EBS/08/124
Correction 1

CONFIDENTIAL

November 24, 2008

To: Members of the Executive Board

From: The Secretary

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

The attached corrections to EBS/08/124 (11/15/08) have been provided by the staff.

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 6, para. 5, line 5: for "bolstered its reserves by drawing on the currency swap arrangements"
read "bolstered its reserves by partly drawing on the currency swap arrangements"

Page 10, para. 9, line 6: for "particularly in the case of uncertainty about policy commitments, or financial assistance from other countries."
read "particularly in the case of uncertainty about policy commitments."

Page 15, Box 4, para. 2, line 4: for "Derivatives and unrecoverable assets were transferred to the old banks."
read "Derivatives and unrecoverable assets were not transferred to the new banks."
line 6: for "The resolution committees were"
read "The FME was"
line 9: for "within 60 days" read "within 90 days"

Page 18, para. 27, footnote 5: for "Dutch and U.K" read "concerned authorities'"

Page 21, para. 32, line 4: for "have been downgraded to BBB"
read "have been downgraded to BBB-/BBB"

Page 22, para. 32, line 1: for "mineral resources" read "natural resources"

Page 61, para. 4, line 5: for "mineral resources" read "natural resources"

Typographical Error

Page 18, Text Table, column 1, row 5: for "12.2" read "11.2"

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

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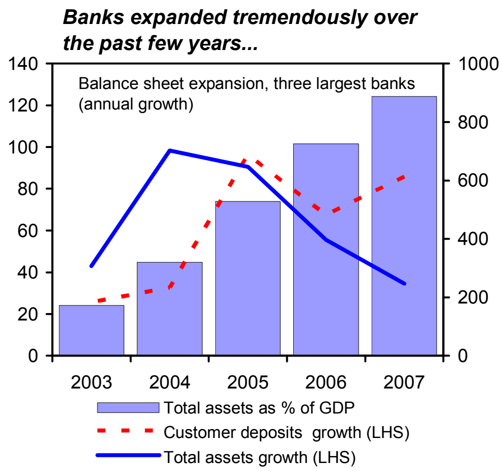
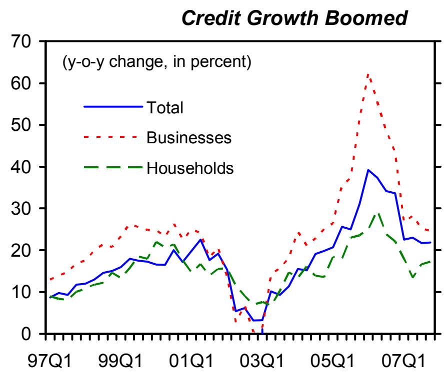
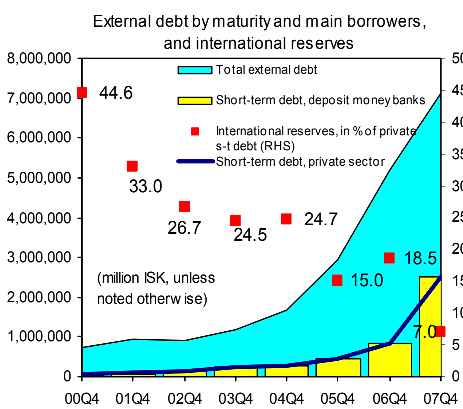
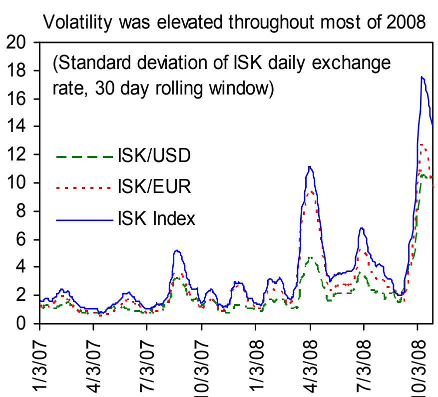
past three years, and inflation soared (Figure 2). Completely privatized in 2003, the banking sector relied on the availability of ample foreign wholesale funding to rapidly expand abroad and accumulate almost 900 percent of GDP in assets by end-2007. At the same time, gross external indebtedness reached 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 partly 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.

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,

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 not transferred to the ~~old~~ new 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~~FME was 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~~ 90 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	11.2	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 the U.K.~~ concerned 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.

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-/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~~ natural 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.

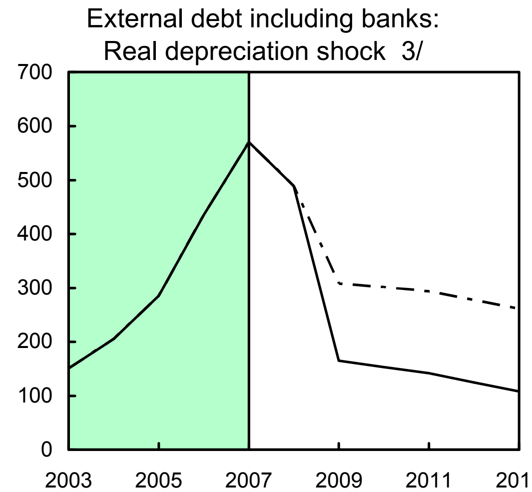
35. **A first-time safeguards assessment of the CBI will need to be completed no later than the first review under the Stand-By Arrangement.** Financial statements audited by the National Audit Bureau (NBA) are published on the central bank's website. Staff is in the process of obtaining additional information 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

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~~ natural 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.