FOR AGENDA

EBS/08/124

CONFIDENTIAL

November 15, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Iceland—Request for Stand-By Arrangement**

Attached for consideration by the Executive Directors is a paper on Iceland's request for a Stand-By Arrangement, which is tentatively scheduled for discussion on **Wednesday, November 19, 2008**. Draft decisions appear on page 38. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Iceland indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Thomsen (ext. 34847), Ms. Koeva Brooks (ext. 39809), and Mr. Luzio (ext. 38327) in EUR.

This document will be posted on the secure page of the extranet website for Executive Directors and member country authorities.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

ICELAND

Request for Stand-By Arrangement

Prepared by the European Department in Consultation with Other Departments

Approved by Poul Thomsen and Tessa van der Willigen

November 15, 2008

Executive Summary

Background: Iceland's economy is in the midst of a banking crisis of extraordinary proportions that is expected to lead to a deep recession, a sharp rise in the fiscal deficit, and a dramatic surge in public sector debt, reflecting a very high fiscal cost of restructuring the banking system. The virtual collapse of the on-shore foreign exchange market poses a serious and immediate risk to the economy considering its very high import dependence.

Request for Stand-By Arrangement: The authorities have requested a two-year Stand-By Arrangement from the Fund in the amount of SDR 1.4 billion (1190 percent of quota), with SDR 560 million available upon Board approval and the remainder in eight equal installments of SDR 105 million, subject to quarterly reviews.

The Program: The focus is on addressing three key challenges:

- *Preventing a further sharp króna depreciation:* the immediate emphasis of the program is on stabilizing the króna, to reduce the risk of highly adverse balance-sheet effects and attendant further output compression. This risk reflects the high leverage of the economy and very high share of foreign exchange denominated and inflation-indexed debt. To this end, the policy focus in the short-run is on stemming capital flight when access of current account transactions to the foreign exchange market is gradually normalized, by maintaining an appropriately tight monetary stance in the context of a flexible exchange rate policy. Capital controls will be maintained for the time being.
- *Ensuring medium-term fiscal sustainability*: while automatic fiscal stabilizers will be allowed to work in full in 2009, a strong medium-term fiscal consolidation program will be launched in 2010. This is needed to secure medium-term fiscal sustainability following the sharp increase in public sector debt.
- *Developing a comprehensive bank restructuring strategy*: the strategy includes measures to ensure fair valuation of assets, maximize asset recovery, strengthen supervisory practices, among other measures. Settling claims by depositors and other creditors in a fair, collaborative, and best-effort manner is essential to preserve Iceland's integration into the international financial system and restore access to international capital markets.

Exchange Rate Regime. Flexible exchange rate regime.

Contents Page

Appendix

Attachments

I. INTRODUCTION

1. **Iceland's economy is facing a banking crisis of extraordinary proportions**. Triggered by a loss of confidence and fuelled by the financial sector's high leverage and dependence on foreign financing, the crisis swiftly led to the collapse of Iceland's three main banks, accounting for around 85 percent of the banking system. This precipitated an abrupt adjustment in key asset prices and severely disrupted operations in the onshore foreign exchange market and external payment systems. The economy is heading for a deep recession, a sharp rise in the fiscal deficit, and a dramatic surge in gross public sector debt—of about 80 percent of GDP—reflecting an unprecedented high fiscal cost of restructuring the banking system.

2. **To restore confidence and stabilize the economy, the authorities have requested a two-year Stand-By Arrangement from the Fund**. The arrangement is in the amount of SDR 1.4 billion (1190 percent of quota), with SDR 560 million available upon Board approval and the remainder in eight equal installments of SDR 105 million, subject to quarterly reviews. The arrangement is in support of a focused program targeted on three main objectives:

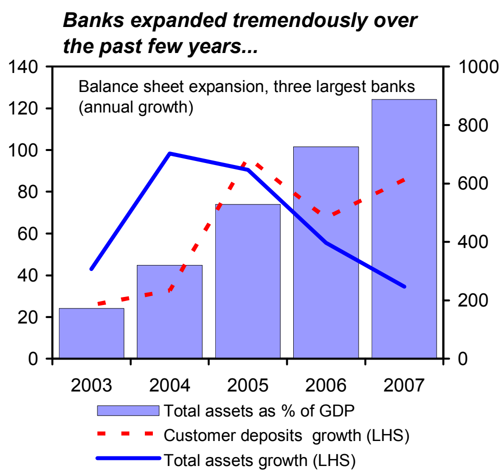
- in the near term, restore confidence and stabilize the exchange rate through strong macroeconomic policies. This is essential to contain the negative impact of the crisis on output and employment;
- limit socialization of losses in the collapsed banks and implement a strong multi-year fiscal consolidation program starting in 2010. This is intended to safeguard medium-term viability by steadily reducing public debt;
- design and implement a comprehensive and sound banking system strategy that is nondiscriminatory and collaborative. This is needed to promote a viable domestic banking sector and safeguard international financial relations.

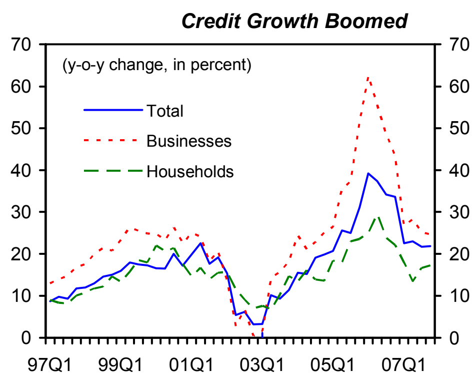
II. BACKGROUND

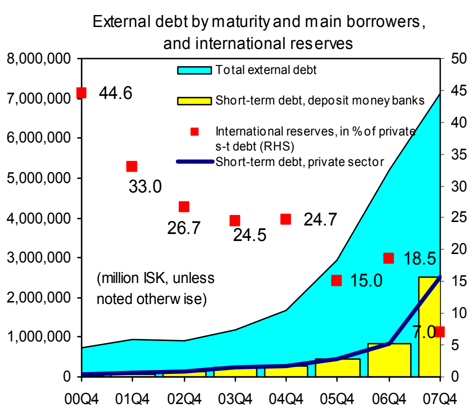
3. **Iceland's highly leveraged economy was unprepared to withstand the global financial turmoil.** Over the past several years, a number of underlying imbalances built up, which made the economy vulnerable to adverse external shocks (Figure 1). A long home-grown, foreign-funded boom led to overstretched private sector balance sheets, with high corporate and household leverage and a large share of foreign exchange-linked and inflation-indexed debt.[1] The current account deficit surged to over 15 percent of GDP in each of the

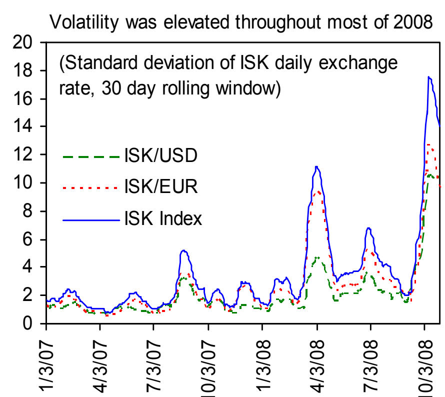
[1] Corporate debt was over 300 percent of GDP at end-2007, and household debt exceeded 225 percent of disposable income at end-2006. Around 80 percent of household debt is inflation indexed and 13 percent is in foreign currencies. About 70 percent of bank loans to corporations are foreign exchange-linked.

past three years, and inflation soared (Figure 2). Completely privatized in 2003, the banking sector relied on the availability of ample foreign wholesale funding to rapidly expand abroad and accumulate almost 900 percent of GDP in assets by end-2007. At the same time, gross external indebtedness reached 550 percent of GDP at end-2007, largely on account of the banks. Given these imbalances and the heightened risk aversion since the onset of the global financial turmoil last year, banks' CDS spreads rose to unprecedented levels, prompting a sharp increase in the sovereign risk premium and contributing to an increased volatility of the exchange rate throughout 2008 (Figure 3).









4. **The crisis hit swiftly and powerfully.** Pressures in international markets and the loss of confidence in Iceland's financial system in October 2008 led to the collapse of its three largest banks in the span of a week. As a result, key asset prices plummeted: the onshore foreign exchange market dried up, the króna depreciated by more than 70 percent in the off-shore market, and the equity market tumbled by over 80 percent. The external payment systems were severely disrupted, hampering repatriation of export proceeds. The real economy was threatened with severe disruptions (Figure 4).

5. **The government took a number of initial actions while developing the comprehensive program for which it is seeking Fund support.** The three collapsed banks

were immediately intervened and a “new bank/old bank” approach adopted. The “new” banks are to service domestic banking needs, while most of the foreign liabilities have been allocated to the “old” banks. The domestic payment system is functioning, and access to deposits and ATMs has been maintained throughout the crisis, supported by a new blanket guarantee on domestic deposits. Meanwhile, the Central Bank of Iceland (CBI) bolstered its reserves by drawing on the currency swap arrangements with Norway and Denmark (set up in May 2008). At the same time, it imposed current and capital account restrictions and began daily foreign exchange auctions to satisfy the immediate needs of banks and their clients for imports of priority goods (Box 1).

Box 1. Iceland: Foreign Exchange Market Developments

From around October 5, the foreign exchange market for ISK, both on-shore and off-shore, ceased operating in the face of uncertainties about bank credit quality, the appropriate exchange rate, and an apparently huge excess supply of ISK. It was judged essential to re-start at least some form of foreign exchange trading, both to provide foreign exchange in support of essential imports and as a starting point from which the market could find its own level. The authorities chose the method of a foreign exchange auction, held daily since October 15, as this maximizes transparency as compared with administrative allotment or bilateral sales. The process was discussed in advance with the major banks. Banks are free to undertake foreign exchange business outside of the auction, provided they adhere to the exchange guidelines issued on October 10. These guidelines indicate that foreign exchange should be used for priority imports, and should not be used to support capital outflows. Banks can use foreign exchange sold to them by exporters to fund their customers' imports, and go to the auction for their net requirements. The authorities hope that the continuation of market trading, albeit for restricted purposes, will support price formation and facilitate the return to normal trading as soon as circumstances permit.

The auction is run on a common-price basis at 10:15 each day, and results are published on the CBI website by 11:00. All banks can participate; they can offer to sell foreign exchange as well as to buy it. Banks are required to supply the CBI with information on their purchases and sales of foreign exchange, as confirmation that they are abiding by the exchange guidelines. Where exporters have a short-term need for foreign exchange, the CBI is facilitating the provision of a foreign exchange swap, rather than an outright sale of foreign exchange. It was agreed that the restrictions on current account transactions should be removed as soon as possible; the CBI is gathering further information from the banks on the backlog of demand. It was also agreed that capital account restrictions will need to remain in place for longer, as the potential demand for foreign exchange could overwhelm official reserves with a knock-on damage to the real economy.

The króna has stabilized around the rate of the first auction (ISK 150 = EUR 1). The authorities have made it clear that there is no exchange rate target. That said, broad stability of the exchange rate should, in the short-term, promote some restoration of normality to markets, and support expectations of lower inflation.

It was expected that in the first few auctions, the central bank would be a substantial supplier of foreign exchange, and would remain a net supplier for some weeks. But a rapid turnaround in the current account (on a cash basis) could soon lead to a net surplus supply of foreign exchange in the auction, provided exporters can and will sell foreign exchange earnings into the market. In the meantime, the central bank is restricting the amount of its net foreign exchange sales. This may, depending on short-term developments in net demand, result in a further weakening of the exchange rate of the króna in the short term, although thus far net demand has fallen sufficiently for there to be no price impact. In tandem with this, and bearing in mind the restricted amount of collateral which is held by the new banks in Iceland, the central bank will control supply of additional ISK liquidity to the market.

III. The Program: Macroeconomic Framework

6. **The macroeconomic baseline is predicated on several key tenets**. First, the program is anticipated to be successful in restoring confidence. This allows the króna to stabilize in the short run and to appreciate in real terms over the program period. Second, the cost to the budget of bank restructuring is expected to be contained, including only the cost of capitalizing the new banks, the compensation of insured depositors, and the recapitalization of the central bank (Box 2). The collapse of the three private banks is expected to not give rise to any other increase in public sector liabilities. Third, bank restructuring is expected to be resolved in a cooperative and non-discriminatory manner, allowing access to international capital markets over the medium-term.

Box 2. The Fiscal Costs of Bank Restructuring

The fiscal cost of bank restructuring is tentatively estimated at 83 percent of GDP on a gross basis (55 percent of GDP on a net basis). These estimates, which are subject to considerable uncertainty, reflect the following assumptions:

- **The cost to the budget of capitalizing the new banks is estimated to be 26 percent of GDP,** reflecting an estimated capital injection of 385 billion Króna. Consequently, these banks are expected to be relatively well-capitalized, as in determining the capitalization need, the authorities have already assumed asset write-downs for all three banks of about 50 percent. The new banks could still see a significant loss of assets as the sharp króna depreciation and rise in inflation cause a wave of corporate and household defaults due to the very high share of foreign exchange-linked and inflation-indexed loans. The baseline scenario does not assume privatization of the new banks within the projection period.

- **The gross cost to the government of compensating insured foreign depositors is tentatively estimated to reach 47 percent of GDP,** while the net cost is projected at about 19 percent of GDP. Subject to considerable uncertainty, the cost of compensating foreign branch depositors in Icelandic banks is assumed to be about $8.2 billion, or about 47 percent of GDP in 2008. Staff's baseline scenario assumes that 50 percent of compensation payments to foreign branch depositors will be recovered, entailing a net cost, after taking into account exchange rate developments, of about 19 percent of GDP.

- **Staff's baseline also assumes that the CBI will be recapitalized at a cost of 10 percent of GDP.** To obtain liquidity earlier this year, the three major banks had used each other's bonds—including through the savings banks—to access the CBI's repo facility. As a result, the CBI's balance sheet contained uncovered bonds of the three intervened banks. The capital injection to compensate the CBI for the incurred losses is estimated at 150 billion Króna.

The fiscal projections also incorporate higher interest costs due to bank restructuring debt. Assuming that asset sales occur with a lag (starting in 2009 and taking a total of two years), there will be additional interest costs on the gross debt of 47 percent of GDP related to the payments to insured foreign depositors, next to interest costs from bank restructuring and central bank recapitalization. These interest costs are projected to add in total about 5.4 percent of GDP in 2009 to the fiscal burden.

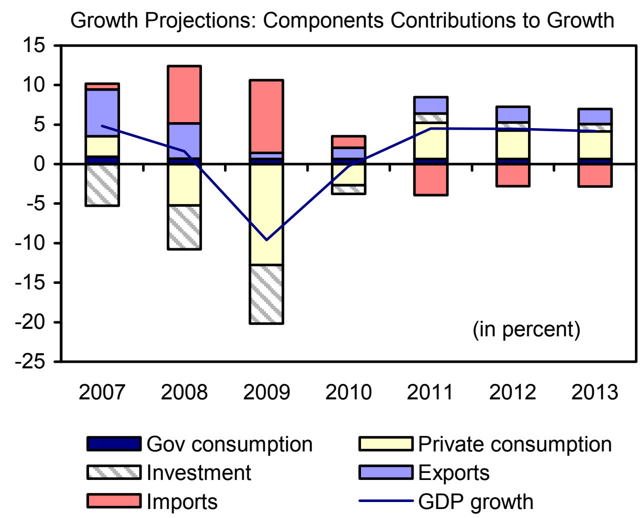
7. **Under this baseline, the Icelandic economy is expected to adjust sharply in the near term.** Given the high leverage in the economy and significant dependence of the private sector on inflation-indexed and foreign currency debt, the economy is set to enter into a severe recession in 2009–10. Domestic demand is projected to plunge as private consumption and investment contract massively, reflecting significant corporate and household sector distress (Box 3). The large import compression will, however, lead to a rapid swing in the current account into surplus. Inflation is expected to rise in the next few months, due to the króna depreciation, but then to decline quickly as the króna stabilizes and then appreciates.

Iceland: Selected Indicators, 2007–13
(Percentage change, unless otherwise indicated)

	2007	2008	2009	2010
	(Percentage change)			
Real economy				
Real GDP	4.9	1.6	-9.6	-0.3
Real domestic demand	-1.5	-9.1	-19.7	-3.6
Private consumption	4.3	-8.7	-23.7	-5.9
Public consumption	4.2	3.2	2.9	2.5
Gross fixed investment	-13.7	-19.7	-33.6	-6.8
Net exports 1/	6.6	11.7	10.0	2.9
CPI inflation (end of period)	5.9	20.5	4.5	2.0
Current account (in percent of GDP)	-14.6	-10.7	1.0	2.8

Sources: CBI; and IMF staff estimates.
1/ Contributions to growth
2/ In percent of potential output

8. **Growth is expected to recover relatively rapidly beyond the near term.** Once confidence is restored and balance sheets readjust, domestic demand is expected to rebound strongly by 2011. This reflects the economy's flexibility and proven capacity to adjust to large shocks in the past. Both investment, driven by the aluminum sector, and consumption, fuelled by strong growth in disposable income, are expected to pick up following their sharp retrenchment in the near term. Continued strong export growth is projected to sustain a small current account surplus and support growth.



Box 3. The Perfect Storm

Households and firms face a combination of at least five major shocks that are expected to have significant effects on both consumption and investment decisions, mainly due to the large asset price and balance sheet imbalances:

- **Exchange rate shock** (over 65 percent depreciation in the nominal exchange rate on a traded-weighted basis so far this year): Households and firms are heavily exposed to foreign exchange with about ¾ of corporate borrowing and 1/5 of household borrowing denominated or linked to foreign currencies. Moreover, the leverage of households and firms is among the highest in developed economies (over 300 percent of GDP and 225 percent of disposable income, respectively). The impact of the depreciation would be non-trivial given the potential default risks, especially in the corporate sector.

Corporate debt: selected countries, 2007

	(In percent of GDP)
Iceland	308
Euro area 1/	77
United Kingdom	278
United States	73

Household debt: selected countries, 2006

	(In percent of GDP)	(In percent of DI)
Iceland	103	225
Spain	80	140
Ireland	90	180
United States	89	134

Sources: Central Bank of Iceland, Eurostat, and IMF.
1/ Latest data is for 2005
2/ Financial liabilities

- **Inflation shock** (expected to be over 20 percent by end-2008)**:** Given the inflation-indexation of household debt (about 75 percent of total debt, mostly in mortgages), rising inflation will erode household net worth. That said, the direct flow effect is less significant given that debt service does not rise as fast as inflation as the effects of higher inflation are spread over the whole maturity of the loans.

- **Asset shock**: Equity prices have collapsed. More than 80 percent of the domestic stock market capitalization has been wiped out and corporate debt values have declined. Mutual funds assets held by households were heavily exposed to the domestic market and have suffered massive losses. Moreover, real estate prices are projected to fall by over 25 percent in nominal terms, reducing substantially household assets (possibly by as much as 100–150 percent of GDP).

- **Income and employment shock**: Real wages are expected to fall by as much as 18 percent in 2008–10, and unemployment is expected to jump to over 8-9 percent in 2010 as firms scale back or go bust. In addition, a large share of foreign workers is expected to leave the workforce, thereby reducing total income and consumption. Out-migration will add further downward pressures to housing prices.

- **Credit crunch**: Supported by easy access to credit, private savings plunged during the recent boom. This is likely to reverse sharply in coming years. Credit is expected to grind to a halt in the next few months. The new banks would be expected to be far more cautious in their lending practices. As household assets and incomes decline and firm profits shrink, the access of households and corporations to credit will be greatly reduced.

Impact of a 10-percent increase in real credit growth and net wealth
(In percent)

	Real credit growth	Net wealth
Consumption growth	3.0	...
Net wealth	15.0	...
Consumption level 1/	...	0.75

Sources: OECD; IMF estimates.
1/ Percent change compared to baseline.

9. **The outlook is, however, subject to exceptional uncertainties and risks**. In the near term, output could be further compressed through balance-sheet effects arising from a further króna depreciation and higher-than-expected inflation, especially if capital outflows are larger than anticipated. This also points to the risk of a longer-than-expected period of relatively tight monetary policy if confidence is only returning slowly, particularly in the case of uncertainty about policy commitments or financial assistance from other countries. Over the medium term, the recovery could be slower, if the deleveraging process is prolonged. Possible difficulties in maintaining market access could require further large adjustments in the current account.

IV. The Program: Policy Discussions

10. **The authorities' program is focused on addressing the key challenges at hand**:

- ***Preventing a further sharp króna depreciation***: by maintaining a flexible exchange rate policy while using monetary policy and, in the near term, capital controls to stabilize the exchange rate. The immediate emphasis on stabilizing the króna reflects the risk of highly adverse balance-sheet effects.

- ***Ensuring medium-term fiscal sustainability***: while automatic fiscal stabilizers will be allowed to work in full in 2009, a strong medium-term fiscal consolidation program will be launched in 2010. This is needed to deal with the dramatic increase in public sector debt.

- ***Developing a comprehensive and collaborative strategy for bank restructuring***: by securing continued domestic operations of the banking system, maximizing asset recovery, and strengthening supervisory practices, among others. A collaborative approach is essential to restoring access to international capital markets.

11. **The emphasis on a flexible exchange rate regime is driven by Iceland's ability to adjust rapidly to shocks and by the limited foreign financing.** As in the past, large and quick import compression (due to income and balance sheet effects) will likely lead to sharp improvements in the current account. The supply side response is expected to be moderate in the near-term because of the dependence on fisheries and energy-intensive sectors, not least aluminum, but Iceland's strong record of adjusting to shocks suggests that the economy could bounce back after a relatively short period, especially given its flexible labor market.

A. Monetary and Exchange Rate Policy

12. **Iceland's monetary and foreign exchange framework has unraveled with the collapse of the banking sector**. As confidence faded, the króna depreciation accelerated, and the domestic foreign exchange market dried up, coming to a complete halt. Despite the central bank's large liquidity provisioning, money markets withered as investors rushed to safe haven instruments (mostly government-guaranteed paper). Under these circumstances,

the CBI's inflation targeting regime no longer provided a credible anchor for monetary policy, which further fuelled capital outflows.

13. **There was broad agreement on the potential risks of further massive capital outflows and on the need for exchange rate flexibility**. External pressures to unwind króna positions were mounting, and there were significant risks that domestic depositors and investors could lose confidence in the króna, despite the government's blanket guarantee on domestic deposits. These pressures, coupled with a low level of reserves, meant that a fixed foreign exchange regime would not be credible in the prevailing situation.

14. **At the same time, the authorities and staff agreed that the stabilization of the exchange rate needed to be a key priority of the program**. A further significant depreciation of the króna could have devastating effects for the economy, given the high level of corporate and household debt denominated in foreign currency and indexed to inflation.

15. **It was agreed that a pragmatic approach to monetary policy would be needed to stabilize the currency in the short run**. On October 28, the central bank raised its policy rate by 600 basis points to 18 percent, reversing a previous cut of 350 basis points in mid-October. However, with the collapse of confidence and the openness of the economy, interest rate changes were unlikely to be enough to prevent large-scale capital outflows once restrictions on the access to the foreign exchange market for current account transactions were lifted. This pointed to the need for a combination of interest rate policy, liquidity management, foreign exchange intervention, and restrictions on capital flows. However, if these measures were unable to stem pressures for króna depreciation, the exchange rate would have to be allowed to adjust to market forces. While current account restrictions should be lifted very soon, capital account restrictions might have to be maintained for a somewhat longer period

16. **Staff warned against a premature relaxation of monetary policy.** The authorities and staff agreed that —as confidence returns—steps would be taken during 2009 to gradually normalize the monetary and exchange rate policy framework. This would involve increasingly relying on the policy rate as the main monetary policy instrument and gradually easing quantitative restrictions with regard to liquidity management and capital flows. The normalization was likely to be helped by the anticipated rapid improvement in the current account, which would ease pressures on the króna. Inflation pressures were also expected to subside with the emergence of a large output gap. This suggested that the króna should be expected to rebound next year, after its crisis-driven overshooting, with inflation declining relatively fast. However, staff warned against relaxing monetary policy prematurely, noting that in view of the dramatic collapse of the banking system it could take some time for confidence to be restored. In this regard, staff expressed concern that recent policy actions had caused confusion about the monetary policy strategy, and stressed that a determined and well-communicated focus by the CBI on stabilizing the króna would be key to securing the

return of confidence in policies and in the króna that would eventually allow the CBI to begin an easing cycle.

17. **The assessment of monetary conditions is subject to exceptional uncertainty at this stage**. It is currently unclear how the splitting of the three intervened banks into new and old banks will affect monetary and credit aggregates, overall liquidity conditions, and the stability of monetary parameters. The lack of a monetary survey has hampered the setting and monitoring of the full set of standard monetary performance criteria. For the period beyond December 2008, such performance criteria will be set at the time of the first review when comprehensive monetary data are available.

18. **In the medium term, the authorities recognized the need to reassess the broader monetary policy framework.** Among the options that are being debated in Iceland, there is increasing support for replacing the now-defunct inflation targeting with some form of peg or currency board, including EU membership and eventual adoption of the Euro. However, there is also support for the view that exchange rate flexibility has served Iceland well and remains appropriate due to its dependence on fisheries and energy-intensive production.

B. Fiscal Policy

19. **The fiscal situation is set to deteriorate dramatically**. On unchanged policies, the deep output contraction is projected to lead to a sharp widening of the primary deficit from 0.6 percent of GDP in 2008 to 8.5 percent of GDP in 2009. In addition, the draft 2009 budget proposal, formulated before the crisis, envisages a discretionary relaxation of 2.7 percent of GDP, which would further increase the primary deficit. At the same time, public debt will increase by over 80 percent of GDP on a *gross* basis, due to the costs of recapitalization of both commercial banks and the central bank, and of fulfilling deposit insurance obligations to depositors in foreign branches of Icelandic banks. While the *net* cost can be lower through asset recovery from the "old" banks over the medium-term, prospects for this are uncertain (Box 2).

Iceland: Summary of the General Government Fiscal Accounts
(In percent of GDP)

		Staff projection					
	2007	2008	2009	2010	2011	2012	2013
Total revenue	50.0	45.3	41.7	43.0	44.0	44.3	44.5
Total expenditure	44.5	45.5	55.2	53.6	51.3	46.0	42.6
Overall balance	5.5	-0.2	-13.5	-10.5	-7.3	-1.7	2.0
Primary balance	5.8	-0.6	-8.5	-5.2	-1.1	2.8	6.2
Structural primary balance 1/	1.8	-3.8	-3.9	-1.4	1.1	3.7	6.1
Structural balance 1/	1.5	-3.4	-8.7	-6.5	-4.8	-0.7	1.9
Gross Debt	28.9	108.9	108.6	104.4	105.7	100.7	92.6
Net debt	7.3	90.6	97.0	92.8	94.8	90.5	83.0
Memorandum items:							
Output gap 2/	4.8	4.6	-5.4	-6.3	-3.8	-1.8	0.0

Sources: Ministry of Finance; and Fund staff estimates and calculations.
1/ In percent of potential GDP. Structural estimates adjusted to account for the effect of the asset price movements.
2/ Actual output less potential in percent of potential.

20. **The authorities are facing a difficult policy trade-off in the short run**. The need to embark on an ambitious fiscal consolidation program to lower public debt and secure medium-term fiscal viability must be carefully balanced against the risk of exacerbating the recession in the near term. In addition, some new budget initiatives have already been announced and are not easily reversible.[2] The authorities were, however, also mindful of the monetary and financial sector implications of allowing a very large increase in the public sector's borrowing needs. In the event, they decided to allow automatic stabilizers to work in full, but limit the discretionary relaxation to no more than ¼ percent of GDP in 2009. Thus the structural primary balance would be limited to a deficit of 3.9 percent of GDP in 2009 and any revenue overperformance would be saved. The launch of the medium-term consolidation plan would be delayed until 2010, by which time the recession was expected to have bottomed out. Under this scenario, the 2009 deficit would be financed domestically, including through an expected increase of purchases of government securities by public and other pension funds,[3] alongside some drawdown of government deposits with the central bank. Financing and evolving market conditions will be reassessed in subsequent program reviews to ensure that the fiscal program remains supportive of the near-term exchange rate stabilization objective.

21. **The details of a medium-term consolidation program will be developed next year**. Keenly aware that the fiscal consolidation over the medium-term would have to be of a significant magnitude to restore fiscal viability, the authorities stressed that an adjustment effort on such a scale should be based on a broad-based political consensus. They were committed to starting right away the collaborative, consensus-building process that would be required. The authorities were confident that the broad areas of focus would be identified before the end of 2008, with the consolidation plan fully calibrated by mid-2009. Staff stressed that the consolidation should strike an appropriate balance between revenue and expenditure measures and be designed with a view to minimizing distortions and the impact on potential growth. Progress on development of a consolidation plan will be a main focus of the quarterly program reviews during 2009.

22. **The authorities plan to strengthen the fiscal framework.** They believed that this would help reinforce the confidence in their medium-term fiscal consolidation plan. They acknowledged that the current framework is excessively focused on one-year budgets, and that there was a need for medium-term targets and expenditure plans to have stronger bearing on the annual budgets. A number of fiscal institutional arrangements that have supported successful consolidations elsewhere were discussed, and the authorities indicated that they

---

[2] This includes the lowering of the corporate income tax from 18 to 15 percent, among others.

[3] The exchange rate depreciation has increased the share of foreign assets on pension funds' balance sheets closer to the limit on their foreign investments. This would imply they rebalance portfolios toward investment in domestic assets.

are likely to seek technical assistance, including from the Fund, to develop a framework suitable for Iceland. They noted that the new framework will be developed in time for the 2010 budget.

C. Incomes Policy

23. **Wage moderation is expected to help the economy adjust to the shock**. The authorities noted that in the past, income policy in Iceland had been very effective, with previous wage agreements aiding the economic adjustment when difficult circumstances demanded it. The need for a national consensus—consistent with the objectives of the macroeconomic program—was generally acknowledged. Preliminary indications by social partners suggested that they recognize that current circumstances call for wage restraint and that there will be a wage agreement that is commensurate with the seriousness of the situation.

D. Banking Policy

24. **Iceland's overstretched, over-leveraged banking system was ill-positioned to cope with the global financial turmoil.** The Icelandic banking sector experienced a dramatic expansion in just a few years, funded by cheap foreign financing, which allowed it to boost its assets from 100 to almost 900 percent of GDP between 2004 and end-2007. This expansion made the Icelandic banking system one of the largest in the world in relation to GDP. As global conditions deteriorated in early 2008, banks' CDS spreads rose to unprecedented levels. In response, banks slowed lending growth, enhanced liquidity buffers, reduced costs, and started a process of downsizing non-core operations and laying off staff. But their ability to deleverage was limited by the global risk aversion. A recent FSAP update and Article IV Consultation conducted in June 2008 pointed to several risks that were mounting throughout 2008: (i) liquidity and funding risks, associated with the banks' reliance on market funding and their large funding needs over the short run, (ii) credit and market risks, resulting from foreign currency, equity exposures, and high indebtedness of domestic borrowers, as well as collateralized lending, connected lending, and large exposures; (iii) operational risks, associated with the banks' rapid expansion in recent years, and (iv) quality of capital risks, related to complex ownership structures. In this light, the Staff Report concluded that "if risks were to materialize in full, Iceland could face severe financial strains."

25. **Despite the authorities' attempts to prepare for contingencies earlier in the year, the crisis brought down the three main banks within a week.** In May 2008, the central bank entered into swap agreements with other Nordic central banks, in an effort to secure liquid foreign exchange should the need arise. In September, the government borrowed 300 million Euro to further boost reserves. At the same time, the central bank had been increasing liquidity provision, easing rules on eligible collateral (including by accepting uncovered bonds from banks) and reducing reserve requirements. But renewed global

pressures in late September led to a swift loss of investor confidence in the Icelandic economy and financial system, and a massive depreciation of the króna. The three main banks could not secure payments for their due obligations, and the government decided to promptly intervene rather than to continue what was considered to be an eventually unsustainable process of supporting the three banks. A “new bank/old bank” approach was adopted, with the “new” bank set to service domestic banking needs, while most of the foreign liabilities would be allocated to the “old” bank (Box 4).

Box 4. Iceland—Bank Restructuring

Background: On Oct 6, 2008 the Parliament of Iceland passed a law, which gave the Iceland Financial Supervisory Authority (FME) far-reaching powers to deal with problem banks. In the following days, the FME took control of Glitnir, Landsbanki and Kaupthing. Though it was unclear if the banks were insolvent, the FME’s rationale for intervening was to prevent the problems from escalating further, given growing liquidity pressures. Accounting for about 85 percent of the banking system before the crisis, these banks have a large number of branches and subsidiaries in several European countries.

Splitting the banks: The authorities’ strategy to downsize the banking system was to split each bank into a new bank and an old bank. The new banks covered the domestic operations funded by local depositors. The old banks included activities in foreign branches and subsidiaries, mainly funded through the issuance of bonds and foreign deposits. Derivatives and unrecoverable assets were transferred to the old banks. In each of the three banks, the FME replaced the board with a resolution committee in order to ensure the continued operation of the banks as domestic commercial banks. The resolution committees were put in charge of splitting the banks and making a preliminary assessment about asset quality. Large provisions were made in both the new and the old banks, bringing loan values in line with expected market values. Once the split was completed, international auditing firms would, within 60 days, conduct a second valuation to ensure that assets were properly valued. At that point, a tradable bond issued on market terms would be given from the new banks to the old banks, in order to compensate creditors in the old banks.

New banks: The Ministry of Finance appointed a new board in each of the new banks. After the second valuation is completed, the government will recapitalize these banks to a capital adequacy ratio of at least 10 percent. The authorities estimate a total capital injection of 385 billion Króna (200 billion in Landsbanki, 110 billion in Glitnir, and 75 in Kaupthing). Looking forward, the intention is to privatize the banks when confidence is restored and the banks are operating normally.

Old banks: The resolution committees will be in charge of liquidating the old banks. The amount recovered by depositors and other creditors will depend on the funds collected through the asset sales. The shareholders of the old banks remain the legal owners of these banks, but they are essentially displaced from decision-making under Icelandic bank resolution laws. All important decisions made by the resolution committees are to be confirmed by the FME.

Iceland. Balance Sheet of the New and Old Banks 1/
(In billions of krona)

	Landsbanki		Glitnir		Kaupthing	
	New bank	Old bank	New bank	Old bank	New bank	Old bank
Asset						
Cash and cash balance with financial institutions	238	3.9	146	0.1	77	0
Loans to credit institutions	64	603	19	536	27	1,021
Loans to the public	1,673	614	632	884	1,409	700
Provisions 2/	-848	-13	...	...	-954	0
Market securities 3/	216	183	11	224	65	712
Derivatives 4/	-4	196	40	396	0	41
Other assets	67	156	23	331	76	463
Total assets	**1,406**	**1,743**	**870**	**2,371**	**700**	**2,937**
Liabilities						
Deposits from credit institutions and central bank	107	700	17	133	78	158
Deposits	463	1,124	338	69	339	47
Syndicated loans and other borrowings 5/	0	1,255	0	2,464	0	2,900
Derivatives		66	0	144	0	208
Other liabilities	48	52	0	270	36	457
Total liabilities	**618**	**3,197**	**355**	**3,080**	**453**	**3,770**
Bond issue to new bank	586	-586	405	-405	172	-172
Equity	201	-867	110	-304	75	-661
Total liabilities and equity	**1,406**	**1,743**	**870**	**2,371**	**700**	**2,937**

Source: Iceland's Financial Supervision Authority.
1/ Data are preliminary and tentative.
2/ Asset impairment in the New Glitnir bank is not available, but is netted out in loans to the public
3/ Includes bonds, equities, and other market instruments.
4/ Includes derivatives held for trading and those held for hedging.
5/ Includes subordinated loans.

26. **Given the swift and massive collapse of the banking sector, discussions focused on the main ingredients of a comprehensive strategy to restructure it**. Following the banks' intervention, it was agreed that key elements of the strategy going forward would include:

- *Putting in place an efficient organizational structure to facilitate the restructuring process*. A new committee to coordinate the restructuring process has been formed. The committee includes representatives from relevant government institutions, notably the Prime Minister's Office, the Financial Supervisory Authority (FME), the CBI, the Ministry of Finance, and the Ministry of Commerce. It will be chaired by a newly appointed, well-reputed expert in banking. Initially, the most important task for the committee will be to collect information about the crisis and its consequences and ensure its dissemination to the relevant policy makers and the public. The experience of other countries suggests that to ensure consistency, one person should be put in charge of making comments to the media, public and market participants.

- *Proceeding promptly with the valuation of banks' assets.* The formal valuation of both new and old banks will proceed expeditiously and in line with international best practice. The authorities noted their plans to hire an international auditing firm to oversee the valuation process and assist the FME in developing a methodology in accordance with international best practice. They intend to hire separately other international auditing firms to conduct the actual valuations using this methodology. The auditing firm overseeing the process would then verify and confirm that the valuations were conducted based on the prescribed methodology and make a final decision on the valuation. At that point, a tradeable bond issued on market terms will be given from the new banks to the old banks, in order to ensure equal treatment of creditors. Staff stressed that fair valuation of banks' assets would be key to recovering assets, limiting litigation, and restoring Iceland's access to international capital markets.

- *Putting the new banks on a sound footing*. Once the asset valuation is complete, the new banks will need to be recapitalized and their business strategy examined. The authorities planned to recapitalize the three new banks up to a capital adequacy ratio of at least 10 percent. The total amount of capital needed to be injected was estimated at 385 billion ISK. The injection would be completed by end-February 2009, using tradable government bonds issued on market terms. It was also agreed that the FME would closely monitor the operational soundness of the new banks and review their five-year business plans. In addition, the mission welcomed the authorities' intention to sell the government's holdings of bank equity in the future, when market conditions become appropriate.

- *Maximizing asset recovery in the old banks*. The strategy for assets recovery remains to be developed. The authorities plan to put the old banks into a payments moratorium under Icelandic insolvency law, with the resolution committees working on asset recovery under the supervision of a court-appointed administrator. Recognizing that a sound strategy for asset recoveries will be crucial in order to minimize the ultimate cost of bank resolution, the authorities intend to hire an advisor to assist in formulating such a strategy by end-November 2008. In principle, every option should be available to maximize asset recoveries, including the establishment of an asset management company, with the capacity to restructure loans to maintain and increase their values. It was acknowledged, however, that asset recovery will take time, given the currently unfavorable global environment and would likely not cover all creditor claims in the insolvency proceedings. In addition, the authorities expressed concern that the freezing of assets abroad was leading to a rapid deterioration in asset values.

- *Ensuring the fair and equitable treatment of depositors and creditors of the intervened banks*. It was agreed that the treatment of depositors and creditors of the intervened banks should be fair and equitable. To that end, the authorities expressed their commitment to progress on a sound and transparent process as regards depositors and creditors of the intervened banks. They planned to work constructively towards comparable agreements with all international counterparts for the Iceland deposit insurance scheme, in line with the European Economic Area legal framework.

- *Strengthening supervisory practices.* Stressing the need to safeguard against a recurrence of the problems in the banking system, the authorities recognized that the bank regulatory framework and supervisory practice needs to be strengthened. Staff agreed with the authorities' plan to invite an experienced bank supervisor to conduct an assessment of the regulatory framework. In particular, the assessment would cover the framework of rules on liquidity management (the responsibility of the central bank), connected lending, large exposures, cross-ownership, and the "fit and proper" status of owners and managers—and propose needed changes. The authorities expected the assessment to be completed and made public by end-March 2009. Previous senior managers and major shareholders in intervened banks who were found to have mismanaged the banks will not be allowed to assume similar roles for at least three years.

- *Improving the insolvency framework.* The insolvency framework will be adjusted. Specifically, the mission underscored the need for a special bank insolvency law, which would resolve the uncertainty over the legal status of intervened banks and provide a coherent framework for the supervisory and debt-resolution aspects of bank insolvencies. There was also general agreement that the corporate insolvency regime should be refined to facilitate out-of-court workouts between creditors and viable firms.[4]

V. External Financing Needs

27. **The collapse of the banking system has left the economy with a considerable external financing need**. Staff estimates this need to be about $23.5 billion for 2008–10. Of this, about $10.3 billion represent arrears on obligations (amortization and interest due) of the three intervened private banks. Financing earmarked for payments in relation to the foreign branch deposits of the Icelandic banks is tentatively estimated at about $8.2 billion. The authorities are negotiating bilateral loans that are expected to be earmarked to pay these foreign deposits.[5] The remainder is a cash financing gap of $5 billion.

Iceland. Financing Needs, 2008-10
(In US $ billions)

	2008	2009	2010
Overall Balance	-18.5	-2.0	0.1
Financing	18.5	2.0	-0.1
Reduction in reserves	-3.0	0.6	-0.7
Accumulation of arrears	10.3	0.0	0.0
Extraordinary Financing	12.2	1.4	0.6
Fund	0.8	0.6	0.6
Bilateral (earmarked/ non-cash)	8.2	0.0	
Residual Financing gap	2.2	0.8	
Memo: Level of Gross reserves	*5.6*	*5.0*	*5.7*

Sources: Central Bank of Iceland; Fund staff estimates and calculations.

[4] Provisions to include secured creditors in agreed restructuring plans and to facilitate new financing during a firm's rehabilitation would be critical in this respect.

[5] Negotiations are ongoing with the Dutch and U.K. authorities on the amounts and terms of such loans. A bilateral MoU for an official loan earmarked to cover foreign deposit insurance has been agreed in principle with the Netherlands, and the Icelandic authorities are engaged in discussions with the U.K. for a similar type of arrangement.

28. **The restructuring of the banking sector will increase the external public sector debt burden significantly.** At end-2007, gross external debt amounted to 551 percent of GDP, of which public sector and public sector guaranteed external debt was about 19 percent of GDP. Including the arrears of the banking sector, external debt could reach 670 percent of GDP at end-2008. The private sector external debt burden could be significantly reduced after the bank restructuring. However, public and publicly guaranteed external debt, including the IMF and other expected exceptional balance of payments support, is set to rise steeply, to an estimated 100 percent of GDP by end-2008, reflecting the costs of settling foreign deposit insurance and borrowing to cover the exceptional balance of payments need during the remainder of the year. Although the debt sustainability analysis shows that—with resolute fiscal adjustment over the medium-term—the public sector and public sector guaranteed external debt can be reduced substantially to around 49 percent of GDP by end-2013, this is still high relative to standard external debt thresholds. The large public sector and public sector guaranteed external debt and debt service burdens pose a risk to the outlook, and resiliency is tested particularly in the face of a further exchange rate shock (see Attachment I on the Debt Sustainability Analysis).

VI. Program Modalities and Risks

29. **The proposed Stand-By Arrangement entails exceptional access** (Attachment IV). The cash financing needs from 2008 to the end of 2010 are around $5 billion. The risk of potentially large capital outflows is significant. But the program aims to mitigate this risk by focusing monetary and exchange rate policies on building confidence, by achieving rapid current account adjustment and, until the situation has stabilized, through the imposition of controls on capital outflows. A two-year Stand-By Arrangement of SDR 1.4 billion (US$ 2.1 billion, 1190 percent of quota) would provide part of the much-needed boost to net international reserves that would underpin confidence in the exchange rate (Box 5).

Box 5. Iceland: Stand-By Arrangement

Access. SDR 1.4 billion.

Phasing. A two year Stand-By arrangement. SDR 560 million will be made available upon the Board's approval of the arrangement to address the need to replenish reserves. The eight subsequent tranches will equal SDR 105 million. The next two tranches could be made available in February and May 2009, and quarterly thereafter.

Conditionality (and rationale for inclusion in the program)

Prior Actions

- Raise the policy interest rate to 18 percent. (*Rationale*: help stabilize the exchange rate.)
- Establish a committee comprising representatives from the Prime Minister's Office, the Financial Supervisory Authority, the Central Bank of Iceland, the Ministry of Finance and the Ministry of Commerce to coordinate policy input, chaired by the expert in charge of the bank restructuring process. (*Rationale:* facilitate a coordinated, cohesive process for bank restructuring.)

Quantitative Performance Criteria

- A floor on the central government net financial balance.
- A ceiling on changes in net credit of the Central Bank of Iceland to the private sector.
- A ceiling on changes in net domestic claims of the Central Bank of Iceland to the public sector.
- A floor on net international reserves.
- A ceiling on contracting or guaranteeing new medium and long term external debt.
- A ceiling on short-term debt.
- A ceiling on the accumulation of external arrears by central government.

Structural Performance Criteria

- A capital injection into the three new banks, made using tradable government bonds issued on market terms, to raise the capital adequacy ratio to at least 10 percent. *By end-February 2009*. (*Rationale*: ensure the financial soundness of the new banks.)
- An experienced banking supervisor to provide an assessment (to be published) of the regulatory framework and supervisory practices, including rules on liquidity management, connected lending, large exposures, cross-ownership, and the "fit and proper" status of owners and managers, and propose needed changes. *By end-March 2009.* (*Rationale*: lay foundations for stronger prudential regulation and banking supervision.)

Structural Benchmarks

- Develop a strategy for asset recoveries. *By end-November 2008.* (*Rationale*: limit ultimate cost of bank resolution.)
- FME to review the business plans of each of the new banks. *By January 15, 2009.* (*Rationale*: help achieve financial soundness of the new banks.)
- International Auditing Firm to conduct valuations of the old and new banks using a methodology in accordance with international best practice. *Complete by end-January 2009.* (*Rationale*: achieve fair valuation of banks' assets, to help limit litigation and restore market access.)
- Prepare plans to embark on medium-term fiscal consolidation. *By end-2008*. Improve the medium-term fiscal framework. *By end-June 2009*. (*Rationale*: maintain fiscal sustainability.)

30. **The external cash financing gap is expected to be filled by the Fund with substantial support from other official creditors.** The program envisages that the Stand-By Arrangement will fill about 42 percent of the 2008–10 financing gap and around 32 percent of the financing gap to the end of 2009. The remainder is to be met from other official institutions, who are in the process of assessing the size, timing and modalities of their contribution. Discussions in this regard are well-advanced and staff expects to there will be assurances to fill the first-year financing gap by the time of the Board meeting; an update on further financing commitments will be provided at the Board meeting. Discussion of financial assurances will be included in the program reviews.

31. **There is a presumption that exceptional access in capital account crises will be provided using resources of the Supplemental Reserve Facility (SRF) where the conditions for the SRF apply.** While Iceland is suffering from a capital account crisis, this was triggered by a banking sector collapse that is globally unprecedented in scale (relative to the domestic economy) compared to previous banking crises. The SRF is geared towards a "large short-term financing need resulting from a sudden and disruptive loss of confidence reflected in pressure on the capital account and the member's reserves". However, in the case of Iceland it is not likely that these effects will be short-term. Past experience of managing banking crises suggests they are complex and take time to resolve, and the impact on the domestic economy is likely to be severe.[6] As pressures on the capital account are likely to have a longer duration than those envisaged by the SRF, staff instead proposes a two-year SBA arrangement with exceptional access under "credit tranche" terms.

32. **Iceland's capacity to repay the Fund is good, although significant risks arise from the scale of public and public sector guaranteed external debt**. Until March 2008 Iceland's government international bonds were rated as A+ by Fitch and Standard and Poor's but have been downgraded to BBB in the aftermath of the banking crisis; Moody's also downgraded Iceland from Aaa to A1. Total access proposed under the program is exceptionally high as a percent of Iceland's quota, and large at 12.5 percent of GDP. Public and publicly guaranteed external debt[7] is expected to jump to 100 percent of GDP at the end-2008, from 33 percent of GDP in June. The debt ratio falls back over the forecast horizon, but it remains high in the medium term. Total public sector external debt service costs are also substantial and, including rollover of short term debt, could amount to 20–25 percent of GDP in 2009–11. These numbers are high but the authorities' commitment to the program, and intention not to take on any further fiscal costs of the bank restructuring, provides assurance of timely repayments to the Fund. Policies to further tap Iceland's rich endowment

---

[6] See *Managing Systemic Banking Crises* By a Staff Team led by David.S. Hoelscher and Marc Quintyn (OP 224, 2003)

[7] Includes IMF and the new loans to fill the financing gap.

of mineral resources and tourism potential could potentially provide additional foreign exchange earnings beyond those projected.

33. **Conditionality focuses initially on bank restructuring and restoring confidence, then on medium term fiscal sustainability, all of which are essential for program success**. Two prior actions have been taken and over the next six months the program entails 2 structural performance criteria and 5 structural benchmarks geared towards progress on banking resolution and restoring macroeconomic stability (Box 5). While private external arrears arising from the imposition of exchange controls remain, the Lending into Arrears policy would apply. This would subject each purchase to a financing assurances review assessing whether Iceland continues to make a good faith effort to facilitate collaborative agreement between the relevant private debtors and their creditors and that good prospects exist for removal of the exchange controls.

34. **The program risks are substantial, not least because of large uncertainties about the impact of the banking crisis and its eventual resolution**. The banking sector disruption is of an unprecedented scale and there is a risk that its resolution could be protracted. At this juncture, it is extremely difficult to assess the magnitude of the impact on the real economy or to gauge the potential capital outflows. The sheer scale of the problem brings along significant risks. The program is designed to mitigate these risks by concentrating conditionality on the banking sector, building reserves, launching an ambitious medium-term fiscal consolidation program, and for an interim period, allowing the imposition of exchange controls. Nonetheless, careful monitoring will be needed to ensure that the program adapts to emerging risks and ensure that they are contained.

35. **A first-time safeguards assessment of the CBI will need to be completed no later than the first review under the Stand-By Arrangement.** Financial statements audited by the National Audit Bureau (NBA) are published on the central bank's website. Staff is in the process of obtaining additional information needed to complete the assessment, and has requested that the CBI authorize the NBA to hold discussion with Fund staff and to provide all relevant information needed to complete the assessment.

VII. Staff Appraisal

36. **Iceland faces the daunting task of adjusting to the collapse of its oversized banking system.** Having allowed its banks to rapidly grow to levels that significantly outstrip the CBI’s lender-of-last resort capabilities, Iceland is now faced with its public sector having to take on obligations relating to the restructuring of the collapsed banks on a scale that will dramatically circumscribe the medium-term fiscal outlook. More immediately, the loss of confidence and the attendant sharp fall in the value of the króna will severely compress investments and GDP. A deep recession appears unavoidable.

37. **The immediate macroeconomic challenge is to stabilize the króna**. The economy is extremely open and will quickly face wide-spread disruptions unless foreign exchange

restrictions for current account transactions are substantially lifted soon. But doing so risks large balance-sheet-effects, a wave of defaults and a further worsening of the already dire prospects for economic growth next year unless the króna can be stabilized, reflecting very high corporate and household leverage and a high share of foreign exchange linked and inflation-indexed loans. In view of this, the authorities are right in initially focusing their macroeconomic efforts on stabilizing the króna.

38. **Monetary policy is key to stabilizing the exchange rate.** Confidence in the króna has been seriously shaken. Even if capital account restrictions are retained for now, the porosity of Iceland's financial and corporate sectors means that there is a notable risk of large capital outflows as current account transactions are gradually allowed back into the on-shore foreign exchange market. The large foreign obligations of the non-bank sector suggest that the scope for such outflows is very large, dwarfing the CBI's foreign reserves and available foreign assistance from other countries. In view of this, staff believes that the authorities rightly decided that they have no other option at this juncture than restoring confidence in the króna through an appropriately tight monetary policy, in the context of a flexible exchange rate regime.

39. **Prospects for success are good**. The current account is rapidly swinging into surplus and the outlook for the balance of payments is fundamentally strong. This—together with a determined focus of monetary policy on stabilizing the króna, support from the international community, and an ability to smooth foreign exchange volatility through limited and temporary foreign exchange interventions—should lead to an early return of confidence. In staff's view, firm adherence to this approach will open up prospects for a gradual easing of monetary policy during next year, and for steady króna appreciation.

40. **But there are appreciable risks**. High leverage means that the relatively high interest rates needed until confidence returns will seriously burden the economy. This points to the risk of a premature relaxation of monetary policy. In this regard, the untimely reduction in interest rates in mid-October as pressures on the króna mounted, might have weakened confidence in the resolve and ability to focus monetary policy on stabilizing the króna. If this is the case, the cost to the economy going forward will have increased, as it will take a longer period of relatively high interest rates to reestablish confidence in the management of monetary policy and, therefore, in the króna. The program's success hinges, above all, on the CBI's determination to keep monetary policy focused on króna stability, postponing a loosening until there is firm evidence that confidence has returned and the króna can be stabilized without support from current account restrictions and foreign exchange interventions.

41. **The CBI needs to communicate its strategy**. In view of the risk of capital outflows, the CBI has rightly opted for a short-term mix of conventional and unconventional policy measures that are not easily explained to the public. In the absence of a simple and transparent monetary policy framework, a communication strategy would have to involve

convincing announcements about policy intentions and explanations as to why it is crucial to avoid premature interest rate reductions. Policy makers need to explain that the resulting króna depreciation and attendant rise in inflation would not only impose an equally, if not more, devastating burden on the economy in the near-term, but would soon have to be followed by an even more burdensome monetary tightening. The current account adjustment would have to be larger in order to accommodate larger capital outflows, an adjustment that would be brought about mainly through deeper compression of incomes and employment.

42. **The exchange controls, temporarily imposed in response to the sharp deterioration in the króna and pressures on reserves, will be removed during the program period** (See Box 1). These controls include exchange restrictions on certain current international transactions, which have contributed to private external payment arrears. Implementation of the key program objective of strengthening the current account position to allow bolstering reserves and reestablishing free international payments through the banking system would support an early removal of the exchange restrictions and clearance of these private external payment arrears. In the meantime, staff supports the authorities' request for temporary Fund approval of the exchange restriction in line with Fund policy, on the basis that it has been imposed for balance of payments reasons and is non-discriminatory. Furthermore, staff notes the authorities' commitment not to impose or intensify restrictions on the making of payments and transfers for current international transactions nor to introduce multiple currency practices.

43. **Turning to fiscal policy, staff supports the decision to allow automatic stabilizers to work in full in 2009.** This will importantly cushion the recession that is in store. Consistent with this, staff supports the decision to delay the launch of an ambitious medium-term program of fiscal consolidation until 2010. Staff believes that the ambitious targets in this regard are commensurate with the severity of increase in public indebtedness. Developing the details of this program in a manner that minimizes disruptions and distortions of incentives will be the key challenge facing the authorities next year.

44. **The authorities must resist pressures to socialize losses.** Incurring merely the cost of recapitalizing banks and covering guaranteed deposits has virtually overnight transformed the public sector from being low indebted to being very highly indebted, severely circumscribing fiscal policy for years to come. It is, therefore, essential that the Government does not take on responsibility for liabilities of the intervened banks other than those relating to guaranteed deposits. More generally, the public sector should not socialize other losses, however painful the impact of the banking crisis will be on those who have lost substantial wealth, domestically and abroad.

45. **Bank resolution must not discriminate against foreigners.** The size, openness, and high specialization of the Icelandic economy makes it of paramount importance that the strategy for bank resolution does not jeopardize Iceland's integration into the world economy. The evolving bank resolution strategy is beginning to conform with international

best practice in important areas, but for it to be perceived as fair it is essential that the new "domestic" banks do not cherry-pick assets from the old "foreign" banks, and that the bonds to be issued by the new banks and transferred to the old banks be based on a fair assessment of the value of assets and liabilities. It is equally important that the authorities maintain a non-discriminatory, cooperative, and best-effort approach to reaching agreement with other countries on payments on insured deposits in branches of Icelandic banks in these countries.

46. **Iceland has dealt well with shocks in the past.** One important aspect of this is the history of cooperation between the social partners in the labor market, not least when economy is exposed to adverse shocks. A responsible wage agreement will be crucial for limiting the fallout from the current crisis. More generally, strong political and social cohesiveness and a tradition of mobilizing broad political support for difficult policies are among Iceland's great strengths. This, and the proven flexibility of the economy, augur well for the authorities' ability to tackle the daunting tasks ahead.

Table 1. Iceland: Selected Economic Indicators, 2003–09

	2003	2004	2005	2006	2007 est.	2008 staff proj.	2009 staff proj.
	(Percentage change unless otherwise noted)						
National Accounts (constant prices)							
Gross domestic product	2.4	7.7	7.4	4.4	4.9	1.6	-9.6
Total domestic demand	5.6	10.0	16.0	9.9	-1.5	-9.1	-19.7
Private consumption	6.1	7.0	12.9	4.4	4.3	-8.7	-23.7
Public consumption	1.8	2.2	3.5	4.0	4.2	3.2	2.9
Gross fixed investment	11.1	28.1	35.7	20.4	-13.7	-19.7	-33.6
Export of goods and services	1.6	8.4	7.2	-5.0	18.1	12.1	1.9
Imports of goods and services	10.7	14.5	29.4	10.2	-1.4	-15.2	-23.1
Output gap 1/	-4.7	-1.2	2.3	3.2	4.8	4.6	-5.4
Selected Indicators							
Nominal GDP (bln ISK)	841.3	928.9	1,026.4	1,167.9	1,293.2	1,490.1	1,495.1
Central bank gross reserves (bln ISK)	58.1	65.6	67.3	167.8	162.8	686.5	562.7
Unemployment rate 2/	3.4	3.1	2.1	1.3	1.0	1.4	5.7
Real disposable income per capita	-1.7	3.8	6.6	-2.0	5.4	...	...
Consumer price index	2.1	3.2	4.0	6.8	5.0	12.7	14.3
Nominal wage index	5.6	4.6	6.5	9.1	9.3	6.7	2.3
Nominal effective exchange rate 3/	6.2	1.8	10.4	-10.7	2.8	...	...
Real effective exchange rate (CPI) 3/	6.3	2.8	12.7	-6.8	5.7	...	...
Terms of trade	-4.1	-1.3	1.0	3.5	0.1	...	...
Money and Credit							
Deposit money bank credit (end-period)	26.7	41.9	76.0	44.4	56.6	...	...
of which to residents (end-period)	20.0	37.2	54.7	33.6	28.3	...	...
Broad money (end-period)	17.5	15.0	23.2	19.6	56.4	...	...
CBI policy rate (period average) 4/	5.3	8.2	10.5	14.1	13.8	...	...
Public Finance (in percent of GDP)							
General government 5/							
Revenue	44.6	45.9	48.8	49.7	50.0	45.3	41.7
Expenditure	47.5	45.9	44.0	43.4	44.5	45.5	55.2
Balance	-2.8	0.0	4.9	6.3	5.5	-0.2	-13.5
Structural balance	0.5	1.0	2.9	3.5	1.5	-3.4	-8.7
Balance of Payments (in percent of GDP)							
Current account balance	-4.8	-9.8	-16.1	-25.4	-14.6	-10.7	1.0
Trade balance (goods)	-1.9	-3.9	-9.1	-13.4	-6.8	1.0	6.4
Financial and capital account	1.2	12.7	13.5	36.4	13.2	-119.7	-11.4
o/w: reserve assets 6/	-2.8	-1.5	-0.5	-7.3	-0.5	-17.6	4.1
Net errors and omissions	3.6	-2.9	2.6	-11.0	1.4	2.4	0.0
Gross external debt	139.6	179.1	285.7	445.9	551.5	670.2	159.5
Central bank gross reserves (in months of imports of goods and services) 7/	2.2	2.1	1.8	3.4	3.3	11.0	9.9

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

1/ Staff estimates. Actual minus potential output, in percent of potential output.
2/ In percent of labor force.
3/ A positive (negative) sign indicates an appreciation (depreciation).
4/ Data prior to 2007 refers to annual rate of return. 2007 and on, refers to nominal interest rate.
5/ National accounts basis.
6/ A positive (negative) sign indicates a decrease (increase) in gross official foreign reserves.
7/ Excluding imports from the construction of hydropower facility and smelters in 2003-04.

Table 2. Iceland: Medium-Term Projection, 2007–13
(Percentage change, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013
	(Percentage change)						
Real economy							
Real GDP	4.9	1.6	-9.6	-0.3	4.5	4.5	4.2
Real domestic demand	-1.5	-9.1	-19.7	-3.6	7.5	6.0	5.7
Private consumption	4.3	-8.7	-23.7	-5.9	10.7	8.0	7.5
Public consumption	4.2	3.2	2.9	2.5	2.5	2.5	2.5
Gross fixed investment	-13.7	-19.7	-33.6	-6.8	7.7	6.4	5.8
Net exports 1/	6.6	11.7	10.0	2.9	-1.9	-0.8	-0.9
Exports of goods and services	18.1	12.1	1.9	3.1	4.3	4.2	4.1
Imports of goods and services	-1.4	-15.2	-23.1	-4.3	12.1	8.0	7.8
Output gap 2/	4.8	4.6	-5.4	-6.3	-3.8	-1.8	0.0
Unemployment rate 3/	1.0	1.4	5.7	6.9	5.4	4.0	3.0
Real wages	4.3	-6.0	-12.0	3.0	2.0	3.0	3.0
CPI inflation	5.0	12.7	14.3	2.7	2.0	2.0	2.0
CPI inflation (end of period)	5.9	20.5	4.5	2.0	2.0	2.0	2.0
	(In percent of GDP, unless otherwise indicated)						
Balance of Payments							
Current account	-14.6	-10.7	1.0	2.8	2.9	2.4	2.3
Trade balance	-10.1	0.1	10.3	10.9	7.7	6.2	4.6
Net income balance 5/	-4.2	-10.5	-9.0	-7.9	-4.5	-3.5	-2.0
Capital and financial account	13.2	-119.7	-11.4	-7.2	-2.9	1.0	2.9
Direct investment, net	-44.8	-4.4	2.0	10.5	6.3	6.4	4.3
Portfolio investment, net	-33.7	11.6	-9.8	-7.2	-5.5	-3.2	-0.9
Other investment, net 6/	92.4	-109.1	-7.7	-5.3	-3.0	-1.5	-0.4
Reserve assets	-0.5	-17.6	4.1	-5.0	-0.5	-0.5	-0.2
Accumulation of arrears	0.0	61.3	0.0	0.0	0.0	0.0	0.0
Extraordinary financing	0.0	66.7	10.5	4.5	0.0	-3.4	-5.2
Gross external debt 6/	551.5	670.2	159.5	147.0	135.7	118.1	101.3
Central bank reserves (US$ billion)	-0.1	-3.0	0.6	-0.7	-0.1	-0.1	0.0
General government accounts 7/							
Revenue	50.0	45.3	41.7	43.0	44.0	44.3	44.5
Expenditure	44.5	45.5	55.2	53.6	51.3	46.0	42.6
Overall balance	5.5	-0.2	-13.5	-10.5	-7.3	-1.7	2.0
Structural balance	1.5	-3.4	-8.7	-6.5	-4.8	-0.7	1.9
Gross debt	28.9	108.9	108.6	104.4	105.7	100.7	92.6
Net Debt	7.3	90.6	97.0	92.8	94.8	90.5	83.0

Sources: CBI; and IMF staff estimates.

1/ Contributions to growth

2/ In percent of potential output

3/ In percent of labor force.

4/ Icelandic Krona per euro, annual average.

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

6/ Includes possible arrears accumulated by the financial sector.

7/ Assumes banking sector recapitalization in 2008, depositor insurance-related loans by the government in 2008, central bank recapitalization in 2009, and asset recovery in 2010 and 2011.

Table 3. Iceland: Balance of Payments, 2007–13
(US dollar billions)

	2007	2008	2009	2010	2011	2012	2013
Current Account	-2.9	-1.8	0.1	0.4	0.4	0.4	0.4
Balance on Goods	-1.4	0.2	0.9	0.8	0.6	0.4	0.3
Merchandise exports f.o.b.	4.8	5.8	4.9	4.8	5.0	5.2	5.5
Merchandise imports f.o.b.	-6.2	-5.6	-4.1	-3.9	-4.4	-4.8	-5.2
Balance on Services	-0.7	-0.1	0.5	0.6	0.5	0.5	0.5
Exports of services, total	2.2	2.7	2.6	2.6	2.7	2.8	3.0
Imports of services, total	-2.9	-2.8	-2.0	-2.0	-2.2	-2.3	-2.5
Balance on Income 1/	-0.8	-1.8	-1.2	-1.1	-0.6	-0.5	-0.3
Receipts	5.0	3.9	0.3	0.4	0.7	0.8	0.9
Expenditures	-5.9	-5.6	-1.5	-1.5	-1.3	-1.3	-1.2
Current transfer, net	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Capital and Financial Account	2.8	-17.1	-2.1	-0.3	-0.3	0.2	0.5
Capital transfer, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	2.8	-17.1	-2.1	-0.3	-0.3	0.2	0.5
Direct investment, net	-9.1	-0.7	0.3	1.4	0.9	1.0	0.7
Abroad	-12.2	0.5	0.0	-0.1	-0.1	0.0	0.0
In Iceland	3.1	-1.3	0.3	1.5	1.0	1.0	0.8
Portfolio investment, net	-6.8	1.9	-1.3	-1.0	-0.8	-0.5	-0.1
Assets	-7.6	0.1	-1.3	-0.5	-0.1	0.0	0.1
Liabilities	0.8	1.9	0.0	-0.5	-0.7	-0.5	-0.2
o/w new borrowing debt securities		2.5	1.5	1.7	1.7	0.3	0.0
amortization debt securities		-0.9	-1.5	-2.3	-2.4	-0.8	-0.3
other		0.3	0.0	0.0	0.0	0.0	0.0
Other investment, net 2/	18.7	-18.3	-1.0	-0.7	-0.4	-0.2	-0.1
Assets	-16.8	-3.0	1.1	1.4	-0.3	0.0	0.1
o/w asset recovery			2.1	2.1			
other			-1.0	-0.7	-0.3	0.0	0.1
Liabilities	35.5	-15.4	-2.1	-2.1	-0.1	-0.2	-0.1
o/w new borrowing		1.9	0.0	0.0	0.0	0.3	0.4
amortization		-1.5	0.0	0.0	-0.1	-0.6	-0.5
short-term debt		0.2	0.2	0.2	0.2	0.2	0.2
short-term debt amortization		-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
banks foreign deposits		-15.8					
amortization of deposit insurance loans			-2.1	-2.1			
Net errors and omissions	0.4	0.4	0.0	0.0	0.0	0.0	0.0
Overall Balance	0.2	-18.5	-2.0	0.1	0.1	0.6	0.9
Financing	-0.1	18.5	2.0	-0.1	-0.1	-0.6	-0.9
Reduction in reserves	-0.1	-3.0	0.6	-0.7	-0.1	-0.1	0.0
Accumulation of arrears 2/		10.3	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing 3/		11.2	1.4	0.6	0.0	-0.5	-0.8
Fund		0.8	0.6	0.6	0.0	-0.5	-0.8
Bilateral (earmarked/ non-cash)		8.2	0.0				
Residual Financing gap		2.2	0.8				
Level of Gross reserves (eop)	2.6	5.6	5.0	5.7	5.8	5.9	5.9
As a percent of GDP	13	33	38	43	41	39	36

Sources: CBI; and IMF staff estimates.

1/ Includes interest payments due from the financial sector and income receipts to the financial sector in 2008.

2/ Includes possible arrears accumulated by the financial sector in 2008. From 2009 onwards, and so as not to prejudge the outcome of the banking sector resolution, arrears are not recorded in the BOP and are assumed to have been paid off through asset recovery or written down in the bankruptcy process.

3/ Debt service payments on extraordinary financing are shown in the capital account, except for repurchases by the Fund.

Table 4. Iceland: Money and Banking
(In billion of Krona, unless otherwise noted)

	Sep-08	Oct-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
		Latest			Projection		
	Q3-2008	Est. 1/	Q4-2008	Q1-2009	Q2-2009	Q3-2009	Q4-2009
Central Bank							
Net international reserves 2/	97	-48	-84	-140	-196	-252	-307
NIR (in billion of US$) 3/	1.0	-0.4	-0.7	-1.2	-1.7	-2.2	-2.7
Net domestic assets	146	378	425	475	525	574	623
Net claims on the public sector	-197	-200	-175	-150	-125	-100	-75
Net credit to banks 4/	228	307	330	354	379	403	428
Other, net	116	271	271	271	271	271	271
Base Money	243	330	341	334	328	322	317
Currency issued	16	32	33	33	32	31	31
Reserve deposits	227	298	308	302	296	291	286
Banking System							
Net foreign assets	-2,842	-104	-104	-104	-104	-104	-104
Net domestic assets	4,385	1,616	1,720	1,713	1,690	1,664	1,649
Net claims on the central bank	-228	-307	-330	-354	-379	-403	-428
Credit to private sector	5,297	2,732	2,544	2,517	2,491	2,465	2,439
Other items, net	-685	-809	-494	-450	-422	-397	-362
Domestic deposits	1,472	1,512	1,616	1,609	1,586	1,560	1,545
Local currency	1,334	1,370	1,464	1,458	1,437	1,413	1,400
Foreign currency	138	142	152	151	149	147	145
Consolidated Financial System							
Net foreign assets	-2,746	-152	-189	-245	-301	-356	-411
Net domestic assets	4,531	1,994	2,146	2,188	2,215	2,239	2,273
Net claims on the public sector	-197	-200	-175	-150	-125	-100	-75
Net credit to private sector	5,297	2,732	2,544	2,517	2,491	2,465	2,439
Other, net	-569	-538	-223	-179	-151	-126	-91
Broad Money (M3)	1,488	1,544	1,649	1,641	1,618	1,592	1,576
Money and sight deposits (M2)	730	758	732	729	718	707	700
Time deposits	758	786	917	912	899	885	876
Monetary aggregates							
Base money	243	330	341	334	328	322	317
Broad money (M3)	1,488	1,544	1,649	1,641	1,618	1,592	1,576
Domestic lending	4,722	2,732	2,544	2,517	2,491	2,465	2,439
Money velocity (GDP/base money)	5.9	4.4	4.4	4.5	4.6	4.7	4.7
Broad money velocity (GDP/M3)	1.0	1.1	1.1	1.1	1.1	1.1	1.1
Multiplier (M3 / base money)	6.1	4.7	4.8	4.9	4.9	4.9	5.0
Memo items							
Change in NIR (US$ billion)	0.0	-1.4	-0.3	-0.5	-0.5	-0.5	-0.5
Change in net claims on the public sector	-10.7	-3.2	25.0	25.0	25.0	25.0	25.0
Change in net credit to the private sector	46.2	79.6	22.3	24.5	24.8	24.4	24.2
	(12-month percentage change in real terms)						
Base money	89.4	213.2	65.8	68.7	98.7	18.7	-11.1
Broad money (M3)	10.5	15.1	9.4	-3.2	-2.4	-4.2	-8.5
Domestic lending 5/	20.1	-35.3	-24.3	-39.4	-39.5	-43.9	-8.2

Sources: Central Bank of Iceland; and Fund staff estimates

1/ Estimates using balance sheet data as of Oct. 15 for the 3 new banks, end-Sept. for other banks, and Oct. 21 for the central bank.

2/ Net of Fund and other unidentified financing. Excludes foreign assets stemming from foreign currency deposits of financial institutions and the general government at the Central Bank of Iceland

3/ Uses program exchange rate of ISK 113.9 per U.S. dollar.

4/ Includes central bank collateral loans net of bank deposits and CBI paper holdings by banks.

5/ Adusted for CPI inflation and foreign exchange changes.

Table 5. Iceland: Summary Operations of the General Government, 2006–13
(in percent of GDP)

		Prel.	Staff projection					
	2006	2007	2008	2009	2010	2011	2012	2013
Total revenue 1/	49.7	50.0	45.3	41.7	43.0	44.0	44.3	44.5
Current revenue	48.0	48.2	43.8	40.0	41.1	42.1	42.4	42.7
of which:								
Direct taxes	21.6	21.8	19.2	17.5	19.1	19.2	19.3	19.3
0f which:								
Corporate income tax	2.4	2.7	1.7	1.3	2.0	2.0	2.0	2.0
Personal income tax	13.9	13.9	12.6	12.4	13.1	13.1	13.2	13.2
Social security contributions	3.3	3.1	2.8	2.8	2.9	2.9	2.9	2.9
Capital tax and rental income	1.9	2.2	2.1	1.1	1.1	1.2	1.2	1.3
Indirect taxes	19.8	19.2	17.0	15.2	14.7	15.6	16.0	16.3
Interest income	1.7	2.3	2.5	2.2	2.3	2.1	2.0	1.9
Other current income	4.8	4.9	5.1	5.1	5.1	5.1	5.1	5.1
Capital revenue	1.8	1.8	1.5	1.7	1.9	1.9	1.9	1.9
Total expenditure (incl. measures needed 1/)	43.4	44.5	45.5	55.2	53.6	51.3	46.0	42.6
Current expenditure	38.9	39.7	39.7	48.7	50.1	49.5	46.4	44.9
of which:								
Operational cost	27.7	27.7	27.2	29.9	30.6	29.8	29.0	28.4
0f which:								
Wages and salaries	15.3	15.3	16.2	17.3	…	…	…	…
Purchase of goods and services	7.3	7.2	9.5	10.8	…	…	…	…
Interest expenditure	2.2	2.6	2.1	7.3	7.6	8.3	6.5	6.1
Subsidies	1.7	1.8	1.6	1.6	1.7	1.6	1.5	1.5
Income transfers	6.3	6.4	7.3	8.4	8.6	8.2	7.9	7.5
Other expense	1.0	1.2	1.4	1.6	1.6	1.6	1.5	1.4
Capital expenditure	4.6	4.8	5.8	6.5	6.7	6.4	6.1	5.9
Discretionary measures needed 1/	0.0	0.0	0.0	0.0	-3.2	-4.7	-6.6	-8.2
Primary balance	6.7	5.8	-0.6	-8.5	-5.2	-1.1	2.8	6.2
Overall balance	6.3	5.5	-0.2	-13.5	-10.5	-7.3	-1.7	2.0
Financing	-6.3	-5.5	0.2	13.5	10.5	7.3	1.7	-2.0
Net domestic financing 2/	…	…	0.2	13.5	10.5	7.3	1.7	-2.0
Net external financing	…	…	0.0	0.0	0.0	0.0	0.0	0.0
Debt position								
General government gross debt 3/	30.1	28.9	108.9	108.6	104.4	105.7	100.7	92.6
General government net debt 3/	7.8	7.3	90.6	97.0	92.8	94.8	90.5	83.0
Cyclically adjusted 4/								
Primary revenue	46.5	45.7	41.6	41.4	41.6	42.5	42.5	42.7
Primary expenditure	42.6	43.9	45.4	45.4	43.1	41.3	38.8	36.5
Primary balance	3.9	1.8	-3.8	-3.9	-1.4	1.1	3.7	6.1
Total revenue 5/	48.3	48.1	44.2	43.6	43.7	44.5	44.4	44.5
Total expenditure	44.8	46.6	47.6	52.2	50.2	49.3	45.2	42.6
Overall balance	3.5	1.5	-3.4	-8.7	-6.5	-4.8	-0.7	1.9
Memorandum items:								
Output gap 6/	3.2	4.8	4.6	-5.4	-6.3	-3.8	-1.8	0.0
Change in structural primary balance	-0.2	-2.1	-5.6	-0.1	2.5	2.6	2.5	2.4
Bank restructuring debt	0.0	0.0	25.8	25.8	25.7	24.2	22.7	21.3
Assumed liability to honor foreign depositor obligations 3/	0.0	0.0	47.0	32.8	18.7	17.7	16.5	15.5
Central Bank recapitalization costs	0.0	0.0	0.0	10.0	10.0	9.4	8.8	8.3

Sources: Ministry of Finance; and Fund staff estimates and calculations.

1/ Measures needed have been reflected as expenditure measures, but could also include revenue measures.
2/ In 2009, it is assumed that the government draws down on its deposits at the central bank to finance half of the deficit
3/ Includes the liability assumed by the government from the deposit insurance to honor foreign depositor obligations.
4/ In percent of potential GDP.
5/ Structural revenue estimates were adjusted to account for the impact of the asset boom/bust price cycle.
6/ Actual output less potential in percent of potential.

Table 6. Iceland: External Financing Requirement and Sources, 2008–13
(In billions of US dollars)

	2008 Proj	2009 Proj	2010 Proj	2011 Proj	2012 Proj	2013 Proj
A Gross Requirements	23.1	3.1	4.8	2.3	1.2	0.6
Current account deficit	1.8	-0.1	-0.4	-0.4	-0.4	-0.4
Amortization	18.3	3.8	4.5	2.7	1.5	0.9
Official	0.8	0.5	0.3	2.3	1.1	0.6
Private other financial and other	17.3	1.0	1.9	0.2	0.3	0.2
Loans to cover deposit insurance		2.1	2.1			
Short-term debt (end of previous year)	0.2	0.2	0.2	0.2	0.2	0.2
Reserves accumulation (+: increase)	3.0	-0.6	0.7	0.1	0.1	0.0
B Sources of Financing	1.2	1.7	4.2	2.4	1.7	1.4
Foreign Direct Investment (net)	-0.7	0.3	1.4	0.9	1.0	0.7
FDI outflows Abroad	0.5	0.0	-0.1	-0.1	0.0	0.0
FDI inflows to Iceland	-1.3	0.3	1.5	1.0	1.0	0.8
Net inflows of equity and other capital	0.4	-1.3	-0.5	-0.1	0.0	0.1
Asset recovery		2.1	2.1			
New borrowing	4.5	1.7	1.9	1.9	0.7	0.5
Other net assets	-3.0	-1.0	-0.7	-0.3	0.0	0.1
C Financing Gap (A-B)	21.9	1.4	0.6	0.0	-0.5	-0.8
Errors and omissions	0.4	0.0	0.0	0.0	0.0	0.0
Accumulation of arrears	10.3	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing	11.2	1.4	0.6	0.0	-0.5	-0.8
Fund	0.8	0.6	0.6	0	-0.5	-0.8
Bilateral (earmarked/ non-cash)	8.2	0.0	0.0	0.0	0.0	0.0
Residual Financing gap	2.2	0.8	0.0	0.0	0.0	0.0

Sources: CBI; and IMF staff estimates.

Table 7: Indicators of Fund Credit 2008–15
(in millions of SDR)

	2008	2009	2010	2011	2012	2013	2014	2015
Proposed SBA								
Disbursements	560.0	420.0	420.0					
Stock 1/	560.0	980.0	1400.0	1400.0	1041.3	472.5	131.3	0.0
Obligations 2/	2.9	35.5	59.4	73.5	425.9	612.0	356.1	134.3
Principal (repurchases)	0.0	0.0	0.0	0.0	358.8	568.8	341.3	131.3
Charges and interest	2.9	35.5	59.4	73.5	67.2	43.2	14.8	3.1
Stock of Fund credit								
In percent of quota	476.2	833.3	1190.5	1190.5	885.4	401.8	111.6	0.0
In percent of GDP	5.1	11.2	16.0	15.1	10.6	4.5	1.2	0.0
In percent of exports of goods and services	10.1	20.0	29.3	28.1	20.0	8.7	2.3	0.0
In percent of gross reserves	15.3	29.8	37.7	37.3	27.5	12.4	3.5	0.0
Obligations from Fund arrangements								
In percent of quota	2.5	30.2	50.5	62.5	362.2	520.4	302.8	114.2
In percent of GDP	0.0	0.4	0.7	0.8	4.3	5.8	3.2	1.1
In percent of exports of goods and services	0.1	0.7	1.2	1.5	8.2	11.2	6.2	2.3
In percent of gross reserves	0.1	1.1	1.6	2.0	11.2	16.1	9.4	3.5

Sources IMF Finance Department and Fund staff estimates and projections.

1/ end of period

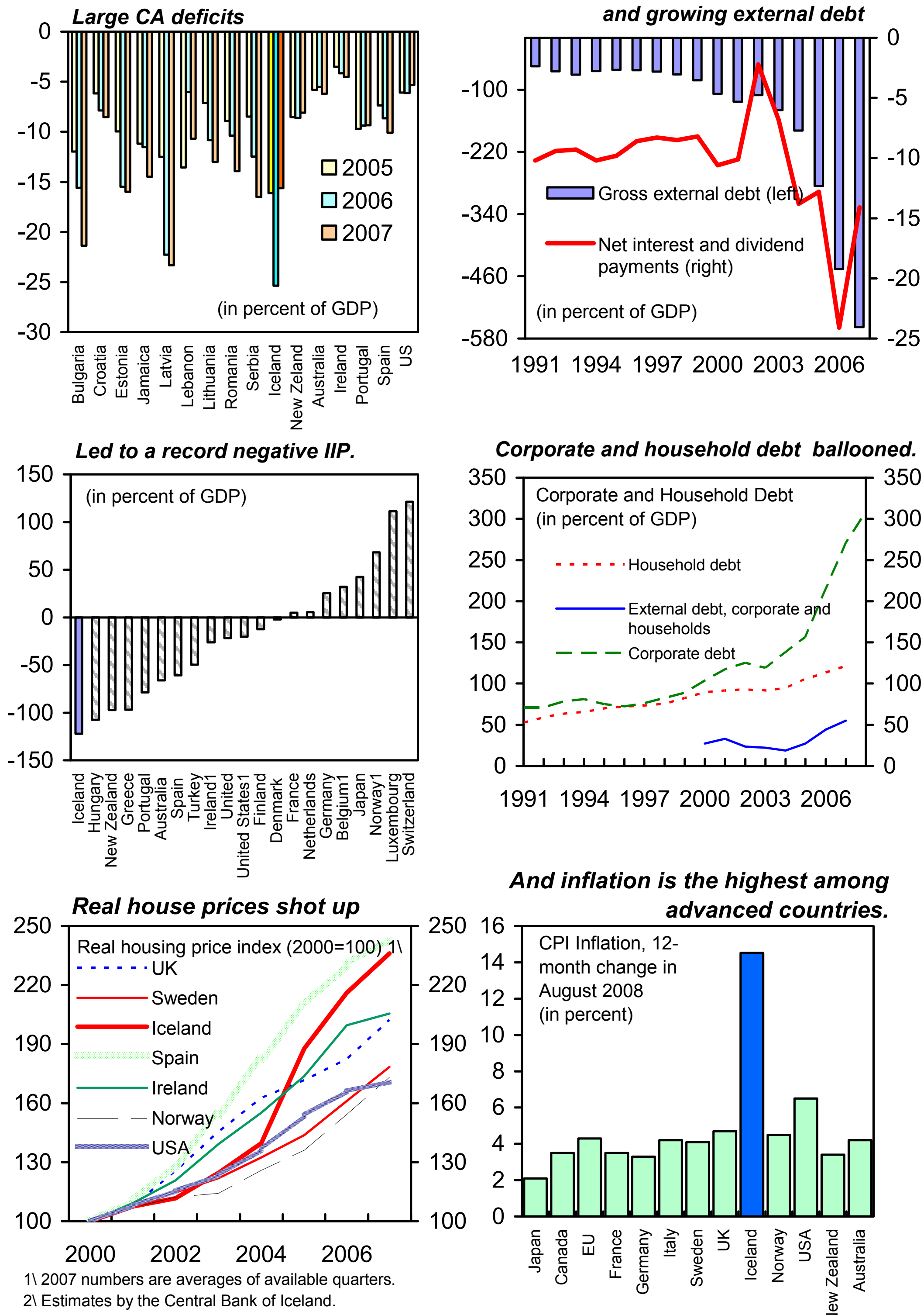
2/ Repayment schedule based on repurchase obligations

Table 8. Iceland: Access and Phasing Under a Proposed Stand-By Arrangement, 2008–10

Review	Date Available	Purchases		Conditions include
		In millions of SDRs	In percent of quota	
	November 2008	560	476.2	Board approval of arrangement
First Review	25 February 2009	105	89.3	Observance of end-December PC and completion of the first review
Second Review	25 May 2009	105	89.3	Observance of end-March PC and completion of the second review
Third Review	25 August 2009	105	89.3	Observance of end-June PC and completion of the third review
Fourth Review	25 November 2009	105	89.3	Observance of end-September PC and completion of the fourth review
Fifth Review	25 February 2010	105	89.3	Observance of end-December PC and completion of the fifth review
Sixth Review	25 May 2010	105	89.3	Observance of end-March PC and completion of the sixth review
Seventh Review	25 August 2010	105	89.3	Observance of end-June PC and completion of the seventh review
Eighth Review	25 October 2010	105	89.3	Observance of end-September PC and completion of the eighth review
Total		1400	1190	

Sources: Fund staff estimates.

Figure 1. Iceland: Large Imbalances Built Up During the Boom

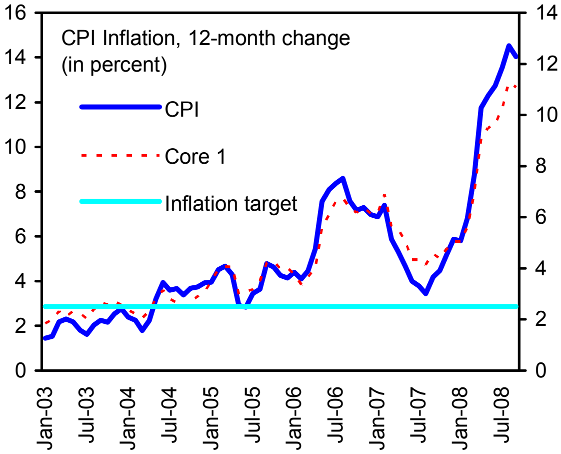


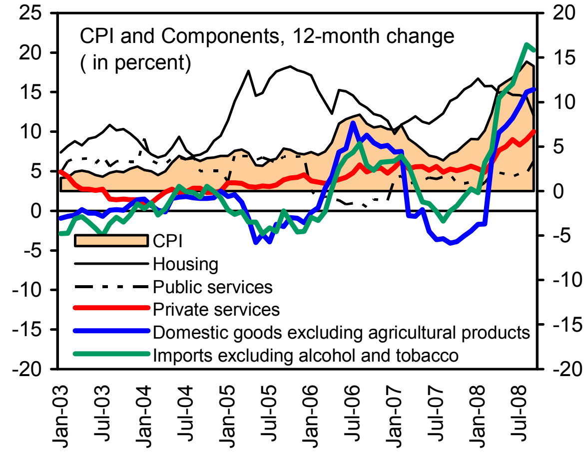
1\ 2007 numbers are averages of available quarters.
2\ Estimates by the Central Bank of Iceland.

Source: Haver Analytics, Iceland Central Bank, Land registry of Iceland, OECD, WEO, IMF staff calculations.

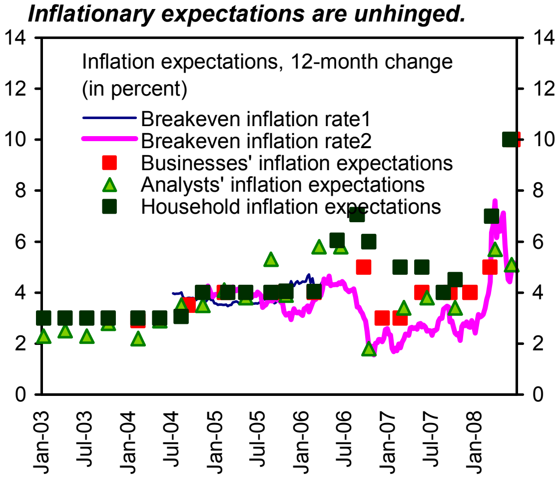
Figure 2. Iceland: Inflation Is High and Expectations Are Unhinged

Inflation is well above the target and pressures are rising, domestically and abroad...

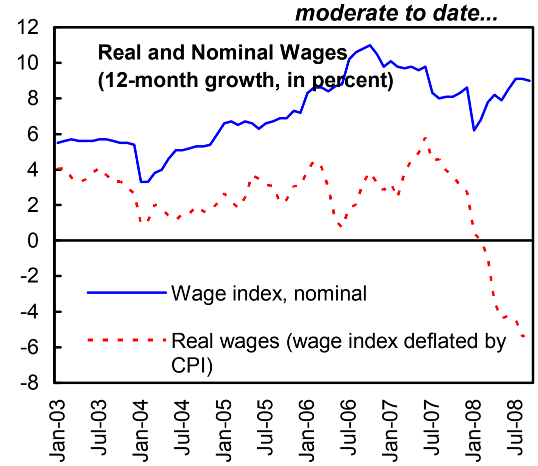




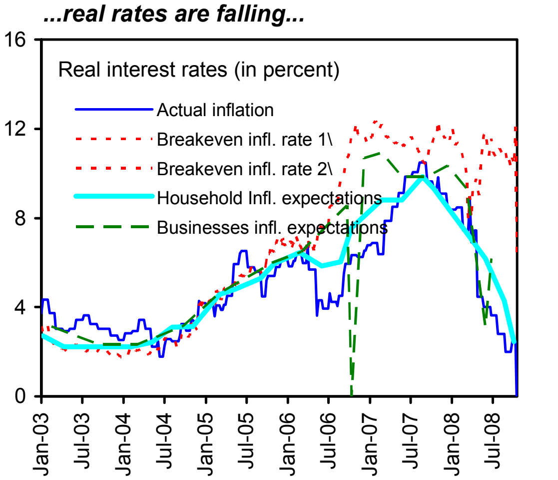
Inflationary expectations are unhinged.



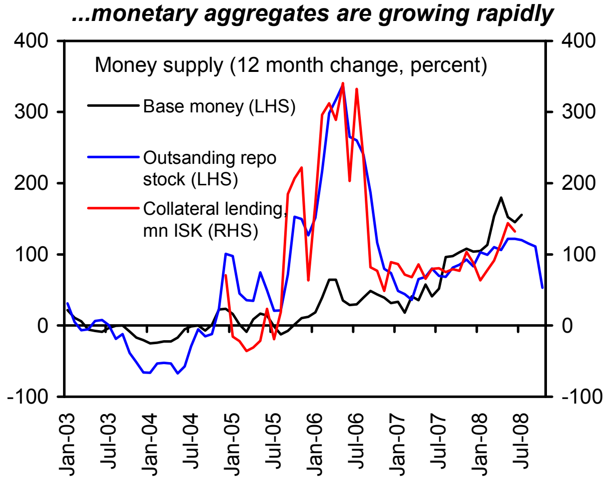
Although wage growth has been moderate to date...



...real rates are falling...

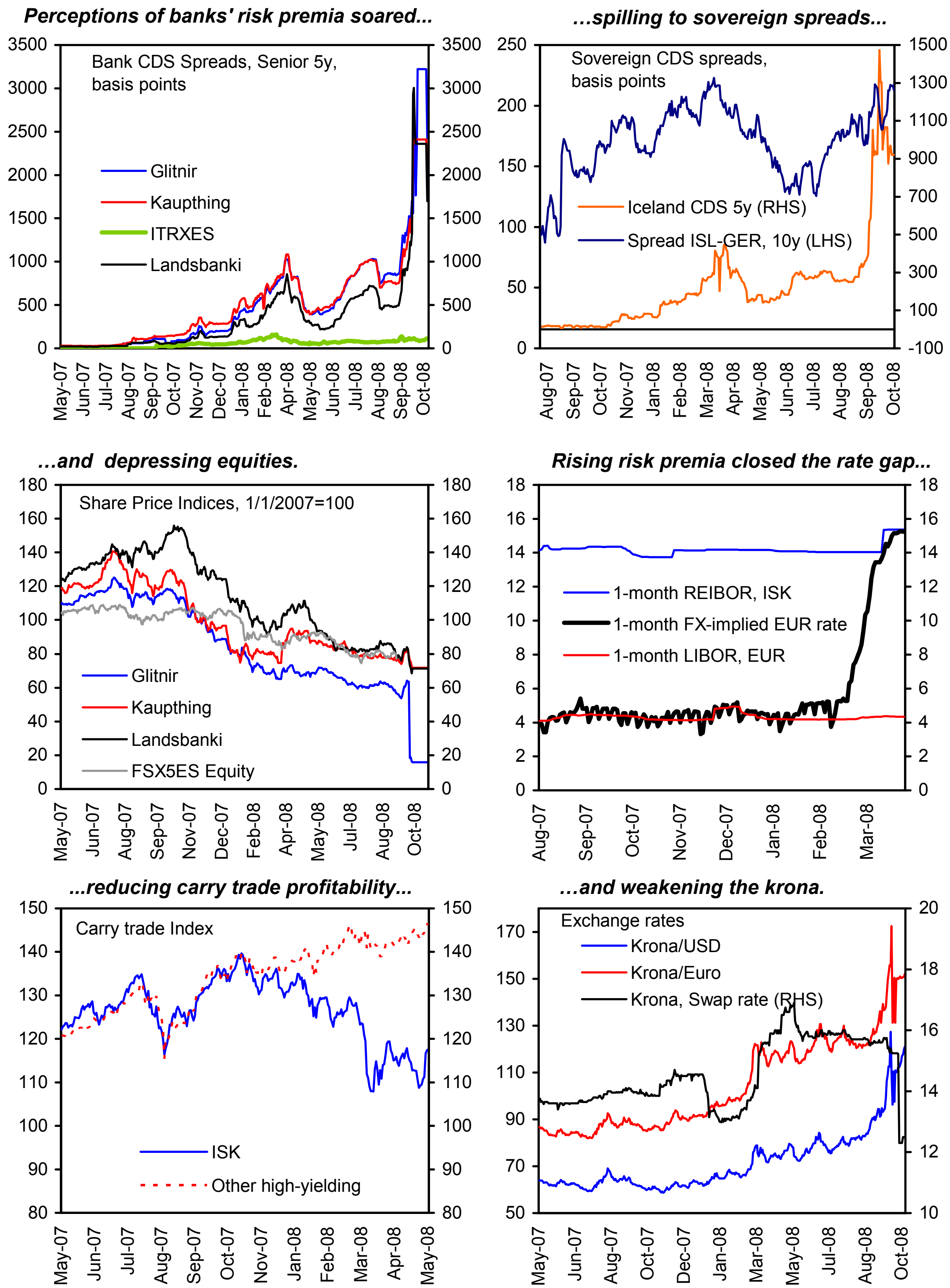


...monetary aggregates are growing rapidly



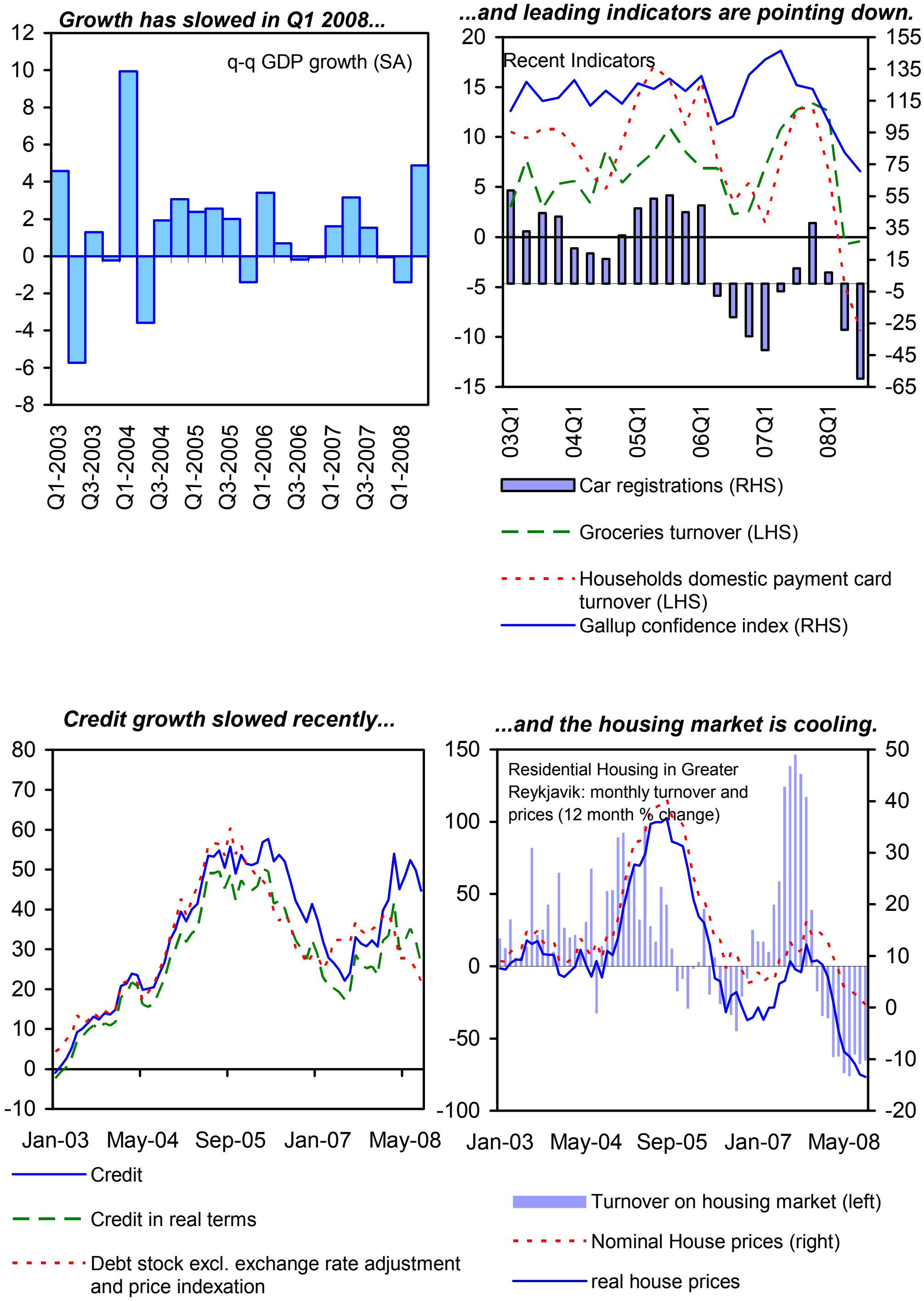
Source: Central Bank of Iceland

Figure 3. Iceland: Hard Hit by the Financial Turbulence



Source: Bloomberg, Datastream

Figure 4. Iceland: The Overheated Economy is Quickly Slowing



PROPOSED DECISIONS

The following decision, which may be adopted by a majority of the votes cast, is proposed for adoption by the Executive Board:

1. Iceland has requested a Stand-By Arrangement in an amount equivalent to SDR 1.4 billion for a period of twenty-four months from November 19, 2008.

2. The Fund approves the Stand-By Arrangement for Iceland set forth in EBS/08/124 and decides that purchases may be made under the arrangement on the condition that the information provided by Iceland on the implementation of the measures specified as prior actions in Table 2 of the Technical Memorandum of Understanding attached to the letter from the Chairman of the Central Bank of Iceland and the Minister of Finance, dated November 15, 2008, is accurate.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

The following decision, which may be adopted by a majority of the votes cast, is proposed for adoption by the Executive Board.

Iceland maintains an exchange restriction due to the rationing of foreign exchange in respect of certain imports, subject to Fund approval under Article VIII, section 2(a). In the circumstances of Iceland, the Fund grants approval for the retention of the exchange restriction until November 18, 2009.

ICELAND —STAND-BY ARRANGEMENT

Attached hereto is a letter from the Chairman of the Central Bank of Iceland (CBI) and the Minister of Finance dated November 15, 2008 (the "Letter"), with an attached Technical Memorandum of Understanding (the "TMU") requesting a Stand-By Arrangement from the International Monetary Fund and setting forth:

(a) the objectives and policies that the authorities of Iceland intend to pursue for the period of this Stand-By Arrangement;

(b) the policies and measures that the authorities of Iceland intend to pursue during the first half-year of this Stand-By Arrangement; and

(c) understandings of Iceland with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Iceland will pursue for the remaining period of this Stand-By Arrangement.

To support these objectives and policies, the International Monetary Fund grants this Stand-By Arrangement in accordance with the following provisions:

1. For a period of 24 months from November 19, 2008, Iceland will have the right to make purchases from the Fund in an amount equivalent to SDR 1.4 billion, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. (a) Purchases under this Stand-By Arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 560 million until February 25, 2009, the equivalent of SDR 665 million until May 25, 2009, the equivalent of SDR 770 million until August 25, 2009, the equivalent of SDR 875 million until November 25, 2009, the equivalent of SDR 980 million until February 25, 2010, the equivalent of SDR 1085 million until May 25, 2010, the equivalent of SDR 1190 million until August 25, 2010, and the equivalent of SDR 1295 million until October 25, 2010.

(b) None of the limits in (a) above shall apply to a purchase under this Stand-By Arrangement that would not increase the Fund's holdings of Iceland's currency subject to repurchase beyond 25 percent of quota.

3. Iceland will not make purchases under this Stand-By Arrangement that would increase the Fund's holdings of Iceland's currency subject to repurchase beyond 25 percent of quota:

(a) during any period in which the data at the end of the preceding period indicate that:

(i) the floor on the change in net financial balance of the central government, or

(ii) the ceiling on the change in net credit of the CBI to the private sector, or

(iii) the ceiling on the change in the domestic claims of the CBI to the public sector, or

(iv) the floor on the change in net international reserves of the CBI, or

(v) the ceiling on the level of contracting or guaranteeing of new medium and long term external debt by the central government,

as specified in the TMU including Table 1, is not observed; or

(b) if Iceland does not carry out its intentions with respect to the following structural performance criteria:

(i) by February 28, 2009, a capital injection into the three new banks, set out in Table 2 of the TMU and paragraph 7 of the Letter, or

(ii) by March 31, 2009, an assessment by an experienced banking supervisor, set out in Table 2 of the TMU and paragraph 10 of the Letter; or

(c) if, at any time during the period of the Stand-By Arrangement,

(i) the ceiling on the stock of short-term external debt of the central government, as specified in the TMU including Table 1, or

(ii) the ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by the central government from multilateral or bilateral official creditors, as specified in the TMU including Table 1,

is not observed; or

(d) after February 24, 2009, May 24, 2009, August 24, 2009, November 24, 2009, February 24, 2010, May 24, 2010, August 24, 2010 and October 24, 2010, until the reviews contemplated in paragraph 24 of the Letter have been completed; or

(e) unless a financing assurances review is completed, while there are outstanding non-sovereign external payments arrears by virtue of Iceland's imposition of exchange controls; or

(f) if, at any time during the period of the Stand-By Arrangement, Iceland

(i) imposes or intensifies restrictions on the making of payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements that are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Iceland is prevented from purchasing under this Stand-By Arrangement because of this paragraph 3, purchases will be resumed only after consultation has taken place between the Fund and Iceland and understandings have been reached regarding the circumstances in which such purchases can be resumed.

4. Iceland will not make purchases under this Stand-By Arrangement during any period in which Iceland: (i) has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation (a) in respect of a noncomplying purchase pursuant to Decision No. 7842-(84/165) on the Guidelines on Corrective Action, or (b) in respect of a purchase in support of debt and debt service reduction operations pursuant to Decision No. 9331-(89/167), or (c) pursuant to paragraphs 17 and 31 of Decision No. 8955-(88/126), as amended, on the Compensatory Financing Facility, or (d) in respect of a purchase under Decision No. 11627-(97/123) SRF on the Supplemental Reserve Facility and Contingent Credit Lines, or (e) pursuant to paragraph 1(b) of Decision No. 5703-(78/39) or paragraph 10(a) of Decision No. 4377-(74/114); or (ii) is failing to meet a repayment obligation to the PRGF-ESF Trust established by Decision No. 8759-(87/176) PRGF, or a repayment expectation to that Trust pursuant to the provisions of Appendix I to the PRGF-ESF Trust Instrument.

5. Iceland's right to engage in the transactions covered by this Stand-By Arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Iceland. When

notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Iceland and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this Stand-By arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, unless, at the request of Iceland, the Fund agrees to provide SDRs at the time of the purchase.

7. Iceland shall pay a charge for this Stand-By Arrangement in accordance with the decisions of the Fund.

8. (a) Iceland shall repurchase the amount of its currency that results from a purchase under this Stand-By Arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchases, as Iceland's balance of payments and reserve position improves.

(b) Any reductions in Iceland's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

9. During the period of the Stand-By Arrangement, Iceland shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Iceland or of representatives of Iceland to the Fund. Iceland shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Iceland in achieving the objectives and policies set forth in the Letter and the Memorandum.

10. In accordance with paragraph 25 of the Letter, Iceland will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the government or whenever the Managing Director requests consultation because any of the criteria in paragraph 3 above have not been observed or because the Managing Director considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Iceland has outstanding purchases in the upper credit tranches, the government will consult with the Fund from time to time, at the initiative of the government or at the request of the Managing Director, concerning Iceland's balance of payments policies.

ATTACHMENT I. LETTER OF INTENT

Reykjavík, November 15, 2008

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

Dear Mr. Strauss-Kahn:

1. **In the wake of the recent international financial turmoil, Iceland's economy is facing a banking crisis of extraordinary proportions**. Triggered by a loss of confidence and fuelled by the financial sector's high leverage and dependence on foreign financing, the crisis led to the collapse of Iceland's three main banks, accounting for around 85 percent of the banking system. This precipitated an abrupt adjustment in key asset prices, while the onshore foreign exchange market dried up, and external payment systems have been severely disrupted. The economy is heading for a deep recession, a sharp rise in the fiscal deficit, and a dramatic surge in public sector debt—by about 80 percent of GDP—reflecting an unprecedented high fiscal cost of restructuring the banking system.

2. **While the economy is flexible, adjustment to this significant shock could be sharp and costly**. The Icelandic economy has a history of quickly adjusting to shocks, mainly through large and swift import compression and strong improvements in the current account. Still, given that confidence has been severely shaken, potentially substantial capital outflows could lead to a further large loss in the value of the króna. In the context of the high leverage in the economy, this would produce massive balance sheet effects and a substantial contraction in domestic activity. The immediate challenges facing us are, therefore, to restore a functioning and viable banking system, and to stabilize the króna. Looking further ahead, the challenge will be to reduce a very high level of public debt, by embarking on a process of sustained fiscal consolidation.

Banking sector restructuring and insolvency framework reform

3. **We have embarked on a comprehensive strategy to address the crisis in the banking sector that has been escalated by the global credit crunch**. As an emergency measure the Parliament of Iceland on October 6, 2008 passed a law that gave the Iceland Financial Supervisory Authority (FME) far-reaching powers, which it used to intervene in three of the larger banks. These banks also had a number of branches and subsidiaries, mainly in several European countries.

4. **The strategy for intervening the banks was driven by the need to secure continued domestic operations and downsize the banking sector to a level consistent with the size of the economy**. To achieve this objective each of the three banks was split into a new bank and an old bank. The new banks included the domestic operations funded by local depositors. The old banks included activities in foreign branches and subsidiaries, mainly funded through the issuance of bonds and foreign deposits. Derivatives were left in the old banks. In each of the three banks, the FME replaced the board with a resolution committee and named a team of professional auditors from three of the major international auditing firms to be in charge of a preliminary assessment about asset quality. In this regard, appropriate loan provisions were made in the new banks, bringing loan values in line with expected market values.

5. **We have decided on the organizational structure to resolve intervened banks and to transparently maximize asset recovery**. Our strategy has developed in recent days. A well-reputed expert in banking was appointed to be in charge of managing the bank restructuring process. The expert reports to the Prime Minister and has the overall responsibility of developing, implementing and communicating a comprehensive strategy for bank restructuring. A committee comprising representatives from the Prime Minister's Office, the Financial Supervisory Authority, the Central Bank of Iceland, the Ministry of Finance, and the Ministry of Commerce has been established to coordinate policy input and will be chaired by the expert.

6. **The next step in the restructuring process will be a second valuation of both the new and the old banks to ensure that creditor recovery is not affected by the split.** A well-reputed international auditing firm will be hired to oversee the process and to assist the FME in developing a methodology in accordance with international best practice on which the valuations will be based. The methodology will be finalized by November 15, 2008 after which separately hired international auditing firms will conduct the valuations, to be completed by end-January, 2009. The auditing firm overseeing the process will confirm by February 15, 2009 that the valuations have been conducted according to the prescribed methodology and make a final decision on the valuation. The valuation process will also include an assessment of whether or not managers and major shareholders have mismanaged or abused the banks.

7. **After the completion of the second valuation we will recapitalize the three new banks up to a capital adequacy ratio of at least 10 percent**. The total amount of capital to be injected has been estimated at 385 billion ISK. The injection, which will be made using tradable government bonds issued on market terms, will be completed by end-February 2009. Consistent with standard procedures in licensing new banks and to monitor their operational soundness, the FME will review the business plans of each new bank. These five-year business plans will describe banking services, capitalization, staffing, profitability, and branch network. We plan to sell the government's holdings of bank equity—as and when the situation stabilizes and market conditions permit.

8. **The government is determined to ensure that asset recovery is maximized.** To that end, the plan is to put the old banks into Moratorium under the Insolvency Act and the Act on Financial Undertakings, under which the resolution committees will continue to work on maximizing the value of the assets under the supervision of a court-appointed administrator. To ensure asset recoveries are maximized, we will hire an advisor, who will assist us in developing by end-November 2008 a strategy for asset recoveries.

9. **We are committed to progressing a sound and transparent process as regards depositors and creditors in the intervened banks.** We will be working constructively towards comparable agreements with all international counterparts for the Iceland deposit insurance scheme in line with the EEA legal framework. Under its deposit insurance system Iceland is committed to recognize the obligations to all insured depositors. We do so under the understanding that prefinancing for these claims is available by respective foreign governments and that we as well as these governments are committed to discussions within the coming days with a view to reaching agreement on the precise terms for this prefinancing. Furthermore, we recognize that the payment by the new banks of the fair value for the assets transferred from the old banks is a key factor in the fair treatment of depositors and creditors in the intervened banks. Accordingly, we have instituted a transparent process involving two sets of independent auditors to establish the fair value of the assets. More generally, we will ensure the fair, equitable and non-discriminatory treatment of depositors and creditors in line with applicable law.

10. **Going forward, we will review the bank regulatory framework and supervisory practice to strengthen the safeguards against potential new crises**. We will invite an experienced bank supervisor to assess the regulatory framework and supervisory practices and to propose needed changes. In particular, the expert will assess the framework of rules on liquidity management, connected lending, large exposures, cross-ownership, and the "fit and proper" status of owners and managers. Previous senior managers and major shareholders in intervened banks who are found to have mismanaged the banks should not assume similar roles for at least three years. The assessment, which will be made public, should be completed by end-March 2009. We will discuss in advance with IMF staff any changes to the adopted strategy.

11. **We need to address the insolvency framework to manage deleveraging and recovery in the banking, corporate and household sectors**. A special bank insolvency law (distinct from the general insolvency law) is needed to resolve the uncertainty over the legal status of intervened banks and to provide a coherent framework for the supervisory and debt-resolution aspects of bank insolvencies. The corporate insolvency regime, which has been relatively effective in normal times, should be refined to facilitate out-of-court workouts between creditors and viable firms. In particular, provisions to include secured creditors in agreed restructuring plans and to facilitate new financing during a firm's rehabilitation are critical.

Fiscal policy

12. **The resolution of the banking crisis will result in a huge burden being placed on the public sector**. Preliminary estimates suggest that the *gross* cost to the budget of honoring deposit insurance obligations and of recapitalizing both commercial banks and the Central Bank of Iceland could amount to around 80 percent of GDP. The *net* cost will be somewhat lower on the assumption that money can be recovered by selling assets from the old banks. To this cost should be added the surge in the overall deficit of the general government to 13.5 percent of GDP that is expected in 2009 because of the recession that is likely to follow in the wake of the banking crisis. Overall, gross government debt could rise from 29 percent of GDP at end-2007 to 109 percent of GDP by end-2009. Thus, the banking crisis will significantly constrain the public sector and burden the public for years to come.

13. **We plan to let the automatic fiscal stabilizers operate in full in 2009**. In order not to exacerbate the recession, our intention is to allow the fiscal deficit to widen to the extent that this is driven by higher expenditures and lower revenues due to the effects of the economic cycle. But given the high financing need and the dramatic increase in public sector debt, we plan to significantly scale back a planned discretionary fiscal relaxation in 2009, keeping it to a minimum. Should revenues exceed expectations, we intend to save any windfall and lower the deficit accordingly. Pressures on financial markets resulting from the sharp rise in the government's financing need are expected to be limited by increased purchases of government securities by the pension funds. The operations of the central government will be subject to a quarterly ceiling on net borrowing, and agreement on the 2009 budget will be a key condition for the completion of the first review of the Stand-By Arrangement.

14. **We plan to embark on an ambitious medium-term fiscal consolidation program.** Such a plan will start to be implemented with the 2010 budget. Our intention is to take measures that will reduce the structural primary deficit by 2–3 percent annually over the medium-term, with the aim of achieving a small structural primary surplus by 2011 and a structural primary surplus of 3½–4 percent of GDP by 2012. We will begin soon the development and consensus-building process around this plan, with the aim of identifying the broad areas of focus before the end of 2008 and having a fully calibrated plan ready by mid-2009. Progress in this regard will be a key condition for completion of each of the quarterly reviews under the Stand-By Arrangement during this period. Icelandic society has a strong track record in responsible fiscal management as evidenced by the very low level of public debt at the outset of this crisis. This policy has been supported by broad social consensus. A significant reduction in government debt through the sale of the government's stake in the new banks could help reduce the needed fiscal adjustment over the medium term.

15. **To underpin confidence in debt sustainability, we will also strengthen our fiscal framework**. For the first time this year, a four-year medium term framework was sent to parliament at the same time as the budget. Moreover, we will undertake a debt sustainability

analysis and develop a debt strategy. Nonetheless, we realize that more needs to be done to improve the current framework. Therefore, we will conduct a thorough analysis of our fiscal framework and make recommendations, including on how local government finances can be better aligned with the governments' overall fiscal plans. The findings of this analysis will be discussed during the first program review, and progress in improving the fiscal and expenditure frameworks will be a condition for completion of each of the quarterly reviews under the program.

16. **The public sector will not take on additional obligations with regard to the banking crisis.** Unfortunately, the pension funds, domestic money market funds, and various foreign creditors, among others, are set to incur significant losses as a result of the collapse of the private commercial banks. Given the already high debt level, it will be critical not to burden the public sector balance sheet by further socializing such losses.

Monetary and exchange rate policy

17. **The immediate challenge facing the Central Bank of Iceland at this time is to stabilize the króna and set the stage for a gradual appreciation.** During the run-up to the banking crisis, the króna depreciated precipitously, culminating, when the banks collapsed, in the shut-down of the on-shore foreign exchange market and a further sharp depreciation in the off-shore market. The depreciation and the attendant surge in inflation have severely strained household and corporate balance sheets because of the high share of foreign-currency denominated and inflation-indexed debt. To prevent a wave of defaults from exacerbating what already is set to be a severe recession, we believe that it is a matter of urgency for the Central Bank of Iceland to stabilize the króna.

18. **We are particularly concerned about the near-term risk of pressure on the króna when the normal functioning of the foreign exchange market is restored.** While we believe the króna to be significantly undervalued, the collapse of the three banks has shaken confidence in the currency and the risk of substantial capital outflows in the short term is considerable. Concerns in this regard are heightened by uncertainty about the liquidity of the newly restructured banking system. This suggests that we need extraordinary measures to deal with short-term risks. The next paragraph describes these measures; the subsequent paragraph is devoted to monetary policy once a return of confidence will allow us again to use traditional monetary policy instruments.

19. **In the very short-run, we intend to adopt the following pragmatic mix of conventional and unconventional measures to stem capital outflow**:

- **To raise the policy interest rate to 18 percent.** We stand ready to increase it further, but we are aware that higher interest rates alone may not suffice to stem capital outflow in the current exceptional circumstances.

- **To maintain tight control over banks' access to Central Bank credits.** We are tightening liquidity management, in particular, by adjusting the structure of our liquidity facilities, so that the Central Bank can manage more proactively the volume of reserve money; and we have raised the spread of the standing facility rate to avoid excessive liquidity being drawn down through this route. We have narrowed the range of instruments accepted by the Central Bank as collateral—newly-issued uncovered bank bonds will no longer be acceptable. If necessary, we are ready to adjust the operational framework for reserve money management further, such as by changing parameters for reserve averaging and collateral requirements. Initially, we will allow little if any increase in the volume of central bank credit.

- **To stand ready to use foreign reserves to prevent excessive króna volatility.** While we do not have an exchange rate target and are prepared to let the rate move to equilibrate supply and demand, we are conscious that excessive short-run volatility would be undesirable and so are ready to draw on our reserves, to support the market if needed. Our ability to do so has been helped by the augmentation of our reserves, as discussed below.

- **To temporarily maintain restrictions on capital account transactions.** We realize that such restrictions have considerable adverse implications and intend to remove them as soon as possible. But their interim use is necessary until we have ensured that our monetary policy instruments are correctly calibrated to deal with the extreme uncertainty and lack of confidence that followed the banking sector collapse.

20. **We expect confidence to return soon, paving the way for a reduction in interest rates.** This process of normalization can start as soon as the króna stabilizes in the foreign exchange market, all demand for foreign exchange in respect of current account transactions is having unrestricted access to the foreign exchange market, and we no longer need to support the market by drawing on our reserves. With the current account rapidly swinging into a surplus, the króna significantly undervalued, the bank resolution scheme not giving rise to net outflow of foreign exchange in the coming year, and—above all—the policy undertakings and the support from the international community described in this letter, we expect to reach this point soon. This will allow us to begin to ease control over Central Bank's credit volume and increasingly rely on the policy interest rate as the primary monetary policy instrument, in the context of a flexible exchange rate policy. In this regard, we expect to see an early strengthening of the króna and a fast reduction in inflation year-on-year of 4½ percent at end-2009, with additional strengthening of the króna and further disinflation in 2010.

21. **The calibration of monetary policy is hampered by unusual uncertainty about monetary conditions.** Considering the uncertainties about the restructuring of the banking system, overall liquidity conditions, and the stability of monetary parameters, we intend to review comprehensive end-October monetary data with Fund staff as soon as data become

available, and will present a modification of the monetary program to the Executive Board if required. Our program contains a quarterly ceiling for net domestic assets and a quarterly floor for net international reserves of the Central Bank of Iceland.

22. **The exchange controls, temporarily imposed on October 10 in response to the sharp deterioration in the króna and pressures on reserves, will be removed during the program period**. These controls include exchange restrictions on certain current international transactions, which have contributed to private external payment arrears. Implementation of the key program objective of strengthening the current account position to allow bolstering reserves and reestablishing free international payments through the banking system would support removal of the exchange restrictions and clearance of these private external payment arrears. In the meantime, we request temporary Fund approval of the exchange restrictions in line with Fund policy, on the basis that they have been imposed for balance of payments reasons and are non-discriminatory. Furthermore, we commit not to impose or intensify restrictions on the making of payments and transfers for current international transactions nor to introduce multiple currency practices. This is a continous performance criteria under the program.

Incomes policy

23. **It will be important to have a national consensus consistent with the objectives of the macroeconomic program**. Historically, income policy in Iceland has been very effective, with past agreements supporting the economic adjustment when difficult circumstances demanded it. Social partners recognize the need to enter an agreement that is commensurate with the severity of the situation.

External financing

24. **The collapse of the banking system has left us with considerable external financing needs**. We estimate this need to be about $24 billion during the period from now and until the end of 2010. Of this, about $19 billion are composed by arrears on obligations of the three intervened private banks as well as financing earmarked for payments in relation to foreign deposits, leaving a cash financing need of $5 billion. We expect purchases from the IMF to amount to about $2 billion, leaving a residual need of $3 billion. We expect to cover this through assistance from bilateral creditors, and to obtain concrete commitments in this regard before IMF Board consideration of our program. Progress in covering our financing need will be assessed during the quarterly program reviews.

Fund arrangement

25. **Given our extraordinary financing needs, we request a Stand-By Arrangement for the period of November 2008 to November 2010** in the amount of SDR 1.4 billion, equivalent to 1190 percent of our quota**.** The program will be supported on the basis of policies and specific targets described in this letter. We believe that the policies set forth in

this Letter are adequate to achieve the objectives of its program, in particular underpinning renewed confidence in the Iceland economy. However, we will take any further measures that may become appropriate for this purpose. Iceland will consult with the IMF on the adoption of these measures, and in advance of revisions to the policies contained in this Letter, in accordance with the IMF's policies on such consultation. We will maintain a close and proactive dialogue with the Fund, in accordance with Fund policies on such matters.

26. **We recognize the importance of completing a first-time safeguards assessment of the CBI by the first review of the SBA**. In this regard, the Central Bank will receive a safeguards mission from the Fund and provide the information required to complete the assessment by the first review.

27. We authorize the IMF to publish the Letter of Intent and its attachments, and the related staff report.

Sincerely yours,

Davíd Oddsson /s/	Árni M. Mathiesen /s/
Chairman of the Central Bank	Minister of Finance

Table 1. Iceland Quantitative Performance Criteria Under the 2008 Economic Program

	Performance Criteria	Indicative Targets	
	December-2008 Ceiling/ Floor 1/	March-2009 Ceiling/Floor 2/	June 2009 Ceiling/Floor 3/
(In billions of króna)			
1. Floor on the change in the central government net financial balance.4/	-12	-55	-55
2. Ceiling on the change in net credit of the Central Bank of Iceland to the private sector. 5/	25	50	50
3. Ceiling on the change in the domestic claims of the Central Bank of Iceland to the central government	25	25	25
(In millions of US dollars)			
4. Floor on the change in net international reserves of the Central Bank of Iceland 6/	-500	-500	-500
5. Ceiling on the level of contracting or guaranteeing of new medium and long term external debt by central government 7/	4000	4075	4150
6. Ceiling on the stock of central government short-term external debt 7/ 8/	650	650	650
7. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors.8/ 9/	0	0	0

1/ Quantitative performance criteria from October 22, 2008 to December 31, 2008 (unless otherwise indicated).
2/ Indicative targets from January 1, 2009 to March 31, 2009.
3/ Indicative targets from April 1, 2009 to June 30, 2009.
4/ From October 1 to December 31. At end-September, the central government net financial balance was króna 4.28 billion. After contributions to the government employees pension fund. 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.
5/ On October 21, net credit of the central bank to the private sector was króna 438 billion.
6/ (-) indicates decrease. On October 21 net international reserves stood at - $ 0.425 billion. NIR is 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).
7/ Cumulative from October 1 contracting medium and long-term external borrowing. Excludes IMF and excludes official bilateral loans for deposit insurance. On September 30, medium and long term external debt of the central government was $ 2,678 million and short term external debt was $ 619.8 million. 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.
8/ Applies on a continuous basis.
9/ On October 20 the central government had no arrears to multilateral and official bilateral creditors.

Table 2. Iceland Structural Conditionality Under the 2008 Economic Program

Prior Actions

- Raise the policy interest rate to 18 percent.
- Establish a committee comprising representatives from the Prime Minister's Office, the Financial Supervisory Authority, the Central Bank of Iceland, the Ministry of Finance and the Ministry of commerce to coordinate policy input and will be chaired by the expert in charge of the bank restructuring process.

Structural Performance Criteria

- A capital injection into the three new banks, made using tradable government bonds issued on market terms, to raise the capital adequacy ratio to at least 10 percent. *By end-February 2009*.
- An experienced banking supervisor to provide an assessment (to be published) of the regulatory framework and supervisory practice, including the framework of rules on liquidity management, connected lending, large exposures, cross-ownership, and the "fit and proper" status of owners and managers, and propose needed changes. *By end-March 2009.*

Structural Benchmarks

- Develop a strategy for asset recoveries. *By end-November 2008.*
- FME to review the business plans of each of the new banks. *By January 15, 2009.*
- International Auditing Firm to conduct valuations of the old and new banks using a methodology in accordance with international best practice. *Complete by end-January 2009.*
- Prepare plans to embark on medium-term fiscal consolidation. *By end-2008*. Improve the medium-term fiscal framework. *By end-June 2009*.

ATTACHMENT II. ICELAND: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

November 15, 2008

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 dollar 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.

Quantitative Performance Criteria, Indicative Targets, and Continuous Performance

Criteria: Definitions and Reporting Standards

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

5. 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 employees 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) consists of financing by the banking system (the central bank of Iceland and commercial banks) and non-bank financial institutions to the central government. NDF consists of treasury bills, government bonds, promissory notes and other domestic debt instruments issued by the government, and loans and advances net of government deposits with the central bank of Iceland and commercial banks. NDF is calculated as the sum of (i) financing to the government by the central bank of Iceland, including any interest arrears, minus the change in all central government deposits with the central bank of Iceland, from the balance sheet of the central bank of Iceland; (ii) loans and advances to the central government by the commercial banks, including any interest arrears, minus the change in all government deposits held with the banks, from the balance sheet of the commercial banks; (iii) the changes in the outstanding stock of treasury bills, government bonds, promissory notes and other domestic debt instruments issued by the government, including any interest arrears.

Net external financing is defined as the total of financing disbursed to the central government, net change in external arrears, minus amortization. Amortization includes all external debt-related payments of principal by the central government.

For the purposes of the program, the net financial balance will exclude any debt issuance for the purposes of bank restructuring, central bank recapitalization, and exclude debt accumulation for honoring obligations to depositors in foreign branches of Icelandic banks.

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 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. This will include data on redemptions of foreign central government liabilities and data on the foreign exchange cash balances of the MOF at the Central Bank of Iceland and in commercial banks.

- Data will be provided at the actual exchange rates.

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

6. **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 foreign exchange liabilities to residents and nonresidents, including commitments to sell foreign exchange arising from derivatives, and all credit outstanding from the Fund. Foreign currency deposits and other liabilities of financial institutions and the general government at the CBI will be included in gross foreign liabilities.

- **For program monitoring purposes**, the stock of foreign assets and foreign liabilities of the Central Bank of Iceland shall be valued at program exchange rates as described on paragraph 2 above. The stock of NIR amounted to - $ 425 million as of October 21, 2008 (at the program exchange rate).

7. **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 Central Bank of Iceland's foreign exchange 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 Credit of the Central Bank of Iceland to the Private Sector

8. **Definition:** Net credit of the central bank to the private sector is defined as the difference between CBI lending to private banks through its overnight and weekly collateral facilities and any other instruments to which the CBI would extend credit to the private sector, and current account balances of the banks at the CBI and central bank CDs in issuance. Performance against the net credit will be measured at program exchange rates.

9. **Supporting material**: The CBI will provide to the IMF with data on central bank lending to private banks 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.

D. Ceiling on Net Credit of the Central Bank of Iceland to the Central Government

10. **Definition**. Net credit of the Central Bank of Iceland to the public sector is defined as the difference between CBI lending to the central government and central government deposits at the CBI in domestic currency.

11. **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.

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

12. **Definition:** This performance criterion applies not only to debt as defined in point No. 9 of the IMF's Guidelines on Performance Criteria with Respect to External Debt (Decision No. 12274-(00/85) August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received.[1] Previously contracted debt that has been rescheduled will be excluded from the definition of "new debt" for the purposes of this performance criterion. The performance criterion covers public and publicly guaranteed external debt with an original maturity of more than one year. 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. Debt falling within the limit shall be valued in US dollars at the time the contract or guarantee becomes effective.

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

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

14. **Definition:** The limit on short-term external debt applies on a continuous basis to the stock of short-term external debt owed or guaranteed by the central government of Iceland,

[1] Point No. 9 of the IMF's guidelines reads as follows: "(a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, 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 and take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to 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); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., 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 Guideline, 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. (b) Under the definition of debt set out in point 9a above, 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."

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). Debt falling within the limit shall be valued in US dollars at the time the contract or guarantee becomes effective.

15. **Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors.** This performance criterion applies on a continuous basis. External payment arrears consist of external debt service obligations (principal and interest) falling due after October 20, 2008 and that have not been paid at the time due, taking into account the grace periods specified in contractual agreements.

Table 1. Iceland Quantitative Performance Criteria Under the 2008 Economic Program

	Performance Criteria	Indicative Targets	
	December-2008 Ceiling/ Floor 1/	March-2009 Ceiling/Floor 2/	June 2009 Ceiling/Floor 3/
(In billions of Krona)			
1. Floor on the change in the central government net financial balance.4/	-12	-55	-55
2. Ceiling on the change in net credit of the Central Bank of Iceland to the private sector. 5/	25	50	50
3. Ceiling on the change in the domestic claims of the Central Bank of Iceland to the central government	25	25	25
(In millions of US dollars)			
4. Floor on the change in net international reserves of the Central Bank of Iceland 6/	-500	-500	-500
5. Ceiling on the level of contracting or guaranteeing of new medium and long term external debt by central government 7/	4000	4075	4150
6. Ceiling on the stock of central government short-term external debt 7/ 8/	650	650	650
7. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors.8/ 9/	0	0	0

1/ Quantitative performance criteria from October 22, 2008 to December 31, 2008 (unless otherwise indicated).
2/ Indicative targets from January 1, 2009 to March 31, 2009.
3/ Indicative targets from April 1, 2009 to June 30, 2009.
4/ From October 1 to December 31. At end-September, the central government net financial balance was króna 4.28 billion. After contributions to the government employees pension fund. 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.
5/ On October 21, net credit of the central bank to the private sector was króna 438 billion.
6/ (-) indicates decrease. On October 21 net international reserves stood at - $ 0.425 billion. NIR is 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).
7/ Cumulative from October 1 contracting of medium and long-term external borrowing. Excludes IMF and excludes official bilateral loans for deposit insurance. On September 30, medium and long term external debt of the central government was $ 2,678 million and short term external debt was $ 619.8 million. 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.
8/ Applies on a continuous basis.
9/ On October 20 the central government had no arrears to multilateral and official bilateral creditors.

Table 2. Iceland Structural Conditionality Under the 2008 Economic Program

Prior Actions

- Raise the policy interest rate to 18 percent.
- Establish a committee comprising representatives from the Prime Minister's Office, the Financial Supervisory Authority, the Central Bank of Iceland, the Ministry of Finance and the Ministry of commerce to coordinate policy input and will be chaired by the expert in charge of the bank restructuring process.

Structural Performance Criteria

- A capital injection into the three new banks, made using tradable government bonds issued on market terms, to raise the capital adequacy ratio to at least 10 percent. *By end-February 2009*.
- An experienced banking supervisor to provide an assessment (to be published) of the regulatory framework and supervisory practice, including the framework of rules on liquidity management, connected lending, large exposures, cross-ownership, and the "fit and proper" status of owners and managers, and propose needed changes. *By end March 2009.*

Structural Benchmarks

- Develop a strategy for asset recoveries. *By end November 2008.*
- FME to review the business plans of each of the new banks. *By January 15, 2009.*
- International Auditing Firm to conduct valuations of the old and new banks using a methodology in accordance with international best practice. *Complete by end-January 2009.*
- Prepare plans to embark on medium-term fiscal consolidation. *By end-2008*. Improve the medium-term fiscal framework. *By end-June 2009*.

Table 3. Program Exchange Rates

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

Attachment III. External Debt Sustainability Analysis and Fiscal Sustainability Analysis

1. **Prior to the banking crisis, Iceland's external debt had ballooned, and by end 2007 it had reached 551 percent of GDP.** The external debt of the banking sector had risen at an astronomical pace from around 131 percent of GDP in 2004 to an estimated 464 percent at end 2007. While the banking sector accounted for the bulk of the debt stock (around 85 percent), the nonbank private sector also expanded its external borrowing rapidly. Following the intervention of the three main banks in October debt sustainability has become exceptionally difficult to assess.

2. **After the banking crisis, the external debt increases and remains vulnerable to shocks.** The baseline is predicated on the assumption that external banking sector activity does not resume over the forecast horizon. The main analysis therefore covers *only* the activity of the nonbank private sector and public sector.[1] Based on the baseline scenario which assumes program success, a quick turnaround in the current account, stabilization of the exchange rate, and that borrowers are able to rollover or reduce outstanding debt, the DSA shows debt on a downward path but from very high levels. The key points are:

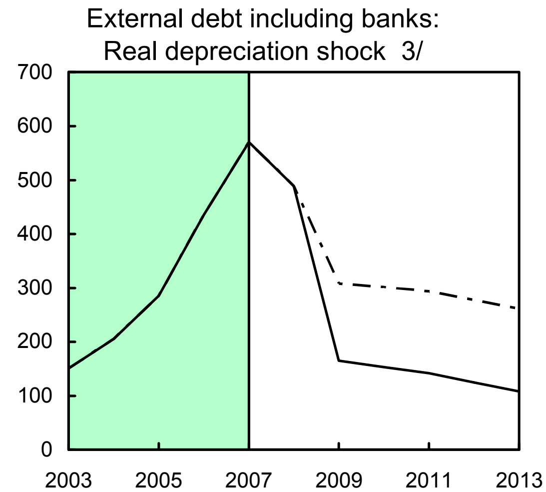
- The external debt ratio is estimated at 160 percent of GDP in 2009 as the public sector takes on loans to finance reimbursement of foreign deposit insurance, and new loans to fill the financing gap. Thereafter some net debt repayments are made and external debt falls back as a percent of GDP.

- While the external debt ratio falls back significantly over the forecast horizon, it remains very high at 101 percent of GDP by 2013.

- Within the total, public sector external debt declines to 49 percent of GDP by 2013 from 100 percent in 2008, as a result of debt repayments and a resumption in GDP growth over the medium term.

External debt remains extremely vulnerable to shocks—most notably the exchange rate. A further depreciation of the exchange rate of 30 percent would cause a further precipitous rise in the debt ratio (to 240 percent of GDP in 2009) and would clearly be unsustainable.

[1] The public sector includes public and publicly guaranteed external debt. It includes IMF and includes amounts of financing that are needed to cover the financing gap over 2008–10. This is wider than the definition of general government used in the fiscal DSA.



3. **An alternative analysis including the banking sector shows a similar picture, but starting from a higher initial point**. Debt starts off at extremely high levels (see chart), given the pre-crisis level of bank's external debt. It then reverts to the same path as that described above, as banks' external arrears initially accumulate and then are eventually resolved. Future banking activity is assumed to be focused on the domestic economy.

4. **External sustainability could turn out to be healthier than presented in the baseline over the medium term, although there are also other potential risks. On the one hand,** asset recoveries could help reduce debt significantly. In addition, Iceland's rich endowment of mineral resources and tourism potential could provide additional foreign exchange earnings that could permit further reductions in external debt over the medium term. On the other hand, there is also a risk that bank creditors seek to attach assets which could lead to the government's asset recoveries being tied up in litigation for a protracted period. That would create uncertainty regarding Iceland's net debt and reduce the prospect of an early return to market access.

5. **At end-2007, Iceland's gross public debt (of general government) reached 28.9 percent of GDP**. Debt had fallen steadily since 2001 from 45.9 percent of GDP to below 30 percent in 2007, thanks to high growth, an appreciating exchange rate, and prudent fiscal policies which resulted in fiscal surpluses. The share of external government debt in total public debt had also fallen from 63 percent in 2001 to 47 percent at end-2007. During 2006 and 2007, a large amount of deposits accumulated at the central bank such that net debt amounted to less than 10 percent of GDP at end-2007.

6. **Under the baseline, the fiscal cost of the banking crisis dramatically changes public indebtedness**. Debt rises to 108.9 percent of GDP in 2008, due to the immediate cost of bank restructuring payments to depositors from foreign branches of Icelandic banks. In 2009, debt would further rise due to the cost of recapitalizing the central bank and the widening fiscal deficit.[2] However, asset recovery is assumed to start in 2009, and its proceeds lower public debt in 2009, such that on balance the debt ratio remains broadly constant as a share of GDP in 2009. Subsequently, fiscal

[2] Please note that the large residual in 2009 reflects the difference between the average and end of period exchange rate.

consolidation, and further asset recovery help achieve a gradual lowering of the debt to 93.6 percent of GDP by end-2013.

7. **Alternative scenarios and stress tests indicate that Iceland's debt indicators remain on a declining path, but that debt is particularly vulnerable to further exchange rate depreciation**. While the historical scenario would indicate much more favorable debt dynamics, reflecting the past economic growth episode with large fiscal surpluses, further shocks would leave the debt-to-GDP ratio at a higher level, even though under all alternative scenarios, the debt-to-GDP ratio remains on a declining path after the shock. Under a 30 percent real exchange rate depreciation shock in 2009, debt-to-GDP would peak at 144.7 percent of GDP in 2009, and decline after that to 133.1 percent of GDP by 2013, hence staying well above the baseline debt-to-GDP level. A growth shock and contingent liability shock would also leave the debt in excess of 100 percent of GDP by end-2013.

Table 1. Iceland: External Debt Sustainability Framework, 2003–13
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt (excludes banking sector)**	57.9	47.7	51.4	80.9	87.7	**165.0**	**159.5**	**147.0**	**135.7**	**118.1**	**101.3**	**-4.1**
2	Change in external debt	-4.4	-10.2	3.7	29.4	6.8	77.4	-5.5	-12.6	-11.3	-17.6	-16.8	
3	Identified external debt-creating flows (4+8+9)	-5.9	11.6	31.3	25.2	44.3	11.0	14.7	-12.9	-15.2	-14.0	-11.0	
4	Current account deficit, excluding interest payments	3.4	8.8	15.1	22.8	11.1	2.4	-12.4	-13.8	-12.3	-10.9	-9.8	
5	Deficit in balance of goods and services	3.0	5.5	12.2	17.7	10.1	-0.1	-10.3	-10.9	-7.7	-6.2	-4.6	
6	Exports	34.3	34.1	31.5	31.9	34.8	50.5	56.0	54.7	53.9	52.9	52.0	
7	Imports	37.2	39.6	43.7	49.5	44.9	50.4	45.7	43.7	46.2	46.7	47.4	
8	Net non-debt creating capital inflows (negative)	0.9	11.8	24.1	1.0	43.9	2.4	-2.0	-10.5	-6.3	-6.4	-4.3	
9	Automatic debt dynamics 1/	-10.2	-8.9	-7.8	1.4	-10.7	6.2	29.1	11.4	3.4	3.2	3.1	
10	Contribution from nominal interest rate	1.3	1.0	1.1	2.6	3.5	7.9	10.6	11.0	9.4	8.5	7.4	
11	Contribution from real GDP growth	-1.2	-3.7	-2.9	-2.2	-3.2	-1.7	18.5	0.4	-6.0	-5.3	-4.3	
12	Contribution from price and exchange rate changes 2/	-10.3	-6.3	-6.0	1.1	-10.9	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	1.4	-21.8	-27.6	4.2	-37.5	66.3	-20.2	0.3	3.9	-3.6	-5.8	
	External debt-to-exports ratio (in percent)	169.0	140.1	163.4	253.8	252.2	326.8	285.0	268.8	251.5	223.2	194.8	
	Gross external financing need (in billions of US dollars) 4/	2.1	2.4	3.6	5.2	4.4	3.8	4.3	4.2	2.2	1.6	1.4	
	in percent of GDP	19.0	18.4	22.2	31.1	21.5	21.5	28.8	27.5	14.0	9.6	7.5	
	Scenario with key variables at their historical averages 5/						**165.0**	**150.3**	**158.0**	**168.1**	**173.5**	**177.1**	**-2.6**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	2.4	7.7	7.4	4.4	4.9	1.6	-9.6	-0.3	4.3	4.2	3.9	
	GDP deflator in US dollars (change in percent)	19.7	12.1	14.5	-2.0	15.6	-14.5	-5.5	0.9	1.8	2.5	2.5	
	Nominal external interest rate (in percent)	2.6	2.1	2.8	5.1	5.2	7.8	5.5	7.0	6.8	6.7	6.7	
	Growth of exports (US dollar terms, in percent)	12.3	20.0	13.7	3.5	32.3	20.6	-11.5	-2.2	4.7	4.8	4.6	
	Growth of imports (US dollar terms, in percent)	27.6	28.3	35.9	16.0	9.8	-6.7	-27.6	-4.2	12.1	8.0	8.0	
	Current account balance, excluding interest payments	-3.4	-8.8	-15.1	-22.8	-11.1	-2.4	12.4	13.8	12.3	10.9	9.8	
	Net non-debt creating capital inflows	-0.9	-11.8	-24.1	-1.0	-43.9	-2.4	2.0	10.5	6.3	6.4	4.3	

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 (based on GDP deflator).

i 3/ For projection, line includes the impact of price and exchange rate changes.

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.

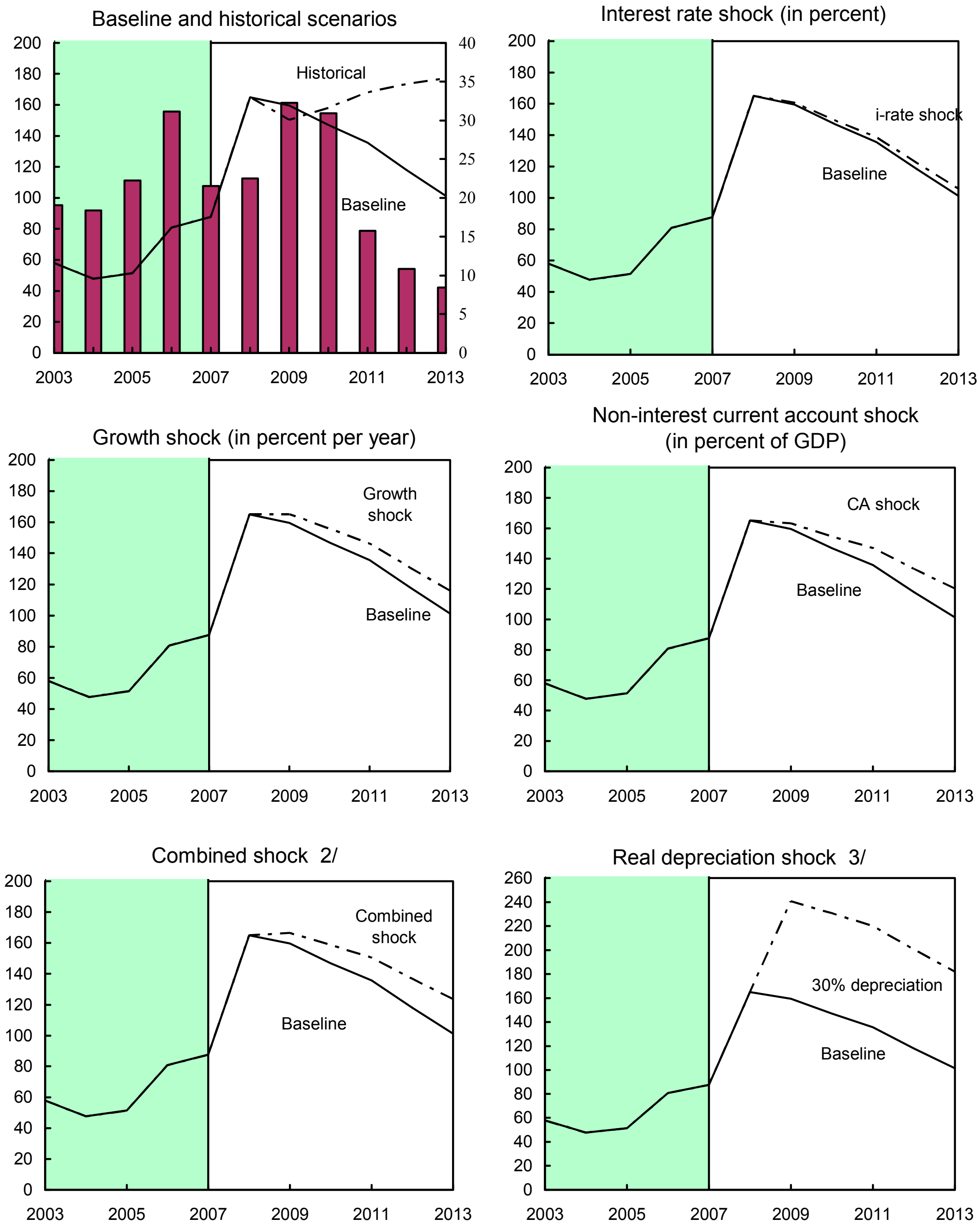
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 2. Iceland: External Sustainability Framework--Gross External Financing Need, 2003–13

	Actual					Projections					
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
I. Baseline Projections											
Gross external financing need in billions of U.S. dollars 1/	2.1	2.4	3.6	5.2	4.4	3.8	4.3	4.2	2.2	1.6	1.4
in percent of GDP	19.0	18.4	22.2	31.1	21.5	22.5	32.3	30.9	15.8	10.8	8.4
II. Stress Tests											
Gross external financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2008-2013 3/						3.9	8.5	10.6	8.7	8.8	9.6
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						3.9	4.9	4.9	2.8	2.1	1.8
B2. Real GDP growth is at baseline minus one-half standard deviations						3.9	4.8	4.9	2.8	2.1	1.9
B3. Non-interest current account is at baseline minus one-half standard deviations						3.9	5.3	5.5	3.5	2.9	2.7
B4. Combination of B1-B3 using 1/4 standard deviation shocks						3.9	5.2	5.4	3.3	2.7	2.5
B5. One time 30 percent real depreciation in 2009						3.9	5.4	5.8	3.6	3.0	2.8
Gross external financing need in percent of GDP 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2008-2013 3/						21.9	43.4	49.0	36.2	32.8	32.4
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						21.9	32.5	32.4	17.2	12.3	9.8
B2. Real GDP growth is at baseline minus one-half standard deviations						21.9	32.3	33.4	17.9	13.0	10.8
B3. Non-interest current account is at baseline minus one-half standard deviations						21.9	35.4	36.6	21.5	16.9	15.0
B4. Combination of B1-B4 using 1/4 standard deviation shocks						21.9	34.8	36.5	20.9	16.2	14.2
B5. One time 30 percent real depreciation in 2009						21.9	52.2	55.7	32.7	25.3	22.1

1/ Defined as non-interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.
2/ Gross external financing under the stress-test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.
3/ 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.
4/ The implied change in other key variables under this scenario is discussed in the text.

Figure 1. Iceland: External Debt Sustainability: Bound Tests 1/
(External 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 current account balance.
3/ One-time real depreciation of 30 percent occurs in 2009.

Table 3. Iceland: Public Sector Debt Sustainability Framework, 2003–13
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing primary balance 9/**
1 **Baseline: Public sector debt 1/**	40.8	34.5	25.4	30.1	28.9	**108.9**	**108.6**	**104.4**	**105.7**	**100.7**	**92.6**	**-0.2**
o/w foreign-currency denominated	22.9	17.9	10.4	16.8	13.5	65.2	48.2	33.5	31.6	29.6	27.8	
2 Change in public sector debt	-1.2	-6.4	-9.1	4.7	-1.2	80.0	-0.3	-4.2	1.3	-5.0	-8.1	
3 Identified debt-creating flows (4+7+12)	-2.6	-5.7	-9.9	-8.3	-9.8	69.2	9.1	-3.6	1.3	-5.0	-8.1	
4 Primary deficit 2/	0.1	-2.5	-7.1	-8.5	-8.1	-1.9	6.2	2.9	-1.0	-4.8	-8.0	
5 Revenue and grants	44.6	45.9	48.8	49.7	50.0	45.3	41.7	43.0	44.0	44.3	44.5	
6 Primary (noninterest) expenditure	44.7	43.4	41.8	41.3	41.9	43.4	47.9	46.0	42.9	39.5	36.5	
7 Automatic debt dynamics 3/	-2.7	-3.3	-2.8	0.2	-1.7	-1.7	6.9	7.4	2.3	-0.2	0.0	
8 Contribution from interest rate/growth differential 4/	1.5	-1.4	-1.1	-0.9	-0.3	-1.7	6.9	7.4	2.3	-0.2	0.0	
9 Of which contribution from real interest rate	2.5	1.4	1.2	0.1	1.0	-1.3	-3.5	7.1	6.8	4.2	3.9	
10 Of which contribution from real GDP growth	-1.0	-2.8	-2.3	-1.0	-1.3	-0.4	10.4	0.3	-4.4	-4.4	-3.9	
11 Contribution from exchange rate depreciation 5/	-4.2	-1.9	-1.7	1.1	-1.4	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	72.8	-4.0	-14.0	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	0.0	0.0	0.0	0.0	0.0	47.0	-14.0	-14.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	25.8	10.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 6/	1.4	-0.6	0.8	13.0	8.6	10.8	-9.4	-0.6	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	91.5	75.0	52.0	60.6	57.9	240.4	260.3	242.7	240.4	227.5	207.9	
Gross financing need 7/	11.9	8.1	1.9	-1.2	0.6	7.6	37.5	34.5	36.3	22.1	18.9	
in billions of U.S. dollars	1.3	1.1	0.3	-0.2	0.1	1.4	5.7	5.3	6.0	3.9	3.6	
Scenario with key variables at their historical averages 8/						**108.9**	**92.1**	**74.8**	**69.6**	**64.5**	**59.5**	**-0.9**
Scenario with no policy change (constant primary balance) in 2008-2013						**108.9**	**100.5**	**90.9**	**91.0**	**88.8**	**86.9**	**-0.1**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	2.4	7.7	7.4	4.4	4.9	1.6	-9.6	-0.3	4.5	4.5	4.2	
Average nominal interest rate on public debt (in percent) 9/	6.7	6.6	7.1	9.7	9.6	8.5	6.7	7.0	8.5	6.5	6.4	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	6.1	4.1	4.2	0.7	4.0	-4.9	-4.3	6.6	6.9	4.3	4.2	
Nominal appreciation (increase in US dollar value of local currency, in percent)	19.0	9.4	11.3	-10.1	9.5	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	0.6	2.5	2.8	9.0	5.6	13.4	11.0	0.4	1.5	2.2	2.2	
Growth of real primary spending (deflated by GDP deflator, in percent)	6.5	4.7	3.3	3.2	6.5	5.2	0.0	-4.4	-2.3	-3.9	-3.7	
Primary deficit 2/	0.1	-2.5	-7.1	-8.5	-8.1	-1.9	6.2	2.9	-1.0	-4.8	-8.0	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Includes interest revenue, which accounts for the difference primary deficit numbers shown in Table 5.

3/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

4/ The real interest rate contribution is derived from the denominator in footnote 3/ as r - π (1+g) and the real growth contribution as -g.

5/ The exchange rate contribution is derived from the numerator in footnote 3/ as ae(1+r).

6/ For projections, this line includes exchange rate changes.

7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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

10/ 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.

Table 4. Country: Public Sector Debt Sustainability Framework--Gross Public Sector Financing Need, 2003–13
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
I. Baseline Projections											
Gross financing need 1/	11.9	8.1	1.9	-1.2	0.6	7.6	37.5	34.5	36.3	22.1	18.9
in billions of U.S. dollars	1.3	1.1	0.3	-0.2	0.1	1.4	5.7	5.3	6.0	3.9	3.6
II. Stress Tests											
Gross financing need 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2008-2013 3/						7.6	29.9	18.2	19.4	12.8	12.4
A2. No policy change (constant primary balance) in 2008-2013						7.6	29.2	27.2	30.4	21.2	21.9
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						7.6	38.6	35.9	38.1	23.9	20.9
B2. Real GDP growth is at baseline minus one-half standard deviations						7.6	38.6	36.6	39.8	26.1	24.1
B3. Primary balance is at baseline minus one-half standard deviations						7.6	39.1	36.5	39.0	24.8	22.1
B4. Combination of B1-B3 using 1/4 standard deviation shocks						7.6	39.0	36.6	39.2	25.0	22.3
B5. One time 30 percent real depreciation in 2009 5/						7.6	38.3	45.1	50.0	32.1	29.4
B6. 10 percent of GDP increase in other debt-creating flows in 2009						7.6	37.8	37.5	40.1	24.9	21.8
Gross financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2008-2013 3/						1.4	5.3	3.4	3.9	2.7	2.8
A2. No policy change (constant primary balance) in 2008-2013						1.4	4.5	4.2	5.0	3.7	4.1
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						1.4	5.9	5.5	6.3	4.2	3.9
B2. Real GDP growth is at baseline minus one-half standard deviations						1.4	5.8	5.5	6.3	4.4	4.3
B3. Primary balance is at baseline minus one-half standard deviations						1.4	6.0	5.6	6.4	4.4	4.2
B4. Combination of B1-B3 using 1/4 standard deviation shocks						1.4	5.9	5.6	6.3	4.3	4.1
B5. One time 30 percent real depreciation in 2009 5/						1.4	4.1	4.8	5.7	3.9	3.9
B6. 10 percent of GDP increase in other debt-creating flows in 2009						1.4	5.8	5.8	6.6	4.4	4.1

1/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

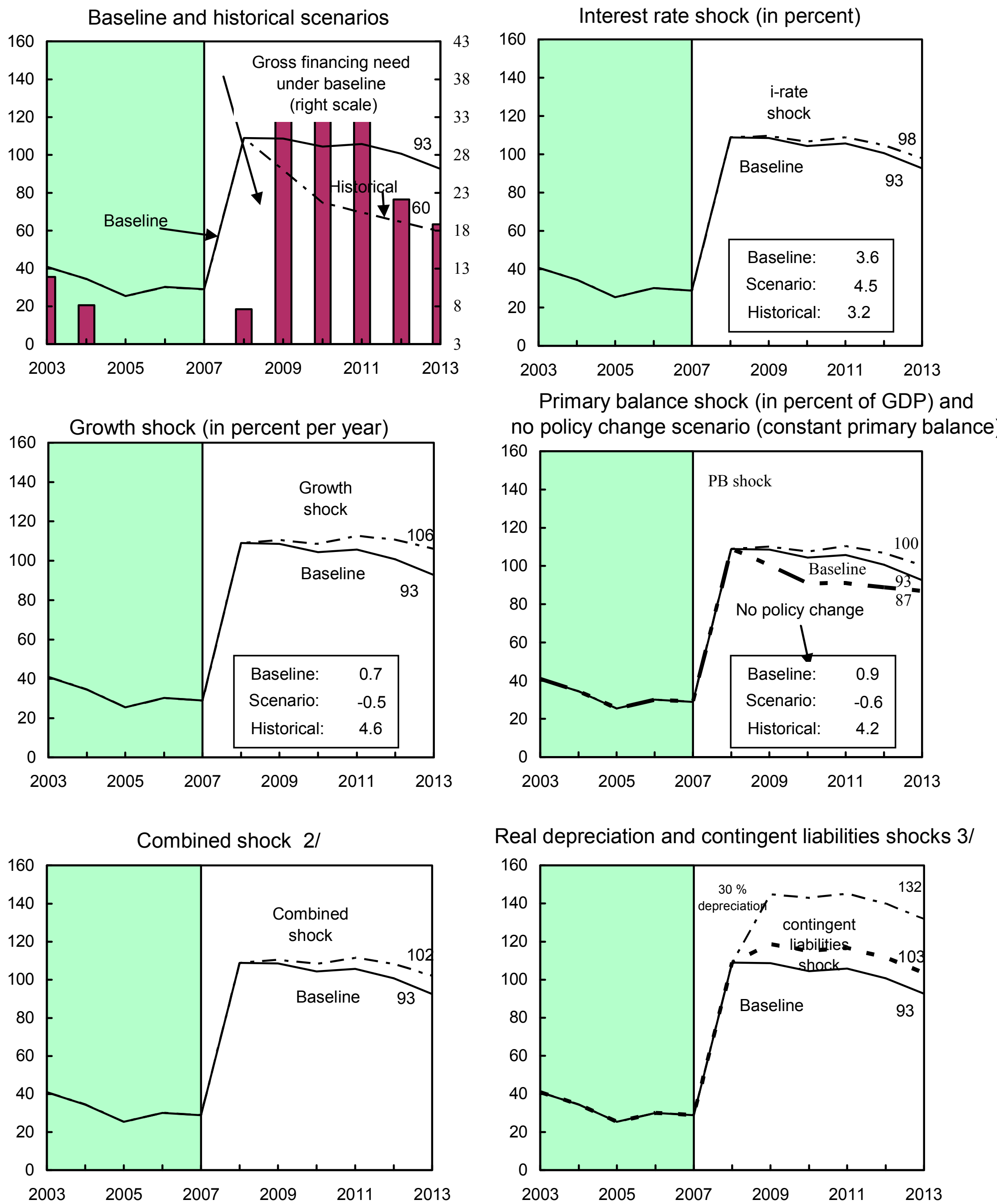
2/ Gross financing under the stress test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.

3/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

4/ The implied change in other key variables under this scenario is discussed in the text.

5/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 2. Iceland: Public Debt Sustainability: Bound Tests 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 and 10 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).

ATTACHMENT IV. ICELAND: EXCEPTIONAL ACCESS FOR REQUESTED STAND-BY ARRANGEMENT

A. Introduction

1. **The amount of Fund resources requested by Iceland under the proposed SBA constitutes exceptional access.** The total access under the SBA would equal SDR 1.4 billion (1190 percent of quota)[1], of which SDR 560million would become available upon the Board's approval of the program.[2] Both cumulative and annual access under the program would exceed the normal access limits, requiring an evaluation of the case for exceptional access.

2. **This appendix evaluates the case for exceptional access under the proposed SBA.** The evaluation is based on the four substantive exceptional access criteria in capital account crises as required under the Fund's framework for exceptional access.

3. **There is a presumption that exceptional access in capital account crises will be provided using resources of the Supplemental Reserve Facility (SRF) where the conditions for the SRF apply.** While Iceland is suffering from a capital account crisis, this was triggered by a banking sector collapse that is globally unprecedented in scale (relative to the domestic economy) compared to previous banking crisis. The SRF is geared towards "large short-term financing need resulting from a sudden and disruptive loss of confidence reflected in pressure on the capital account and the member's reserves". However, in the case of Iceland it is not likely that these effects will be short-term. Past experience of managing banking crises suggests they are complex and take time to resolve, and the impact on the domestic economy is likely to be severe.[3] Thus the pressures on the capital account are likely to have a longer duration than those envisaged by the SRF. Staff therefore proposes a two-year arrangement with exceptional access under "credit tranche" terms.

B. Exceptional Access Criteria in Capital Account Crises

4. **Criterion 1—The member is experiencing exceptional balance of payments pressures on the capital account resulting in a need for Fund financing that cannot be met within normal limits**. The disintegration of the banking system has prompted significant capital outflows, as illustrated by the massive króna depreciation. Recent rating downgrades and dramatically elevated sovereign spreads indicate restricted market access.

---

[1] Iceland's quota is SDR 117.6 million.

[2] SDR 875 million (744 percent of quota) would be made available during the first year of the arrangement.

[3] See *Managing Systemic Banking Crises* By a Staff Team led by David.S. Hoelscher and Marc Quintyn (OP 224, 2003)

Default on banking sector liabilities could trigger further large capital outflows outside the banking system. Given the currently low level of international reserves, absent a Fund program, the authorities have limited scope (beyond the imposition of exchange controls) to stem an additional flight of capital. There is an urgent need to build a reserves buffer to help to restore confidence and reverse the overshooting exchange rate.

5. **Criterion 2—A rigorous and systematic analysis indicates that there is a high probability that debt will remain sustainable.** Prior to the crisis Iceland's gross and net public debt ratios were low (gross debt was 19 percent of GDP at end-2007). The króna depreciation, imminent recession, and banking sector restructuring will all raise the debt level substantially with gross public sector external debt expected to be 95 percent of GDP in 2009 and total external debt expected to be 160 percent of GDP. However, the authorities' intention not to take on additional obligations from the banking crisis, resolute fiscal adjustment in the medium-term supported by the Fund program, and the potential for asset recoveries to finance claims on foreign deposits, should all help to reduce the public sector debt back to sustainable levels in 2013 with gross public external debt estimated at around 49 percent of GDP, and total external debt at 101 percent of GDP. There are however risks to this assessment. The required medium-term fiscal adjustment is large, there are uncertainties as to how the bank restructuring will play out, and the overall external debt burden remains high albeit on a downward path.

6. **Criterion 3— The member has good prospects of regaining access to private capital markets within the time Fund resources would be outstanding, so that the Fund's financing would provide a bridge.** Until earlier this year, Iceland had a AAA rating from Moodys on its sovereign debt. But the global turbulence exposed vulnerabilities (outsized banking sector, large macroeconomic imbalances, overstretched private sector balance sheets, and high dependence on foreign financing) and triggered a financial crisis. Once the current crisis resolves, capital controls are removed, and the economy adjusts, it is expected that Iceland would be able to regain market access relatively quickly—within the maturity of credit tranche resources—provided that the bank resolution is done in the collaborative and cohesive manner envisaged in the Fund-supported program and which is subject to conditionality.

7. **Criterion 4—The policy program of the member country provides reasonably strong prospects of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.** The program is focused on the three critical goals: resolution of the banking sector and restoration of confidence in the exchange rate, and medium-term fiscal adjustment. While there are implementation risks, given the inherently complex nature of the economic challenges being faced, Iceland's sound institutions and consensus-based approach to policy formulation should underpin the proposed program. Preliminary indications suggest that social partners (labor unions and employers) recognize the severity of the crisis and would be willing to support a wage agreement that is consistent with the objectives of the program.

C. Overall Assessment

8. **Staff supports the authorities request for a two year SBA**. The proposed access is exceptionally high relative to quota (see Table 1). Staff believes that such high access is warranted, given the urgent need to build a reserves buffer and provide confidence in the exchange rate in the face of potentially large and unpredictable pressures on the balance of payments. The authorities have formulated a strong set of policies that forcefully tackle the banking sector problems on a non discriminatory basis, and a monetary policy that should underpin the restoration of confidence. There are program risks, given the large scale of the uncertainties. However, by providing financing support at this critical juncture, when financing needs are large, the Fund can assist Iceland in the needed buildup of reserves and pave the way for an early exit from the crisis.

Table 1. Iceland: Proposed Access, 2008–10

		High-Access Cases 1/			
	Proposed Arrangement	Proposed Arrangement (Percentile)	20th Percentile	80th Percentile	Average
Access					
In millions of SDRs	1,400	10	2,749	13,427	8,975
Average annual access	700	93	116	457	435
Total access in percent of: 2/					
Actual quota	1,190	90	293	822	621
Gross domestic product	12	85	3	9	11
Gross international reserves	37	28	27	103	91
Exports of goods and nonfactor services	25	50	12	46	34
Imports of goods and nonfactor services	37	71	12	61	34
Total debt stock 5/					
Of which: Public	35	86	7	27	20
External	12	52	6	17	13
Short-term	312	100	19	55	54
M2	11	33	6	24	29

Source: Executive Board documents, MONA database, and Fund staff estimates.

1/ High access cases include data at approval and on augmentation for the 29 requests to the Board since 1994, involving the use of the exceptional circumstances clause or SRF resources. Exceptional access augmentations are counted as separate observations. For the purpose of measuring access as a ratio of different metrics, access includes augmentations and previously approved and drawn amounts.

2/ The data used to calculate ratios is the actual value for the year prior to approval for public and short-term debt, and the projection at the time of program approval for the year in which the program was approved for all other variables.

3/ Phasing is based on program years.

4/ Amounts include augmentations.

5/ For Iceland 2007 data exclude the banking sector