November 29, 2010
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 10/96-2

10:05 a.m., September 29, 2010

2. Iceland - Staff Report for the 2010 Article IV Consultation and Third Review Under the Stand-By Arrangement and Request for Modification of Performance Criteria

Documents: EBS/10/176 and Correction 1, and Supplement 1, and Supplement 2; SM/10/242 and Correction 1

Staff: Flanagan, EUR; Roaf, SPR

Length: 37 minutes

Executive Board Attendance

M. Portugal, Acting Chair

Executive Directors	Alternate Executive Directors
	M. Majoro (AE)
	K. Assimaidou (AF)
	D. Vogel (AG)
	C. Legg (AU)
	J. Prader (BE)
P. Nogueira Batista, Jr. (BR)	M. Arbelaez (BR)
J. He (CC)	
	M. de Las Casas (CE), Temporary
	S. O'Sullivan (CO)
	J. Poulain (FF), Temporary
K. Stein (GR)	
	M. Patra (IN), Temporary
	F. Spadafora (IT), Temporary
M. Furusawa (JA)	T. Shimoda (JA)
	S. Maherzi (MD), Temporary
	M. Choueiri (MI), Temporary
A. Bakker (NE)	
P. Callesen (NO)	J. Bergo (NO)
	L. Palei (RU), Temporary
	A. Al Nassar (SA)
	A. Chua (ST)
	K. Zajdel-Kurowska (SZ)
	J. Franco (UA), Temporary
A. Gibbs (UK)	R. Elder (UK)

L. Hubloue, Acting Secretary
R. Dall'Orto, Assistant

Also Present
European Central Bank: G. Pineau. European Department: M. Flanagan, J. Kozack, P. Thomsen. Finance Department: C. Janada. Legal Department: K. Christopherson Puh. Monetary and Capital Markets Department: T. Olafsson. Secretary's Department: H. Malothra, P. Martin. Strategy, Policy, and Review Department: J. Roaf, M. Shannon, A. Stuart. Senior Advisors to Executive Directors: E. Barendregt (NE), P. Phan (ST), M. Ricaurte (AG), P. Fachada (BR), A. Sutt (NO). Advisors to Executive Directors: L. Alfredsdottir (NO), H. Do (ST), P. Gasiorowski (SZ), T. Haruki (JA), R. Hills (UK), M. Holmberg (NO), M. Merhi (MI), D. Mevis (BE), S. Meyer (GR), E. Ndong Ondo Bilee (AF), M. Sajkunovic (CO), T. Tira (AU), E. Uanguta (AE).

2. ICELAND—STAFF REPORT FOR THE 2010 ARTICLE IV CONSULTATION AND THIRD REVIEW UNDER THE STAND-BY ARRANGEMENT AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERIA

Mr. Callesen and Mrs. Alfredsdottir submitted the following statement:

Iceland has made significant progress on combating the effects of the collapse of the nation's financial sector, which took place exactly two years ago this week. Economic activity has stabilized and growth is expected to resume in the second half of 2010. Inflation continues on a downward path and the outlook for a positive balance of payments is favorable. However, numerous challenges remain after a financial crisis that has affected every sector of the economy. My authorities broadly agree with staff's assessment and wish to thank the Fund and its staff, Mr. Mark Flanagan in particular, for their excellent work in Iceland.

The Fund program has helped to restore confidence and coordinate our responses to the crisis. Policy implementation is broadly on track, and has met all end-May criteria as well as the end-June structural benchmark concerning legislation to strengthen the framework for household debt restructuring. The recapitalization of some weak banks, a structural benchmark for end-May that was delayed, can now go ahead after the recent Supreme Court judgment.

My authorities are fully committed to going forward with the program with continued emphasis on i) further restoration of the financial system where significant uncertainty has now been removed after the September Supreme Court decision on exchange rate linked loans; ii) maintaining exchange rate stability and promoting further disinflation towards the inflation target set for the Central Bank in 2001; iii) corporate and household debt restructuring; iv) taking steps towards capital account liberalization; v) securing public debt sustainability; and vi) normalizing relations with international creditors and reviving market confidence in Iceland.

Since the second review, some progress has been made in negotiations with the authorities of the United Kingdom and the Netherlands. The Icelandic authorities will continue to negotiate in good faith with the aim of concluding an agreement on the Icesave issue. My authorities have also sought to maintain constructive dialogue with the creditors of the failed private banks in accordance with best international practice.

The Supreme Court Decision

The Supreme Court ruled on September 16, 2010 that the lowest interest rates on new non-indexed loans at credit institutions as published by the Central Bank should prevail in the case of non-binding foreign exchange indexation clauses in loan agreements. The judgment substantially reduces the uncertainty resulting from the Supreme Court's June ruling on the illegality of exchange rate linkage. If the Supreme Court rulings are confined to consumer loans, the cost to the banking sector will be contained with no or very limited need for additional capital injection from the Treasury or other shareholders. Even if corporate loans are found to be illegally linked to foreign currencies, the additional capital injection into the banks will be manageable, and far below levels required if the foreign contractual interest rates would have prevailed. The government is committed to clarifying the legal environment in light of the judgments, in order to facilitate the settlement of claims and speed up debt restructuring, which might otherwise fall victim to long-winded court proceedings. This will be done in cooperation with the financial institutions. Increased clarity will also support the financial restructuring of the savings banks system. The Icelandic State Financial Investments agency will be responsible for the government's stake in these relatively small, but not insignificant, institutions.

The Outlook

GDP contracted less than expected in 2009. While the first half of 2010 was sluggish, partly due to a volcanic eruption that affected tourism, a positive growth is expected in the second half of 2010. Unemployment, which was almost non-existent before the crisis, stood at 8.7 percent in mid-2010. This level of unemployment is uncharacteristic of Icelandic society. Moreover, participation rates have traditionally been very high. The Government has introduced several measures to stimulate small enterprise start up and retraining of labor. Lower unemployment levels should be registered when growth picks up next year.

Risks to the outlook are further deleveraging and contraction of demand, if growth in the main export markets weakens. The fall in the exchange rate has made the export sector more competitive and exports have been relatively robust during the contraction. In general, private sector investment will be a key element in promoting growth and for that purpose my authorities aim to create an environment that encourages investment, foreign direct investment in particular, with due regard for environmental impact.

Fiscal Policy

Implementation of the 2010 budget is advancing well, with both expenditures and revenues on target during the first half of the year. The authorities are confident that this will bode well for the 2011 budget, which is to be presented to Parliament on October 1, 2010. The budget is expected to be passed in December. The passing of the budget will mark an important step in Iceland's path towards recovery, as general government finances will be returned to a primary surplus of around half a percent of GDP as a result of the 3.25 percent primary adjustment subscribed in the bill. The improvement is more than four percent of GDP over the 2009 figures. All revenues exceeding targets in 2010 will be saved. The medium-term fiscal path will be set on a firmer footing and concurrently, the budget will include 2-year nominal ceilings that will guide policy through 2012 in line with the planned medium-term consolidation plan which aims at a primary surplus of six percent after 2012.

The staff's debt sustainability analysis indicates that external and public debt levels remain sustainable with lower levels than in the second review. The gross external debt of the Icelandic economy, excluding Icesave liabilities, is expected to reach 240 percent of GDP. The net international position is still uncertain but is likely to be in the range 40-60 percent of GDP once the winding-up process of banks and leveraged asset holding companies is concluded a few years from now. Under a plausible scenario, external debt peaks at the 240 percent of GDP level in 2009 and 2010, falling to 190 percent of GDP in 2015. It should be noted that a large part of Iceland's external private sector liabilities are a legacy of the activities of multinational corporations with operations mainly in other countries but headquarters in Iceland.

Gross general government debt is expected to peak at around 120 percent of GDP this year. The purchase of a Netherlands-based holding company and its assets and through buyback operations of Eurobonds from the market at a discount reduces external debt somewhat. The staff points out that debt dynamics are favorable under the program design and could tolerate moderate reductions in the medium-term fiscal target. To achieve debt targets, my authorities are committed to continuing to contain financial sector contingent liabilities and to limiting the absorption of further private sector losses.

Monetary Policy

The Central Bank has continued to lower interest rates, keeping a close eye on the ISK exchange rate, and inflation developments and expectations. The Monetary Policy Committee decided to lower the Central Bank's interest rates by 100 basis points in August and again on September 22, by 75 basis points. The effective policy rate, which the Central Bank deems to be an average of the current account rate (4.75 percent) and the Certificate of Deposits rate (6 percent), is now just below 5½ percent, the lowest it has been since May 2004. In the statement accompanying its interest rate decision, the Monetary Policy Committee noted that the capital controls, developments in terms of trade and other factors affecting the current account balance, and the monetary policy stance relative to trading partner countries all continue to support the exchange rate. The committee also stated that the prospects of lifting capital controls would complicate monetary policy decisions and could limit its room for maneuver in the coming period. The committee underlined that it stands ready to adjust the monetary stance as required to achieve its interim objective of exchange rate stability and ensure that inflation is close to target over the medium term.

The exchange rate has continued to rise, with the appreciation approaching 17 percent against the euro since the beginning of the year (over 12 percent in trade-weighted terms). At the same time, the five-year CDS spread for Iceland has dropped from 412 basis points to around 300 basis points. The Central Bank has begun regular purchases of foreign exchange in order to accumulate reserves. This operation does not signal any preferred level for the krona. Initial purchases have been small but additional purchases will be undertaken in the case of large irregular inflows and the pace of regular purchases will be stepped up when conditions allow. Foreign exchange reserves will be strengthened further following the completion of the September 18 sale of the Danish FIH Erhvervsbank A/S to a consortium of four foreign companies. When the transaction is complete in the next few weeks, the Central Bank will receive EUR255 million, and will, depending on the performance of the current balance sheet of FIH, also have the possibility over the medium term to recover the remainder of a EUR500 million loan granted to one of the failed Icelandic banks in October 2008 against share collateral.

In late 2008, capital account restrictions were imposed to stabilize the currency and contain damaging capital outflows. Enforcement of the controls has gradually become stricter, which is reflected in the current account and a stronger krona among other factors. However, ways to circumvent the controls will be found as time goes on and my authorities will continue to lift the controls gradually as soon as conditions permit. The next step could follow the conclusion of the third review, but not until after the solidity of the financial sector in the wake of Supreme Court decisions has been confirmed.

Inflation has been falling this year. Inflation is expected to close on the inflation target by year-end and to fall somewhat below the target early in 2011. A reasonable outcome from the labor market negotiations scheduled for later this year will be crucial to anchoring inflation expectations and securing more permanent price and income stability.

The Policy Framework

Reforms of regulations on banking and financial supervision are on schedule. Among these are organizational reforms of the Financial Supervisory Authority including enhanced on-site inspection and off-site supervision; bank resolution procedures and prudential requirements, including adjustment in 2011 to new Basel capital and liquidity requirements and relevant EU directives; and this autumn passage of a draft bill aimed at harmonizing the deposit guarantee regime with EU Directives.

Public financial management reforms include a two-stage budget approval process. The 2011 budget will establish a binding two-year nominal ceiling. Amendments to the Local Government Act include two fiscal rules, namely a zero-balance rule requiring corrective measures if a local government is in breach, and a ceiling on the ratio of local government debt and commitments to tax revenues.

External Financing

While access to external market financing will not be essential in order to meet the debt roll over coming due in 2011 and 2012, it will be a key to building up confidence and paving the way for private sector access to foreign capital markets. In the event of any shortfalls, we stand ready to consult with the Fund to implement necessary measures to meet program objectives. My authorities will meet the preconditions of some of our bilateral partners to access bilateral program financing. In this regard, my authorities reiterate the undertaking contained in their previous and current Letters of Intent to ensure that the United Kingdom and the Netherlands will be reimbursed for deposits of Landsbanki branches and will receive the reasonable time value of money, provided that comprehensive agreements are reached. The Icesave issue has complicated the recovery for too long and a successful resolution is an important step towards reestablishing confidence in the Icelandic economy.

Mr. Majoro submitted the following statement:

We thank staff for a well-written report and Mr. Callesen and Mrs. Alfredsdottir for their helpful buff statement. We note that Iceland's economy is beginning to exhibit signs of a gradual recovery from the effects of the global recession. We commend the authorities for their strong commitment to sound policy implementation, including interest rate policy, capital controls, and private sector wage restraint, which have helped stabilize the exchange rate and contained impacts on banks' balance sheets. The Fund-supported program, initiated after the crisis, has also shielded the economy and facilitated the unwinding of imbalances. The program is on track as all end-May performance criteria and end-June structural benchmarks have been met. We, therefore, support the authorities' request for the completion of the third review under the Stand-By Arrangement, as well as modification of the performance criteria.

We observe that Iceland's financial crisis has substantially increased the country's debt burden. We are, however, pleased to note the progress being made to reduce it to sustainable levels. In particular, the authorities' fiscal consolidation plan, which is predicated on an overarching theme of creating favorable conditions for stronger economic activity, is a welcome development. We are cognizant of the difficulty the authorities face in implementing fiscal adjustment. In this regard, we encourage the authorities to strike a reasonable balance between fiscal consolidation and supporting the recovery.

We encourage that the authorities' commitment to preserving exchange rate stability remain a key policy priority. We note that the krona stability has served the economy well and helped address key imbalances and vulnerabilities in the economy. Also, given the relatively low level of international reserves, we encourage the Central Bank of Iceland to start building up its stock of reserves to respond adequately to short-term external debt and capital outflow risks.

We urge the authorities to expedite their banks' recapitalization plans to ensure the soundness of the system. In addition, implementation of the commercial banks' restructuring plan, to address various risks emanating from the resolution process and inefficient savings banks, also needs to be accelerated. Further, efforts to strengthen regulatory and supervisory framework for the entire financial system should be prioritized. In light of the Supreme Court ruling on foreign exchange indexed loans, we urge the authorities to identify remaining legal uncertainties regarding foreign currency linked loans and address them in a satisfactory manner.

With these comments, we wish the Icelandic authorities success in their future endeavors.

Mr. Virmani and Mr. Patra submitted the following statement:

We thank staff for a well-written set of papers and Mr. Callesen and Mrs. Alfredsdottir for their informative buff statement. Significant progress has been made in lifting the economy from the depths of the sharp recession that followed the financial crash. We regard the SBA with the Fund as the anchor of this improvement. We commend the authorities for their strong commitment to and ownership of the program, and support the completion of the third review with the modifications to the performance criteria for September 2010 recommended by staff.

Outlook

The deterioration in economic performance appears to have become more pronounced in the second quarter of 2010, with all components of demand except government final consumption having contracted. This suggests that a sizable catch-up is required in the second half of 2010 in order to realize staff's projection of real GDP (-3.0 percent). What is likely to be its driver, given the weak profile of domestic demand constituents and staff's own assessment that the contribution of net exports could diminish? With aluminum and energy sector investment being postponed, what are the prospects for general business investment recovering? We note that there has been a pick-up in imports of investment goods in the second quarter of 2010 which, along with a smaller contraction in residential investment, has encouraged the central bank to raise its growth projection for 2010. We look forward to staff's views.

Quarter to quarter changes tend to be volatile, especially for an economy emerging out of deep recession. A better indicator of underlying economic activity is employment. Why does the employment situation not receive adequate attention in the staff report? There are indications of recovery in the labor market in terms of hours worked and number of persons at work. What is the medium-term outlook for labor demand? This has implications for wage growth, productivity changes and competitiveness. We would, therefore, encourage a fuller and forward-looking analysis of employment dynamics.

Financial Sector

The staff report seems to be dominated by the Supreme Court ruling on foreign exchange indexed loans. Given that the bulk of these loans were contracted to take advantage of the strength of the krona before its collapse, could the Supreme Court ruling be, in fact, removing perverse incentives tolerated by the regulatory regime at that time? This could be a positive development from a longer-term perspective. As Mr. Callesen and Mrs. Alfredsdottir indicate, the Supreme Court's ruling of September 16, 2010 substantially reduces uncertainty and limits the need for capital. Turning to other financial sector issues, we are interested in the follow-up on the April 2010 report of the Parliamentary Investigation Commission, analogous to the status of the Jannari report recommendations presented in Table 11. Specifically, what are the steps taken to prevent the banking system from expanding again beyond the capacity of the supervisory system? Are there macro-prudential tools available to contain too rapid growth of international banking operations? We note from Table 11 that work is underway for monitoring large exposures; are there similar processes for foreign exchange mismatches which were at the heart of the crisis? We also look forward to an update on collateral policy and liquidity management at the central bank under assistance from the Fund.

Alongside the review of financial sector rules and regulations, the need for amendments to the legal architecture has been recognized as a priority. Is a review of the central bank act under consideration? Current arrangements for financial sector supervision as set out in Table 11 seem to be compromising the independence of the central bank. Likewise, we look forward to any progress that can be reported on the legislations introduced in parliament in May 2010 on deposit insurance, investment funds, insurance activities and financial undertakings.

Fiscal Policy

The authorities are undertaking a large fiscal adjustment of nearly 8 percent of GDP in 2010-11 under the program in terms of the primary balance. While this compression may be appropriate from the point of view of winning confidence, we are concerned about the massive deflationary impact that it could unleash on a weak economy. In 2010 so far, public sector consumption is the only factor supporting aggregate demand. Tax revenues appear to have fallen below expectations in the first half of 2010, mainly on account of the turnover tax. Could there be implications for the fiscal effort of 2011, if these shortfalls continue in the rest of 2010?

Monetary Policy

On the exchange rate, it needs to be recognized that the krona went through a sharp decline following the financial sector collapse. This depreciated rate is being sustained by capital controls approved by the Fund, notwithstanding the modest appreciation in recent months. Accordingly, staff's assessment that it is undervalued appears counterintuitive. What is the expected effect of recent monetary policy easing on the valuation of the krona, as interest rate differentials with major trading partners could narrow?

Medium-Term Policy Challenges

The authorities face daunting challenges on several fronts. Revitalizing growth assumes priority and this, in our view, hinges on an investment-oriented strategy. While addressing the debt overhang of private and public sectors is critical and a concomitant, this would be facilitated by a stronger economy and the application of fiscal consolidation needs to be appropriately modulated. The authorities' commitment to financial sector overhaul is commendable. We agree with staff that capital controls need to be in place until financial stability is assured. We also agree that building up international reserves in the space provided by these controls and exchange rate appreciation is important, especially in anchoring the exit from the SBA. We wish the authorities all success.

Mr. Mojarrad and Mr. Maherzi submitted the following statement:

We thank staff for a well-focused set of papers and Mr. Callesen and Mrs. Alfredsdottir for their informative statement. We are encouraged by Iceland's considerable progress in stabilizing the economy and paving the way for a sustainable recovery. Steadfast implementation of the Fund-supported program has been instrumental in this regard. The authorities' renewed commitment to sound policies and reforms bodes well for gradually improving medium-term prospects. Sustained efforts to garner broad domestic support should help ensure successful implementation of the remaining reform agenda, including ensuring medium-term fiscal and debt sustainability, strengthening the stability and soundness of the financial system, and promoting enabling conditions for higher investment. Continued support from the international community, including from the Fund, remains crucial. We support the proposed decisions.

Fiscal consolidation remains appropriately central in the authorities' strategy. Substantial progress has been made thus far, the 2010 target appears to be within reach, and the authorities' are committed to save any excess revenue should it materialize. We look forward to the passage of the 2011 budget with the identified measures, including higher capital and corporate tax rates, public employment rationalization, and wage and benefit restraint. The envisaged inclusion of a 2-year nominal ceiling to guide policy through 2012 is noteworthy.

The authorities are encouraged to move ahead with identifying additional revenue and expenditure measures to meet their medium-term targets while supporting the recovery. Ongoing efforts to overhaul the fiscal framework should serve public finance well. We are encouraged by the progress made in bringing the debt dynamics under control. While sustainable, as assessed in the staff's debt sustainability analysis, external and public debt remains high and calls for continued efforts to ensure that the projected downward path materializes.

Monetary policy is appropriately geared towards reducing inflation and preserving currency stability. The authorities' intention to maintain capital controls until the stability of the financial system is well-anchored should help stem potentially destabilizing capital outflows which could complicate the conduct of monetary policy. The focus on reserve accumulation to improve confidence in the economy and strengthen the central bank position ahead of future capital account liberalization is well-placed. Important steps are being taken to strengthen the financial system, including through legislation to improve banking supervision and regulation, enhance the bank resolution framework, and strengthen the safety net. Following the recent Supreme Court Decision, which, as indicated by Mr. Callesen and Mrs. Alfredsdottir, could reduce uncertainty and the need for capital, speeding up the private sector debt restructuring process and moving ahead with the financial restructuring of the savings banks system would go a long way in strengthening confidence in the financial system.

With these remarks, we wish the authorities success in their endeavors.

Mr. Legg and Ms. Tira submitted the following statement:

We thank staff for their comprehensive report and Mr. Callesen and Mrs. Alfredsdottir for the additional information provided in their buff statement.

We join staff in commending the authorities for the progress achieved under their economic program supported by the SBA. The economy has stabilized and the financial system is slowly being restored. Program targets have been met, and the authorities' commitment and responsiveness to changing circumstances have been key to their success. Against this background we support conclusion of the third review under the SBA and the request for modification of performance criteria.

There remain significant downside risks to economic growth, which can be mitigated through higher FDI, in particular investment in the tradable sectors. Along with other measures, liberalization of capital controls will be essential. While we note progress in this area, we also recognize the need to proceed carefully and to ensure that the stability of the financial system is anchored before proceeding any further. In this context, we can go along with the authorities' request to maintain the capital controls on the basis that the measures remain temporary in nature and subject to being phased out as the financial sector strengthens.

The uncertainties arising from the Supreme Court ruling on foreign exchange indexed loans is regrettable, in particular its cost implication with time and effort being redirected to clarify the legal requirements and especially the fiscal costs from the potential delay in implementation of the program. The objective should clearly be to protect the public sector from absorbing any further losses from the restructuring and recapitalization of the banking system, while working hard to restore contractual certainty as quickly as possible. In this regard, the authorities' responsiveness to the changing circumstances will be crucial. The adaptability of the Fund program will also be put to the test and we are encouraged and commend staff and the authorities for their vigilance in this regard.

Turning to the longer-term challenges, we agree with the three program elements identified by the staff and authorities, in paragraph 34, as central to laying the groundwork for higher investment. However, we also note the long-term fiscal challenge confronting Iceland, together with the observation in paragraph 36 of the report regarding the need for better targeting of transfers. We would therefore be interested in any elaboration staff could provide on the practical implications of managing these challenges while preserving the fundamentals of the Nordic social welfare model.

With these comments we wish the authorities success and all the best in their endeavors.

Mr. Chua and Mr. Do submitted the following statement:

We commend the authorities for their efforts in implementing the challenging adjustment strategy that has placed Iceland towards a more sustainable development path. The outlook for the medium term is positive, despite numerous challenges going forward. We are reassured by Mr. Callesen and Mrs. Alfredsdottir that policy implementation is broadly on track and all end-May criteria and the end-June structural benchmark concerning legislation to strengthen the framework for household debt restructuring have been met. We therefore support the completion of the 2010 Article IV consultation and third review under the Stand-By Arrangement, and the request for modification of performance criteria.

Fiscal Consolidation

We welcome the planned measures to consolidate Iceland's fiscal position and support the 2-year nominal ceilings that will guide policy through 2012. Nonetheless, we see it a challenge to achieve the fiscal target in the plan—a general government primary balance of 6 percent of GDP by 2013—that requires 3 percent of GDP in additional measures to be defined for 2012-13. We believe that enhancing revenue measures well above the current plan of 0.6 percent of GDP could help address the fiscal challenge.

Financial Stability and Banking Consolidation

Financial stability is a key in regaining public confidence. It is positive that the government has taken forceful measures in solving problematic banks. We note in the staff report that new banks have been set up with the domestic assets and liabilities of the failed banks and that the delayed full operation by new banks has partly caused slow set-up of effective debt-restructuring mechanisms for consumer and corporate debts.

We believe that accelerated progress of debt restructuring would be beneficial to economic restoration. With this in mind, we note the information in Mr. Callesen and Mrs. Alfredsdottir's statement on the Supreme Court's September ruling and hope that the judgment substantially reduces the uncertainty resulting from the Supreme Court's June ruling on the illegality of exchange rate linkage, which could forcefully facilitate the debt restructurings. Despite the staff's assessment of Iceland's external and public debts as sustainable and trending downward, the authorities should still be mindful of the high levels of external debt of more than 240 percent of GDP and the public debt of more than 120 percent of GDP.

Capital Control Regime and Exchange Restriction

We welcome the recent changes in the monetary framework to strengthen the level of transparency by introducing a five-member Monetary Policy Committee, including two outside members.

We find it reasonable to apply the special restrictions in abnormal economic conditions. We support the authorities' request for further retention of exchange restriction until the earlier of 12 months or the completion of the next Article IV consultation.

Mr. Alazzaz submitted the following statement:

I thank staff for a comprehensive set of papers and Mr. Callesen and Mrs. Alfredsdottir for their helpful buff statement. I welcome the impressive progress made under the Stand-By Arrangement in Iceland under difficult circumstances. Indeed, the program has helped in rebuilding financial sector stability, restoring confidence, improving government debt dynamics, and stabilizing the exchange rate. In this regard, the authorities deserve to be commended for their strong resolve and policy implementation in the wake of the crisis and their willingness to adjust the program in light of evolving circumstances. On the macroeconomic front, I am encouraged that growth is expected to resume in the second half of 2010, inflation remains on a downward path, and the outlook for the balance of payments is strong. Against this background, I support the completion of the third review, as well as the modification of performance criteria. Going forward, key program risks remain and I agree with staff that strict program implementation should help Iceland continue to cope with such risks.

On the fiscal front, it is reassuring that implementation of the 2010 budget is advancing well and the 2010 primary fiscal deficit target, which is a considerable improvement over 2009, remains well within reach. In this context, the commitment of the authorities to save any revenue over-performance during the second half of the year is also encouraging. It is also important to continue with the efforts to address weaknesses in the budget framework. In addition, it is reassuring that an overhaul of the fiscal framework for local governments is expected to be completed by year-end.

Looking ahead, it is creditable that sufficient measures both on the revenue and expenditure sides have been identified to deliver a primary surplus of about ½ percent of GDP in 2011. For the medium-term fiscal adjustment plan, I note that there is need for additional measures equivalent to 3 percent of GDP over 2012-13 to reach the target of a general government primary balance of 6 percent of GDP by 2013. I also note that there is a broad consensus in Iceland that the measures should be balanced between revenue increases and expenditure cutbacks, and welcome the TA work done by the Fund regarding revenue options.

On monetary and exchange rate policy, the focus on preserving exchange rate stability has served the economy well as this policy has contributed to the sharp decline in inflation and the less severe-than-expected recession. Going forward, given the recent krona strength and continuing balance of payments inflows, the stress on reserve accumulation is appropriate, which would improve confidence and strengthen the position for the gradual elimination of capital controls.

On the financial sector, I welcome the framework being put in place to secure the capitalization of the banking system. As noted by the staff, implementation of the recapitalization framework will need to be matched by work to restructure banks' balance sheets and their operations before a normal functioning of the financial sector can be achieved. I also agree with staff that maintaining capital controls and the deposit guarantee is essential until the stability of the financial system is secure. Efforts to improve the quality of bank supervision and regulation, enhance bank resolution procedures, and strengthen the safety net should continue. I also welcome the continued efforts to normalize relations with international creditors.

With these remarks, I wish the authorities further success.

Ms. Lundsager and Ms. Franco submitted the following statement:

Iceland has made commendable progress under the Stand-By Arrangement, and we support the proposed decisions. We appreciate that the staff and the authorities have been flexible in adapting the program objectives to developing circumstances, enabling program modification that has helped to stabilize the economy. Nonetheless, significant downside risks remain, including new risks such as the legal uncertainty in the banking sector and the downturn in growth the first half of this year.

We welcome efforts by the staff and the authorities to look beyond immediate crisis management toward developing a medium-term recovery framework. Iceland faces significant challenges to generating dynamic growth, most particularly fostering investment to boost production, exports and job creation. While taking actions on the medium-term agenda now may be premature given the current economic environment, it is important to lay the ground work to ensure policy mistakes are not repeated and that the economy is more flexible and resilient.

Financial Sector Policies

In our view, renewed stress in the banking sector poses a major risk to the economy. While the Supreme Court ruling in June raised questions of confidence and financial stability, we are reassured by the staff's assessment that even under the most adverse scenario all banks would retain positive net worth and a capital to risk-weighted assets ratio of over four percent. Given that some non-bank institutions may be severely affected by the June ruling, further details about how the authorities plan to facilitate orderly exits for any non-bank institutions that fail to meet the capital requirements would be welcome.

Despite the setback of the recent ruling, the authorities continue to take swift and decisive actions to bolster financial stability. We welcome efforts to recapitalize the banking system, restructure commercial banks, reform the framework for household debt restructuring to speed the process and encourage participation, and to expedite corporate debt restructuring. Bond issuance in order to cover capitalization costs, which thankfully appear to be lower than anticipated due to the September Supreme Court ruling, seem prudent. We understand that the authorities are pursuing a framework to help banks expedite the conversion of foreign exchange loans into krona loans, and welcome any additional details the staff can provide.

We encourage continued efforts to resolve Icesave and normalize relations with external creditors in order to unlock supplementary external financing and enhance confidence in the financial sector.

Monetary and Exchange Rate Policies

The June Supreme Court ruling poses a major setback for one of the fundamental goals of this program, namely to restore confidence so that capital account controls can be lifted. We agree with the authorities' request to retain these controls at this time, given the additional time needed to secure resolution of the treatment of foreign exchange indexed loans. We are encouraged by the authorities' continued commitment to remove capital controls when financial stability is more fully secured, as the staff notes that capital controls hinder the investment needed to support improved growth dynamics going forward.

To guard against downside risk and to manage upcoming roll-over needs, we welcome the authorities' recent purchases of foreign exchange, through periodic, preannounced auctions. We note that reserve coverage is still inadequate relative to short-term external debt once controls are lifted, and encourage efforts to accumulate non-borrowed reserves.

Looking ahead, we note that the staff's suggested de jure inflation targeting framework may be inappropriate for Iceland, but that a decision on the post-program framework would be premature at this point. We welcome additional staff analysis on the costs and benefits of alternative exchange rate regimes, including further thinking on the timeline and how best to coordinate a regime change with the removal of capital controls.

Fiscal Policies and Debt Management

We agree with Mr. Callesen and Mrs. Alfredsdottir that passing the 2011 budget marks an important step in Iceland's path toward recovery and has been central to restoring the government's credibility.

According to the staff's analysis, public and external debt is sustainable and declining, albeit from high levels. The authorities should be commended for the repurchase transactions that have allowed them to take advantage of market dynamics and obtain a significant discount on their debt. Sustaining the pace of consolidation will be important to managing interest rate risk and further reducing debt levels. We take note of the staff's caveat that if debt dynamics continued to remain favorable there may be some scope to reduce the total amount of targeted fiscal adjustment. That said, we urge the authorities to take all necessary actions to address fiscal consolidation and sustainability over the medium term, should debt dynamics not allow for any relaxation in targets.

Mr. Bakker and Mr. Gibbs submitted the following joint statement:

We thank staff for an informative paper, and Mr. Callesen and Mrs. Alfredsdottir for their helpful buff statement. We can support the request to complete the third review and the corresponding purchase of SDR 105 million.

We do so in the firm expectation, based on the considerable progress made over the past few weeks, that in the coming days a final agreement is concluded with the United Kingdom and the Netherlands on Icesave. This would imply that the authorities' commitments as reaffirmed in the Letter of Intent to meet their international obligations regarding Icesave are fully honored. On that basis, we can agree that the program contains sufficient funding assurances. At the time of the last review, the Board rightly noted that "Iceland's ability to fully implement the program is dependent on mobilizing bilateral external financing and regaining confidence of the markets," and called on all parties "to come to a final (Icesave) agreement expeditiously."

More generally, we agree with staff that Iceland has made good progress with the implementation of this program, particularly on fiscal policy and the financial sector. Significant fiscal adjustment measures have already been taken, and the government debt dynamics now look much healthier. However, passing a strong 2011 budget remains a central challenge; given this, it might be a little premature for staff to conclude that "there may be scope to reduce the total amount of fiscal adjustment now targeted." The uncertainty surrounding the outlook add to this; global economic developments and thereby export demand remain uncertain, and domestically the high private indebtedness and possible balance sheet adjustments could negatively impact in the economic recovery.

The government's actions since the crisis have helped to stabilize the financial sector, in particular the measures taken to avoid deposit runs, and then to restructure and recapitalize the failed banks. We nevertheless note that further restructuring of the banking sector is likely to be necessary, given the still-high levels of NPLs, the need for revised business plans for the commercial banks, and the continued presence of a large number of inefficient smaller savings banks. Finding ways to speed up private sector debt restructuring could help these processes.

In addition, the greatest downside risk to the program is clearly the impact of the recent Supreme Court ruling on foreign exchange indexed loans.

Although there remains considerable uncertainty about the scope of this ruling, we are encouraged by the framework that has been put in place to ensure that the banks would be adequately capitalized, even in an adverse scenario and despite the additional contingent liabilities that this places on the sovereign.

We agree that it would not be appropriate to lift capital controls until this legal uncertainty has been resolved, but that the authorities should continue to take steps to strengthen the financial sector, with a view to further capital account liberalization as soon as feasible.

The staff rightly identifies a number of medium-term challenges that Iceland will have to address in order to achieve sustainable post-crisis growth. Rebalancing the economy towards the production of tradable goods and services is probably the most important of these; we agree that, given the depreciation of the krona and the sharp improvement in ULCs, the key priority in this respect is to encourage investment in the tradable sectors, for which financial sector repair is an essential precondition. Medium-term fiscal consolidation will be necessary, and selected issues paper IV presents a very helpful menu of options. And there will be further challenges in enhancing the financial regulatory and supervisory framework; strengthening the budgetary framework (particularly at the sub-national level); and developing a revised inflation targeting regime for monetary policy that addresses some of Iceland's unique characteristics.

Mr. He and Ms. Wang submitted the following statement:

We thank staff for the well-written report, and Mr. Callesen and Mrs. Alfredsdottir for their informative buff statement.

With the authorities' strong determination, policy implementation is broadly in line with the program and the Fund-supported program has thus far proved to be successful in mitigating recession and restoring confidence. We welcome the latest Supreme Court ruling, which clarifies prevailing interest rates to be used for recalculating foreign exchange indexed loans ruled to be illegal. It seems the legal risks regarding Iceland's banking recapitalization have substantially receded. It is encouraging that on September 17, the first bond issuance in international markets since the crisis signals lower corporate refinancing risk. In light of these developments, we support the completion of the third review and modification of performance criteria. Yet, determined and robust reductions in debt, preservation of currency stability, and restructuring of the financial sector are weighing on the program outlook. We encourage further efforts to resolve the Icesave dispute so as to gain early access to remaining bilateral financing.

The combination of fiscal adjustment and phasing out of capital controls, together with an enhanced focus on financial sector recapitalization and private debt restructuring, has contributed to a robust downward path for debt. The approval of the 2011 budget, with total consolidation measures amounting to 10 percent of GDP, would help reinforce the confidence and underpin sound debt reduction. We agree with the staff that there may be room to reduce the targeted fiscal adjustment under the program given the favorable debt dynamics.

We agree that the stabilization of the exchange rate is the key priority of the program. In this context, Iceland will have to further accumulate international reserves. Given that potential capital outflow remains too large to be addressed through interest rate policy alone, certain capital controls seem justified and liberalization should be gradual under close market monitoring.

We welcome the framework for bank recapitalization. According to the staff projection, private shareholders would cover half of the recapitalization costs, and the actual recapitalization need may be lower given the legal uncertainties. We encourage the authorities to pursue their voluntary framework with banks, to backstop capital raising efforts in support of financial stability.

With these remarks, we wish the authorities success in the completion of the program.

Mr. Prader and Mr. Mevis submitted the following statement:

We thank the staff for their comprehensive set of papers and Mr. Callesen and Mrs. Alfredsdottir for their insightful buff statement. We support the conclusion of the third review of the Stand-By Arrangement with Iceland and the modification of performance criteria. We consent to the authorities' retention of one exchange restriction as it is temporary and justified by a balance of payments need.

We would like to commend the authorities for their impressive performance under the program so far and we urge them to continue on this path. Nevertheless, the authorities should not become complacent in view of what has been achieved to date. Going forward, remaining vulnerabilities have to be reduced and the policy framework has to be adapted to the medium term.

Fiscal consolidation appears to be on track and the numbers are enormous in view of an improvement in the primary balance of more than 10 percent planned in the course of four years. We look forward to the adoption of the 2011 budget which will provide the authorities with the first surplus in the primary balance in several years. This should instill further confidence in the authorities' ability to engineer a turnaround in a very fragile situation. It is important that the consolidation remains on track and is supported by all parties. Therefore, we are of the view that while any over-performance should be saved to the extent possible, the buffers in consolidation targets mentioned by the staff could become useful at a later stage to foster a consensual consolidation. The authorities should handle the buffers carefully and we agree with staff that the authorities should monitor closely developments of private sector losses and contingent liabilities.

We agree that the fiscal framework needs to be strengthened over the medium term while designing a consolidation strategy with a positive impact on growth. The crisis has shown how important a sound and cautious fiscal stance is for small open economies. We welcome the work being done by the staff and the discussions with the authorities on a consolidation strategy that would lead to a sound fiscal position while promoting growth. A review and adjustment of program targets may be necessary in order to adapt the strategy to the economic realities. A reorientation of the fiscal framework towards medium-term objectives is also well placed and the implementation of two-year nominal spending ceilings is welcome in this regard. The overhaul of the fiscal framework for local governments and the proposals by a working group are welcome.

Normalizing the situation for external financing should be a priority. We urge the authorities and all participants to quickly settle the issue of Icesave and differences with other foreign creditors. We welcome the fact that no new arrears have been incurred as well as the considerable reduction of external debt. Iceland needs to get access to international capital markets as soon as possible. One major obstacle is the remaining capital controls. While these have been useful in the short term, the authorities are encouraged to proceed rapidly with their elimination. A timetable would be a useful signal to markets. Such a timetable could of course take account contingencies related to external and internal developments.

The Supreme Court ruling has provided an unfortunate setback to the stabilization of the economy. It is somewhat surprising that the possibility of such a ruling was overlooked in the design of the program. The staff may wish to comment. Going forward, the design of the program should be more robust with respect to such events. Does the staff foresee any further potential for legal difficulties to program implementation?

The financial sector stabilization remains one of the essential issues in the program. We welcome the progress made in the set-up of new banks and note that the capitalization of commercial banks appears adequate. Further efforts in recapitalizing the Housing Finance Fund and smaller savings banks are required. We welcome the new recapitalization framework in this respect. A further threat to stability is private sector debt. We agree that household and corporate debt should be resolved in a swift manner. We welcome the recent changes to the framework for household debt restructuring and the forthcoming initiatives for corporate debt.

Fostering growth is a key aspect for a quick exit from the crisis and a successful program. The authorities should develop strategies for growth and we strongly welcome the staff's work on this issue in the selected issues paper. While we note the staff's finding that the specialized structure may place a constraint on Iceland's scope for additional growth, we would like to mention that a high degree of specialization seems to be a stylized fact for many small economies. While this poses a risk in a situation where external demand for a specific export good suffers, it may be the only option that small open economies have. Nevertheless, we agree that the authorities should buttress investment through incentives and be proactive in business development strategies.

Mr. Furusawa and Mr. Haruki submitted the following statement:

We thank the staff for their report and Mr. Callesen and Ms. Alfredsdottir for their helpful statement. We support the completion of the third review under the Stand-By Arrangement, taking into account that all the performance criteria for this third review have been met and the program is broadly on track.

Treatment of Foreign Creditors

Foreign creditors have expressed uneasiness regarding the degree to which they are engaged in the process of debt restructuring. The Japanese financial sector owns a large amount of credit to Icelandic banks, including unsettled foreign exchange (Yen/U.S. dollar) transactions; Japanese side has not been received.

We would like to reiterate that, during the restructuring process, it is imperative that the practices of international financial transactions be emphasized and that fair and equitable treatment of both foreign creditors and domestic depositors be ensured, not only in line with applicable law but also in terms of substance. While the necessary information is released to foreign creditors, we request that the restructuring processes proceed with high transparency.

For instance, in cases in which domestic depositors have priority rights toward redeeming credits, and when some assets are to be transferred to new banks, with the specific condition that domestic depositors enjoy priority rights to redeem credits, the redemption amounts to foreign creditors could be less than expected if there are further declines in the value of assets. Consequently, this would result in the inequitable treatment of foreign and domestic creditors. It is also problematic that the contents of compensation packages offered to old banks are decided without the agreement of foreign creditors. Additionally, with opportunities for foreign creditors to express their opinions limited, the Resolution Committee's decisions don't seem to dully reflect their opinions.

Foreign creditors' concerns about such a potentially inequitable treatment could lead to litigation actions in the future. Such litigation risks might jeopardize the financial sector's sustainability. In this regard, we would like to ask the staff's assessment on such litigation risks. Furthermore, there is a risk that future access to international finance markets could be adversely affected by such concerns. It is our sincere hope that these risks will warrant the authorities' proper attention.

Supreme Court Ruling on Foreign Exchange-Indexed Loans

In view of the fact that, in June, Iceland's Supreme Court delivered a ruling indicating that a part of foreign exchange indexed loan contracts was illegal, it is necessary to carefully monitor the impact of this ruling on the financial sector. According to the information presented in Supplement 1, the amount of the expected losses of the financial sector, which would result from the Supreme Court's ruling, would be below the level of losses contemplated under the most adverse scenario assumed by the staff in the staff report. Nevertheless, since the definition of foreign exchange-indexed loans is still unconfirmed, uncertainty remains regarding the sustainability of the financial sector.

Going forward, once the impact of the Supreme Court's ruling is determined, it will be imperative that the financial sector make certain efforts to increase capital so as to ensure adequate capital. With public debts hovering around 115 percent of GDP, we can go along with the authorities' intention not to mull additional capital injections. Nonetheless, it is inevitable that the authorities carefully assume further downside risks. In this regard, if further downside risks were to materialize, we encourage the authorities to be open to additional capital injections, so as to ensure the sustainability of the financial sector.

Exchange Rate Policy

As indicated in the staff report, given the country's large amount of external debt, the stabilization of exchange rates is an important issue. We support the authorities' request to extend the period of capital controls given that the uncertainty of the financial sector's soundness is increasing due to the Supreme Court's ruling on foreign exchange indexed loans. Nevertheless, it is necessary that the authorities mull exit strategies on capital controls on the premise of ensuring the financial sector's soundness and confidence in the country's public finances.

With these comments, we wish the authorities every success in their endeavors.

Mr. Stein and Ms. Meyer submitted the following statement:

We thank the staff for an instructive set of papers and broadly concur with its analysis and recommendations. Program implementation continues to be satisfactory and we support the proposed decisions. We also follow the staff's recommendation concerning the approval of restrictions on current account transactions, given that these are temporary, for balance of payments purposes, and non-discriminatory.

We commend the authorities on the progress made in consolidating fiscal balances, stabilizing the financial sector, and maintaining overall macroeconomic stability. At the same time, sizeable risks remain as the economic recovery has slowed down, and uncertainties associated with restructuring the banking sector and related litigation risks as well as the crisis legacy of high debt levels in the public and private sector continue to weigh on the economic outlook. These challenges require continued steadfast policy implementation going forward. Against this background, we offer the following comments.

A gradual removal of capital controls will be important with a view to reestablishing the confidence in the Icelandic economy and providing the preconditions for investment and growth.

With regard to facilitating the process of gradually removing capital controls, we welcome the authorities' decision to use the recent krona strength to purchase foreign exchange. This strengthening of the net international reserves position will buttress confidence ahead of considerable external debt rollover needs in 2011/2012. The modifications of the NIR and NDA performance criteria are appropriate in this context.

The soundness of the financial system is an important precondition for gradually lifting controls. The heightened uncertainty following the recent court decision on foreign exchange-indexed loans, where the classification of loans has yet to be determined, appears to warrant additional caution concerning capital account liberalization. At the same time, we welcome the authorities' commitment towards liberalizing the capital account once the necessary preconditions are in place. In this regard, we welcome Mr. Callesen and Mrs. Alfredsdottir's statement that the delayed structural benchmark for end-May on the recapitalization of some weak banks can now go ahead after the recent Supreme Court judgment. This announcement is particularly reassuring as it is not proposed to formally reset the related benchmark in the current review. Furthermore, we welcome the authorities' emphasis on the need to continue to work towards a successful resolution with its bilateral partners and to seek to normalize its relations with international creditors as stated by Mr. Callesen and Mrs. Alfredsdottir.

Furthermore, a prudent monetary policy will be important in order not to jeopardize the timing of the capital account liberalization.

In addition to the welcome passing of legislation to strengthen the framework for household debt restructuring, the authorities should consider to step up progress in resolving the consumer and corporate debt problem. In this context, a possible reemergence of expectations of more favorable debt relief measures following the Supreme Court ruling on foreign-indexed loans would be a set-back and we agree with the staff that this risk should be actively addressed by the authorities.

Mr. Assimaidou submitted the following statement:

We thank staff for a comprehensive report, and Mr. Callesen and Mrs. Alfredsdottir for their informative buff statement.

We welcome Iceland's achievements under the Stand-By Arrangement and commend the authorities for their strong policy implementation. We note that program implementation has been key to the country's success, with numerous fiscal adjustment measures put in place contributing to stabilizing the public debt, while the financial system is slowly being restored.

Nonetheless, future prospects remain uncertain. In particular, the private debt overhang, barriers to energy sector investment, and global factors could all slow growth, while cost-push pressures emanating from wage agreements could threaten inflation. Increased attention must therefore be given to strengthening the policy framework. In this regard, we concur that key steps ahead should include the reform of the fiscal framework for local governments, full implementation of legislated financial sector supervisory reforms, and further strengthening of the supervisory framework in line with the evolution of international norms.

On the basis of the considerable progress to date and accomplishments under the program, we support the authorities' request for completion of the third review under the SBA.

Fiscal Policy

We agree that the passage of the 2011 budget would mark a significant milestone, with the projected primary position of the general government moving back into surplus. However, firm political commitment will be needed to bring the budget to a conclusion.

Looking forward, we concur that there may be scope to reduce the total amount of fiscal adjustment currently targeted. We note that debt dynamics are very favorable under the existing program design, and can tolerate moderate reductions in the medium-term fiscal target, provided that the financial sector's contingent liabilities are contained and the authorities continue to resist absorbing private sector losses.

Financial Sector

We welcome the framework being put in place to secure the capitalization of the banking system. We agree that it will be critical for the government to backstop capital raising efforts, in support of financial stability. The authorities must however structure their participation to minimize the risk that the government will have to absorb potential new losses.

We also share the view that, until the stability of the financial system is secure, capital controls and the government's blanket deposit guarantee must be maintained. However, to achieve a normal functioning of the financial sector, implementation of the recapitalization framework will need to be matched by work to restructure banks' balance sheets and their operations.

External Sector

We encourage the authorities to build up the country's stock of international reserves. While noting that program financing will help address this need, Iceland, from a longer-term perspective, will need to purchase reserves in the market to help redeem program loans. We welcome the central bank's commitment to get a head start on this in 2010. Nevertheless, we would like to know how the planned purchases would affect the foreign exchange market, if any. The staff's comments will be appreciated.

Iceland should also continue its efforts to normalize relations with international creditors. This is important not only to unlock program bilateral financing, but more generally to revive market confidence in Iceland's re-integration into global markets. We welcome the authorities' continued commitment to reaching an agreement with the United Kingdom and the Netherlands concerning Icesave deposits.

With these remarks, we wish the authorities of Iceland success in their future endeavors.

Mr. Hockin and Mr. Sajkunovic submitted the following statement:

We thank the staff for their report and Mr. Callesen and Mrs. Alfredsdottir for their helpful buff statement. We welcome the progress that Iceland has made under its Fund-supported program. As all performance criteria were met and progress is being made on the structural reform agenda, we support the completion of the third review under the Stand-By

Arrangement (SBA) and the request for a modification of performance criteria.

While we are pleased that growth is projected to have resumed in the second half of 2010, inflation appears contained, and notable progress has been made on fiscal consolidation and reform, considerable challenges and uncertainty remain. Overall, we agree with the thrust of the staff's assessment and offer the following points and questions for emphasis.

Financial Sector

We welcome the greater certainty on the recapitalization needs of the banking sector provided by the September 16 Supreme Court ruling on foreign exchange indexed loan contracts. The authorities' efforts to further reduce uncertainty by pursuing a voluntary framework with banks to convert certain foreign currency loans into krona denominated loans is a positive step forward. Given this new development, could the staff comment on whether the court decision will have any effect on the authorities' approach to recapitalization as detailed in the Letter of Intent.

Private Sector Debt Restructuring

Bringing closure to household and corporate debt restructuring is a very important part of Iceland's recovery. In this respect, we welcome the steps that the authorities are taking to speed the process and encourage participation in the voluntary approach to restructuring. As there seems to be some sentiment that additional across-the-board debt relief measures are possible, we agree with the staff that it is important for the authorities to be very clear that a further transfer of problems from the private sector to the public sector is not an affordable solution.

Fiscal Policy

Fiscal policy has been sound under the program but there is clearly room to improve the policy framework. In this respect, the authorities' efforts to improve the budget framework through a new two-year binding nominal ceiling and the introduction of amendments to the Local Government Act to limit local government deficits and debt is a good start. We have also taken note of the staff's reference to a working group that has been established on fiscal reform. We would appreciate some additional background information on its mandate and composition, as well as whether the recommendations coming out of this group may factor into the future fiscal reform priorities and potentially the SBA.

Looking at the current landscape, we concur with the staff that the 2011 budget will mark a significant milestone as the primary position moves back into surplus after significant adjustment. That said, we would note that sizeable medium-term fiscal consolidation measures (equivalent to 3 percent of GDP) are still to be identified for 2012. Given Iceland's coalition government and the difficult decisions that have already been taken and are still ahead, early attention next year to identifying agreeable measures will be important.

Monetary Policy and Capital Controls

The administration of capital controls may be necessary for the time being, however, the underlying objective of the authorities should be the removal of these controls once exchange rate stability is achieved. We are, therefore, encouraged by the authorities' recognition that the effectiveness of the capital controls is eroding over time, and also by their intention to lift the capital account restrictions as soon as conditions permit.

We have also taken note of the staff's comments regarding the challenges of implementing a de jure inflation targeting framework in Iceland. We would not dismiss the notion or merits of a revised IT regime too quickly. Like Ms. Lundsager and Ms. Franco, we would welcome additional staff analysis in this area going forward. That being said, we agree that a decision on the post-program framework would be premature at this point and find the authorities' current approach, as detailed by Mr. Callesen and Mrs. Alfredsdottir in their buff statement, to be sensible.

Normalizing Relations with International Creditors

Finally, we are encouraged by the progress that is reported by the staff and Mr. Callesen and Mrs. Alfredsdottir towards reaching an agreement with the authorities of the United Kingdom and the Netherlands on an agreeable conclusion to the Icesave issue.

With these comments, we wish the authorities well in the implementation of their Fund-supported program.

Mrs. Zajdel-Kurowska and Mr. Gasiorowski submitted the following statement:

We agree to the completion of the third review under the SBA, the modification of the performance criteria and the further retention of exchange restrictions. We welcome the progress achieved during the program but are still concerned about the policy sequencing with regard to the financial sector and would expect a stronger performance in this regard. Policy challenges remain and still have the potential to hamper the stabilization of the economy. The pending solution of the Icesave case and the recent court ruling on foreign exchange loans still pose risks to program success.

Outlook

The staff rightly notes that Iceland would have to find new, sustainable sources of growth. However, it will take time, strategy and capital. We find the current growth projections to be rather optimistic. Given the changes in private savings and huge indebtedness of the private sector, we would be interested to hear staff's opinion about the prospects for the growth in domestic demand.

Fiscal Policy

We note the very radical fiscal adjustment achieved under the program but consider that lowering the public debt is still a challenge. The public debt should be reduced to a safe level, much below the average for the advanced economies and the fiscal policy should aim at achieving surpluses. We do not see space for moderating the pace of fiscal adjustment; particularly, not before the Icesave issue is resolved. We are also worried that there is no consensus yet about the measures to be taken to complete a medium term adjustment.

Iceland's policy framework, including capital controls, has played an important role in insulating Iceland from spillovers of external events in sovereign markets. We welcome the reorientation of the budget financing towards the domestic market as it increases the stability of funding. We also note that the authorities managed to reduce the public external debt by a repurchase of Eurobonds with a discount and the operations related to Avens. Are these transactions—especially the purchase of Eurobonds on the market—subject to appeal?

Monetary Policy and Competitiveness

It seems that staff has a dilemma whether an inflation targeting regime is the proper monetary framework for Iceland. All arguments for and against should be reconsidered when the prospect of lifting the capital controls becomes clearer.

The next steps to liberalize capital controls should be considered with due diligence, even in the case of a favorable outcome of the Supreme Court ruling. Large-scale capital outflows continue to constitute a substantial risk, which is indicated by the more depreciated offshore rate. We fully agree that before proceeding with further liberalization, financial system stability has to be secured, even if this means constrains to growth rates in the near term.

The staff's analysis properly indicates large uncertainties related to the assessment of competitiveness. These uncertainties, together with the recent break down of the Stability Pact on wage moderation, indicate that it might be difficult to improve competitiveness while keeping the Nordic social welfare model. Could staff elaborate more on this topic?

Financial Sector

We agree with the authorities that the private debt restructuring should be conducted on a voluntary basis. Nevertheless, the authorities should provide every possible incentive to finish the restructuring fast, and avoid expectations of the population that general debt relief be granted on too favorable terms. Moreover, the prudential regulations should be brought up to international standards.

We welcome the explanation provided by Mr. Callesen and Mrs. Alfredsdottir about the September's Supreme Court decision regarding the interest rate on foreign exchange indexed loans. However, we understand that the range of applicability of the ruling on foreign exchange indexed loans is not clarified and thus the impact of this ruling on banks' assets valuation is not clear. The authorities should spare no effort to specify the applicability of this ruling. The staff's update on this issue would be welcomed.

We urge the involved parties in the Icesave dispute (and ESA) to find a solution that is just but also sustainable. Could staff brief us about the status of the disbursements under the Nordic loans?

Mr. Mac Laughlin, Mr. Vogel and Mr. Ricaurte submitted the following statement:

Iceland's substantial efforts seem to be starting to reap some fruits. The country has been able to avoid its collapse associated with a deep financial and economic crisis. We do believe that the Fund-supported program has played a key role by reinforcing a very scarce element when the crisis erupted: confidence. However, substantial challenges and risks to the program largely remain; a huge dose of uncertainty still surrounds Iceland's economy and particularly its economic program, as the Supreme Court decisions and, more generally, the vulnerable indicators remind us. We are encouraged by the authorities' awareness of the problems, and their commitment to address the situation through sound policies. In particular, we welcome the authorities' emphasis on further restoration of the financial system; taking steps towards capital account liberalization; and securing public debt sustainability, as noted in Mr. Callesen and Mrs. Alfredsdottir's helpful buff statement.

Progress in restructuring consumer and corporate private debt has become more complicated following the Supreme Court's recent ruling on foreign exchange indexed loans, although a subsequent decision reduced some uncertainty. The situation tends to exacerbate incentives and expectations, and we agree with the staff that a clear message to contain them is needed.

To restore sustained growth, the authorities must foster investment in the tradable sector of the economy. Currently there is excess capacity in the non-tradable sector, but developments with regard to the currency and labor costs should contribute to improving the tradable sector outlook. Regarding the economic outlook, we would like to have further elaboration from the staff on the factors that will reduce unemployment to less than half of its current level over the next few years (from 8.6 percent in 2010 and 8.4 percent in 2011 to 3.4 percent in 2014). We note that "this level of unemployment is uncharacteristic of Icelandic society," as stated by Mr. Callesen and Mrs. Alfredsdottir, however the expected GDP dynamics do not seem to be significant enough to allow for the above-referred labor market evolution.

Considering the fiscal indicators and the uncertainty about contingent liabilities, we fully agree that consolidation is imperative. We support the minor modification to fiscal targets. We recognize that to achieve a primary balance of 6 percent of GDP in 2013 constitutes a substantial challenge, taking into account, for instance, that it would imply a reduction in expenditure (relative to GDP) from 48.2 percent in 2010 (52.1 percent in 2009) to 39.2 percent in 2013. Therefore, as noted in the staff report, firm political commitment and social consensus behind the measures and targets chosen are critical.

The authorities are requesting retention of the capital control regime currently in place for up to an additional 12 months. We support this request on the grounds that the authorities are committed, as previously noted, to taking steps towards capital account liberalization, which, as we understand, will be further accelerated once the stability of the financial system is secure.

With these comments, we support the proposed decision and wish Iceland and its people the best in their future endeavors.

Mr. Sadun and Mr. Spadafora submitted the following statement:

We thank staff for the well-written set of papers, and Mr. Callesen and Mrs. Alfredsdottir for their informative buff statement.

As we broadly agree with the staff's assessment and recommendations, we add a few comments for emphasis.

In the context of an improving macroeconomic outlook, led by rising net exports, the Icelandic authorities have commendably kept the IMF-supported program broadly on track while facing distinct challenges posed by the crisis.

The authorities are now coping with the broad consequences of the Supreme Court ruling on foreign exchange indexation in loan contracts. The ruling is having a significant impact on several parts of the program, notably through the legal uncertainty that has followed suit. As effectively highlighted by staff, full restoration of financial stability and private sector restructuring may be delayed as a result of this uncertainty, and foreign investment discouraged. The additional conditionality that supports the program's objectives in the face of the Supreme Court ruling is appropriate. On the positive side, the authorities' resolve to once again adapt their strategy to new events is reassuring. Moreover, we acknowledge the staff's update on the new ruling of September 16 by the Supreme Court, which has materially mitigated legal risks.

The framework for bank recapitalization put in place by the authorities is an important step and necessary step to support confidence in the banking system, notably by ensuring that banks remain solvent even in adverse legal scenarios. This framework aptly relies on capital risings by shareholders, and backstops by the government if needed.

We concur with staff that the case for maintaining capital controls has been reinforced by the increased risk to financial stability triggered by the Supreme Court ruling. Gradual removal of such controls is to be strictly dependent on meeting the preconditions identified by staff. The accumulation of foreign exchange reserve favored by the recent appreciation of the exchange rate is in order, also in light of the high debt rollovers falling due in 2011-12.

Fiscal policy is set to meet the program's target, and the sustainability of external and public debt seems to be improving. We welcome the definition of the adjustment measures to be incorporated in the 2011 budget (including the 2-year nominal spending ceilings), whose approval would be an important step toward further progress on the ambitious adjustment strategy.

Against this background, the scope for a further relaxation of the fiscal targets going forward should be carefully evaluated. Despite the impressive successes to date, the Supreme Court ruling implies additional risk to program implementation, notably policy mis-sequencing, as highlighted by staff in paragraph 42.

Speeding up the process of restructuring consumer and corporate debt is essential to ensure a sustained normalization of credit relationships. We welcome the changes to the framework for household debt restructuring that address identified shortcomings; the planned steps on corporate debt restructuring are also a positive development.

We welcome the reaffirmed commitment of the Icelandic authorities to reach a settlement with the United Kingdom and Dutch authorities on the Icesave dispute, and we encourage the parties to make further progress to this end.

Finally, we appreciate staff's comprehensive analysis of the three medium-term challenges faced by Iceland, which all point toward strengthening the policy frameworks.

In light of the actions taken, and their renewed commitment to the Fund-supported adjustment program, we support the authorities' requests and the completion of the third review.

Mr. Mozhin and Mr. Palei submitted the following statement:

Repeated delays in program reviews reflect still high degree of uncertainty in program implementation. The summer Supreme Court ruling on foreign exchange indexed loans elevated the risks to the banking sector. Negotiations with the authorities of the United Kingdom and the Netherlands on the Icesave issue pose another risk to the economic and debt outlook. The staff expressed concerns about the authorities' ability to reach consensus with their social partners on wage settlements. At the same time, we note that, despite this highly uncertain environment progress under the program has been satisfactory, and we commend the Icelandic authorities for their achievements. We support the proposed decision, modification of NIR and NDA targets for end-September and establishment of the performance criteria.

The authorities are appropriately concerned about maintaining investors' confidence in fiscal sustainability. At the same time, we agree with other Directors that fiscal strategy should not put in jeopardy the nascent growth prospects. In our view, credible structural reforms already provide necessary credibility to the announced medium-term goals. The authorities are implementing a range of measures elaborated with the assistance from the Fund. The two-stage budget approval process and planning for budget contingencies has helped the authorities to carry out significant fiscal adjustment. We welcome their commitment to rely on binding two-year nominal ceilings on expenditures. Given the prominent role of the municipalities, we also commend the authorities for their efforts to put in place a transparent and rules-based framework for local governments.

In the monetary policy area, market conditions and relatively favorable inflation outlook allowed the authorities to embark on a sequence of adjustments in policy interest rates. We view positively the authorities' plans to accumulate additional foreign exchange reserves. At the same time, it would be important to assure the markets that this task does not interfere with the main goals of the monetary policy and that no particular exchange rate level is targeted. Until the resolution of the key issues related to public and private debt restructuring allows for sufficient strength of the banks' balance sheets, the transmission mechanism is likely to malfunction. We agree with the authorities and staff that for the time being Iceland needs to continue using capital controls. Overall, the authorities' cautious monetary policy stance is well-tailored to the unusually challenging economic circumstances.

To facilitate the return to more effective monetary policy, the authorities need to facilitate expeditious household and corporate debt restructuring. As the main features of the needed frameworks are already in place, it is time to focus on implementation of this essential task. We agree with staff that the authorities should avoid creating impression that further significant adjustments in the terms of restructuring are forthcoming.

With these remarks we wish the Icelandic authorities success in their endeavors.

Mr. Nogueira Batista and Mr. Fachada submitted the following statement:

The Icelandic Stand-By Arrangement (SBA) returns to the Board agenda after new setbacks and delays. According to the program's original schedule, approved in November 2008, the seventh review should have been completed by mid-August. However, the Board is meeting today to discuss the third review. As we have stressed in our statements for the first and second reviews, this is possibly one of the most controversial, complex and less transparent of all programs approved by the Fund since the outset of the global financial crisis.

That said, we recognize that Iceland has made considerable progress in the fiscal, external and financial fronts and we support the completion of the third review and the request for modification of performance criteria. Nevertheless, risks remain tilted to the downside, especially regarding the real economy.

The staff expresses the view that the recession in Iceland has been mild compared with other hard hit countries and less intense than could be expected given the magnitude of the country's financial crisis of 2008. However, real GDP contracted by 6.8 percent in 2009. Moreover, staff does not highlight the fact that there was a 20.9 percent drop in domestic demand last year, the deepest in any advanced country and not far from the collapse in demand in the Baltic countries during the current crisis.

Among the components of aggregate demand, household consumption declined by 16 percent as a result of the restructuring of household balance sheets, low confidence and the reduction in disposable income. Fixed capital formation contracted more dramatically (50.9 percent). Of note, the sharp downturn in investment took place after two successive declines in the previous years (11.1 percent in 2007 and 20.9 percent in 2008). Considering the staff's forecasts of another contraction this year, investment will have decreased by nearly 70 percent in the four-year period through 2010.

Although the figures are somewhat distorted by one large industrial investment, the plunge is nonetheless appalling.

The recession has been mitigated by a strong increase in net exports—particularly by contraction in imports. The significant real exchange rate depreciation in the aftermath of the banking crisis, coupled with the contraction in disposable income, contributed to a sharp improvement in the external accounts. Given the openness of the Icelandic economy, the large real depreciation attenuated the fall in GDP. As we have already highlighted on other occasions, a clear advantage of Iceland over other hard hit European countries—for instance, some advanced economies in the euro area and emerging economies that have a currency board or an inflexible exchange rate—is that its currency was allowed to adjust, making the economy more competitive internationally and facilitating a tradable sector-led recovery (mostly, it seems, through import-substitution).

The staff and the Icelandic authorities are hopeful that a durable recovery will take hold during the second half of this year. However, it is not clear if the recession has bottomed out yet. On a quarterly seasonally adjusted basis, GDP contraction has accelerated in the last quarter and household consumption registered the largest decline since end-2008. The staff attributes the recent deepening of the downturn to effects of the volcanic eruption, but ongoing balance sheet adjustments seem to continue to take a toll on the economy.

Fiscal consolidation is a factor that will also weigh on growth over the medium term. According to the staff, general government gross debt is expected to reach 115 percent of GDP this year from just 29 percent of GDP in 2007. Net debt has also increased dramatically, although it is expected by the staff to peak at a more moderate level (around 80 percent of GDP next year). The sharp deterioration of the fiscal position reflects the operation of automatic stabilizers, coupled with the costs of recapitalization of the banking system and the residual obligations of the government to the Depositor's and Investor's Guarantee Fund, including the Icesave imbroglio. The staff's public debt sustainability analysis indicates a relatively benign scenario, assuming that the authorities are able to deliver a non-trivial adjustment of the structural primary balance of near 9 percent of GDP from 2009 to 2013.

The Central Bank of Iceland has continued to de facto target the exchange rate, which has appreciated moderately during the year, contributing to maintain inflation on a downward trend. Capital controls had a fundamental role in sustaining the exchange rate. We welcome the authorities' strategy to strengthen international reserves, including through purchases of foreign exchange in the market. This will increase the external resilience of the economy and prepare it for pressures on the currency once controls are eased.

We note that the restructuring of the banking sector is mostly complete and regulatory reforms have advanced. The recent ruling by the Supreme Court on foreign exchange indexed loans reduced uncertainty about potential costs to financial institutions and contributed to normalize the outlook.

Mr. Fayolle submitted the following statement:

We thank staff for a comprehensive report and Mr. Callesen and Ms. Alfredsdottir for their informative buff statement. In spite of the complexity of the restructuring process, the program remains on track. Furthermore, thanks to projected current account surpluses, existing capital controls, and progress regarding the resolution of the Icesave dispute, we are confident that the program remains fully financed over the next 12 months. We can therefore support the completion of this third review. We also support the modification of performance criteria. Further building reserves is crucial to strengthen medium-term viability, to ensure the capacity to service debt and to gradually remove all capital controls and return to a fully flexible exchange rate regime. As we broadly share the thrust of the staff appraisal, we will focus our comments on a few issues.

Although the economy is set to rebound, significant downside risks for growth remain. Exchange rate developments have supported competitiveness, and unemployment is decreasing. Nevertheless, the high level of external debt, the uncertainty regarding FDI prospects, potential emigration, and most importantly a slower pace of balance sheet repair could affect future growth negatively. We share staff's views regarding the importance of encouraging investments in the tradable sectors to support medium-term growth.

The repair of the financial sector has progressed, but legal risks have materialized and put achievements at risk. Indeed, the restructuring of the banking sector—and the orientation of the overall policy mix—has been complicated by the recent Supreme Court ruling on foreign exchange-indexed loans. We take positive note of the most recent decision of September 16 that the lowest interest rates as published by the CBI should prevail, as stated by Mr. Callesen and Ms. Alfredsdottir. This is likely to limit the adverse impact of the ruling on the new banks' capital while reducing the legal uncertainty. Nevertheless, the scope of the ruling is still uncertain, which complicates efforts to repair the banking sector and risks slowing the private debt restructuring. We therefore welcome the authorities' plans to address this issue. Based on the latest available information, staff's assessment of the potential cost for the new banks and eventually for public finances would be most welcome.

The exchange rate has stabilized but pressures remain and are compounded by the decision of the Supreme Court, thus complicating the capital control liberalization schedule envisaged. We fully agree with the need to retain the controls at this stage, but would welcome staff's further elaboration on the pre-conditions and timing for relaxation of these controls.

Significant fiscal consolidation has already been achieved, but sustained efforts remain necessary. Achieving a primary surplus in 2011 is within reach and public debt is expected to peak in 2011 before gradually declining. We take note of staff's assessment that the additional adjustment need might be lower than the 3 percentage points of GDP currently targeted. Nevertheless, given the high remaining uncertainties and potential additional costs stemming from the restructuring of the financial sector, we would err on the cautious side and invite the authorities to stick to the current target. Have the potential recapitalization needs of the HFF been accounted for in deficit and debt projections?

Mr. Guzmán and Mr. De Las Casas submitted the following statement:

We thank the staff for their detailed set of papers, and Mr. Callesen and Mr. Alfredsdottir for their insightful buff statement.

We welcome the good progress of the Icelandic economy under the program, which has allowed stabilization and generated expectations of early growth resumption. Authorities' management and adaptability within the framework of the program deserve credit. Since (i) the program targets and the structural benchmark on the restructuring framework of household debt have been met; (ii) borrowing under the program is still necessary; and (iii) financing assurances seem to remain in place, we are ready to support the completion of the third review and associated purchase under the SBA. At the same time, we agree on the modification of targets and the establishment of quantitative performance criteria in the terms and conditions recommended by staff. Finally, we also agree on the maintenance of the temporary and non-discriminatory exchange restrictions.

Notwithstanding the good performance so far, especially in the fiscal domain and in the stabilization of the financial sector, we would encourage authorities to remain focused on the challenges and uncertainties ahead. Global and domestic downside risks—especially the potential implications of the recent Supreme Court ruling—are significant. In this sense, the clear and detailed recognition and commitment expressed by authorities in Mr. Callesen's statement are reassuring.

Since we agree with the staff's analysis and recommendations, we will limit ourselves to the following points and questions:

Financing assurances, while secured in principle, seem conditional on a number of issues, among them the unlocking of Nordic financing and the resolution of the Icesave dispute. The latter has constituted an obstacle for quite a long time and we look forward to the prompt conclusion of a comprehensive agreement with the United Kingdom and the Netherlands, where both parties should show flexibility.

Tackling the risks highlighted by the staff will certainly require a significant amount of social and political support. For instance, the definition and execution of a medium-term fiscal consolidation plan will be extremely demanding. As in previous occasions, we would appreciate it if staff could elaborate on current and presumable levels of support for the program, taking into account the already protracted period of adjustment suffered by the Icelandic economy.

In addition, regarding downside risks, we would like to hear from staff the contingency measures foreseen by authorities should any of these materialize.

We find particularly interesting staff's remarks regarding the difficulties for implementing the de jure inflation-targeting framework. We would welcome further elaboration on this matter, including possible alternatives, taking into consideration prospects of Iceland joining the EMU.

With these remarks, we wish the Icelandic authorities success in the difficult tasks that lie ahead.

The representative from the European Central Bank submitted the following statement:

We thank staff for their informative report and Mr. Callesen and Mrs. Alfredsdottir for their lucid buff statement.

We broadly share the staff assessment of Iceland's performance under the Stand-By Arrangement. Iceland has indeed made significant progress in stabilizing the economy in the aftermath of the collapse of its financial sector. The authorities' strategy, which implied using unconventional measures like capital controls and delaying loss recognition, has helped cushion the short-term impact of the crisis. However, this immediate response, if not reversed in a timely manner, might become a complicating factor in designing a new medium-term policy framework. In this context, it is encouraging to see that the authorities have used currently improved conditions to reduce legal uncertainties surrounding foreign exchange indexed lending and to advance negotiations in the Icesave dispute.

Macroeconomic Outlook and Monetary Policy

Iceland's economy failed to return to positive growth in the first half of 2010 and a gradual recovery is currently expected to take hold in the second half of the year. However, downside risks predominate (notably for 2011), against the background of remaining tight financing conditions, high debt overhang and significant uncertainties about the timing and outcome of capital control liberalization. A more muted rebound in fixed capital investments than the one projected by Fund staff cannot be ruled out. The ECB considers that Iceland's growth prospects would be enhanced by further expanding (as well as diversifying) exports, regardless of a future possible EU membership.

We agree with staff that, as financial stability risks ease, further steps in removing capital account restrictions would be warranted. In this context, the CBI should use current favorable conditions to further replenish its foreign exchange reserves. At the same time, monetary policy should assign proper weight to exchange rate stability as an effective channel to further the ongoing disinflation process. A medium-term challenge for the authorities will be the design of a credible monetary policy framework once capital account restrictions have been removed.

Fiscal Policy

Significant progress has been achieved in the fiscal domain. The ECB notes that public debt developments remain subject to considerable uncertainty, notably relating to the containment of contingent liabilities. Restoring lasting confidence of foreign creditors through a resolution of the Icesave dispute, which complies with Iceland's internationally recognized sovereign obligations, is important. We concur with the assessment that

Iceland's progressive return to international markets for the funding of government debt remains a major challenge for the authorities, since this will be key to rebuild confidence and pave the way to private sector access to foreign capital markets.

Financial Sector

We welcome the most recent ruling by the Supreme Court relating to foreign exchange indexed loan contracts, which should contribute to clarifying the legal conditions affecting further recapitalization needs in the banking sector.

In view of the high ratio of non-performing loans, voluntary corporate and household debt restructuring appears to be a key aspect of financial sector repair.

Mr. Callesen made the following statement:

I will start by saying that the program for Iceland has been one of success both for the Fund and for Iceland. A number of indicators suggest that, although many tasks remain to be dealt with, Iceland is emerging from this financial crisis. The cooperation between the Icelandic authorities and the Fund has been exemplary. I would like to make three introductory comments on this issue.

First, the report deals in depth with the previous Supreme Court ruling on foreign exchange indexation clauses in loan agreements. It is important to note that these risks have now been contained. The most recent Supreme Court ruling has deemed that the lowest interest rates on new, non-indexed loans at credit institutions, as published by the central bank, should prevail in the case of non-binding foreign exchange indexation clauses in these loan agreements. This ruling substantially reduces the uncertainty in the financial sector. The cost to the banking sector will be contained with no or very limited need for additional capital injection from the treasury or other shareholders. So, this is a piece of good news.

Second, the economic recovery has indisputably been negatively affected by the well-known bilateral dispute that Iceland has with the United Kingdom and The Netherlands. As Directors know, the dispute regards compensation for depositors in those countries, who held online accounts in one of Iceland's main banks that collapsed in October 2008. The delay in finding a settlement has led to persistent uncertainty and not helped economic developments. We are therefore pleased to inform that the parties involved in the Icesave dispute have made very significant progress toward reaching an amicable and consensual resolution to what has been truly a regretful affair for all parties concerned. Parties engaged in a very constructive effort and have managed to bridge differences. They are now optimistic that an agreement can be finalized very shortly.

Third, staff has provided very interesting and innovative analysis of external debt in the selected issues paper. I would recommend reading it, as there is a balance sheet approach and a focus on return differentials on assets and liabilities, which is interesting in a broader international context. On substance—of course, one should be aware not to mix up figures from it and gross external debt—the net foreign asset position of Iceland is negative, surely. It is roughly 30 percent of GDP according to staff estimates, but it is not out of line with peer country. The gross numbers are, of course, much higher for all countries, and they are higher in Iceland than in most countries, but due account needs to be taken of the corresponding assets. In recent years, there has been strong reduction in both liabilities and assets, and be aware that, if one has a country of this small size, transactions within single companies or single institutions can actually change the gross balance of assets and liabilities a lot.

Finally, the authorities realize that firm debt management is, of course, of utmost importance to restore confidence and enhance growth in the Icelandic economy.

Ms. Choueiri made the following statement:

We thank Mr. Callesen and Mrs. Alfredsdottir for their informative statement and the comments made this morning, and we thank staff for their well-balanced reports.

The authorities have made commendable progress in their economic program supported by the Stand-By Arrangement. All program targets have been met. Accordingly, and in view of the authorities' commitment to the program's objectives, we support the proposed decisions.

We also welcome Iceland's continued efforts to normalize relations with the international creditors. We broadly agree with the staff appraisal, and will turn to two issues related to capital control liberalization and growth challenges.

Higher investment, particularly in the tradable sector, can help promote higher growth. Liberalization of capital controls, as conditions permit and when the operational restructuring of the financial sector is complete, would be helpful in this regard. In this connection, we would be grateful if staff could elaborate on the envisaged capital control liberalization process in light of the most recent Supreme Court ruling.

We found the selected issues paper on Iceland's growth challenges very interesting. While several program elements would pave the way for higher investment, there remain important obstacles including uncertainty about foreign investment in the energy sector. In view of these uncertainties, we look forward to updates on the growth strategy to support investment in future reports.

Mr. Gibbs made the following statement:

I issued a joint gray with Mr. Bakker, but I would like to give a very brief update of how we see the current negotiations on Icesave.

The staff update circulated on Monday reported that there had been significant progress in recent weeks, and Mr. Callesen just referred to that as well. An agreement is very important, as it would enable Iceland to meet its international obligations and ensure that the program is fully financed.

I just wanted to confirm that my authorities share the perspective that there has been good progress. This has clearly required a lot of flexibility and goodwill on both sides, but we do not have an agreement yet. We have learned that we should never make assumptions about how things are going to progress. But, all sides are working hard to finalize the legal documentation and there appears to be a lot more momentum now than at any time since the referendum on the previous agreement.

We are cautiously optimistic and are happy to support the review. Once this agreement is concluded, we look forward to a new chapter in the relations with Iceland.

Mr. Furusawa made the following statement:

We broadly agree with the staff's assessment and support the completion of the third review. I would like to make one comment regarding the debt restructuring.

The debt restructuring is a key element to recover the economy and restore confidence. In this regard, we welcome the authorities' emphasis on normalizing relations with international creditors, as mentioned by Mr. Callesen in his statement. On the other hand, we hear noise from foreign creditors expressing some uneasiness regarding their engagement in the debt restructuring process. We are very confident that the Icelandic authorities are fully committed to a fair and equitable treatment for foreign and domestic creditors, but I have a concern that this dissatisfaction of the foreign creditors could lead to a risk of litigation, which might damage the financial sector's stability and market confidence.

I do not have every detail of the negotiations of the individual private banks with the Icelandic authorities. Maybe the staff has more objective information. I am very happy to hear staff's view regarding the litigation risk.

Mr. Bakker made the following statement:

The staff paper shows that Iceland is entering a new phase. The economy and the exchange rate seem to have stabilized, and there is considerable progress in financial sector resolution. Moreover, despite all the risks in the financial sector, the staff and authorities are right in starting to look beyond the most immediate problems and consider models for sustainable growth—Ms. Lundsager also addressed this issue in her statement. Part of such a model must be a return to international capital markets and liberalization of the capital account, in line with what Mr. Callesen and Mr. Gibbs said.

In order to be in a position to do that, the resolution of the Icesave conflict, which is very close, will be key, as was recognized by many Directors not only in this meeting, but also in earlier occasions. All authorities—my authorities, Icelandic, and the U.K. authorities—have worked very hard over the last months, as they had over the last years actually, to reach an agreement with Iceland.

As said in my joint statement with Mr. Gibbs, substantial progress has been made, and we expect to receive an acceptable proposal by Iceland in the coming days. On that basis, even though there is no final agreement, we support this review.

The staff representative from the European Department (Mr. Flanagan), in response to questions and comments from Executive Directors, made the following statement:

> First of all, let me note that we received a number of what we would call technical questions, and we prepared some detailed responses to those. They will be circulated to the whole Board after the meeting.[1] I would also encourage any Director who has any follow-up questions about those answers to get in contact with us bilaterally.
>
> Now, there are several questions I do want to address here at the Board.
>
> There was a question about what staff thinks about the level of support for the program, given that we have now had to endure two years of difficult adjustment. This is obviously something we look at. When one is looking at moving from 7 percent of GDP in measures to 10 percent of GDP in measures, there are obviously no easy measures left—all the low hanging fruit is gone and there is going to be some dissatisfaction.
>
> We have noted that there is a debate in Iceland not so much about the amount of fiscal adjustment, but about the composition of fiscal adjustment. And that is in part why we produced the selected issues paper on strategies for fiscal adjustment—to help inform this debate.
>
> Overall, the program tries to build support by two means. One is to build ownership by allowing the authorities wide latitude to select the measures they implement; and secondly, by outreach to affected groups. Overall, the government has done a good job of reaching out in the context, in particular, of Stability Pact discussions with social partners—reaching out and explaining to them what they are doing and why.
>
> It is true that the previous social pact broke down, although that was not related to fiscal adjustment matters. That was related to issues of fishing quotas and growth strategy. There are new discussions under way for a new Stability Pact starting in September this year. We certainly hope that, in that context, the government will be able to build support for the 2011 budget.
>
> We had several questions about the economic outlook—growth, domestic demand, and employment.

[1] Subsequently, SEC circulated the staff representative's additional responses by email. For information, these are included in an annex to this minute.

We have always expected the economy to go through a rough period in early 2010. Why? Because there are very important head winds, as fiscal adjustment kicks in, for instance. We still have the debt overhang and have the added problem that there was a volcanic eruption, which had an impact on tourism during the second quarter. We do see signs of stability now in the third quarter. We don’t have data yet, but we have short-term indicators on credit card turnover, consumer confidence, exports, passenger arrivals, etcetera, and we see signs of stability and even a bit of a pickup.

We have been appropriately cautious about the medium-term outlook. Ignoring 2009 and 2010, which capture the crisis-related recession, average growth over the next five years, starting in 2011, is projected at about 2.5 percent per year. That compares to about 4.5 percent in the period from 2000 to 2007. It is comparable to the growth rates experienced by Iceland in the 1990s, when Iceland also went through a period of significant fiscal adjustment and liberalization of capital controls. The growth rate has also been calibrated against the experiences of other countries, after financial cum balance of payments crises and it is slightly more conservative.

Similarly, we have been very conservative about domestic demand, where we have considerably lower projections than the pre-crisis growth rate. We have reduced consumption and investment projections relative to the average one sees in a post-crisis case, because we do see that there was a big debt buildup and this will affect consumers’ and corporations’ ability to spend.

Still, it is clear that there are risks. We have gone over them rigorously in this report and in the selected issues paper on growth constraints. They are tilted a bit to the downside. To the extent they vest, we do have options, particularly if the government is able to contain financial sector contingent liabilities, and the September Supreme Court ruling is an important step in this direction. But if it can do that, or if it can make further progress on asset sales, then we have a bit of room to adjust the total amount of medium-term fiscal adjustment and support the economy in that way. We have been using that to date. Directors will note that at this review and in the last review we did make some adjustments, and again there is probably room going forward, provided these contingent liabilities are contained.

Regarding employment, we project it to grow in line with economic growth in the medium term. Now, how does this reduce unemployment so rapidly? The answer is emigration. Iceland has a common labor market with the Nordic countries. Typically, during past post-crisis periods in Iceland, during past recessions in Iceland, we have seen an outflow. Our projections are in line with that, and it can be substantial. Last year it was on the order of 1 percent of the labor force. So, this is a mechanism that will help equilibrate the labor market.

In terms of fiscal policy, there were a couple of questions about how the authorities' intention to preserve the Nordic welfare state model would be consistent with fiscal adjustment needs and the need to improve competitiveness. Certainly, there are revenue options to achieve adjustment. We have had technical assistance from the Fiscal Affairs Department. They have identified a number of options that can be taken and that are consistent with preserving the simplicity and efficiency that characterize the current tax system in Iceland. Even on the social spending side, the basic model can be preserved just simply by keeping real benefits constant, which will reduce them in percent of GDP, and by better targeting.

Concerning competitiveness, Iceland has already realized enormous improvements in competitiveness via exchange rate depreciation and through nominal wage restraint. So we do not have a need to use social spending and wage policy to improve competitiveness here—we already have competitiveness. The exchange rate is, by our assessment, mildly undervalued. It is a question of just maintaining this.

There were several questions on the financial sector. First of all, does the recent Supreme Court ruling affect the strategy? No. The strategy was set up to be robust to a variety of legal outcomes. The authorities still need to move forward at this point and classify the loans into those affected by the two rulings, those not affected, and those possibly affected. On that basis, they need to assess capital needs in the banks and provide a government backstop to the extent private shareholders will not bring in capital.

Does it affect the cost? Yes, it affects the cost very considerably. As we noted in the supplement, we now expect total cost to be limited to at most 3 percent of GDP and there are good reasons to believe it is going to be less than that. In particular, the Supreme Court ruling does not yet cover the issue of corporations versus households. There are differences in legislation. We have consumer protection legislation in Iceland. If in fact the court draws a line between corporations and households, then the cost would drop by a further 50 or 60 percent. In addition, there is a loan classification exercise that remains to be completed. It is due by end-September. The feedback we are getting is that a number of the loans that were classified as possibly affected are now being put into the not affected category. Finally, bank owners are expected to provide some resources. So the final cost to the government is expected to be substantially less than 3 percent of GDP.

There is a question about the framework for converting loans that the authorities have announced. What they intend to do is offer households the voluntary option of rewriting mortgages and car loans on the terms mandated by the Supreme Court in its September decision. The authorities would address this in legislation. They would also back it up with agreements with financial institutions. They would make clear that banks have the option of offsetting any repayments owed against any future amounts due, and that would handle any liquidity risks to the banking system.

There was a good question about why the program did not perceive this issue to be a risk and mitigate it. We were aware of the cases pending, but there were a number of issues that led us and the authorities to believe that they would not be material. First of all, courts have enforced these contracts in the past in Iceland. Secondly, the authorities did not attach material importance to it, which obviously feeds into our assessment. The due diligence conducted by the auditors of the banks did not attach material importance to this. They recognized it as a risk and issued a qualification to their finding, but did not see it is a materially important. Finally, the creditors who were acquiring the banks in doing their due diligence with their investment bankers and lawyers did not perceive this to be a material risk.

In retrospect, and in light of the second ruling, I think the authorities will be proven right—it was not a material risk. However, in the interim between the two decisions, that certainly was not clear and it produced an immense amount of political pressure to extend debt relief in ways that would have been very damaging to the public finances.

There was a more general question about legal risks and a specific question about litigation risks in the financial sector. Concerning the general question of legal risks, this is always an issue in program implementation. In the wake of a crisis, many laws need to be changed. Just in this case, we have changes in laws to implement the fiscal adjustment, to implement changes to regulation and supervision, and to address other issues, as well. The Supreme Court in any country is going to review some of the legal changes. On occasion, they will overturn laws—I do not think I have ever been involved in a program where this has not happened at some point. What do we do about it? With the Legal Department's assistance, we have been reviewing the authorities' proposed legislation and we have been asking questions about constitutionality of draft laws, and changes have been made. Going forward, we will continue with this process and, if we perceive any residual legal risks, we will alert the Board to this.

Concerning litigation risks in the financial sector, there is litigation underway regarding the Emergency Law, which changed the order of recovery in the bank restructuring process for creditors; in particular, by instituting depositor preference in recovery. At the moment, we have nothing new to report versus the second review. At that point, we indicated that a complaint had been taken before the European Surveillance Authority and the Surveillance Authority had rejected the complaint about the Emergency Law.

Our present assessment is that the creditors in this case do not stand a very good chance of winning their case on the Emergency Law. We do not consider it to be a significant risk in terms of probability. However, in terms of impact, if this risk ever did vest, it would have very important implications for the program, because it would be very expensive for the government to try to make up to wholesale creditors amounts that have essentially been diverted to depositors.

There were a couple of questions about the monetary framework. First, on capital control liberalization, does the Supreme Court ruling affect the pace of it? The answer is yes. It does contribute greatly to reestablishing financial system stability. There was a week or two in June, when things got shaky in the wake of the original ruling, when we had a nascent deposit run into cash. This serves to underscore how important it is to get the sequencing right here. The decision does have an effect. It reduces the potential for system instability, and we do think it will open the door to a future limited step concerning liberalization of holdings of long-term assets. But, again, the strategy has always been to be gradual, and the next step in the next six months will be small, and we will have to stop and take stock at that point.

Finally, on the monetary regime, we were asked to give some analysis of the costs and benefits of alternative regimes. First of all, let me say that we do not take a view, in this report, on whether Iceland should have inflation targeting or not—I think there is confusion about that. It is the de jure regime at the moment. It is clear that the previous regime did not work. It did not deliver lower and more stable inflation even excluding the impact of the crisis—we know that. There is going to be a debate in Iceland, at some point, about this issue of monetary regime. There is an extensive academic literature that can be drawn on. Iceland also has extensive experience with different regimes—three in the last 20 years—and that will be taken into account. We can say that this will be a topic for a future review. The timeline is not urgent at the moment. The program itself is a monetary framework. The gradual phase out of capital controls also leaves some time to have a further discussion about this. And, overall, a decision about the monetary regime will clearly be nested in Iceland's decision on how it wants to proceed with its EU application.

Mr. Callesen made the following concluding statement:

At this stage, I have not that much to add. I would like to thank staff for the answers and explanations, and thank Directors for all the input. We will convey the messages to the authorities. We have had some delays in the past reviews. We all know why that has been taking place: because of the common concern about not messing up with ongoing negotiations, and that has been helpful on balance. We are pleased to see this review taking place on schedule.

Mr. Flanagan referred to the issue of monetary policy regime. That has been appropriate in this post-crisis environment. But the authorities are looking to the costs and benefits of alternative exchange rate regimes. There will be an analysis of this coming up by the central bank and probably finalized by the middle of next year.

I can also stress that the authorities remain fully committed to fair and equitable treatment of foreign and domestic creditors within the parameters of the applicable law. They are fully aware of the importance of having this process as open and transparent as possible.

Finally, let me stress that the ownership of this program is very strong in Iceland, and the authorities believe that the economy has benefited greatly from the cooperation with the Fund. Once again, thanks to staff, thanks for all the work being done; especially to Mr. Flanagan, who will now leave the country desk, as we understand it, and to Franek Rozwadowski, who is the resident representative in Reykjavik.

The Acting Chair (Mr. Portugal) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for their strong and determined program implementation and readiness to adapt policies as warranted. This helped Iceland overcome a deep financial and economic crisis. Growth is expected to begin to rebound, although uncertainties remain, including from the global outlook and the private debt overhang. To better secure the ongoing recovery, Directors encouraged the authorities to develop a strategy to unlock investment and to reach consensus with social partners on wage settlements. Continued steadfast implementation of the program will be crucial.

Directors emphasized that it is important to maintain the momentum towards restoration of the financial system. They welcomed the authorities' framework to secure bank capital in the face of legal uncertainty about banks' foreign exchange linked loans. Directors observed that the Supreme Court's most recent ruling has substantially lessened risks to the system and recommended that the authorities take the necessary steps to ensure that banks meet capital requirements within the expected timeframe.

Directors stressed the importance of accelerating the restructuring of banks' operations and balance sheets. They recognized recent steps to improve the frameworks for household and corporate debt restructuring, which would help support the economy. Directors underscored the need to expedite implementation of the framework and improve incentives for debtors to use it by limiting expectations of further debt relief.

Directors commended the authorities' commitment to further fiscal adjustment in 2011. They emphasized the need to reach the targeted primary surplus, and to build consensus for measures taken. Directors observed that, subject to careful evaluation, there might be scope to moderately scale back the targeted adjustment if financial sector contingent liabilities prove contained and the government continues to resist absorbing private sector losses.

Directors welcomed the downward trend in inflation, supported by a stronger exchange rate and the central bank's careful execution of monetary policy. They noted that the mild undervaluation of the real exchange rate would support continuation of the underlying current account surplus.

Directors considered that it is critical for Iceland to build up its international reserves. They welcomed the central bank's purchases of foreign exchange and highlighted the need to build reserves as market conditions and balance of payment developments permit. Welcoming recent progress, Directors supported continued efforts towards an early normalization with international creditors, including towards finalization of negotiations regarding Icesave deposits, which would unlock bilateral program financing and ease Iceland's reintegration into global markets.

Directors noted that preconditions for capital account liberalization are falling into place, including stronger reserves and more secure public finances. They agreed that capital controls should be maintained until the stability of the financial system has been secured.

Directors noted the importance of strengthening policy frameworks. They welcomed the measures taken to improve budget planning and implementation as well as the new legislation to strengthen bank regulation and supervision. Directors encouraged the authorities to press ahead with reform of the local government fiscal framework, and with implementation of supervisory reforms.

It is expected that the next Article IV consultation with Iceland will be held in accordance with the Executive Board decision on the consultation cycle for members with Fund arrangements.

The Executive Board took the following decisions:

Iceland—Third Review Under the Stand-By Arrangement and Request for Modification of Performance Criteria

1. Iceland has consulted with the Fund in accordance with paragraph 3(d) of the Stand-By Arrangement for Iceland (the “Stand-By Arrangement”) (EBS/08/124, 11/15/08) in order to review program implementation and modify and establish performance criteria.

2. The letter dated September 13, 2010 from the Prime Minister, the Minister of Finance, the Minister of Economic Affairs, and the Governor of the Central Bank of Iceland (the "September 2010 Letter"), together with its Technical Memorandum of Understanding (the "September 2010 TMU") shall be attached to the Stand-By Arrangement for Iceland, and the letters dated November 15, 2008 from the Chairman of the Central Bank and the Minister of Finance and its attachments, the letter dated October 20, 2009 from the Prime Minister, the Minister of Finance, and the Governor of the Central Bank of Iceland and its attachments, and the letter dated April 7, 2010 from the Prime Minister, the Minister of Finance, the Minister of Economic Affairs, and the Governor of the Central Bank of Iceland and its attachment, shall be read as supplemented and modified by the September 2010 Letter and its attachment.

3. Accordingly, the following amendments shall be made to the Stand-By Arrangement:

   a. Paragraph 3(a) of the Stand-By Arrangement shall be revised to read as follows:

"(a) subject to paragraph 2 of Decision No. 14407-(09/105), during any period in which data at the end of the preceding period indicate that the:

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

(ii) ceiling on the change in net domestic assets of the CBI, or

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

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

as specified in Table 1 of the September 2010 Letter and as further specified in the September 2010 TMU, was not observed, or."

b. Paragraph 3(c)(iii) of the Stand-By Arrangement shall be deleted.

c. The performance criteria set forth in paragraphs 3(a)(i)-(iv) of the Stand-By Arrangement for September 30, 2010 and December 31, 2010, and the continuous performance criteria set forth in paragraphs 3(c)(i) and (ii) of the Stand-By Arrangement, shall be as specified in Table 1 of the September 2010 Letter and as further specified in the September 2010 TMU.

4. The Fund decides that the third review specified in paragraph 3(d) of the Stand-By Arrangement for Iceland is completed, and that Iceland may make purchases under the Stand-By Arrangement. (EBS/10/176, 9/14/10)

Decision No. 14744-(10/96), adopted
September 29, 2010

Iceland—Exchange System

1. Iceland maintains an exchange restriction subject to Fund jurisdiction under Article VIII, Section 2(a) of the Fund's Articles of Agreement, which arises from the rules governing Iceland's capital controls regime that restrict the conversion and transfer of interest on bonds whose transfer the rules apportion depending on the period of the holding.

2. In the circumstances of Iceland, the Fund grants approval of the retention of this exchange measure for a period of twelve months from the date of this decision or the completion the next Article IV consultation with Iceland, whichever is earlier. (EBS/10/176, 9/14/10)

Decision No. 14745-(10/96), adopted
September 29, 2010

APPROVAL: December 6, 2010

SIDDHARTH TIWARI
Secretary

Annex

The staff representative from the European Department (Mr. Flanagan), in response to technical questions from Executive Directors, circulated the following written answers after the Executive Board Meeting:

Fiscal Policy

1. What are the implications for the fiscal effort of 2011, if tax revenues continue to fall in the rest of 2010? (*Virmani*)

   The staff does not expect a revenue shortfall for 2010. Tax revenues have recovered during the summer and are in line with expectations. In addition, the continuing under-spending at the central government level will help achieve the 2010 fiscal target. Should there emerge a possibility for a shortfall, its potential implication for the fiscal effort in 2011 will be discussed at the time of the next review and before the adoption of the 2011 budget in December.

2. Regarding the working group that has been established on fiscal reform, could staff provide some additional background information on its mandate and composition? May the recommendations coming out of this group factor into the future fiscal reform priorities and potentially the SBA? (*Hockin*)

   The Working Group was established to provide recommendations for the amendment of the Local Government Act in the context of reforming the local government framework. The Working Group is mandated to identify the key vulnerabilities in the current regime and bring it closer to international best practice. The Working Group has taken a comprehensive approach to reforming the regime, looking at the options for fiscal rules for local government and at the legal, institutional, and procedural reforms that are required to ensure that these rules are respected. The recommendations of the Working Group have direct bearing on the SBA as strengthening the local government framework is a structural benchmark for end-2010.The Working Group comprises representatives from the: Ministry of Economy, Ministry of Communications, Transport, and Local Government; Association of Local Authorities; City of Reykjavik; and an independent member from academia

3. Have the potential recapitalization needs of the HFF been accounted for in deficit/debt projections? (*Fayolle*)

   The potential costs of the HFF recapitalization—3 percent of GDP—have been incorporated in the fiscal accounts. The debt sustainability analysis on page 59 of the staff report covers this issue.

4. Are these transactions—repurchase of Eurobonds and the operations related to Avens—subject to appeal? (*Zajdel-Kurowska*)

   No, the purchase of the Eurobonds in the market is not subject to legal appeal. The authorities in fact had an open auction.

Monetary and Exchange Rate Policies

5. Could staff give an update on collateral policy and liquidity management at the central bank under assistance from the Fund? (*Virmani*)

   The central bank's collateral policy was tightened in June 2009, taking into account the lessons of the crisis. Liquidity management has improved, and the CBI started regular auction of central bank CDs since last year to absorb excess liquidity. Fund TA in the area of monetary operations is ongoing to help the authorities adapt to the new post-crisis circumstances.

6. Is a review of the central bank act under consideration? Does this undermine the independence of the central bank? (*Virmani*)

   The central bank has been put under the umbrella of the ministry of Economic affairs to facilitate coordination between the economic and banking authorities on financial sector supervision, and in early 2011 the authorities plan to have ready draft amendments to the Central bank law to formalize new arrangement. This has nothing to do with monetary policy implementation, and we do not see this as a threat to CBI independence.

7. What is the expected effect of recent monetary policy easing on the valuation of the krona, as interest rate differentials with major trading partners could narrow? (*Virmani*)

   Even with capital controls, the interest rate differential could still have an impact on the exchange rate through the incentive for circumvention and through current account transactions (i.e. exporters deciding to hold fx or krona or non-resident investors deciding to convert krona interest payments). The recent loosening appears to have slowed the appreciation of the krona. Of course the impact of the monetary policy stance on the exchange rate is something that the CBI evaluates carefully before each interest rate decision.

8. How would the planned purchases affect the foreign exchange market? (*Assimaidou*)

   The planned purchases will affect the fx market and prevent further appreciation. The CBI intends to make sure that the purchase volume is moderate so that it will not destabilize the fx market. The purchases so far since end-August have left the exchange rate more or less unchanged.

9. What are the pre-conditions and timing for the relaxation of the controls? (*Fayolle*)

   Preconditions for lifting the capital controls are (i) comfortable reserve coverage and balance of payments outlook; (ii) improving fiscal and public debt position (diminishing fiscal financing risk); and (iii) a financial system that is strong enough to withstand possible deposit outflows and losses. According to the authorities' liberalization strategy (published last year), liberalization will be event-driven, subject to these preconditions, and therefore no specific timetables or numerical reference points have been set.

Financial Sector

10. Given that some non-bank institutions may be severely affected by the June ruling, could staff give further details about how the authorities plan to facilitate orderly exits for any non-bank institutions that fail to meet the capital requirements? (*Lundsager*)

    If these institutions are unable to meet capital requirements, creditors will be allowed to convert part of their claims into equity. In the event that private efforts to restore their solvency were unsuccessful, the banking authority will instruct them to wind down their operations with no implications to the fiscal sector. More importantly, considering that the non-bank financial institutions do not take deposits from the public and account for only 9 percent of the financial system, no major repercussion on financial stability is expected.

11. Given that the bulk of the foreign exchange indexed loans were contracted to take advantage of the strength of the krona before its collapse, could the Supreme Court ruling be removing perverse incentives tolerated by the regulatory regime at the time? (*Virmani*)

    The Supreme Court ruling addresses fx indexed loans, not fx loans. As such it will not affect borrowers' ability to take on fx risk. With the September Supreme Court decision, which effectively neutralized any advantage that could have been gained through fx-indexed loans, it is hard to see that there is any impact on incentives.

12. What are the steps taken to prevent the banking system from expanding again beyond the capacity of the supervisory system? Are there macro-prudential tools available to contain too rapid growth of international banking operations? (*Virmani*)

    The authorities have increased capital requirements on banks from 8 percent to 16 percent of risk weighted assets. Additionally, liquidity requirements are also under review. The staff is of the view that it will take several years for the Icelandic banks to be able to expand their international banking operations. Nonetheless, once the international debate on the subject has been completed, staff plans to engage on discussions with the authorities on what instruments could be more effective in controlling rapid growth in the Icelandic banking system, if this should be a problem in the distant future.

13. Work is underway for monitoring large exposures; are there similar processes for foreign exchange mismatches which were at the heart of the crisis? (*Virmani*)

    The banks' foreign exchange mismatches are currently under close monitoring by the banking authorities.

14. Could staff provide an update on the April 2010 report of the Parliamentary Investigation Commission, similar to the Jannari report recommendations in Table 11? (*Virmani*)

    The authorities plan to reflect recommendations by the Commission in a new set of draft amendments to the banking law and in prudential regulations currently under review. Overall, the findings of the Parliamentary Special Investigative Commission largely paralleled the findings of the Jannari Report, although it certainly added many detailed examples about the supervision and regulation problems that had been identified.

15. Could staff give an update on any progress that can be reported on the legislations introduced in Parliament in May 2010 on deposit insurance, investment funds, insurance activities and financial undertakings? (*Virmani*)

    The legislation was introduced in parliament in May 2010. It still awaits consideration, and this is expected during the upcoming fall session of Parliament.