proj	2015 Proj	2016 Proj
A Gross Requirements	12.5	9.9	7.8	2.5	3.0	3.3	3.2
Current account deficit	1.0	-0.3	-0.3	0.2	0.2	0.3	0.2
Amortization (MLT)	3.2	4.6	4.3	1.4	1.8	2.0	2.0
Official (excl. IMF)	1.9	6.0	3.0	3.1	0.3	0.4	0.4
Deposit insurance loans	0.0	-2.0	0.6	0.3	0.4	0.4	0.4
Private	1.3	0.5	0.7	-2.0	1.1	1.2	1.1
Short-term debt	8.3	5.6	3.8	0.9	1.0	1.0	1.1
B Sources of Financing	13.1	8.1	8.2	3.1	3.4	3.8	3.5
Foreign Direct Investment (net)	1.1	0.9	0.9	0.8	0.6	1.1	0.9
FDI outflows Abroad	0.3	0.4	0.1	-0.1	-0.1	0.4	0.3
FDI inflows to Iceland	0.8	0.5	0.7	0.9	0.8	0.7	0.7
Net inflows of equity and other capital	0.8	0.4	0.3	0.0	-0.5	-0.6	-0.5
Disbursements (MLT)	3.8	1.3	2.4	0.8	0.7	0.9	0.6
Short-term debt	8.0	3.0	2.0	-1.9	1.0	1.0	1.1
Other net assets	1.3	2.9	1.6	0.9	1.0	1.9	1.0
Reserves accumulation (-: increase)	-1.9	-0.4	1.0	2.5	0.6	-0.4	0.3
C Financing Gap (A-B)	-0.6	1.8	-0.4	-0.5	-0.4	-0.5	-0.2
Errors and omissions	-1.6	0.0	0.0	0.0	0.0	0.0	0.0
Accumulation of arrears	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing	1.0	2.1	-0.4	-0.5	-0.4	-0.5	-0.3
Fund	0.3	0.8	-0.4	-0.5	-0.4	-0.5	-0.3
Bilateral (earmarked/ non-cash)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other identified new financing	0.7	1.3	0.0	0.0	0.0	0.0	0.0
Residual Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: CBI; and IMF staff estimates.

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

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Existing and prospective Fund credit									
Disbursements	560	105	210	525	0	0	0	0	0
Stock	560	665	875	1400	1120	761	512	171	0
Obligations	0	13	18	21	321	389	269	349	172
Principal (repurchases)	0	0	0	0	280	359	249	341	171
Charges and interest	0	13	18	21	41	30	19	8	1
Stock of existing and prospective Fund credit									
In percent of quota	476	565	744	1190	952	647	435	145	0
In percent of GDP	5.1	8.6	10.7	15.8	12.0	7.9	5.1	1.6	0
In percent of exports of G&S	11.5	16.3	18.9	26.9	20.5	13.4	8.6	2.8	0
In percent of gross reserves	24.3	26.9	23.3	35.5	33.8	45.1	40.1	11.1	0
Obligations to the Fund from existing and prospective Fund arrangements									
In percent of quota	0.0	11.1	15.2	18.1	272.8	330.7	228.3	297.1	146.4
In percent of GDP	0.0	0.2	0.2	0.2	3.4	4.0	2.7	3.3	1.6
In percent of exports of G&S	0.0	0.3	0.4	0.4	5.9	6.9	4.5	5.7	2.7
In percent of gross reserves	0.0	0.5	0.5	0.5	9.7	23.1	21.0	22.7	12.8

Source: IMF staff estimates and projections.

ATTACHMENT I. LETTER OF INTENT

Reykjavik, May 19, 2011

Mr. John Lipsky
The Acting Managing Director
International Monetary Fund
Washington, DC 20431
USA

Dear Mr. Lipsky:

1. **The Icelandic economy is gradually recovering**. Our policies have laid the basis for this recovery: domestic demand has started growing, inflation is low, and the trade balance remains strong. The krona has remained broadly stable. A key challenge for the coming year is to reduce the still-high level of unemployment.

2. **Our policy implementation remains broadly on track**. All end-March performance criteria, and the end-February structural benchmark on the FME requiring rehabilitation and/or recapitalization measures to be taken by non-bank financial institutions, have been met. Other structural benchmarks for this review have been delayed, although we have made significant progress on them. In particular, the cabinet approved in March a revised strategy for lifting capital controls and the Basel Core Principles assessment of weaknesses in the supervisory framework was completed in mid-April. The main problems in the former savings banks are being addressed by merging SpKef with a commercial bank (completed in March) and the restructuring of new Byr (which is still ongoing). The benchmark on the Icelandic State Financial Investment Company—a two-year strategic plan for savings banks—will not be met. However, the underlying objective of this benchmark is largely achieved by the SpKef merger and plans to present by end-May a strategy for the reorganization of the remaining savings banks. The status of all program measures is summarized in Tables 1 and 2.

3. **On this basis, and on the basis of the policies defined in this letter, we request completion of the fifth review under the Stand-By Arrangement**. As set out in Table 1, we request that quantitative performance criteria be modified for June 30, 2011. As detailed below, we propose that the structural benchmark on passage of the legislation to strengthen the fiscal framework for local government be reset to end-June 2011 (Table 2). In light of the modest delay in completing the fifth review, we also propose a rephasing of access to combine the seventh and eighth purchases into one tranche to be drawn upon completion of one final review, which we expect to be completed after July 14, 2011.

4. **We believe that the policies set forth in this and previous letters will deliver the objectives of our program**. We stand ready to take any further measures that may become appropriate for this purpose. We will consult with the Fund on the adoption of any such

measures and in advance of revisions to the policies contained in this letter, in accordance with the Fund's policies on such consultation.

The outlook

5. **We expect positive growth in 2011 for the first time since the crisis**.

- We expect the recovery in investment and private consumption to turn GDP growth positive in 2011. Unemployment is set to decline. But risks to the projected 2¼ percent growth are tilted to the downside. Prospects for investment are still uncertain, while still high unemployment and the need to restore balance sheets continue to weigh on private consumption.

- Headline inflation is slightly above the central bank's target (2½ percent), and we expect it to rise temporarily to just above 3 percent later this year due to the recent increases in petrol and commodity prices. The still significant slack in the economy and broadly stable exchange rate are expected to ensure that inflation returns to target in mid-2012. Risks to the inflation outlook emanate mainly from possible wage increases in export sectors spreading to non-tradables sectors and the rise in inflation expectations. To mitigate these risks, the government held discussions with social partners that culminated in a 3-year wage agreement signed in early May. Additional risks arise from fluctuations in the value of the krona and import prices.

- We believe that the balance of payments outlook is sufficiently strong to support a gradual lifting of capital controls. The current account surplus, the planned resumption of sovereign external borrowing, the realization of program financing, and disbursements from bilateral partners are expected to further increase reserves to about $6.2 billion at end-2011, or around 70 percent of short-term external debt. This will create scope to take some initial steps toward the gradual lifting of capital controls and offset payments to external creditors of the old banks. As steps towards the liberalization of capital controls could place the external position under pressure, the liberalization will be managed cautiously (paragraph 13).

6. **Both public and external debt ratios are expected to decline rapidly**. Gross external debt is projected to amount to about 240 percent of GDP in 2011, but we project that debt repayments, the release of captive non-resident krona holdings in line with our capital account liberalization strategy, and ongoing asset recovery will reduce this to around 150 percent of GDP by 2016. We expect general government debt to peak at 100 percent of GDP in 2011 before declining over the medium term, reaching 71 percent of GDP in 2016.

Policy overview

7. **Our policies are aimed at achieving a sustainable recovery**. We have made significant progress in stabilizing the economy and the exchange rate, and in bringing down

inflation, and our policies seek to build on these successes. In this regard, we expect to achieve a key fiscal milestone—a primary surplus—in 2011, which keeps our public finances on a sustainable path. The health of our banking system is gradually being restored, and the recently adopted measures to accelerate household and corporate debt restructuring should reduce the private sector debt overhang and improve bank balance sheets. While the unemployment rate remains high, it is our expectation that the measures we have put in place to facilitate job retraining and skill upgrading will help spur job creation this year. Looking ahead, our overarching policy challenge will be to lift the capital controls in an orderly manner that preserves the stabilization gains that we have achieved. To this end, we have published a revised strategy for the liberalization of capital controls. We are confident that the policies set out in this letter will lay the basis for a durable recovery.

Securing fiscal sustainability

8. **Our consolidation efforts delivered an improved primary fiscal position in 2010**. Revenues in 2010 exceeded expectations due to a pick-up in corporate and capital income tax revenues while central government expenditures remained within budgeted amounts. Despite preliminary data suggesting slippages in the local governments' fiscal performance, the general government overall balance improved by ¼ percent of GDP relative to the program, while the primary deficit reached 2½ percent of GDP (an improvement of 4 percentage points of GDP relative to 2009).

9. **We are committed to meeting our 2011 fiscal targets**. Our revenue projections for 2011 remain cautious in view of the fall in property prices and declines in nontax revenues that are putting downward pressure on local government revenues. Budget implementation has remained in line with expectations in the first quarter. However, our efforts to facilitate a long-term wage agreement among our social partners will lead to higher expenditures, which could amount to as much as ½ percent of GDP in 2011. This additional spending will be partly offset by higher government revenues arising from higher-than-expected wages. The remainder of the spending can be accommodated through our contingency fund, which is intended to meet unexpected outlays, such as those arising from price and wage fluctuations. Moreover, we are introducing a special levy on financial institutions to finance the temporary interest subsidy. Thus, we expect that the 2011 general government primary surplus will remain within the targeted ¼ percent of GDP and improve by 2¾ percent of GDP relative to 2010.

10. **We are revising our medium-term fiscal consolidation plan.** Given the evolution of the macroeconomy and the progress in putting our public finances on a sustainable path, we intend to update our medium-term plan in the coming weeks. In this context, we maintain our commitment to achieving an overall surplus in 2013, although we see scope to ease the pace of consolidation to accommodate higher spending on social protection and investment.

11. **We are strengthening the fiscal framework and finances of local governments**. With revenues declining, local governments plan to curtail costs in 2011 to keep primary fiscal positions near balance. Measures focus on reducing overhead and administrative costs, and better targeting social benefits. The comprehensive legislation on local government was presented to parliament in early April 2011, after extensive consultations. We will seek parliamentary approval of the new fiscal framework by end-June (**structural benchmark**). This will allow sufficient time for its implementation by the local governments in the 2012 budget cycle. The working group tasked with assessing the near-term external debt repayment capacity of the local governments has delivered its report and has been charged with a broader mandate to evaluate local governments' debt rollover difficulties. We will remain vigilant in monitoring the financial situation of the local governments, and will introduce a new quarterly data compilation system administered by Statistics Iceland by end-June.

12. **We do not envisage major changes to our medium-term debt management strategy**. The strategy was published in February, and its positive reception by market participants bodes well for implementing our 2011 annual borrowing plan. We achieved our funding objectives in the first quarter: the maturity profile of our debt portfolio has been extended with the successful issuance of a 20-year nominal bond. In line with the revised strategy for lifting capital controls (see below), we intend to issue a new 20-year inflation-linked bond that will help secure robust long-term funding in advance of the full lifting of capital controls. We still plan to access international capital markets in the coming months, but our plans have been somewhat delayed by the uncertainty regarding the impact of the outcome of the Icesave referendum on our sovereign rating. To the extent that the external environment is favorable, we may scale up our external borrowing over the medium term.

Capital controls

13. **We have revised our strategy for lifting capital controls**. The revised strategy was prepared by the CBI in coordination with key government ministries and the FME, and was approved by cabinet in late March (**structural benchmark**). Our legal experts have determined that the strategy is consistent with our EEA obligations.

14. **The revised strategy seeks to first address the challenge posed by the large stock of "offshore" krona.** The large amount of (mainly short-term) krona-denominated deposits and securities held by nonresidents (ISK 460 billion, about 30 percent of GDP, and 2/3 of gross reserves) and the large spread between the offshore and onshore exchange rates both undermine the confidence needed to ease controls. Our strategy aims to address these challenges by reducing the stock of potentially unstable "offshore" krona and replacing it with longer-term investment. Once the stock of offshore krona holdings has been sufficiently reduced we will proceed to a gradual, but eventually comprehensive, lifting of capital controls.

15. **The liberalization will take place in two phases and use a variety of methods.**

- The first phase will employ several market-based mechanisms to reduce the stock of "offshore" krona holdings by allowing those who do not wish to maintain their krona exposure to exit. In the first steps, offshore krona holders will be permitted to bid for foreign currency in CBI-organized auctions, while holders of foreign currency would be permitted to bid for krona to be invested in long-term government securities or other qualified investment projects. Later, we will broaden the range of investments available to offshore krona holders and may offer to swap krona-denominated government securities for long-term foreign exchange-denominated bonds. We have designed these steps to contain the impact on international reserves, safeguard government financing, and preserve exchange rate stability, while reducing the stock of short-term external debt.

- We recognize, however, that new inflows may not be available to finance the release of all offshore krona holdings and that central bank reserves may need to eventually be used. Thus, the strategy also envisages that, after reserve-neutral methods have been exhausted, some offshore krona would be allowed to exit after paying an exit levy.

- In the second phase, controls on onshore krona will be gradually lifted as warranted by the adequacy of the reserves and financial and exchange rate stability.

16. **The strategy maintains a gradual approach to capital account liberalization, and retains the flexibility needed to respond to developments during the liberalization process**. Our communication strategy has been carefully coordinated by the CBI and key ministries to guide investors' expectations for a gradual and orderly lifting of capital controls.

- In order to protect macroeconomic and financial stability, the pace of implementation of the strategy will be guided by macroeconomic developments, reserve adequacy, and the robustness of the financial sector. In this regard, whereas progress has been made in meeting macroeconomic preconditions for lifting controls, particular attention will be paid to the financial sector, which is still vulnerable and has limited capacity to withstand possible volatility in capital flows if controls where not in place.

- A comprehensive assessment of reserves and the medium-term balance of payments outlook will precede each major step toward liberalization to ensure that reserve adequacy will be maintained. Similarly, assessments will be undertaken with respect to the government bond market and financial sector stability (for instance, bank liquidity). Successful issuance of a long term sovereign bond in international markets would provide an important signal of investor confidence and will precede any liberalization steps that might result in significant outflows. To the extent that access to international capital markets is delayed, the lifting of capital controls will proceed more slowly and steps that are conditioned on market access will be delayed.

- A working group which includes the PMO, MoEA, the MoF, the FME and the CBI will monitor the implementation, pace, and adaptation of the strategy. Given the flexibility inherent in the strategy, we will consult with the Fund before taking each major step in liberalization process—including the steps involving the introduction of a new method of liberalization, such as the exit levy, and before beginning the release of onshore krona holdings—consistent with our undertakings in paragraph 4 of this letter.

17. **Throughout the liberalization process, the remaining controls will continue to be enforced**. We are in the process of amending our legislation on capital controls, taking into account the experience gained so far and the prospect for gradual liberalization. In addition, the repatriation requirement and the restriction on the use of krona in international transactions will remain in effect. Should circumvention arise, we will close any loopholes as needed. To this end, we will ensure that administrative capacity in the CBI and the police are sufficient to administer, monitor, and enforce controls which need to be maintained during the liberalization. Ongoing investigations of possible circumvention will be brought to closure and swiftly forwarded to the courts.

Monetary policy

18. **Our monetary policy will remain focused on inflation and preserving exchange rate stability**. The Monetary Policy Committee has removed the bias in monetary policy and kept rates on hold in its last two meetings. The uptick in inflation from rising commodity prices, higher inflation expectations, the somewhat weaker krona, and the forthcoming steps toward lifting capital controls underpinned this decision.

19. **We intend to further improve our liquidity management**. Ample liquidity and market fragmentation have kept short-term interest rates towards the lower-end of our policy corridor. Measures taken recently, notably the increase in the stock of CDs, had some success in moving market rates towards the center of the corridor, but their impact was short-lived. We will in the coming months endeavor to implement liquidity management more consistently, notably by improving management of the stock of CDs, strengthening our liquidity forecasting capabilities, and, if needed, engaging in high frequency fine-tuning operations. This should help keep interbank rates around the center of the policy corridor. Going forward, liquidity management will have to be strengthened as capital controls are liberalized. The first steps in the liberalization will drain some excess liquidity from the (currently highly liquid) banking system, increasing the need for liquidity management. To this end, we have undertaken a further evaluation of the availability and distribution of eligible collateral.

20. **We will continue to purchase foreign exchange to increase the CBI's non-borrowed reserves**. The large year-end foreign exchange operations undertaken to reduce commercial banks foreign exchange imbalances (€312 million purchased forward and €160 million spot) have helped accelerate this process. To ensure that reserves remain sufficient to ensure confidence in the krona during the process of lifting capital controls, we will closely monitor reserve adequacy using a range of indicators and periodic stress scenarios. When conditions permit, weekly purchase operations will be scaled up to help meet this goal.

21. **We are beginning to develop a new monetary policy framework**. The financial crisis has exposed the difficulties of implementing monetary policy in a small open economy like Iceland that is subject to large shocks and volatile capital flows. We believe that a new monetary framework must better take into account underlying imbalances in financial markets and their potential impact on the real economy without undermining the medium term commitment to low and stable inflation. Because of risks to financial stability, a strategic foreign exchange intervention and reserve management policy aimed at leaning against excessive swings in capital flows will be required. We also intend to deploy macroprudential tools to reduce the risks of a repeat of the pre-crisis excesses, and would seek to achieve better coordination of monetary and fiscal policies. The CBI has produced a report laying out some options. We are still at an early stage and are consulting with stakeholders to assess the relative merits of different monetary regimes.

Restoring the financial system

22. **Iceland's commercial banks remain well-capitalized, and we are in the process of bringing the rest of the financial system back into solvency**. Work is underway in several areas:

- ***Review of capital levels of the commercial banks***. The FME is currently reviewing the commercial banks' Internal Capital Adequacy Assessment Process (ICAAP). This review is supported by an ongoing special examination of the banks' loan portfolio with a forward looking view. If the FME were to find material discrepancies with the banks' asset valuation, it will promptly take action to determine the size of the potential overvaluation and the impact on bank capital. The situation of one small troubled commercial bank has been clarified and addressed with the participation of a group of private investors, and without the use of public funds.

- ***Wrapping up the recapitalization process of the savings banks*** (**structural benchmark**). The savings bank SpKef was intervened in early March and merged with a commercial bank, and we are preparing to inject funds to meet our obligations under the blanket guarantee. The agreement reached in October with the Winding-up Board of Byr savings bank on the restructuring of new Byr is being implemented: the recapitalization of new Byr is expected to be completed shortly once its 2010 financial statements have been finalized.

- ***Restoring the solvency of the Housing Finance Fund (HFF)***. We have injected funds equivalent to around 2 percent of GDP in order to increase the capital of the HFF towards the regulatory minimum of 5 percent. Furthermore, by end-June we will introduce legislation to put the HFF under full supervisory oversight by the FME. Finally, by end-September, we will publish a policy on the future structure of the HFF within the framework of a restored financial system.

- ***Recapitalizing remaining non-banks is near completion***. All credit card management companies and all leasing companies were adequately capitalized by end-April (**structural benchmark**). A decision as to whether, and if so to what extent, to recapitalize Byggdastofnun (a small regional fund) will be made on the basis of the recommendations of a working group, which will be presented in May.

23. **We continue to make progress in strengthening prudential rules and supervision**. Advances are being made on several fronts:

- ***Prudential rules***. Revised rules on connected lending have already been issued, and by end-June new prudential rules and guidelines on large exposures and sound banking practices will be issued by the FME, addressing key weaknesses leading to the crisis. By end-June 2011, the FME and the CBI, respectively, will prepare plans to strengthen their rules on capital and liquidity requirements in line with preparations for the eventual adoption of Basel III standards. Additionally, the FME is currently developing a new set of rules covering other banking services and ancillary activities, effects on capital requirements of the collateralization of bank shares and qualifications of board members and CEOs of financial undertakings. These will be made public by end-July 2011.

- ***Credit registry***. The FME, in collaboration with the CBI, is developing a data base to closely monitor exposures above ISK 300 million per borrower per bank. This registry—which is expected to be operating by end-July 2011—will allow the supervisory authority to identify credit concentration and large exposures of banks' related and non-related economic groups.

- ***Harmonization of bank reporting***. In February the FME completed its examination of the consistency and fairness of existing accounting practices related to income and impairment recognition on loans acquired at fair value by the new banks from the old banks. By mid-June 2011, the FME, drawing heavily on the work done by a technical committee comprising its staff and industry representatives, will issue guidelines to harmonize financial reporting on non performing loans and progress in debt restructuring and facilitate the comparison and understanding of the banks' financial statements.

- ***Identification of remaining supervisory gaps***. In mid-March the FME completed a self-assessment of the country's compliance with the Basel Core Principles for Effective Banking Supervision. This assessment was subjected to an independent evaluation by a well-known foreign assessor, who issued his report (containing recommendations and a possible agenda) in mid-April (**structural benchmark**). By end-June, the FME will have issued an action plan (including a clear timetable for deliverables over the following 24 months) to address remaining supervisory gaps.

24. **Operational restructuring of the savings banks is advancing**. With the merger of SpKef, 50 percent of the savings banks system by assets has been addressed. For the remaining savings banks the Icelandic State Financial Investments (ISFI) is cooperating with the privately held savings banks to develop proposals for further operational restructuring, including consolidation, to strengthen their medium-term viability. A working group with representatives of all savings banks, led by the ISFI, has been commissioned to develop proposals on the reorganization/restructuring of the remaining savings banks. This working group will submit its proposals to the boards of the savings banks and the ISFI by end-May. Depending on the decisions of the boards, these proposals would subsequently be presented to the guarantee capital holders, including the ISFI. These proposals, together with the SpKef merger, meet the objective of the end-March **structural benchmark** on a two-year strategic plan for the savings banks' restructuring and consolidation.

25. **We are reviewing the existing banking legislation and laws governing the FME and CBI as part of our further financial reforms.** Many improvements have been made to the legal and regulatory environment since the crisis of 2008, in line with recommendations by an external adviser and evolving developments in the EU. A revised Act on the deposit guarantee scheme will reestablish the private guarantee fund—we have introduced a legislative proposal to parliament that meets international best practices and core principles for effective deposit guarantee systems, notably regarding contributions, coverage and pay-out. The goal of this legislation is to help restore confidence in the banking system and pave the way towards the orderly and gradual lifting of the blanket guarantee on deposits. Further changes are envisaged. We will continue to focus our attention on current and future developments on banking regulation within EU, especially regarding the adoption of Basel III, the coordination of micro- and macro-prudential supervision and supervisory tools. A working group comprised of specialists in this field, will prepare a report—drawing on the experience in the EU and other financial centers as well as recommendations made by the international expert assessing country's compliance with Basel Core Principles for Effective Banking Supervision—to be presented to Parliament by the Ministry of Economic Affairs. On the basis of this report and consultations with stakeholders and the IMF, we plan to submit legislative proposals to the Parliament during its next session. The legislation will, inter alia, substantially reduce the threshold for reporting exposures to the credit registry in order to ensure more comprehensive coverage of the registry.

Accelerating private sector debt restructuring

26. **We are implementing measures for corporate and household debt restructuring**. We continue to attach high priority to accelerating private sector debt restructuring, as we believe that this will be critical to a sustainable recovery and job creation. The measures that we agreed with key stakeholders in December and January preserve scarce fiscal resources while imposing a manageable cost on creditors. We do not intend to take further measures, and have clearly communicated this to the public in an effort to advance the process. We are working with the FME and financial institutions to compile aggregate data to monitor progress with household and corporate debt restructuring.

- ***Corporate debt restructuring***. Restructuring of small- and medium-size enterprises (SMEs) and large corporates is advancing, but at a slower pace than we had expected. For SMEs, the agreed measures—consisting of a standardized approach for writing down debt to the value of the firm—are being implemented, but it is taking banks somewhat longer to prepare debt restructuring proposals for firms. The three commercial banks expect that this process will be largely completed by end-2011. We have requested monthly reports to monitor progress in SME debt restructuring and will take steps to remove obstacles that may arise. For large corporates, the process is likely to take longer, as these cases tend to be more complex and require significant documentation before restructuring can take place.

- ***Household debt restructuring***. The measures for household debt restructuring, alongside our commitment not to take further measures, has encouraged households to enter the debt restructuring process. The Office of the Debtor's Ombudsman is now processing roughly 1500 applications for debt mitigation, and banks have reported an increased number of applications for debt restructuring. At the same time, the process has been held up somewhat by delays in recalculating foreign-currency indexed mortgages (in line with the Supreme Court rulings) and in obtaining for HFF the legal authority to provide debt writedowns. Nonetheless, the three commercial banks expect to complete the household debt restructuring process by end-2011.

External financing

27. **We have made progress in securing adequate external financing and boosting reserves**. Reserves increased substantially in the last quarter of 2010, and we expect them to increase further during 2011. Our Nordic bilateral partners are in the process of extending the availability of financing under their arrangements until end-December 2011, and we intend to draw on this funding as financing gaps require. Going forward, our foreign currency borrowing strategy will be aimed at securing regular access to international capital markets and to maintaining a diversified investor base. The planned issuance of an external bond in the coming months and further rollovers in 2012 are an important part of this strategy, and will further strengthen reserves coverage. Progress towards covering our external financing

needs will be reassessed during the next program review and throughout the capital account liberalization process. In the event of shortfalls, we stand ready to consult with the Fund on any additional measures that would prove necessary to meet program objectives (consistent with our undertakings under paragraph 4 above).

28. **We attach high importance to resolving the Icesave issue**. For this reason, and despite our view that reimbursement of the Icesave deposit payouts is not a sovereign obligation, we sought and reached a negotiated solution with the United Kingdom and the Netherlands. Legislation authorizing the Minister of Finance to provide the necessary state guarantees was passed by parliament in February, but rejected in a referendum in April. The process regarding the disputed deposit guarantees will now continue through legal channels. We are fully engaged in this process. On May 2, 2011 we responded to the EFTA Surveillance Authority's (ESA's) Letter of Formal Notice, recommending that ESA close the issue on the basis of that response. If, however, a competent court finds that Iceland has a sovereign obligation stemming from the Icesave deposits, we will honor that obligation.

Yours sincerely,

/s/
Jóhanna Sigurðardóttir
Prime Minister

/s/
Steingrímur Sigfússon
Minister of Finance

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

/s/
Árni Páll Árnason
Minister of Economic Affairs

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

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

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

Table 2. Iceland: Structural Conditionality

Structural Conditionality	Status
Structural Benchmarks	
• Passage of legislation to strengthen the fiscal framework for local governments, covering (i) the fiscal rule to be applied; (ii) restrictions on municipal borrowing; (iii) mechanisms for dealing with revenue volatility; (iv) surveillance modalities; (v) coordination mechanisms; and (vi) sanctions for non-compliance (LOI ¶11). *By end-December 2010.*	Not met/Reset to end-June 2011
• Recapitalization of Byr and Keflavik, the two largest savings banks, up to 16 percent of their risk weighted assets. (LOI ¶22). *By end-February 2011.*	Not met/SpKef was merged with a commercial bank. Byr's recapitalization is awaiting finalization of 2010 financial statements.
• Publication of a Basel Core Principles assessment of weaknesses in Iceland's supervisory framework, along with a strategic plan to address the weaknesses (LOI ¶23). *By end-March 2011.*	Not met/Assessment completed in mid-April 2011.
• Completion by Icelandic State Financial Investment Company of the two year strategic plan to ensure medium term viability of the savings banks through consolidation (LOI ¶24). *By end-March 2011.*	Not met/Plan for reorganization of remaining savings banks to be presented by end-May 2011.
• Cabinet approval of the updated strategy for lifting capital controls in line with program objectives (LOI ¶13). *By end-February 2011.*	Not met/Updated strategy approved by cabinet on March 25, 2011.
• The FME to require rehabilitation and/or recapitalization measures to be taken by non-bank financial institutions (other than the Housing Finance Fund) as determined to be necessary by a review of their business plans (LOI ¶22). *By end-February 2011.*	Met

ATTACHMENT II. TECHNICAL MEMORANDUM OF UNDERSTANDING

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

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

Central Government

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

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

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

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

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

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

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

6. **Adjustment mechanism**:

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

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

7. **Supporting Material:**

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

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

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

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

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

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

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

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

9. **Adjustment mechanism:**

- The NIR floor will be adjusted upward at the program exchange rate by the cumulative amount of Nordic disbursements since December 31, 2010. For every one dollar of disbursements, the NIR floor for each period will be adjusted upward by 0.5

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

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

C. Ceiling on Net Domestic Assets

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

15. **Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors.** This performance criterion applies on a continuous basis. External payment arrears consist of external debt service obligations (principal and interest) falling due after October 20, 2008, and that have not been paid at the time due, taking into account the grace periods specified in contractual agreements. Data will be provided on a monthly basis with a lag of no more than 20 days.

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

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

Table 3. Program Exchange Rates

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

APPENDIX I. DEBT SUSTAINABILITY ANALYSIS

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

A. External DSA

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

- Available data on the three old banks' asset recovery up to December 2010 suggest that recovery has continued to be faster than previously anticipated. This increases external debt because these assets are recorded as liabilities to nonresidents until they can be paid out to creditors. The time at which the old banks are assumed to pay out the recovered assets to external creditors is as follows: two old banks start paying out to creditors in 2011, while the third old bank starts in 2013.

- The treatment of potential liabilities related to Icesave deposits has changed since the dispute will be settled through legal channels. The United Kingdom and the Netherlands are now treated as priority claimants on the Landsbanki estate (previously, when a negotiated solution to the dispute was envisaged, the UK and Dutch claims were treated as an upfront external loan to Iceland's deposit insurance agency, in line with the terms of the latest agreement). The new treatment of Icesave-related debt 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). This change in treatment has reduced estimates of external debt.

- Interest rates for new borrowing throughout the projection period are assumed to be higher than in the last DSA, reflecting higher assumed global funding costs, and the change from LIBOR to long-term bond yield as the benchmark.

- External borrowings by the central government and its enterprises are assumed to be rolled over. The remaining Nordic tranches are assumed to be drawn in the second half of 2011. In addition, the central government is assumed to issue bonds to cover (on average 30 percent) of the CBI's external debt that falls due over 2012–16.

- Local municipalities are assumed to only partially roll over their debt, with an average rollover rate of around 30 percent assumed over 2011–16. Moreover, it is assumed that a local government utility, previously assumed to roll over part of its debts, will no longer be unable to access financing to roll over its external obligations during the entire projection period.

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

3. **Estimates of the external debt path are lower than at the fourth review.** External debt is estimated at almost 290 percent of GDP in 2010, and is expected to fall to around 150 percent of GDP by 2016. Around 20 percent of the 2010 debt stock (64 percent of GDP) reflects external liabilities to nonresidents (i.e., foreign creditors) associated with asset recovery of the old banks. Until ongoing litigation is resolved, assets recovered by the old banks cannot be paid out to creditors. Over time, on a net basis, however, these liabilities are mostly matched by the assets recovered externally. As such, debt covered by these recovered external assets has no implications on the net external stocks or flows.

4. **The external debt path is contingent on the eventual outcome of the Icesave dispute**. Litigation surrounding the Icesave claim poses risks to the baseline. Scenarios considered in this DSA are: (i) Iceland is found by the relevant court to be liable for all (insured and uninsured) Icesave deposits; and (ii) Iceland is found by the relevant court to be liable for insured Icesave deposits. Under both assumptions 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. In addition, for comparison, the implications of the December 2010 agreement for external debt as well as a scenario where insured deposit have super-priority status (i.e., insured deposits would be paid out before uninsured deposits) in the estate of Landsbanki—which would imply that they would be reimbursed in full by end-2012—are also included. Each of these scenarios is treated the same way as in the Public DSA, and would involve an upward revision of the debt path, with coverage of both the insured and uninsured deposits having the largest impact. Payments from Landsbanki's estate are expected to begin in the second half of 2011.

5. **Stress tests suggest that the downward trajectory remains a robust result.** Standard shocks would not disturb the downward trajectory of the external debt ratio. Realization of any of the litigation risk scenarios would result in higher debt throughout the medium term, although the debt path remains on a downward trajectory as assets are recovered and claims settled. An exchange rate depreciation of 30 percent would have the strongest effect, but even under this scenario the debt ratio would resume falling after the initial increase.

B. Public Debt Sustainability

6. **The following assumptions underlying the public debt sustainability analysis have been changed since the fourth review**:

- Preliminary 2010 data suggest that the primary deficit was 2.5 percent of GDP (slightly worse than expected during the fourth review). However, the decline in interest payments led to an improvement in the overall deficit of about ¼ percent of GDP.

- The primary balance adjustment in 2011 is as assumed under the program, raising the primary surplus to ¼ percent of GDP. The assumptions for road construction spending have been scaled down significantly and have no material implications for the primary surplus in 2011. Road construction spending may reduce the primary balance by about ¼ percent of GDP in 2012.

- Potential Icesave-related obligations of the government are currently treated as contingent liabilities until a court decision has been made (see below). Meanwhile, Landsbanki's asset recovery is expected to be slightly more frontloaded, with additional ¼ percent of GDP in recoveries in 2010. This implies asset recovery relative to the total Icesave deposits of about 90 percent, about 51 percent of which are expected to the distributed by end 2012.

- The called guarantees of the Government Guarantee Fund assumed by the government will be repaid gradually by 2023.

- HFF recapitalization amounting to 2 percent of GDP has been accrued in 2010, while the savings bank recapitalization amounting to 1¼ percent of GDP is expected to take place in 2011.

- Eurobond repurchases finalized reached about 6¼ percent of GDP in 2010, and 3½ percent of GDP in 2011.

- The timing and rollover rates for external loans have also been adjusted in line with assumptions used for the external debt analysis. In particular, the third and fourth tranches of the Nordic loans are expected to be drawn by end-2011. Furthermore, 30 percent of CBI's debt falling due in 2012–16 is assumed to be rolled over and add to gross general government debt.

- Local governments with external debt falling due in 2011–16 are expected to service their external debt and finance domestically, and one municipality is expected to reach an agreement with its external creditors on slightly rescheduled payments. The external debt payments of the two most vulnerable local governments represent ¾ percent of 2012 GDP.

7. **At 92½ percent of GDP, the 2010 gross public debt ratio is 1½ percentage points higher compared to the fourth review due to a downward revision in 2010 GDP and larger cash buffers**. Public debt is expected to peak in 2011 and stand at 100 percent at year end. This will be due to the full disbursement of bilateral loans and further strengthening of the central government's cash buffer.

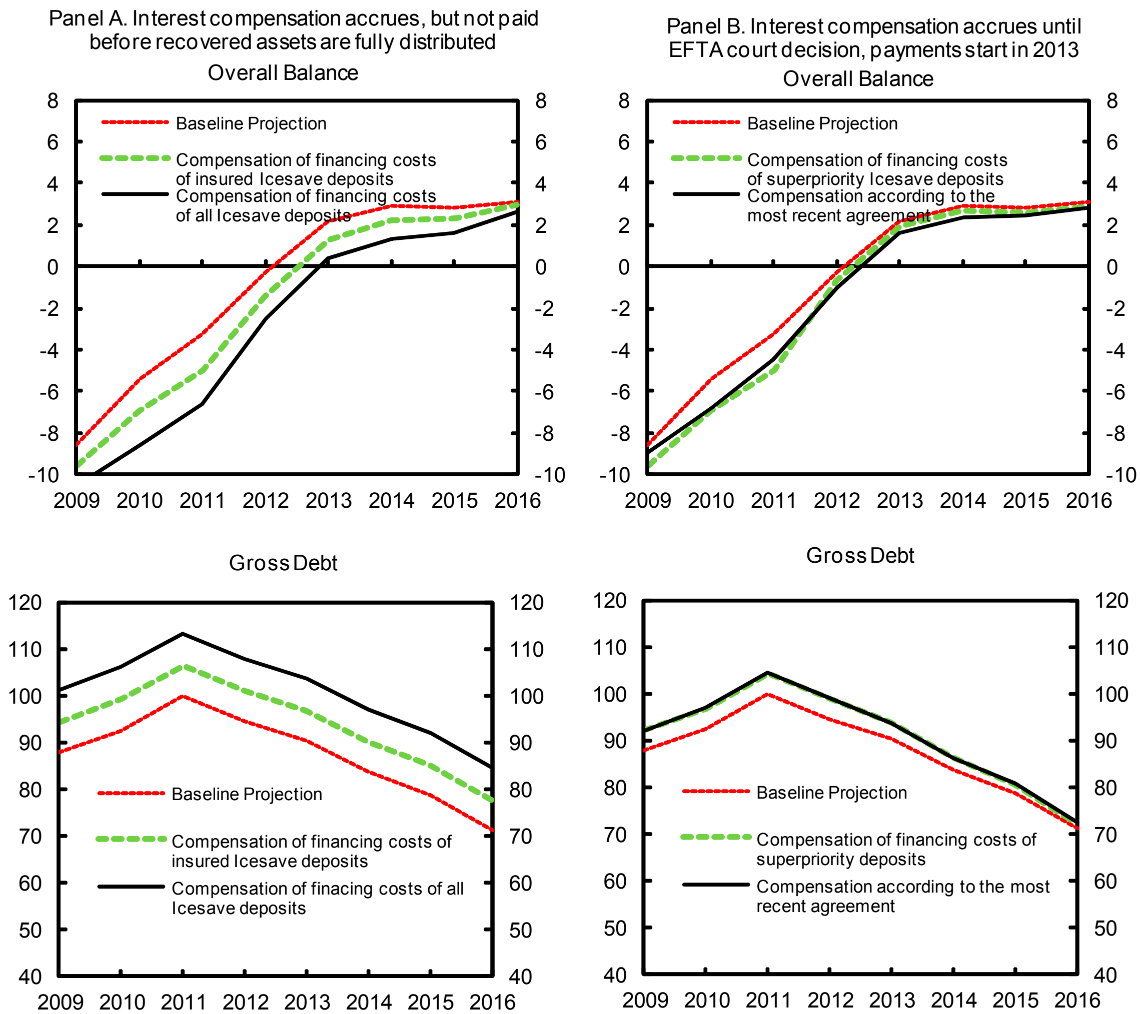
8. **Over the medium term, Iceland's public debt declines steadily after 2011 under the program baseline scenario** (Table A2, Figure A2). The downward path will be more gradual than before due to the greater cash buffers the authorities would like to maintain in 2011 and in the medium term and the assumed partial refinancing of CBI debt by the government. The real interest rate/GDP growth differential will continue to contribute to debt growth in the medium term. By 2012, the actual primary balance is projected to exceed the debt-stabilizing level, with debt reduction continuing beyond the projection period.

9. **The debt level is contingent upon the outcome of the Icesave dispute.**

- Two stress scenarios are considered: (i) government reimbursement of the residual amount of *insured* Icesave deposits after asset distribution plus compensation of the UK and Dutch governments for any financing costs; and (ii) government reimbursement of the residual amount of *insured plus uninsured* Icesave deposits after asset distributions, as well as the attendant financing costs (Panel A). Based on current exchange rate and asset recovery and distribution assumptions, asset recovery should cover around 90 percent of deposits. Therefore, the contingent liability of the government is estimated at about 6½ percent of GDP in 2011 if insured deposits were to be covered (13¼ percent of GDP should the financing costs of all deposits be covered). This would reflect financing costs in the form of accrued interest at the currently projected interest rates on long-term euro and UK government bonds.

- There are also two contingent outcomes with more benign implications for the government (Panel B). In one such case, insured deposit would have super-priority status in the estate of Landsbanki (i.e., insured deposits would be paid out before uninsured deposits), which would imply that they would be reimbursed in full by end-2012. The NPV of the potential financing cost obligation of the government would amount to 4¼ percent of GDP at end-2011. For comparison, the most recent Icesave agreement is also presented: the NPV of the cost to the government would amount to 4 percent of GDP at end-2011, assuming payments commence in 2013.

Figure. Icesave Scenarios
(Percent of GDP)



10. **The baseline debt trajectory is also sensitive to growth and program implementation shocks** (Figure A2):

- **Contingent liability shock unrelated to the outcome of the Icesave dispute.** A shock to public debt of 30 percent of GDP arising from the need to inject further capital in the banking sector, assume larger debt guarantees, or provide financing to local governments would raise the debt ratio to almost 130 percent of GDP in 2012. Given an unchanged fiscal consolidation path and no significant side effects on interest rates, public debt would rise sharply before falling to 106 percent of GDP in 2016.

- **Macro shocks.** A growth shock would flatten the debt path and keep debt at 99 percent of GDP in 2016. A 30-percent depreciation of the exchange rate would raise the debt ratio to 110 percent of GDP in 2012 and leave debt at 87 percent of

GDP in 2016. The impact of an interest rate shock and a combined macro shock would be more benign, with an interest shock bringing debt to 82 percent of GDP and a combined shock to 85 percent of GDP in 2016.

- **No policy change scenario**. Halting the implementation of the fiscal consolidation program—i.e. maintaining a small primary surplus as in 2011—would further compress the doward debt trajectory and leave at 101 percent of GDP in 2016.

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

	Actual												
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016		Debt-stabilizing non-interest current account 6/
Baseline: External debt (including old banks)	433.5	605.9	564.7										
Baseline: External debt	101.3	171.8	189.0	267.9	289.9	**240.8**	**217.0**	**185.4**	**176.4**	**164.8**	**152.9**		**4.2**
Change in external debt	35.4	70.6	17.2	78.9	22.0	-49.2	-23.8	-31.7	-9.0	-11.6	-11.8	0.0	
Identified external debt-creating flows	31.3	26.8	40.0	39.5	-9.5	-29.8	-29.9	-18.4	-13.2	-13.5	-11.1	0.0	
Current account deficit, excluding interest payments	22.2	10.1	13.1	0.2	0.1	-13.7	-15.4	-12.3	-12.7	-11.9	-12.0	-4.2	
Deficit in balance of goods and services	17.5	10.1	2.3	-8.6	-10.6	-10.4	-9.4	-8.3	-8.1	-8.2	-8.3		
Exports	32.1	34.5	44.2	52.8	56.6	58.8	58.5	58.5	58.9	58.6	58.2		
Imports	49.6	44.6	46.5	44.2	46.1	48.4	49.1	50.3	50.8	50.4	49.9		
Net non-debt creating capital inflows (negative)	7.3	28.9	-23.0	11.9	-26.5	-21.5	-21.4	-14.0	-9.7	-10.1	-7.7	-2.2	
Automatic debt dynamics 1/	1.9	-12.2	50.0	27.4	16.9	5.3	7.0	8.0	9.1	8.6	8.5	6.5	
Contribution from nominal interest rate	3.4	6.1	12.9	10.3	8.0	11.4	13.5	13.5	13.9	13.7	13.2	13.2	
Contribution from real GDP growth	-3.0	-4.9	-2.0	17.2	8.9	-6.1	-6.6	-5.6	-4.8	-5.1	-4.7	-4.6	
Contribution from price and exchange rate changes 2/	1.4	-13.4	39.1	44.5	-19.6	...	...	...	...	...	...	-2.2	
Residual, incl. change in gross foreign assets 3/	4.1	43.7	-22.8	39.4	31.5	-19.3	6.1	-13.3	4.2	1.9	-0.7	0.0	
External debt-to-exports ratio (in percent)	315.8	498.4	427.9	507.3	512.1	409.7	371.1	316.7	299.5	281.2	262.8		
Gross external financing need (in billions of US dollars) 4/	8.0	8.7	13.1	6.5	9.5	12.7	9.8	8.7	3.1	3.6	3.2		
in percent of GDP	47.6	42.8	78.1	53.6	75.3	91.6	67.3	57.6	19.7	21.9	18.7		
Scenario with key variables at their historical averages 5/						**288.2**	**297.8**	**283.4**	**287.0**	**288.9**	**289.5**		**-9.8**
Key Macroeconomic Assumptions Underlying Baseline												For debt stabilization	
Real GDP growth (in percent)	4.6	6.0	1.0	-6.5	-3.5	2.3	2.9	2.7	2.7	3.0	3.0	2.7	
Nominal external interest rate (in percent)	5.3	7.4	6.2	3.9	3.1	4.3	5.9	6.5	7.8	8.1	8.4	7.8	
Growth of exports (US dollar terms, in percent)	4.5	31.3	5.4	-13.9	11.6	14.1	4.7	3.8	4.3	4.0	4.6		
Growth of imports (US dollar terms, in percent)	16.3	9.8	-14.1	-31.6	8.5	15.5	6.8	6.1	4.7	3.8	4.3		
Current account balance, excluding interest payments 7/	-22.2	-10.1	-13.1	-0.2	-0.1	13.7	15.4	12.3	12.7	11.9	12.0		
Net non-debt creating capital inflows	-7.3	-28.9	23.0	-11.9	26.5	21.5	21.4	14.0	9.7	10.1	7.7		

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

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

3/ Projections also reflect the impact of price and exchange rate changes, inflows of extraordinary financing (and Fund repurchases). The large projected residuals in 2011 and 2013 reflect the imapct of large payments by the oldbanks which (discretely) reduce external debt with 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 growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

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

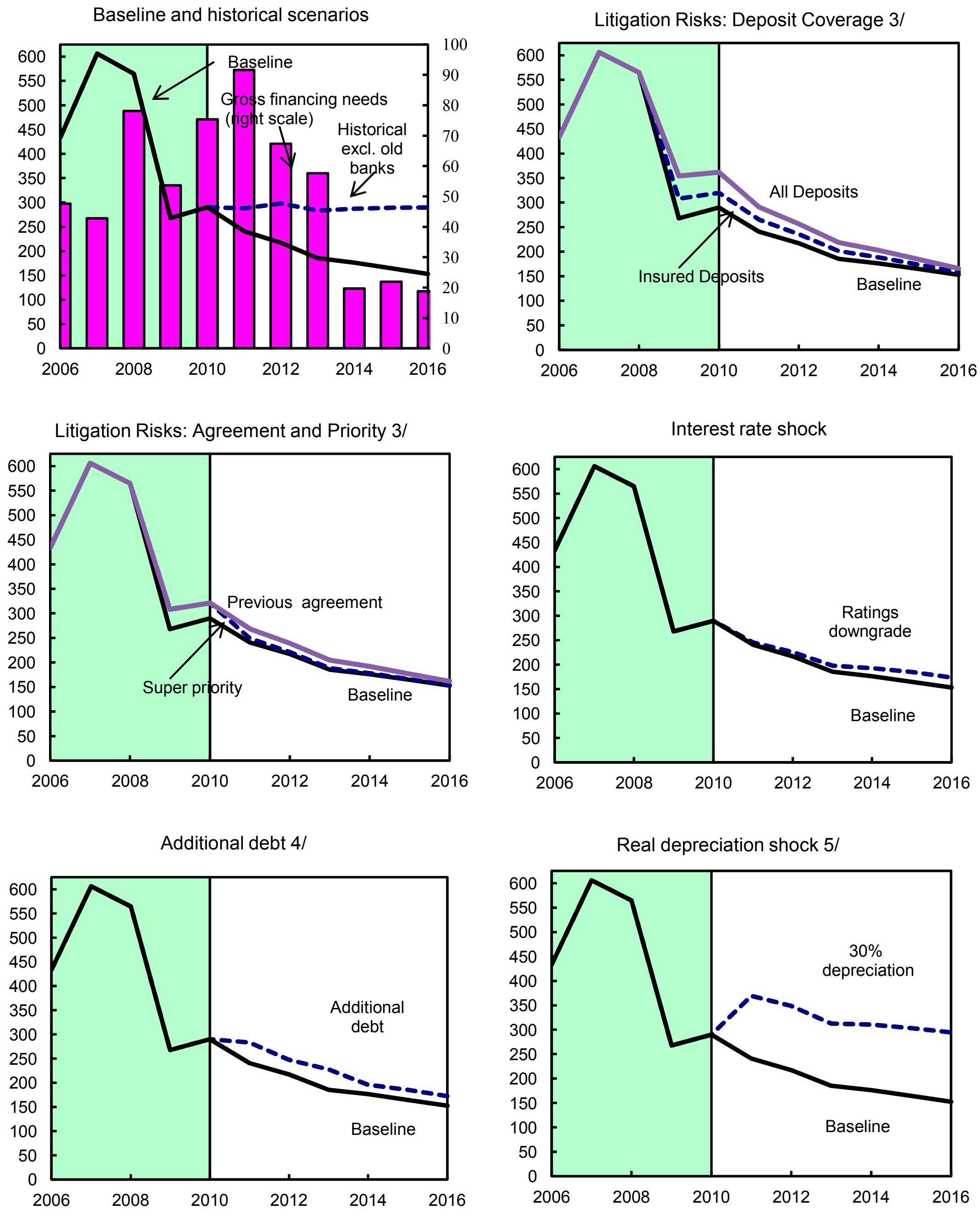
7/ Historical debt and interest data exclude old bank data (based on staff and Central Bank estimates).

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

	Actual					Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	30.1	28.6	69.7	87.7	92.6	**100.1**	**94.6**	**90.3**	**83.8**	**78.9**	**71.3**	**0.8**
o/w foreign-currency denominated	16.8	13.3	24.0	26.6	24.4	30.6	28.7	30.5	29.9	29.7	28.0	
Change in public sector debt	4.7	-1.5	41.1	17.9	4.9	7.5	-5.4	-4.3	-6.5	-4.9	-7.5	
Identified debt-creating flows (4+7+12)	-8.0	-10.8	27.9	17.4	7.0	5.3	-5.2	-6.7	-7.3	-7.1	-7.1	
Primary deficit (including interest income)	-8.5	-8.0	-2.8	3.4	0.3	-1.8	-5.5	-7.9	-8.0	-8.0	-8.0	
Revenue and grants	48.0	47.7	44.1	41.1	42.3	40.8	42.4	43.2	43.5	43.4	43.3	
Primary (noninterest) expenditure	39.5	39.7	41.3	44.5	42.5	39.0	37.0	35.4	35.4	35.4	35.3	
Automatic debt dynamics 2/	0.5	-2.8	12.5	4.4	2.3	0.2	0.3	1.1	0.7	0.9	0.9	
Contribution from interest rate/growth differential 3/	-0.9	-0.6	0.0	4.6	2.6	0.2	0.3	1.1	0.7	0.9	0.9	
Of which contribution from real interest rate	0.1	1.0	0.3	-0.1	-0.3	2.2	3.0	3.5	3.0	3.3	3.2	
Of which contribution from real GDP growth	-1.0	-1.6	-0.3	4.8	3.0	-2.0	-2.7	-2.4	-2.3	-2.4	-2.2	
Contribution from exchange rate depreciation 4/	1.4	-2.2	12.5	-0.3	-0.3	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	18.2	9.6	4.4	6.9	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities 5/	0.0	0.0	0.0	6.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (capitalization of banks, bilateral loans) 6/	0.0	0.0	18.2	3.1	4.4	6.9	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 7/	12.7	9.3	13.2	0.5	-2.1	2.2	-0.2	2.5	0.8	2.1	-0.4	
Public sector debt-to-revenue ratio 1/	62.8	60.0	158.2	213.4	219.0	245.1	222.9	209.0	192.9	181.8	164.6	
Gross financing need 8/	-0.4	0.5	13.0	26.1	25.4	19.0	11.1	9.0	10.1	5.4	6.4	
in billions of U.S. dollars	-0.1	0.1	2.2	3.2	3.2	2.6	1.6	1.4	1.6	0.9	1.1	
Scenario with key variables at their historical averages 9/						**100.1**	**96.7**	**96.1**	**93.9**	**93.0**	**89.5**	**-0.2**
Scenario with no policy change (constant primary balance) in 2011-2016						**100.1**	**98.3**	**100.1**	**99.9**	**101.4**	**100.3**	**1.2**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.6	6.0	1.4	-6.9	-3.5	2.3	2.9	2.7	2.7	3.0	3.0	
Average nominal interest rate on public debt (in percent) 10/	9.7	9.6	13.2	7.5	6.0	5.9	6.3	6.3	6.0	6.5	6.6	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.9	4.0	1.4	-0.7	-0.6	2.6	3.3	4.0	3.6	4.3	4.3	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-12.1	15.9	-48.7	1.0	1.1	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	8.8	5.7	11.8	8.3	6.7	3.3	3.1	2.4	2.4	2.3	2.3	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.2	6.5	5.4	0.3	-7.6	-6.2	-2.5	-1.8	2.8	2.9	2.9	
Primary deficit (including interest income)	-8.5	-8.0	-2.8	3.4	0.3	-1.8	-5.5	-7.9	-8.0	-8.0	-8.0	
Net public sector debt	7.8	10.8	41.7	55.8	63.5	66.0	62.9	58.1	52.7	47.4	42.0	

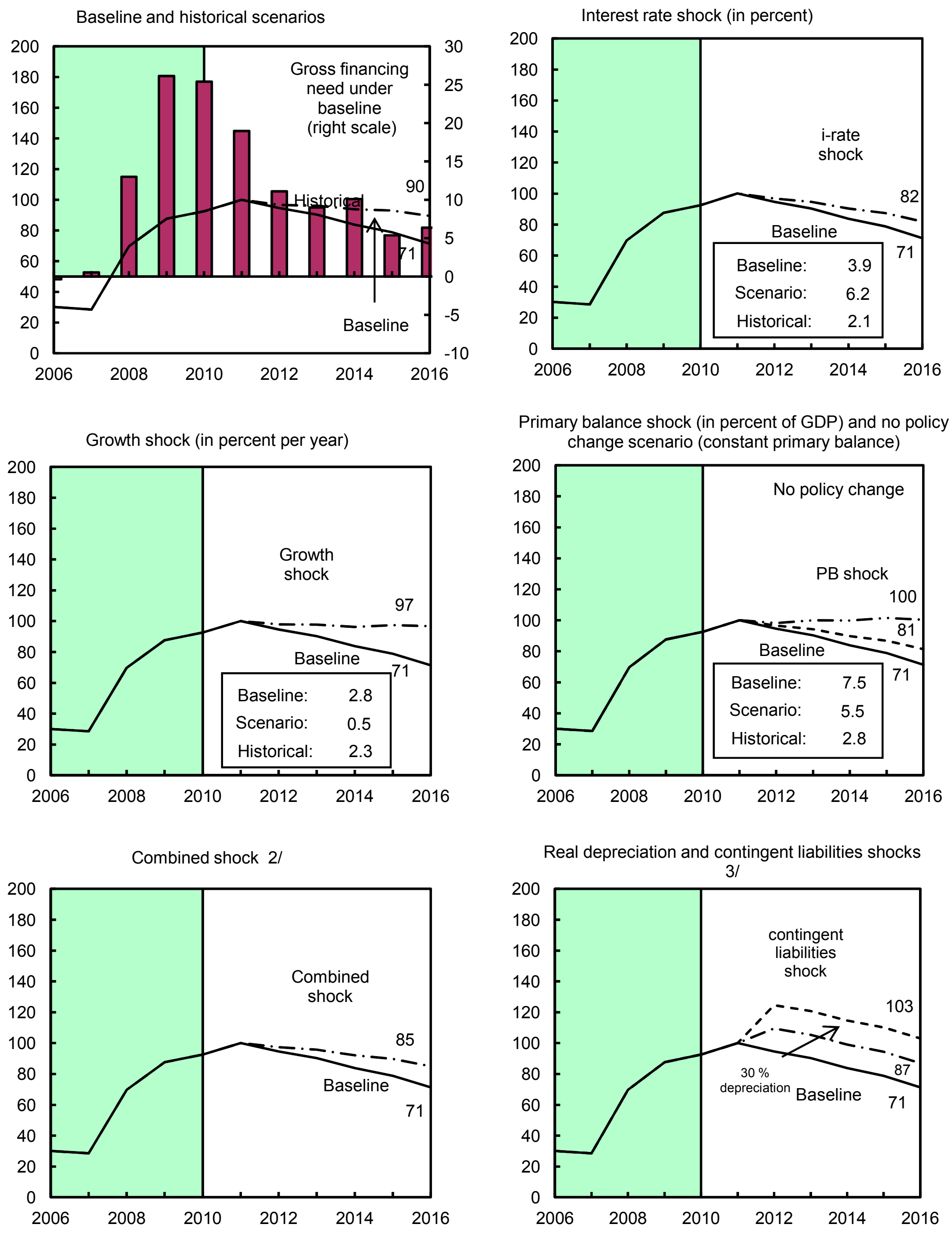
1/ General government gross debt (including bilateral loans to the central government to support central bank reserves; excludes IMF loans).
Also includes the estimated impact of the guarantee on UK/Dutch IceSave loans, net of asset recovery. It estimates, under given assumptions for asset recovery and on a cash flow basis, the residual obligation for the government and growth thereof due to accruing interest.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Reflects the estimated "net present value" of the guarantee on UK/Dutch IceSave loans, after asset recovery.
6/ Includes capitalization of new banks, savings banks, and bilateral loans to support CBI reserves.
7/ For projections, this line includes exchange rate changes. In 2009-11, the residual also reflects use of deposits at the central bank and sale of financial assets obtained during the financial crisis.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.
10/ Defined as general government deficit, plus amortization of medium and long-term general government debt, plus short-term debt at end of previous period.

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



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent preliminary actual data including old banks unless otherwise indicated. Except for the interst rate shock, the Individual shocks are permanent one-half standard deviation shocks. The interest rate shock is a one standard deviation shock.
2/ GDP is converted into $ at average exchange rates.
3/ Litigation risks are assumed as follows:
All despostis: Compensation for financing all Icesave deposits.
Insured deposits: Compensation for financing costs of insured deposits.
Super priority: Compensation for financing costs of super-priority deposits.
Agreement: Compensation for financing costs according to the most recent Icesave agreement.
4/ Assumes 20 percent of GDP increase in external debt in 2011.
5/ One-time real depreciation of 30 percent occurs in 2011.

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



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

INTERNATIONAL MONETARY FUND

ICELAND

Fifth Review Under the Stand-By Arrangement, and Request for Modification of Performance Criteria and Rephasing of Access

Informational Annex

Prepared by the European Department

May 19, 2011

Content | Page

ICELAND: FUND RELATIONS

(As of March 31, 2011)

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

II. **General Resources Account:**	**SDR Million**	**Percent Quota**
Quota	117.60	100.00
Fund holdings of currency	1,078.93	917.46
Reserve position in Fund	18.67	15.88
Holdings Exchange Rate		

III. **SDR Department:**	**SDR Million**	**Percent Allocation**
Net cumulative allocation	112.18	100.00
Holdings	67.49	60.16

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent Quota**
Stand-By Arrangements	980.00	833.33

V. **Latest financial Arrangements:**

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-By	Nov 19, 2008	Aug 31, 2011	1,400.00	980.00

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

	Forthcoming				
	2011	2012	2013	2014	2015
Principal		280.00	358.75	196.88	131.25
Charges/Interest	20.84	25.10	14.65	4.87	1.63
Total	20.84	305.10	373.40	201.74	132.88

VII. **Implementation of HIPC Initiative, MDRI, and PCDR:** Not applicable

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

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

X. **Last Article IV Consultation:**

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

XI. **Fifth Review Mission:**

Discussions were held during January 31–February 11 and April 28–May 5. The mission met with Prime Minister Sigurðardóttir, Finance Minister Sigfússon, Economic Affairs Minister Árnason, Central Bank Governor Guðmundsson, and other senior officials, as well as parliamentarians, CEOs of the new banks and Icelandic corporations, the employers' federation and labor unions, and academics. The staff team comprised J. Kozack (head), A. Chailloux and W. Maliszewski (EUR); I. Petrova (FAD); L. Cortavarria and A. Kokenyne (MCM); N. Porter (SPR). The mission was assisted by F. Rozwadowski and E. Karlsdóttir from the resident representative office. L. Alfredsdottir (OED) attended many meetings.

XII. **Technical Assistance:**

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

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

XIII. **Resident Representative:**

Mr. Franek Rozwadowski assumed the position in March 2009.

Statement by the Staff Representative on Iceland
Executive Board Meeting
June 3, 2011

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

Risks to external financing have diminished after all three credit rating agencies affirmed Iceland's rating. Rating agencies updated their assessments of Iceland following the referendum on the Icesave agreement. Last week, Standard & Poor's affirmed Iceland's BBB- long-term foreign currency rating and removed Iceland from its "credit watch" list. This followed a previous announcement by Moody's, affirming Iceland's local and foreign currency ratings of Baa3. Fitch also kept its rating unchanged, but raised the outlook from "negative" to "stable". The authorities have indicated that they plan to proceed with a bond issuance in international capital markets in the near future. Iceland's CDS spreads fell to 210 bps in recent days.

Landsbanki's Resolution Committee has further increased its asset recovery projections. In a recent report, the resolution committee announced that the recovery process as of end-March would likely cover at least 94 percent of the priority claims (depending on the exchange rate assumption) rather than 90 percent estimated earlier.

The CBI announced on May 23 an auction of foreign currency—the first step toward a comprehensive lifting of capital controls. Offshore krona holders were invited to present offers to sell ISK 15 billion in exchange for foreign currency in an auction to be held on June 7. The spread between the onshore and offshore exchange rates declined following the announcement.

The eruption of the Grímsvötn volcano appears likely to have a limited impact on the economy. Although it is too early to assess the full impact on tourism and public finances, signs of abating volcanic activity suggest that this eruption should impact the economy less severely than the Eyjafjallajokull eruption in 2010.

Press Release No.11/214
FOR IMMEDIATE RELEASE
June 3, 2011

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Fifth Review Under the Stand-By Arrangement for Iceland

The Executive Board of the International Monetary Fund (IMF) today completed the fifth review of Iceland's economic performance under a program supported by a Stand-By Arrangement (SBA). The completion of this review enables the immediate disbursement of an amount equivalent to SDR 140 million (about € 155 million, or US$224.58 million), which would bring total disbursements under the program to an amount equivalent to SDR 1,120 million (about € 1.2 billion or US$ 1.8 billion). The Board also approved a request for a modification of end-June performance criteria and the rephasing of access to combine the last two purchases

The 33-month SBA was approved on November 19, 2008 (see Press Release No. 08/296) for an amount equivalent to SDR 1.4 billion (about US$2.2 billion) and was subsequently extended to August 31, 2011 (see Press Release No 10/156). The arrangement entails exceptional access to IMF resources, amounting to 1,190 percent of Iceland's quota.

Iceland is continuing to emerge from the crisis. The economy is gradually recovering, and annual growth is set to turn positive in 2011. Impressive progress has been made in implementing program policies, notably with respect to putting public finances on a sustainable path, stabilizing the exchange rate, and bringing inflation down. The key challenges going forward are to reduce the high level of unemployment, lift capital controls in an orderly manner, accelerate private sector debt restructuring, and strengthen financial sector supervision and regulation.

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

"Considerable progress has been made under the Fund-supported program. Policy implementation has remained strong, laying the foundation for a sustainable recovery. Inflation has remained low, although recent pressures from wages, commodity prices, and the exchange rate have increased risks. Risks to growth emanate mainly from delays in investment projects, slow debt restructuring in the private sector, and high unemployment.

“The new strategy to lift capital controls is appropriately cautious. Given the scale of potential outflows, the removal of capital controls must proceed gradually. The authorities’ intention to condition the pace of liberalization on the balance of payments outlook and the stability of the financial system is appropriate. A further build-up of international reserves will be important for the successful implementation of this strategy.

“The authorities are appropriately focused on continuing to pursue a prudent fiscal policy over the medium term. There may be some scope to moderately ease the pace of fiscal adjustment to support the nascent recovery. At the same time, it will be important that the government continues to resist absorbing private sector losses and safeguard public debt sustainability. The strength of asset recovery from the Landsbanki’s estate provides some comfort that contingent liabilities remain contained, although the resolution of the Icesave dispute through legal channels could increase fiscal risks.

“The pace of household and corporate debt restructuring should accelerate. The new measures to provide relief to distressed households and corporates, and reduce the level of nonperforming loans, should be implemented as soon as possible.

“Strengthening the financial sector remains a priority. This would require improving prudential oversight, recapitalizing vulnerable institutions, lowering banks’ funding and liquidity risks, and reducing non-performing loans. Remaining gaps in the legal, regulatory, and supervisory framework should also be addressed.”

Statement by Benny Andersen, Executive Director for Iceland and Lilja Alfredsdottir, Advisor to Executive Director June 3, 2011

The Icelandic economy continues to navigate the rough seas created in the wake of the 2008 banking and currency collapse. Although smooth sailing has not yet been fully achieved, significant progress has been made towards economic stabilization and growth. All end-March performance criteria have been met. Our authorities request a modification of end-June performance criteria and a rescheduling of access by combining the last two purchases, due to delays in completing recent reviews.

Recent developments indicate a strong trade surplus, some revival of private consumption and growth of investment. Headline inflation is seeing some uptick to above the 2.5 percent inflation target. The challenges ahead include reintegrating Iceland into international financial markets through capital account liberalization and Treasury borrowing as well as revitalizing the lending and financing activities of the banking system with the objective of enhancing economic growth and reducing high unemployment. While progress has been made in the restructuring of household and corporate balance sheets, our authorities acknowledge the importance of accelerating the pace of restructuring.

The Icelandic authorities continue to seek an amicable solution to the Icesave-dispute and reiterate their commitment to honor Iceland's international obligations. It is important to note that the estate of the fallen bank now estimates that it will cover at least 99 percent of priority claims. This means that the UK and Dutch authorities – and also unsecured UK and Dutch depositors such as the UK charities and Dutch depositors with over 100,000 Euros in deposits – will in all likelihood be repaid by the estate in full. In addition, the repayment profile is more frontloaded than previously estimated with nearly a third of the claims being paid before the end of this year. Our authorities continue to be willing to explore ideas with the UK and Dutch authorities, keeping in mind and respecting that the Icelandic people have rejected the issuance of a State guarantee of these obligations by over 60% in the April referendum. The EFTA Surveillance Authority has initiated a legal process which could lead to a court pronouncing whether Iceland and other European countries carry legal obligations to honor all contingent liabilities of deposit insurance funds. The European legal structures are set up to deal with disputes of this nature and small nations need to be able to rely on these structures for the common European market to serve its purpose as an equal playing field. Iceland will of course honor a legal obligation defined by a competent court.

Our authorities welcome staff's careful analysis and useful recommendations in this fifth review and thank our Nordic, Polish, and Faeroese neighbors that have contributed to the financing of the economic program.

Fiscal Policy

Fiscal targets for 2010 were met and our authorities will continue on the path set in the program to achieve a primary balance in 2011 and an overall surplus in 2013. So far, the outcome of the first months of 2011 is in line with projections. On the revenue side a new tax will be levied on financial institutions to finance the temporary interest subsidy to households. On the expenditure side, the new 3 year wage agreements will put pressure on public spending and create additional inflationary pressures. The agreements are, however, important for economic stability as they remove key uncertainties in the labor market for the next three years. Local government finances have been given greater focus in recent months. The Government intends to pass a new law in June setting a stricter framework for local government finances including requirement of a rolling three-year balanced budget, limits on municipal borrowing, and enhanced monitoring of municipal finances. The number of municipalities in Iceland has been reduced significantly in recent years, which has helped to increase efficiency and stability.

Public and external debt ratios are expected to decline rapidly with gross external debt going from 240 percent of GDP in 2011 to around 150 percent of GDP in 2016. Staff finds that external and public debt is sustainable and stress tests by staff suggest that the downward trajectory is robust. The Central Bank of Iceland of has estimated that once assets and liabilities of banks in winding-up procedures have been settled and other distorting factors have been taken into account, Iceland's international investment position will be satisfactory or around -25 percent of GDP, which is a more favorable position than has been for decades. Our authorities look forward to discussions with staff on the medium-term fiscal path in the next review. The medium-term debt strategy was well received by the market. It lays out the borrowing strategy in a transparent manner. Domestic financing is considered well-anchored. Access to external financing, however, will be important to relieve pressures on foreign reserves and promote capital account liberalization. Preparations for a reentry into the international bond market are underway. Recent rating actions, a recent bond repurchase tender, and contained CDS spreads on Iceland should support access to capital markets.

Financial Sector and Debt Management

The banking sector is slowly recovering. The commercial banks currently have capital ratios well exceeding the regulatory minimum of 12 percent of core tier one capital. Our authorities agree with staff on the need for more frequent ICAAP assessments and stress testing on the basis of macroeconomic scenarios prepared by the authorities and in line with the European Banking Authorities exercise. Finalizing the recapitalization of the remaining savings banks does not require substantial public financing. A reform of the Housing Financing Fund is underway and the necessary actions will be taken when the results of the assessment of HFF's asset quality are available.

The high level of non-performing loans in the banking system and slow progress of household and corporate debt restructuring continue to be of concern. Our authorities will ensure the full implementation of the measures that have been put in place. It should be kept in mind, however, that restructuring following a collapse is traditionally a time-consuming and costly process. In the case of Iceland there have been additional complications resulting from court rulings on the illegality of FX-denominated lending.

Assets and liabilities of the new banks are still subject to mismatches and uncertainty of valuation but strong capital and liquidity requirements in addition to improvements in banking supervisions have reduced the likelihood of surprises of a systemic nature from this sector. The Icelandic authorities continue to work on implementing measures aimed at keeping up to speed with international best practices in the area of financial supervision, including the adoption of best practices of banking supervision in line with Basel Core Principles on effective Supervision.

Monetary Policy

Monetary policy has shifted to a neutral stance and continues to focus on preventing any significant depreciation of the krona in the short term and ensuring price stability over the medium term. The annual inflation rate rose to 3.4 percent in May which is above the inflation target of 2.5 percent. Global oil and commodity price increases have contributed to higher prices in areas such as food and transport. If the exchange rate does not weaken and inflation expectations become anchored, inflation should return to target next year.

Implementing independent monetary policy with a floating exchange rate in a small open and financially integrated economy has proved to be challenging in the face of volatile capital flows and high dependence on external price developments. The Central Bank is exploring possible improvements in the monetary framework, including macro-prudential tools and strategic foreign exchange interventions. The lessons from the crisis have also underlined the need for much better synchronization of fiscal and monetary policies.

Capital Controls

Lifting the capital controls on outflows is a difficult task as underlined by staff. The large overhang of offshore krona holdings needs to be reduced without disrupting financial stability or undermining bank liquidity. Adverse balance sheet effects through a further depreciation of the krona must also be avoided. A conditions-based strategy to liberalize capital flows has been put forward by our authorities. The first step to be executed in early June is an auction where owners of offshore krona holdings can buy a limited amount of foreign currency. This step will test the market and, if successful, will be repeated to significantly reduce the amount of “impatient” money in the system. Our authorities agree with staff that existing controls need to be vigorously enforced and that the process of bringing relevant cases to court needs to be enhanced. Having said that, it is clear that a prolonged use of capital controls leads to loss of economic efficiency, *inter alia,* by limiting the appetite of foreign investors to supply equity and risk capital to research and development intensive industries. It is therefore not surprising that impatience towards capital controls is growing among the more dynamic sectors of the economy. The risk of going to slow in lifting capital controls should thus be appreciated along with the risk of going too fast, as emphasized by staff.

Structural Reforms and Outlook

The management of the fisheries resource in Icelandic waters has been successful in maintaining and protecting fish stocks. The government has put before the parliament a draft legislation containing fundamental changes of the fisheries quota system for allocation of quotas which is currently being debated. The draft legislation is not expected to materialize in its final form until next year. Besides the work undertaken to stimulate private entrepreneurship, retraining the unemployed, and establishment of small businesses, the authorities aim to create a climate conductive to more FDI inflows.

On the export side, the outlook for fish prices is still favorable but supply constraints are present. Prices for aluminum have also remained robust and production levels stable. The prospects for further investment in the energy sector remain encouraging. Firms in other sectors such as software and pharmaceutical industries are still expanding. The tourist industry experienced record bookings for this summer, and the recent eruption in the Grímsvötn volcano will probably cause only limited setbacks.

Our authorities believe that full implementation of the present economic program will create favorable conditions for economic progress based on sustainable public finances, private enterprise, and free markets.