



## ICELAND'S ECONOMY

### ECONOMIC PROGRAMME WITH IMF

- Iceland's Economic Recovery Programme with the IMF was successfully completed on 31 August 2011. Iceland is the first country to graduate from such a programme following the financial crisis in 2008.
- Economic growth has resumed and the economy is slowly recovering as the main objectives of the programme have been met. They were: a) Stabilising the exchange rate and rebuilding confidence in monetary policy, b) revising fiscal policy and maintaining a manageable level of public sector debt, c) restructuring the financial sector and its regulatory framework and d) household and corporate debt restructuring.
- Iceland's return to international capital markets in June 2011 was an important milestone on this path.
- The króna remains fairly stable and the banking sector is well capitalised with Capital Adequacy Ratios well above the current regulatory minimum of 16%. Household and corporate debt restructuring is progressing, inter alia through the lowering of mortgages to 110% of loan-to-value and a fast-track process for small and medium sized companies.
- Total disbursement under the programme amounted to US\$2.25 billion. In addition, Iceland has access to US\$2.5 billion from the Nordic countries and Poland, around half of which has already been drawn.
- The IMF programme was established in November 2008, in the aftermath of the collapse of Iceland's three large international commercial banks, Glitnir, Kaupthing and Landsbanki. The combined liabilities of the failed banks exceeded 10 times the country's GDP.
- Emergency legislation was passed by the Icelandic parliament on 6 October 2008 in order to secure the

continuation of domestic banking services and payment systems abroad after the collapse of the banks. The three banks were put into receivership and their boards replaced by Resolution Committees.

### MONETARY POLICY

- A revised strategy for lifting of the capital controls introduced in late 2008 was announced in March 2011. The strategy aims at gradual lifting of the controls without threatening financial stability. The first step according to the new strategy was taken by the Central Bank in June 2011, aiming at reducing the risk from foreign holdings of liquid króna assets that is estimated at around 30% of GDP. Controls on new foreign currency inflows had already been removed in October 2009. All controls are to be lifted at year-end 2013.
- The Central Bank published a report in late 2010 on the possible future of the monetary policy framework. The government continues to review the bank's proposals, including the need for new macro prudential tools in light of current international developments in this area and Iceland's international commitments.
- Currency stability has remained the short-term focus of monetary policy since the crisis but the Central Bank intends to revert increasingly to inflation targeting as conditions permit. This will be done within a stronger monetary policy framework, increased transparency and improved organisational structure of the Central Bank.

## FISCAL POLICY

- The government has embarked on an ambitious fiscal consolidation plan. Fiscal measures of nearly 10% of GDP were implemented in 2009-2011. Further progress is being made with the aim of reaching a surplus in 2014. The intermediate goal of a positive primary balance (the balance excluding net interests) is to be achieved in 2011/2012.
- The fiscal measures have included rate increases for all major taxes while expenditures have been cut through public administration restructuring and cost reducing reforms in the health and education sectors.
- The fiscal framework is being strengthened through a medium-term fiscal plan and longer term nominal ceilings and stronger implementation measures.

## FINANCIAL SECTOR RESTRUCTURING

- The Financial Services Authority of Iceland (FME) prepared the ground for the establishment of three new banks by carving out the old banks' domestic operations, after their collapse.
- The Resolution Committees of the failed banks, Kaupthing and Glitnir, on behalf of their creditors, have decided to recapitalise and become majority owners of the new Arion Bank and the new Íslandsbanki, respectively. The Icelandic state will remain the majority owner of Landsbanki, with the Resolution Committee taking a 20% stake.
- All three new banks have been recapitalised with strong capital ratios.
- Extensive reforms of financial market regulations have been carried out. This has been done in accordance with international best practice with a clear aim of building up a solid sustainable financial system. Further work is being carried out, in part due to rapid developments in international policy circles.
- The legislative reforms include stricter rules on internal auditing responsibility and qualifications, increased responsibilities for boards and management, strict regulation of bonus pay, golden handshakes and golden parachutes, revision of the

deposit insurance scheme and transparency of ownership in limited companies.

- A Basel Core Principles Assessment of Effective Banking Supervision was carried out in early 2011. Further amendments will be made to the financial sector supervision on basis of the assessment. In addition, the government is embarking on a holistic review of the financial sector institutional and regulatory framework.

## DEBT RESTRUCTURING

- Due to the devaluation of the króna, Icelandic households and companies have experienced a great increase in their debt through the widespread inflation indexing of mortgages and use of loans in foreign currencies.
- Major debt restructuring is ongoing for individuals and firms. A formalised process has been introduced for writing down mortgages to 110% of the value of mortgaged assets, subject to a certain ceiling and meeting criteria on debt service capacity, which should help most households with negative equity and debt service difficulties. A forum has been created to help creditors reduce their coordination problems.
- The government increased the interest payment rebate from 2009-2011 in addition to a special supplementary interest rate subsidy and access has been granted to third-pillar private pension savings. Total after-tax effect of pension withdrawals amounts to over 1.5% of GDP for 2009-2010.
- Corporate debt restructuring proceeded slower than anticipated at first, in part due to the complicated nature of the problems facing the corporate sector and the need for clarity on some loan agreements widely used before the crisis – including the legality of foreign currency indexation of loans.
- Restructuring of SME debt has been catalysed through a voluntary framework between the government, banks and social partners.
- Debt restructuring is expected to be largely finalised by year-end 2011.

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*Iceland, with a population of around 318,000, is a constitutional republic with a parliamentary government. The Republic of Iceland was established in 1944, Iceland joined the United Nations in 1946, became a founding member of the OECD in 1948, of NATO in 1949 and joined EFTA in 1970. With Iceland's accession to the European Economic Area in 1994, Iceland gained access to EU's internal market. The main components of Iceland's GDP (US\$11.7 billion in 2009) are fishing and fish processing, industry, tourism, commerce and transport.*