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Iceland: Fourth Review under Stand-By Arrangement, Request for Waivers of Applicability, and Request for Establishment of Performance Criteria—Staff Report; Informational Annex; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Iceland.

The following documents have been released and are included in this package:

- The Staff Report for Fourth Review under Stand-By Arrangement and Request for Waivers of Applicability, and Request for Establishment of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on November 14, 2010, 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 December 22, 2010. 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.
- Press Release on the Executive Board Discussion
- A statement by the Executive Director for Iceland.

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

Letter of Intent sent to the IMF by the authorities of Iceland*
Technical Memorandum of Understanding*
*Also included in Staff Report

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

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INTERNATIONAL MONETARY FUND

ICELAND

Fourth Review Under the Stand-By Arrangement, Request for Waivers of Applicability, and Request for Establishment of Performance Criteria

Prepared by the European Department in Consultation with Other Departments

Approved by Poul M. Thomsen and James Roaf

December 22, 2010

- **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, and fourth purchases, equivalent to SDR 105 million each, were made following completion of the first, second, and third reviews. The fifth purchase, equivalent to SDR 105 million, would become available upon completion of the fourth review. The Arrangement is set to expire on August 30, 2011.
- **Status**. The program is on track, and all end-December performance criteria are expected to be met. The authorities are requesting waivers of applicability on all end-December performance criteria, except net domestic assets of the central bank, as data will not be available to evaluate these targets when the Executive Board considers this review.
- **Summary**: The Icelandic economy is gradually recovering from its deep recession, helped by program policies. Annual growth is set to turn positive in 2011, but a key challenge remains to bring down the high level of unemployment. Program discussions focused on the strategy for private sector debt restructuring and the 2011 budget. In this context, the authorities have taken a number of new measures to facilitate household and corporate debt restructuring while minimizing fiscal costs. The authorities and staff agreed that, with these new measures in place, the debt restructuring framework must now be given time to work, including by giving a clear signal that additional measures will not be forthcoming. Since the recovery is projected to be a little less vigorous than previously expected, it was agreed that the 2011 fiscal target could be modestly eased to help support domestic demand. The 2011 budget was passed by parliament in line with this new target. On capital controls, the authorities intend to revise the strategy for lifting controls to reflect the evolving macroeconomic and financial situation. Financing assurances are in place, and Iceland's Nordic partners have supported an extension of their loans until end-2011. An agreement between Iceland, UK, and Dutch negotiators has been reached to resolve the Icesave dispute, and the relevant legislation is now before the Icelandic parliament.
- **Discussions.** See Fund Relations Appendix.

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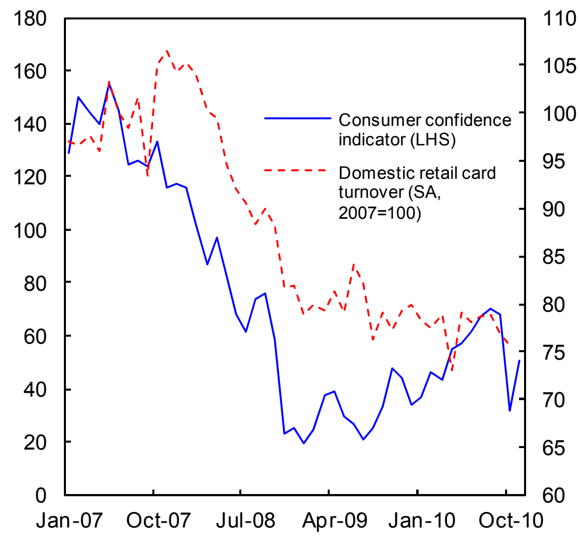
I. RECENT ECONOMIC DEVELOPMENTS

1. **Iceland's economy has stabilized and recovery is in sight** (Table 1; Figures 1–2). National accounts estimates and short-term indicators suggest that growth turned positive in the third quarter of 2010. Consumption has picked up, offsetting a weaker performance in investment activity, and net exports have remained strong helped by the competitive krona, higher commodity prices, and a recovery in aluminum exports after temporary disruptions. Consumer confidence has also recovered after a sharp deterioration in October, in part related to discontent on the pace of household debt restructuring. But unemployment remains high, and business confidence has yet to pick up. The still-significant slack, stable exchange rate, and lower inflation expectations have led to faster disinflation: headline inflation approached the central bank target of 2½ percent in November. The underlying current account balance remains positive, supported by strong trade balances.



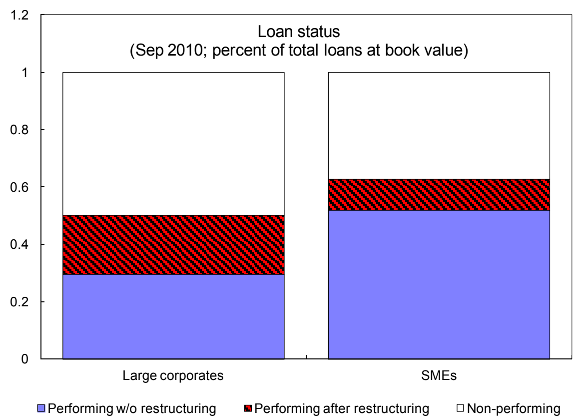
2. **The slow pace of private sector debt restructuring has held back the recovery**.

- Earlier efforts, focusing on postponing debt payments, delivered some relief to borrowers but debt restructuring initiatives did not elicit a large response. Both households and corporates have held out from existing debt restructuring mechanisms owing to expectations that more generous debt relief would be forthcoming. The problem was compounded in June 2010 when a Supreme Court decision put in question the legality (and value) of tens of thousands of foreign exchange-related loans, undermining the legal basis for restructuring. A subsequent Supreme Court ruling and newly enacted legislation provide guidance on how illegal loans should be revalued, but uncertainty persists as to whether individual loans are legal or not—this remains to be tested by the courts.

- Corporate debt restructuring has proceeded slowly. Defaults have been widespread, but only a small fraction of companies have filed for bankruptcy or restructured their debt. Earlier steps taken by the authorities and financial institutions have facilitated debt restructuring for large firms. However, there has been little progress in restructuring the debt of small- and medium-sized enterprises. The slow pace has left corporations with significant uncertainty regarding their future debt payments and has hindered a reallocation of resources to viable operations.

- The debt situation of households remains difficult. Payment smoothing, payment suspensions, and an extension of the deadline to apply for a stay on forced sales have provided some temporary relief, but widespread restructuring of household debt has been elusive. The complexity of debt problems—which may involve several creditors and more than one debtor (through the use of so-called "third party guarantees")—and continued declines in house prices (which have reduced incentives for households to seek writedowns based on loan-to-value ratios) have also slowed progress.

3. **Delays in restructuring are also harming financial institutions**. While the three large commercial banks remain capitalized at over 12 percent of Tier I capital and loans are carried at about 50 percent of their face value (implying sizable buffers), the sluggish pace of restructuring is undermining their ability to improve asset quality, and corporate NPLs remains around 50 percent. In the absence of new lending, banks continue to maintain liquidity buffers well-above minimum prudential standards of 20 percent of total deposits. However, deposit concentration and the lack of funding diversification remain key challenges to proper liquidity management.



4. **Financial and capital markets have remained stable, cushioned by capital controls** (Table 2; Figure 3). The trade-weighted exchange rate has appreciated slightly since September, supported by strong trade surpluses. This has allowed for modest regular foreign exchange purchases by the central bank (EUR 1.5 million per week). Nonetheless, the government bond market is the only active capital market in Iceland, as government bonds—and bank deposits—remain the instrument of choice for locked-in capital, pushing yields on these instruments to very low levels. Corporate bond and equity markets remain dormant. Despite the turbulence in European sovereign debt markets, Iceland's CDS spread has hovered below 300 bps. Short-term interbank rates have broadly tracked cuts in policy interest rates, amounting to 350 bps since August (and some tightening of liquidity conditions, alongside increased CD issuance by the CBI, has moved interbank rates up, away from the floor of the policy corridor). Bank lending conditions remain tight, and credit is flat.

5. **Public debt has been revised down, while external debt has been revised up significantly** (Tables A1 and A2). General government debt is now expected to reach 96 percent of GDP at end-2010. Slower than anticipated accrual of Icesave-related liabilities (because of lower interest costs and more frontloaded asset recovery, see Box 1), krona appreciation, and greater net interest income have more than offset the impact of the materialization in 2010 of a government guarantee (related to a now-defunct agricultural fund, which received this guarantee prior to the crisis). Gross external debt estimates in

2010 have been revised upward to around 330 percent of GDP, although assets have been revised up by a similar amount. This reflects better-than-previously expected asset recovery from the old banks, which are recorded as both external assets and liabilities because they cannot be paid out to creditors until ongoing litigation is resolved. Thus, both gross external assets and liabilities have increased on account of the faster-than-expected asset recovery.

II. OUTLOOK

6. **The recovery is set to continue in 2011, although at a slower pace than previously expected** (Table 2 and 3; Figure 4):

- Growth next year is projected to be lower than at the time of the third review (2 percent instead of 3) on account of delays in a large investment project in the energy-intensive sector. The expansion in activity is still expected to be largely driven by investment (on account of other projects in the energy-intensive sector, see IMF Country Report 10/176), with support from a gradual recovery in private consumption. Fiscal adjustment will continue to be a drag on domestic demand, but some high-multiplier public infrastructure projects should help boost employment in the construction sector. Risks to growth are mainly on the downside, and emanate from the private sector debt overhang, further delays in investment projects, and shocks to external demand and commodity prices. On the upside, faster implementation of the postponed investment project would accelerate growth, and discussions are under way on several smaller projects.

- Headline inflation is projected to be close to the central bank's target of 2½ percent in 2011. Still-significant slack in the economy, a stable krona, and well-anchored inflation expectations are expected to continue to dampen inflation pressures. Risks to the inflation outlook are balanced, and staff and the authorities are monitoring two key channels of risk: (i) wage pressures; and (ii) exchange rate fluctuations which would affect import prices.

- The balance of payments is projected to remain strong, helped by capital controls. Reserve accumulation is expected to continue, supported by trade surpluses, the recovery of assets related to CBI claims on failed financial institutions, and the realization of program financing from the Fund ($800 million remaining under the program) and Iceland's bilateral partners ($1.2 billion).[1]

[1] The defaults of the three largest Icelandic commercial banks resulted in the transfer of large amount of collateral to the CBI. Collateral having some residual value (foreign equities, bonds, loans) were bundled into a holding company that is consolidated within the central bank balance sheet. This holding company had ISK 409 billion of assets denominated in foreign exchange and krona at end-November 2010.

7. **Public and external debt are projected to decline steadily, but risks remain significant given their current high levels** (Appendix I, Tables A1-A2; Figures A1-A2).

- Based on staff's preliminary assessment, public debt dynamics are expected to improve considerably on account of the new Icesave deal (Box 1). The public debt ratio is expected to start falling in 2012 and to reach about 72 percent of GDP in 2015. Lower projections of medium-term nominal growth and new spending on road infrastructure projects (see section III.B) will partially offset the savings from the more favorable terms of the new Icesave agreement, but the outlook for public debt still improves by over 3 percentage points of GDP compared to the third review. These favorable debt dynamics could be derailed by too slow a pace of fiscal consolidation over the medium term, the materialization of significant contingent liabilities, or the absorption of private sector losses by the public sector. While this debt ratio is still high, the authorities continued commitment to fiscal adjustment and to the introduction of a new fiscal framework for local governments (which will enshrine greater fiscal discipline, see below), and the significant stock of public assets should help mitigate risks.

Table. General Government Debt Indicators

	2010	2010	2011	2011	2015	2015
	3rd Rev	Proj.	3rd Rev	Proj.	3rd Rev	Proj.
Gross Debt	115.6	96.3	107.8	100.5	75.8	72.4
of which						
Net present value of Icesave guarantee	13.7	5.2	15.3	3.5	15.2	1.3
Bilateral loans	15.2	7.3	14.5	13.7	9.2	10.5
Bank restructuring debt 1/	16.0	17.3	14.9	16.2	12.0	12.8
Local government debt	9.7	9.2	9.7	9.3	7.8	7.2
Other	60.9	57.2	53.4	57.8	31.6	40.5
Liquid Assets 2/	39.9	27.3	29.3	28.5	23.9	19.3
Net Debt	75.6	69.0	78.6	72.0	51.8	53.0

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

- Gross external debt is expected to fall to about 267 percent of GDP in 2011 and reach around 182 percent of GDP by 2015, with net debt still significantly lower reflecting large asset holdings. Although gross external debt is still high, it is in line with that in other advanced economies. The main risk emanates from exchange rate depreciation.

Box 1. Icesave Agreement—Preliminary Assessment of the Impact on Debt

In December 2010, a new agreement was reached by Icelandic, UK, and Dutch negotiators to resolve the Icesave dispute. The new agreement involves a loan from the United Kingdom and the Netherlands to the Icelandic deposit insurance agency (the Icelandic Guarantee Fund). The loan is covered by a government guarantee on the part of the Icelandic government. Although staff is still assessing the precise details of the new agreement, early indications are that the lower interest rate would lead to a reduction in public debt by some 13 percentage points of GDP in the medium term (relative to the third review). Because the agreement involves the extension of a government guarantee, parliamentary approval is required, and the relevant legislation has been submitted to parliament. The President would also need to sign the law.

Implications for external debt. The Icesave loans are included in the headline external debt figure reported by the Fund, and preliminary staff estimates suggest that these would amount to 39 percent of GDP at end-2010. Icesave debt is projected to decline over the medium term as assets recovered from Landsbanki's estate are paid out to the UK and Dutch governments (Landsbanki is the failed Icelandic bank that owned the Icesave branches).

Implications for public debt. The general government debt figure reported by the Fund includes an estimate of the portion of the Icesave loan that is expected to be covered by the government guarantee. This is estimated as the present value of the amount owed by the Icelandic Guarantee Fund in June 2009, increased by the amount of accrued interest until interest payments commence, and reduced by the amount of payments made upon the release of Landsbanki's recovered assets and the Guarantee Fund's own assets. Preliminary staff estimates suggest that this liability could amount to 5 percent of GDP at end-2010 (14 percent of GDP under the third review), and fall to 1½ percent of GDP by end-2015 (15 percent of GDP under the third review).

III. Policy Discussions

8. **Discussions focused on securing the recovery in Iceland, which has required some recalibration of policies**. New measures to facilitate household and corporate debt restructuring have been agreed to address the debt overhang in a comprehensive way. With 2011 growth set to be less vigorous than previously expected, it was agreed that a more modest fiscal adjustment in 2011 would help support domestic demand. On the financial sector, the authorities and staff concurred that further progress in bank recapitalization and restructuring, alongside stronger prudential regulations and more intrusive supervision, were needed to pave the way for a restoration of bank balance sheets.

A. Private Sector Debt Restructuring

9. **The authorities remain determined to accelerate household debt restructuring**. Given the scale of the household debt problem (see table), and to assess the cost and effectiveness of a number of proposals for household debt relief, the Prime Minister formed a Working Group of Experts which used a rigorous framework to undertake its analysis. The Working Group examined a variety of alternative approaches, including across-the-board writedowns of debt, case-by-case restructuring, reductions in loan-to-value ratios, and an increase in the income tax rebate, and found that no single measure would effectively address the debt problems of the most distressed households. Like Fund staff, the authorities remain convinced that across-the-board debt writedowns are too costly, ill-targeted, and ineffective. The authorities have, however, identified a number of measures that can speed the process (see below), and will now allow time for the system to work.

Iceland: Households with Debt and Debt Service Problems, 2009 1/

	Number of households 2/	
	Scenario 1	Scenario 2
All home owners	99,965	99,965
Households with mortgages	72,761	72,761
Households with "under water" mortgages (LTV>100 per cent)	20,348	20,348
Households with debt service problems 3/	10,753	17,763
- No debt service capacity 4/	3,651	7,097
- Capacity to pay only part of debt service due	7,102	10,666
Both "under water" and with debt service problems	5,366	8,065
Either "under water" or with debt service problems	25,735	30,046

Source: Report of Working Group of Experts appointed by the Prime Minister for assessment of household debt problems

1/ The assessment is based on tax returns for 2009

2/ Scenarios 1 and 2 assume that a household's cost of living (excluding housing) is equal to the Debtors' Ombudsman's reference line for living expenses plus, respectively 50 and 100 percent.

3/ Households whose disposable income is less than non-housing living expenses plus debt service due

4/ Households whose disposable income is less than non-housing living expenses

10. **The framework for household debt restructuring has been enhanced** (LOI ¶9).

- Drawing on the findings of the Working Group, the authorities have developed a package of voluntary and tax-based measures that aim to reach a large number of households while limiting costs. The measures are set out in a Memorandum of Understanding signed by commercial banks, pension funds, and the government. They include fast-track procedures for writing down qualified mortgages to 110 percent of collateral value, an expansion of the voluntary debt mitigation framework to reduce mortgages to 100 percent of collateral value based on debt-service capacity, an enhanced and more progressive tax rebate on interest, and a temporary (two year) interest subsidy in amounts related to the household's net worth. The tax rebate is expected to cost ISK 3 billion per year while the interest subsidy, which will be financed by financial institutions (possibly through a temporary levy), is expected to cost ISK 6 billion per year over two years. The writedowns are not expected to have a significant impact on bank capital (after taking into account existing buffers), but the temporary levy on banks may reduce their profitability by about 10 percent.

- These financial measures will be buttressed by strengthened institutions. These include the creation of a forum to resolve disputes among creditors, the clarification of procedures for forced sales (the deadline to apply for a stay on forced sales has been extended until March 2011), and the development of mechanisms to provide social housing where necessary. In addition, public information campaigns have been launched, the capacity of the DO has been increased (Box 2), and an effort is being made to contact all households in distress.

11. **Initiatives to advance corporate debt restructuring are underway** (LOI ¶10).

- For larger enterprises, banks will continue to deal with their corporate borrowers on individual basis. All commercial banks have established special units to deal with corporate debt restructuring, and restructuring has proceeded on the basis of analysis of debt service capacity and valuation of cash flows, assets, and collateral. Relief has typically taken the form of temporary payment reductions of interest and principal, writedowns of company debt against an equity injection by the owner, and conversion of debt into equity in collaboration with owners. In some cases, loans have been split into "regular" and subordinate loans. One commercial bank has reportedly restructured about two-thirds of its corporate loan book, but the other two banks are proceeding more slowly and expect to complete corporate restructuring only in late 2011 or early 2012.

- For small- and medium-sized enterprises, the authorities and lenders have signed a non-legally binding agreement aimed at an expedited solution for viable companies. Under the agreement, banks have agreed to provide debt relief based on the principle that gross debt should not exceed the estimated value of the company's assets and operations (as defined by the banks). The government will facilitate this process by removing tax-related obstacles to restructuring (debt write-downs would essentially become tax-exempt and tax arrears would be restructured). The framework is voluntary but provides for binding arbitration of disputes. The plan is to deliver proposals to all qualified companies by end-May 2011.

12. **Some uncertainties arising from the June and September Supreme Court rulings on foreign exchange-indexed loans are being addressed**. In particular, legislation has been passed that aims to provide clear guidance on how creditors should recalculate loans that

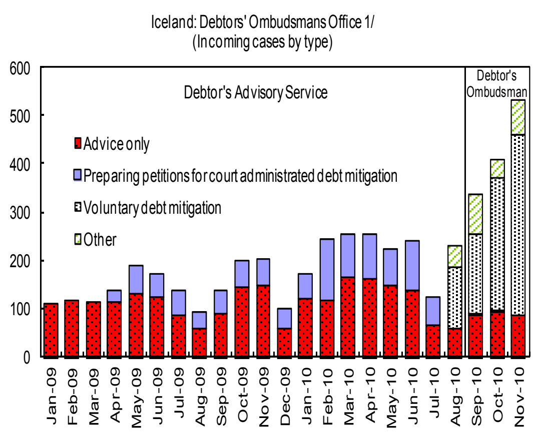
Box 2. Office of the Debtor's Ombudsman

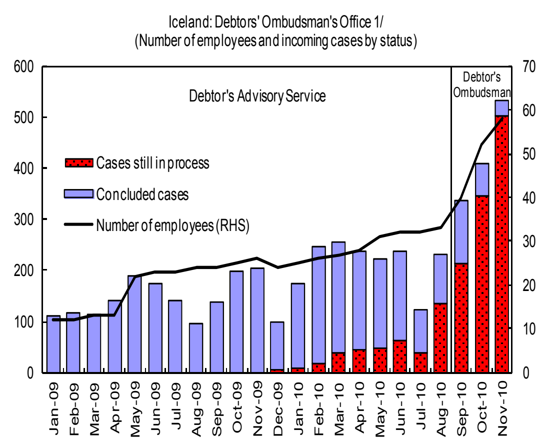
The Office of the Debtor's Ombudsman (DO) was created in August 2010 to oversee debt mitigation procedures for individuals, and to provide advisory and mediation services. It replaces the Debtor's Advisory Services, which was established in1996.

A key need identified in the previous program review was to increase the capacity of the DO. Some progress has been made: the DO has doubled the number of its employees, outsourced some activities, and opened a satellite office in a hard-hit municipality.

The September Supreme Court ruling (which clarified households' financial situations with respect to foreign-exchange linked loans) and the passage of legislation to shield debtors seeking mitigation from legal action by their creditors have helped increase the number of households seeking relief under the auspices of the DO. Since September, the DO's caseload has more than doubled, and 1500 cases are now being processed. The vast majority are households seeking voluntary debt mitigation. Since the DO's formal procedures take time to be completed, it will be several months before a significant number of applications reach final resolution.

The DO is also seeking to raise public awareness. Public information campaigns have been launched to ensure that the public is informed of the available debt mitigation options and financial advisory services. The DO is in the process of contacting all households who are in foreclosure procedures to advise them of their options under the framework for household debt restructuring.

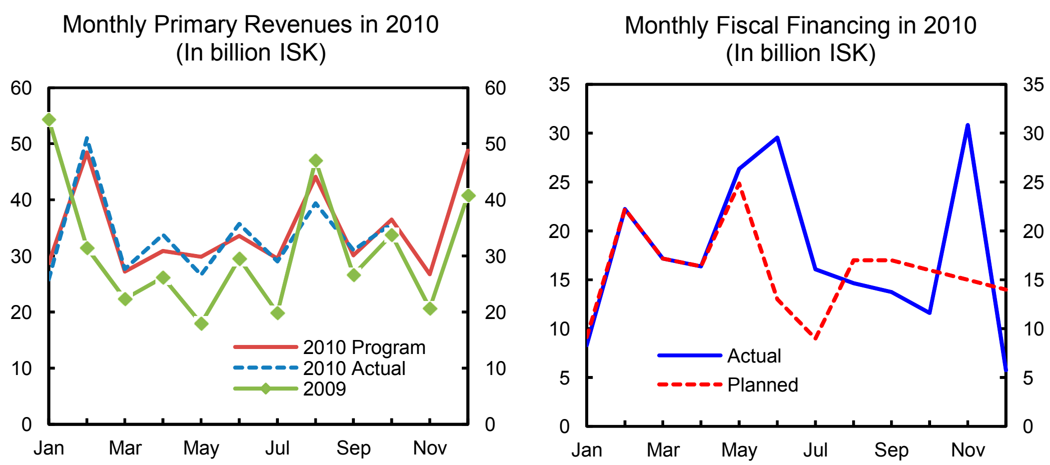




have been declared illegal. The legislation also provides a special regime that allows individuals with foreign-exchange linked mortgages or car loans to convert them into local currency loans. The authorities and staff agreed that reducing uncertainties associated with the Supreme Court decisions was essential, but staff expressed concern that the special regime for individuals could give rise to additional litigation risks (see below).

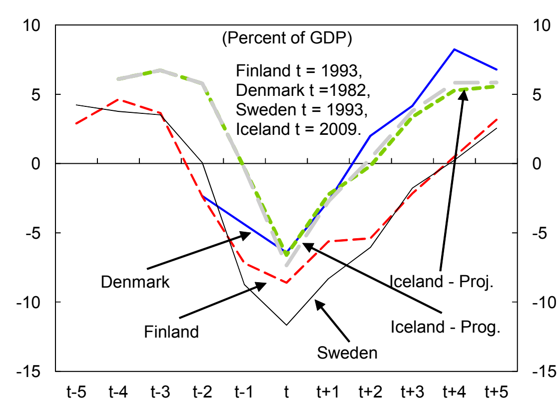
B. Fiscal Policy

13. **The authorities are on track to meet the 2010 fiscal target with a comfortable margin, owing in part to windfall revenues** (Figure 5). With strong excise performance offsetting some weakness in personal income tax, non-windfall revenue remains broadly on track. Primary expenditures have remained within the budget ceiling, despite additional investment spending of ¼ percent of GDP, which was carried over from 2009 appropriations. As a result, the primary balance is set to improve by ½ percentage point of GDP (compared to the third review) while the overall balance would improve by 3½ percentage points of GDP—the latter due to stronger net interest income on account of lower public debt and more favorable interest rates.



Sources: Ministry of Finance of Iceland, Government Debt Management of Iceland, and IMF staff estimates.

14. **The authorities and staff agreed that there was scope to support the weaker-than-expected economy by scaling back the adjustment in 2011** (LOI ¶13; Tables 5-6). A moderate easing of the 2011 fiscal target is consistent with program objectives, remains in line with adjustment in other post-crisis cases, and supports the authorities' objectives of accelerating private sector debt restructuring and boosting growth. The smaller adjustment in 2011 will accommodate automatic stabilizers, most notably



Source: WEO, Icelandic authorities, and Fund staff on the revenue side, and some additional expenditure related to household debt restructuring. The budget also includes expenditures on high-return infrastructure projects, amounting to ¼ percent of GDP in 2011 (see below). On this basis, the general government would deliver a small primary deficit in 2011 (although the primary balance would be positive if the infrastructure projects are excluded). The target will be delivered by the central government, given a balanced primary position of the local governments. Public debt would remain on a firm downward path, and financing remains readily available on account of the capital controls.

15. **The 2011 budget includes measures sufficient to achieve the authorities' fiscal target** (Table 7). The 2011 adjustment relies mainly on expenditure rationalization, with only a third of the measures entailing revenue increases. The measures amount to 2¼ percent of GDP, in line with the improvement in the primary balance. About two-thirds of the measures are permanent and the remaining measures could be extended to 2012 or replaced by new measures.

- Revenue measures amount to about ¾ percent of GDP. These include increases in the capital and corporate income tax rates from 18 to 20 percent, the inheritance tax rate from 5 to 10 percent, and the wealth tax rate by 25 basis points. Additional revenue will be raised through a revision of the base for motor vehicle levies focusing on carbon emissions, and by temporarily allowing a larger withdrawal of voluntary pension savings. The authorities have also introduced a new tax on financial institutions, expected to yield some 0.1 percent of GDP, akin to a levy adopted in Sweden in 2008.[2] The relatively wide perimeter of the levy, including all deposit-taking and lending financial institutions and securities brokers, discourages tax arbitrage. The broad tax base—all uninsured liabilities—has allowed for the establishment of a low tax rate of 0.045 percent. Finally, additional revenue of ISK 6 billion—to cover the costs of the interest subsidy associated with the new measures on household debt restructuring—has been introduced.

- Expenditure measures amount to about 1½ percent of GDP relative to the budget baseline for 2011. Civil service nominal wages and benefits have been kept flat, curtailing baseline spending by about ½ percent of GDP. Rationalization of healthcare costs and a targeted reduction of welfare benefits and subsidies will reduce these expenditure items by 3 percent relative to 2009. Education and public order costs have been reduced by nearly 5 percent relative to 2009 and general administrative costs have been reduced by almost 9 percent. The authorities have followed OECD recommendations by reorganizing and consolidating administrative services, increasing means testing of benefits and subsidies, and rationalizing more

[2] The tax is consistent with one of the options identified in IMF, 2010, *"A Fair and Substantial Contribution by the Financial Sector"*.

heavily in areas with greater scope for efficiency improvements (healthcare, education). This has preserved the main features of its welfare state, to which the authorities remain committed. At the same time the authorities have also increased some expenditures (the income tax rebates on mortgage interest and the interest subsidy) to ease the debt service burden on households and mitigate social pressures arising from household debt overhang.

Table. Fiscal Projections for the General Government, 2010-11

(percent of GDP)

	2010	2010	2011	2011
	3rd Rev	Proj.	3rd Rev	Proj.
Total Revenue	38.9	40.6	38.5	39.6
of which Interest income	2.2	2.0	2.0	1.7
Revenue measures			0.6	0.7
Expenditure	48.2	46.4	44.2	44.9
of which Interest expenditure	8.7	5.6	8.1	6.9
New road construction projects				0.4
Expenditure measures			1.9	1.6
Measures to reduce the deficit 1/			2.6	2.3
Overall Balance	-9.2	-5.8	-5.6	-5.3
Overall Balance (incl. write-offs) 2/	-9.2	-7.4	-5.6	-5.3
Primary balance (excl. road projects)	-2.7	-2.2	0.5	0.3
Change in the primary balance	4.6	4.4	3.2	2.5

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

1/ Identified measures

2/ Write-offs include called guarantees transferred from the Government Guarantee Fund

16. **The authorities intend to provide additional support to the economy with a moderate amount of spending on high-return road infrastructure projects**. The projects would amount to 2¼ percent of 2011 GDP and are set to take place over 2011–15. The authorities have estimated that the economic internal rate of return on the largest project would be 15¾- 16¾ percent, in line with international benchmarks.[3] The projects will be accommodated within the program (captured by an adjuster for program purposes), and the medium-term consolidation path (excluding the infrastructure projects) will remain unchanged.

17. **Progress has been made on strengthening the framework for local government finances, which will reduce medium-term fiscal risks** (LOI ¶15; Table 8). A new framework for local governments will require three-year budgeting, strict limits on municipal borrowing, and a three-tier system of monitoring municipal finances (including sanctions for

[3] For example, the average economic internal rate of return of investment projects sponsored by the EU is 15.5 percent, with a standard deviation of 9.6 (European Commission, 2008, "*Guide to Cost-Benefit Analysis of Investment Projects*")

non-compliance). A comprehensive bill introducing the new framework will be presented to parliament in February. Although passage of the legislation is likely to take place only in June (a delay relative to earlier expectations), the government is preparing a policy coordination agreement with the local governments to help ensure that common economic and financial objectives are met. Thus, risks to the fiscal target arising from the delay in passage of the legislation are likely to be limited. After a municipal default on external debt, the authorities established a commission to assess the external obligations of local governments, suggest measures to ensure timely repayment of local government debt, and provide advice on local government debt refinancing and debt management.

18. **The authorities and staff agreed that the medium-term debt management strategy would facilitate a return to international markets and improve the profile of domestic debt** (LOI ¶17). The medium-term debt management strategy, which will be published in January, will strengthen communication with market participants and facilitate a broadening of market access. The successful external bond issuance by Landsvirkjun, the state-owned power company, bodes well for sovereign issuance in the international markets, and the authorities are proceeding with a non-deal road show. The authorities' domestic issuance program has benefitted from high demand and low yields, which have provided opportunities to prefund 2011 financing needs and further extend the average maturity of domestic debt, as well as to reduce the amount of non-marketable debt.

19. **The authorities remain committed to further fiscal adjustment over the medium-term** (LOI ¶16). The consolidation, which is frontloaded, aims to achieve a primary surplus of 6 percent of GDP by 2015 and keep public debt on a declining path. Staff and the authorities agreed that a more robust budget framework with 3-year binding nominal expenditure constraints would support the consolidation. The medium-term fiscal path will be kept under careful review: given the favorable debt dynamics, there could be scope to ease the pace of consolidation (notably in 2012) and moderately reduce the medium-term fiscal target, provided that private sector losses are not absorbed by the public sector. The new Icesave agreement, if implemented, would reduce contingent liabilities significantly.

Table. Medium Term Consolidation Measures

	2011 1/	2012	2013
In ISK million			
Revenue	11,006		
Expenditure	25,811		
Total Measures	36,817	44,000	14,000
In Percent of GDP			
Revenue	0.7		
Expenditure	1.6		
Total Measures	2.3	2.5	0.8
Primary balance (excl. road projects)	0.3	3.9	6.0
Change in the primary balance	2.5	3.6	2.1

Sources: Ministry of Finance of Iceland, and staff estimates.
1/ Identified measures

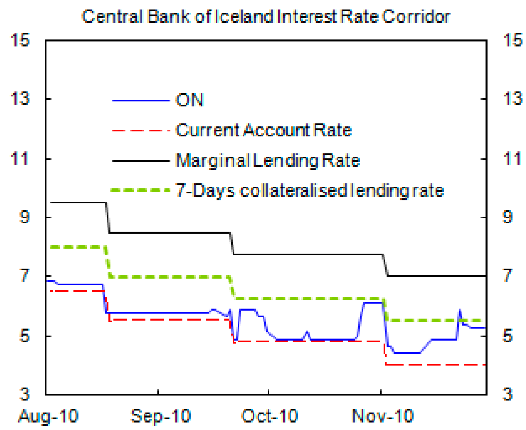
C. Monetary Policy and Capital Controls

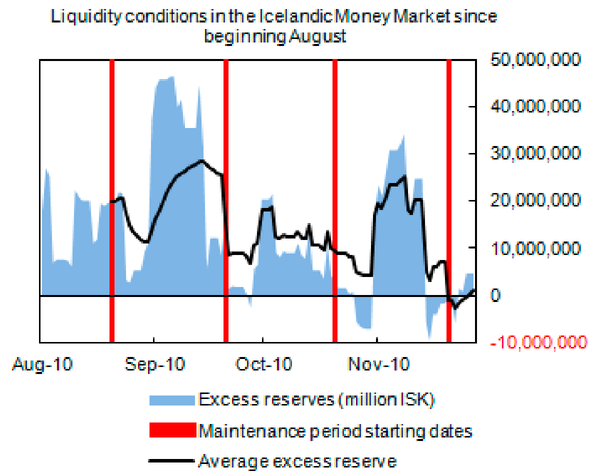
20. **The authorities and staff agreed that monetary policy decisions should remain focused on maintaining low inflation and preserving krona stability** (LOI ¶23). The faster-than-expected decline in inflation toward the CBI target of 2½ percent, the appreciation of the krona, and the reduction in Iceland's risk premium have supported steady interest rate cuts. Policy interest rates have been cut four times since August, and the current account rate now stands at 3.5 percent in nominal terms and 1 percent in real terms. The prospects for further monetary accommodation, while supported by recent downward revisions to the growth outlook, will have to be balanced against the CBI's exchange rate stability objective as capital controls are eventually lifted.

21. **The authorities reaffirmed their intention to increase non-borrowed international reserves**. Regular purchases and a set of one-off operations have led to an accumulation of nearly euro 30 million since August. The strong balance of payments outlook should facilitate an increase the volume of foreign exchange purchases through weekly auctions, per the authorities' intention (LOI ¶21). They are also open to purchasing large, irregular, inflows of foreign currency (typically related to large transactions from multinational firms) to avoid abrupt shifts in the exchange rate.

22. **The authorities have taken steps to normalize liquidity conditions in the interbank market** (LOI ¶22). Banks continue to exhibit a preference for liquidity, and money market transactions remain centered on very short-term maturities. Looking ahead, the authorities and staff agreed that the monetary policy implementation framework should be strengthened to address eventual shifts in liquidity conditions that are likely to arise in due course as capital controls are lifted. In particular, the CBI should strengthen its capacity for more active liquidity management by enhancing liquidity forecasts and engaging in higher-

frequency operations. This will help mitigate volatility in short-term interest rates and support a more effective transmission of policy rates to the whole term structure of wholesale and retail interest rates.





23. **The authorities intend to revise the strategy for lifting capital controls**. They consider a revision necessary given the evolution of macroeconomic and financial conditions since August 2009 (when the initial strategy was published) and on account of better information on the investor base for krona assets. To ensure careful coordination among key government agencies, a working group consisting of the CBI, the Ministry of the Economic Affairs, Ministry of Finance, and FME has been formed. The CBI will prepare the revised strategy in cooperation with this group, and with the help of an external expert, with a view to presenting it to cabinet for adoption by end-February 2011 (LOI ¶18). This is proposed as a new structural benchmark. The updated strategy will be published to facilitate public awareness.

24. **The authorities and staff agreed that the lifting of controls should proceed cautiously, as preconditions are met**. It was agreed that, while much progress had been made toward securing macroeconomic stability (including fiscal sustainability) and building up international reserves, the financial system was still weak. Thus, the revised strategy would retain a cautious approach that paid close attention to the strength of the financial sector and the evolution of macroeconomic conditions, including exchange rate expectations. Staff emphasized the need for careful sequencing of the steps toward liberalization, and stressed that reserve adequacy and domestic liquidity should be safeguarded throughout the process. As the strategy is being revised, the CBI is considering operations (in the form of asset exchanges or auctions at market-determined prices) aimed at reducing the overhang of what it views as "impatient" krona holdings—it considers that such operations would provide a signal of the propensity for investors to hold foreign currency rather than krona. Staff was of the view that such operations would best be undertaken in the context of the revised strategy, as this would improve the information content of the signal.

25. **The authorities and staff agreed that preparation of the post-program monetary framework will be a key topic for future reviews**. Over the past two years, monetary policy successfully achieved both a stabilization of the exchange rate and a sharp reduction in inflation back to its target, while at the same time securing low domestic interest rates. But it was aided considerably by capital controls, and their eventual liberalization will create considerable challenges for the implementation of monetary policy: the strong pass through of exchange-rate fluctuations to inflation, the still-impaired monetary transmission mechanism, and the potentially destabilizing impact of large capital flows will all have to be taken into account when determining the appropriate monetary policy framework for Iceland. Due consideration will also have to be paid to financial stability and macro-financial linkages. In this regard, macro-prudential tools and policies will be essential to supporting monetary policy going forward.

D. Financial Sector Policies

26. **The authorities confirmed that banking system capital is likely to remain adequate**. Taken together, the June and September Supreme Court rulings on foreign-exchange linked loans—which gave rise to considerable uncertainty regarding banking system capital adequacy at the time of the third review (see IMF country report 10/176)—are now expected to have a limited impact on bank capital. In late October, the FME refined its earlier classification of bank loans categorized as "potentially affected" by the rulings, and found that the three largest banks are expected to meet minimum regulatory standards after accounting for estimated losses. Consequently, the worst case outcomes addressed in the government's contingency plan—that shareholders might need to inject more capital or that government recapitalization might be needed—now appear unlikely to materialize. Nonetheless, the government has received authorization to issue bonds to inject necessary capital as needed, and the structural benchmark in this area was met. Going forward, given that new rulings on foreign currency loans cannot be ruled out, the FME will need to remain vigilant to ensure that banks continue to meet minimum capital requirements. The FME is also conducting its annual capital adequacy assessment on banks (Internal Capital Adequacy Assessment, ICAAP) and the outcome of this review is expected to be published in March 2011. Any capital deficiencies found through the ICAAP will be addressed in line with the existing legal and prudential framework.

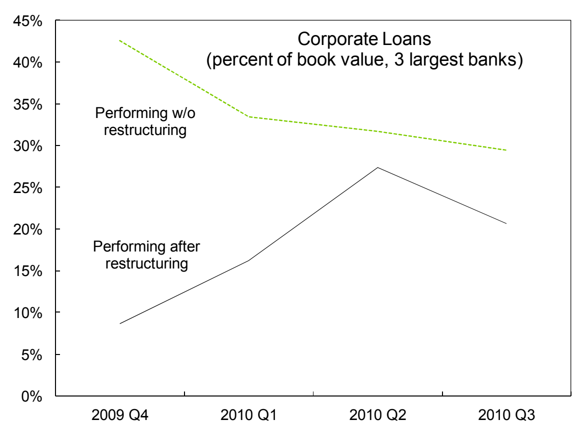
27. **The savings banks are being recapitalized and restructured in line with the timetable set earlier this year** (LOI ¶25). The recapitalization of all saving banks should be completed by end-February 2010. Negotiations have been concluded with the Resolution Committee of old Byr and the recapitalization of new Byr will be carried out as soon as the legal documentation is finalized. Negotiations with SpKef's creditors are being finalized and their buy-out (for a modest sum) is to be followed by a government recapitalization of the new bank. The Icelandic Financial Investment Agency will unveil a two-year strategic plan that will strengthen the medium-term viability of the saving banks, notably through

operational restructuring and consolidation where necessary (this is proposed as a new structural benchmark, LOI ¶25).

28. **The authorities and staff concurred on the need for further action to strengthen non-banks** (LOI ¶26). Specifically, the government will inject by end-December sufficient capital into the Housing Finance Fund (HFF) to bring its capitalization to 5 per cent of its risk-weighted assets (2¼ percent of GDP). The authorities also plan to prepare a timeline to harmonize the HFF capital requirements to those of other financial institutions, and submit legislation that will put the HFF under FME regulatory and supervisory authority. Leasing companies and other specialized non-deposit taking financial entities will be recapitalized by their creditors by end-February 2011.

29. **There was also agreement on the need to further strengthen prudential regulations** (LOI ¶27).Given the persistence of a high level of non-performing loans, albeit largely due to delays in debt restructuring, the authorities and staff agreed that it would be critical to ensure that banks hold sufficient provisions against losses, recognize income only on performing loans, and maintain sufficient capital to address unexpected losses. Moreover, it was agreed that the recent volatility in banks' classification of restructured corporate loans required close scrutiny to ensure that loan workouts are reported as performing only after borrowers established a track record of making payments under revised loan conditions. To this end:

- The FME is reviewing bank accounting practices on the treatment of income arising from restructured or impaired assets. It has issued guidelines in this area to ensure consistency across banks and compliance with international standards. To the extent that deviations are found, banks' financial statements will be revised to better align cash and accounting revenues. Banks will also be required to engage in semi-annual audits of their financial statements in 2011 and 2012.



- The FME has further overhauled its prudential framework by enacting new regulations on bank governance, liquidity risk, and the fit-and-proper criteria for banks officers. Additional regulations on large exposures, sound business practices, and connected lending will be adopted by end-January 2011.

30. **Reforms to banking legislation are also on track, in line with program commitments**. A committee of experts will be formed to take stock of best practices in

supervision and financial regulation, and their findings will be a key input in the ongoing review of the legislative and regulatory framework for financial supervision. Amendments to the law on financial undertakings regarding capital adequacy and large exposures will be also submitted to parliament in the coming months. The new deposit insurance law will achieve harmonization with European Union directives and restore the intervention capacity of the guarantee fund through a premium charged on banks. Staff urged the authorities to consider a premium that is in line with international practices.

E. Program Modalities

31. **Program commitments have been set through mid-2011**.

- **Program performance will continue to be monitored through quarterly reviews** (Table 10). All quantitative performance criteria (PCs) have been specified through June 30, 2011 (LOI Table 1 and TMU). The fifth and sixth reviews are expected to take place after February 25 and May 25, 2011 respectively.

- **Two new structural benchmarks are proposed in support of program objectives** (LOI Table 2, and LOI ¶3).

    - Completion by Icelandic State Financial Investments company of a two-year strategic plan to ensure medium-term viability of the savings banks through consolidation (by end-March 2011). The plan will envisage the strategic position of the savings bank system within the broader financial system

    - Cabinet approval of the updated strategy for lifting capital controls (by end-February 2011) will help guide market expectations through a cautious approach. The updated strategy which will also be coordinated with debt management, and monetary and financial sector policies.

32. **Significant external financing is still needed under the program** (Table 11). With large external amortizations falling due in late 2011 and early 2012 and the uncertain timing of outflows associated with the old banks' estates, there remains a clear need to increase international reserves. The lifting of capital controls will also require higher reserves. To date, Fund and bilateral disbursements, alongside proceeds from asset-liability management transactions, have improved Iceland's reserve position. The authorities' commitment to step up purchases of foreign currency will also help bolster reserves. Unlocking the full amount of program financing will further raise reserves to 81 percent of short-term debt at end-2011.

33. **Financing assurances are in place** (LOI ¶29). 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 required. The Icelandic authorities plan to draw on the

remaining amounts as financing gaps require. They remain committed to meet the preconditions of some of the bilateral partners to access bilateral program financing. In this regard, the new Icesave agreement was presented to parliament on December 16, 2010.

34. **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 2013–14 at a manageable 10 to 13 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.

35. **There remain large risks, which the program addresses:**

- Key program risks identified in previous reports (see IMF country report 10/176) remain. These include a low-growth, high emigration trap induced by the debt overhang; policy missequencing, notably on a too-rapid pace of capital control liberalization; and litigation risks, particularly with respect to the Emergency Law and, to a lesser extent, the recent Supreme Court rulings on foreign exchange indexed loans. Continued calibration of policies, is expected to help the program cope with these risks should they materialize. The authorities' commitment to preconditioning capital controls liberalization on the health of the financial sector also mitigates these risks. As regards litigation risks arising from the Emergency Law, the European Surveillance Authority's recent decision that it is not inconsistent with EEA law bodes well for Iceland.

- External financial risk is becoming more relevant. Although Iceland has largely been sheltered from the European sovereign crisis, mainly due to the capital controls, its sovereign debt issuance plan could be negatively impacted. Program financing, as well careful calibration of the timing of capital account liberalization, would help mitigate this risk.

- New litigation risks are emerging. The recent passage of legislation to address uncertainties arising from the Supreme Court rulings may also increase litigation risks, as the legislation extends beyond the narrow ruling of the Court on car leases. To mitigate this risk, the new legislation has been limited to those areas which have been assessed by the authorities and their legal advisors to minimize litigation risks. More broadly, public debt stress tests show that within limits contingent liabilities can be managed by the program without endangering debt sustainability.

IV. Staff Appraisal

36. **Iceland has made impressive progress under its Fund-supported program**. The severity of the crisis called for an eclectic and flexible approach to program design, including the imposition of capital controls and the operation of automatic fiscal stabilizers in the immediate wake of the crisis. This, alongside the authorities' successful implementation of program policies, has eased concerns of a worst-case outcome and underpinned the economic stabilization that is now underway.

37. **The Icelandic economy is gradually recovering**. Growth turned positive in the second half of 2010 and the economy is set to expand on an annual basis in 2011, for the first time in two years. The still-wide output gap and krona appreciation have further reduced inflation pressures, and the underlying current account remains in surplus. Financial markets have remained stable, despite turbulence in European sovereign debt markets.

38. **Still, there are still significant risks to the recovery**. Slow progress in corporate and household debt restructuring continue to impede a more robust turnaround in activity. Further delays in investment projects and shocks to external demand and commodity prices could also slow growth, while higher-than-expected wage increases could push inflation higher. It will therefore be important that authorities and social partners agree on wage settlements consistent with low inflation and sustained competitiveness. Looking farther ahead, delays in energy sector investment could continue to dampen growth over the medium term, while credit is likely to be constrained for some time as banks continue to repair balance sheets.

39. **Successful implementation of program policies has underpinned Iceland's progress to date**. Significant fiscal adjustment has already take place, and is set to continue in 2011. With sustained adjustment in line with the program, the public debt ratio should begin to decline in 2012. The financial system is gradually being restored, and the recapitalization of key institutions marks an important milestone in this area. Structural benchmarks on the FME's decision on commercial banks' plans to meet capital requirements and on submission of a supplementary budget to parliament to issue sufficient bonds to cover bank recapitalization costs have been met.

40. **With the new measures now in place, household debt restructuring must be accelerated and expectations of additional relief contained**. Staff welcomes the new measures, particularly those that are targeted to households in distress. Although they involve a modest budgetary cost, the measures are expected to reduce the debt and debt service burdens of households. To increase incentives for household participation, it is now critical that the authorities contain expectations for additional debt relief by sending a clear signal that the framework for household debt restructuring is complete.

41. **The new framework for corporate debt restructuring is welcome**. The fast-track approach for SMEs is sensible and should help to quickly alleviate the debt burdens of many of these companies. Repairing corporate balance sheets is critical to jumpstarting investment

and to reducing unemployment in Iceland, as well as to restoring the health of the financial sector. At the same time, the FME must remain vigilant that banks are properly reporting restructured loans, including by ensuring that losses are not put off into the future through improper use of accrual accounting.

42. **Staff welcomes passage of the 2011 budget**. The general government is projected to attain a small primary deficit, which is a significant achievement only two years after the crisis. The authorities are to be commended for their commitment to fiscal adjustment, even in the face of difficult and painful expenditure cuts, and for their effort to undertake the adjustment in a way that preserves Iceland's social welfare system.

43. **There may be scope to reduce the pace and amount of fiscal adjustment over the medium term**. Moderate easing of the pace of consolidation and fiscal targets in the medium-term would still deliver sustainable debt dynamics, provided that private sector losses are not absorbed by the public sector and that contingent liabilities continue to be contained. In this regard, the government must continue to refrain from absorbing significant private sector losses to preserve social fairness. If such losses were to be absorbed, the additional fiscal adjustment that would be required to keep debt on a sustainable path would likely result in cuts in public services, with potentially adverse effects on the most vulnerable groups in Icelandic society.

44. **Iceland should continue to build up its stock of international reserves**. Although gross reserves have increased considerably over the past year, they remain inadequate relative to standard benchmarks. Thus, the increase in non-borrowed reserves in recent months is welcome. Purchases must continue, and amounts should be scaled up given the favorable balance of payments outlook. Iceland should also continue to draw on available official financing. The CBI's recent steps to improve liquidity management are welcome, but additional efforts are needed to enhance liquidity forecasts and undertake more high-frequency operations.

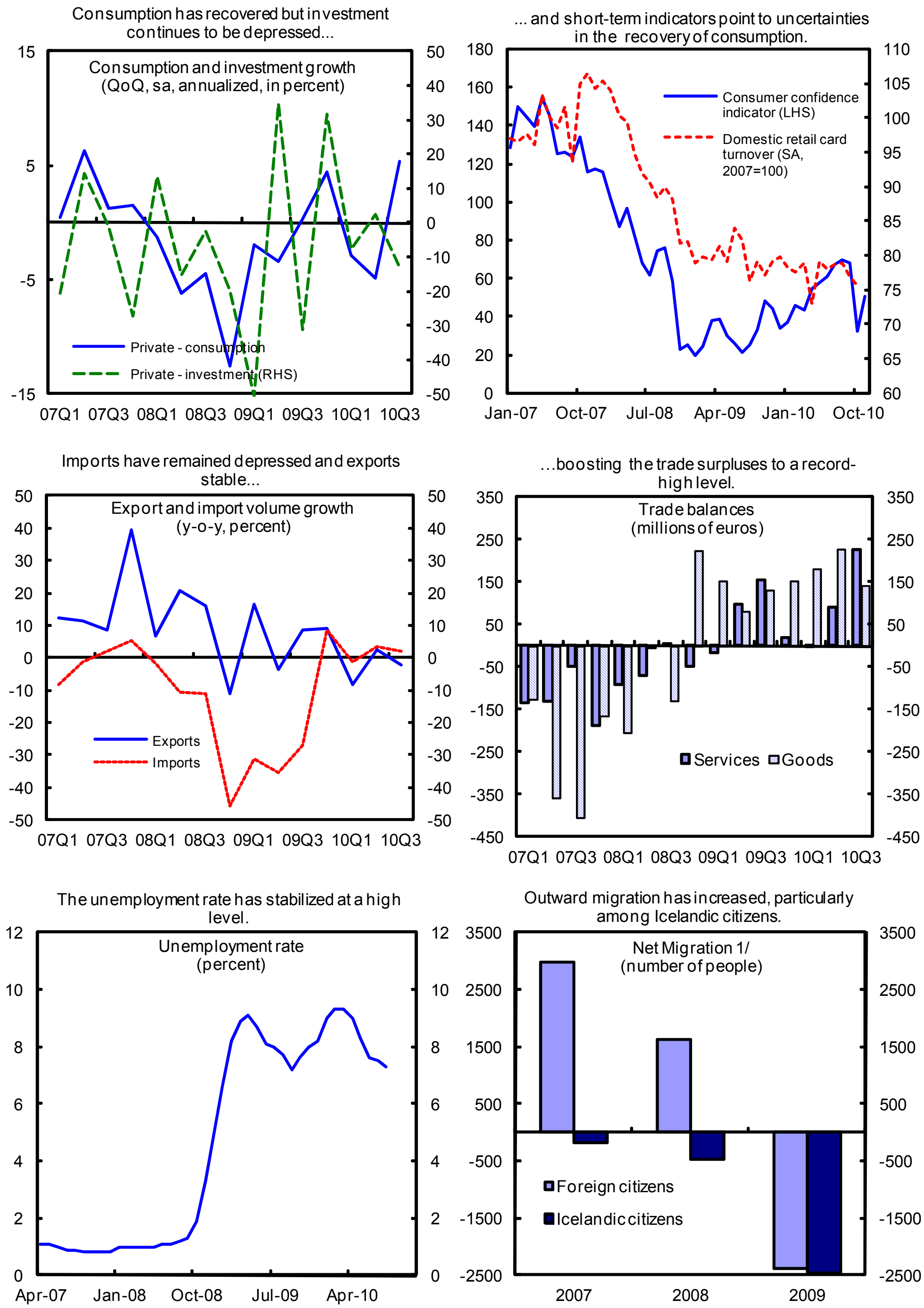
45. **The revised strategy for lifting capital controls must retain a cautious, and carefully coordinated, approach**. Staff is concerned that the liberalization of controls may proceed too rapidly, before the financial sector is sufficiently robust and additional sources of budgetary financing are secured. It will thus be critical that liberalization moves ahead cautiously, as preconditions—notably with respect to the health of the financial sector and the management of public debt—are met. In this regard, any interim release of offshore krona should take place in limited amounts, consistent with underlying conditions in debt markets, continued stability of the financial system and the exchange rate, and preferably in the context of the revised liberalization strategy. Staff welcomes the creation of the inter-agency working group that will provide input to the revised strategy, as it is essential that the eventual lifting of capital controls be coordinated with debt and liquidity management and communicated in a consistent manner.

46. **The progress on bank restructuring is welcome**. The savings banks are set to be recapitalized in the coming months, and the three largest commercial banks appear likely to meet minimum capital requirements despite the effects of the Supreme Court rulings on foreign currency indexation. The injection of capital by the government to bring HFF's capital ratio to 5 percent is most welcome, and the next step will be to bring HFF under FME supervisory and regulatory umbrella. Prudential and regulatory measures to bolster financial stability should proceed quickly. Nonetheless, banks are unlikely to achieve financial stability until the current high level of NPLs is reduced significantly, and efforts to accelerate debt restructuring must continue.

47. **Staff welcomes the agreement on Icesave**. The agreement marks a milestone in Iceland's emergence from crisis. Under the new terms, Iceland's public finances will remain on a sustainable footing, and public debt should continue to decline rapidly. The agreement should also help unlock remaining program bilateral financing and bolster market confidence in Iceland.

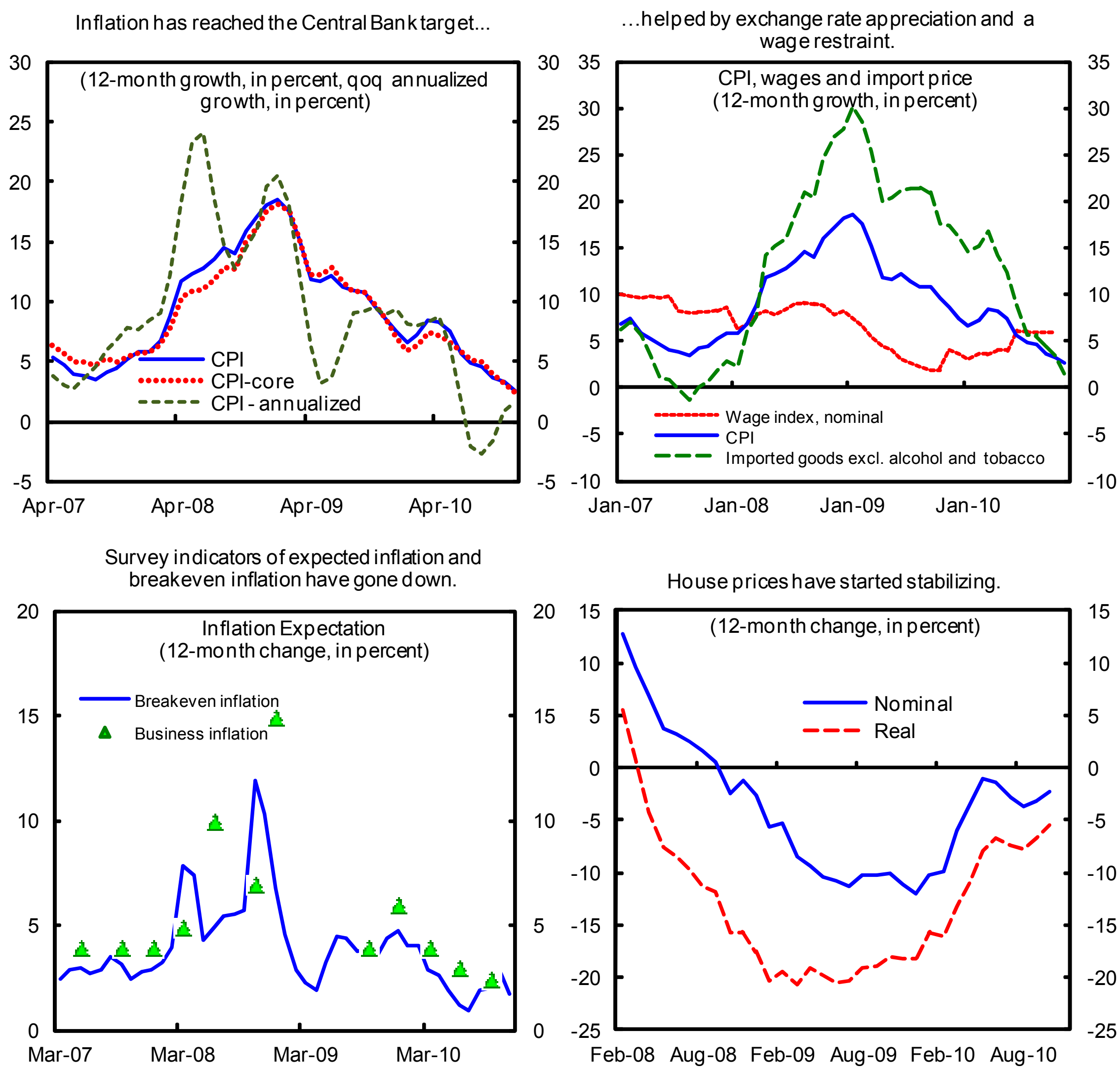
48. **On the basis of the considerable progress to date, staff supports the authorities' request to complete the fourth review**. Staff recommends the establishment of quantitative performance criteria for end-March and end-June 2011. It also supports the authorities' request for waivers of applicability on all end-December performance criteria, except net domestic assets of the central bank. Staff expects that all end-December performance criteria will be met.

Figure 1. Iceland: Recent Developments in Demand and Labor



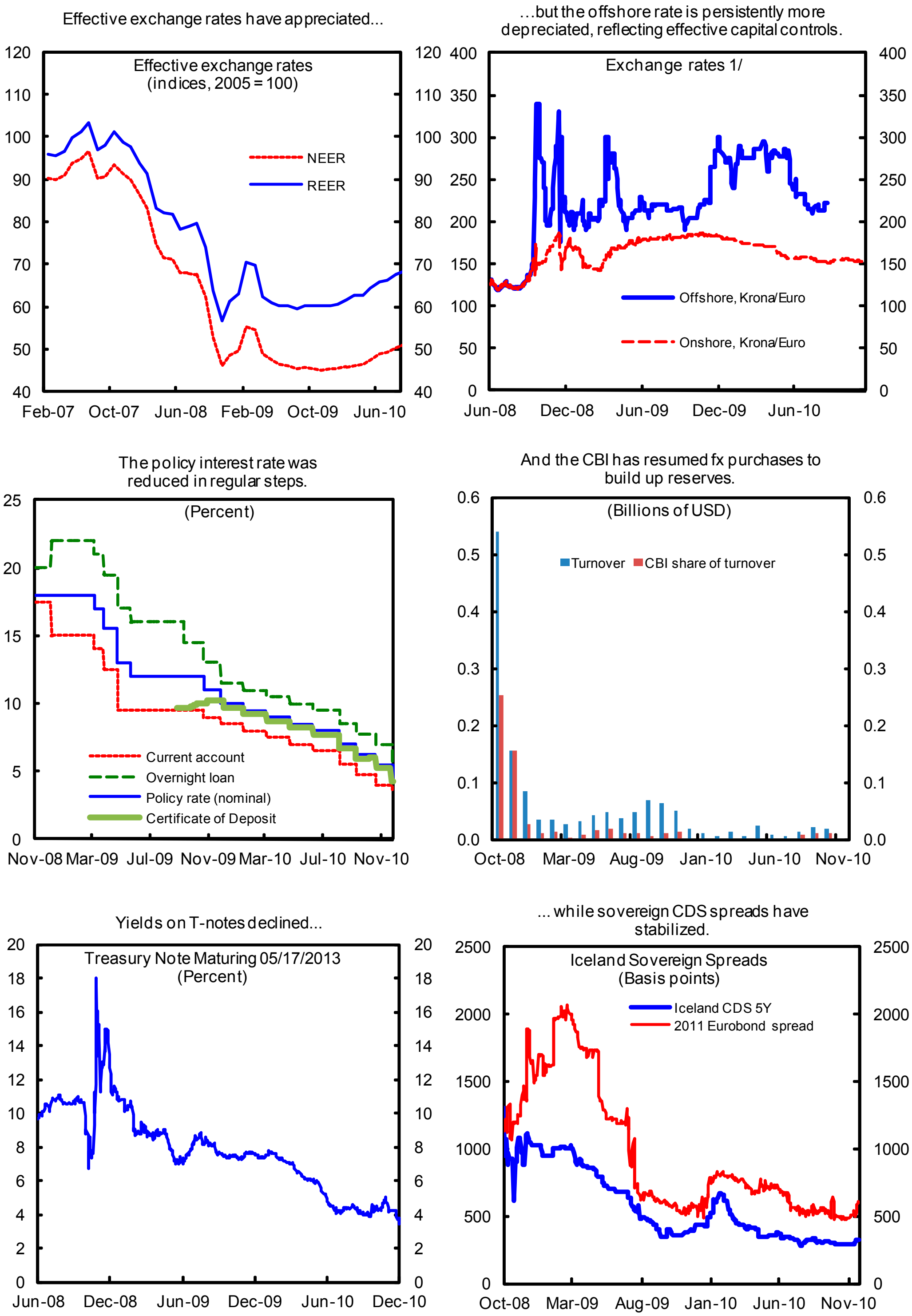
Sources: Iceland Statistics; Bloomberg; and IMF.
1/ Cumulative monthly data January through September for 2009.

Figure 2. Iceland: Price and Exchange Rate Developments



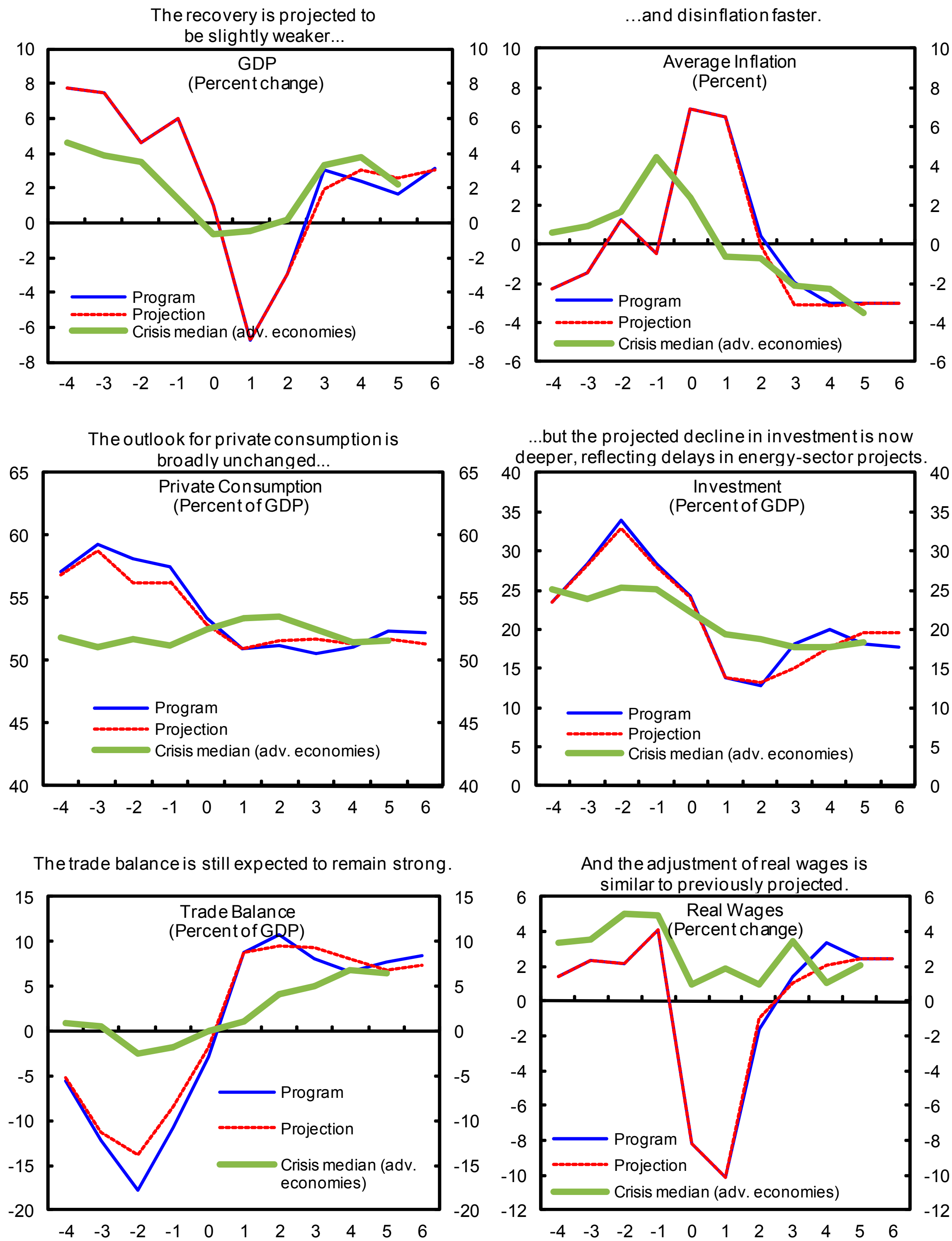
Sources: Central Bank of Iceland; and IMF's International Financial Statistics.

Figure 3. Iceland: Financial and Asset Markets Developments



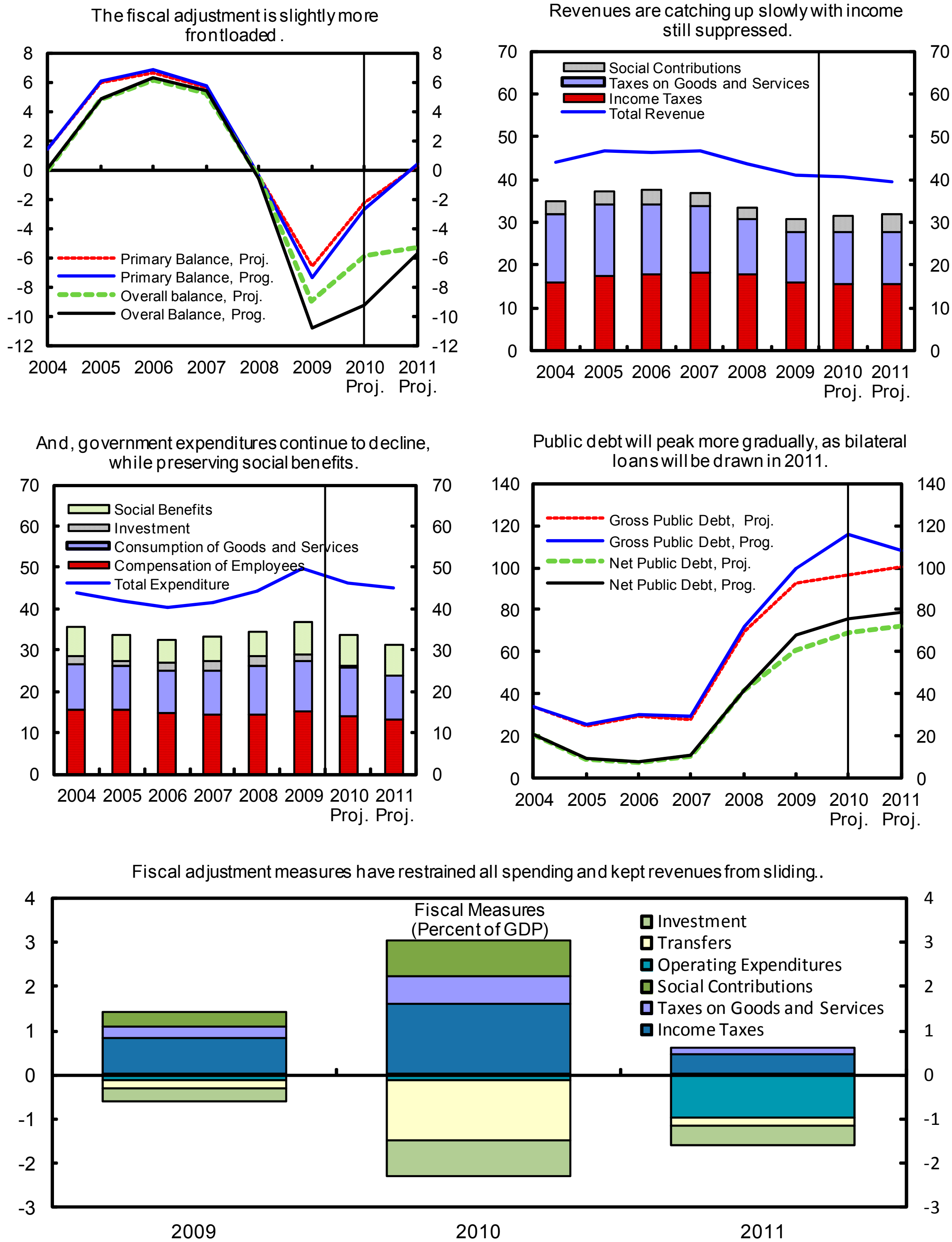
Sources: Central Bank of Iceland; Bloomberg; and DataStream.

Figure 4. Iceland: Macroeconomic Outlook Compared to the Original Program and Other Crisis Cases



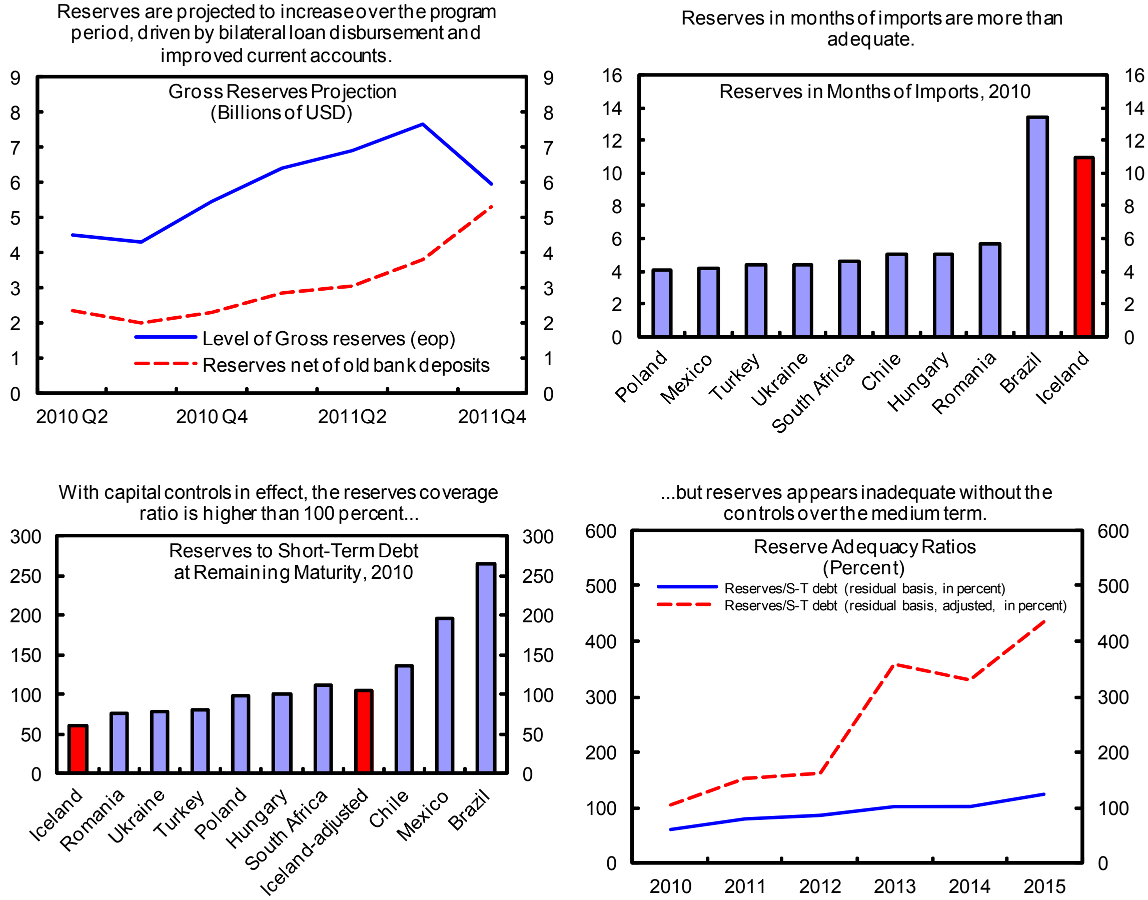
Sources: Program documents; and staff projections.
Notes: Crisis year = 0. Advanced crisis countries include Finland, Norway, Sweden and Spain.
Dates of the crisis defined as in Laeven and Valencia (2008) (2008 for Iceland).

Figure 5. Iceland: Fiscal Performance
(Percent of GDP)



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

Figure 6. Iceland: Reserve Adequacy Metrics



Sources: Central Bank of Iceland; and staff estimates.

Table 1. Iceland: Selected Economic Indicators, 2005–10

	2005	2006	2007	2008	2009		2010	
					Prog.	Est.	Prog.	Proj. 1/
(Percentage change unless otherwise noted)								
National Accounts (constant prices)								
Gross domestic product	7.5	4.6	6.0	1.0	-8.5	-6.8	-3.0	-3.0
Total domestic demand	15.8	9.0	0.2	-8.9	-20.7	-20.7	-1.9	-1.8
Private consumption	12.7	3.6	5.6	-7.9	-17.0	-16.0	0.6	-0.3
Public consumption	3.5	4.0	4.1	4.6	-0.1	-1.7	-3.5	-3.8
Gross fixed investment	35.7	22.4	-11.1	-20.9	-50.6	-50.9	-8.9	-4.0
Export of goods and services	7.5	-4.6	17.7	7.1	-1.5	7.4	-0.6	-0.2
Imports of goods and services	27.9	5.0	1.8	-16.1	-30.5	-22.0	1.7	2.1
Output gap 2/	3.1	2.1	3.6	1.8	-3.2	-3.1	-4.0	-4.0
Selected Indicators								
Nominal GDP (bln ISK)	1,036.4	1,208.7	1,336.3	1,492.9	1,472.5	1,500.8	1,598.1	1,551.4
Unemployment rate 3/	2.1	1.3	1.0	1.6	8.6	8.0	8.6	8.3
Consumer price index	4.0	6.8	5.0	12.4	11.7	12.0	5.9	5.4
Nominal wage index	6.5	9.1	9.3	3.3	3.3	0.6	4.2	4.4
Nominal effective exchange rate 4/	10.4	-10.7	2.7	-40.4	...	-34.2	...	...
Real effective exchange rate (CPI) 4/	13.3	-7.1	5.1	-20.7	...	-18.4	...	...
Terms of trade	1.0	3.5	0.1	-9.3	-8.5	-6.8	6.0	4.1
Money and Credit								
Base Money	32.2	27.9	190.7	-31.5	24.4	1.3	6.5	3.6
Deposit money bank credit (end-period)	76.0	44.4	56.6	-28.3	...	-28.9	1.0	-5.2
of which to residents (end-period)	54.7	33.6	28.3	...	...	...	...	...
Broad money (end-period)	23.2	19.6	56.4	36.3	8.3	-4.4	6.5	-2.5
CBI policy rate (period average) 5/	10.5	14.1	13.8	15.4	...	13.7	...	...
Public Finance (in percent of GDP)								
General government 6/								
Revenue	46.7	46.4	46.7	43.8	38.4	40.9	38.9	40.6
Expenditure	41.8	40.3	41.4	44.3	52.7	49.8	48.2	46.4
Balance	4.8	6.1	5.3	-0.5	-14.4	-8.9	-9.2	-5.8
Primary balance	6.0	6.5	5.6	-0.3	-8.3	-6.6	-2.7	-2.2
Balance of Payments (in percent of GDP)								
Current account balance	-16.0	-24.7	-15.9	-25.7	-3.5	-10.8	-0.9	-4.0
Trade balance	-12.1	-16.9	-9.9	-2.3	8.6	9.8	10.8	9.6
Financial and capital account	13.8	42.5	26.8	-76.5	6.8	-22.0	4.9	-14.5
Net errors and omissions	2.6	-10.7	-10.4	-17.1	-5.3	35.5	3.0	17.6
Gross external debt 7/	284.5	433.5	605.9	564.7	306.9	307.6	278.5	333.1
Central bank reserves (US$ billion)	1.1	2.3	2.6	3.6	4.9	3.9	6.9	5.5

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

1/ Projections for 2010 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 Est.	Mar-10 Est.	Jun-10 Est.	Sep-10 Est.	Dec-10 Proj.	Mar-11 Proj.
Central Bank						
Net foreign assets 2/	-177	-190	-383	-327	-344	-302
Assets	485	490	574	488	738	954
Liabilities	662	680	957	815	1,082	1,256
Net domestic assets	293	303	476	403	459	423
Net claims on the public sector	-52	8	-29	-38	-15	-32
Net claims excluding recap bond	-218	-172	-193	-207	-185	-202
Recapitalization bond	165	181	164	169	170	170
Net claims on banks 3/	-34	-65	-75	-15	-1	-16
Others, net	379	359	340	290	475	471
Base Money 4/	120	116	93	76	115	120
Currency issued	29	27	30	31	35	38
DMB deposits at the central bank	91	89	63	45	80	82
Banking System						
Net foreign assets	-31	-47	-4	102	152	201
Net domestic assets	1,611	1,605	1,497	1,368	1,274	1,199
Net claims on the central bank	120	137	137	64	80	98
Credit to private sector	1,854	1,919	1,876	1,813	1,818	1,820
Credit to government	34	245	212	220	220	220
Other items, net	-397	-696	-728	-730	-844	-939
Domestic deposits	1,580	1,557	1,493	1,470	1,426	1,400
Local currency	1,463	1,444	1,378	1,384	1,361	1,357
Foreign currency	117	114	115	86	65	43
Consolidated Financial System						
Net foreign assets	-207	-238	-387	-225	-192	-101
Net domestic assets	1,813	1,819	1,906	1,722	1,687	1,643
Net claims on the public sector 5/	-18	253	183	182	205	188
Net credit to private sector	1,854	1,919	1,876	1,813	1,818	1,820
Other, net	-22	-354	-153	-274	-336	-365
Broad Money (M3)	1,606	1,581	1,519	1,497	1,495	1,542
Memorandum items:						
Base money (y-o-y percentage change)	4.1	-13.1	-36.4	-52.7	-4.0	3.6
Broad money (y-o-y percentage change)	-3.8	-4.2	-12.3	-12.3	-6.9	-2.5
Credit to private sector (y-o-y percentage change)	-25.9	-15.5	-15.5	2.0	-1.9	-5.2
Money velocity (GDP/base money)	12.5	13.2	16.5	20.5	13.5	13.4
Broad money velocity (GDP/M3)	0.9	1.0	1.0	1.0	1.0	1.0
Multiplier (M3 / base money)	13.4	13.7	16.4	19.7	13.0	12.8

Sources: Central Bank of Iceland; and Fund staff estimates

1/ Although the balance sheets of the new banks have been finalized, the CBI has not received full monetary data reports.
Therefore the items under the banking system and consolidated financial system remain estimates for all periods after October 2008.

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

3/ Net claims on banks is the difference between CBI's lending to banks and banks' holding of certificates of deposits (exclude exception

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

5/ Net claims on the public sector of the consolidated system include only net claims of the central bank up to January 2009.
Starting Feb 2009, the data also include oustanding government bonds held by the banks.

Table 3. Iceland: Medium-Term Projections, 2009–15
(Percent change, unless otherwise indicated)

	2009		2010		2011	2012	2013	2014	2015
	Prog.	Est.	Prog.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Percentage change)								
Real economy									
Real GDP 1/	-8.5	-6.8	-3.0	-3.0	2.0	3.0	2.5	3.0	3.0
Real domestic demand	-20.7	-20.7	-1.9	-1.8	2.6	4.9	4.3	2.9	2.6
Private consumption	-17.0	-16.0	0.6	-0.3	3.0	3.3	3.5	3.0	3.0
Public consumption	-0.1	-1.7	-3.5	-3.8	-4.3	-3.0	-1.0	2.0	2.0
Gross fixed investment	-50.6	-50.9	-8.9	-4.0	15.5	23.2	13.6	3.5	2.1
Net exports 2/	11.2	11.1	-0.8	-0.8	-0.4	-1.0	-1.0	0.4	0.7
Exports of goods and services	-1.5	7.4	-0.6	-0.2	0.6	1.8	2.0	4.8	5.4
Imports of goods and services	-30.5	-22.0	1.7	2.1	2.1	5.6	5.4	4.7	4.9
Output gap 3/	-3.2	-3.1	-4.0	-4.0	-2.0	-1.0	-0.5	0.0	0.0
Unemployment rate 4/	8.6	8.0	8.6	8.3	7.5	5.8	4.1	3.4	3.4
Real wages	-7.5	-10.1	-1.6	-1.0	1.0	2.0	2.4	2.4	2.4
CPI inflation	11.7	12.0	5.9	5.4	2.5	2.4	2.5	2.5	2.5
CPI inflation (excl. effect of ind. taxes)	…	11.4	4.9	4.4	2.2	2.3	2.5	2.5	2.5
CPI inflation (end of period)	7.0	7.5	4.0	2.6	2.4	2.5	2.5	2.5	2.5
Nominal ISK/EUR exchange rate	…	172.0	...	...	...	...	...	...	...
Real exchange rate (+ appreciation)	…	-18.4	...	...	...	...	...	...	...
Nominal GDP (bln ISK)	1472.5	1500.8	1598.1	1551.4	1628.2	1726.2	1820.2	1934.2	2052.7
	(In percent of GDP, unless otherwise indicated)								
Balance of Payments									
Current account	-3.5	-10.8	-0.9	-4.0	1.3	1.5	0.3	1.2	2.3
Underlying current account 5/	…	8.2	0.8	12.4	8.0	8.0	6.4	7.0	7.7
Trade balance	8.6	9.8	10.8	9.6	9.4	8.2	6.8	7.4	8.2
Net income balance 6/	-11.6	-20.0	-11.2	-13.1	-7.7	-6.4	-6.2	-5.9	-5.7
Capital and financial account	6.8	-22.0	4.9	-14.5	-9.0	8.7	-13.0	4.3	9.7
Capital transfer, net	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0
Direct investment, net	8.4	-17.7	-0.8	-3.3	6.8	6.5	5.7	4.4	6.6
Portfolio investment, net	-6.6	-3.0	-0.3	-0.5	-0.8	-1.8	-0.6	-3.1	-3.8
Other investment, net 7/	5.1	-1.2	6.2	-10.7	-15.0	4.0	-18.1	3.1	7.0
Accumulation of arrears	-47.2	0.0	-41.2	-44.1	0.0	0.0	0.0	0.0	0.0
Extraordinary financing	61.8	5.5	59.5	51.3	11.5	-3.1	-3.9	-3.0	-3.2
Gross external debt 8/	306.9	307.6	278.5	333.1	267.2	253.1	215.0	199.6	182.6
Underlying gross external debt 9/	…	…	…	311.9	248.1	233.7	195.9	199.2	182.6
Central bank reserves (US$ billion)	4.9	3.9	6.9	5.5	6.0	7.0	4.5	4.9	6.4
General government accounts									
Revenue	38.4	40.9	38.9	40.6	39.6	40.3	41.0	40.8	40.6
Expenditure	52.7	49.8	48.2	46.4	44.9	42.0	40.3	39.0	38.1
Overall balance	-14.4	-8.9	-9.2	-5.8	-5.3	-1.7	0.8	1.8	2.5
Primary balance	-8.3	-6.6	-2.7	-2.2	-0.1	3.4	5.3	5.6	6.0
Primary balance (excl. new road projects)	-8.3	-6.6	-2.7	-2.2	0.3	3.9	6.0	6.0	6.0
Change in primary balance (excl. new road projects)	-8.0	-6.3	4.6	4.4	2.5	3.6	2.1	0.0	0.0
Gross debt	125.2	92.6	115.6	96.3	100.5	93.9	88.1	79.0	72.4
Net Debt	89.5	60.8	75.6	69.0	72.0	69.1	64.7	59.0	53.0

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.

Table 4. Iceland: Balance of Payments, 2008–15
(In billions of US dollars)

	2008	2009	2010	2011	2012	2013	2014	2015
	Prel.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj
Current Account	-4.4	-1.3	-0.4	0.2	0.2	0.0	0.2	0.4
Trade Balance	-0.4	1.2	1.4	1.2	1.1	1.0	1.2	1.4
Balance on Goods	-0.1	0.8	0.9	0.8	0.7	0.5	0.7	0.9
Merchandise exports f.o.b.	5.3	4.2	4.5	4.6	4.9	5.1	5.6	6.2
Merchandise imports f.o.b.	-5.4	-3.4	-3.6	-3.8	-4.2	-4.6	-4.9	-5.2
Balance on Services	-0.3	0.4	0.4	0.4	0.5	0.5	0.5	0.4
Exports of services, total	2.1	2.3	2.5	2.6	2.7	2.8	2.9	3.1
Imports of services, total	-2.4	-1.9	-2.1	-2.2	-2.2	-2.3	-2.4	-2.6
Balance on Income 1/	-3.9	-2.4	-1.7	-1.0	-0.9	-0.9	-0.9	-0.9
Receipts	1.0	-0.3	0.1	0.3	0.4	0.5	0.6	0.6
of which dividends and reinvested earnings	-0.9	-0.5	0.0	0.1	0.2	0.2	0.3	0.3
of which interest receipts	1.8	0.2	0.1	0.2	0.2	0.3	0.3	0.3
Expenditures	-4.9	-2.2	-1.8	-1.3	-1.3	-1.4	-1.5	-1.5
of which dividends and reinvested earnings	0.9	0.4	-0.2	-0.6	-0.6	-0.6	-0.6	-0.6
of which interest payments	-5.8	-2.5	-1.5	-0.8	-0.7	-0.8	-0.9	-0.9
of which interest payments of old banks	…	-1.8	-1.0					
Current transfer, net	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Cap and Finan. Acct	-12.1	-3.3	-1.8	-1.2	1.2	-1.9	0.7	1.6
Capital transfer, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	-12.1	-3.3	-1.8	-1.2	1.2	-1.9	0.7	1.6
Direct investment, net	5.1	-2.1	-0.4	0.9	0.9	0.8	0.7	1.1
Portfolio investment, net	0.0	-0.4	-0.1	-0.1	-0.3	-0.1	-0.5	-0.6
Assets	2.2	0.4	0.7	-0.3	-0.4	-0.1	-0.2	-0.3
Liabilities 2/	-2.3	-0.8	-0.8	0.2	0.1	0.0	-0.3	-0.4
Net borrowing	-0.4	-0.8	-0.9	0.2	0.0	-0.1	-0.4	-0.5
Equities	-1.8	0.0	0.0	0.0	0.1	0.1	0.1	0.1
Other investment, net 3/	-18.1	-0.1	-1.4	-2.0	0.6	-2.7	0.5	1.2
Assets	-2.1	0.9	-0.9	2.6	0.1	-0.1	0.1	0.9
Liabilities 2/	-16.0	-1.1	-0.4	-4.6	0.5	-2.6	0.4	0.2
of which external asset recovery (Landsbanki)	0.0	0.8	0.5	0.3	0.6	0.2	0.2	0.1
of which other external asset recovery	…	0.2	1.0	1.1	1.5	1.8	1.0	0.6
of which deposit insurance loan payments	0.0	0.0	-0.2	-1.8	-0.6	-0.3	-0.4	-0.4
of which other asset recovery payments	0.0	0.0	-0.1	-1.8	-0.9	-4.9	-1.0	-1.5
of which old banks foreign deposits	-18.8	…	…	…	…	…	…	---
Net errors and omissions	-2.9	4.3	2.2	0.0	0.0	0.0	0.0	0.0
Overall Balance	-19.4	-0.3	0.0	-1.0	1.4	-1.9	0.9	2.0
Overall financing	18.7	0.3	0.0	1.0	-1.4	1.9	-0.9	-2.0
Change in gross reserves ("-" = increase)	-0.9	-0.3	-1.6	-0.5	-1.0	2.4	-0.4	-1.4
Accumulation of arrears ("-" = paydown)	18.8	0.0	-5.6	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing 4/	0.8	0.7	7.2	1.5	-0.4	-0.6	-0.5	-0.5
Fund ("+" = net disbursement)	0.8	0.2	0.3	0.8	-0.4	-0.6	-0.5	-0.5
Bilateral (earmarked/ non-cash)	0.0	0.0	5.6	0.0	0.0	0.0	0.0	0.0
Other identified new financing 5/	0.0	0.5	1.2	0.7	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
Level of gross reserves (eop)	3.6	3.9	5.5	6.0	7.0	4.5	4.9	6.4
Level of gross reserves (eop) excluding old bank deposits		2.7	3.9					
Memo								
GDP $ bln	17.0	12.1	12.8	13.2	14.0	14.7	15.6	16.5
Underlying balance of income 6/	-3.5	0.3	0.3	-0.1	0.0	0.0	0.0	0.0
Underlying current account balance 6/	-3.1	1.4	1.5	1.1	1.1	0.9	1.1	1.3
Reserves (months of imports of G&S)	8.1	8.2	10.9	11.1	12.1	7.4	7.5	9.1
Reserves/S-T debt (residual basis, in percent)	68.0	49.3	59.8	80.9	86.5	100.5	103.1	124.0
Reserves/S-T debt (residual basis, adjusted, in percent) 7/	68.0	94.8	104.6	152.7	160.6	359.1	331.1	433.4
Reserves (in percent of GDP)	20.9	32.0	42.8	45.3	49.9	30.7	31.4	38.5
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.

Table 5. Iceland: General Government Operations, 2008–15 (GFS modified cash basis, percent of GDP 1/)

	2007	2008	2009	2010		2011		2012	2013	2014	2015
			Est. Mod. Cash	3rd Rev.	Proj.	3rd Rev.	Proj.	Proj.	Proj.	Proj.	Proj.
Total revenue 2/	**46.7**	**43.8**	**40.9**	**38.9**	**40.6**	**38.5**	**39.6**	**40.3**	**41.0**	**40.8**	**40.6**
Taxes	**36.6**	**33.5**	**30.6**	**30.1**	**30.8**	**29.9**	**31.0**	**31.8**	**32.3**	**32.1**	**31.9**
Taxes on income and profits	18.1	17.6	16.0	15.5	15.7	15.8	15.7	15.4	15.6	15.6	15.6
Personal Income Tax	13.5	13.1	12.8	13.0	12.9	13.0	13.0	13.1	13.3	13.3	13.2
Corporate Income Tax	2.4	1.9	1.8	0.9	1.0	0.9	1.1	1.1	1.1	1.1	1.1
Capital gains tax, rental income	2.2	2.6	1.4	1.7	1.7	1.9	1.6	1.3	1.3	1.3	1.3
Taxes on payroll and workforce	0.0	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Taxes on property	2.3	2.1	2.1	1.8	2.3	1.6	2.3	2.2	2.2	2.1	2.1
Taxes on goods and services	15.7	13.1	11.7	11.8	11.9	11.6	12.1	13.2	13.6	13.5	13.4
VAT	10.3	9.0	8.0	7.9	7.9	7.8	7.9	9.1	9.2	9.1	9.1
Other taxes on goods and services	5.4	4.1	3.6	3.9	4.0	3.8	4.2	4.1	4.4	4.3	4.3
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	0.1	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Social contributions	**3.0**	**2.8**	**3.1**	**3.8**	**4.0**	**3.6**	**4.0**	**4.0**	**4.1**	**4.1**	**4.0**
Grants	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**
Other revenue	**6.9**	**7.3**	**7.1**	**5.0**	**5.7**	**4.8**	**4.6**	**4.4**	**4.6**	**4.5**	**4.5**
o/w Interest income	2.2	3.1	3.2	2.2	2.0	2.0	1.7	1.5	1.5	1.5	1.5
New discretionary revenue measures 2/						**0.6**	**0.7**	**1.9**	**2.3**	**2.3**	**2.3**
Total expenditure 2/ 3/	**41.4**	**44.3**	**49.8**	**48.2**	**46.4**	**44.2**	**44.9**	**42.0**	**40.3**	**39.0**	**38.1**
Current expense 3/	**39.0**	**41.7**	**48.5**	**48.1**	**45.9**	**44.1**	**44.8**	**41.7**	**39.9**	**38.3**	**37.7**
Compensation of employees	14.5	14.5	14.9	13.5	14.0	12.3	13.0	12.0	11.8	11.4	11.3
Use of goods and services	10.6	11.5	12.5	11.6	11.7	10.6	10.8	10.0	9.6	9.3	9.2
Consumption of fixed capital	1.7	1.8	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Interest	2.5	3.3	5.5	8.7	5.6	8.1	6.9	6.6	6.1	5.3	4.9
o/w Interest on IceSave guarantee	..	..	0.3	2.6	1.2	2.6	1.3	0.7	0.6	0.4	0.3
Subsidies	1.7	1.8	1.9	1.8	1.7	1.6	1.6	1.4	1.4	1.3	1.3
Grants	0.2	0.2	0.4	0.2	0.3	0.2	0.3	0.3	0.3	0.2	0.2
Social benefits	5.6	6.0	8.1	7.4	7.5	6.6	7.5	6.8	6.5	6.3	6.3
Other expense	2.1	2.5	3.0	2.7	2.9	2.5	2.6	2.4	2.3	2.3	2.3
Nonfinancial assets	**2.4**	**2.6**	**1.4**	**0.1**	**0.5**	**0.1**	**0.1**	**0.3**	**0.4**	**0.7**	**0.4**
Non-financial assets, acquisition	4.1	4.4	3.5	2.2	2.6	2.3	2.3	2.4	2.5	2.7	2.5
of which: road construction projects							0.4	0.6	0.7	0.4	0.1
Consumption of fixed capital (-)	-1.7	-1.8	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1
New discretionary expenditure measures 2/						**-1.9**	**-1.6**	**-3.0**	**-3.5**	**-2.7**	**-1.4**
Net lending/borrowing 3/	**5.3**	**-0.5**	**-8.9**	**-9.2**	**-5.8**	**-5.6**	**-5.3**	**-1.7**	**0.8**	**1.8**	**2.5**
Net lending/borrowing incl. write-offs	**5.3**	**-13.4**	**-16.4**	**-9.2**	**-7.4**	**-5.6**	**-5.3**	**-1.7**	**0.8**	**1.8**	**2.5**
Financial assets, transactions	**6.9**	**21.7**	**7.5**	**0.4**	**-2.0**	**-6.2**	**-3.1**	**-1.6**	**-0.3**	**-1.8**	**0.4**
Currency and deposits	2.1	4.2	3.0	-2.1	-4.3	-4.8	-4.4	-1.6	-0.3	-1.8	0.4
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	0.9	14.3	-7.7	-0.5	0.0	-1.5	1.3	0.0	0.0	0.0	0.0
Shares and other equities	2.3	0.2	9.3	3.0	2.3	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	1.6	3.1	2.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities, transactions	**1.6**	**35.1**	**23.9**	**9.7**	**6.6**	**-0.6**	**3.5**	**0.8**	**-0.5**	**-3.1**	**-1.8**
Securities other than shares	0.9	10.6	20.9	6.0	9.0	0.0	2.3	-0.1	-0.9	-3.2	-1.7
Loans	1.3	21.3	2.6	3.7	-2.4	-0.6	1.1	0.9	0.4	0.1	-0.1
Domestic loans	2.1	18.9	1.0	1.0	0.4	-3.2	0.3	0.2	-0.1	-0.3	-0.4
Foreign loans	-0.8	2.4	1.6	2.6	-2.8	2.6	0.9	0.7	0.6	0.4	0.3
Insurance technical reserves	-1.9	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts payable	1.3	3.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net operation balance (1-2)	**7.7**	**2.1**	**-7.5**	**-9.1**	**-5.3**	**-7.3**	**-5.1**	**-1.4**	**1.1**	**2.5**	**2.9**
Discrepancy	0.0	0.0	0.0	0.0	2.8	0.0	1.3	0.7	0.6	0.4	0.3
Stock of debt 4/											
General government gross debt 4/	28.0	69.3	92.6	115.6	96.3	107.8	100.5	93.9	88.1	79.0	72.4
Domestic	15.5	45.4	60.9	66.2	68.4	62.9	68.1	64.6	60.6	53.8	48.9
Foreign currency 4/	12.6	23.9	31.7	49.4	27.8	44.9	32.4	29.2	27.5	25.2	23.5
of which:											
Bilateral loans to support CBI reserves	0.0	0.0	3.1	15.2	7.3	14.5	13.7	12.6	12.1	11.2	10.5
'Net present value' of depositor guarantees 5/	0.0	0.0	5.2	13.7	5.2	15.3	3.5	2.7	2.1	1.6	1.3
Other	12.6	23.9	23.4	20.4	15.3	15.1	15.2	14.0	13.4	12.4	11.7
General government net debt 6/	10.6	41.5	60.8	75.6	69.0	78.6	72.0	69.1	64.7	59.0	53.0
Structural Balances 7/											
Structural balance	1.0	-2.4	-5.1	1.9	0.7	-3.9	-3.5	-0.8	1.0	1.8	2.5
Structural primary balance	1.4	-2.4	-2.7	7.7	4.1	2.1	1.6	4.2	5.5	5.6	6.0
Memo Items											
Nominal GDP (billion ISK)	1336	1493	1501	1598	1551	1717	1628	1726	1820	1934	2053
Real GDP	6.0	1.0	-6.8	-3.0	-3.0	3.0	2.0	3.0	2.5	3.0	3.0
Inflation (avg)	5.0	12.4	12.0	5.9	5.4	3.5	2.5	2.4	2.5	2.5	2.5
Primary revenue	44.5	40.7	37.7	36.7	38.6	36.5	38.0	38.8	39.5	39.3	39.1
Primary expenditure	38.8	41.0	44.3	39.4	40.8	36.0	38.0	35.4	34.2	33.7	33.1
Primary balance (excl. interest income)	5.6	-0.3	-6.6	-2.7	-2.2	0.5	-0.1	3.4	5.3	5.6	6.0
Change in the primary balance		-5.9	-6.3	4.6	4.4	3.2	2.1	3.4	1.9	0.3	0.4
Primary balance (excl. new road projects)		-0.3	-6.6	-2.7	-2.2	0.5	0.3	3.9	6.0	6.0	6.0
Change in the primary balance (excl. new road projects)	-0.9	-5.9	-6.3	4.6	4.4	3.2	2.5	3.6	2.1	0.0	0.0

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

1/ Historical data are semi-accrual; projections are modified cash.
2/ Nominal measures have been divided about equally between tax and expenditure measures in 2012.
Measures are counted cumulatively from 2011 onward.
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.
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/ Cash flow impact 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.

Table 6. Iceland: Central Government Operations, 2008–15
(GFS modified cash basis, percent of GDP)

	2008	2009	2010		2011		2012	2013	2014	2015
		Est.	3rd Rev	Proj.	3rd Rev	Proj.	Proj.	Proj.	Proj.	Proj.
Cash receipts from operating activities 1/	**29.8**	**27.7**	**27.9**	**29.4**	**27.8**	**28.0**	**28.7**	**29.3**	**29.1**	**29.0**
Tax revenue	23.4	21.3	21.3	21.6	21.5	21.4	22.2	22.7	22.5	22.4
Taxes on income, profits, and capital gains	10.2	9.3	8.6	8.5	9.0	8.0	7.7	7.8	7.8	7.7
Personal income tax	5.9	5.5	6.0	5.8	6.2	5.3	5.4	5.5	5.4	5.4
Corporate income tax	2.0	1.2	0.9	1.0	0.9	1.1	1.1	1.1	1.1	1.1
Other taxes on income and profit	2.4	2.6	1.7	1.7	1.9	1.6	1.3	1.3	1.3	1.3
Taxes on payroll and workforce	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Taxes on property	0.5	0.4	0.3	0.5	0.3	0.6	0.6	0.6	0.6	0.6
Taxes on sales and services	12.0	10.8	11.4	11.7	11.3	11.8	13.0	13.4	13.2	13.2
Taxes on international trade and transactions	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Other tax revenue	0.1	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Social contributions	2.8	2.8	3.8	4.0	3.6	4.0	4.0	4.1	4.1	4.0
Grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other receipts	3.5	3.5	2.8	3.6	2.6	2.5	2.4	2.5	2.5	2.4
of which:										
Interest income	2.6	2.9	1.9	1.7	1.7	1.4	1.2	1.3	1.3	1.2
New revenue measures (cumulative) 1/					0.6	0.7	1.9	2.3	2.3	2.3
Total spending 1/	**30.3**	**34.4**	**33.6**	**34.5**	**30.2**	**32.8**	**30.0**	**28.6**	**27.7**	**26.9**
Cash payments for operating activities	**28.0**	**31.9**	**32.2**	**32.8**	**29.0**	**31.3**	**28.4**	**26.9**	**25.8**	**25.4**
Compensation of employees	8.4	8.5	8.0	8.2	7.4	7.5	7.0	6.7	6.6	6.4
Purchases of goods & services	5.5	6.0	6.1	6.5	5.1	5.8	5.2	4.9	5.0	5.5
Interest 2/	1.8	3.0	4.9	4.9	4.6	6.1	5.6	5.4	4.8	4.5
Transfer payments	12.2	14.4	13.2	13.3	11.9	12.0	10.6	9.8	9.3	9.0
Net cash inflow from operating activities	**1.8**	**-4.2**	**-4.3**	**-3.4**	**-1.2**	**-3.3**	**0.3**	**2.5**	**3.4**	**3.6**
Investments in NFAs	2.2	2.5	1.4	1.7	1.2	1.4	1.6	1.7	1.9	1.5
of which: r oad construction projects						0.4	0.6	0.7	0.4	0.1
New discretionary expenditure measures (cumulative) 1/					-1.9	-1.6	-3.0	-3.5	-2.7	-1.4
Overall deficit (incl. adjustment to cash)	**0.3**	**-7.6**	**-5.7**	**-5.2**	**-2.4**	**-4.8**	**-1.3**	**0.8**	**1.5**	**2.1**
Write-offs	12.9	7.5	0.0	1.5	0.0	0.0	0.0	0.0	0.0	0.0
of which:										
CBI recapitalization related write-offs	11.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities lending related write-offs	1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Called guarantees	0.0	5.7	0.0	1.5	0.0	0.0	0.0	0.0	0.0	0.0
Retro-active interest on bank capitalization	0.0	1.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Augmented Balance	-12.5	-15.2	-5.7	-6.7	-2.4	-4.8	-1.3	0.8	1.5	2.1
Memorandum Items:										
Nominal GDP	1,493	1,501	1,598	1,551	1,717	1,628	1,726	1,820	1,934	2,053
Inflation (avg)	12.4	12.0	5.9	5.4	3.5	2.5	2.4	2.5	2.5	2.5
Real GDP growth	1.0	-6.8	-3.0	-3.0	3.0	2.0	3.0	2.5	3.0	3.0
Primary revenue	27.2	24.8	25.9	27.7	26.1	26.6	27.5	28.1	27.9	27.8
Primary expenditure	28.4	31.4	28.7	29.7	25.6	26.7	24.3	23.2	22.9	22.4
Primary balance (excl. interest income)	-1.2	-6.6	-2.8	-2.0	0.4	-0.1	3.1	4.9	5.0	5.4
Change in primary balance		-5.4	4.0	4.6	3.2	2.0	3.2	1.8	0.1	0.4
Primary balance (excl. new road projects)		-6.6		-2.0	0.4	0.3	3.7	5.6	5.4	5.4
Change in the primary balance (excl. new road projects)		-6.6		-2.0	3.2	2.3	3.3	2.0	-0.2	0.0

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

1/ Measures, added in total revenue and expenditure lines, are about equally divided between revenue and spending measures, except in 2009.

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	2.1	0.1
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/	8.4	0.5
Total Revenue Measures	**11.0**	**0.7**

Expenditure Measure 1/	Nominal Amount (In ISK Billion)	Nominal Amount (In Percent of GDP)
Current expenditure	**15.9**	**1.0**
Wages	7.5	0.5
Other current expenditure	8.5	0.5
Transfers	**3.1**	**0.2**
Capital expenditure	**6.8**	**0.4**
Total Expenditure Measures	**25.8**	**1.6**

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

Weakness Identified	Reforms Proposed	Progress to Date
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 that would implement the working group's recommendations is being drafted and is expected to be introduced into Parliament early next year. 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 working group has recommended that municipalities be prohibited 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 working group has recommended that a debt-to-revenue ceiling of 150 percent be introduced, and that municipalities whose debt-to-revenue ratio already exceeds 150 percent be allowed to borrow only in local currency, from Municipal Credit Iceland
Municipal revenues extremely volatile	Require municipalities to satisfy the deficit rule (above) not year by year but over three-year rolling periods	The working group has recommended 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 working group has recommended that municipalities be subject to a three-tiered approach, in which municipalities breaching fiscal rules are subject to increasing monitoring
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 working group has recommended a new approach to coordination that differs in some respects from the one proposed by the IMF but has similar objectives. Among other things, it includes the creation of a coordination committee that comprises at least three ministers (including the Minister of Finance and the Minister of Local Government) and three representatives of local government
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 working group has proposed a wide range sanctions that can be applied to noncompliant municipalities, which range from mild to severe

1/ Based on FAD TA recommendations.

Table 9. Iceland: Status of the Financial Sector 1/

	Total assets				Capital adequacy ratio (in percent) 3/	Leverage ratio (in percent)	Status
	end-September 2009 2/		end-Sep 2010 2/				
	ISK billion	in percent of GDP	ISK billion	in percent of GDP			
A. Commercial banks 1/	**2,591**	**173**	**2,682**	**173**	17		
Landsbankinn	1,050	70	1,085	70	17	15.7	Going concern
Arion	705	47	820	53	18	12.5	Going concern
Islandsbanki	779	52	715	46	23	14.7	Going concern
MP bank 2/	57	4	62	4	9	5.1	Going concern
	end-June 2009		end-June 2010				
B. Saving banks	**388**	**26**	**306**	**20**	…		
BYR sparisjóður 4/	232	15	165	11	…	…	In April 22, 2010 the bank was intervened, assets and deposits were transferred to a new Byr-commercial bank. Negociations between creditors and the authorities have ben finalized and recapitalization process is underway.
Sparisjóður Keflavíkur	90	6	78	5	…	…	In April 22, 2010 the bank was intervened, assets and deposits were transferred to new Spkef saving bank. Negociations between creditors and the authorities have been finalized in the fall of 2010 and creditors bought-out.
Other saving banks	66	4	63	4	…	…	Include 6 small saving banks in recapitalization. The process should be finalized by end-2010.
					…	…	
C. Housing Finance Fund (HFF)5/	**795**	**49**	**833**	**54**	…	…	The HFF recapitalisation law was adopted by Althingi in December 2010. A 33 bln ISK capital injection will bring the HFF to 5.5% of CAD.

Sources: Preliminary data from CBI and FME, and staff calculations.

1/ Numbers for new banks are tentative and available from the FME, adjusted for the sub-ordinated instruments provided by the government under private capitalization.

2/ As of end-June 2010 for MP . Data for saving banks are June 2009 to June 2010

3/ As of September 2010. Includes tier 1 and tier 2 capital for the new banks.

4/ Byr h.f. ("new Byr") was set-up by the FME on April 23 2010 as a commercial bank. It is left under the heading "saving banks" for presentational purposes.

5/ HFF data are for March and June 2010

Table 10. Iceland: Access and Phasing Under the Stand-By Arrangement, 2008–11 1/

Date Available	Purchases		Conditions include
	SDR mns	Percent of quota	
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
25 May 2011	140	119.0	Sixth review completion and observance of end-March 2011 PCs
15 August 2011	140	119.0	Seventh review completion and observance of end-June 2011 PCs
Total	1400	1190.5	

Source: IMF staff estimates

Table 11. Iceland: External Financing Requirements and Sources, 2010–15
(In billions of US dollars)

	2009 Proj	2010 Proj	2011 Proj	2012 Proj	2013 Proj	2014 Proj	2015 Proj
A Gross Requirements	8.2	12.5	13.0	9.4	10.2	6.3	6.6
Current account deficit	1.3	0.4	-0.2	-0.2	0.0	-0.2	-0.4
Amortization (MLT)	1.8	4.2	4.0	2.2	2.1	2.0	2.2
Official (excl. IMF)	0.8	1.9	1.7	1.5	1.6	1.1	1.6
Deposit insurance loans	0.0	0.2	1.8	0.6	0.3	0.4	0.4
Private	1.0	2.2	0.5	0.2	0.2	0.6	0.2
Short-term debt	5.0	7.9	9.1	7.4	8.0	4.5	4.8
B Sources of Financing	3.9	8.6	11.5	9.8	10.7	6.8	7.2
Foreign Direct Investment (net)	-2.1	-0.4	0.9	0.9	0.8	0.7	1.1
FDI outflows Abroad	-2.2	-0.2	0.5	0.2	-0.1	-0.1	0.4
FDI inflows to Iceland	0.1	-0.2	0.4	0.8	1.0	0.8	0.7
Net inflows of equity and other capital	0.4	0.7	-0.3	-0.3	0.0	-0.1	-0.2
Disbursements (MLT)	0.6	1.6	2.0	1.3	1.6	1.1	1.1
Short-term debt	3.7	8.4	5.9	7.9	5.0	4.6	4.8
Other net assets	1.7	-0.1	3.5	1.0	0.8	1.0	1.8
Reserves accumulation (-: increase)	-0.3	-1.6	-0.5	-1.0	2.4	-0.4	-1.4
C Financing Gap (A-B)	4.3	3.9	1.5	-0.4	-0.6	-0.5	-0.5
Errors and omissions	4.3	2.2	0.0	0.0	0.0	0.0	0.0
Accumulation of arrears	0.0	-5.6	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing	0.7	7.2	1.5	-0.4	-0.6	-0.5	-0.5
Fund	0.2	0.3	0.8	-0.4	-0.6	-0.5	-0.5
Bilateral (earmarked/ non-cash)	0.0	5.6	0.0	0.0	0.0	0.0	0.0
Other identified new financing	0.5	1.2	0.7	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 2008–15
(In millions of SDR)

	2008	2009	2010	2011	2012	2013	2014	2015
Existing and prospective Fund credit								
Disbursements	560	105	210	525	0	0	0	0
Stock	560	665	875	1400	1120	761	459	118
Obligations	0	13	18	35	318	387	319	347
Principal (repurchases)	0	0	0	0	280	359	302	341
Charges and interest	0	13	18	35	38	28	17	6
Stock of existing and prospective Fund credit								
In percent of quota	476	565	744	1190	952	647	391	100
In percent of GDP	5.1	8.6	10.4	16.2	12.2	7.9	4.5	1.1
In percent of exports of G&S	11.5	16.2	18.9	29.4	22.4	14.7	8.2	2.0
In percent of gross reserves	24.3	26.9	24.3	35.7	24.5	25.7	14.3	2.8
Obligations to the Fund from existing and prospective Fund arrangements								
In percent of quota	0.0	11.1	15.2	30.0	270.7	329.0	271.3	295.5
In percent of GDP	0.0	0.2	0.2	0.4	3.5	4.0	3.1	3.2
In percent of exports of G&S	0.0	0.3	0.4	0.7	6.4	7.4	5.7	5.7
In percent of gross reserves	0.0	0.5	0.5	0.9	7.0	13.1	9.9	8.3

Source: IMF staff estimates and projections.

ATTACHMENT I. LETTER OF INTENT

Reykjavik, December 22, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC 20431
USA

Dear Mr. Strauss-Kahn:

1. **An economic recovery is gradually taking hold**. The policies in place have underpinned continued stability of the krona, a declining debt path, and falling inflation. Trade surpluses have allowed us to begin purchases of foreign currency to bolster reserves. Recent indicators suggest that demand is slowly picking up, and we expect growth to turn positive in 2011.

2. **Our policy implementation remains broadly on track**. All structural benchmarks relevant for this review have been met, except the one on passage of legislation for the new fiscal framework for local governments. The latter has been incorporated into a wider reform of local government legislation which will be presented to parliament in February 2011. We request waivers of applicability for all end-December performance criteria except the ceiling on net domestic assets of the CBI, since data on those PCs for which we are requesting the waivers will not be available at the time that the Fund's Executive Board considers the Fourth Review. 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 fourth review under the Stand-By Arrangement**. As set out in Table 1, we request that quantitative performance criteria be established for March 31, 2011 and June 30, 2011. Following previous delays due to the Supreme Court decisions on foreign-exchange linked loans, we request that the structural benchmark on recapitalization of Byr and SpKef be reset to end-February 2011. The structural benchmark on nonbank financial institutions and the HFF was also delayed on account of the Supreme Court rulings, but progress on recapitalizing these institutions is proceeding at different paces. Consequently, we request that a new benchmark, for end-February 2011, be established on other non-bank recapitalization. As detailed below, we also propose two new structural benchmarks covering: (i) completion by Icelandic State Financial Investments company of a two-year strategic plan to ensure medium-term viability of the savings banks through consolidation, by end-March 2011; and (ii) cabinet approval of the updated strategy for lifting capital controls, by end-February 2011, as set forth in ¶20 of this letter (Table 2). Our program will continue to be monitored by quarterly performance criteria and reviews.

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. **Iceland's economy is recovering, but at a slower pace than we had previously expected**.

- We estimate that recovery began in the second half of this year, and will continue next year. We project buoyant net exports and a nascent recovery in private consumption, resulting in GDP growth of about 2 percent in 2011.We expect growth next year to be largely driven by investment. Several investment projects are expected to begin in 2011, although not on as large scale as previously expected resulting in lower growth than previously projected. The private sector debt overhang, further delays in investment projects, and shocks to external demand remain the key downside risks. Upside potential could be realized through higher investment.

- Headline inflation has reached the central bank's target (2½ percent), and we expect it to remain close to the target in 2011. The appreciation of the krona, the weak economy, and inflation expectations that have converged to our target contributed to the faster-than-projected disinflation in 2010. The still significant slack in the economy, alongside a stable krona, is expected to keep inflation in check next year. Risks to the outlook emanate from possible wage increases in export sectors spreading to non-tradables sectors.

- The outlook for the balance of payments remains strong. Over the next 12 months, we expect continued reserve accumulation due to a trade surplus, recovery of assets related to CBI claims on failed financial institutions, and the realization of program financing. However, short-term external debt is expected to increase by more, which will reduce the coverage of reserves in 2011.

6. **We expect public and external debt to decline**. We have further reduced gross external public debt through the recent repurchase of a syndicated loan. Gross general government debt is expected to reach 96 percent of GDP in 2010 and gross external debt is projected to amount to about 330 percent of GDP in 2010. Over the medium term, gross public and external debt are set to continue to decline, but levels will remain high. Risks associated with high debt ratios can be managed through the continued firm implementation of the program.

Policy overview

7. **With the economy now largely stabilized, the key objective of our policies is to lay the basis for a sustainable economic recovery**. We have identified a package of policies to deliver this objective. To address the debt overhang in the private sector, which is essential to boost consumption and investment, we have modified the existing frameworks for households and corporate debt restructuring. To provide additional support to domestic demand, we have revised our fiscal targets to allow for a more moderate fiscal adjustment in 2011. With respect to monetary policy, the overarching challenge will be to ensure that interest rate decisions are carefully coordinated with the eventual and gradual lifting of capital controls, in a manner that preserves currency and financial stability. Finally, fully restoring the health of the banking system remains a key objective. Our policies in this area are focused on continuing to strengthen bank balance sheets and improving supervision and regulation. Although we face a formidable challenge in revitalizing our economy after the significant shock that it has endured, we are confident that these policies will underpin a durable recovery.

Accelerating private sector debt restructuring

8. **We attach high priority to accelerating private sector debt restructuring, and have identified measures to further improve the framework**. Restoring the balance sheets of households, corporates, and banks is critical to a sustainable recovery and job creation. We believe that the measures elaborated in ¶9 and ¶10 will eliminate remaining gaps in the existing debt restructuring framework, and we do not intend to take further measures. To ensure that debt restructuring proceeds in a way that preserves scarce fiscal resources, we will avoid absorption of private sector losses by the public sector.

9. **We have worked with banks and other stakeholders to strengthen the existing, targeted framework for household debt restructuring**. Before taking key decisions, we established a commission to assess the costs and effectiveness of various debt-relief proposals. Based on the commission's findings, we reaffirm our position that across-the-board writedowns of household debt would be excessively costly and would not provide sufficient relief to the vast majority of households in distress. To ensure that distressed borrowers receive debt relief targeted to their individual needs, we have taken the following measures:

- Through an agreement with the financial sector we have formalized a process for writing down mortgages to 110 percent of the value of the mortgaged assets, up to a certain ceiling and subject to meeting criteria on debt services capacity. This writedown will be offered to debtors until July 1, 2011. The special voluntary debt mitigation scheme launched in October 2009 has also been adjusted with the aim of increasing access for low-income households.

- The supplementary tax rebate on interest that has been in effect in 2009 and 2010 will be preserved and made more progressive. In addition, an interest rate subsidy, financed by the financial sector, has been introduced.

- We have increased the capacity of the Office of the Debtor's Ombudsman (DO) to enable faster processing of applications.

- We have enacted into law a temporary suspension of all debt payments for households who file an application with the DO for debt mitigation, in an effort to encourage greater participation in the framework.

- We have also amended the Bankruptcy Act to limit to two years the discharge period following bankruptcy to ensure that individuals facing bankruptcy are quickly given a fresh start.

- Although we were committed to not extending further the period in which households could apply for a 3 months stay on forced sales, a final extension, to March 2011, was needed to allow households to avail themselves of the new options for debt restructuring.

- In collaboration with the banking sector and social partners, we will continue to raise awareness of the options available to households under the debt restructuring framework.

These measures are beginning to bear fruit: applications for debt restructuring have increased, and the DO is currently processing some 1500 applications.

10. **In partnership with key stakeholders, we are advancing corporate sector debt restructuring**.

- Legislation is in place on how to handle corporate tax arrears and tax liabilities arising from corporate debt writedowns.

- We have developed, in coordination with the corporate and banking sectors, a new framework to accelerate voluntary debt restructuring of small and medium enterprises (SMEs) in a harmonized manner. The framework is intended for viable SMEs (corporates with liabilities under ISK 1 billion) whose liquidation is likely to lead to larger loss of value for stakeholders than restructuring. The framework is designed to encourage owners to restore the value of the company and contains provisions that discourage misuse. It also addresses a number of bottlenecks, including by introducing a mechanism for resolving disputes among the parties involved. The aim is for the banks to finalize proposals on restructuring by end-May 2011.

11. **Legislation has been passed that addresses a number of uncertainties associated with the June and September Supreme Court rulings on the legality of foreign indexed loans**. In particular, this legislation clarifies in general how loans that are found to be illegal are to be adressed and recalculated. It also includes a temporary provision on how qualified foreign-currency mortgages and car loans with foreign-exchanged linked clauses are to be recalculated and settled.

Securing fiscal sustainability

12. **We are on track to meet our 2010 fiscal targets**. Windfall revenue from asset sales will allow us to deliver a stronger primary balance than expected under the program. Revenue projections (excluding the one-off windfall revenue) are broadly on track, as underperformance of personal income tax and VAT was partly offset by strong excise revenue performance. We are also undertaking some additional investment spending, amounting to about ¼ percent of GDP, which will be carried over from 2009 appropriations. Other primary expenditures are broadly in line with budget projections. The general government primary deficit will reach 2¼ percent of GDP in 2010, which is an improvement of about 4¼ percent of GDP over the finalized 2009 accounts. Interest costs have declined considerably relative to our previous budget projection, contributing to an improvement in the overall balance and a reduction in our financing needs. We are committed to saving any windfall revenue.

13. **We have moderately eased the fiscal targets for 2011 to provide support to the economy, while still achieving a key program objective**. In mid-December, parliament approved a 2011 budget for the central government that targets a small primary surplus of the general government (an improvement of about 2½ percent of GDP over 2010). With passage of this budget, we have achieved a key milestone in the medium-term consolidation strategy that we set out in 2009. The easing of the fiscal target in 2011 (by ¼ percentage point of GDP relative to the program) will provide room for automatic stabilizers and allow us to increase and better target the interest tax rebate (as discussed in ¶9 above). We expect that the local governments will deliver a balanced primary position, while phasing in the new fiscal framework (see below).

14. **We have further elaborated the package of measures to deliver our 2011 fiscal targets**.

- *Revenue measures*. These amount to about ¾ percent of GDP and include increases in the capital and corporate income tax rates from 18 to 20 percent, the inheritance tax rate from 5 to 10 percent, the wealth tax rate by 25 basis points, as well as the rates of excise taxes on alcohol, tobacco, and carbon emissions. We will also revise the base for motor vehicle levies, introduce a new bank tax, and increase the allowance for withdrawal of voluntary pension savings.

- *Expenditure measures*. These will amount to about 1½ percent of GDP relative to the budget baseline for 2011. Civil service nominal wages and benefits will not be increased, curtailing baseline spending by about ¼ percent of GDP. Rationalization of medical insurance costs (by 3 percent), education and police service costs (by 5 percent), and general administrative costs (by 9 percent) are expected to reduce expenditures by 1.1 percent of GDP relative to the budget baseline. A targeted reduction of welfare benefits and subsidies has also been introduced.

- *Household debt restructuring measures*. As described above (¶9), the costs of the temporary interest subsidy (up to 1/3 percent of GDP) will be fully financed by temporary revenue raised from the financial sector, with no net impact on the primary balance. These revenues and expenditures are in addition to those discussed earlier in this paragraph.

15. **We continue to work to improve the fiscal framework and finances of local governments**. The working group tasked with providing recommendations on this issue has published its report. The reformed fiscal framework is part of a comprehensive new Local Government Bill—which has been prepared in consultation with local governments—and will be presented to parliament in February 2011. We intend to pass this legislation by end-June 2011 **(structural benchmark)**. The bill includes fiscal rules for local governments, and its explanatory notes provide for a three-tier system for monitoring municipal finances, to be implemented by regulation. Meanwhile, we have strengthened our efforts to improve the financial situation of highly-indebted local governments, including through the creation of a special commission to recommend how these local governments will meet their obligations. Local governments' 2011 budgets were prepared under the old framework, but the surveillance function has already been strengthened and will lead to closer and more intrusive monitoring. The new law will be fully operational for fiscal year 2012. To this end, we are preparing an agreement on economic coordination between central and local governments to ensure that common economic and financial objectives are met.

16. **We have published an updated medium-term consolidation plan**. We remain committed to an overall general government surplus by 2013. We expect that the plan will deliver a stable gross general government debt ratio of 60 percent of GDP in the long run. To achieve this, we have introduced 3-year binding nominal expenditure constraints—one essential element of strengthening our budgetary framework. Medium-term targets will be kept under review, and could be modified if contingent liabilities remain contained and private sector losses are not absorbed by the public sector.

17. **We have updated our medium term debt management strategy**. Its publication in early January 2011 will strengthen our communication with market participants and facilitate a broadening of market access. We will seek opportunities to further extend the average maturity of domestic debt as well as to reduce the amount of non-marketable debt.

Monetary policy and capital controls

18. **We plan to revise our strategy on the lifting of capital controls**. We consider a revision appropriate on account of a stronger external position and because we now have better information on the investor base and on market behavior in the face of the controls than when the original strategy was formulated.

19. **The updated strategy will retain a cautious approach to lifting controls, as preconditions are met**. The lifting of controls will proceed in a way that does not jeopardize macroeconomic or financial stability, including by ensuring adequate reserve coverage. The updated strategy will elaborate measures to ensure that system liquidity can be adequately managed during the liberalization process and in the context of an open capital account. It will specify the methods and techniques for capital control liberalization. It will also clarify how we will assess whether the following preconditions have been met: (i) the sustainability of the government debt and confidence in our ability to access international capital markets; (ii) the availability of sufficient investment opportunities in Iceland, including through the revival of domestic capital markets; and (iii) financial sector stability in the context of a liberalized capital account. Since the effectiveness of the controls needs to be maintained throughout the liberalization process, we will continue to provide sufficient resources to administer, monitor, and enforce the controls.

20. **The updated strategy will be coordinated with debt management, and monetary and financial sector policies**. To this end, it will be prepared by the CBI, in cooperation with the FME and the government. The updated strategy will be adopted by the cabinet by end-February 2011 (**structural benchmark**). To increase public awareness of the strategy, we intend to publish it following its adoption. We will consult with the Fund before finalizing and adopting the new strategy, consistent with our undertakings in paragraph 4.

21. **Against this background, we will continue our purchases of foreign exchange to increase our non-borrowed reserves**. Weekly purchase auctions that began in late August 2010, as well as some one-off exceptional operations, have allowed us to accumulate close to EUR 25 million in the past two months. The krona has remained stable despite these operations. Given the strong balance of payments, we plan to scale up the weekly purchases of foreign exchange to further improve our reserve position.

22. **We have taken steps to normalize liquidity conditions in the interbank market**. The increase in the outstanding amount of central bank CDs has helped shift short-term interest rates towards the center of our policy corridor. However, banks continue to exhibit a preference for liquidity, and money market transactions remained centered on very short-term maturities. In preparation for capital control liberalization, we will strengthen our capacity for more active liquidity management by enhancing our liquidity forecasts and by engaging in more high-frequency operations.

23. **Monetary policy decisions will remain focused on inflation and preserving krona stability**. Rapid disinflation, the appreciation of the krona, and the reduction in the risk premium have supported steady interest rate cuts. While the slower-than-expected recovery may warrant further monetary accommodation, this will need to be balanced against the need to preserve currency stability as capital controls are eventually lifted.

Restoring the financial system

24. **We are addressing the effects of the Supreme Court rulings on banks**.

- *Assessment.* The FME, in coordination with banks and with external legal support, has completed its assessment of potential losses on the banks' pool of foreign exchange-indexed loans arising from the Supreme Court rulings in June and September. The impact of these rulings on bank capital is considered to be manageable and banks are expected to remain in compliance with minimum capital requirements. A communication on individual results has been sent to the commercial and savings banks. For the next two years, the FME, jointly with banks, will update its assessment on a quarterly basis.

- *Accounting for losses.* On an on-going basis, at the end of each quarter and based on prior discussion with individual banks on the potential impact of Supreme Court rulings, the FME will require banks to fully provision likely losses on probably affected loans. The FME will include as a supervisory deduction for the banks' capital computation the amount of expected losses, on current estimates, as of end-December 2010.

- *Recapitalization when needed.* We will encourage bank owners to provide additional capital (thus minimizing fiscal costs). If, at any time, any of the three new commercial banks cannot demonstrate that they will meet their capital requirements within the designated time frame, the government will provide sufficient funds to bring their capital to required levels after losses have been absorbed by the current shareholders (the mid-October **structural benchmark** on authorization to issue recapitalization bonds was met).

25. **Significant progress has been made in resolving the savings banks.** We have completed negotiations with the Resolution Committee of old Byr on the recapitalization of new Byr, and we are now finalizing the legal documentation. We are also finishing discussions to buy out old Keflavik's creditors for a very modest sum, after which we will proceed with the new Keflavik's (SpKef's) recapitalization. We expect that by end-February 2011 all savings banks will be recapitalized (**structural benchmark**). Upon completion of the savings banks' recapitalization, the Icelandic State Financial Investment Agency will complete a two year-strategic plan aimed at ensuring medium-term viability of the savings banks through operational restructuring, including business consolidation where necessary.

We propose that the completion of the two- year strategic plan become a **structural benchmark** for end-March 2011.

26. **We are continuing our work to strengthen the non-bank sector:**

- *The Housing Finance Fund (HFF).* In late November, the FME communicated to HFF the minimum capital injection required to bring its capitalization to 5 percent of risk-weighted assets. By end-December, we expect to make the required capital injection into HFF and submit to the FME a timetable for harmonizing HFF capital and other requirements with those of other financial institutions. By end-March 2011, we plan to submit legislation to put the HFF under full supervisory oversight by the FME.

- *Other non-bank financial intermediaries.* Negotiations between owners and creditors of the largest leasing company on the necessary haircuts and writedowns to restore their solvency have been completed, and legal documentation is now being finalized. Two leasing companies related to commercial banks are in process of being recapitalized by their parent institutions. The FME will require all non-bank financial intermediaries to complete their recapitalization by end-February (**structural benchmark**). If these institutions are not recapitalized by this time, the FME will begin the winding-up process.

27. **We continue working on several fronts to address bank balance sheet vulnerabilities**. This is key to ensuring financial stability going forward:

- *Updated prudential rules*. In October 2010, the FME published guidelines regarding: board members' roles and responsibilities; sound management and supervision of liquidity risk; and fit and proper criteria for key bank officers. The regulations on large exposures, sound business practices, and loans to related parties have been drafted and will be published by end-January 2011.

- *Revised Internal Capital Adequacy Assessment Process (ICAAP).* The FME has initiated its annual ICAAP to ensure that banks hold sufficient capital to cover the risks associated with their activities. This review is expected to be completed by end-March 2011.We remain committed to ensuring that banks are adequately capitalized and to taking prompt action when capital shortages are identified.

- *Revised bank accounting practices*. To ensure that banks are properly accounting for restructured or impaired loans, the FME has taken a number of measures. It will complete by end-February 2011 its assessment of whether banks are accounting for interest income from restructured or impaired and non-performing loans in a manner consistent with international standards. Should deviations from such standards be identified, the FME will require banks to revise their financial statements and will also issue guidelines to ensure consistent application of accounting standards. Banks are also being required to engage in semiannual audits of their financial statements, (during 2011-12) to ensure appropriate loan valuation.

28. **Reforms to banking legislation are on track**:

- *Central bank and banking law:* We intend to establish a Committee of Experts by end-December to gather information on new trends and international best practices in supervision of financial institutions and markets. This work will be a key input to any revisions to the legislative and regulatory framework for financial supervision. At the same time, we plan to submit to parliament technical amendments to the Act on Financial Undertakings regarding the definition of tier I capital, limitations on large exposures, and information sharing between the relevant supervisory authorities (both within and outside Iceland).

- *Deposit insurance.* We now expect that the draft bill fully harmonizing the deposit guarantee regime with the relevant EU directives—especially regarding coverage and timeframe to reach the targeted fund—will be passed by end-January 2011.

External financing

29. **Our ability to fully implement the program described above remains dependent on access to adequate external financing**. This financing will contribute to confidence during the gradual capital account liberalization process and help us smoothly manage our external debt rollover during 2011–12. We have further improved our reserves position through asset recovery and foreign currency purchases. We have also requested an extension of the availability of financing from our bilateral partners to end-December 2011, and our Nordic counterparts have agreed to support this request. We intend to draw remaining amounts of committed financing, as financing gaps require. In the event of any shortfalls, we stand ready to consult with the Fund on any additional measures that would prove necessary to meet program objectives (consistent with our undertaking in paragraph 4 above).

30. **We have made significant progress in meeting the preconditions of some of our bilateral partners to access bilateral program financing**. We have reached an agreement on the level of negotiators with the Netherlands and the United Kingdom respectively over the deposit guarantees of the Landsbanki Icesave accounts. On that basis, legislation authorising the Minister of Finance to sign the agreements and thereby undertake the commitment contained therein, has been presented to parliament and referred to the budgetary committee following its first reading. A second reading is scheduled in the latter half of January once Parliament resumes after the Christmas recess. We are confident that the agreement, negotiated by a team jointly appointed by all parliamentary parties, will be approved by parliament.

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 Preliminary	Dec 10 Ceiling/Floor	Mar 11 Ceiling/Floor	Jun 11 Ceiling/Floor
										(In billions of Króna)	
1. Floor on the change in the central government net financial balance 2/	-175	-139.5	-200	-166.7	-55	-41.0	-140	-81.9	-150	-40	-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	35	35
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	10.1	80	70	70
										(In millions of U.S. dollars)	
5. 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	-592	-588
6. 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	150	2500	2000	2000
7. Ceiling on the stock of central government short-term external debt 6/	1400	0	1400	0	750	0	750	22	750	700	700
8. 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

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 onlending 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 ¶15). *By end-December 2010.*	Not met 1/
• Recapitalization of Byr and Keflavik, the two largest savings banks, up to 16 percent of their risk weighted assets. (LOI ¶25). *By end-May 2010.*	Not met /Reset to end-February 2011 (LOI ¶26) 1/
• The FME to require rehabilitation and/or recapitalization measures to be taken by the Housing Finance Fund, as determined to be necessary by a review of their business plans (LOI ¶26). *By end-August 2010.*	Not met 1/
• Publication of a Basel Core Principles assessment of weaknesses in Iceland's supervisory framework, along with a strategic plan to address the weaknesses. *By end-March 2011.*	
• Passage of legislation to strengthen the framework for household debt restructuring, addressing (i) access to information, advice, and mediation mechanisms in the context of voluntary workouts; (ii) eligibility; and (iii) incentives for financial institutions and debtors to expedite voluntary restructuring agreements. *By end-June 2010.*	Met
• A decision by the FME on commercial banks' plans to meet capital requirements as defined in the Letter of Intent. *By November 15, 2010.*	Met
• Submission of a supplementary budget to parliament requesting authorization to issue sufficient bonds to cover recapitalization needs of the banking system if losses on all probably affected and possibly affected loans are realized. *By October 15 2010.*	Met
New Structural Benchmarks	
• 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 ¶25). *By end-March 2011.*	
• Cabinet approval of the updated strategy for lifting capital controls in line with program objectives (LOI ¶20). *By end-February 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 ¶26). *By end-February 2011.*	

1/ Delayed because of SC ruling

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. Information about such debt issuance and on-lent amounts will be provided monthly.

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.

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 gross foreign assets minus foreign liabilities of the CBI.

- **Gross foreign 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.

- **Gross foreign liabilities** 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 gross foreign liabilities. General government fx liabilities at the CBI will not be included in gross foreign liabilities.

- **For program monitoring purposes**, the stock of foreign assets and foreign liabilities of the CBI shall be valued at program exchange rates as described on paragraph 2 above. The stock of NIR amounted to $634 million as of December 31, 2009 (at the program exchange rate).

9. **Adjustment mechanism:**

- The NIR floor will be adjusted downward at the program exchange rate by the amount of Nordic disbursements relative to the technical assumption below. For every one dollar of disbursements, the NIR floor for each period will be adjusted downwards 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

NIR Adjustment

Cumulative flows from End-November 2009	In millions of US dollars at program exchange rate	Adjustment per one dollar of additional Nordic disbursements
Nordic Disbursements (technical assumption for the adjuster purpose)		
End-March 2011	0	-0.50
End-June 2011	0	-0.50

10. **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

11. **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.

12. **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)

13. **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

14. **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.

15. **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

16. **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.

17. **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

18. 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. DEBT SUSTAINABILITY ANALYSIS

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

A. External DSA

2. **External debt is expected to about reach 330 percent of GDP in 2010 and fall to 185 percent of GDP by the end of the medium term.** Although 2010 stock is estimated to be higher than previous projection of 300 percent, it is mainly because of faster asset recovery of the old banks from external sources. This means that it is covered by earmarked foreign assets and has no implications on the net external flows. Revised data and assumptions, especially on the old banks' path of asset recovery and payout, are the main drivers of the revised external debt path:

- Data on the three old banks' asset recovery up to June 2010 suggest that recovery has been faster than previously anticipated. This has driven up total external debt in 2010 by about 30 percentage points. About half of the increase (in percentage of GDP terms) is from the dollar exchange rate movement in 2010.

- The old banks' first detailed reports submitted to the CBI suggest that expected payout time has also changed. The DSA now assumes two old banks to start paying out to creditors in Q4 2011 and the third old bank to start in Q4 2013.

- The new Icesave agreement has been taken into account in this revised DSA. Lower interest rates and no capitalization of interest payments (except up to October 2009) lower annual interest payments by about 1 percent.

- Interest rates for new borrowing for 2011–13 are assumed to be lower by about 200 bps, following the actual cost of borrowing that a few Icelandic enterprises have experienced so far.

3. **Stress tests suggest that the downward trajectory remains a robust result.** Standard shocks would not disturb the downward trajectory of the debt ratio. A permanent 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

4. **Since the third review, assumptions underlying the analysis have been changed, affecting debt dynamics in 2010–15**:

- The expected 2010 primary deficit is now 2¼ percent of GDP (an improvement of ½ percent of GDP relative to the third review). Given an improvement in the net interest income of about 3 percent of GDP, the 2010 adjustment effort has contributed to an additional 3½ percentage-point reduction of the 2010 debt to GDP ratio.

- It is now assumed that the adjustment in 2011 will be more moderate, with a primary surplus (excluding the road construction) of ¼ percent of GDP rather than ½ percent of GDP as expected under the third review. Road construction expenditures of about 2¼ percent of GDP over 2011–15 will lead to a more gradual adjustment of the primary balance, which will still reach 6 percent in 2015.

- The Icesave assessment has been updated, with a significant downward adjustment to the government's liability due to the new Icesave agreement. The interest rate on Icesave liabilities has been reduced from 5.5 to 3.2 percent, and interest payments are expected to start in 2011. Assuming payouts of recovered assets will also commence in 2011, the total residual public obligation is estimated to be about 1½ percent of 2015 GDP—about 13 percentage points lower than estimated during the third review.

- The central government has assumed called guarantees of the Government Guarantee Fund related to the restructuring of the old banks. These amount to 1.5 percent of GDP in 2010 and are expected to expire in 2023.

- HFF and savings bank recapitalization amounts to 3¾ percent of 2010 GDP .

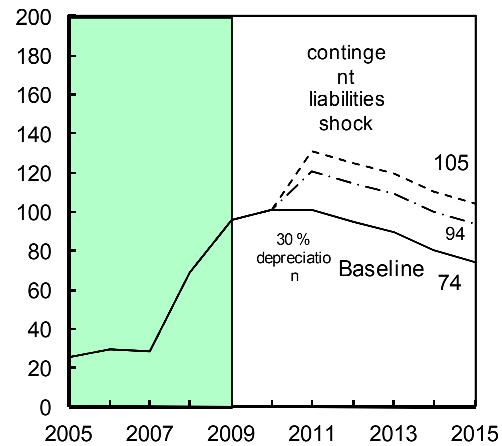
- Eurobond and syndicated loan repurchases are expected to reach about 7¾ percent of GDP in 2010. The timing and rollover rates for external loans have also been adjusted in line with assumptions used for the external debt analysis. In particular, the third and fourth tranches of the Nordic loans are expected to be drawn in 2011, rather than in 2010.

5. **Under these assumptions, at 96½ percent of GDP, the 2010 gross public debt ratio is nearly 20 percentage points lower compared to the third review**. However, public debt is now expected to peak at about 100 percent of GDP in 2011 due to the full disbursement of bilateral loans.

6. **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—after the one-time downward adjustment of the government's Icesave liability—and continues to be driven by fiscal adjustment. The 2011 real interest rate/GDP growth differential will be much less favorable than previously expected, but will improve sharply after 2013. By end-period, the actual primary balance would exceed the debt-stabilizing level, with debt reduction continuing beyond the projection period.

7. **The downward debt trajectory is sensitive to growth and program implementation shocks** (Figure A2):

- **Contingent liability shock.** A shock to public debt of 30 percent of GDP arising from the need to inject further capital in the banking sector or assume larger debt guarantees would lead to debt exceeding 131 percent of GDP in 2011. Provided that the fiscal consolidation path is maintained, and there are no significant side effects on interest rates, public debt would come down, but remain above 100 percent of GDP in 2015.



- **Macro shocks.** While an interest rate shock is not expected to reverse the public debt path, a growth shock would flatten it and warrant a more austere implementation of the fiscal consolidation plan.

- **Downside scenario**. Likewise, a low growth, high interest rate, depreciated exchange rate scenario would compress the downward trajectory for public debt, and may require greater consolidation effort should the low-growth trap appear too deep.

- **No policy change scenario**. As the debt dynamics hinge upon continued implementation of the consolidation program, should the government halt further fiscal adjustment, the debt to GDP ratio would continue to grow—albeit moderately – past 2011.

Table A1. Iceland: External Debt Sustainability Framework Current Baseline, 2005-2015

(In percent of GDP, unless otherwise indicated)

	Actual					Projections							
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015		**Debt-stabilizing non-interest current account 6/**
Baseline: External debt (including old banks)	284.5	433.5	605.9	564.7									
Baseline: External debt	65.9	101.3	171.8	189.0	**307.6**	**333.1**	**267.2**	**253.1**	**215.0**	**199.6**	**182.6**		**-3.6**
Change in external debt	-6.5	35.4	70.6	17.2	118.6	25.5	-65.9	-14.1	-38.2	-15.3	-17.1	0.0	
Identified external debt-creating flows	46.4	31.3	26.8	40.0	56.0	-4.4	-23.8	-26.4	-21.2	-17.3	-18.1	0.0	
Current account deficit, excluding interest payments	14.3	22.2	10.1	13.1	0.6	-4.9	-13.9	-13.2	-11.9	-12.8	-13.4	3.6	
Deficit in balance of goods and services	12.2	17.5	10.1	2.3	-9.7	-10.6	-9.4	-8.2	-6.8	-7.4	-8.2		
Exports	31.4	32.1	34.5	44.2	53.3	55.0	54.9	54.5	53.9	54.5	55.9		
Imports	43.6	49.6	44.6	46.5	43.6	44.4	45.5	46.3	47.1	47.2	47.7		
Net non-debt creating capital inflows (negative)	44.1	7.3	28.9	-23.0	27.4	-16.1	-16.1	-17.2	-14.9	-10.0	-10.2	-2.5	
Automatic debt dynamics 1/	-11.9	1.9	-12.2	50.0	28.0	16.5	6.3	4.1	5.5	5.5	5.5	-1.1	
Contribution from nominal interest rate	1.8	3.4	6.1	12.9	10.2	7.9	12.6	11.7	11.6	11.6	11.1	10.8	
Contribution from real GDP growth	-4.4	-3.0	-4.9	-2.0	17.8	8.7	-6.3	-7.7	-6.1	-6.1	-5.6	-5.7	
Contribution from price and exchange rate changes 2/	-9.4	1.4	-13.4	39.1	43.0	...	...	...	...	...	...	-6.2	
Residual, incl. change in gross foreign assets 3/	-52.9	4.1	43.7	-22.8	62.6	29.9	-42.1	12.3	-16.9	2.0	1.0	0.0	
External debt-to-exports ratio (in percent)	209.6	315.8	498.4	427.9	577.2	605.6	486.7	464.4	398.9	366.0	326.4		
Gross external financing need (in billions of US dollars) 4/	5.7	8.0	8.7	13.1	6.5	11.1	13.1	10.1	11.2	7.0	7.8		
in percent of GDP	35.1	47.6	42.8	78.1	53.8	86.7	99.4	72.1	76.1	45.0	47.4		
Scenario with key variables at their historical averages 5/					**307.6**	**333.1**	**282.3**	**287.5**	**264.9**	**260.2**	**253.2**		**-20.1**
Key Macroeconomic Assumptions Underlying Baseline												For debt stabilization	
Real GDP growth (in percent)	7.5	4.6	6.0	1.0	-6.8	-3.0	2.0	3.0	2.5	3.0	3.0	3.0	
Nominal external interest rate (in percent)	3.1	5.3	7.4	6.2	3.9	2.7	3.9	4.6	4.8	5.7	5.9	5.7	
Growth of exports (US dollar terms, in percent)	13.7	4.5	31.3	5.4	-12.8	8.4	3.2	5.1	4.1	7.6	8.3		
Growth of imports (US dollar terms, in percent)	35.9	16.3	9.8	-14.1	-32.3	7.0	5.9	7.8	7.1	6.4	6.8		
Current account balance, excluding interest payments 7/	-14.3	-22.2	-10.1	-13.1	-0.6	4.9	13.9	13.2	11.9	12.8	13.4		
Net non-debt creating capital inflows	-44.1	-7.3	-28.9	23.0	-27.4	16.1	16.1	17.2	14.9	10.0	10.2		

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).

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, 2005–15
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing primary balance 9/**
1 **Baseline: Public sector debt 1/**	25.2	29.1	28.0	69.3	92.6	**96.3**	**100.5**	**93.9**	**88.1**	**79.0**	**72.4**	**0.5**
o/w foreign-currency denominated	10.3	16.2	13.0	23.9	31.7	27.8	32.4	29.2	27.5	25.2	23.5	
2 Change in public sector debt	-9.2	4.0	-1.1	41.2	23.3	3.7	4.2	-6.7	-5.8	-9.1	-6.6	
3 Identified debt-creating flows (4+7+12)	-7.6	-7.7	-10.5	27.7	15.9	9.3	7.6	-4.0	-5.6	-7.0	-7.1	
4 Primary deficit (including interest income)	-7.0	-8.2	-7.8	-2.8	3.4	0.2	-1.6	-4.9	-6.8	-7.1	-7.4	
5 Revenue and grants	46.7	46.4	46.7	43.8	40.9	40.6	39.6	40.3	41.0	40.8	40.6	
6 Primary (noninterest) expenditure	39.6	38.2	38.8	41.0	44.3	40.8	38.0	35.4	34.2	33.7	33.1	
7 Automatic debt dynamics 2/	-0.5	0.5	-2.7	12.4	4.2	2.4	2.5	0.9	1.2	0.1	0.4	
8 Contribution from interest rate/growth differential 3/	-1.1	-0.9	-0.6	0.1	4.4	2.4	2.5	0.9	1.2	0.1	0.4	
9 Of which contribution from real interest rate	1.2	0.1	0.9	0.3	-0.2	-0.2	4.3	3.7	3.5	2.6	2.6	
10 Of which contribution from real GDP growth	-2.3	-1.0	-1.5	-0.2	4.6	2.6	-1.8	-2.9	-2.3	-2.5	-2.2	
11 Contribution from exchange rate depreciation 4/	0.5	1.4	-2.1	12.3	-0.3	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.0	0.0	0.0	18.1	8.3	6.7	6.7	0.0	0.0	0.0	0.0	
13 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	
14 Recognition of implicit or contingent liabilities 5/	0.0	0.0	0.0	0.0	5.2	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (capitalization of banks, bilateral loans) 6/	0.0	0.0	0.0	18.1	3.1	6.7	6.7	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 7/	-1.6	11.7	9.4	13.6	7.4	-5.6	-3.4	-2.7	-0.2	-2.1	0.4	
Public sector debt-to-revenue ratio 1/	53.9	62.8	60.0	158.2	226.2	237.2	253.6	233.0	214.7	193.5	178.3	
Gross financing need 8/	0.5	-0.6	0.3	12.3	26.4	26.7	19.2	12.1	10.2	10.3	3.7	
in billions of U.S. dollars	0.1	-0.1	0.1	2.1	3.2	3.4	2.5	1.7	1.5	1.6	0.6	
Scenario with key variables at their historical averages 9/						**96.3**	**95.8**	**89.4**	**85.5**	**79.6**	**76.4**	**-0.3**
Scenario with no policy change (constant primary balance) in 2010-2015						**96.3**	**102.3**	**100.8**	**102.1**	**100.3**	**101.5**	**0.6**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	7.5	4.6	6.0	1.0	-6.8	-3.0	2.0	3.0	2.5	3.0	3.0	
Average nominal interest rate on public debt (in percent) 10/	7.1	9.7	9.6	13.2	8.0	6.3	7.5	6.9	6.8	6.4	6.6	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.2	0.9	4.0	1.4	-0.9	-0.5	4.7	4.0	4.0	3.3	3.6	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-3.1	-12.1	15.9	-48.7	1.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	2.8	8.8	5.7	11.9	8.9	6.7	2.7	2.9	2.8	3.1	3.1	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.3	3.2	6.5	5.4	-0.3	-10.8	-4.8	-4.1	-0.9	1.5	1.2	
Primary deficit (including interest income)	-7.0	-8.2	-7.8	-2.8	3.4	0.2	-1.6	-4.9	-6.8	-7.1	-7.4	
Net public sector debt	9.4	7.5	10.6	41.5	60.8	69.0	72.0	69.1	64.7	59.0	53.0	

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 - π (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.

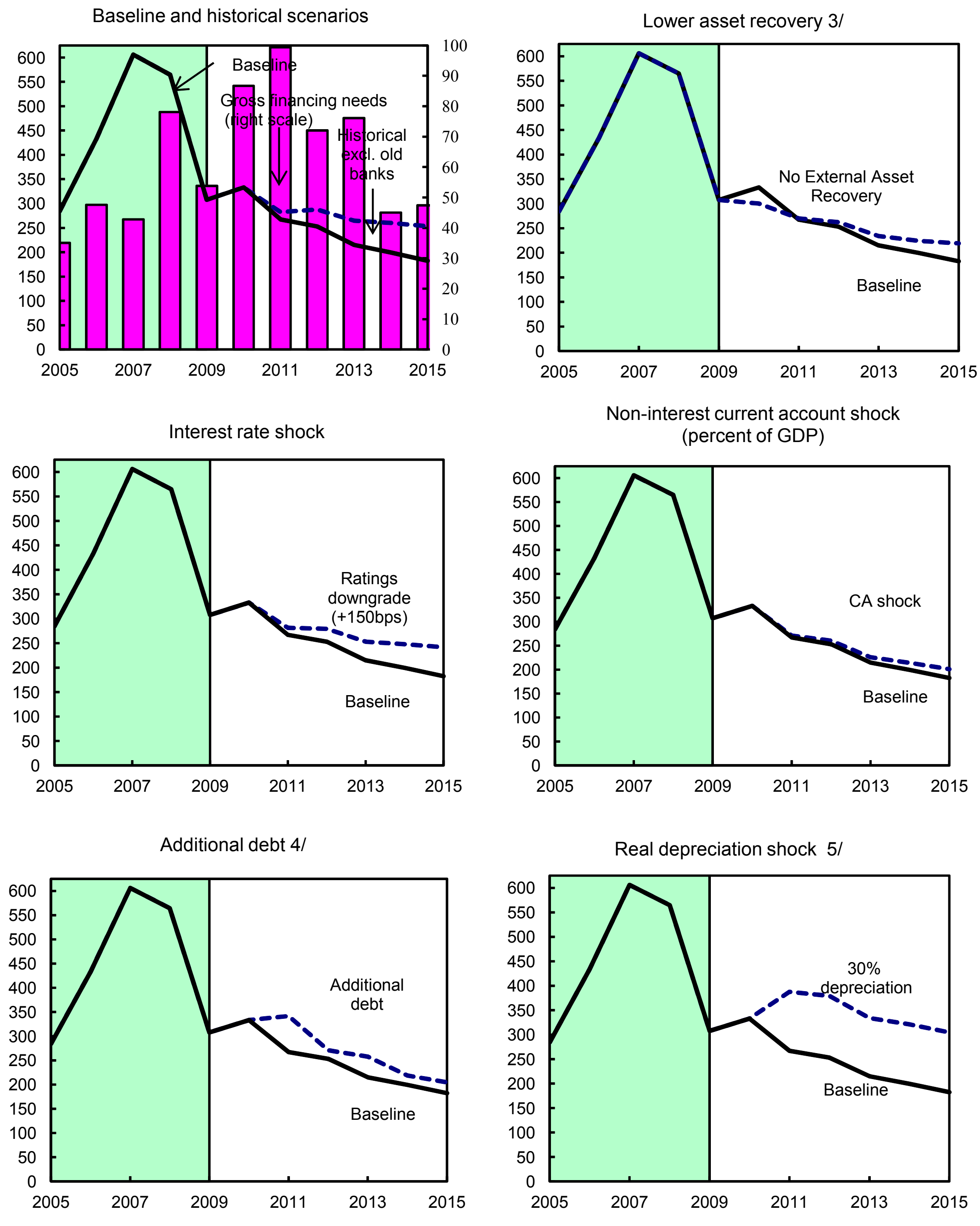
7/ For projections, this line includes exchange rate changes. In 2009-11, the residual also reflects use of deposits at the central bank and sale of financial assets obtained during the financial crisis.

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.

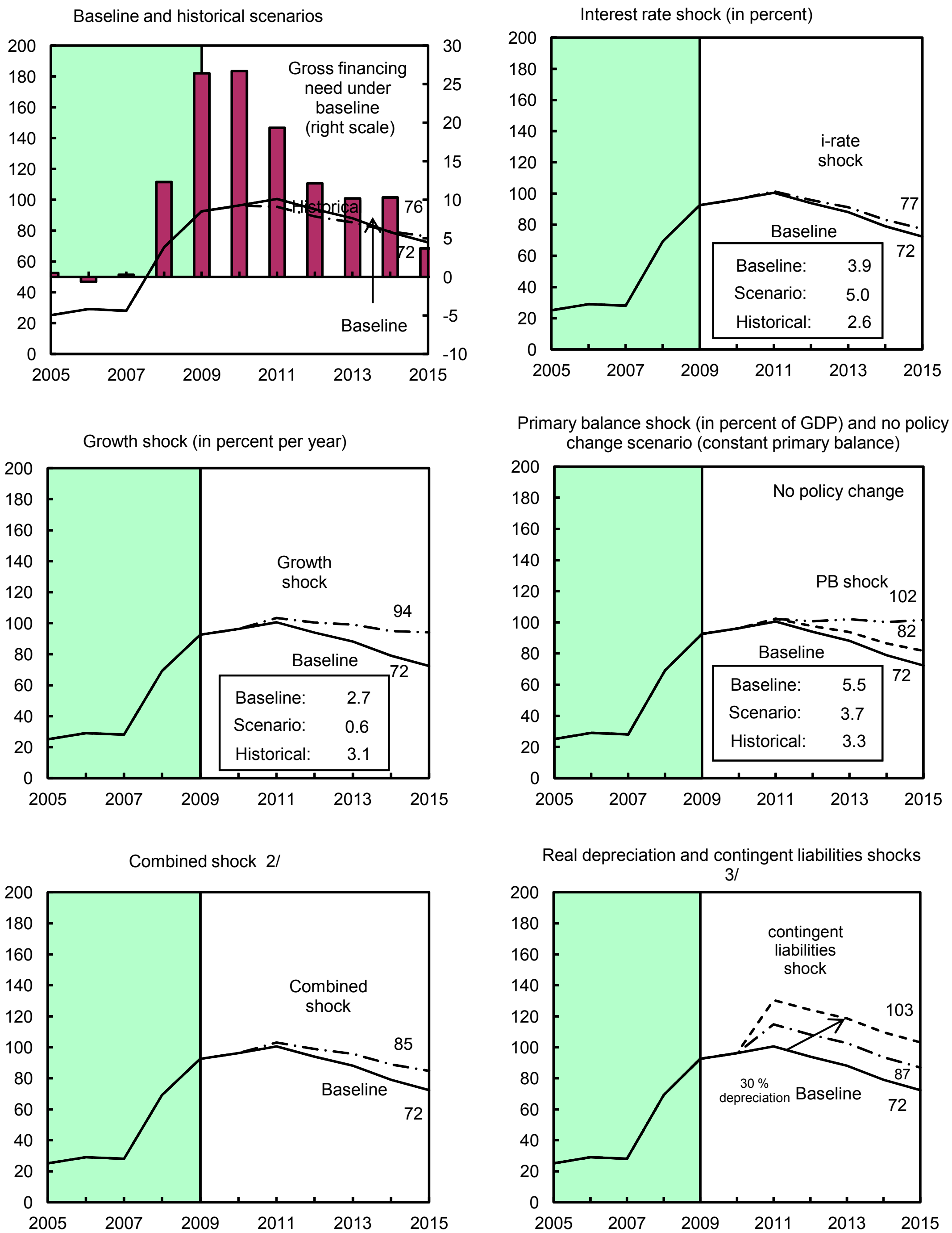
10/ Defined as general government deficit, plus amortization of medium and long-term general government debt, plus short-term debt at end of previous period.

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. Individual shocks are permanent one-half standard deviation shocks.
2/ GDP is converted into $ at average exchange rates.
3/ Lower asset recovery scenario assumes no payout from asset recovery to Icesave loan through 2015
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 2009, 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

Fourth Review Under the Stand-By Arrangement, Request for Waivers of Applicability, and Request for Establishment of Performance Criteria

Informational Annex

Prepared by the European Department

December 22, 2010

Content | Page

Annex

ICELAND: FUND RELATIONS
(As of November 30, 2010)

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	868.95	738.91
Reserve position in Fund	18.66	15.86
Holdings Exchange Rate		

III. **SDR Department:**	**SDR Million**	**Percent Allocation**
Net cumulative allocation	112.18	100.00
Holdings	73.78	65.77

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent Quota**
Stand-By Arrangements	770.00	654.76

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	770.00

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

	Forthcoming				
	2010	2011	2012	2013	2014
Principal			280.00	358.75	105.00
Charges/Interest		20.30	17.13	7.33	1.43
Total		20.30	297.13	366.08	106.43

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

VIII. **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.

IX. **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.

IX. **Fourth Review Mission:**

Discussions were held during Nov 2–12. The mission met with Prime Minister Sigurðardóttir, Finance Minister Sigfússon, Economic Affairs Minister Árnason, Central Bank Governor Guðmundsson, and other senior officials, as well as parliamentarians, CEOs of the new banks and Icelandic corporations, the employers' federation and labor unions, and academics. The staff team comprised J. Kozack (head), A. Chailloux and W. Maliszewski (EUR); I. Petrova (FAD); L. Cortavarria (MCM); M. Chivakul (SPR). M. Flanagan (EUR) joined the first week of the mission. The mission overlapped with a technical assistance mission by MCM. The mission was assisted by F. Rozwadowski and E. Karlsdóttir from the resident representative office. L. Alfredsdottir (OED) attended many meetings.

X. **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 build and liquidity management	June 2010
MCM	Debt management	July 2010

FAD	Fiscal framework issues	August 2010
MCM	Capital Control Liberalization	November 2010

XI. **Resident Representative:**

Mr. Franek Rozwadowski assumed the position in March 2009.

Press Release No. 11/5
FOR IMMEDIATE RELEASE
January 11, 2011

International Monetary Fund
Washington, D.C. 20431 USA

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

The Executive Board of the International Monetary Fund (IMF) on Monday completed the fourth 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 105 million (about €123.99 million, or US$159.98 million), which would bring total disbursements under the program to an amount equivalent to SDR 980 million (about €1.16 billion or US$1.49 billion).

The Executive Board also approved the authorities' request for waivers of applicability on end-December performance criteria for which data are not yet available.

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$2.13 billion) and was subsequently extended to August 31, 2011 (see Press Release No 10/156). The arrangement entails exceptional access to IMF resources, amounting to 1,190 percent of Iceland's quota.

Following the Executive Board's discussion, Mr. Murilo Portugal, Deputy Managing Director and Acting Chair, stated:

"Iceland has made considerable progress under its adjustment program. The successful implementation of fiscal adjustment, the effective use of capital controls, and financial sector restructuring, have underpinned the recovery. Growth is expected to turn positive in 2011, while the downward trend in inflation should continue. Possible risks to the recovery are from delayed investment, external shocks, or delays in restoring a sound financial system.

"Recent measures aimed at providing debt relief to distressed households are welcome, and need to be given time to work by containing expectations of any further relief. The recently adopted framework for corporate debt restructuring should help repair companies' balance sheets and jumpstart investment.

"Passage of the 2011 budget marks a key achievement for Iceland. Given the favorable debt dynamics, there might be scope to moderately scale back the targeted adjustment provided that contingent liabilities prove contained and the government continues to resist absorbing private sector losses.

"The revised strategy for lifting capital controls should maintain a cautious pace of liberalization, with due consideration given to the financial sector resilience to potential outflows. Continuing to build up international reserves by increasing purchases of foreign currency and by drawing on available program financing will be essential.

"Strengthening the financial sector remains a priority, and progress has been made. Ongoing efforts to overhaul the prudential framework and support financial stability should be advanced.

"The recent agreement between Icelandic, UK, and Dutch negotiators regarding the Icesave deposits is welcome, and its rapid conclusion would mark an important milestone for Iceland's return to international capital markets."

Statement by Per Callesen, Executive Director for Iceland and Lilja Alfredsdottir, Advisor to Executive Director January 10, 2010

The Icelandic economy continues to recover from the effects of the negative financial and economic shocks of 2008, aided by the Fund's program. Progress has been more than satisfactory in most program areas. All relevant structural benchmarks have been met, except for the passage of legislation for the new fiscal framework for local governments, which is in its final stages and will be presented to Parliament in February 2011. While all end-December performance criteria are expected to be fulfilled, the authorities request waivers of applicability for all end-December performance criteria; except for net domestic assets of the Central Bank as data to confirm these targets is not yet available. Although the program is on track and the authorities are fully committed to achieving program targets, significant challenges remain.

Fiscal policy

Fiscal policy is on track on the basis of the program. The budget for 2011 has been passed by Parliament, and the fundamental fiscal objectives of the Government have been met. The 2011 budget for the central government was passed with a primary balance surplus as aimed for, at the equivalent of 0.3 percent. The overall budget deficit will be reduced by more than half, or by 3.6 percent of GDP, and will be less than 3.0 percent of GDP. The accomplishment of these objectives paves the way for the achievement of an overall surplus in 2012. However, if the interest payments resulting from the new Icesave agreement are included the deficit will be higher according to staff estimates. Additional economic stimulus is planned through investment in road infrastructure projects that will be economically sound while providing support for the construction sector and labor market. These projects are within the medium-term consolidation path. Comprehensive legislation will strengthen local government finances, which have proven to be a weak link in public finances. Among other items, a three-year budget and limits on borrowing will ensure a more disciplined approach and compliance with overall fiscal strategies.

A debt management strategy that is compatible with and supports the medium-term fiscal consolidation path will be published in January but has already been put into practice. The Treasury's financing need in 2011 is estimated at ISK 130 bn or EUR 850 m. Which will be met by bond issuance in the amount of ISK 120 bn, and a reduction of the Treasury's Central Bank balance by 10 bn. Net issuance will be ISK 67 bn. Foreign reserves have been bolstered significantly under the IMF program and are sufficient to meet repayments of the Government's foreign debt in the medium term. Foreign currency obligations originally amounting to EUR 1.3 bn will mature in 2011. Approximately half of this amount has already been prepaid or purchased in the market. The remainder is expected to be refinanced. Restoration of market confidence overseas will be facilitated by a generally sound fiscal situation, declining debt, and the implementation of the new Icesave agreement. Market-based indicators of Icelandic risk have declined steadily over the past year.

Legislation authorizing the Minister of Finance to sign the new Icesave agreements with the Netherlands and United Kingdom and to undertake the commitment contained therein has been presented to Parliament and referred to the Parliamentary Budget Committee following its first reading. The authorities are confident that this agreement, which was negotiated by a team jointly approved by all parliamentary parties, will be approved by Parliament.

Monetary policy

Inflation declined rapidly and reached the 2½ percent inflation target in the last months of the 2010. This achievement was underpinned by the appreciation of the króna by close to 12 percent in trade-weighted terms over the course of 2010 and the anchoring of inflation expectations at the target, with the economic slack speeding up the process. The Monetary Policy Committee (MPC) has cut Central Bank interest rates four times since August. Since the interest rate corridor was narrowed at the MPC's December meeting, the current account interest rate stands at 3.5 percent, and the Central Bank's collateralized lending rate at 4.5 percent. The bias of the MPC has been shifted towards a more neutral stance although, depending on developments, it considers that there might still be some scope for further monetary easing. Monetary policy continues to be guided by exchange rate stability as an interim objective but by inflation over the medium term.

The Central Bank bought last year approximately EUR 195 m in the interbank market in Iceland so as to bolster foreign exchange reserves. Towards the end of the year the Central Bank bought FX spot and forward with the aim of reducing excessive FX imbalances of financial institutions. These transactions will expand the Central Bank's foreign reserves by around EUR 472 m during the term of the agreement, in addition to promoting increased financial system stability.

The Central Bank recently published a report to the Minister of Economic Affairs on monetary policy framework options after the IMF program ends and the capital controls have been lifted. The central proposal of the report is to radically alter the present inflation targeting (IT) framework, drawing lessons from experience gained since its introduction in 2001. The changes would augment IT with macro-prudential tools, provide better support from fiscal policy and improved policy co-ordination, and substitute relatively free float with a managed one. Following the publication of the report, the Ministry of Economic Affairs is initiating a wide-ranging consultative process on the relevant options. A second report of the Central Bank is planned focusing on the pros and cons of EMU membership.

Capital controls imposed after the collapse of the banking system have been successfully implemented, particularly after regulation and enforcement were tightened in late 2009. The controls have played an important role in stabilizing the króna while confidence was being restored; however, economic distortions created by the capital controls over the long term are a matter of concern. Hence it is important to lift the controls as soon as feasible without jeopardizing the stability of the króna and the financial system. In order to prepare the ground for removal of the capital controls, the capital account liberalization strategy published in August 2009 is currently being revised. The Central Bank has hired an experienced consultant to assist with the revision of the strategy. The preconditions for successful gradual liberalization of the capital account are largely in place as far as macroeconomic fundamentals are concerned; however, substantial non-resident ISK positions, which may be cause for instability if the controls are lifted abruptly, remain a major challenge to financial and currency stability during the liberalization process. The revised strategy will include proposals on ways for either tying down or releasing some of these positions in advance of the general removal of capital controls.

The financial sector and debt restructuring

Progress has been made in recapitalizing the savings banks, and the Government has recapitalized the Housing Financing Fund (HFF) up to the regulatory minimum, following an extensive review of its business plan. The budget outlay is estimated to total ISK 33 bn, with up to ISK 16 bn allocated to meet the cost of household debt restructuring. Further revision of the Fund's operational environment is underway, and the Government is committed to submitting legislation to Parliament by end-March 2011 so as to place the HFF under the full supervisory oversight of the FME.

The Central Bank recently concluded contractual agreements concerning the restructuring of five small savings banks' debt with the Bank. In addition, two savings banks have paid their debts to the Central Bank. Claims to be written off amount to ISK 4.5bn, whereas a total of ISK 4bn was received in satisfaction of the claims. During the restructuring process, the Central Bank acquired a large part of the savings banks' guarantee capital. The guarantee capital shares have been transferred by the Ministry of Finance to Icelandic State Financial Investments, which administers the holding on behalf of the State.

New legislation to reduce legal uncertainties and clarify the value of exchange rate-linked loans in the wake of the Supreme Court decisions of June and September 2010 has just entered into force. Financial institutions were granted 90 days to convert foreign-denominated motor vehicle loans in accordance with the interest rates published by the Central Bank of Iceland. Furthermore, households with residential mortgages will have the option of converting these loans into inflation-linked or non-indexed loans. The legislation aims at the efficient recalculation and reimbursement of foreign-denominated loans that have been deemed to carry unlawful exchange rate linkage clauses, despite the complicated and diverse nature of the loan contract arrangements. The legislation facilitates household debt restructuring through substantial debt write-offs without threatening the stability of the financial system or generating significant further costs for the Treasury.

Other debt restructuring measures have been introduced or reinforced in cooperation with banks and the pension funds. These include a formal process for writing down mortgages to 110 percent of the value of mortgaged assets, a temporary supplementary progressive tax rebate and an interest rate subsidy financed by the financial sector, limitation of the discharge period following bankruptcy to two years, and a final extension to March 2011 of the three-month suspension of forced sales, which is granted so as to enable households to benefit from the new debt restructuring measures. In addition, the Office of the Debtor's Ombudsman has been strengthened.

For corporate debt restructuring, a new fast-track framework aimed at accelerating voluntary debt restructuring of SMEs is available, and new legislation addresses corporate tax arrears and tax liabilities arising from corporate write-downs.

With these measures, the authorities are giving a clear signal that no further "more advantageous" actions will be taken in this area. The authorities believe that these measures are sufficient to resolve one of the most difficult problems arising in the wake of the financial crisis. Targeted debt restructuring is a slow and complex process, but authorities are finally seeing some encouraging signs that these new final measures are effective, including a vast increase in the number of voluntary participants.

The outlook

According to the Central Bank's latest baseline forecast, published in the November 2010 issue of *Monetary Bulletin*, the current account balance excluding accrued interest due to deposit institutions undergoing winding-up proceedings remains positive, supported by healthy export demand and improvements in terms of trade. The trade surplus is projected at slightly over 10 percent of GDP this year, yet export volume increases are somewhat restricted, with the November forecast projecting a 5 percent decline in the volume of marine product exports in 2011. Nonetheless, news of groundfish recruitment is encouraging, which could boost exports in the future. The net international investment position of the economy is still uncertain, but according to the latest statistics from the Central Bank it is likely to be in a deficit in the range 30-50 percent of GDP once the winding-up process of banks and leveraged asset holding companies is concluded a few years from now. The gross external debt of the Icelandic economy is around 330 percent of GDP according to the staff report. There is considerable uncertainty around these figures, but the gross assets of the economy can be estimated to be around 280-300 percent of GDP.

Output growth has been somewhat weaker than previously hoped, although the latest data suggest that recovery began in Q3. Unemployment also remains very high compared to previous years, despite significantly reduced labor costs, and investment (especially FDI) remains at historically low levels. Despite this, the authorities have seen many new entrepreneurial opportunities coming into existence, aided by various programs initiated by the authorities and private organizations in cooperation. Also in the pipeline are several large investment projects based mainly on utilization of energy resources. The tourist industry has not suffered as feared from last spring's volcanic eruptions and is as vigorous as ever. Although significant risks remain, not least from delayed growth in Iceland's main trading partner countries, authorities are optimistic that economic activity will pick up in 2011, thus facilitating the continuing recovery of Iceland from the economic and financial crises.