ICELAND

PRE-ACCESSION ECONOMIC PROGRAMME 2011

Ministry of Economic Affairs

January 2011

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1. Overall Policy Framework

The Pre-Accession Economic Programme (PEP) is prepared on the basis of the government's medium-term fiscal programme, the 20/20 strategy adopted by the government in January 2011 and policy commitments related to Iceland's cooperation with the International Monetary Fund (IMF). The PEP is prepared by the Ministry of Economic Affairs with contributions from relevant ministries and institutions.

The main objective of the government's economic policy in the near-term is to lay the foundation for a sustainable economic recovery following the collapse of the banking sector in October 2008. Inflation has subsided quickly as the exchange rate has stabilized thus allowing for extensive interest rate cuts from March 2009. Preliminary national account data suggests that growth has resumed in the third quarter of 2010, thus ending the longest and deepest recession since Iceland's independence.

To support this nascent growth, private sector debt restructuring has been at the forefront of economic policy in recent months. The existing frameworks for households and corporate debt restructuring were modified in December 2010. The objective of these changes was to establish a fair and efficient process to facilitate a faster reduction of the private sector debt overhang, which is essential to boost consumption and investment.

Large steps have been taken towards an improved fiscal stance since late 2008 when the financial crisis hit government finances hard. The 2011 budget foresees a return to a primary surplus when certain profitable investment projects, which will be financed through user fees, are excluded. The overarching objective of fiscal policy is to return general government back to an overall surplus by 2013 as was prescribed in the government's medium-term fiscal programme presented to parliament in mid-2009. At the same time, the fiscal framework is being adapted to international best practice, with a longer budget horizon and stronger follow-up.

Exchange rate stability temporarily replaced price stability as the monetary policy objective in late 2008. The exchange rate has strengthened and later stabilized since November 2009 without interventions from the Central Bank. The overarching challenge for monetary policy will be to ensure that interest rate decisions are carefully coordinated with the eventual and gradual lifting of capital controls imposed in late 2008, in a manner that preserves currency and financial stability. A revised strategy for capital account liberalization will be presented by end-February 2011. The execution of this strategy and development of a more robust monetary policy framework will be of central concern to economic policy in the near future. It is important that this work leads to increased economic stability going forward.

Finally, fully restoring the health of the banking system remains a key objective. Policies in this area are focused on continued strengthening of bank balance sheets and improved supervision and regulation. As a member of the European Economic Area, Iceland's future financial sector framework will largely depend on developments in the European Union. The same is true for much of the legal framework for the general business sector.

As the economy emerges from the crisis, the government continues to put great emphasis on preserving the flexibility of the Icelandic labour market to support economic growth that leads to employment growth. As before, Iceland intends to be at the forefront among OECD countries in implementing international best practice in this field.

The policies put forward in the Pre-Accession Programme are intended to build a foundation for sustainable growth to support a Nordic welfare society based on equality and fairness.

2. Economic Outlook

The macroeconomic assumptions underpinning the medium-term fiscal programme and the annual budgets are developed by an independent research division within Statistics Iceland. The most recent forecast was updated in November/December 2010.

The economic programme is largely defined by the effects of the financial crisis that engulfed the Icelandic economy in October 2008. The economy has, however, fared better than initially forecast. As the effects of the financial crisis are overcome and the capital account is liberalized, international developments will have an ever increasing impact on domestic economic stability and growth.

External assumptions underlying the forecast are based on the most recent IMF World Economic Outlook. It forecasts moderate growth among Iceland's most important trading nations. Aluminium and fisheries exports account for approximately 80-85 percent of merchandise exports. Price increases for aluminium and marine products are expected to moderate following somewhat large price increases in 2010. The forecast assumes that average price for aluminium will rise by 7 percent in 2011 and around 6 percent in 2012 after a 28 percent increase in 2010. The forecast assumptions for aluminium and oil prices are based on forward prices in international markets as well as specialist estimates. Modest price increases are forecast for marine goods in 2011 and 2012 after a 6 percent increase in 2010.

Overall, the Icelandic economy is forecast to gain momentum following two years of falling output as the effects of the financial crisis have materialised. Positive GDP growth of 2 percent is expected in 2011 and over the medium term a modest but robust growth of around 3 percent is forecast. Inflation should remain close to or below 2 percent for the next two years and unemployment is set to decline from current levels to around 4.5 percent in 2013.

Going forward, risks are seen to be evenly balanced as important milestones have already been achieved in establishing internal and external balance. The competitive position of domestic industries has improved significantly, effects of the financial turmoil are largely behind us, and policies have been adjusted accordingly. Nevertheless important tasks remain, in particular balance sheet restructuring needs to be accelerated in order for households and corporations to push the economy on to a sustainable growth path.

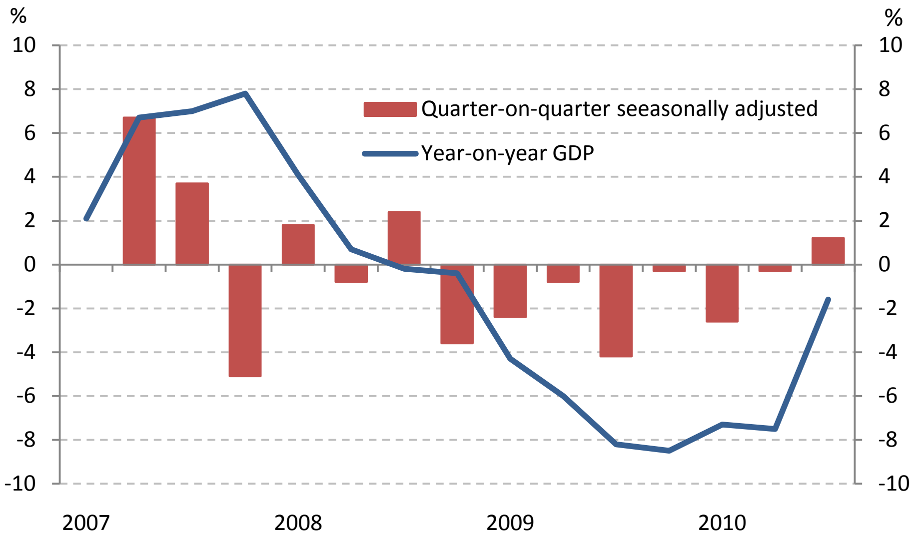
2.1 Recent Economic Developments

The economy continues to process the effects of financial crisis of October 2008 and adjustment following overheating of the pre-crisis years. After seven continuous quarters of economic contraction in seasonally adjusted terms, the economy grew by 1.2 percent in the third quarter of 2010 compared with the preceding quarter. These preliminary figures suggest somewhat weaker growth than had been forecast. Private consumption contributed to economic growth while all other sub-categories had a drag on growth.[1] The economy contracted by 1.6 percent compared with the

[1] As was stated by Statistics Iceland in December 2010: During economic turbulence, like at present time, major structural changes have effects on seasonally adjusted results that can be more volatile than would be the case otherwise. For small countries irregular items also have great impact on seasonally adjusted results and make it more difficult to detect seasonality in the data and quarterly GDP estimates can become even more unstable.

previous year while domestic expenditure fell by 0.5 percent in non-seasonally adjusted terms. For the first nine months of 2010, GDP decreased by 5.5 percent compared with same period of the previous year after a 6.8 percent contraction in 2009.

FIGURE 1: GROSS DOMESTIC PRODUCT



Source: Statistics Iceland

Private consumption increased by 3.8 percent in the third quarter of 2010 in seasonally adjusted terms following two consecutive quarters where private consumption contracted. Non-seasonally adjusted figures show a 1.8 percent growth in private consumption compared with the same period in 2009. This contrasts with a 3.4 percent contraction in the second quarter of 2010 compared with the year-earlier period. Recent high-frequency data, such as payment card turnover, indicate continued growth in private consumption in the last three months of 2010. The government policy to allow early withdrawal from the private pension scheme may have had positive impact on the private consumption. The total amount of withdrawal from the beginning of year 2009 until third quarter of 2010 is about ISK 39 billion. A more detailed discussion about the private pension scheme is in chapter 3.4.

The seasonal results should therefore be interpreted with care.
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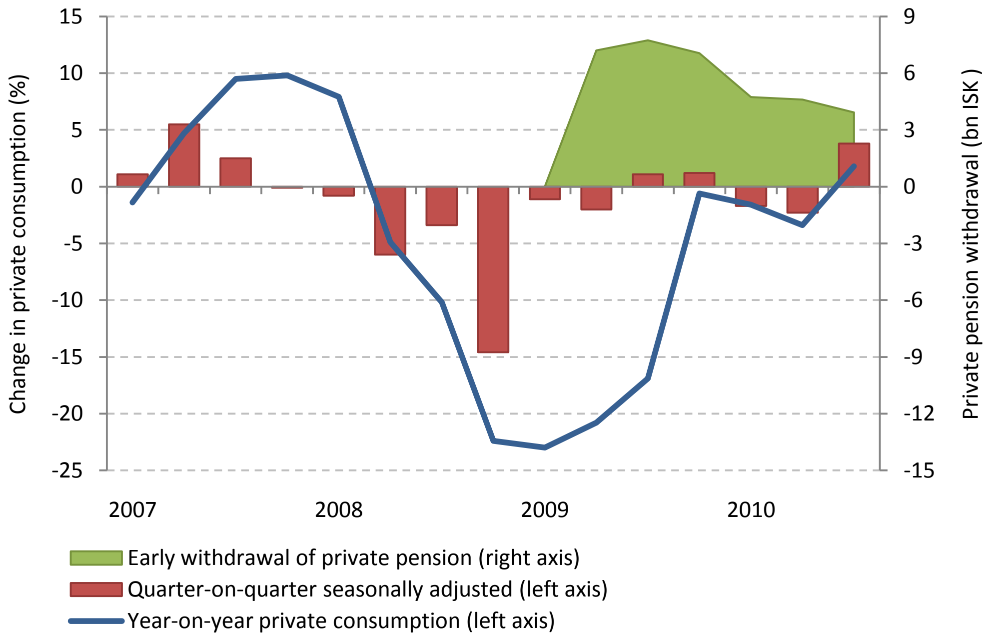
FIGURE 2: PRIVATE CONSUMPTION



Source: Statistics Iceland

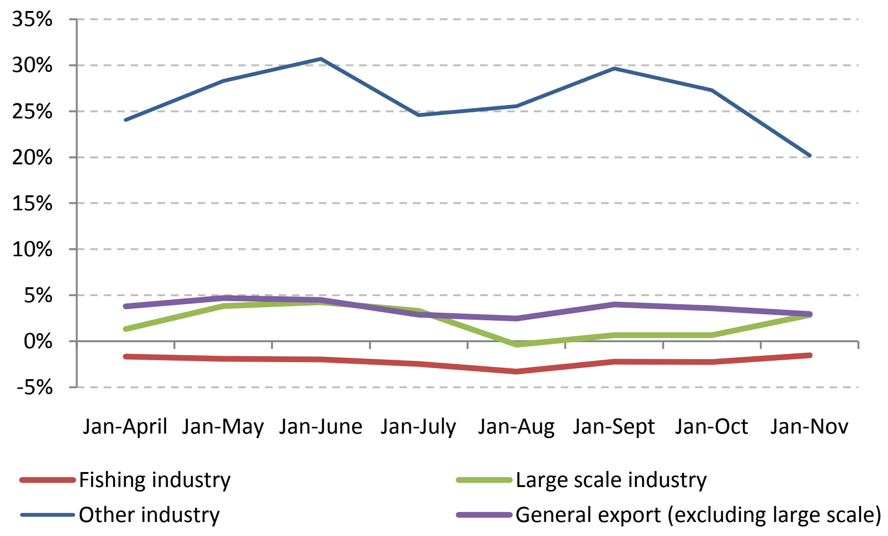
Government consumption has been curtailed since the beginning of 2009 as government finances adjust are adjusted to the new reality. The contraction amounted to 0.6 percent in seasonally adjusted terms in the third quarter of 2010 compared with the three earlier months. Compared with the year-earlier period, government consumption fell by 2 percent in non-seasonally adjusted terms.

Investment declined by a further 5.6 percent in the third quarter of 2010 from the previous three months. This follows a contraction of 50 percent on 2009. Investment is now at a historically low level at 12 percent of GDP. Business investment fell by 9.6 percent while government investment increased by 0.6 percent and housing investment by 4.1 percent. In non-seasonally adjusted-terms, investment fell by 10.8 percent in the third quarter compared with the same period in 2009.

Net exports of goods and services declined in the third quarter of 2010 compared with the three earlier months in seasonally adjusted terms. Exports increased by only 0.8 percent as exports of goods fell by 1.2 percent. Service exports grew on the other hand by 3.1 percent. Imports increased by 6.8 percent during the same period, driven by an 11 percent growth in the imports of goods while imports of services remained relatively stable with a 0.8 percent growth. Non-seasonally adjusted numbers show a 0.1 percent contraction in exports and a 1.6 percent increase in imports compared with the year-earlier period. The export base is relatively small and narrow with fisheries and aluminium products representing nearly 85 percent of regular goods exports.[2] Both of these sectors are resource constrained and have therefore not been able to increase production despite the low real exchange rate.

[2] Regular exports exclude trade in airplanes and ships.

FIGURE 3: VOLUME CHANGE IN EXPORTS



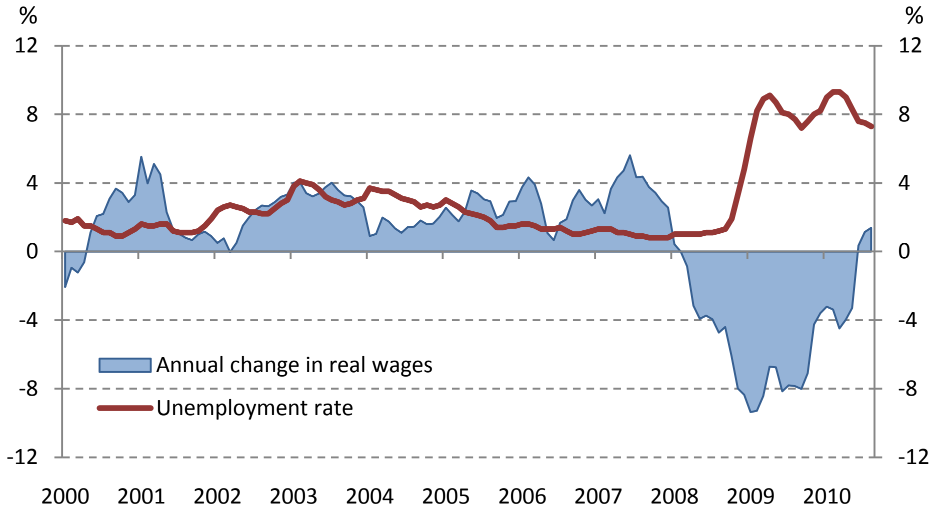
Source: Statistics Iceland

The service sector appears to have adjusted to the new lower real-exchange rate, as well as certain other non-resource bound sectors, such as the pharmaceutical sector. Regular exports outside the resource constrained sectors rose by 20 percent in the first eleven months of 2010. Nearly half of this increase results from increased pharmaceutical exports. This trend is expected to continue as the largest pharmaceutical factory increased its production capacity by 50 percent at the beginning of 2011.

Labour market

The financial crisis had a strong impact on the labour market, especially in the first 6 months after October 2008. Unemployment rose from 1.6 percent in 2008 to 8.0 percent in 2009 and was 8.2 percent in 2010, thus leaving unemployment at 7 to 9 percent in the last two years. A certain level of flexibility in the labour market is reflected by the depreciation of real wages, which fell by 8.4 percent in 2008 and 3.6 percent in 2009. In 2010, however, real wages appreciated by 2.0 percent.

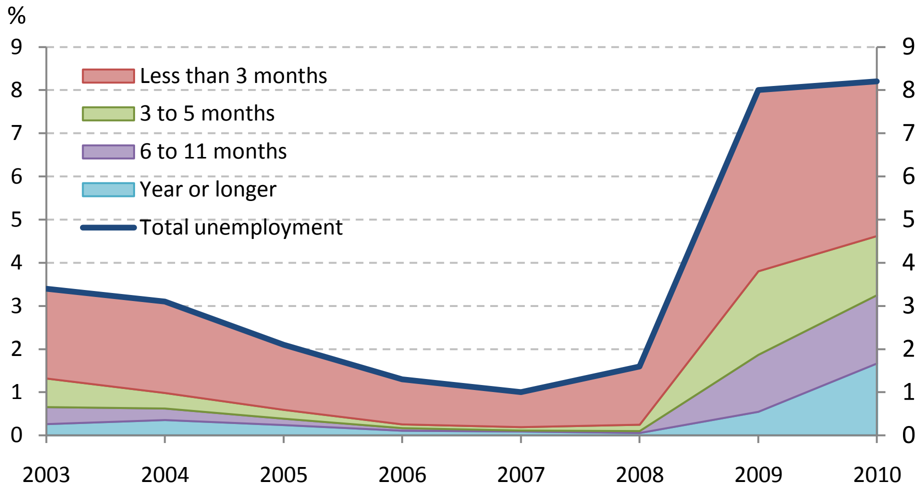
FIGURE 4: UNEMPLOYMENT AND REAL WAGES



Source: Statistics Iceland

Long-term unemployment, the share of those unemployed who have been without a job for more than 1 year, has been rising steadily since the last quarter of 2008. In 2009 the long-term unemployment reached 0.5 percent while it was 0.05 percent the year before, and in 2010 it rose to 1.7 percent. As displayed in figure 5 over half of those who are unemployed have been so for 3 months or longer. There is, therefore, an increased likelihood of rising structural unemployment.

FIGURE 5: LONG TERM UNEMPLOYMENT

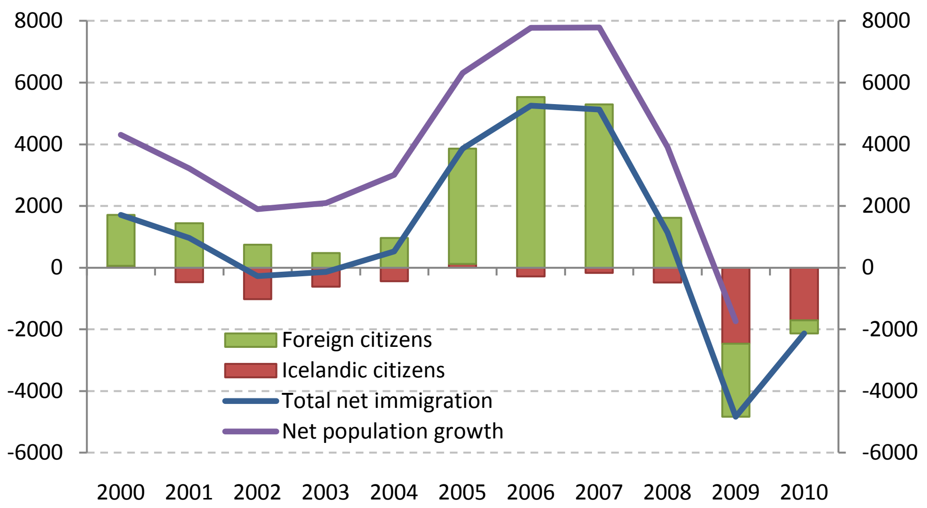


Source: Statistics Iceland

In 2010 the participation rate was 81.1 percent and increased by 0.2 percent on an annual basis compared to the year before. The participation rate rose during the first two quarters in 2010, compared to the previous year, but has fallen during the last two quarters. The number of persons in full time employed fell by 9.5 percent in 2009 and 2.0 percent in 2010. At the same time the number of persons employed in part time increased by 6.6 percent in 2009 and 4.9 percent in 2010. The labour market seems to be adapting to the new conditions by offering part time work instead of dismissal.

The total population in Iceland in 2010 was 317.6 thousand, falling by 0.5 percent from the previous year. The working-age population were 213.1 thousands in 2010 and contracted by 1.2 percent from the previous year. This is contrary the evolution of the last decade where the annual growth of both total population and working-age population was around 1 - 3.5 percent. The reason for the recent population contraction is mainly emigration of both Icelandic and foreign citizens from Iceland. Likewise, an influential factor on population growth in Iceland during the pre-crisis years was net immigration of foreign citizens at working-age. When the economy was expanding between 2003 and 2008 the labour market attracted foreign citizens in sectors such as construction industry. Figure 6 shows how foreign citizens have immigrated at the same time as Icelandic citizens have emigrated and the population growth.

FIGURE 6: NET IMMIGRATION AND POPULATION GROWTH



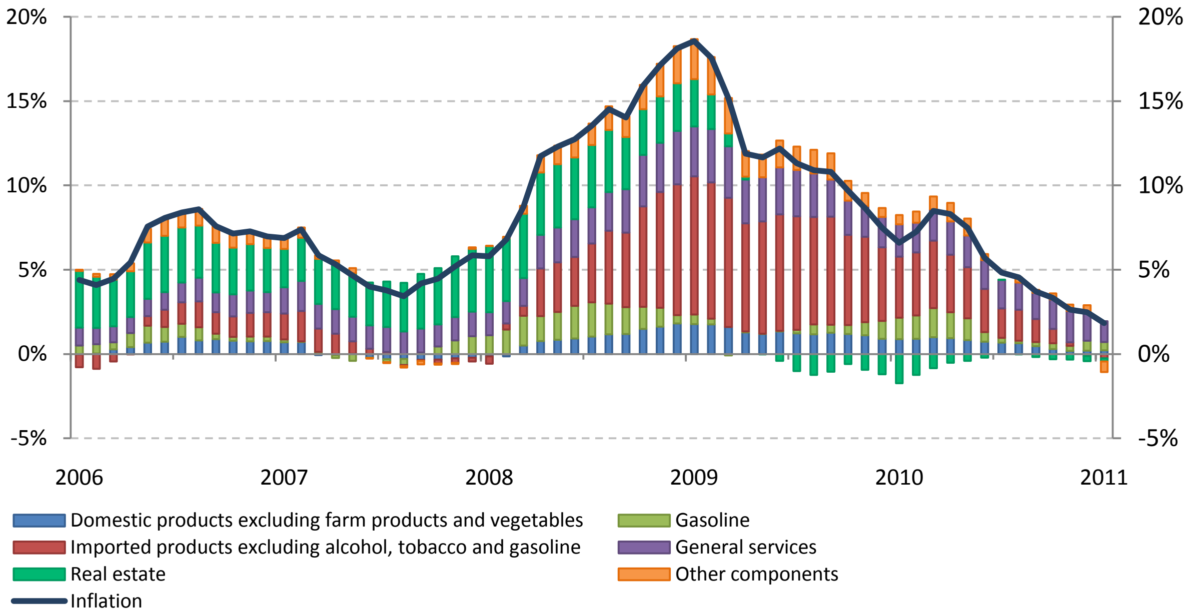
Source: Statistics Iceland

Inflation, exchange rate and interest rates

The exchange rate of the króna appreciated by almost 20 percent between November 2009 and August 2010, following a revision of the capital controls regime. From that point on, the exchange rate has remained stable even though the Central Bank began weekly purchases of foreign exchange at the end of August 2010 to build up the foreign currency reserves.

With a stable exchange rate and limited demand pressures, inflation has fallen fast from its peak of 18.6 percent in January 2009 to 1.8 percent in January 2011.The relatively stable exchange rate and falling inflation has allowed the Central Bank of Iceland to cut interest rate from 18 percent in March 2009 to the current policy rate of 4.5 percent, with effective interest rate even lower at around 3.75 percent. Interest rate decisions remain focused on exchange rate stability and are affected by the capital account liberalization strategy.

FIGURE 7: INFLATION SUBCOMPONENTS



Source: Statistics Iceland

Financial markets remain weak following the bank failure. Only a handful of domestic companies are traded on the stock exchange on a relatively active basis. The only active capital market is in government and government guaranteed bonds. That market remains relatively sensitive as developments in the second half of 2010 demonstrated when bond market volatility rose as market participants became uncertain over the speed of capital account liberalization. The restructuring of an active capital market is vitally important for economic recovery. The government has, therefore, put great emphasis on rapid debt restructuring that would allow restructured healthy companies to form a new foundation of the domestic capital market.

2.2 Medium-term macroeconomic scenario

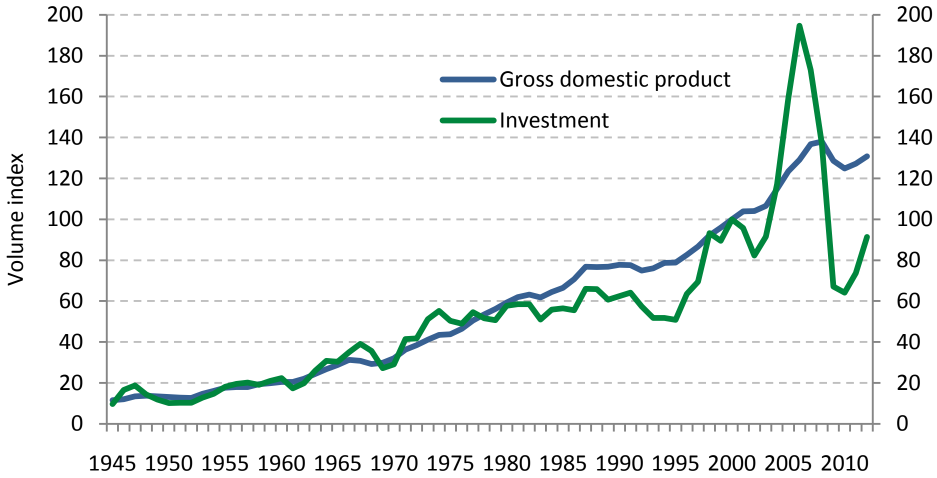
2.2.1 Real sector

Preliminary figures from Statistics Iceland indicate a 3 percent decline in GDP in 2010, largely due to contraction in investments and public consumption. In 2011, a positive GDP growth is forecast following an unusually protracted contraction. With a strong recovery in investment and a gradual pick up in private consumption, GDP growth is expected at around 2 percent in the current year increasing further to a 3 percent annual growth rate in 2012 according to the Statistics Iceland forecast.

Economy still faces challenges

Economic activity remains weak following the banking crisis in 2008. In order to fully appreciate the enormous change which has taken place, a quick backward glance in figure 8 is helpful. Most notable is the change in investment expenditure which peaked in 2006 after doubling from the level in 2000.

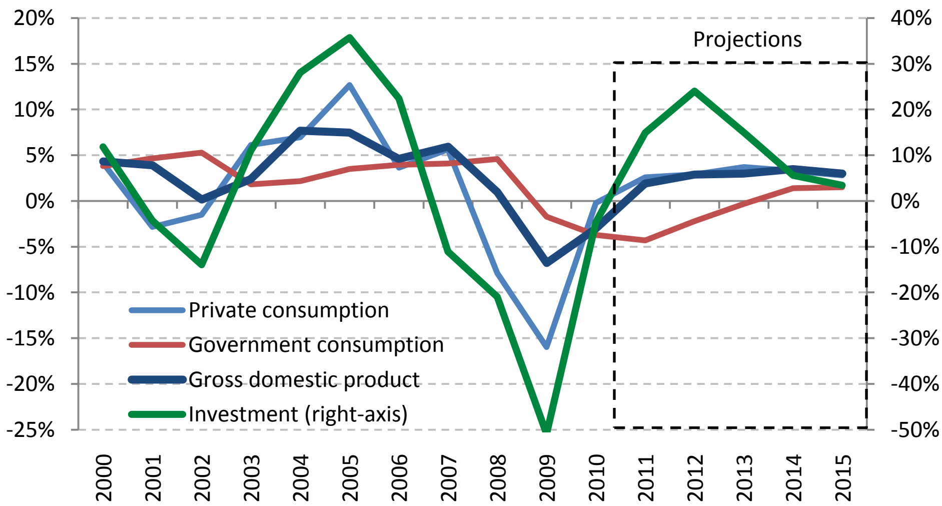
FIGURE 8: GDP AND INVESTMENT
Volume indices, 2000 = 100



Source: Statistics Iceland

Relative to the peak, investment in 2011 is forecast to decline in real terms by 62 percent. Contraction of large energy intensive investment projects is important, but fluctuations of this magnitude are nevertheless unique in recent history as can be seen in figure 8. Other demand components such as consumption, both private and public, show a similar pattern peaking in 2007 or 2008 but have since then declined. Private consumption has decreased in real terms by 20 percent since 2007 in line with falling real incomes. Figure 9 shows the annual real growth of private consumption, government consumption, investment and gross domestic product.

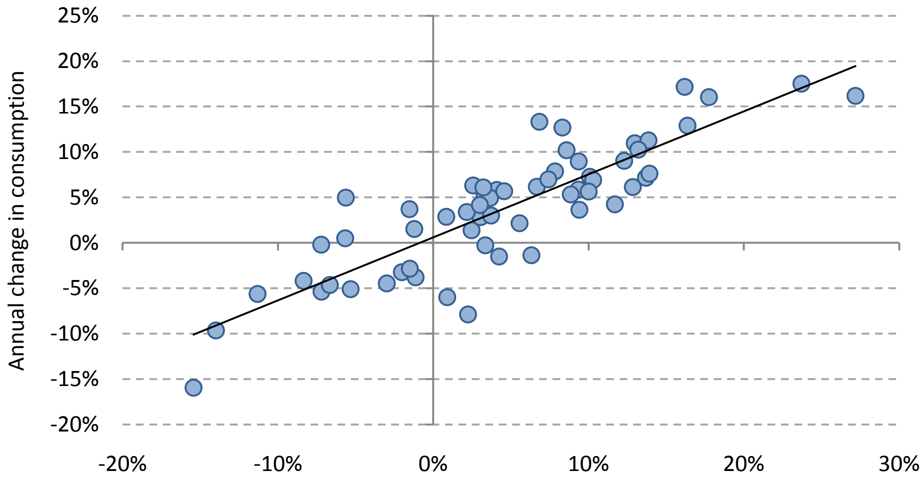
FIGURE 9: ANNUAL REAL GDP GROWTH



Source: Statistics Iceland

In previous business cycles private consumption has followed a similar pattern as changes in household purchasing power show up as a comparable change in private consumption.

FIGURE 10: PURCHASING POWER AND CONSUMPTION



Source: Statistics Iceland, own calculations

Real economy resilience

Since 2008 sectors have fared differently with respect to output, with the construction and financial services sectors leading on the downside. According to preliminary estimates, the overall output decline in these two sector is around 30 percent and the number of jobs lost is 5,700 thousand or 3 percent of the total labour force. With output decline strongly concentrated to construction and financial services, output decline in other sectors was 6 percent as measured by sector contribution to GDP growth, compared with 10.5 percent overall decline in 2008-2010, and overall number of jobs lost was around 5 thousand. Consequently, the real economy, excluding construction and financial services has shown considerable resilience under the weight of the banking crisis.

TABLE 1: PRODUCTION BY SECTORS 2005-2010

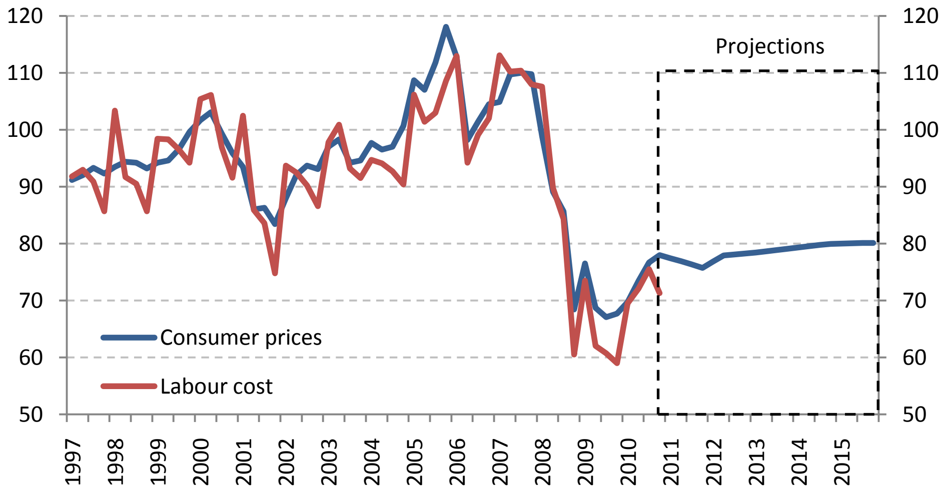
Volume index	2005	2006	2007	2008	2009	*estimate* 2010
Total Economy	100	106.3	114.2	113.9	105.4	102.3
Construction	100	113.5	129.4	134.1	116.5	-
Financial services	100	119.3	136.0	140.9	122.5	-
Sub-total	100	116.2	127.6	121.2	92.8	86.3
Other sectors	100	104.3	111.5	112.4	108.1	105.6
% change from previous year						
Total Economy	7.0	6.3	7.4	-0.3	-7.4	-3.0
Construction	17.8	13.5	6.2	-13.1	-35.0	-
Financial services	18.1	19.3	14.0	3.6	-13.1	-
Sub-total	17.9	16.2	9.8	-5.0	-23.4	-7.0
Other sectors	5.0	4.3	6.9	0.8	-3.8	-2.3

Source: Statistics Iceland, own calculations

Clearly the fall in the real exchange rate of the Icelandic króna has played a crucial role in enhancing the competitive position of Icelandic industries, along with other factors such as moderate cost pressures in the wake of the banking crisis. Since 2008 the exchange rate has fallen by around 40 percent translating into a significant fall in the real exchange rate. The real exchange rate, as measured by relative wage cost, is currently 25 percent below the 1990-2008 historical average, and, measured by relative prices, 20 percent below the historical average. This has allowed industries such as tourism and export sectors not bound by natural resource constraints or other supply factors, to expand in spite of the crisis.

FIGURE 11: REAL EXCHANGE RATE INDEX

2000=100



Source: Central Bank of Iceland, Statistics Iceland

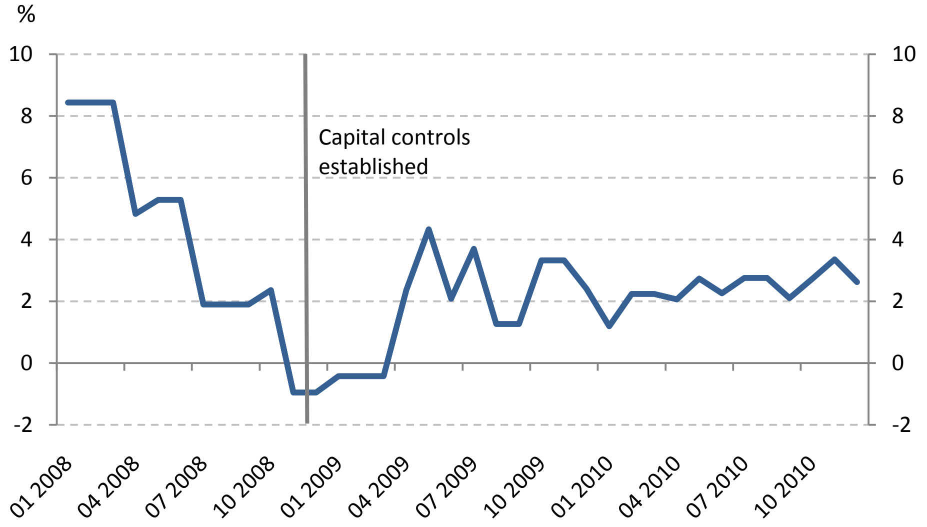
As the exchange rate is forecast to remain broadly unchanged over the medium term, the economy is expected to maintain its favourable competitive position, allowing for continued robustness of growth sectors.

Investments

Large energy intensive investments projects have been high on the agenda, with the Helguvik green field aluminium project and the enlargement of the Straumsvik aluminium plant as frontrunners. The Helguvik project is already well under way, but in 2010 construction work was stopped, primarily due to uncertainties regarding energy delivery. Previously, the Statistics Iceland's forecasts have included both these large projects, but in the latest forecast a delay until 2012 is presumed for the Helguvik project. As for the Straumsvik enlargement project, however, it is assumed to get underway already this year. The total impact of these two projects is estimated at ISK 25 bn in the current year and ISK 40 bn in 2012, amounting to 1.5 percent of GDP in 2011 and 2.3 percent of GDP in 2012

Despite a strong competitive position, business investments expenditure has remained low. Real interest rates have not fallen particularly fast given the overall weakness of the economy. Measuring the real rate by the Central Bank policy rate and corresponding one year inflation forecast, the real rate remained around 2 percent through 2010.

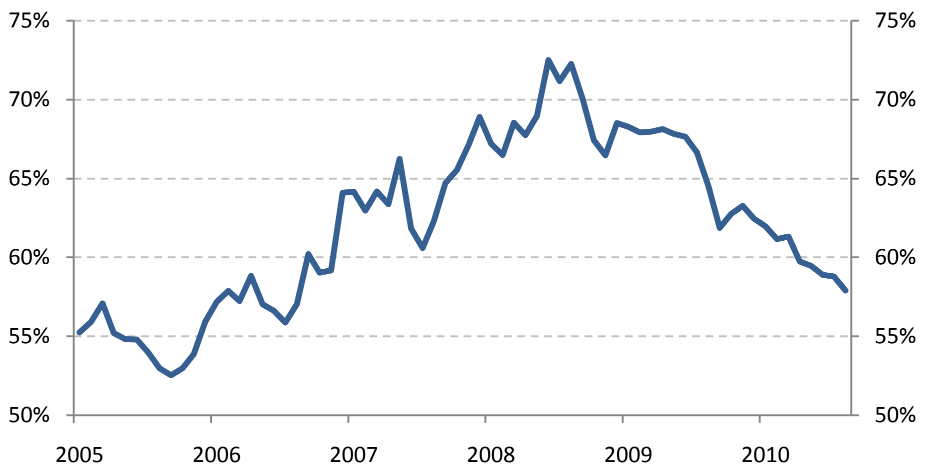
FIGURE 12: FORWARD LOOKING REAL POLICY RATE



Source: Central Bank of Iceland

More importantly, however, falling domestic demand, weak world economic outlook and financial distress has held back investment expenditure in Iceland as elsewhere.

FIGURE 13: FOREIGN CURRENCY CORPORATE DEBT RATIO OUT OF TOTAL DEBT



Source: Central Bank of Iceland

With high corporate debt prior to the crisis, Icelandic firms currently face an unusually challenging debt restructuring task given the huge impact of the currency depreciation as the share of foreign currency denominated debt was above 70 percent of total debt when the crisis occurred. Since then this debt overhang has fallen, but still remains high.

Unfortunately, corporate debt had been held back by several factors, both legal and organizational. In the meantime balance sheet problems persist and corporate loans remain non-performing in the banks. In the latest Financial Stability Report by the Central Bank, non-performing loans in the new banks, both corporate and household, are reported as high as 40 percent.

Solving the corporate debt issue is, according to Icelandic authorities, a key prerequisite for increased business investments. In order to speed-up this process, authorities have in co-operation with the business community and banks, initiated a campaign initially targeted at small and medium sized companies. Larger corporate restructuring projects have so far been handled by the banks without government intervention.

The banks are well equipped to carry out successfully debt restructuring, as they were well provisioned when they were set up following the financial crisis. The three large commercial banks, Landsbanki, Íslandsbanki and Arion Bank acquired these loans on a fair value basis at 40% percent of book value on average. So far only a small proportion of these loans has been restructured. Corporate debt therefore remains largely non-performing. As long as this stand-still remains, increased business sector investment will not be forthcoming (see further discussion of the debt restructuring framework in chapter 4.1).

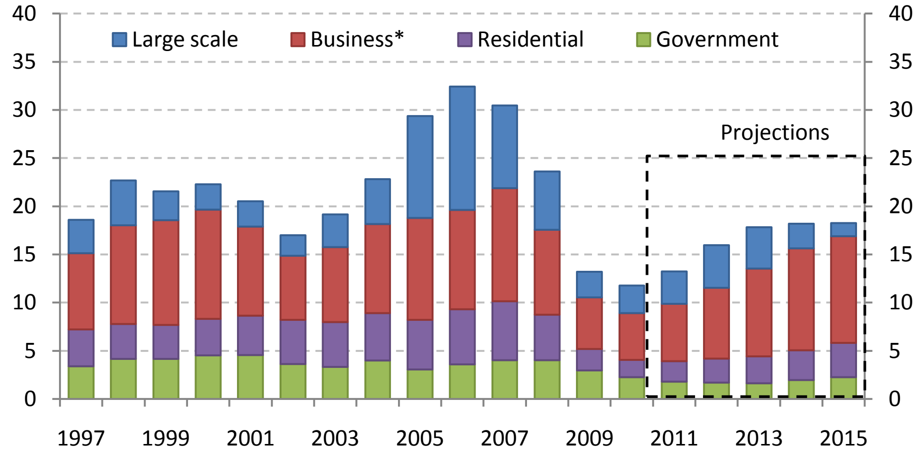
Medium term outlook

Over the medium term the main challenge will be to regain momentum in the economy following the crisis and overexpansion in the preceding years. With corporate balance sheets badly impaired and important restrictions regarding access to international financial markets, as financial sector restructuring is not fully achieved, the risk of a low growth scenario is significant. However, important factors are pulling the economy on to a higher medium term growth path.

Now that the inflationary spike following the currency depreciation in 2008-2009 is over, effects of the favourable real exchange rate will continue to provide opportunities to Icelandic business both domestically and abroad. In addition, as corporate balance sheet restructuring gets under way in full force, Icelandic businesses will regain financial soundness, allowing them to expand and increase employment. Finally, as restrictions on capital movements are removed as conditions become ripe, capital market access will be normalized.

A successful implementation of these policies will pave the way for a modest but robust GDP growth in the medium term of around 3% annually. Investment should pick up form extremely low levels, and in the latest Statistics Iceland forecast, business investment excluding large scale energy intensive projects will increase gradually as a share of GDP and reach 12 percent in 2015.

FIGURE 14: INVESTMENT, PERCENT OF GDP



** excluding large scale investments*
Source: Statistics Iceland

Inflation will be at or below the old Central Bank inflation target of 2.5 percent and unemployment should fall from current highs to around 4.5 percent in 2015.

TABLE 2: MEDIUM TERM FORECAST

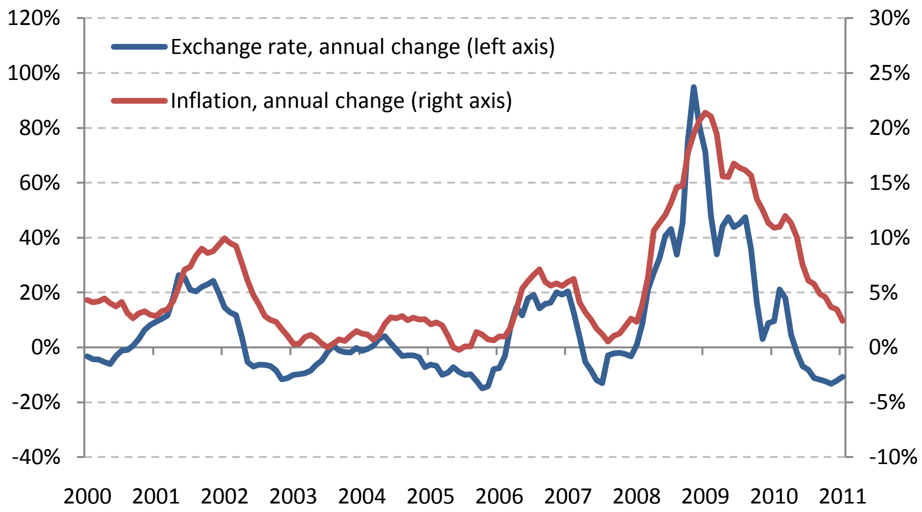
Annual change, percent	*prel.* 2009	*estimate* 2010	*forec.* 2011	*forec.* 2012	*forec.* 2013	*forec.* 2014	*forec.* 2015
Private consumption	-16.0	-0.2	2.6	2.9	3.7	3.3	2.8
Public consumption	-1.7	-3.7	-4.3	-2.2	-0.3	1.4	1.5
Gross fixed capital formation	-50.9	-4.6	14.9	24.0	15.0	5.6	3.4
National expenditure	-20.9	-1.9	2.4	5.0	4.9	3.3	2.6
Exports of goods and services	7.4	-0.1	1.0	2.0	2.4	4.0	3.6
Imports of goods and services	-24.1	2.7	2.0	6.0	5.9	3.7	3.1
Gross domestic product	**-6.8**	**-3.0**	**1.9**	**2.9**	**3.0**	**3.5**	**3.0**
Inflation (CPI)	12	5.4	2.3	2.5	2.5	2.5	2.5
Real exchange rate	-18.4	6.4	2.9	1.5	1.1	1.1	0.2
Unemployment rate	8	8.2	7.3	5.6	4.5	4.3	4.4
Wage rate index	3.9	4.6	4.4	4.4	4.8	4.9	4.9

Source: Statistics Iceland

2.2.2 Inflation

Inflation has fallen rapidly in recent months from around 7 percent in early 2010 to below 2 percent now in early 2011 and seems set to decline even further. The pass-through effect of the currency depreciation on domestic prices seem to be complete, and judging from previous spikes, the overall impact of currency movements looks familiar despite the unusually strong decline of domestic demand.

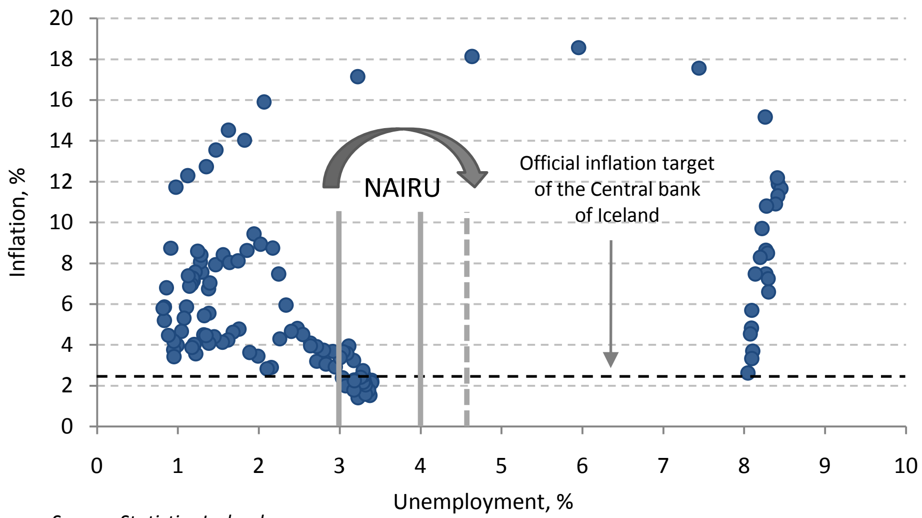
FIGURE 15: INFLATION AND THE EXCHANGE RATE



Source: Central Bank of Iceland, Statistics Iceland

According to the latest forecast from the Central Bank, inflation should remain close to or below 2 percent for the next two years, the lowest inflation since 1998 as the exchange rate remains stable or even appreciates slightly. Furthermore both the Central Bank and Statistics Iceland forecast a negative output gap in the coming years, contributing to a lower inflation pressure. Here the influence of labour market and demand conditions on inflation is of paramount importance.

FIGURE 16: INFLATION AND UNEMPLOYMENT



Source: Statistics Iceland

Figure 16 displays the unemployment-inflation trade-off on a monthly basis since 2000. Low unemployment is obviously linked to rising inflation as pressure in the labour market usually leads to a surge in wage inflation which sooner rather than later translates into price increases. The NAIRU[3] identifies the equilibrium unemployment rate which leads to stable inflation, which in Iceland has

[3] Non Accelerating Inflation Rate of Unemployment

been assumed to be around 3 percent.[4] Data seems to confirm this view as prior the financial crisis, unemployment below this level almost exclusively is associated with rising inflation. In the aftermath of the financial crisis this correlation seems to have broken down as unemployment surged from around 2 percent in late 2008 to around 8 percent in 2009 where it still remains. Inflation, however, has fallen rapidly from around 20 percent in early 2009 to below 2 percent in early 2011.

By increasing unemployment benefits and other labour market measures, government policies may have somewhat reduced labour market flexibility, at least temporarily. These measures are mainly targeted at people who have lost their jobs as a result of the crisis and may well have led to increase in the equilibrium in the labour market as measured by the NAIRU. Here, the overriding issue relates to whether or not government policy will have a permanent negative impact on long-term unemployment, i.e. those who have been unemployed for more than one year. So far long term unemployment has risen considerably, as was discussed above.

Recent OECD research indicates that the financial crisis will have a lasting negative impact on long term unemployment in almost all OECD countries.[5] For Iceland, the effect is expected to be relatively modest, less than 1 percent, and the impact on the NAIRU should be even lower. This supports the result that inflation can remain close to or even below the current rate as GDP growth picks up and unemployment falls significantly.

Inflation according to the Central Bank inflation forecast will be 1.9 percent in 2011 and 2012 rising to 2.3 percent in 2013. Unemployment will, according to the Central Bank forecast, be around 4 percent in 2013 close to the post-crisis NAIRU. Statistics Iceland expects inflation to be a bit higher, 2.3 percent in 2011 and 2.5 percent in 2012.

2.2.3 Monetary and exchange rate policy

The IMF programme and the introduction of temporary capital controls

Following the banking and currency crisis in 2008 and in accordance with the joint economic policy agreed upon by the Icelandic authorities and the IMF in November 2008, the main focus of monetary policy in the aftermath of the crisis has been to stabilise the króna. Stabilising the currency using conventional tools would probably have called for much higher interest rates, which would have amplified the contraction. In the absence of controls, limited foreign exchange reserves made foreign exchange market intervention untenable as a tool for stabilising the króna, especially given the sizable short term exposure of non-residents to the króna and the general lack of confidence in the currency and fiscal sustainability. Hence, temporary capital account restrictions were imposed in December 2008. These measures were notified under article 43 of the EEA Agreement on 28 November 2008. An important goal of this interim objective was to create a shelter for the private sector debt restructuring. A stable exchange rate was also deemed key to bringing inflation into line with the inflation target. The capital controls framework is reviewed every six months and all changes

[4] In the Central Bank of Iceland macro model QMM the NAIRU is set as 3% under normal conditions

[5] See S. Guichard,E. Eusticelli: Assessing the Impact of the Financial Crisis on Structural Unemployment in OECD Countries, OECD (2010)

have been notified to the Joint Committee of the EEA Agreement and the Standing Committee of the EFTA States.

The government approved in August 2009 a strategy for lifting capital controls proposed by the Central Bank. In accordance with this strategy, the Central Bank took the first step in the removal of the capital controls at the end of October 2009, by permitting inflows of foreign currency for new investments and potential outflows of foreign currency that may derive from such investments in the future. There is still uncertainty present regarding the exact timing of further liberalisation of the capital controls, but no fundamental changes will be made to the current rules before March 2011. By that date, a revised strategy for lifting of controls will be approved by the government and published. The revised strategy is developed by the Central Bank, in cooperation with the Ministry of Economic Affairs, Ministry of Finance and the Financial Supervisory Authority in light of market developments and experience since the imposition of controls.

While the removal of the controls is a priority, it will be done gradually and appropriately sequenced to preserve the stability of the króna during the phase of capital account liberalisation. The key conditions for lifting the capital controls are macroeconomic stability, including the implementation of a credible plan for fiscal sustainability and declining inflation, a sound financial system and an adequate level of foreign exchange reserves. Two of these conditions have been broadly met, but the financial system is still not fully prepared for lifting the controls.

Although capital controls have permitted a more rapid lowering of interest rates than otherwise, the focus on exchange rate stability may have contributed to somewhat tighter monetary policy than would be warranted by inflation prospects and the degree of slack in the economy. The scope to soften the contraction in the real economy has thus been more limited than otherwise. As the programme has progressed, the inflation outlook has regained more importance in monetary policy decisions, in accordance with the legally mandated long-term monetary policy regime.

Interest rate developments

At the beginning of 2009 the most important Central Bank interest rate for the development of short-term market rates (then the seven day collateralised lending rate) was 18 percent. At year-end the Central Bank rate that has the greatest impact on short-term interest rate developments (the maximum bid rate on 28 day certificates of deposit) was 9.75 percent.[6]

[6] The Central Bank interest rate that is most important in determining short-term market rates may vary. For a long while, the Bank's 7-day collateral lending rate was the determinant of market rates, but since early in 2009, the interest rate on deposit institutions' current accounts with the Bank and the interest on certificates of deposit have been most important in interest rate formation. For further discussion, see *Monetary Bulletin* 2009/4, pp. 7-8 and 21-23.

TABLE 3: CENTRAL BANK INTEREST RATES

	Current account	28-day CDs (maximum)	7 day collateral lending rate	Overnight lending rates
8. Dec. 10	3.5	4.3	4.5	5.5
3. Nov. 10	4.0	5.3	5.5	7.0
22. Sep. 10	4.8	6.0	6.3	7.8
18. Aug. 10	5.5	6.8	7.0	8.5
23. Jun. 10	6.5	7.8	8.0	9.5
5. May. 10	7.0	8.3	8.5	10.0
17. Mar. 10	7.5	8.8	9.5	10.5
27. Jan. 10	8.0	9.3	9.5	11.0
10. Dec. 09	8.5	9.8	10.0	11.5
5. Nov. 09	9.0	10.3	11.0	13.0
24. Sep. 09	9.5	10.0	12.0	14.5
13. Aug. 09	9.5	–	12.0	16.0
2. Jul. 09	9.5	–	12.0	16.0
4. Jun. 09	9.5	–	12.0	16.0
7. May. 09	9.5	–	13.0	17.0
8. Apr. 09	12.5	–	15.5	19.5
19. Mar. 09	14.0	–	17.0	21.0
29. Jan. 09	18.0	–	18.0	22.0

Source: Central Bank of Iceland

Monetary easing continued throughout 2010. Following the MPC's December meeting, the current account rate was 3.5 percent, the maximum bid rate on 28-day certificates of deposit was 4.25 percent, the seven-day collateralised rate was 4.5 percent and the overnight lending rate was 5.5 percent. At the December meeting the Bank's interest rate corridor was narrowed by 1 percentage point, to 2.0 percentage points, with the aim of reducing the volatility of short-term market rates and moving the overnight interbank rate closer to the centre of the corridor (see Table 3).

Future changes to monetary policy framework

On 20 December 2010 the Central Bank of Iceland published a report on domestic monetary policy and submitted it to the Minister of Economic Affairs. The report summarises the Bank's main viewpoints concerning Iceland's future exchange rate and monetary policy regime after the completion of the economic programme of the Government and the IMF in 2011 and the lifting of the capital controls. The report covers possible reforms to the framework for monetary policy based on inflation targeting, including how systemic foreign exchange market intervention, macro-prudential tools, and improvements in the interaction between monetary policy and fiscal policy can contribute to enhanced economic stability. While the report aims to provide an overview of possible improvements, actual policy must be adapted more closely to Icelandic conditions once the future framework has been decided. The Ministry of Economic Affairs is currently reviewing the Central Bank's proposal for the future changes to the monetary policy framework. Some of the proposed changes, including increased macro-prudential tools, will have to be developed in line with other reform of the financial market legislation currently under way (see chapter 4.2).

2.2.4 External sector

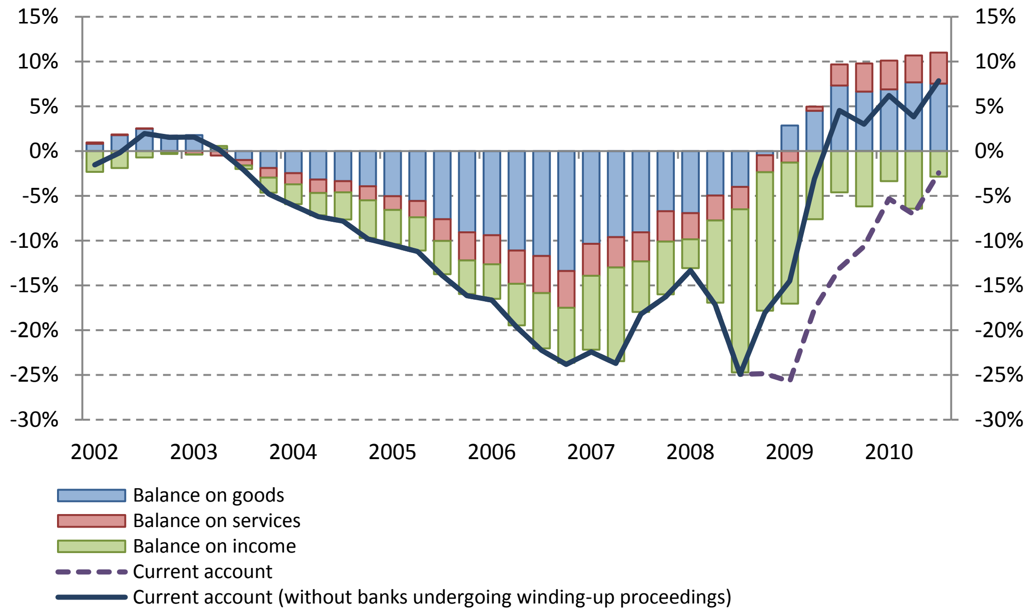
The balance on goods and services was in a substantial deficit in the period of 2003-2008 but turned positive towards the end of 2008 following the financial crisis. The surplus on the goods account grew steadily in 2009 and remained positive each month in 2010.

As in previous downturns, the deficit on the balance on goods and services building up in the period of 2003-2008 was eradicated through a sharp compression of imports, stemming from a sharp depreciation of the króna and a large contraction in domestic demand. From March 2010 imports have been on the rise again. In spite of this, the goods surplus for 2010 was considerably larger than in 2009. As a result, it can be expected that once imports stabilise, they will be lower than during the upswing because imports as a share of GDP are now close to their long-term average after rising far above that value during the pre-crisis years.

Export values have been rising briskly for the past few years, on the back of, amongst other things, increasing aluminium production. Export values continued to increase somewhat in 2010 on the back of marked improvements in terms of trade. The global recession has had a limited affect on Icelandic export volumes. Both marine and aluminium production (the largest share of Icelandic exports) has been at full capacity, and given the weak króna the traded goods sector has been highly competitive. Revenue from tourism has grown despite the global recession while outlays of residents have contracted. This has contributed a gradual improvement on the service account, which turned into surplus in 2009 for the first time since 1997. The surplus on the service account has continued to improve in 2010. The European Economic Area continues to be Iceland's main trading partner, with 82.2 percent of all exports in the first eleven months of 2010 going to EEA countries – small decline from the same period in 2009 when 83.2 percent of all exports when to the EEA. Imports are somewhat more diversified, with 60.8 percent of all imports originating from the EEA in the first eleven months of 2010 compared with 64.5 percent in the year earlier period.

The current account deficit increased enormously in the period of 2003-2008, in large part due to a substantial deficit on the income account, which peaked at almost 25 percent of GDP in 2008. Measured deficit on the income account has remained quite large in 2009 and the first three quarters of 2010. The deficit in the balance on income is due in large part to a negative interest balance. This does however not reflect actual flows of funds. A large share of interest expense derives from unpaid accrued interest on the deposit money banks (DMBs) in winding-up proceedings. A substantial share of this interest will never actually be paid and will disappear from official statistics on factor income when the bankruptcy proceedings for these banks are finally concluded. Therefore, in order to gain a clearer view of future payment obligations and of actual payment flows to and from Iceland during the period, it is useful to consider the balance on income excluding these DMBs. If the income account balance is adjusted for accrued income and expense of DBMs in winding-up proceedings the deficit on the income account balance was much lower in 2009 than in the previous year and has continued to decline in 2010.

FIGURE 17: BALANCE OF PAYMENTS, PERCENT OF GDP



Source: Central Bank of Iceland

Excluding accrued interest of DBMs in winding-up proceedings, the current account moved into surplus in 2009, which increased further in the first three quarters of 2010. According to the latest estimate, a surplus of 6 percent of GDP will be registered in 2010, excluding the DMBs. Furthermore, it should be noted that a single multinational company with headquarters in Iceland but limited domestic activity account for a large part of Iceland´s net external debt. Due to the company´s limited domestic operations, the net debt of the company should be of no consequence for Iceland´s external debt sustainability.

It is expected that the income account deficit will continue to decline in 2011, but rise again in 2012 with international interest rates gradually normalising. At the same time it is assumed that the surplus on the goods and service account will be declining, albeit slowly, as the domestic recovery gathers pace. The current account surplus, adjusted for accrued income and expense of DMBs in winding-up proceedings, will therefore gradually decline over the next 3 years.

2.2.5 Financial sector

The total assets of the financial system amounted to ISK 7,600 bn end-June 2010.[7] Banks and savings banks, collectively referred to as deposit institutions or deposit money banks (DMBs), are the largest entity in the financial system. Their assets amounted to nearly ISK 3,000 bn, or about two times GDP. When Byr Savings Bank failed in April 2010, their assets were transferred to a new commercial bank, Byr hf. With that transaction, the savings bank system contracted sharply, and by end-June the total assets of currently operating savings banks amounted to only about 5 percent of total DMB assets.

[7] Five commercial banks and twelve savings banks are currently operating in Iceland. Nine other credit institutions operate in Iceland: one investment bank, three payment card companies, two investment funds, and two asset financing companies, as well as the Housing Financing Fund (HFF), a State-owned mortgage credit fund.

The assets of credit institutions other than commercial and savings banks totalled ISK 1,145 bn. The vast majority of these are Housing Financing Fund (HFF) assets.

TABLE 4: FINANCIAL SYSTEMS ASSETS

Bn. ISK	31.12.2009	30.06.2010
Banking system	3,910	3,994
-Commercial banks	2,573	2,796
-Savings banks	383	150
Miscellaneous credit institutions	1,194	1,145
-Housing Financing Fund	795	833
Pension funds	1,848	1,900
Insurance companies	129	137
UCITS and investment funds	200	264
Government credit funds	148	157
Total assets	**7,430**	**7,597**

Source: Central Bank of Iceland
Internal transactions not included. Non-resident entities not included.

Commercial banks[8]

In the autumn of 2010, there were five commercial banks operating in Iceland.[9] Together, commercial banks' assets constitute some 87 percent of total DMB assets. The activities of the new commercial banks extend mostly to domestic operations. The year 2010 was the second full operational year for the new commercial banks. The banks' operating results for the years were strongly influenced by the recession and reflected great uncertainty in the aftermath of the financial crisis. In spite of this, their combined return on equity in 2009 and first half of 2010 measured between 16 and 17 percent. Net interest income is the banks' largest income item. Other major income items are service income net of service expense and exchange rate and trading gains on financial operations. In 2009 and first half of 2010, there was considerable income from the rise in the appraised value of the loan portfolios the banks took over from their predecessors.

At the end of June 2010, the book value of the commercial banks' total lending was just under ISK 2,000 bn. Slightly over half of the banks' loans are exchange rate-linked and about one-fourth are inflation-linked. The commercial banks' loans to companies represented about 59 percent of total lending, while some 24 percent of loans were to individuals and 5 percent to non-residents. Since the banks failed in the autumn of 2008, demand for new loans has been negligible. In June, the book value of the three largest commercial banking groups' total lending amounted to ISK 1,765 bn, slightly more than at the beginning of the year. At the same time, loan loss provisioning amounted to just over ISK 128 bn, or about 7.3 percent of total lending.

The balance of the banks' credit provisioning accounts reflects loan impairment after the establishment of the new banks. When the new banks were established, a portion of the loans from the old banks was transferred to the new ones at a substantial discount, as it was clear that

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[8] The restructuring of the financial sector is discussed further in chapter 4.2.
[9] The five commercial banks are NBI hf., Arion Bank hf., Islandsbanki hf., MP Bank hf., and Byr hf.

impairment would be significant and, in many cases, the likelihood of full recovery negligible. In recent months, debts have been restructured.

When the new banks were established, sizeable imbalances between foreign-denominated assets and liabilities resulted. A large majority of the old banks' assets took the form of foreign-denominated loans, while the corresponding liabilities remained in the estates of the old banks. The imbalance far exceeds the limits set forth in Central Bank rules and therefore increases financial undertakings' reserve requirements. The market for hedging instruments is virtually non-functional in Iceland, and the capital controls limit domestic financial undertakings' access to foreign hedging options. Consequently, the banks have few options for correcting the situation while confidence in the Icelandic financial markets is limited and risk aversion is significant. Ever since the banking system collapsed, the commercial banks have worked towards reducing their foreign currency imbalances. In recent months, the Central Bank has sought ways to assist the banks and savings banks temporarily in reducing these imbalances. This will be done through cross-currency interest rate swaps, whose purpose is to reduce the imbalances that can be traced to foreign-denominated assets generating foreign exchange revenues to operations. In end 2010 the Central Bank of Iceland negotiated contracts amounting to ISK 48 bn. In all likelihood, the Supreme Court judgments on exchange rate-linked loans will affect the book value of the imbalances between assets and liabilities denominated in foreign currency. It can be assumed that loan contracts containing non-binding exchange rate linkage clauses will henceforth be specified in Icelandic krónur. The book value of the imbalance will then be reduced by an amount equivalent to the change, reducing the institution's need for economic capital.

The vast majority of the commercial banks' funding comes from deposits. The banks' other borrowings remain limited, with the exception of a foreign currency denominated 10-year bond issued by NBI to Landsbanki Íslands hf. as a part of remuneration for the difference between appropriated assets and liabilities. Consequently, the banks' liquidity risk centres in large part on the possibility of large-scale withdrawals, as well as uncertain inflows from their loan portfolios. Many customers are in genuine financial distress, which reduces payment flows from loans and thus affects inflows of liquid assets.

Nearly 80 percent of the banks' deposits are sight deposits; therefore, the banks must be prepared for large-scale withdrawals at any given time. Once investment options increase in number and risk aversion diminishes, the banks can expect a share of their deposits to shift over to other investment forms. Possible change in the blanket government guarantee of deposits – cf. official declarations that deposits in Icelandic banks are guaranteed in full – might also affect investors' choices. Moreover, non-residents hold about 16 percent of commercial bank deposits, and the old banks hold about 6 percent. Consequently, the banks must be prepared for the expatriation of a portion of these deposits, with the accompanying impact on their liquidity and on foreign exchange market flows.

The Central Bank sets rules governing credit institutions' liquidity. In addition to the Central Bank rules, the Financial Supervisory Authority has demanded that the largest commercial banks hold liquid assets equal to at least 20 percent of all deposits and cash equivalent to at least 5 percent of sight deposits. The commercial banks have met the Central Bank's liquidity requirements and the Financial Supervisory Authority's requirements for deposit payout ratios.

The capital base of the largest commercial banking groups totalled ISK 400 bn as of end-June 2010, including subordinated loans amounting to just under ISK 50 bn. The capital base therefore consists of share capital and accumulated operating revenues. The banks' capital ratio, according to the pertinent provisions of the Act on Financial Undertakings, was 17.8 percent at the end of June 2010 after rising by 1.9 percentage points since the beginning of the year. At the end of June, Arion Bank, Íslandsbanki, and NBI met the Financial Supervisory Authority's 16 percent minimum capital adequacy requirement. Byr was undergoing financial restructuring but has now reached agreements with its creditors. In November 2010, MP Bank had assessed its economic capital and was attempting to strengthen its capital position in consultation with the Financial Supervisory Authority.

Savings banks and Housing Financing Fund

The restructuring of the savings banks has been underway for some time. The Central Bank of Iceland was the principal creditor of five of them. This situation stems from the March 2009 collapse of Sparisjóðabanki Íslands (SPB), after which the Central Bank was forced to take over all savings banks deposits with SPB. In order for the Central Bank to be able to meet those obligations, claims against the savings banks were transferred to the Central Bank with a decision by the Financial Supervisory Authority on the disposal of SPB's assets and liabilities.

In December 2010 the Central Bank of Iceland concluded contractual agreements concerning the debt of five savings banks that did not meet minimum capital adequacy requirements in the wake of the banking collapse. The savings banks in question are: Sparisjóður Bolungarvíkur, Sparisjóður Norðfjarðar, Sparisjóður Svarfdæla, Sparisjóður Vestmannaeyja, and Sparisjóður Þórshafnar og nágrennis. In addition, Sparisjóður Suður-Þingeyinga and Sparisjóður Höfðhverfinga have paid their debts to the Central Bank (see chapter 4.2).

The Housing Financing Fund's (HFF) assets totalled ISK 833 bn as of end-June 2010. Some 95 percent of HFF's assets are loans, which increased by 4 percent from year-end 2009. At end-June 2010, the Fund owned 739 residential properties appropriated in satisfaction of claims, as opposed to 347 properties at year-end 2009. The HFF finances mortgage lending by issuing HFF bonds. The Fund's bond issues totalled ISK 809 bn as of end-June, after increasing 4 percent since the beginning of the year. The Housing Financing Fund's operations generated a loss of approximately ISK 1.7 bn in the first half of 2010. In comparison with the same period in 2009, net interest income fell sharply, deposit interest on liquid assets declined, and freezing of interest payments increased. It is clear that the HFF must increase its interest rate differential in order to cover operating expenses and increased impairment. In the first half of 2010, loan impairment rose in line with default ratios, which increased from 5.3 percent at year-end 2009 to 6.3 percent at end-June 2010. The Fund's equity totalled ISK 8.4 bn as of end-June, and its capital adequacy ratio was only 2.1 percent, down from 3 percent at year-end 2009. The Fund's long-term goal is to maintain an equity ratio over 5.0 percent. In December 2010, the Icelandic parliament Althingi agreed to strengthen Fund´s equity by ISK 33 bn (see chapter 4.2).

Legal, regulatory and supervisory framework

The legal framework for the financial system is based on Iceland's membership of the European Economic Area. Since 1999, the Financial Supervisory Authority (Fjarmalaeftirlitid, FME) has handled the supervisory tasks formerly assigned to the now disbanded Bank Inspectorate of the Central Bank and the Insurance Supervisory Authority. The FME supervises financial undertakings and parties operating in financial and insurance sectors, while the Central Bank's role centres on oversight and prudential regulation. A Cooperation Agreement between the FME and Central Bank of Iceland is in place. Its main aim is to clarify the responsibility of each party and the division of tasks between them. By law, the Central Bank of Iceland sets rules for credit institutions' liquidity ratio – i.e., the ratio of liquid claims to liquid liabilities – and for their foreign exchange balance. Other prudential regulations on financial markets are either provided for by law or adopted by the FME.

Main vulnerabilities and resilience factors

DMBs' asset quality. The assessment of the banks' and savings banks' assets is still subject to considerable uncertainty, and balance sheet mismatches remain. Uncertainty related to exchange rate-linked items has been reduced. The economic contraction was prolonged, and the position of businesses and households is weak.

Funding and limited market activity. Deposits are the backbone of the post-crisis banks' and savings banks' funding. They are usually a more reliable source of funding than short-term borrowings in the whole sale credit market, but some volatility due to transfers of deposits between institutions is to be expected. Funding is now protected by the capital controls and by Government declarations of guarantee. The interbank, bond, equity, and currency markets are weak. Foreign direct investment and access to foreign credit markets remain limited.

Flaws in regulatory framework and supervision. The collapse revealed a number of flaws in regulatory instruments and financial supervision. Correcting them will take time. A strategy to combat systemic risk has yet to be formulated, as has the institutional framework for such a strategy.

Economic outlook. The government's economic programme and monetary policy have succeeded in stabilising the currency, bringing inflation down to target and fortifying public sector finances. The Treasury has taken on substantial financial burdens as a result of the collapse, but its debt is manageable and on a downward trend. A sizable trade surplus will underpin exchange rate stability in the years to come.

Financial system reconstruction. The reconstruction of the financial system is well advanced. The banks' operations now centre on service to domestic firms, institutions, and households. The sphere of activity of banks and savings banks is small in comparison with pre-crisis levels. Nevertheless, the size of the system does still pose significant long term risk to the economy. Hence, it will be necessary to streamline the financial system further, with mergers and other actions, in order to reduce costs.

Institutional and supervisory framework and payment systems. Work on improving the international regulatory framework, as well as that in the EU/EEA, is underway. Corresponding improvements will be implemented in Iceland, including more effective monitoring of systemic risk and authorisations for mitigation action. The Financial Supervisory Authority has formulated a new policy, and a review of legislation pertaining to supervisory activity and financial system stability is in the offing. It is hoped that new core and support structure for payment intermediation will be implemented at the end of the current year.

***Exchange rate-linked loans*[10]**

In June, the Supreme Court of Iceland ruled that two asset leasing agreements were actually loan agreements. Because the principal, disbursed loan amount, and repayments according to the contracts were specified in Icelandic krónur, the contracts were considered loan agreements in Icelandic krónur. According to the Supreme Court's interpretation of the Act on Interest and Price Indexation, no. 38/2001, it is unlawful to link obligations in Icelandic krónur to the exchange rate of foreign currencies. The Supreme Court therefore ruled that the exchange rate linkage provisions of the loan agreements were not binding.

In the wake of these Supreme Court judgments, disputes arose concerning whether the interest rates specified in loan agreements with non-binding exchange rate linkage clauses were binding. In September 2010, the Supreme Court ruled that the interest rate provisions of the above-specified agreements should be set aside and the general, non-indexed interest rate published by the Central Bank should prevail, in accordance with the Act on Interest and Price Indexation, no. 38/2001. The Supreme Court's conclusion was in line with guidelines issued by the Central Bank and the Financial Supervisory Authority on 30 June 2010. The Supreme Court judgments state explicitly that loans in foreign currency do not fall under the rules governing indexation of loans in Icelandic krónur.

In December, legislation regarding unlawfully foreign-denominated loans to Icelandic households came into force following its enactment by parliament. The aim is to guarantee non-discrimination among individuals who took exchange rate-linked mortgages and motor vehicle loans, irrespective of whether the form of the loan agreement in question was deemed unlawful or not. An estimated 37,000 households have exchange rate-linked loans. As a result of the Supreme Court ruling, households' debt may decline by ISK 40-50 bn in nominal terms, but uncertainty about the values of exchange rate-linked loans to households has been eliminated for the most part. The law contains a general provision stating that, if an agreement has been reached concerning unlawful interest or indexation, both shall be reviewed, and the interest at any given time shall be equal to the interest rate published by the Central Bank in accordance with Act no. 38/2001, with reference to the lowest non-indexed or indexed interest rate on new loans granted by credit institutions. According to the law, this interest shall be calculated from the date the monetary claim was established. This eliminates the uncertainty concerning the interest rate on unlawful exchange rate-linked loan agreements. Significant uncertainty concerning the legality of exchange rate-linked loans to legal entities remains, but previous Supreme Court rulings set floor under the possible impact to the bank´s balance sheet.

All of Iceland's financial undertakings have concluded a large number of exchange rate-linked loan agreements, and a variety of contract forms have been used. Based on the results of a contingency work done by the Central Bank and the Financial Supervisory Authority the impact of the above on the three largest commercial banks' capital ratios is manageable. The impact on the capital ratios of smaller financial companies could be greater, although the financial system as a whole would not be threatened.

[10] Exchange rate-linked loans and their classification were discussed in length in Financial Stability 2010/2, published by the Central Bank of Iceland in November 2010 p. 18-21.

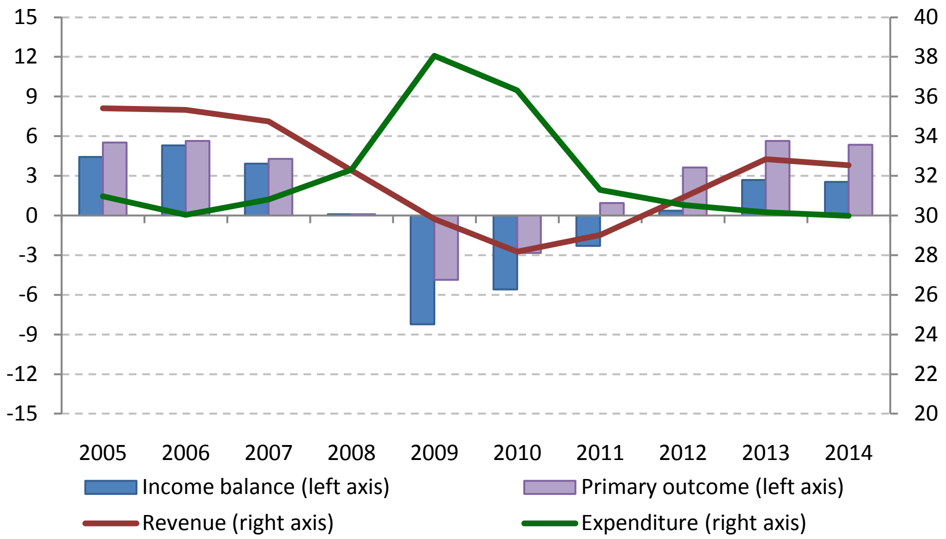
3. Public Finance

3.1 General government balance and debt

3.1.1 Policy Strategy and medium-term objectives

Government finances were hit hard by direct costs from the financial crisis, including recapitalization of the Central Bank and commercial banks, and a sharp fall in revenue and rising expenditures during the recession. To counter the rapidly deteriorating fiscal stance, the Minister of Finance presented to Althingi a medium-term fiscal programme for the central government that outlines a return to a primary surplus by 2011 and an overall surplus in 2013.[11] This programme is considered a cornerstone of the government's economic policy according to the 2009 coalition agreement.

FIGURE 18: CENTRAL GOVERNMENT INCOME BALANCE, PERCENT OF GDP[12]

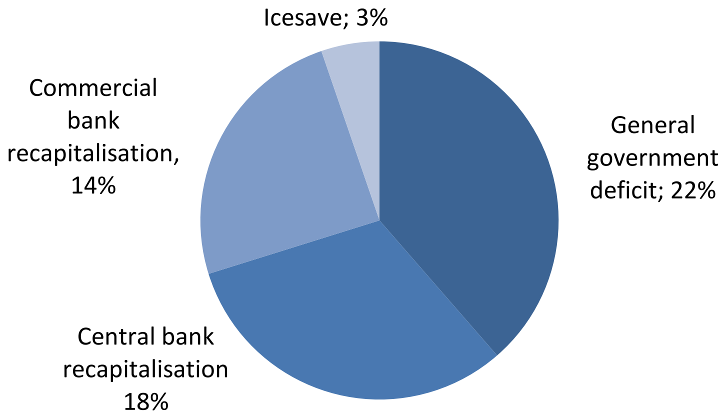


Source: Ministry of Finance

Figure 18 shows the breakdown of the fiscal expenditures caused by the financial crisis. It includes the estimated general government deficit until 2013 and the estimated cost of the proposed Icesave agreement.

[11] An updated programme was published alongside the 2011 budget.
[12] *Irregular items such as the sale of Landsíminn (2005), CBI lost claims (2008) and the sale profits from the Avens deal is not included in figures 1 and 2.*

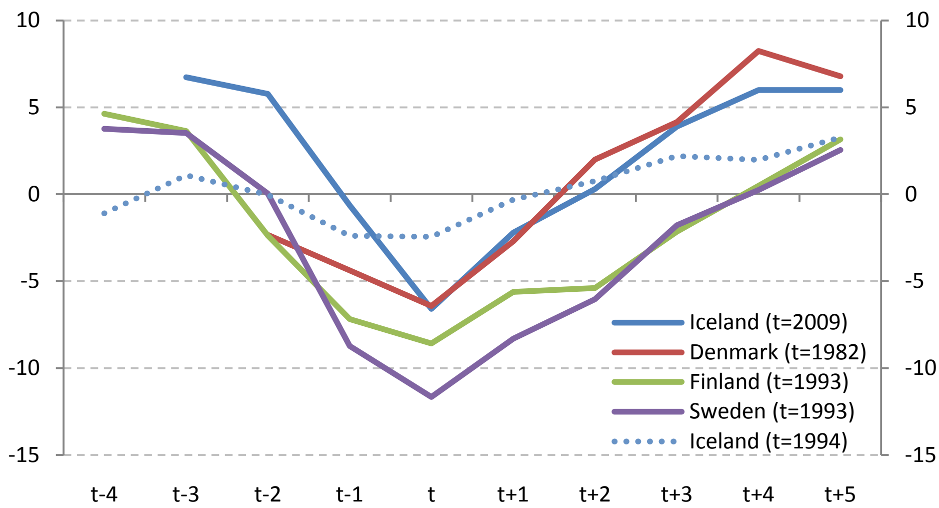
FIGURE 19: BREAKDOWN OF THE FISCAL EXPENDITURE DUE TO THE BANKING CRISIS



Source: Ministry of Finance

The fiscal path has been a central commitment in Iceland's cooperation with the International Monetary Fund (IMF). The government's Letters of Intent underline the government's intention to use the central government finances and a stricter fiscal framework for the local governments to move the general government balance back into surplus on a similar time path as the central government balance. This commitment has been manifested in the budgets for 2010 and 2011 and updates to the medium-term fiscal programme. The speed of the adjustment is broadly similar to that experienced by the Nordic countries in the 1980s and 1990s and based on Iceland's own substantial fiscal adjustment in the 1990s. The commitment is front loaded, with the largest share of the burden falling on 2010 and 2011.

FIGURE 20: GENERAL GOVERNMENT PRIMARY BALANCE, PERCENT OF GDP

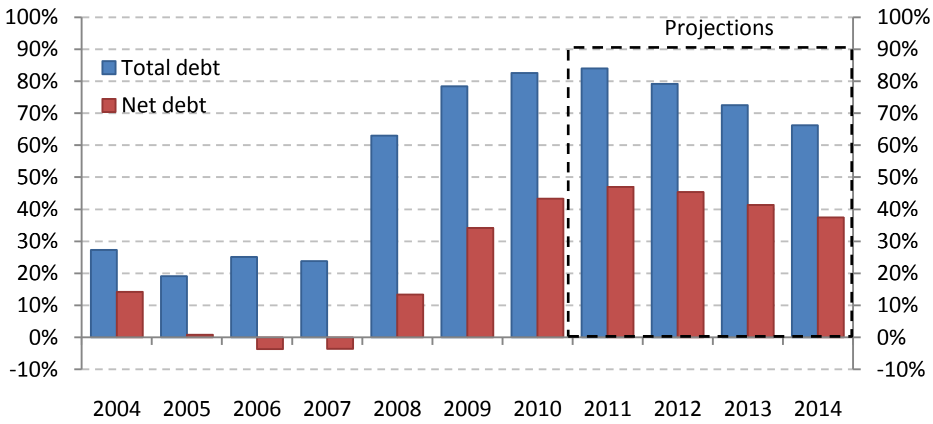


Source: IMF, WEO database

The fiscal path will pave the way for declining government debt. Over the medium-term, government debt is to fall below the current Maastricht ceiling of 60 percent of GDP. In the long-term, however, government debt needs to decrease further as stable and low debt is extremely important to ensure economic stability for a small economy in such a volatile environment. As government debt has risen rapidly in the current crisis, debt management has also been strengthened substantially with increased resources and more transparency, including through a debt management strategy published in early 2011.

Central government debt has risen from approximately ISK 311 billion in 2007 to about ISK 1,285 bn at the end of 2010. This is equivalent to 83 percent of GDP. Government debt will gradually be reduced below 70 percent of GDP by year-end 2014. The net debt is 43 percent of GDP at the end of 2010 and is expected to be reduced to approximately 35 percent of GDP by year-end 2014. Cash at hand and receivables are subtracted from gross debt to calculate net debt. Cash position and receivables amounted to ISK 644 billion at the end of 2010.

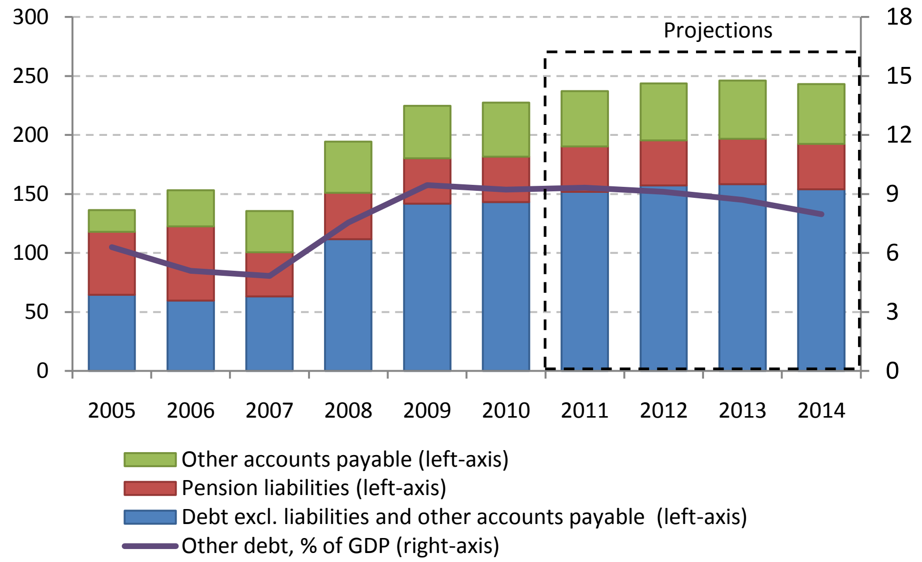
FIGURE 21: CENTRAL GOVERNMENT DEBT



Sources: Statistics Iceland, the Ministry of Finance and the Ministry of Economic Affairs

Operational conditions for municipalities are also challenging as revenues have decreased while expenditure has risen as demand for social services has increased. Total debt and liabilities of municipalities (A-part) at end-2010 amounted to 14.7 percent of GDP but 9.2 percent excluding liabilities and short-term debt. Financial assets of municipalities (A-part) amounted to 9 percent of GDP at end-2010 and have contracted steadily in recent years.

FIGURE 22: LOCAL GOVERNMENT DEBT AND LIABILITIES



Sources: Statistics Iceland and the Ministry of Economic Affairs

The government's goal is to defend the Nordic welfare model during the adjustment period by preserving the key components of the welfare system and utilizing government finances to even the burdens resulting from the recession. Automatic stabilizers were therefore allowed to operate fully in 2009 while revenue measures took most of the burden in 2010. On the other hand, the 2011 budget puts increased burden on expenditure measures, putting on balance a slightly more emphasis on expenditure measures over the whole adjustment period. Extensive consultation between the government and the social partners has taken place to form broad consensus about the foundations underlying the fiscal adjustment path. Broad support for the overall objectives of the fiscal policy is of fundamental importance to ensure successful implementation and sustainable public finances in the future. The fiscal programme is not expected to be affected by the Copenhagen criteria, as economic policy has long been guided by Iceland's membership of OECD and the European Economic Area since 1994.

3.1.2 Actual balances and medium term perspectives

Central government

The government's medium-term fiscal programme foresees a front loaded improvement in the primary balance of an average of 3-4 percent of GDP annually from 2010 to 2013. During this period, the central government primary balance will be transformed from a deficit of around 5 percent of GDP in 2009, according to Statistics Iceland national accounts, to approximately 5.5 percent surplus in 2013. The total turnaround in the primary balance throughout the programme period is 14.4 percent of GDP when compared with the situation in mid-2009 when the primary deficit was expected to reach 9 percent of GDP before the government enacted its first budgetary measures.

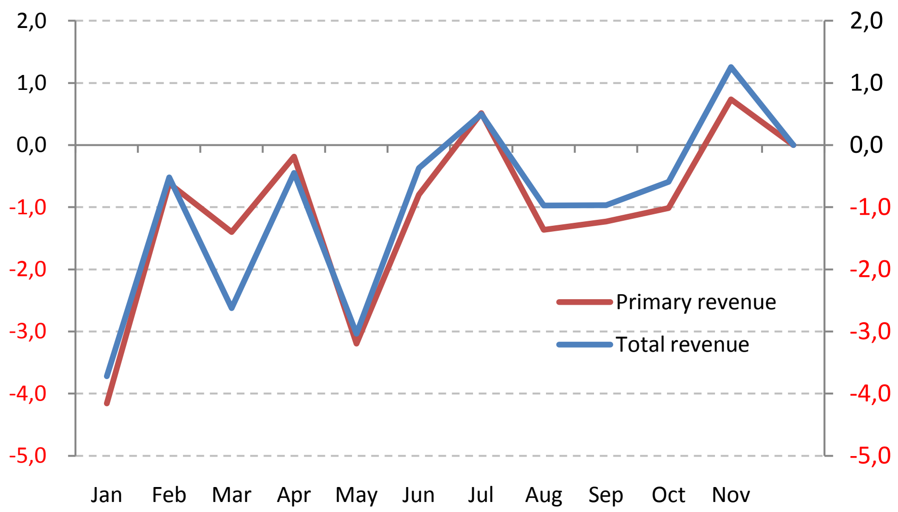
The share of central government revenue to GDP is to increase from 24.7 percent at mid-2009 to 29.9 percent of GDP by 2013 due to the improved economic situation and specific tax measures detailed below. The share of primary expenditure to GDP is to fall from 33.7 percent to 24.5 percent during the same period. Of the total adjustment, approximately ⅓ is to come from rising revenue and ⅔ by reduced expenditure. Net interest costs are estimated at ISK 52.7 bn in 2011. Net interest costs are expected to rise somewhat in 2012 before decreasing slightly in 2013 and 2014.

Medium-term fiscal programmes are subject to extensive uncertainties, not least in such a delicate macroeconomic environment. Revenue and expenditure measures are therefore under constant revision to ensure the required adjustment targets set out in the programme.

2010 results

The central government's primary balance is expected to have improved by 4 percent of GDP on accrual basis in 2010 compared with the 2009 results, excluding ISK 17.5 bn one-off and irregular income resulting from the so-called Avens Agreement.[13] Government revenue regained strength in late 2010 after underperformance for most of the year according to monthly cash data (see figure below). Expenditures were also lower than forecast, mostly due to less unemployment than forecast, thus allowing for over-performance in cash terms for 2010. Even though the budget process is based on accrual accounting, the IMF programme progress is measured on cash basis. Monthly reliable cash numbers also assist the government in reacting swiftly when actual outcomes differ from budget forecasts. Figure 23 displays accumulated central government revenue 2010 (excluding Avens) as a percentage departure from budget forecast.

FIGURE 23: ACCUMULATED CENTRAL GOV. REV. 2010, PERCENT DEPARTURE FROM BUDGET FORACAST



Source: The Ministry of Finance and the Ministry of Economic Affairs

[13] The Central Bank of Iceland, on behalf of the Treasury, sold Housing Financing Fund (HFF) bonds owned by the Treasury to 26 pension funds in May 2010. The Treasury and the Central Bank acquired the bonds following Landsbanki's collapse and with agreements with Banque centrale du Luxembourg and the liquidator of Landsbanki Luxembourg on 18 May 2010. The total nominal value of the bonds is ISK 90.2 bn, and the sale is made with the aim of expanding the foreign exchange reserves. Furthermore, it reduces the Treasury's net foreign-denominated debt, which had increased because of the financing of the aforementioned purchase. According to the agreement, the pension funds will sell foreign assets and pay for the bonds in euros, remitting a total of EUR 549 million. This transaction increases the Central Bank of Iceland's foreign exchange reserves by ISK 82 bn (512 million euros), or by 17 percent.

2011

The government budget foresees a primary surplus in 2011 of 0.9 percent of GDP, or ISK 15.4 bn on accrual basis. This implies an improvement in the primary balance of 3.8 percent of GDP. The outcome on cash basis is slightly lower at 0.3 percent of GDP, or ISK 5.2 bn. The 2011 budgetary measures are estimated at ISK 44 bn, with ¾ on the expenditure side and ¼ on the income side (see further chapter 3.1).

TABLE 5: CENTRAL GOVERNMENT ESTIMATED INCOME BALANCE ON ACCRUAL BASIS, 2010 - 2014

	Estimation	*Budget*		*Forecast*	
In billions of ISK	2010	2011	2012	2013	2014
Total revenue	477.7	472.5	533.2	599.4	629.3
Total expenditure	564.6	509.8	526.8	550.5	579.9
Balance	-86.9	-37.3	6.4	48.9	49.4
Interest income	27.7	20.9	22.5	29.4	32.3
Interest expenditure	70.4	73.6	78.8	83.5	86.4
Primary balance	-44.2	15.4	62.7	103.0	103.5
Percentage of GDP					
Total revenue	30.7	29.0	30.9	32.8	32.5
Total expenditure	36.3	31.3	30.5	30.2	30.0
Balance	-5.6	-2.3	0.4	2.7	2.6
Primary balance	-2.8	0.9	3.6	5.6	5.4

Sources: The Ministry of Finance and the Ministry of Economic Affairs

Table 5 shows the expected central government outcome on accrual basis. It includes the necessary measures to ensure fiscal developments in line with the programme outlined in the government's Letters of Intent to the International Monetary Fund.

2012-2013

The medium-term fiscal programme foresees a positive overall balance by 2012 and a surplus of 2.6 and 2.7 percent of GDP in 2013 and 2014, respectively. The expected interest costs from the proposed Icesave agreement are excluded from these calculations (see further the section on contingent liabilities in chapter 3.2.1).

The primary balance is to improve by 2.7 percent of GDP in 2012 and 2 percent in 2013. The medium-term programme foresees a primary surplus of 5.6 percent of GDP in 2013 (5 percent on cash basis) and an overall surplus of 2.7 percent of GDP. From that point onward, the current programme foresees a continued surplus of a similar magnitude. This should set central government debt on a continuous downward path, thus allowing for decreasing interest rate costs.

The medium-term projections entail rising government income in 2012-2014, largely due to positive effects of economic growth, including rising private consumption. The rate of primary revenue to GDP is expected to grow by 1.9 percent points from 2010 to 2014 when the rate will stand at 30.9 percent. Primary expenditure is expected to decrease during the same period by 6.3 percent points of GDP, largely due to a 40 percent fall in unemployment benefits as well as strong expenditure restraint in other areas.

Revenue measures

The government introduced its first revenue measures at the end of 2008. Further changes were approved by the Althingi in May and June 2009 to support the goals set out in the medium-term fiscal programme and Letters of Intent. The revenue measures included temporary and permanent measures that allowed for an over-performance of the 2009 budget. The main thrust for the fiscal adjustment in the 2010 budget was again on the revenue side. Even though the adjustment in 2011 will largely be on the expenditure side, new revenue measures for the year of 2011 are expected to result in increased income of ISK 11 bn, leaving the central government tax revenue at around 27 percent of GDP in 2010 and 2011.

TABLE 6: CENTRAL GOVERNMENT REVENUES, 2011 - 2014

Accrual accounting, bn.ISK in current prices	2011	2012	2013	2014
Total revenue	472.5	533.2	599.4	629.3
Tax revenue	434.4	499.6	558.7	585.3
Interest revenue	20.9	22.5	29.4	32.3
Primary revenue	451.6	510.7	570.0	597.0
Tax revenue as % of GDP	26.7	28.9	30.6	30.3
Primary revenue as % of GDP	27.7	29.6	31.2	30.9

Source: The Ministry of Finance

Even though increased economic activity will lead to rising government revenue during the programme period, extensive revenue measures have been, and continue to be, required for the medium-term fiscal strategy to succeed. Table 7 shows the effects of the revenue measures for 2009-2011.

TABLE 7: EFFECTS OF INCOME RESTRAINT MEASURES

Accrual accounting, bn.ISK *in current prices*	**2009**	**2010**	**2011**
Higher income tax rates	10.8	14.7	21.9
Higher social security contribution	6.0	24.4	25.5
Excise taxes in ISK amounts and user fees	6.5	12.0	12.8
Increase in the higher VAT rate	-	4.0	4.3
New net-wealth tax and higher inheritance tax	-	3.5	6.2
New environmental and resource taxes	-	4.7	6.7
Other	0.4	4.6	4.6
Total excluding effects of pension prepayment	23.7	67.9	82.0
Prepayment of personal pension plans	5.3	4.8	3.9
Total including effects of pension prepayment	29.0	72.7	85.9
Source: The Ministry of Finance			

The revenue strategy for 2012 to 2014 relies on unchanged tax measure throughout the period, i.e. that temporary measures will remain unchanged or that new and equal measures will replace those that expire. Social security contributions will also remain unchanged throughout the period. Moreover, taxes that are based on a certain króna amount will be adjusted annually to inflation.

Increased tax revenue depends of course on economic developments. As presented in chapter 2, the budget macroeconomic assumptions are derived from a forecast developed by an independent office within Statistics Iceland. According to the forecast, growth will resume in 2011. Moreover, the wage share of factor income is set to rise in addition to rising share of private consumption to GDP. Both of these developments will lead to rising tax revenue given unchanged tax rules. If the economic recovery proves less robust than currently forecast, the government is determined to align the strategy in light of new circumstances. Further reduction in spending could therefore be needed if the government revenue does not raise the economic growth rebounds.

TABLE 8: ITEMIZED CENTRAL GOVERNMENT REVENUE ON BOTH ACCRUAL AND CASH BASIS

Bn.ISK	Estimation 2010	Estimation 2010	Budget 2011	Budget 2011
	Accruals	*Cash*	*Accruals*	*Cash*
Tax income	**421.030**	**401.167**	**434.382**	**416.416**
Taxes on personal income and profits	119.200	115.000	114.000	110.000
Taxes on corporate income and profits	21.500	17.500	26.400	22.000
Social security taxes	62.332	59.153	64.572	62.056
Net wealth tax	8.402	7.932	10.658	10.068
Value added tax	126.900	122.000	132.000	126.700
Other taxes on goods and services	68.289	65.924	72.368	71.810
Other taxes	14.407	13.658	14.384	13.781
Other current revenue	**35.154**	**35.433**	**29.778**	**29.688**
Dividends and rental income	1.179	1.179	2.226	2.226
Interest income and other property income	27.628	27.908	20.867	20.777
Other	6.347	6.346	6.685	6.685
Asset sales	19.800	19.800	600	600
Cost sharing transfers	1.708	1.709	7.704	7.704
Total income	**477.692**	**458.109**	**472.464**	**472.464**
% of GDP				
Tax income	27.1	25.8	26.7	25.6
Taxes on personal income and profits	7.7	7.4	7.0	6.8
Taxes on corporate income and profits	1.4	1.1	1.6	1.4
Social security taxes	4.0	3.8	4.0	3.8
Net wealth tax	0.5	0.5	0.7	0.6
Value added tax	8.2	7.8	8.1	7.8
Other taxes on goods and services	4.4	4.2	4.4	4.4
Other taxes	0.9	0.9	0.9	0.8
Source: The Ministry of Finance				

The revenue measures are mainly based on eight categories:

1. **Higher income taxes:** The personal income tax rate was increased by 1.35 percent points at the beginning of 2009. The personal tax credit was increased by 24 percent at the same time, thus raising the tax exempt rate substantially. In mid-2009, a temporary high-income tax was levied on personal and interest income above a certain limit for the remainder of the year. At the beginning of 2010, a tax exempt bracket was introduced into the capital tax system and the tax rate increased from 10 to 18 percent. The personal income tax system was transformed at the same time with three new personal income tax brackets replacing the previous single-bracket system. The personal tax credit was also increased by ISK 24,000 a year to ISK 530,460 while the previous indexation of the credit was abolished. In 2011, the capital and corporate income tax rates were increased from 18 to 20 percent.
2. **Increased social security contribution:** The contribution to the social protection was increased by 1.65 percent points in mid-2009 and a further to 1.66 percent points at the beginning of 2010. This decision was, in part, taken to fund unemployment benefit expenditure due to rapidly rising unemployment rate (see chapter 4.3).
3. **Increased excise taxes and user fees.** Excise taxes on fuels, alcohol and tobacco have been raised in three steps since December 2008. First, the excise taxes were increased at the

beginning of 2011 by 4 percent to keep the real value unchanged.[14] Second, tobacco taxes were increased by 3 percentage points. Moreover, special excise taxes were levied on duty free sales of alcohol and tobacco at airports, 10 percent of the normal excise tax for alcohol and 40 percent of the tax on tobacco. Some of these taxes, which are levied as a króna amount rather than a percentage rate, had remained unchanged for a number of years prior to the crisis. Their real value had therefore declined substantially. A special tax on products with high sugar content was also introduced in the fall of 2009. In addition, a number of service fees were raised at the beginning of 2010. The largest revenue impact comes from higher court fees.

4. **Rise in the higher VAT bracket.** The higher VAT bracket was raised from 24.5 to 25.5 percent at the beginning of 2010. Further tax changes have been studied, including broadening of the tax base and a new middle tax bracket. Tax income from the higher VAT rate is expected to increase the government revenue by ISK 4 bn annually.
5. **New net-wealth tax.** A new temporary 1.25 percent net-wealth tax was imposed on assets above ISK 90 m for individuals and ISK 120 m for couples at the beginning of 2010. The tax rate was increased to 1.5 percent for 2011 and the asset ceiling for lowered to ISK 75 m for individuals and ISK 100 m for couples. The tax is set to expire in 2012. Offsetting revenue measures are being considered. The inheritance tax was also raised from 5 to 10 percent at the beginning of 2011.
6. **New environmental and resource taxes.** A carbon tax on liquid fuels and a resource tax (energy tax) on electricity and hot water were imposed in the 2010 budget. Previously, the carbon tax was based on price of emission permissions on the EU ETS. The tax was 50 percent of the EU ETS price for 2010 but increased to 75 percent in 2011. These tax measures are set to expire at the end of 2012. Taxation of automobiles was also changed in 2011 to reflect the carbon footprint. These above mentioned amendments are not expected to have significant effect on government revenue.
7. **A new bank tax.** In line with developments in number of neighbouring countries, a new tax on banks' liabilities was introduced at the beginning of 2011. The tax is consistent with options identified in IMF 2010 “A Fair and Substantial Contribution by the Financial Sector”. The tax is to return ISK 1 bn annually and will be revised during 2011 in light of further international developments and experience.

[14] Due to lower than expected inflation in 2010, these taxes increase slightly in real terms.

TABLE 9: MAIN TAX CHANGES IN 2011

	Adoption	*Measure*	*Before*	*After*
Capital income tax	1.1.2011	2%	18.0%	20.0%
Corporate income tax	1.1.2011	2%	18.0%	20.0%
Inheritance tax	1.1.2011	5%	5.0%	10.0%
Net wealth tax	1.1.2011	0.25%	1.25%	1.50%
Excise tax on alcohol in duty free	1.1.2011	10% of normal excise duty		
Excise tax on tobacco in duty free	1.1.2011	40% of normal excise duty		
Excise tax on tobacco	1.1.2011	3%	Number of categories	
Carbon tax on gas and diesel fuel	1.1.2011	ISK 1.45	ISK 2.90	ISK 4.35
Carbon tax on petrol	1.1.2011	ISK 1.20	ISK 2.60	ISK 3.80
Carbon tax on jet and airplane fuel	1.1.2011	ISK 1.40	ISK 2.70	ISK 4.10
Carbon tax on fuel oil	1.1.2011	ISK 1.75	ISK 3.60	ISK 5.35
Automobile tax	1.1.2011	New reference for carbon emission		
Excise tax on vehicles	1.1.2011	New reference for carbon emission		
Bank tax	1.1.2011	0.041%	0.000%	0.041%

The table presents the main tax changes in the 2011. It does not include the 4% increase in excise taxes intended to secure unchanged real value of króna amount taxes even though inflation was below the forecast.

Source: The Ministry of Finance

These tax measures are expected to return the central government ISK 8 bn in revenue during 2011.

TABLE 10: THE EFFECTS OF 2011 TAX MEASURES

Accruals, bn.ISK	
Capital gains tax	1.5
Corporate income tax	0.5
Inheritance tax	1.0
Net wealth tax	1.5
Excise tax on tobacco and alcohol	1.3
Carbon tax	1.0
Automobile tax	0.2
Bank tax	1.0
Total excluding effects of pension payments	8.0
Extended permission for pension withdrawals	*3.0*
Total including tax withdrawals	11.0

Source: The Ministry of Finance

8. **Taxation of personal pension plan prepayment.** The Althingi authorised a temporary permission for people before the age of 60 to withdrawal from third pillar private pension schemes in 2009 (see further the section of the private pension schemes under chapter 2.4). Personal income tax from the private pension schemes returned ISK 3.6 bn in 2009 and ISK 5 bn in 2010. A further ISK 3 bn is expected to return in of 2011. It should however be noted, , that this measure is not a new revenue measure but rather an inter-temporal transfer of tax revenue to the present from the future date when the pension plans would have been paid out (see further discussion on macroeconomic implications in chapter 2).

Further amendments have been made to the tax system to spur certain sectors. The deductibility of VAT on work related to renovation and maintenance of housing has been increased and a special tax deduction for the same purpose been introduced. The tax code was also amended in 2010 to assist further research and development as is presented in chapter 4.

Expenditure measures

The largest share of the expenditure measures under the medium-term programme take place in 2010 and 2011. Previously announced expenditure increases were also retracted in 2009, in addition to general expenditure restraint despite automatic stabilizers being allowed to work fully to reduce the effects of the crisis. According to the medium-term fiscal framework, the central government's primary expenditure will stand at ISK 378.6 bn in 2011. This amount excludes certain irregular expenditures, estimated at ISK 132.4 bn for 2011, that are not a part of regular operations and can be expected to fluctuate substantially between years, see Table 11. From 2012 to 2014, primary expenditure is allowed to grow by 1-2 percent of GDP annually.

TABLE 11: IRREGULAR ITEMS AND TOTAL EXPENDITURE FRAME

Bn.ISK in current prices	**Budget**		**Programme**	
	2011	***2012***	***2013***	***2014***
Total expenditure	509.8	526.8	550.5	579.9
Irregular expenditure				
Pension expenditure	5.4	5.5	5.7	5.8
Governments capital gains tax	2.2	2.4	2.4	2.5
Tax write-offs	10.0	10.0	10.0	10.0
Unemployment	23.0	19.0	15.9	15.4
Local governments equalization fund	13.8	12.9	14.1	14.8
Government guarantees	3.1	3.1	3.1	3.1
Lost claims and benefits	0.1	0.1	0.1	0.1
Interest costs	73.6	78.8	83.5	86.4
Total irregular expenditure	***131.2***	***131.8***	***134.8***	***138.1***
Expenditure frames	**378.6**	**395.0**	**415.7**	**441.8**

Source: Ministry of Finance

The government's medium-term fiscal programme presents expenditure developments according to economic activity, divided between current expenditure, interest, transfer payments, maintenance and capital expenditure. The programme, is in part, based on demographic assumption and of planned changes to ministry expenditure commitments, inter alia according to expenditure on temporary projects, foreseeable weaknesses and re-evaluation of the main calculated and structural expenditures.

The medium-term fiscal programme calls for government wage restraint in addition to the 5 to 15 percent cut in public officials salaries in 2009. Wages of government employees are expected to grow by 2 percent annually from 2012 while transfer payments are set to increase in line with inflation. Unemployment expenditure is to develop in line with the Statistics Iceland economic forecast. Interest costs depend on composition of the debt stock, and interest rate categories.

Most other current expenditure, own income and transfer payments are set to rise in line with inflation. The programme assumes an annual 2 percent structural increase in child benefits and a 4 percent increase in the interest rate rebate. In addition, a special government programme was announced in December 2010 to continue the ISK 2 bn temporary interest rate rebate from 2009-2010 (as a part of the household debt restructuring strategy see chapter 4.1). No additional real increases are planned apart from cost from demographic developments related to rising old age, disability benefits and rising cost of medication. Other demand pressures, including rising number of students, will have to be offset with other expenditure. In accordance with the improved fiscal framework, the medium-term fiscal programme includes ISK 5 bn undefined expenditure, which is to offset changes in the price level and unexpected but unavoidable commitments that may come due each year.

Expenditure measures for 2010

Expenditures were reduced by ISK 43.8 bn in the government budget, 2010 compared with the 2009 budget. This equals a decrease of 9.7 percent year-on-year, excluding interest expenditure and irregular items such as tax write-offs and pension fund liabilities. The improvement is partially due to annual effects of measures that were first introduced in 2009. The new measures are estimated at ISK 36 bn. Restraint on wage and benefit increases prevented an additional ISK 11 bn expenditure increase that would otherwise have taken place. Total expenditure measures and effects of this expenditure restraint are estimated to have cut expenditure by a total of ISK 55 bn. The slight over-performance in primary expenditure during 2010, the final numbers for the budget outcome will likely show an even larger improvement.

TABLE 12: EXPENDITURE MEASURES, 2009-2010

Accruals bn.ISK	Reduction	Turnover	Reduction
	2010	*2009*	*%*
Current expenditure	-14.0	198.9	-7.0%
Transfer payments	-15.9	206.0	-7.7%
Investment and maintenance	-13.9	43.7	-31.8%
Total	**-43.8**	**448.6**	**-9.8%**

Source: Ministry of Finance

Current expenditure was reduced by ISK 14 bn in 2010, with 10 percent cut in the cost of the administration and supervisory institutions, 7 percent cut in education and a 5 percent reduction in cost of health care facilities and institutions that provide service for handicapped.

Transfer payments were reduced by ISK 15.8 bn through changes to the benefit system, reduced development assistance and a cut in various grants. The largest cost saving measure was an ISK 4.4 bn cut in pension payments, by among other things, increased means testing (benefits to those with the lowest income were not cut). Health insurance cost was also cut by ISK 3.6 bn by revising government participation in medication costs and less specialist services. Payments for parental leave were cut by a total of ISK 1.6 bn by lowering the maximum payment and increased means testing.

Maintenance and capital expenditure was cut by ISK 13.9 bn, thereof ISK 12.3 bn in reduced investment in roads. After these cuts, government investment is expected to fall to 1.4 percent of GDP after an average expenditure of 1.9 percent of GDP for most of the previous decade.

Expenditure measures for 2011

A total of ISK 33 bn in new expenditure measures are to be carried out in 2011. Thereof, ISK 28 bn comes from new measures while ISK 5 bn will come from cuts in expenditure that would otherwise have taken place. Irregular items, such as interest payments and pension liabilities are excluded. Health insurance cost is reduced by only 3 percent while expenditure on social services, secondary education and law enforcement is reduced by 5 percent. Most other expenditures are cut by 9 percent. The measures in 2011 are based on three main categories:

1. No increases in government wage costs or reference amounts for the main benefit and grant categories. These actions will reduce costs by ISK 5 bn compared with original medium-term fiscal programme.
2. Expenditure cuts in certain large categories will result in savings of ISK 10 bn. Thereof, ISK 3 bn will be spent on road construction.
3. Expenditure related to parental leave will also be cut in addition to cuts in the child benefit scheme through increased means testing.

TABLE 13: EXPENDITURE MEASURES, 2010-2011

Accruals, bn.ISK in current prices	**Reduction**	**Turnover**	**Reduction**
	2011	***2010***	***%***
Current expenditure	-12.7	204.8	-6.2%
Transfer payments	-11.4	211.5	-5.4%
Investment and maintenance	-3.9	27.7	-14.1%
Total	**-28.0**	**444.0**	**-6.3%**

Source: Ministry of Finance

In light of the deteriorating economic situation, the government has announced additional support to the economy with a moderate amount, of spending on high-return road infrastructure projects. The project will be financed through user fees. The total cost of the projects is estimated at 2.25 percent of GDP, or 36 bn, during the 2011-2015, and is estimated to have a high internal rate of return in international comparison (see further chapter 3.3).

Medium-term expenditure measures

Extensive restructuring of the government's institutional structure is expected to result in a large part of the required expenditure cuts over the medium term. This includes the reduction of the number of ministries from 12 to 9 and alignment of institutions accordingly. These measures are to result in savings of at least 5 to 10 percent from improved efficiency of spending.

Net interest cost

The central government received net interest income from 2006 until 2008. The collapse of the financial system and the current recession have led to a sharp revision, with net interest cost amounting to ISK 40 bn in 2009. Net interest cost is expected at between ISK 47 bn and ISK 56 bn annually until 2014.

Interest cost for 2010 was close to ISK 43 bn, nearly ISK 16 bn lower than expected in the budget. First, interest on issued government paper has been lower than expected at the outset despite extensive issuances. Second, less was drawn on committed external bilateral financing than initially planned. Third, the ISK 270 bn bond issued to the Central Bank was reduced by ISK 134 bn at the end of 2009 with the Central Bank buying claims overtaken by the government at the end of 2008. Local government net interest cost was also negative by ISK 1.8 bn as local government debt has risen sharply following the crisis as discussed in chapter 3.1.

The 2011 net interest cost is expected to reach ISK 52.7bn, or around ISK 10 bn higher than the outcome in the year of 2010. Interest income is expected to fall by ISK 7 bn while interest cost is expected to rise by ISK 3 bn. The rising interest cost is largely the result of increased government bond issuances and further draw-down on committed external financing. Interest cost related to the refinancing of the commercial banks should fall as the reference rate on those bonds will fall further. Lower interests will reduce interest income. A draw down of ISK 20 bn from the government's accounts in the Central Bank will also reduce interest income.

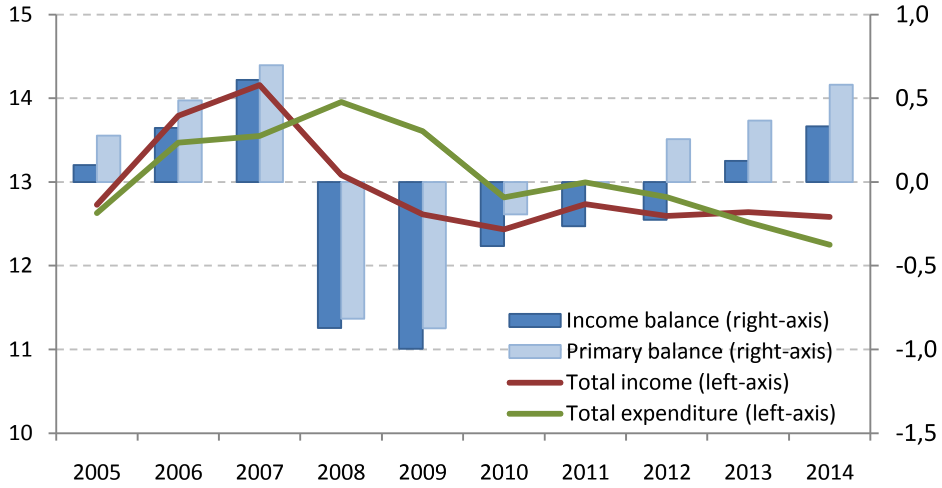
Table 11 shows how net interest cost is expected to grow in 2012 before it starts a gradual decline. This development is based on success of the medium-term fiscal programme. Higher interest rates are forecast to offset that improvement to some extent. Around 70-80 percent of interest payments are due to domestic commitments.

Local and General Government

Substantial effort is required from both central and local governments to secure the required improvement in general government finances. The fiscal tightening has largely been borne by the central government while local government finances have been allowed to remain relatively unchanged. Going forward, however, the local government sector will need to shoulder a larger share of the burden.

Local government finances have been hit hard by the financial crisis, even though the effects have been much milder than on the central government. Local government income fell by 17 percent in real terms between 2007 and 2009 after having risen substantially in the preceding years. Real expenditure decreased also in 2009 after having risen in line with rising real income from 2005. The central government real expenditure decreased by 22 percent in 2009 after having increased substantially in 2008 due to costs related to the Central Bank refinancing. Central government income fell in real terms by 21 percent in 2009. Both levels of government have therefore experienced a large fall in income, which the central government has countered by rising tax income and lower expenditure. Local governments have on the other hand largely had to rely on expenditure cuts, even though certain local governments had some room for increasing tax rates and service fees. The central government has therefore borne the majority of the burden from the financial crisis, not least through rising interest income and a large increase in unemployment benefits.

FIGURE 24: LOCAL GOVERNMENT FINANCES, PERCENT OF GDP



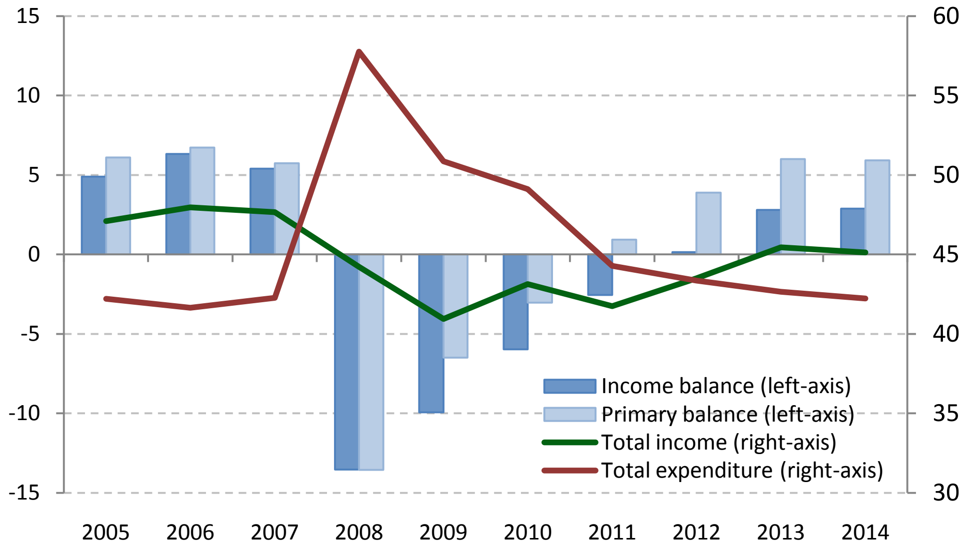
Source: The Ministry of Economic Affairs

Local government revenue has fallen by 1.8 percent points from 2007 and is expected to have been 12.4 percent of GDP in 2010. Local government expenditure is expected to have decreased by 0.7 percent points during the same period to 12.8 percent of GDP in 2010. Local governments recorded a deficit of 0.4 percent of GDP and the primary deficit was 0.2 percent of GDP. Investment represented 10 percent of local government expenditure in 2009. This is a sharp turnaround from the pre-crisis years of 2006-2008 when this level reached 18 percent. The share of investment fell further to 6.8 percent in 2010.

Icelandic local governments play a larger role on average than their peers within the OECD countries, due to their relative fiscal autonomy and volatile revenue posts. To reduce risk, improved coordination and ease the required burden sharing the central and local governments have been working on improving the local government fiscal framework as is explained in chapter 3.5.

The local governments primary and overall balances are set to improve in the coming years in accordance with the targets set out in economic programme with the IMF. Local government revenue is set to remain nearly unchanged from the current level, in terms of GDP, if certain changes to the division of labour between the two government levels are excluded. There is not a large scope when it comes to revenue measures for local governments which means that overall, performance on the income balance will have to take place on the expenditure side.

FIGURE 25: GENERAL GOVERNMENT FINANCES, PERCENT OF GDP



Source: The Ministry of Economic Affairs

3.1.3 Structural balance

Following the financial crisis, a systematic analysis of the structural balance has not been presented by Icelandic authorities. In the previous methodology the structural balance was approximated with an estimation of income and expenditure sensitivity towards the output gap. The income business-cycle-factor was obtained by rectifying real income with the business-cycle by using tax income elasticity towards the business-cycle. The expenditure business-cycle-factor is on the other hand obtained by adjusting total expenditure with the business-cycle for the difference between measured unemployment and NAIRU.

With the benefits of hindsight, it is obvious that the methodology and parameter values used in this exercise greatly overestimated the structural component given an artificial confidence of the fiscal stance in the run up to the crisis.

Icelandic authorities are now considering a revised methodology in order to improve fiscal analysis and intend to draw on international experience in this regard as many other economies are faced with similar issues.

3.1.4 Debt levels and developments

3.1.4.1 Institutional Structure

The Act on the National Debt Management (no. 43/1990 with amendments) stipulates that the Ministry of Finance is responsible for and implements debt management and State guarantees. The Act also gives the responsibility of liability management to the Ministry of Finance, which in turn has made an agreement with the Central Bank of Iceland on the provision of advice and the execution of the Treasury's debt management. The agreement ensures that the Central Bank of Iceland’s monetary policy has no impact on the Treasury’s debt management and vice versa.

Agreement with the Central Bank of Iceland

The Ministry of Finance has made an agreement with the Central Bank of Iceland on the provision of advice and the implementation of Treasury debt management. The purpose of this Agreement is to promote a more economical, efficient and effective debt administration for the Treasury, based on the Ministry of Finance's debt management strategy.

The Government Debt Unit within the Central Bank of Iceland administers debt affairs and debt implementation in accordance with guidelines set by the Ministry of Finance. This Unit is responsible for ensuring that borrowing and liability management are in harmony with the policies set by the Ministry. It handles the regular disclosure of information on the Treasury's domestic and foreign loan stock to market participants, and publishes information on auction days and planned volume of issuance for the year on the basis of the Government's estimated borrowing requirement. It also issues press releases on behalf of the Ministry of Finance.

Debt Management Consultative Committee

The Minister of Finance appoints a Consultative Committee on Debt Management, which comprises representatives from the Ministry and the Central Bank of Iceland. The Committee acts as a forum for the exchange of opinions on the position and prospects of financial markets, and the Treasury's debt management and borrowing plans, both domestically and abroad. It should also intend to facilitate enhancements to the domestic credit market, where necessary.

The committee submits proposals to the Minister of Finance concerning the form of individual series of government securities, maturities, size, proposed market-making, auction arrangements and criteria for the risk management of the Treasury's debt portfolio, in domestic and international markets. Furthermore, the committee discusses and processes the proposed Treasury's Issuance Calendar for the domestic and international markets. The calendar specifies the volume of issuance for the year, issuance dates and the measures that are being envisaged for the credit market that year. The calendar needs to be endorsed by the Ministry of Finance and is later announced to market participants.

3.1.4.2 Guidelines for debt management

The central government's overall main debt management objectives are fourfold:

1. To ensure that the government's financing needs and payment obligations are met at the lowest possible cost over the medium to long-term, consistent with a prudent degree of risk;
2. To establish a sustainable debt service profile consistent with the central government's medium-term payment capacity;
3. To promote the maintenance and further development of efficient primary and secondary markets for domestic government securities;
4. To broaden the government's investor base and diversify funding sources.

In order to meet the demand for new government securities issues and to increase the liquidity of marketable series, endeavours will be made to exchange non-marketable Treasury debt with marketable securities as market conditions permit. .

TABLE 14: COMPOSITION OF THE TREASURY'S DEBT PORTFOLIO

Debt portfolio categories	composition
Nominal	60-80%
Inflation-linked	20-40%
Foreign currency	0-20%
**excludes loans to strengthen foreign currency reserves*	

Source: The Ministry of Finance

The main guidelines for the debt portfolio are:

1. ***The redemption profile.*** The redemption profile of government securities should be as smooth as possible over time, with similar final size of individual issuances.
2. ***Benchmark series.*** To establish liquid benchmark issues of Treasury bonds by taking into account the Treasury's outstanding domestic liabilities when determining the number and size of new issues.
3. ***Proportion of short-term financing.*** To limit the proportion of the Treasury's short-term debt, (i.e. debt maturing within a twelve-month period), less any undrawn credit facilities, to a maximum of 30% of the entire Treasury's total outstanding debt.
4. ***Duration.*** The average time to maturity of the debt portfolio should be at least 4 years.

The government recognizes the importance of clear and measurable quantitative targets, by which it can evaluate its debt sustainability. The targets are based on Iceland's economic programme with IMF and macroeconomic assumptions. The medium-term baseline projections show that between 2011 and 2014:

1. Debt to GDP will be below 70% by 2014 and below 60% in the long-term;
2. Redemption to GDP will be below 6%;
3. The deposit on Treasury Single Account will amount to at least ISK 80 billion.

These targets are subject to revision in the macro and fiscal assumptions. The government will update them as circumstances require.

Domestic issuance plan

The financing needs of the Treasury will be funded through issuance of government securities in the domestic market and a decrease in the Treasury's deposits at the Central Bank of Iceland. These needs are based on budget assumptions made by the Ministry of Finance in relation to its economic programme. Net borrowing requirement is the sum of net cash provided by operating activities and financial transactions.

The Treasury's deposits at the Central Bank of Iceland amounted to approximately ISK 130 billion at year-end 2010. The present stock is sufficient to cover the maturities of Treasury bonds and bills in 2011. At any given time, the Treasury aims to hold deposits in its account at the Central Bank amounting to at least ISK 80 billion.

The structure of the marketable series will be designed so that each series is big enough to ensure active price formation in the secondary market. The aim is to issue a relatively stable amount of Treasury bonds through the year and to tap a number of benchmark points on the yield curve. To fulfil these aims, each year the benchmark Treasury bond series will be issued with maturities of 2, 5 and 10 years. Longer-term nominal bonds and medium to long-term inflation-linked bonds will be issued irregularly, depending on the Treasury's financing needs.

In the beginning of 2011, changes were made to the issuance setup of Treasury bills. Issuance of Treasury bills will mainly be focused on maturities of 3 and 6 months. The issuing amount will be flexible, in order to meet the Treasury’s financing requirements. Issuance of Treasury bonds in 2011 will be ISK 120 billion. Issuance is expected to be reduced to below ISK 100 billion in the period 2012-2014.

TABLE 15: ISSUING PLAN

Series	Maturity	Issuing amount	Frequency of issue
Treasury bills	3 and 6 months	ISK 5-50 billion	Monthly
Treasury bonds	2 years	ISK 40-100 billion	Annually
Treasury bonds	5 years	ISK 40-100 billion	Annually
Treasury bonds	10 years	ISK 40-100 billion	Annually
Treasury bonds	Long-term	ISK 40-100 billion	Irregular
Inflation-linked Treasury bonds	Long-term	ISK 30-100 billion	Irregular

Source: The Ministry of Finance

One of the objectives of debt management, as discussed above, is to ensure that the redemption profile of the Treasury bonds is as even as possible in the long run. The target range for the maturity of domestic Treasury bonds each year is ISK 40-100 bn. This reduces the repayment risk at the same time as liquidity in each series is supported. For those years where redemptions exceed the target range, measures will be taken to reduce the redemption amount.

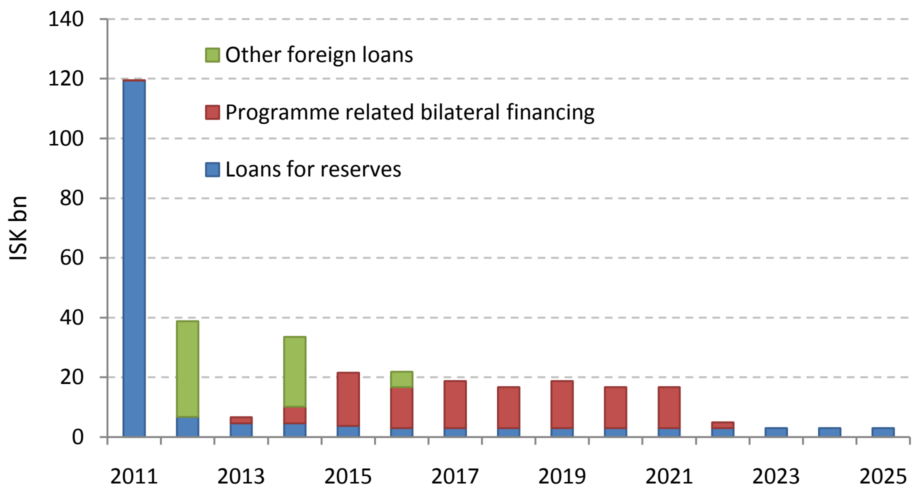
The average time to maturity of domestic Treasury securities is set to be at least 4 years. The Treasury has targeted efforts towards lengthening the duration of its portfolio and has, among other things, issued 15-year Treasury bond in 2009 and 10-year inflation-linked Treasury bond in 2010 for that purpose.

Foreign borrowing

The government's foreign currency borrowings are mainly done to strengthen foreign reserves going forward. The foreign currency borrowing strategy is aimed at securing regular access to international capital markets and to maintain a well diversified investor base. In order to do so the government aims at a regular issuance of marketable bonds. The main purpose of this strategy is to refinance already outstanding marketable bonds and over time to replace non-marketable, i.e. IMF programme related, with marketable instruments.

The Central Bank manages the reserves and uses the profile of foreign currency treasury debt as a benchmark for currency composition and duration of reserve assets. The aim is to minimize fluctuations in the value of the Central Bank's net assets in foreign currencies. This is in broad terms an asset and liability strategy where the government's and Central Bank's balance sheets are looked at on consolidated basis. Debt, totalling EUR 921 million, falls due in the medium-term.

FIGURE 26: REPAYMENT PROFILE OF FX LOANS



Source: Ministry of Finance

At the beginning of 2010 the amount of external debt maturing in 2011 and 2012 used to be larger. During 2010, the Government bought back part of the external debt amounting to approximately EUR 629 million of the EUR 1,550 million external debts- maturing in 2011 and 2012. Part of external debt is related to the programme which is supported by the IMF. The aim of the Icelandic authorities is not to use the programme related liquidity sources for funding the fiscal deficit but to stabilize the foreign currency market and to allow for the lifting of capital control restrictions.

3.1.4.3 Central government debt and debt portfolio[15]

Marketable securities comprise Treasury bonds, Treasury bills and marketable bond to refinance financial institutions. At the end of 2010, total outstanding marketable securities amounted to approximately ISK 722 bn, having increased from ISK 126 bn since 2007. The Treasury issued a special government bond to finance capital contributions and subordinated loans to financial institutions. The series´ maturity is in 2018. Outstanding amount at year-end 2010 is ISK 226 bn. Non-marketable debt consists of bond issued to refinance the Central Bank of Iceland and other domestic liabilities. In 2008, the government issued a 5-year inflation-linked bond to recapitalize the Central Bank of Iceland after the collapse of the banks. At year-end 2010, outstanding amount is ISK 164 bn. The initial amount was ISK 270 bn. or 18 percent of GDP. Other non-marketable debt is mostly attributable to the Treasury's acquisition of municipalities' stakes in Landsvirkjun. These are inflation-linked annuity loans with a maturity in 2034.

Loans, which are contracted within the framework of the Government's IMF supported economic programme, will be used to strengthen the currency reserves of the Central Bank. The bilateral loans, which are from Denmark, the Faroe Islands, Finland, Poland and Sweden, amount to ISK 228 billion

[15] Contingent liabilities are discussed in chapter 3.2

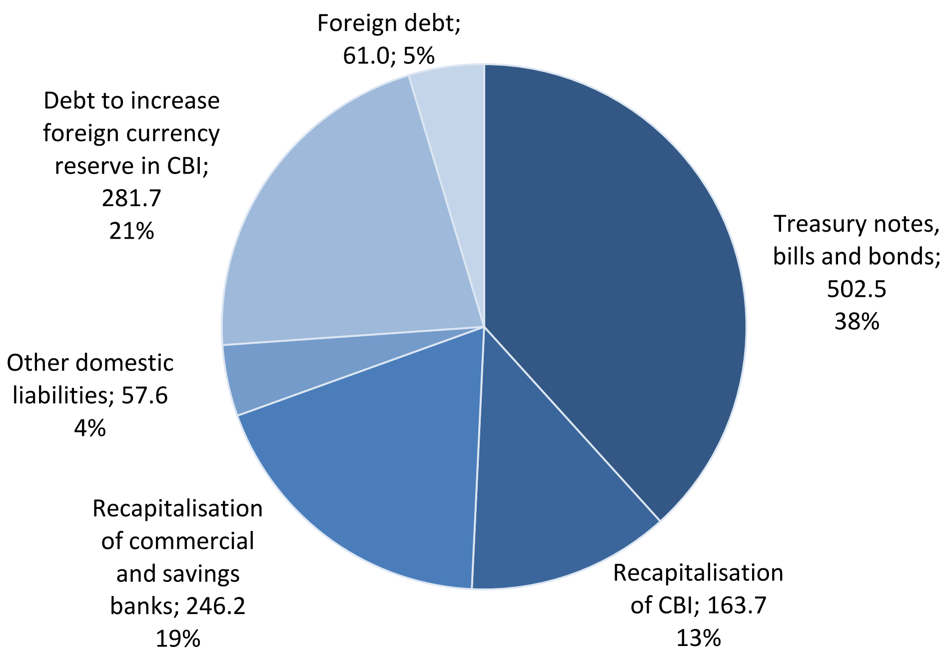
(EUR 1.75 bn) and will be disbursed directly to the Central Bank of Iceland.[16] The Faroese loan has already been fully disbursed equivalent to ISK 6 billion (DKK 300 million). The other loans are paid in stages, as the IMF reviews Iceland's economic programme. Currently, approximately half of the Nordic loans and approximately third of the loan from Poland have been drawn. Further draw-downs will be made as financing gap require.

At year-end 2010, the Treasury's borrowings in relation to the economic programme amounted to ISK 114 bn. Other foreign currency loans to strengthen the foreign currency reserves amount to ISK 202 bn. These loans are a Eurobond issue of EUR 638 million, a syndicated loan of EUR 75 m and a Eurobond issued this year of EUR 373 million. The Treasury has contracted other foreign loans to finance itself in previous years, which now amount to approximately ISK 60 bn. The proportion they make up of the total debt portfolio has been steadily decreasing.

The loans from the IMF at the amount of ISK 250 billion (SDR 1,400 million) are part of government's economic plan and are paid directly to the Central Bank of Iceland. The bilateral loan from Norway amounting to ISK 74 billion (EUR 480 million) is also paid to the Central Bank. These loans are used to strengthen the currency reserves of the bank and are not part of the central government debt.

In September and December 2011, two foreign currency reserve loans for a total amount of EUR 713 m, equivalent of ISK 110 bn, will mature. Also, other foreign currency repayments amount to equivalent of ISK 9 billion. The government bond, which was issued to recapitalise the Central Bank of Iceland, matures in 2014. The government bond is inflation-linked, for the nominal amount of ISK 164 billion. Bilateral loans from Denmark, Finland and Sweden to the Treasury are re-lent to the Central Bank. At the end of 2014, the repayment of bilateral loans will commence and will be paid in equal instalments over a period of 7 years.

FIGURE 27: COMBINATION OF CENTRAL GOVERNMENT DEBT IN BN. ISK



[16] Foreign exchange rate November 24th 2010, EUR/ISK 152.84.

Source: The Ministry of Finance

The Treasury endeavours to offer a broad range of securities with varying maturities. The objective is to appeal to a broad base of investors and limit financing costs. Financial institutions are the largest investors of Treasury securities, with 33% of outstanding Treasury securities. The large ownership of financial institutions is mainly because the new banks where capitalized with a special Treasury bond issue, RIKH 18 1009, for ISK 193 billion. Foreign investors are the second largest group of holders of Treasury securities and are estimated to hold 30% of the securities.[17] Pension funds are the third largest group of investors of Treasury securities with 12% of outstanding Treasury securities. Mutual and investment funds are the fourth largest holders of Treasury securities. Investment and mutual funds have increased their investment in Treasury securities as their investors have become more risk averse. Also, the stock market has yet to recover and investment in foreign markets is not possible because of capital control.

3.1.4.4 Local government debt

Municipalities have in recent years had ⅓ of their long-term debt in foreign currency and they have risen substantially by the devaluation of the króna. Long-term debt in domestic currency has also risen substantially as local governments are now only able to finance their deficit on the income balance in domestic market. However, the extensive increase in short-term debt recorded in recent years has slowed down. Public private partnerships projects gained favour among local governments in recent years, especially in construction projects where the projects are financed by a private company and then leased to the municipality under a long-term contract. Some municipalities have also sold properties to private companies or institutions that have then re-lent. In those instances, the companies or institutions are at least in 50 percent ownership of the municipality and is operated as a financially independent unit (B-part companies). This has allowed debt to move off-balance sheet, even though the projects remain a long-term liability for the municipality in question.

3.1.5 Budgetary implications of major structural reform

In reference to the coalition agreement from 2009, the parties agreed to reduce the number of ministries from 12 to 9 and alignment of institutions accordingly. These measures are to result in savings of at least 5 to 10 percent from improved efficiency of spending. In the beginning of 2011, the number of ministries was 10 and the government is already preparing the last step by merging the Ministry of Industry, Energy and Tourism and Ministry of Fisheries and Agriculture.

The Ministry of Fisheries and Agriculture is preparing a bill for amendment to the fisheries management, which is expected to result in revenue increases. This bill provides, among other things, changes on the regional quota and exploitation right.

3.2 Sensitivity analysis and a comparison with earlier projections

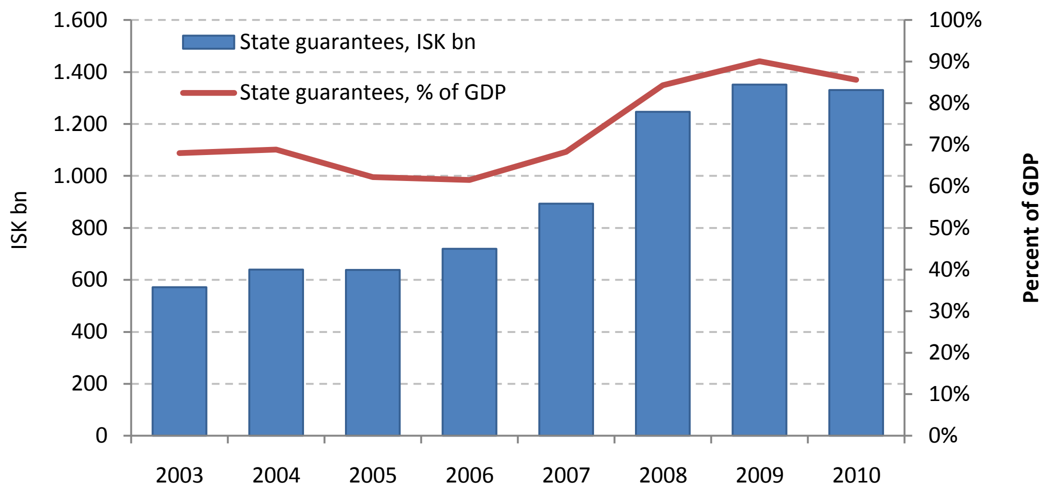
[17] In the Icelandic Securities Depository system, foreign investors are defined as legal entities with foreign ID numbers, however, it should be noted that some of these foreign ID numbers may belong to foreign investment companies owned by Icelanders.

No sensitivity analysis has been performed for the main components of the Icelandic economy, whereas regular analyses have been made for the main risk components of fiscal finances.

3.2.1 Contingent liabilities

Those borrowers that have a Treasury guarantee on its debt or intend to borrow abroad with a government guarantee must according to Act no. 43/1990, request its opinion regarding its borrowing plans. The Ministry of Finance concluded an agreement with the Central Bank where the latter would administer this provision in the same manner as it administers the foreign borrowing transactions of the Treasury. The Government Debt Unit also handles the administration of State guarantees and assesses the Treasury's risk due to such guarantees. The Unit provides the Ministry with opinions on State guarantees and grants such guarantees, on the basis of parliamentary decisions. In November 2010, the total guarantees of the Treasury amounted to ISK 1,330.8 bn, equivalent to about 86 percent of GDP.

FIGURE 28: STATE GUARANTEES



Source: Housing Finance Fund

The guarantees of the Treasury have increased in recent years, mostly due to borrowing by the HFF (Housing Finance Fund) and Landsvirkjun (Electricity Production Company). The share of the HFF in total guarantees is 68.4 percent at the end of 2010 and that of Landsvirkjun 26.4 percent. Total guarantees decreased by 1.6 percent between 2009 and 2010.

TABLE 16: STATE GUARANTEES IN NOVEMBER 2010

	Bn.ISK	**Share**	**Change 2009-2010**
Housing Financing Fund	909.9	68.4%	3.6%
Landsvirkjun	351.5	26.4%	-10.2%
Other	69.4	5.2%	-15.3%
Total	1,330.8	100.0%	-1.6%

Provisional figures, end-November 2010
Source: Government Debt Management

3.2.1.1 The Housing Financing Fund

According to the Housing Act no. 44/1998, the HFF is entrusted with the task of providing loans for home purchases in Iceland and is supervised by the Financial Supervisory Authority. According to Regulation no. 544/2004 on the finances and risk management of the HFF, the Fund shall manage the resources entrusted to it for ensuring as good lending terms as possible and to minimise the risk of the Treasury arising from the Fund's commitments. For this purpose, the HFF must establish a risk management policy. In preparing such a policy, the HFF must take into considerations the guidelines of the Financial Supervisory Authority on internal monitoring and risk management of financial undertakings. The policy is reassessed annually and amended as needed. The Board of the HFF turns in a report to the Minister of Welfare and the Financial Supervisory Authority on the progress of its risk management policy along with key figures from the operation of the Fund. In its report, the Fund must report on the development of non-performing assets, the proportion of loans out of the total loan book that is under special management, the redemption of the issued housing bonds of the Fund and the redemption of outstanding mortgage bonds as well as interest rate developments on new loans. The report should further include an assessment of the loss risk, the interest risk on loans extended and the state of the write-off account. Finally, the report should discuss prospective write-offs and the impact of early repayments and redemptions on the finances of the Fund.

The HFF is authorised to keep its liquid funds in interest-bearing bank accounts, in securities' trading or in other recognised means of investment in the short and long run. Recognised means of investment include purchases of financial contracts or debentures issued by specified counterparties or unit shares in investment funds that invest in securities issued by them. The Fund is also authorised to conclude agreements on the purchase of specified mortgage bonds or interest-bearing assets based on the cash flow from such bonds. The outstanding bonds of the HFF amounted to ISK 808 bn at the end of 2010.

The lending risk of the HFF has increased due to the recession. In 2000-2007, the loan losses of the Fund were largely due to individual borrowers, whereas in the 2007-2010-period the loan losses of legal entities (companies) have increased, particularly due to rental housing. For this reason, special write-offs have taken place on rental housing loans in 2009 and 2010, amounting to ISK 650 m. Furthermore, a special entry into the write-off account of ISK 1,126 m has been made in 2009 and 2010 due to homes taken over from bankruptcies that have been or will be auctioned[18]. The above amounts are included in the table below. As at June 30th 2010, the write-off account stood at ISK 3.7 bn in addition to the ISK 1,126 m due to homes under auction.

The number of bankruptcies and homes taken over has increased sharply. At the end of last year, the Fund owned about 822 housing units that it had purchased at auction.

[18] The write-offs due to rental housing loans ISK 650 m. and homes taken over because of bancruptcies ISK 1,126 m. do not cover the total accumulated contribution amount to write-offs made by the Housing Finance Fund in 2009 and 2010.

TABLE 17: HOUSING UNITS PURCHASED AT AUCTION, CONTRIBUTIONS TO WRITE-OFFS AND THE CAD RATIO

	Number of housing units purchased at auctions	Contributions to write-offs	Capital adequacy ratio
2000	86	564	
2001	99	365	
2002	130	748	
2003	164	937	
2004	123	755	5.6%
2005	55	394	6.0%
2006	77	498	6.3%
2007	123	295	7.0%
2008	212	807	4.6%
2009	321	2,121	3.0%
2010	537	1,492	2.1%

Source: Housing Financing Fund

At the end of 2010, the equity ratio of the HFF was 2.1 percent, whereas the Fund is obligated to maintain a minimum equity ratio of 5 percent pursuant to the regulations of the Financial Supervisory Authority on the equity and equity ratios of financial undertakings. When the equity ratio declines below 4 percent, the Fund must report to the Ministry of Welfare and propose measures to restore the ratio to 5 percent. A special committee of the Ministry estimated the financial need of the Fund in the latter half of 2010, based on the business plan of the Fund and the development of its loan book. In December 2010, the Althingi charged the Treasury with the task of restoring the equity of the HFF, as further discussed in chapter 4.2 on the refinancing of the Fund.

3.2.1.2 Landsvirkjun

The Board of Directors of Landsvirkjun sets the policy for risk management that is defined as acceptable risk limits in each risk category. With active risk management, efforts are made to mitigate uncertainty with respect to cash flow and the balance sheet of the company. Risk is created through the unfavourable development of financial risk elements that are defined as changes in the world price of aluminium, interest rates, the exchange rate and liquidity. According to Act no. 43/1983 on Landsvirkjun, the company must seek the consent of the Minister of Finance if new commitments or guarantees exceed 5 percent of the principal (equity book value at the end of the previous year) in each year.

The financing of Landsvirkjun is mainly in US dollars since the majority of its revenue is in that currency. The main elements of risk for Landsvirkjun relate to its refinancing and the development of the aluminium price. The management of the aluminium price risk of Landsvirkjun consists of cyclical mitigation on the cash flow through derivative contracts in concert with its authorisations and the long-term aims of the company. Landsvirkjun has recently concluded an energy supply contract with Rio Tinto Alcan that is tied to the US consumer price index instead of the aluminium price, thereby reducing the risk attached to the aluminium price.

In 2010, Landsvirkjun was the first Icelandic borrower to issue debt in the international market following the financial collapse. The largest redemption dates in the near future are in 2011 and 2012. The equity of the company is robust, cash at hand and undrawn credit lines ensure that the company can meet all its financial commitments well into 2013. According to the management of Landsvirkjun, the cash flow from operations will also be used to reduce debt in future years. It is therefore seen as unlikely that the state guarantee will be needed over the next several years.

3.2.1.3 Icesave

The Icelandic authorities have been engaged in formal discussions with the Dutch and UK authorities on the Icesave issue arising from the Emergency Act passed by the Althingi following the financial collapse in October 2008. Discussions have been held as to whether the Icelandic authorities would be obligated to pay €1.33 bn to the Netherlands and GBP 2.35 bn to the UK on account of insured Icesave deposit accounts in the branches of the old Landsbanki.

The negotiating committees of the three governments concluded an agreement at the committee level in December 2010. In continuation thereof, the government presented a bill to the Althingi based on the agreement, requesting authority for the government to undertake the commitments embodied in the agreements. The conclusions of the negotiating discussions provide for a redemption and indemnity agreement between the governments in question and the Depositors' and Investors' Guarantee Fund. The agreement stipulates that the Guarantee Fund will repay to the UK and Dutch authorities the amounts they paid to fulfil the minimum deposit insurance amounts to depositors. In return, the Guarantee Fund would receive a commensurate share of the claims on the bankrupt estate of the bank and supervise the recovery thereof. It is assumed that the Guarantee Fund will use the funds already at hand for repayment, after which payment will be made *pari passu* as assets are recovered from the Landsbanki estate up to the end of June 2016. The actual government guarantee underlying the agreement is only tied to (a) interest payments up to June 2016 and (b) the share that has not been recovered from the bank estate after that point in time.

The interest provisions of the agreement are twofold:

1. Interest rates are fixed until the middle of 2016. The interest rate on the Dutch part of the loan is 3.0 percent and 3.3 percent on the UK part. The average interest rate is therefore 3.2 percent. According to the agreement, no interest is calculated on the commitment until after October 1st 2009. Accrued interest for 2009 and 2010 is paid at the beginning of 2011.
2. Interest will be paid quarterly as of the beginning of 2011 until the middle of 2016. In the latter phase, interest on the outstanding principal of the loan after the middle of 2016 will be at the CIRR rate (the Commercial Interest Reference Rate).

The Icelandic negotiating committee has assessed the expected cost that may be incurred by the Icelandic state in implementing the agreement. The estimate is based on the assessment of the resolution committee of Landsbanki regarding the recovery of assets from the bankrupt estate, prospects for payments to creditors and the assumptions of the Central Bank of Iceland on the development of exchange rates. The conclusion of the assessment is that the cost incurred by the Treasury would be less than ISK 50 bn or about 3 percent of GDP. This assessment takes account of the fact that about ISK 20 bn have already been allocated from the Guarantee Fund towards the commitments.

The risk elements of the agreements are mainly threefold: the recovery of assets from the estate, the timing of repayments and the prospects for the exchange rate. The Landsbanki resolution committee has gained full authority over the assets of the bank in the UK and the Netherlands and has thereby reduced the uncertainty related to the assets of the bank. The resolution committee states in its report to the meeting of creditors on November 9th 2010 that the allocation towards priority claims will amount to 86 percent. The assessment of the resolution committee of the value of assets has turned out to be realistic and cautious compared to the three previous assessments. Still, it cannot thereby be concluded that there will be unforeseen changes in the prospects for asset recovery. The recovery could turn out to be worse but also better. If delays would develop in the payments from the Landsbanki estate, the accrued interest on the principal would be higher. Such delays could primarily arise if creditors decide to proceed with the claim before the courts. Finally, the exchange rate of the króna, as well as the exchange rate between other currencies, will have an impact on the total cost to the Treasury. So far, the strengthening of the króna exchange rate has helped lower the commitment. The conclusion that the total cost to the Treasury of the Icesave agreement will be below ISK 50 bn is based on the calculating assumptions of the Central Bank that the króna exchange rate will strengthen in coming years.

The agreement includes two economic stipulations. A ceiling is placed on annual payments from the Treasury and that the lending period will automatically be extended if the remaining balance of the principal of the commitments of the Guarantee Fund exceeds a certain amount in a defined proportion to the remaining balance. The provision is there to ensure unequivocally that the repayment of the Icesave commitments will always be within manageable limits. The ceiling on the annual payments of the Treasury after 2016 will be limited to 5 percent of Treasury revenue in the previous year. Should the amount equivalent to this proportion of Treasury revenue be lower than 1.3 percent of GDP, the limit on repayments shall be based on that GDP ratio.[19] If the remaining balance of the principal of the commitment of the Guarantee Fund falls below the equivalent of ISK 45 bn it shall be paid in full within 12 months, i.e. in the latter half of 2016 and the first half of 2017. If the remaining balance turns out to be higher, the repayment period will be extended by one year for each ISK 10 bn, provided that the remaining balance would be paid up by the end of a 30-year period as of 2016. The outstanding amount shall be paid before the end of a 30-year repayment period commencing in 2016.

3.3 Quality of public finances

The spring 2009 coalition agreement states that the foundations of economic policy must rest on a sound economic program and the charting of a four-year fiscal policy that is aimed at restoring the fiscal budget back to balance within an acceptable period. For this purpose, the government has established goals for fiscal finances in cooperation with the IMF as part of the restoration of the Icelandic economy. These plans of the government were further outlined in a special report on achieving a balance in fiscal finances in the years 2009-2013 that the Minister of Finance presented to the Althingi in June 2009 (see further in chapter 3.1).

[19] 1.3 percent of GDP is currently about ISK 20 billion.

3.3.1 Treasury finances

The central government administration has since 1997 used a so-called frame method for drawing up the fiscal budget. The main point of this work method is that the entire fiscal budget drafting process, i.e. from the government down to individual government agencies, should be based on the limited resources at disposal at each time. The organisation of this process is intended to involve all parties in the fiscal budget process (ministries, agencies and the Althingi) and that they take responsibility for prioritising their tasks. Such guidance of fiscal policy takes place through the setting of budget frames based on the fiscal policy laid down by the government after which the ministries prioritise their tasks within the frames. The frame budget method is periodically revised. In addition, the Financial Management Agency publishes monthly data on revenue and expenditure according to the fiscal budget and the data are accessible on the web of the Agency.

Regulation no. 1061/2004 on the implementation of the fiscal budget deals also with the budget planning of government agencies with reference to the setting of goals under the performance management criteria for government operations. The goal of the plan is threefold. First, to improve and strengthen the setting of goals for the operation of government agencies. Second, to improve the measurement of performance and third, to strengthen all enforcement by systematically reporting on performance in comparison with plans. For this purpose, ministries have concluded a number of performance agreements with government agencies. The agreements contain an understanding of the short-term and long-term plans for operations, the drafting of annual reports, points of emphasis in the work of the agency and a definition of the role and principal goals of agencies. Through such agreements with agencies, a certain interrelationship is created between ministries and its agencies. Ministries must formally comment on the plans of agencies. In addition, agencies must frequently improve their reports compared to earlier practice. In November 2010, a working party on performance management under an inter-ministerial working group and a group of agency managers presented proposals on a new arrangement for performance management. Amongst the proposals, it is recommended that the role of ministries in the performance management process be strengthened by disseminating information and know-how between ministries on performance management and its relationship to other parts of the management and operation of agencies and ministries.

Central government investment

Ministries regularly present their investment plans. One of the initiatives involves investments in high-return road infrastructure projects which will be funded with user fees. The projects would amount to about 2¼ percent of GDP 2011 and are to be implemented over 2011 to 2015. The estimated internal rate of return on the largest projects is between 16 to 20 percent, which is in line with international benchmarks. For example, the average economic internal rate of return of investment projects sponsored by the EU is 15.5 percent, with a standard deviation of 9.6 percent[20].

The Interior Ministry has a communications council that is preparing a twelve-year communications plan that will be presented to the Althingi in March 2011. The plan is aimed at strengthening employment and accelerating investment projects through changed project financing. The plan assesses various ways and means for road projects and the benefit for each alternative, taking

[20] European Commission, 2008, *"Guide to Cost-Benefit Analysis of Investment Projects"*

account of the initial cost, the cost of maintenance, the period of construction, the development of traffic and traffic accidents. The benefit analysis takes account of the present discounted value of revenue over cost as well as the internal rate of return. Such reporting greatly facilitates future decision-making and performance management planning of government investment. In the affairs of road infrastructure the government is targeting three investment projects: Sudurlandsbraut, Vesturlandsvegur and Vadlaheidagong. Table 18 shows the profitability estimate for each project where different solutions are being evaluated.

TABLE 18: AN ASSESSMENT OF ROAD CONSTRUCTION PROJECTS

Projects	Initial capital expenditure bn ISK (NPV)	Income (NPV) bn ISK	Internal Rate of Return	Income/Expenditure ratio
Sudurlandsbraut				
Solution I	12.100	37.000	16%	3.17
Solution II	11.600	37.500	17%	3.37
Solution II	9.600	31.200	17%	3.39
Vesturlandsvegur				
Solution I	5.100	8.000	10%	1.56
Solution II	2.300	7.000	17%	2.96
Solution II	2.000	6.500	20%	3.18
Vadlaheidagong				
Solution I	8.000	9.000	7%	1.07

Source: Ministry of Economic Affairs

3.3.2 Local government finances

In October 1st 2009, the Minister of Transport, Communications and Local Government and the Minister of Finance on behalf of the Treasury and the Chairman and Director of the Association of Local Authorities signed an agreement on guidelines for an economic management agreement between the central government and local governments. The parties to the agreement stated that, with respect to economic management, the finances of the public sector must be viewed as one whole and it is therefore necessary that the responsible parties stay in continuous consultation and cooperation. The guidelines define several main goals for the cooperation as were pointed out by the IMF for improvement in the financial relations between the central and local governments. The guidelines also provide for the setting of fiscal rules for local governments that would ensure that the goals for achieving a balance on operations are reached and place a limit on the indebtedness of local governments. These issues are under active consideration in the working party on cooperation between the central government and local governments on economic issues (see further chapter 3.5 on the proposals of the group). Alongside this work, a committee was appointed in 2009 to draft proposals for amendments to the present Local Government Act that relates to local government finances (see further under chapter 3.5). Another committee working under the auspices of central-local government cooperation is entrusted with the role of revising the Local Government Revenue Act no. 4/1995 and present proposals on the broadening and strengthening of revenue sources. This committee turned in its report in October 2010. The committee proposes that the local government income tax rate be raised and the future organisation of imposing a local property tax be reorganised and that the Treasury enters into agreement with the Local Government Loan Fund on the financing of investment projects for local governments that are burdened with substantial repayments of foreign loans over the next two to three years. The agreement should be for 20 years and should have as its goal to lighten and facilitate the repayment burden of local government and distribute repayments over a longer period.

Local government policy

At the beginning of 2011, the government issued a plan for coordinated action between the central government and each individual region, thus creating a new concerted regional policy. The proposed plans would cover the financing of projects in a long-term investment program through a coordination of economic growth efforts, cultural progress initiatives and the reorganisation and alignment of the support systems for employment and regional policy. The prioritisation of investment projects in each region will be decided by the people of the region. The priorities should take account of plans for regional policy programs, the self-sustaining use of energy, natural resources and the products of each region, the simplification and reorganisation of the support system for employment and regional development of each region and the policy for the cooperation of educational institutions and the centres for know-how and initiative development in each region.

3.4 Sustainability of public finances

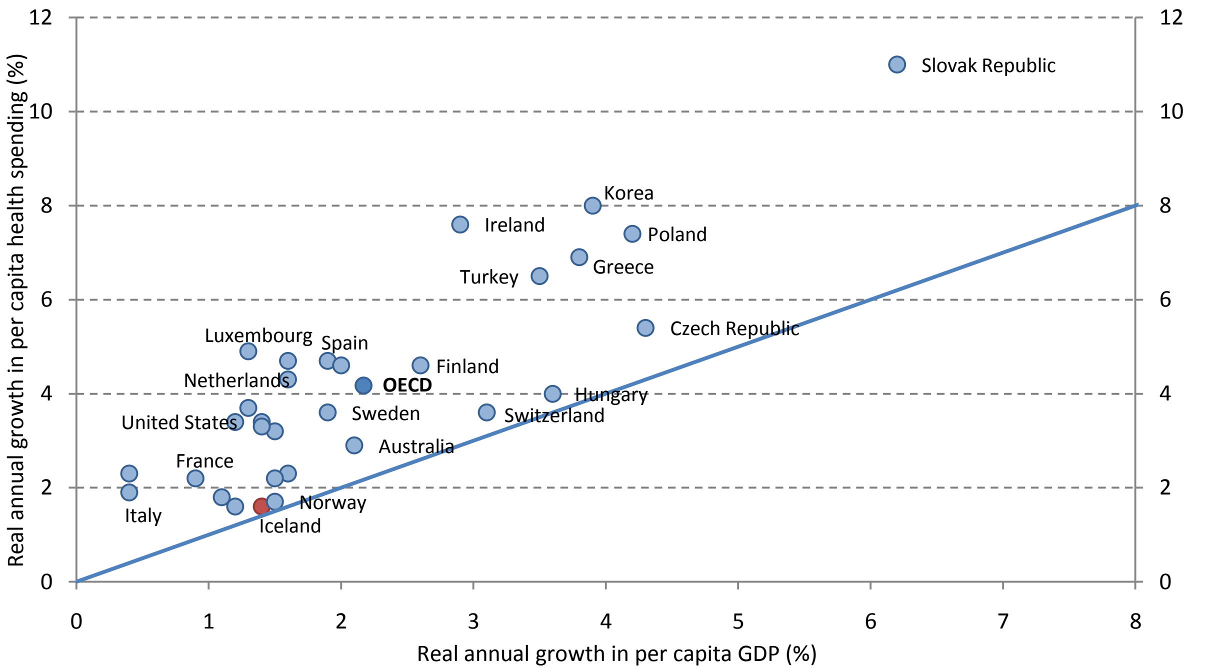
Total public expenditure in 2009 amounted to ISK 763.3 bn or about 51 percent of GDP. Health expenditure accounted for 8.3 percent of GDP in 2009 and social security and social welfare to 11.3 percent.

3.4.1 The health system

Health care expenditure amounted to ISK 125 bn in 2009, having increased by 6 percent from the previous year. The share of health expenditure out of GDP is high in Iceland compared with OECD countries or 8.1 percent compared with an average of 6.5 percent. It should however be noted that 83 percent of the total health expenditure in Iceland is paid by the public sector. Total expenditure on health, both of the public and private sectors, are just above the average for the OECD countries or 9.1 percent of GDP against an OECD average of 8.9 percent. The small size of the country and the low population density also lead to the high level of health expenditure in Iceland.

The increase in health expenditure in real terms has on the other hand not been unfavourable since it amounted to 1.6 percent between 2000 and 2009 whereas real GDP increased by 1.4 percent in the same period. Compared to the average of health expenditures in the EU, the increase in real terms appears to be modest in Iceland, since it is not uncommon that the growth in health expenditures is twice as fast as or more than the growth in real GDP.

FIGURE 29: REAL ANNUAL HEALTH CARE AND REAL GDP GROWTH



Notes: 2000-2006: Luxembourg and Portugal. 2000-2007: Australia, Denmark, Greece, Japan and Turkey. 2000-2009: Iceland.
Source: OECD Health Data 2010.

Should Iceland succeed in containing the real growth in health expenditure and keep it in line with overall economic growth, it will undoubtedly help the sustainability of government expenditure. The Ministry of Welfare is working on a new health care plan for the period until 2020. The main aim of the plan is to increase the density of the hospital system and improve public health (especially of disadvantaged social groups). General public health, measures to strengthen health centre services and improve cooperation amongst medical specialities will be a priority.

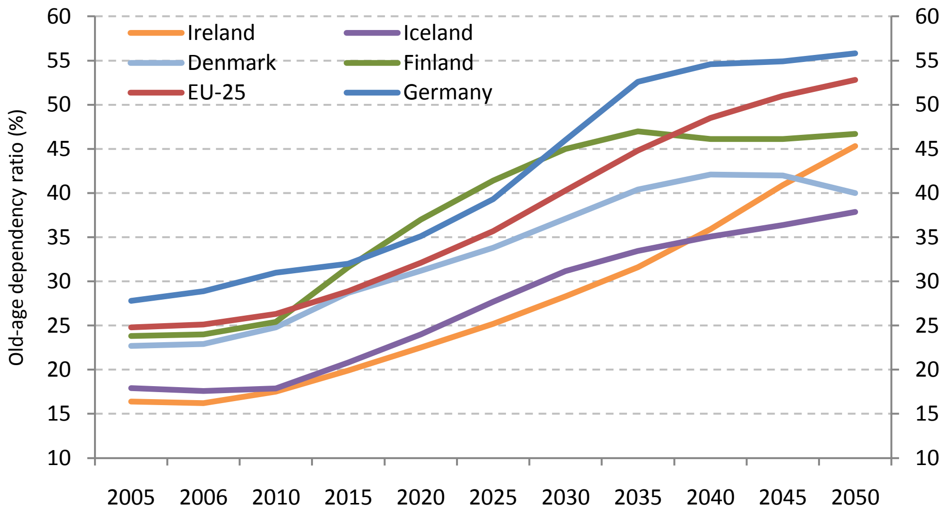
3.4.2 Social security and social welfare

Social security and social welfare are the largest expenditure items of the public sector, amounting to ISK 169.3 bn in 2009, increasing by 28 percent in nominal terms from the previous year. This sharp increase is largely due to increased unemployment compensation and an expansion in unemployment benefits (see further in chapter 4.3). Social welfare benefits have also increased. Such benefits are paid to persons without a job who do not qualify for disability payments or unemployment compensation. In addition, disability payments increased by close to 17 percent between 2008 and 2009 and payments were also increased for equalising the disability burden of pension funds.

3.4.3 The pension system

Status of the Icelandic pension system differs in many respects from those of other European countries. The imbalance between generations is lower in Iceland, in part because of a higher birth rate and because Icelanders retire much later from the labour market and into the pension system than is common in many other countries. The disability burden of the Icelandic pension system is not particularly heavy in comparison with other OECD countries, although this expenditure item has been increasing in recent years. Figure 30 shows the ratio between pensioners and persons of working age – the old-age dependency ratio – and how it is forecast to develop until 2050. Pensioners are defined as persons 65 years or older, whereas person of working age are defined as being between 15 and 64 years of age. The public retirement age in Iceland is however 67 years compared with 62.7 years on average in the OECD countries. The average of old-age dependency ratio for the EU-25 countries is expected to increase from 26 percent in 2010 to 53 percent in 2050. This ratio is somewhat lower in Iceland, at 18 percent in 2010, but is expected to increase to 38 percent by 2050 according to the population forecast of Statistics Iceland.

FIGURE 30: OLD-AGE DEPENDENCY RATIO



Source: Euphix

3.4.3.1 The structure of the pension system

The Icelandic pension system rests on three pillars: A tax-financed social security system, a funded, compulsory employment-related system of pension funds and an optional private pension scheme.

The social security system. The social security system pays old-age pensions, divided into a minimum pension and a supplementary pension. The minimum pension is for all pensioners, regardless of their source of income. Persons with no right to payment from an employment-related pension fund (see chapter 2) and/or other income receive full payment from social security. The supplementary pension is income-related. The supplementary pension is estimated to have amounted to 15 percent of the average income of unskilled labourers, whereas the old-age pension from social security can amount to up to 70 percent of income, including the supplementary pension. Furthermore, the social security system pays disability pensions as well as benefits to surviving spouses and children.

Employment related pension funds. Employment-related pension funds are compulsory, passed into law in 1974. According to present law, cf. Act no. 129/1997 as amended, a minimum of 12 percent of all employment income must be paid to a funded pension fund that provides old-age and disability pensions for the rest of the pension fund member's life. The employer pays 8 percent of the total percentage and the employee the remainder. Those persons on childbirth leave (the right of both genders) pay into the pension fund during their leave period. Payment into a fund commences as soon as an individual begins working, whether in a temporary or a permanent job. The pension accumulation of persons is therefore continuous, unless that person leaves for study or leaves the country.

Many present pensioners receive low pensions from pension funds because their pension rights are not fully matured. In addition, the employment participation of women has long been limited, since they entered the labour market later. This has led to lower rights for women from pension funds. The pension funds system has therefore some way to go before becoming self-sustaining, i.e. when the pension funds can replace the role of the social security system.

Private pension schemes. Employees can choose to contribute towards private pension schemes in addition to the compulsory pension system. The aim of the scheme is to encourage persons 16 to 70 years of age to increase their savings, thereby helping them, if they can, leave the labour market earlier or reduce their workload without significantly reducing their income. Furthermore, the private pension scheme is designed to reduce somewhat the burden on the pension system in the future. Employees can deduct up to 4 percent from their taxable income paid into certified private pension schemes, with employers making a counter-contribution of up to 2 percent. The period of payments from such a scheme can commence at the age of 60 years.[21] Withdrawals from private pension schemes are subject to central and local government income tax as if they were regular income from employment.

In March 2009 the Althingi passed an amendment to Act no. 129/1997 that authorised a temporary withdrawal from private pension schemes before the age of 60 years and up to a limit of ISK 1 million. This temporary provision was to be in effect from March 1st 2009 to October 1st 2010. Before the end of 2009 the Althingi decided to extend the period until April 1st 2011 and at the same time permitting persons to withdraw up to ISK 1.5 m in addition to the ISK 1 m permitted earlier, i.e. a total of ISK 2.5 m. The withdrawal must be spread over a period of up to 18 months, net of central government and local government income tax. When the private pension schemes were opened for such withdrawal, they were estimated to hold about ISK 300 bn, owned by 120,000 persons of which about ISK 200 bn were liquid withdraw able funds. Of this amount, it was estimated that 40 percent would be above ISK 1 m, a total of ISK 80 bn. In the first two months after withdrawals were permitted, a total of 20,046 persons had made withdrawals from the schemes, close to 17 percent of the total number of members. By the end of 2010 48,469 members, or 40.4 percent of the total number of fund members, had availed themselves of this right. The total withdrawals amounted to ISK 37.6 bn in the end of 2010, equivalent to 2.4 percent of GDP.

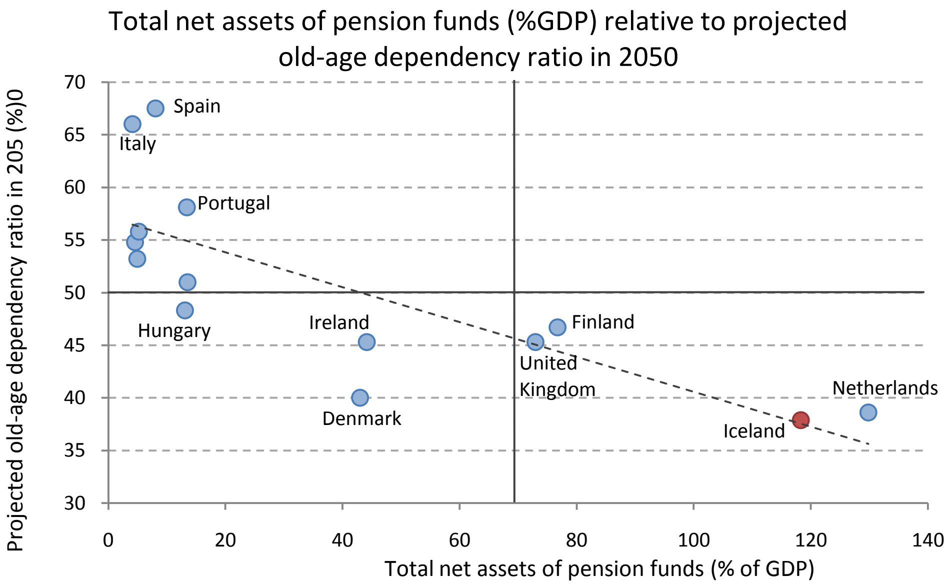
3.4.3.2 Assets and commitments of pension funds

On the whole, the challenges facing the pension funds in Iceland appear light in comparison with pension systems of most other developed countries. In assessing the problem facing countries regarding pension payments, one may look at the net assets of pension funds in relation to GDP on one hand and a forecast on the proportion of pensioners in OECD countries by 2050 on the other. Figure 31 shows that the assets of Icelandic pension funds in relation to GDP are amongst the highest within OECD countries at the same time as the forecast for the pensioner dependency ratio will by

[21] The employers contributes a minimum of 1 percent if the person contributes 2 percent to a private pension scheme and 2 percent if the person contributes 4 percent.

2050 be amongst the lowest. By contrast, countries such as Spain, Italy and Portugal have fairly low pension fund assets at their disposal, whereas their forecast dependency ratio is quite high. The need for increased taxation in Iceland due to increased pension is therefore limited in comparison with other OECD countries.

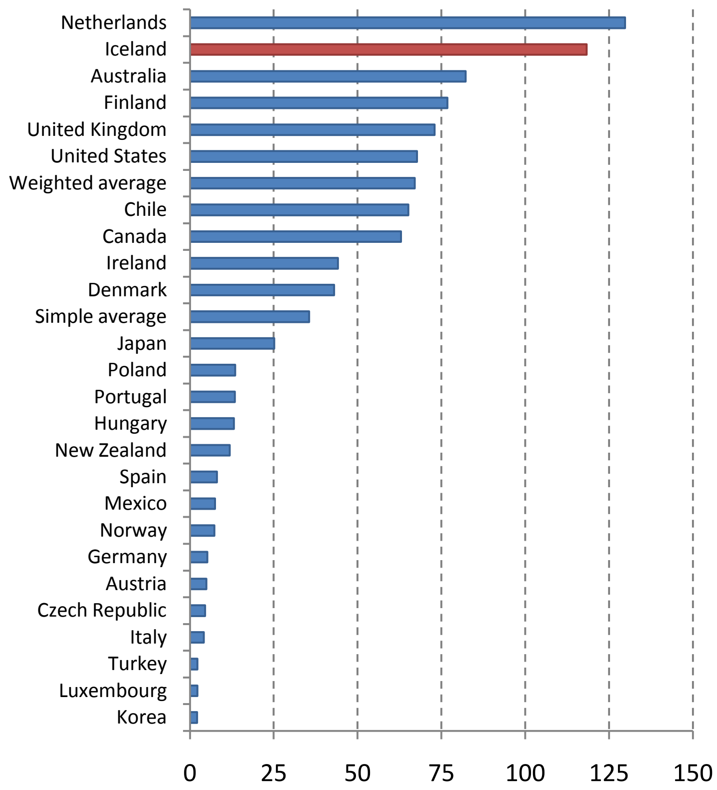
FIGURE 31: NET ASSETS OF PENSION FUNDS AND OLD-AGE DEPENDENCY RATIO IN 2050



Source: OECD Global Pension Statistics, EUPHIX

The pension funds are divided into two groups, those of employees in the public sector and those in the general labour market. Their yield on invested funds can differ but they are required to maintain a 3.5 percent yield on their assets. The average yield in the past ten years has not reached this goal, having been 2.7 percent according to the calculations of the Financial Supervisory Authority. At the end of 2009, total assets of the pension funds were ISK 1,775 bn compared to a GDP of ISK 1,501 bn in 2009. The net assets of the Icelandic pension funds therefore amounted to 118.3 percent of GDP, one of the highest ratios in OECD countries.

FIGURE 32: ASSETS OF PENSION FUNDS (IN % OF GDP) IN OECD COUNTRIES IN 2009



Source: OECD Global Pension Statistics

According to the Pension Fund Act, a balance must be maintained between the assets and commitments of pension funds. If an actuarial review shows a disparity of 10 percent or more or greater than 5 percent continuously for five years, the pension fund must resort to appropriate measures to restore a balance between assets and commitments. In December 21st 2009, a temporary provision was extended under which the pension funds were permitted to have a disparity of up to 15 percent between assets and future pension commitments, based on an actuarial review for 2009, without amending the articles of the fund in question. A total of 25 occupational private sector pension funds were in a negative actuarial position by the end of 2009 of which 3 funds had a disparity greater than 15 percent and must therefore cut their pension payments. The pension funds that enjoy the guarantee of the central government or local governments are exempt from the provisions of the Pension Fund Act that deal with the balance between assets and liabilities of pension funds. The position of these funds has not changed much between years, whereas nearly all departments of the Government Employees Pension Fund are underfunded. The net pension fund commitments of the central government towards pension funds amounted to a total of ISK 339 bn at the end of 2009, equivalent to 23 percent of GDP. The estimate of this commitment is in part based on a yield of 2 percent in excess of wage increases, rising life expectancy, birth rates, marriage status and a 50 percent future disability of the average disability probability.

It is evident that the pension funds will hardly be able to fulfil their payment commitments, ceteris paribus. Iceland also faces the problem as other countries that the number of pensioners will increase in relative terms to persons of working age and their pension rights will increase, in addition to the fact that the disability burden has been increasing. These factors will place an increasing burden on the pension funds in the future and cut pension payments by a substantial margin. A committee was appointed in 2010 to review the pension fund system and present proposals as to how the future problems of the funds shall be met. The committee must consider, among other things, the increase in pension premiums, an increase in the retirement age and the investment policies of the funds. The committee should also consider the possibility of simplifying the pension fund system through interplay of the social security system and the funded pension fund system. The committee will turn in its report in 2011.

3.5 Institutional features of public finances

Following the collapse of the financial system, a plan was drawn up for Treasury finances in cooperation with the IMF with the aim of restoring Treasury finances and the economy to balance, thereby creating conditions for a renewed economic expansion (see chapters 3.1.1 and 3.1.2.).

3.5.1 Treasury finances

The government's plan for achieving a balance in Treasury finances is primarily based on four main pillars:

1. Numerical goals to guide the adjustment of central government finances until 2013 (see chapters 3.1.1 and 3.1.2.).

2. The framework of Treasury finances is to be strengthened, in part based on the plan for achieving a balance in Treasury finances. With the passage of the 2011 fiscal budget, a fixed expenditure frame in nominal terms was for the first time set for the two years. For the years 2011 and 2012, the frame for total expenditure is fixed in nominal terms, provided that the deviation from price assumptions will be less than 1.5 percent. An annual unallocated budget appropriation of ISK 5 bn will be used to meet unforeseen deviations from price assumptions and commitments. All other decisions and deviations must be met within the overall frame. The overall frame will therefore not be amended at a later stage. Increases that may be decided for individual expenditure categories must be offset with commensurate cuts in other categories. In the formulation of this policy, it is assumed that the guidelines for expenditure frames for 2013 and 2014 may be revised in the spring of 2012 when drafting of the 2013 budget with respect to wage and price assumptions and possible change in circumstances. Ministries and government agencies have a better overview over their finances when viewing developments more than one year ahead. This will provide an opportunity to prepare necessary expenditure restraint measures more clearly against a deeper background.

3. In addition, the National Audit Office issues reports to the Althingi each year on the implementation of the budget. The report should publish the conclusions of the Office as to how agencies implement the provisions of the budget, the Government Financial Reporting Act and Regulations on the implementation of the budget. Furthermore, the budget forecast is now based on macroeconomic assumptions from the independent research department at Statistics Iceland rather than from the Ministry of Finance as before.

4. The Ministry of Finance has strengthened its debt management capacity following the sharply increased issuances of government bonds. Schedules for bond issues have been strengthened and the debt management plan for the next several years has been drawn up and will be published in early 2011.

5. The financial framework of local governments will be strengthened. The finances of many local governments have deteriorated sharply since 2008.

The programme for Treasury finances is intended to better support the Central Bank's monetary policy and the joint inflation target of the Bank and the government. It therefore constitutes an important step towards the future coordination of fiscal and monetary policy where both tools of economic management will be used to direct the economy in the same direction, unlike the train of events prior to the financial collapse.

3.5.2. Fiscal rules for local governments

The finances of many local governments have deteriorated in recent years. This differs from developments in earlier years, since many of the larger local governments are currently in dire financial circumstances, whereas that happened mostly in smaller local governments before. At present, nine out of ten of the largest municipalities are amongst the 25 most indebted with debt exceeding 100 percent of the annual revenue.

In the autumn of 2009, a consultative committee of the central government and local governments on economic issues and financial prudence was appointed and charged with drawing up amendments to the current Local Government Act regarding the finances of local governments. These proposals are now at hand. A bill based on the committee's proposals is expected to be presented to the Althingi during its current 2010-2011 session.

The committee proposed that the following fiscal rules be entered into the Local Government Act, cf. Act no. 3/1998:

1. **The balance rule for current operations:** Local governments shall be obligated to balance total consolidated current revenue and expenditure (Parts A and B) over each three-year period. This means that the room for manoeuvre in the budget for the next year will depend on the operation results of the previous year and the estimated outturn for the current year. The balance rule for current operations is based on a three-year period. The reason for opting for a three-year period rather than each fiscal year is that the impact from business cycles of the economy is mitigated thereby. The rule provides increased possibilities for economic management and that the local government finances will be based on the state of the business cycle at each point in time, based on the condition of maintaining a balance over a three-year period. The balance of local government finances is defined as the balance between expenditure arising in the normal operation of the local government and revenue from regular activities, taking account of financial items. The rule also covers the revaluation of assets and debt, such as

due to exchange rate changes that have an impact upon the balance.

2. **The debt rule:** Local governments will be required to limit debt and debt commitments of the consolidated parts A and B to 150 percent of the defined consolidated revenue. Local governments with debt exceeding 250 percent of such revenue shall be prohibited from raising new debt except for refinancing. One exception to the debt rule must be made: For the City of Reykjavík. Due to the high debt of Reykjavík Energy (Orkuveita Reykjavíkur) the consolidated debt of the City is high, even if the finances of part A are quite good. It is also taken into account that investment in the energy sector is by its nature finance-intensive and with a long repayment period. For this reason, it is proposed that a special debt rule shall apply to the capital and that it will be required to align its consolidated debt to the general debt rule over a number of years.

The local governments with the best finances will be given more flexibility than those worse off. This is an important part of the Committee's proposals. It is therefore proposed that local governments be divided into three groups, depending on their standing with respect to the above fiscal rules. This is intended to encourage local governments to gain increasing control over their finances by exercising restraint in their fiscal finances. It is proposed that the monitoring of local government finances will be based on the following categories.

1. Local government with debt below 150 percent of revenue and with a surplus on operations for the past three years together. The monitoring of this group will largely be unchanged from what it is today.
2. Local governments with debt in the range of 150 percent to 250 percent of revenue or a deficit on operations over the past three years together. Local governments in this category must prepare a careful financial plan and firmly implement it. Outside monitoring must be in place regarding borrowing and investment possibilities.
3. A local government with debt in excess of 250 percent of revenue or has not followed the repeated instructions of the monitoring committee regarding its finances. Local governments in this category must make a binding agreement with the government or be placed under financial management.

TABLE 19: FISCAL RULES FOR THREE CATEGORIES FOR LOCAL GOVERNMENTS

Category	1	2	3
Debt/revenue ratio	Below 150%	150% to 250%	Over 250%
Operating balance	In balance or surplus for the past 3 years (t-2, t-1, t)	OR a deficit for the past three years	
The goal of the plan	Balance or surplus on average over 3 years (t-1, t, t+1)	A balance and a sufficient surplus to reduce debt to below 150% within 10 years as a first step	Agreement with the government or direct intervention or bankruptcy
The presentation of a financial plan	3-year plan, a financial plan	5-10 year adjustment period; a 3-year adjustment, a financial plan	5-10 year adjustment period; a 3-year adjustment, a financial plan
Confirmation of a financial plan	Local government agrees to a 3-year and a financial plan	EFS agrees to a step-wise adjustment	EFS agrees to each step
Tax levies	Present upper limits on income and property taxes	Present upper limits on income and property taxes	An income tax surcharge
Reports within the year	Quarterly	Quarterly	Monthly
Limits on borrowing and investments	May invest and borrow in ISK and foreign currencies	May only only invest in ISK and borrow in ISK from the Municipal Loan Fund	EFS must agree
Confirmation of projects	Projects in excess of 12.5 percent of revenue must be assessed by a recognised, independent expert	Projects in excess of 12.5 percent of revenue must be assessed by a recognised, independent expert and confirmed by EFS	All new projects must be approved by EFS

Source: Ministry of Economic Affairs

Further improvements for the future

During the period when balance is being restored to the economy, public finances will primarily be guided by presented nominal figures provided in the medium-term programme. At present, when the period of cooperation with the IMF is drawing to an end, and preparations are under way to lift capital controls and draft a future monetary policy, firm fiscal rules for both the central government as well as local governments are being considered along with a further strengthening of the frame for public finances.

4. Structural reform objectives

4.1 Enterprise sector

Commercial banks, investment funds and companies such as telecoms were privatized in the late 1990s. In wake of the financial crisis, the Treasure has once more become a large shareholder in the financial sector (see chapter 4.2). At the end of 2009 the Treasury had a majority ownership stake in 18 public limited companies and partnerships as is shown in Table 20. Currently, there are no plans for privatisation.

TABLE 20: PUBLIC OWNERSHIP IN THE BUSINESS SECTOR

	Public ownership %	Equity ratio %
Austurhöfn TR efh	54	-0.7
Flugstoðir ofh	100	53.1
Íslandspóstur hf	100	50.7
Keflavíkurflutvöllur ohf	100	20.6
Landskerfi bókasafna hf	52.2	95.9
Matís ohf	100	36.6
Neyðarlínan hf.	73.3	12.6
Rannsókna og háskólanet Íslands hf.	98	71.3
Ríkisútvarpið ohf. (RUV)	100	9.3
Tæknigarður hf.	56.3	28.5
Vísindagarður Háskóla Íslands hf.	100	99.9
Vísindagarðurinn ehf.	80.8	91.9
Þróunarfélag Keflavíkurflugvallar ehf.	100	84.8
Öryggisfjarskipti ehf.	75	36.4

Source: Financial Management Authority

TABLE 21: PUBLIC OWNERSHIP IN THE ENERGY SECTOR

	Public ownership %	Equity ratio %
Eignahlutir ehf.	100	1.8
Landsvirkjun	99.9	32.6
Orkubú Vestfjarða	100	87.7
Rarík ohf.	100	44.8

Source: Financial Management Authority

4.1.1 Debt restructuring of companies

In December 2010, the government, lending institutions and employer associations announced a programme with the goal of restructuring the debt of small and medium-sized enterprises. The debt restructuring had gone slowly, and up to 7,000 companies are estimated to have negative equity capital and about half of the banks’ outstanding loan stock to companies is non-performing. A large part of these debts have resulted from loans taken in foreign currency (the impact on the financial system is discussed in chapter 2.2.5).

The programme entails expediting the processing of viable small and medium-sized enterprises' debts. The programme is based on parties' mutual understanding to the effect that debts shall not exceed the company's value as a going concern. The government will contribute to this process by postponing or relinquishing fees imposed, as relevant. It is anticipated that this restructuring process will be fully operational at the end of May 2011. Further pressures is being levied on the banks to finalize this process through increased monitoring by government agencies and committees, including the FME and monthly dissemination of data on progress made.

Lending institutions will continue working on solving the problems of over-indebted large companies, e.g. through extension of loans, write-down of debts against increased equity contribution or conversion of debt to share capital in collaboration with owners.

4.1.2 Competition surveillance

The EEA Agreement deals with obligations originating in European legislation in the area of competition. Competition policy in Iceland has therefore been based, to a great extent, on European competition rules. The competition Act, no. 44/2005 deals with a ban on illegal collusion, abuse of a market-dominant position and rules on merger, in accordance with European legislation.

In recent years, policy in this area in Iceland has been directed at strengthening competition. In 2005 a new Competition Act entered into force that, among other things, built upon the introduction of the Council of Ministers' Regulation nos. 1/2003 and 139/2004 through the EEA Agreement. Further steps were taken in 2007 when the Prime Minister's Office published a report, entitled "Penalties for Economic Crimes". Among other things, the report discussed penalties for violations of the Competition Act. Consequently, the Competition Act was amended by Act no. 52/2007. Following the amendments, administrative fines can be applied against companies, while individuals can be subject to administrative fines, fines imposed by courts or imprisonment. Fines can be up to 10 percent of the previous operating year's turnover of a company or affiliated company involved in the offence. An employee or manager of a company or affiliated company, who is involved in, encourages or orders collusion violating articles of the Competition Act, shall be subject to fines or imprisonment for up to six years. The Competition Act was also amended with Act no. 94/2008, which tightened up rules on merger, moving them closer to the rules of the European Union on merger according to European Council Regulation no. 1/2003. Furthermore, a parliamentary bill on amendments to the Competition Act is currently under discussion in Althingi. If enacted into law, the Competition Authority will be authorized to take measures regarding conditions or behaviour negatively affecting competition even though prohibitive rules of the Competition Act have not been broken.

The Government of Iceland does not anticipate a need for further changes in policy, framework or legislation in the field of competition affairs in connection with membership of the European Union, except for the institutional changes entailed in the European Commission taking over the duties that the EFTA Surveillance Authority (ESA) has had regarding monitoring of the implementation of the EEA Agreement.

4.1.3 Direct foreign investment in the Icelandic economy

Foreign direct investment in the Icelandic economy has never been substantial in an international comparison. This might be due to the small market size of Iceland as well as its location. The incentive for foreigners to invest in Iceland has mostly been in energy-intensive industry. This is largely due to competitive energy prices[22] and the largely renewable nature of the energy source. In addition, the government has long encouraged energy-intensive industry projects, i.e. Althingi passed specialized acts regarding energy-intensive industry to permit related tax incentives. In 2009 direct investment by foreign parties in Iceland (flow) was about ISK 9.4 bn and had then decreased by 88 percent from the year before.

4.1.3.1 Improved legal environment

In July 2010, Althingi passed a new Act on incentives for initial investments in Iceland. The purpose of this Act is to promote initial investment in commercial operations, the competitiveness of Iceland and regional development by specifying what incentives are permitted in respect of new investments in Iceland and how they should be used. The authorization of the government to grant incentives in the form of regional aid are restricted by the obligations of the government of Iceland under Articles 16–64 of the EEA Agreement, as ratified by Act No. 2/1003 on the EEA, showing in which areas in Iceland regional aid may be granted in the years 2007 to 2013. This Act will expire 31 December 2013 but one year before the Minister of Industry shall appoint a committee to assess the success achieved in the implementation of the Act and submit a proposal on whether its term of effect should be extended following a review of the provisions of the Act.

A general incentive in respect of an investment project, are taken as a percentage or payroll cost of the investment project in question. The Act permits investment in form of new investments of small and medium-sized enterprises, form of enterprises in respect of environment-related, which contain improvement or innovation in environmental protection or form of investment in research and development projects.

Iceland’s foreign investment framework is still one of the world’s most restrictive according to OECD reports. The reasons for Iceland's poor performance, in the OECD's opinion, are the limitations (stipulated in the Act no. 34/1991) set on foreign investors' ownership share in fisheries and processing, harnessing and production of power and distribution, along with ownership in flight operations, cf. The limitations are mostly directed at countries outside the EEA, but in the fisheries sector, all foreign parties, regardless of nationality, are forbidden to own more than 25 percent of share capital or initial capital in fisheries companies and no more than 49 percent shall be owned indirectly. Also, foreign states, local governments or other foreign governments are forbidden to invest in business enterprises except by special license of the Minister of Economic Affairs. Changes to this act are currently being studied in the Ministry of Economic Affairs with the intention to clarify

[22] Energy price not available

the government's policy on foreign investment, strengthening the legal framework and enhancing Iceland's competitiveness in this area.

4.1.4 Energy resources

Iceland possesses extensive renewable energy resources. About 75 percent of all primary energy use is currently met with energy from domestic renewable energy resources, i.e. hydroelectric potential and geothermal energy. Currently, the total energy potential of these resources is estimated at 30-50 TWh/a of electric energy. Today, about 17 TWh/a are being utilised, thereof 80 percent are used by energy intensive industries. In recent years electricity production has increased substantially – about 119 percent between 2000 and 2009. According to the Energy Forecast Committee's calculations, the future producible energy, based on a sustainable utilisation period of 100-300 years will range between 30 TW/a and 50 TW/a.

4.1.4.1 Changes in the legal environment

The passage of Act no. 65/2003 transposed EU legislation on competition in energy production. With the legislation, natural exclusive sales components of the electric energy system (transport and distribution) were separated from the competition elements (production and sales). Following enactment of the law, the administration and operating environment of energy companies changed, e.g. regarding legal status, operating form and organisation. Moreover, government parties (the state and municipalities) sold their share in harnessing completely or in part to private parties (see ownership share of governmental parties in energy companies under chapter 4.1).

In 2008, Althingi enacted important amendments to legislation in the field of resources and energy. The amendments aimed at setting general rules on ownership of energy companies and clarifying the boundaries between the competitive and exclusively licensed aspects of their operations. The purpose was to ensure that all of the most important hydroelectric and geothermal energy rights would continue to be owned by the State and municipalities. The amendments covered the following points:

1. Only the State, municipalities or companies owned by them may own energy resources. However, they may temporarily grant a right of use for the production and sales rights for up to 65 years at a time. A holder of a temporary right of use has a right to discuss extension of the right after half of the agreed period of use has passed. When determining who shall be granted a right of use, equality must be observed, and efficient utilization of resources and investments in structures must be promoted.
2. There are more detailed stipulations regarding the separation of production and sales of energy. It should be mentioned in this regard that distribution and heating utilities may not engage in other operations than those necessary to enable them to perform their duties in accordance with exclusive licenses and relevant laws. It nevertheless continues to be permissible to run all exclusively licensed operations within the same company, such as a distribution utility, a hot water utility, a water utility and sewage utility. Exclusively licensed companies may also engage in other activities that can be equated with exclusively licensed operations, such as the operation of heating utilities not having an exclusive license for operations. On the other hand,

an exclusive license holder may not engage in any competitive operations if the company's annual income from operations exceeds ISK 2 bn, in which case it is mandatory to transfer that part of the company into an independent company.

3. Distribution companies categorized as exclusive license holders in energy company operations and having a natural monopoly have to be at least two-thirds owned by governmental parties.

In addition to the above-specified amendments, emergency electric-energy system collaboration (EESC) was incorporated into Electric Energy Act no. 65/2003. The collaboration is between energy companies, major users and government parties. Its function is to provide assistance and coordinate measures during danger imminent to the production, transport or distribution of electric energy and/or major users. Participants in EESC are obligated to set up a contingency plan, providing for measures and contact persons and relevant parties during emergencies. In addition, guarantee of origin of electric energy produced from renewable energy sources was incorporated into the legislation, in accordance with provisions of the European Parliament and Council's Directive 2001/77/EC. A system has been established to ensure and verify certifications of the guarantee of origin of electric energy produced from renewable energy sources.

4.1.4.2 Energy policy

A task force under the auspices of the Ministry of Industry has formulated energy policy for Iceland. It is intended to take into account possible and conceivable methods to manage the utilization of energy with respect to sustainability, economic build-up and stability. The task force is also intended to discuss possibilities of utilizing energy resources, expertise and experience in energy affairs for job creation over the medium term. The task force is also mandated with formulating a proposal on the prioritisation of energy utilisation and how the use of fossil fuels and carbon dioxide emissions can be reduced through improved energy efficiency, energy-saving, economic incentives and the development and utilisation of ecologically friendly energy sources for automobiles, equipment and ships. Today, over 30 percent of Icelanders' final energy use is obtained from imported fossil fuel, which corresponds to about 12.5 percent of total product imports to Iceland. The highest proportion of fuel (about 40 percent) goes to automobiles, about 29 percent to fisheries and about 20 percent to flight and maritime communications.

The task force recently published a report (a draft for comment) on an energy policy for Iceland. The report addresses the guidelines and main goals regarding energy affairs in Iceland. The guidelines entail that the management of Iceland's energy resources shall be based on the principle of sustainability, for the benefit of the community and general public. The policy goals include that Icelanders' energy needs shall be met securely over the long and short run; that there shall be respect for the environment, nature and Iceland's distinctive feature; that the nation shall enjoy economic benefits from joint energy resources, and the supply of energy shall be tailored to a diverse economy.

It is the task force's view that there are possibilities in Iceland for increased energy security and decreased greenhouse gas emissions, and that it will be possible to fulfil demands for an increased proportion of renewable energy in transport and communications by reducing the use of imported fossil fuels. In this context, the Ministry of Industry has spearheaded cluster collaboration under the name "Green Energy – Ecological Energy in Transport and Communications". The aim is to increase the proportion of ecological domestic energy sources in transport and communications while reducing imported fossil fuel.

The task force lays out many proposals and means in its policy. The focal point is that an utilisation license for government-owned resources shall in the future be for 25-30 years at a time, instead of 65 years as currently stipulated in the Act. However, it shall be made easier, insofar as possible, for a lessee not in default and fulfilling set conditions, e.g. regarding responsible handling of resources, to get an extension to a license. The task force also proposes establishing a special resources fee for the lease of water and geothermal rights, and that it will be a duty, as part of an environmental impact assessment, to present an assessment of the environmental cost and opportunity cost of lost values of nature.

4.2 Financial sector

Restructuring and revitalisation of the financial system has been one of the government’s main tasks for the past two years. The task is essentially two-pronged: on one hand, refinancing of banks and savings banks and, on the other, reshaping of the financial market's institutional and legal environment.

4.2.1 Refinancing of financial companies

Upon the fall of the banks in October 2008, Althingi passed the so-called Emergency Act, no. 125/2008. Shortly thereafter the Treasury took over all Icelanders' commercial banks, new banks were founded and FME appointed resolution committees for the old banks. Refinancing of the new commercial banks followed and was formally completed in January 2010. Following the completion of the banks' refinancing, the biggest share of the banking system came under the control of the claimants of the old banks through their resolution committees. On the other hand, the Treasury became the largest shareholder in Landsbanki and a minority owner in both Íslandsbanki and Arion Bank. The two latter banks were granted subordinated loans from the Treasury.

The savings bank system has sustained substantial damage. Their number has fallen from 20 in 2008 to only 10 now three years later. After agreements on the settlement of savings banks' debts were signed at the end of December 2010, the Treasury acquired a major share in six savings banks (see chapter 2.2.5).

TABLE 22: COMMERCIAL BANKS AND SAVINGS FUNDS

end of year 2010	Public ownership %	State equity bn.ISK	Subordinated loans bn.ISK
Commercial Banks			
Arion banki	13.0	9.9	29.5
Landsbanki	81.3	122.0	-
Íslandsbanki	5.0	3.3	25.0
Savings Funds			
Sparisjóður Bolungarvík	90.9		
Sparisjóður Svarfdæla	90.0		
Sparisjóður Norðfjarðar	49.5		
Sparisjóður Þórshafnar og nágrennis	87.8		
Sparisjóður Vestmanneyja	55.3		
SpKef sparisjóður	100.0		

Source: Financial Management Authority

The savings banks perform an important function in the Icelandic financial market. This applies not least in rural areas where the savings banks often provide the only financial services. The government has therefore put great emphasis on the savings bank system restructuring and providing it with a sound framework in the future.

Financial restructuring of the savings banks began at the start of 2009 when eight savings banks applied for equity capital contributions under provisions of the Emergency Act. One savings bank withdrew its application and acquired initial capital elsewhere. Two of the biggest savings banks, Byr and Sparisjóðurinn í Keflavík, did not reach necessary agreements with their creditors and collapsed in April 2010. New financial companies were founded on their ruins, Byr hf. and SpKef Savings Bank. Agreements have been made on remuneration between the new and the old savings banks. Financial restructuring of five smaller savings banks was originally based on the foundation of the Emergency Act, but after time had passed, the status of the savings banks proved to be worse than previously thought. It was therefore clear that the creditors would have to be involved in negotiations to make the banks' financial restructuring possible.

Under a decision of FME in April 2009, the Central Bank of Iceland became the main creditor of the savings banks. The Central Bank also received claims as payment when it was mandated with taking over the savings banks' deposits at the Sparisjóðabanki Íslands (Icebank) following its collapse. In collaboration with the Ministry of Finance, the savings banks were offered to negotiate settlement of their debts with the Central Bank upon fulfilment of certain conditions. The FME then agreed that the savings banks would enter into final negotiations with the Central Bank and other creditors regarding their financial restructuring, provided that the FME's demands were met. In June 2010, the European Surveillance Authority approved the restructuring plans for five savings banks. The Central Bank sought to ensure the value of the claims that it got as payment for deposits. The savings banks that previously did not fulfil conditions on minimal equity capital withdrew their applications for initial capital contribution from the state on the basis of Act no. 125/2008.

Upon the fall of the major banks, the Central Bank acquired claims against more financial companies. Part of these claims was immediately transferred to the Ministry of Finance after the fall of the banks, but another portion remained in the Central Bank. A consultant was obtained to analyse the most efficient arrangement for administering these claims, and the conclusion was that it was both most advantageous and efficient to transfer all of them to a holding company owned by the Central Bank. All of the claims acquired by the Central Bank upon the collapse were therefore transferred to Eignasafn Seðlabanka Íslands, hf (Portfolio of the Central Bank of Iceland hf) at the beginning of this 2010, where they will be processed.

Icelandic State Financial Investments (ISFI), founded by an Act no. 88/2009, handles the Treasury's share in banks and savings banks. The function of ISFI is to ensure good administration and business practices, build up the state's ownership policy each time and supply funds on behalf of the Treasury, based on authorizations in the budget act. The operations of Icelandic State Financial Investments are intended to emphasize the revitalisation and build-up a dynamic domestic financial market and promote active and normal competition in the market. It is also intended to ensure transparency in all decision making regarding the state's participation in financial activities and ensure active dissemination of information to the public. One of ISFI's tasks is to make proposals to the Minister of Finance on whether and when specified ownership shares in financial companies will be offered for sale on the general market, taking into account the agency's goals and the current law and goals on distributed ownership. ISFI shall have completed its work not later than 2014.

The Housing Financing Fund (HFF) is an independent state-owned agency; about 70 percent of all housing mortgages are granted by the fund. Under the auspices of the FME, a detailed appraisal of the HFF’s assets was conducted in accordance with the premises used for the refinancing of the banks, as the Fund lost substantial amounts following the banking collapse (see chapter 3.1.1). The fund has now been refinanced in accordance with regulations. The 2011 budget provides for the fund to reserve about ISK 33 billion for this task. Part of that amount is intended for cover costs related to measures for introduced for indebted households. At the end of March 2011, plans call for introducing a parliamentary bill in Althingi to improve the Fund's framework for the future, including placing it under FME's comprehensive monitoring.

4.2.2 Effect of judgement on exchange-rate indexed loans

As explained in chapter 2.2.5, the Supreme Court of Iceland ruled in June 2010 that widely used exchange-rate indexed loans were illegal. In light of possible financial shocks, authorisation was granted, in a supplementary budget act in 2010 and the 2011 Budget 2011, to refinance the three commercial banks if necessary. A detailed appraisal by the FME of the possible cost of unlawful exchange-rate indexing nevertheless indicates that the banks' equity capital will be acceptable despite the effect of these conclusions. It must therefore be deemed unlikely that the Treasury will have to supply the banks with additional funding on account of the ruling.

FME will nevertheless continue to closely monitor the banks to ensure their financial strength, taking into account the effect of exchange-rate indexed loans and other risk factors, such as loans in default. In this regard, FME will update its appraisal quarterly in 2011 and 2012 regarding the loans that could conceivably be affected by the rulings. FME will also formally request the banks to transfer loans into depreciation accounts that are deemed likely to include unlawful exchange-rate indexing. In addition, FME will complete an Internal Capital Adequacy Assessment Process (ICAAP) of the banks before the end of March 2011. This will provide a clearer and deeper picture of the banks' financial status.

Following a Supreme Court ruling in September 2010 regarding appropriate interest rates on illegal exchange-rate indexed loans, the Minister of Economic Affairs introduced a parliamentary bill in Althingi, amending the Act no. 38/2001 on Interest and Indexing (the "Exchange-rate Loan Bill"). According to the bill, lending institutions are given a 60-day period to calculate unlawful exchange-rate indexed automobile loans and real-estate mortgages. Althingi enacted the parliamentary bill into law in December 2010, and the act entered into force in January 2011. The act aims at efficiency in remedying, calculating and repaying unlawful exchange-rate indexed loans, despite a high degree of complexity, for example, because of ownership changes, guarantors' payments and different types of loan contracts.[23]

4.2.3 Reshaping of institutional and legal environment

Substantial changes have been made to the Act on Financial Companies since the collapse of the banking system, including proposals set out in Kaarlo Jännäri's report on rules and monitoring of banking operations.[24]

Among the amendments made is to provide formal status to risk management within financial undertakings. An absolute ban has been imposed on granting loans collateralised by own shares or initial shares; rules regarding loans to related parties have been tightened; more stringent demands are now made for increased transparency in the ownership of companies and more encumbrances have been set on the financial companies regarding the provision of documents to monitoring agencies. More stringent demands are also made regarding the qualifications and qualification requirements of directors, managing directors and directors of pension funds. Rules have also been set on bonuses and employment termination agreements.

New rules have been set by the FME on related parties, major risk obligations, loans and foreign currency and cash management. In this regard, the FME is preparing an establishment of a database of claims over ISK 300 million, in order to obtain a better overview of major risk obligations of the financial system. The database is expected to be operational in the summer of 2011. Further changes in the rules and legal framework of financial companies are being prepared, including rules on equity capital, calculations of financial strength and operational authorizations for the individual types of financial companies.

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[23] http://eng.efnahagsraduneyti.is/Publications/nr/3190

[24] http://eng.forsaetisraduneyti.is/media/frettir/KaarloJannari__2009.pdf

Further work is being carried out under the auspices of the Ministry of Economic Affairs to review the legal environment of the FME and Central Bank of Iceland. This work is intended to take into account the responses of neighbouring states to financial shocks and investigate the desirability of merging the Central Bank of Iceland and FME. It is however important that the framework and regulatory structure of both institutions take into account the work now on going under the leadership of the Ministry of Economic Affairs to formulate the future monetary policy framework.(see chapter 2.2.3).

A new bill on Depositors' and Investors' Insurance system is currently before the Althingi. The bill reflects, among other things, EU's insured amounts. In the meantime, however, individuals' deposits are fully insured in accordance with the government's declaration in October 2008. The declaration will only be changed in carefully managed and developed pre-announced steps, as trust in the financial system grows, in consultation with the Central Bank and the FME. The two institutions will submit reports to the Minister of Economic Affairs on the financial system's resilience before depositors' insurance will be abolished.

The Icelandic government will closely follow developments in Europe as the legislation on the financial market in Iceland falls under the EEA Agreement. Under current conditions the Icelandic banks are well prepared to meet the Basel-III requirements as the FME requires minimum Tier1 capital of 12 percent and overall equity capital of 16 percent. Currently all the commercial banks meet these requirements.

TABLE 23: THE CAD RATIO OF THE COMMERCIAL BANKS

End-September 2010	**CAD Ratio**
Arion banki	18.1
Landsbankinn	17.3
Íslandsbanki	22.6

Source: Quarterly reports of each financial institution

4.2.4 Improved coordination regarding financial stability

In addition to improvements in the regulatory structure of the financial market, the organization of the financial stability framework has been developed further.. The transfer of legislation pertaining to the Central Bank to the new Ministry of Economic Affairs in October 2009, which previously supervised legislation on the FME, was an important step in that direction.

In order to strengthen coordination of matters pertaining to financial stability, the Prime Minister, Minister of Economic Affairs, Minister of Finance, Central Bank Governor and Director General of the FME have signed an agreement on a special committee on financial stability. The committee is intended to be a consultation forum on matters relating to financial stability and cooperation within the EEA as a national standing committee. A representative from the Ministry of Economic Affairs leads the committee. The committee is obligated to regularly provide a ministerial committee on economic affairs.

Lastly, the Central Bank and the FME have entered into a new collaboration agreement. Among the main innovations in the agreement is that the Director General of the FME and Central Bank Governor shall meet at least twice a year, along with the senior officials of both institutions. At the meetings systemic risk in the Icelandic financial system is assessed. Among other things, the agenda of the meetings includes factors relating to the national economy, risks in the operations of financial companies, interaction of internal and external risk factors, the status of payment systems, laws and regulations on financial operations and improvement of contingency plans.

4.3 Labour market

The Icelandic labour market has adapted relatively quickly to profoundly changed economic conditions. This can mainly be attributed to labour market flexibility. Real wages have decreased substantially (see chapter 2) without major unrest in the labour market; manpower has emigrated from the country; people have gone from working to studying, and many have reduced their working hours. All of these factors have led to a fall in labour supply, hampering the rise of unemployment. With significant labour hoarding, the risk for a jobless recovery is significant going forward. Therefore, the importance of new investment projects is obvious, and consequently the Icelandic government has announced measures to assist companies, as mentioned in chapter 4.1.3.

4.3.1 Labour market participation

On 1 January 2010 the total population domiciled in Iceland was 317,630, i.e. 1,738 people fewer (0.5 percent) than the previous year. Data on people moving to and from Iceland shows that in 2009, 4,835 more people emigrated from the country than immigrated. In absence if this, it can be supposed, all other things being equal, that unemployment would have been 1-2 percent greater than otherwise. Statistics Iceland's population forecast indicates a similar outcome regarding emigration in 2010. In 2011-2013, Statistics Iceland forecasts insignificant net migration.

TABLE 24: POPULATION AND IMMIGRATION

	Net immigration	Annual population change, percent
2007	5,132	2.6
2008	1,144	2.5
2009	-4,835	1.2
2010*	-3,968	-0.5
2011*	-2,000	-0.4
2012*	-363	0.2
2013*	183	0.7

Source: Statistics Iceland

Although the labour participation rate in Iceland has decreased since the collapse, it is still high, compared with European countries. In 2010 job participation rate (aged 16-74) was on average 81.0

percent, compared with the average 63.5 percent in the EUs 27. The rate of men was 84.4 percent and of women 77.6 percent. The demand for labour decreased considerably between the years 2007 to 2010. The number of those working full-time decreased by 9.2 percent between 2007 and 2010, and the number of people in part-time employment increased at the same time by 6.5 percent. In 2010 the percentage of men working full-time was 86.0 percent and women 62.2 percent. Also, the total number of work hours decreased by 5.7 percent for those having jobs in the criterion week from 2007 to 2010.

TABLE 25: LABOUR MARKET PARTICIPATION

	Iceland			
	2007	**2008**	**2009**	**2010**
Labour participation. (16-74)	83.3	82.6	81.0	81.0
Female	78.6	77.7	77.1	77.6
Male	87.6	87.1	84.7	84.4
Employment rate. (16-74)	81.3	80.1	75.1	74.9
Female	76.8	75.7	72.7	72.4
Male	85.6	84.2	77.4	77.4
Fully employed. (16-74)	77.7	78.8	75.9	74.6
Female	62.6	65.3	63.1	62.2
Male	90.2	90.0	87.4	86.0
Hours worked	41.9	41.6	39.6	39.5
Female	35.6	35.8	34.9	34.8
Male	46.9	46.2	43.8	43.6
Unemployment. (16-74)	2.3	3.0	7.2	7.6
Female	2.3	2.6	5.7	6.7
Male	2.3	3.3	8.6	8.3
Youth unemployment (16-24)	7.2	8.2	16.0	16.2
Longterm youth unempl. 1 year or longer. (16-24)	2.4	1.3	2.9	9.6

Source: Statistics Iceland

In 2009, 66 percent of the workforce had education beyond compulsory school, and of those who were working during the year, about 30 percent of employees had a university degree. On the other hand, the proportion of the labour force in Iceland that has finished upper secondary school is below the average in EU 27. In 2009, the proportion in Iceland was 37.4 percent compared with 49.9 percent on average in the EU 27. The reason for this low proportion in Iceland is not due to low enrolment in the upper secondary schools but rather a high drop-out rate. The aim of the Iceland's Strategy 2020, mentioned earlier in this chapter, is to decrease the number of those who have not formally acquired an upper secondary school in age group 20 to 66, from 33.8 percent to 10 percent before the year 2020. Looking at university education, the proportion of those completing university studies is around and above average, compared with other European countries. In 2009 the proportion in Iceland was 29.6 percent compared with 28.7 percent on average in the EU 27.

Although unemployment has increased in all educational groups, unemployment in Iceland, as in other countries, is inversely related to education. According to Statistics Iceland's measurements, those with compulsory schooling were about 53 percent of the unemployed in 2009, compared with 16 percent of those with a university education. Focusing solely on education groups reveals that the employment participation rate is lowest among those with compulsory schooling, but highest for those with university educations. Likewise, more are working and fewer are unemployed in the group having more education.

TABLE 26: EDUCATION AND LABOUR MARKET PARTICIPATION

Level of education	Total Labour Force	Employed	Un-employed	In Labour force	Employed	Un-employed
Total	**100.0**	**100.0**	**100.0**	**80.9**	**75.1**	**7.2**
Primary education	33.8	32.3	52.7	74.3	65.9	11.2
Secondary education	37.4	37.8	31.3	80.9	76.0	6.1
University education	28.6	29.6	16.0	91.2	87.6	4.0

Source: Statistics Iceland

The government has taken various measures to fight against the unemployment trend, particularly measures against long-term unemployment and unemployment of young people. In parallel with government measures, the Act on Unemployment Insurance has been amended, with the goal of injecting more steadfastness in the implementation of unemployment compensation and reducing compensation fraud.

4.3.2 Payments from the Unemployment Insurance Fund

In December 2010 amendments to Act no. 5/2009 on Unemployment Insurance entered into force. First, the amendments provide those who have been paid unemployment compensation for the first time 1 March 2008 on later a right to unemployment compensation for four years instead of three. In this regard consideration was particularly given to the fact that long-term unemployment had increased, and it was anticipated that there would be more than 2000 people at year-end 2011 finishing their three-year continuous compensation period, based on the situation at the start of 2011. This measure is deemed important, with the goal of keeping job seekers and, at the same time, reducing the incentive to enter the disability system. Nevertheless the measure has a short validity period (through 30 June 2011) when a certain turnaround in the economy is anticipated. Second, the amendment entails an extension of the temporary provisions authorising payment of unemployment compensation against reduced work percentage, for the authorisation would otherwise have expired at the end of 2010. Wage earners' work percentage will nevertheless be cut by at least 30 percent instead of 20 percent as previously, so that those affected will be eligible for proportional payments. This is done for the purpose of achieving goals in state finance. By taking these measures it will continue to be more difficult for those who are unemployed to seek work, but since unemployment is still high and job creation is not expected to pick up until around mid-2011, this authorisation was extended through 30 June 2011.

The Unemployment Insurance Fund is financed by an employment insurance fee, paid by employers on wage earners' total wages. In 2009 the fund could not sustain itself, and the Treasury had to make up the difference, totalling ISK 14,461 million. In 2010 a state contribution to the fund is anticipated.

An extension of compensation to four years is estimated to increase the fund's costs by ISK 640 million in 2011; on the other hand, the proportion of unemployment compensation is expected to decrease the fund's costs during the year by a total of ISK 470 million.

TABLE 27: NUMBER OF BENEFIT RECIPIENTS AND UNEMPLOYMENT SPENDING, BN.ISK

	Total	Females	Males	Total outlays bn.ISK	Surplus/Deficit
2007	5,241	3,012	2,229	3,054	1,742
2008	12,014	5,019	6,995	5,299	371
2009	31,433	12,486	18,947	26,422	-14,861
2010 est.	26,276	11,113	15,163	28,350	-13,844

Source: Directorate of Labour

4.3.3 Participation rate of job seekers in labour market programmes

While an individual accepts unemployment compensation, it is assumed that the person will follow a certain job search plan. The individual is also offered participation in labour market remedies and receives special grants from the Unemployment Insurance Fund because of participation in remedies and/or because of moving residence within the country due to a job offer. The goal is to promote the job seeker's being active and facilitate getting off the unemployment rolls and out on the job market or accepting work or vocational training far from his domicile.

The Directorate of Labour supervises job market remedies and offers participants job-related and study-related remedies. For a job-related remedy, an agreement is signed with a company or institution on hiring a job seeker for vocational training, trial employment or job rehabilitation. The job seeker agrees that the Directorate of Labour shall pay his base unemployment compensation, in addition to an 8 percent matching contribution to a pension fund, directly to the company or institution paying him wages. With a study agreement, the job seeker undertakes job-related studies, which he has chosen for himself, in collaboration with an advisor at the Directorate of Labour, following an assessment of his skills and an evaluation of his position. The Directorate of Labour pays him unemployment compensation at the same time. Other remedies offered by the Directorate of Labour are agreements on up to six month employment in developing business ideas, with the goal of implementing the ideas. The agency is also authorised to enter into a separate entrepreneurial agreement with a company or institution planning to launch a new business concept, such as an innovation project or product development project, not entailing violations of competition policy. Finally, the agency can enter into an agreement on a temporary intensive project or volunteer effort beyond statutory and usual operations at companies or institutions.

Table 28 shows that in 2010 the number of participants increased substantially from 2009. Most of the increase was in job-related courses, stemming chiefly from how easy it was to implement such remedies. It is more difficult to get job seekers into job training because of the lack of jobs. Nevertheless, job training is the most productive remedy since the workplace, more often than not, benefits from hiring those involved to work when the training is finished.

TABLE 28: PROGRAMMES FOR UNEMPLOYED

	Occupational courses	Apprentices	Internships and provisional contracts	Other	Total outlays, bn.ISK
	Percent of unemployed				
2009	7.0	4.3	1.7	7.2	724
2010	21.3	5.1	2.6	17.8	1,370

Source: Directorate of Labour

4.3.4 Special programmes for youths

By age group the greatest unemployment is among young people, age 15-24. This group is generally more subject to fluctuation than other age groups and has achieved little foothold in the labour market. In November 2010, 2,329 youths in Iceland, age 15-24, were unemployed according to the rolls of the Directorate of Labour, i.e. about 17 percent of the unemployed. If the 25-29 age group is included, the proportion is 33.4 percent. A majority of them (70 percent) has only finished compulsory school. The proportion is still higher among the youths that have been outside the labour market longer than six months, 73 percent.

In 1 January 2010, a programme was launched called "Youth to Action". The goal of the programme is for no more than three months to pass from when an individual, age 16-29, becomes unemployed until he is offered work, study opportunities, vocational training or participation in other worthwhile projects. In April 2010 employment agencies throughout Iceland began reaching out to all youths in this age group and offering them participation in job or study remedies. A number of optional projects are offered, such as computer science and business administration, computer repair, music, languages, artistic creation, food preparation, driving and heavy-equipment handling courses, hygiene or self-improvement. At the end of November 2010, a total of 8,630 youths looking for work had accepted offers to participate in some remedy, which is about 52 percent of all of those covered by the programme. Of these, 3,985 had completed at least one remedy lasting from one hour up to six months. From the start of 2010 through the end of November 2010 the total cost of the remedies was about ISK 341 million, and the Directorate of Labour is now working on evaluating their results.

4.3.5 Education policies

New legislation from 2006 to 2008, part of a foundation for a lifetime education policy, has come into force for all levels of schooling, from university to preschool, along with teacher education. The legislation stipulates improved quality of teacher education, better ties between education and social partners, and certification of formal and informal education. Emphasis is placed on cooperation between education and research, entrepreneurial effort, innovation and democracy, both within the system as a whole and within each school and university. The policy "Education and Training 2010" is currently being implemented through changes in curricula, and regulations are based on power distribution, key skills, curricular goals and NQF (a criterion framework on education and degrees).

4.4 Agriculture

Agricultural policy aims at ensuring farmers' ability to make a living, provide consumers with a sufficient supply of products at an advantageous price, maintain settlement in rural areas and ensure food and feed security. On accession, a competent authority must be defined that is responsible for domestic implementation of the Common Agricultural Policy (CAP) and sees to domestic policy formulation as well as on the EU-level. In most member states, this party is the Ministry of Agriculture.

It is clear that with Iceland's membership of the EU, the operating environment in Icelandic agriculture will be completely changed, and the entire legal framework will have to be reviewed. The Icelandic agricultural system builds for the most part on production-related agricultural grants, direct or indirect. Animal husbandry is the most common form, while field cultivation, other than for growing feed, is less important, making Icelandic agriculture distinct from that in EU member states, in that respect. Production support for milk production, sheep husbandry and vegetable production in the Budget Act 2011 totals about ISK 10.6 billion, which amounts to around 2 percent of the state's total expenditure. The ownership of the 4,000 farms in Iceland is mostly by private parties, but 8 percent of farms are publicly owned. The goal is to review the agricultural support system, with emphasis on facilitating recruitment.

A great deal depends on the outcome of membership discussions regarding how changes in the Icelandic agricultural system will be arranged. The EU's agricultural policy generally falls outside the purview of the EEA Agreement, and no directives have therefore been adopted in this area. All legislation regarding implementation of the agricultural system in Iceland must be reviewed. This includes review of the Act on Production, Pricing and Sale of Agricultural Products, no. 99/1993, and Agricultural Act, no. 70/1998. The review has to take into account current agreements with the Farmers' Association of Iceland on agricultural production.

The Ministry of Fisheries and Agriculture is now preparing a detailed evaluation of the changes required to harmonise the Icelandic agricultural system with the EU's demands upon membership. Such changes will entail establishing a special payment agency for agricultural supports and an Integrated Administration Control System (IACS). The payment agency will see to the actual implementation of the policy in Iceland, implementation of a support system, monitoring, intervention in the market and monitoring of imports and exports in respect of third states. The agency falls under the first pillar of the CAP regarding agricultural product production. The new system will be more costly than the current one, and it will also be necessary to strengthen the ministry upon membership.

Today, many parties are involved in implementation of agricultural policy in Iceland, for example, the Farmers' Association of Iceland, agricultural federations, municipal feed supply monitors, the Agricultural Productivity Fund and the Icelandic Food and Veterinary Authority. Many of the tasks that the payment agency is intended to execute are already administered by these parties in Iceland, and transfer of tasks would therefore often be involved. Under the rules of the EU, the agency can entrust parties with specified tasks as its agents, but then the defects of distributed administration must be taken into account. The payment agency must be operating and prepared to pay subsidies and accept contributions from the EU's funds from the first day of membership.

Subsidies from CAP are allocated in Euros to a member state that has adopted the currency, but in the member state's currency if it has not adopted the Euro. This means that if the exchange rate of the currency falls, the farmer does not get higher subsidies that year. The context of a criterion exchange rate of the Icelandic króna must be considered carefully with respect to the Euro for subsidy amounts and currency issues in the area of agriculture.

Iceland has adopted most of the EU's legislation in the area of organic agricultural production. Work is going on to harmonise a new regulation, no. 834/2007, and derivative regulations with the EEA Agreement. A comparable quality control system will be introduced for conservation of geographical labelling and traditional special products. Improvements must be made in the collection for and processing of agricultural accounting, and that task is now done by the Agricultural Statistical Service.

The introduction of CAP in Iceland will involve substantial change in the market environment. Market subsidies for agriculture in Iceland primarily involve protective duties. Duties are imposed on most unprocessed and originally processed agricultural products produced in Iceland, while others are generally duty-free upon importation. Duty quotas are employed to facilitate the importation of a limited quantity of specified products for a specified period or a limited or unlimited quantity of specified products for a specified period, depending on needs on the domestic market. Duties are also imposed on several processed agricultural products produced in Iceland.

Export compensation to compensate farmers for differential between domestic prices and world market prices upon export to third states was abolished in Iceland in 1992, however, it persists in the EU. A report is being prepared to shed light on the price competitiveness of Icelandic agriculture by agricultural branch in respect of agriculture within the EU.

The working environment of cattle farmers and product centres will suffer major changes upon membership in the EU. A system exists in Iceland, which limits the quantity of milk on the domestic market and ensures specified support for the production quota. The EU will abandon milk production quotas in 2015 and have initiated preparation for the forthcoming changes. Huge investment has taken place in Icelandic milk quotas that needs to be considered. Recently the first over-the-counter market was established for milk support targets under the auspices of the Icelandic Food and Veterinary Authority. The market's purpose is to meet the industry's needs for necessary transfer within it, increase the transparency of trading and, at the same time, prevent pricing of milk supports that works against the interest of consumers and the industry itself. General rules of competition in force in Iceland reflect EU legislation in the issue category even though the EEA Agreement does not cover agricultural policy. A legal evaluation will be prepared of the effect of the EU's competition rules, specifically regarding the dairy industry.

In all membership agreements, new states have been granted leeway in time to adapt to the main aspects of the agricultural system. There are also examples of agreements made for changes in EU legislation to take into account circumstances in candidate states.

The second pillar of the agricultural policy pertains to rural developments. No comparable integrated policy on rural development exists in Iceland, but a certain correspondence can be found in the Agricultural Productivity Fund, forestation, land reclamation and the quality control project in sheep husbandry. Introduction of the policy in Iceland therefore calls for a review of the current arrangement, revision of laws and regulations and new legislation in some areas.

The goal of supporting rural development is to promote increased competitiveness of agriculture and forestry by supporting reorganization, development and innovation. There are also goals to improve the environment and profile of the land by supporting land utilization of the land improvement projects. Finally, by improving the quality of life in rural areas and stimulating diversity in working patterns.

When formulation of a rural development policy for Iceland has started, there will be an exhaustive list of the legislation that will require amendments. A considerable part of the projects and operations now provided support in Iceland will be accommodated with him the EU's rural development policy. It will therefore rather involve reorganization, redefinition and harmonisation.

A domestic plan will also have to be formulated and approved regarding support of rural development within the framework of the joint policy. An act will have to be passed on how this policy formulation shall be organised, who will be involved in defining it, in what way, and who will be responsible for overall implementation of the policy. It is also likely that statutory authority will be required to define the parties having the functions, as stipulated regarding member states being obligated to see to implementing and monitoring, whether new units will be established to take care of these functions, or they will be entrusted to parties within the current administrative system.

Upon membership a managing authority must be specifically designated for rural development funds, which in most states is the Ministry of Agriculture. A Monitoring Committee must be established to ensure effective implementation of the rural development committee. The payment agency also has administrative functions to perform regarding implementation of the policy, and finally states must establish administration of a national rural network to ensure consultation of all parties within the policy, collect and analyse information, prepare various plans and conduct monitoring measures.

It does not seem that special systemic changes are required regarding the management of fisheries resources, but one agency will have to be designated as the competent authority in communications with the EU. At this time a comprehensive review of the EU's fisheries policy is underway. A new basic regulation is scheduled to enter into force on 1 January 2013. Iceland's membership would hardly come to pass before completion of the review, and there is therefore some uncertainty regarding which rules will be enforced on fisheries within the EU in the future.

Review is underway of the Icelandic fisheries management system, with the goal of conserving fishing stocks, promoting efficient utilisation of resources, strengthening employment, strengthening settlement, creating an accord between the nation and ownership and utilisation of marine resources and, finally, laying a foundation for retirement and re-disposition of catch authorisations over a 20 year period. A recently released report of a task force on review of the Fisheries Management Act lays a foundation for this work.

4.5 Administrative reform

From the collapse of the banking system, considerable changes have been made in the administration of economic affairs as there was an evident shortage of collaboration and consultation on economic management. In addition, increased funding has been granted to the FME (the Financial Supervisory Authority), the biggest part of which is financed by a fee imposed on regulated financial undertakings.

One of the most important changes in the administration of economic affairs the last several years was the founding of a special Ministry of Economic Affairs in October 2009. With the founding of the ministry, legislation of a large part of the financial market was merged into one ministry. Legislation pertaining to the Statistics Iceland and general economic management were also transferred from the Office of the Prime Minister to the new Ministry of Economic Affairs.

These amendments constituted an important step in harmonizing proposals of the Finnish financial specialist Kaarlo Jännäri on merging all legislation regarding the financial market under one ministry. Nevertheless, the step was not fully taken since legislation on pension funds was left in the Ministry of Finance, and legislation on the Housing Financing Fund continues to be under the Ministry of Welfare. Regarding the affairs of the Housing Financing Fund, increasing effort has been made to coordinate the forces of different ministries involved in the fund's affairs. In order to improve integration of the two ministries now handling economic affairs, i.e., the Ministry of Economic Affairs and the Ministry of Finance, a special Ministers' Committee on Economic Affairs was founded. Participating in the committee are the Prime Minister, Minister of Economic Affairs and Minister of Finance. Other ministers join the committee in accordance with the matter under discussion.

4.5.1 Additional funding for the Financial Supervisory Authority

There was a great deal of turbulence in the operating environment the FME following the banking collapse. These changes reflected the scope and organization of the monitoring. The FME has since the crisis received addition financing both through the Treasury and higher fees on financial undertakings. The imposition of monitoring fees in 2010 is estimated at about ISK 1.153 bn, while the Budget Act for 2011 provides for ISK 1.619 bn, i.e. an increase of about 40 percent between years. The increased resources of the FME have been translated into rising staff numbers with nearly 100 employees at FME at year-end 2010, up from 45 in 2006 and 60 just following the crisis. The number of full-time equivalent positions is expected to increase to 117 at the end of 2011. It is estimated that about 17 full-time equivalent positions in the above figures will be temporary jobs because of the great scope of investigative tasks in the period 2011 to 2013, related to the banking collapse.

The financing of FME is expected to follow the Bank for International Settlements' Core Principles for Effective Banking Supervision. The core principles form a framework that was followed when legal provisions on the Financial Supervisory Authority's operations were originally drafted as well as upon their later revision. By ensuring adequate resources for the Financial Supervisory Authority's operations, a suitable legal framework for monitoring, effective provisions for powers to address compliance and independence in respect of other interests than those entailed in operational independence, the agency ought to be able to work in accordance with these core principles. Before the end of March, internationally recognized experts will finish an assessment of whether the FME's framework stands up under these core principles. Upon completion of this assessment, a strategic plan will be developed on how to deal with the items that are not fully met.

4.5.2 The Special Investigation Commission (SIC)

The Special Investigation Commission (SIC) delivered its report to Althingi in April 12 2010. The Commission was established by Act No. 142/2008 by Althingi in December 2008, to investigate and analyse the processes leading to the collapse of the three main banks in Iceland. Members of the Commission are Supreme Court Judge, Mr. Páll Hreinsson, Parliamentary Ombudsman of Iceland, Mr. Tryggvi Gunnarsson, and Mrs. Sigríður Benediktsdóttir Ph.D., lecturer and associate chair at Yale University, USA. The aim of the report was to portray as comprehensively as possible the events that lead to the collapse of the banks and seek to answer what caused their failure.[25]

4.6 Additional reform areas

4.6.1 Indebtedness of households

Following the collapse in October 2008, the government introduced various measures on behalf of households and companies. In November 2009, an act entered into force on measures on behalf of individuals, households and companies because of the banking and currency collapse. The act laid out a general framework and rules about specialised data adjustment that claimants and debtors make between themselves on debt concessions. Creditors are obligated to set rules for themselves on the implementation of specialised debt measures and publish them where they are accessible to everyone. Also, parties subject to the FME's monitoring are obligated to set working procedures for themselves approved by the FME. They shall take into account the assessed status of debtors, payment ability, conditions on terms, objectivity in decisions taken by claimants and the perspective of competitiveness. The act also stipulates that the Minister of Economic Affairs shall appoint a committee to monitor the implementation of specialised debt measures carried out by parties subject to monitoring on the financial market. The committee was formed in mid-2009 and has now submitted two status reports to the minister.

In the fall of 2010 the government began a separate inquiry into the payment and debt problems of households, utilisation of the remedies that had already been implemented and proposed further solutions to the problems of households. The inquiries were made in collaboration with stakeholders. Following this the government, financial companies and pension funds presented new measures to respond appropriately to the problem of delayed debt restructuring. Different circumstances of households were taken into account, and the measures were therefore diverse. The measures covered the following aspects:

1. Collateralised households were offered to have their real estate mortgages adjusted to the value of the collateralised real estate, totalling up to 110 percent of the value of the asset, upon fulfilment of certain conditions. Concessions of collateralised debts under this remedy can be up to ISK 4 million for an individual and ISK 7 million for a couple, people in the cohabitation and

[25] Selected chapters from the SIC report can be found on the Althingi web: http://sic.althingi.is/

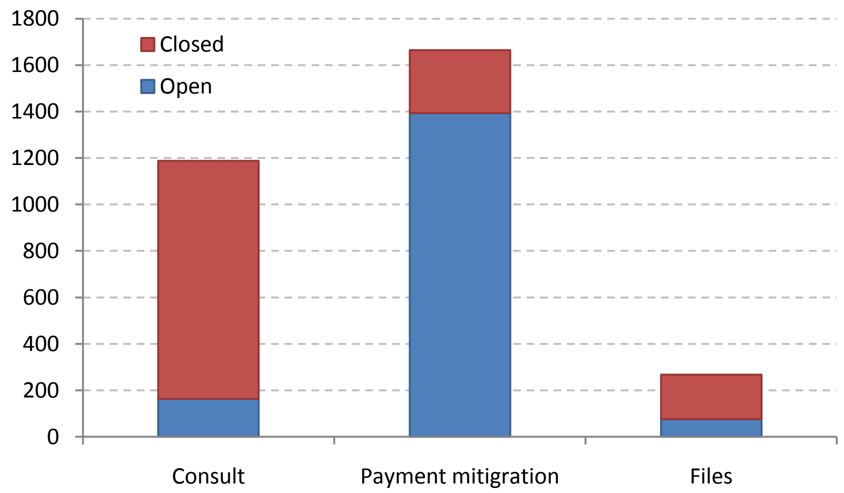
single parents. Further concessions will be considered after a detailed survey of the asset position and assessment of the ability to pay. The maximum concession in those instances is up to ISK 15 million for individuals and ISK 30 million for people with children. The cost of the Housing Financing Fund for this measure is estimated to be ISK 10 billion and it will cover about 9400 households indebted to the fund. If this measure is not sufficient, plans call for a specialised debt measure to be applied, and housing loans will be decreased by up to 70 percent of the property value. Up to 30 percent of the asset value is then put into an interest-free, no-payment loan for three years, and debts exceeding 100 percent are written off.

2. Mortgage interest rebates have been available to households and will increase in 2011. The maximum mortgage interest rebate for single people will be ISK 400,000 instead of ISK 247,000 and for a single parent ISK 500,000, instead of less than ISK 318,004. For couples or people who are cohabiting, the maximum rebate will be ISK 600,000, up from over ISK 408,000. Assistance will also be extended to households with heavy debt burdens and low and middle income levels. This increase will cost the Treasury more than ISK 2 billion (see chapter 3.1.2).
3. Individuals and households are offered remedies in 2011 and 2012 to subsidise interest costs because of residential housing. The subsidy is independent of income but is not applicable when a borrower's net ownership exceeds a specific limit. It is anticipated that the payment burden of households can decrease by up to ISK 200,000-300,000 per year. The goal is for lending institutions to be involved in financing these costs. The cost of this measure is estimated at about ISK 6 billion (see chapter 3.1.2).
4. A special campaign was set up to reach households in default.

4.6.1.1 Debtors’ Ombudsman

The Office of the Debtors’ Ombudsman was established in August 2010 and is based on the Advisory Office for Households' Finances. The DO's role is to protect debtors' interests and provide those with substantial payment difficulties assistance at no cost. In parallel with this function, the DO provides assistance in drafting agreements on payment adjustment and prepares a living standard criterion, cf. Act no. 101/2010.

FIGURE 33: DO'S ACTIVITIES BY YEAR-END 2010



Source: The Debtors' Ombudsman. Includes cases referred from the Advisory Office.

The activities of the Ombudsman for Debtors have increased substantially. The number of employees has doubled, and a new branch has been opened in Reykjanesbær. There are now 59 employees and about 1700 cases are being processed at the office. Lending institutions defray the costs of operations of the Ombudsman for Debtors with payment of a special fee.

4.6.2 Research and development

International measurements show that the government funding for research and development in Iceland has in recent years produced diverse innovation and a strong position for the sciences in the international arena. In 2009 the total contribution for research and development was about 3.0 percent of the GDP and from government 1.3 percent , which is comparable to the average contribution in European states.

TABLE 29: R&D OUTLAYS, PERCENT OF GDP

	Total R&D Outlays	Public R&D Outlays
2007	2.7	1.0
2008	2.7	1.2
2009	3.0	1.3

Source: Statistics Iceland, The Icelandic Centre for Research (Rannis)

The policy of the Science and Technology Policy Council for 2010-2012 emphasises that with a harmonized campaign of individuals, government institutions, universities and companies, there will be new value and even new industries in the economy interacting with the sciences and innovation. The policy emphasises reinforcing collaboration of Icelandic innovation companies and institutions with other countries on financing research and tax concessions. Emphasis is also placed on better and more coordinated information on quality and results of research at universities, institutions and companies.

In January 2010 Act no. 152/2009 entered into force. Its goal is to improve competitive conditions of innovation companies and strengthen research and development effort by providing innovative companies a right to a tax deduction for costs of innovation projects and providing individuals and legal entities with incentives to invest in innovative companies, given specified conditions. The act increased the tax deduction from 15 percent to 20 percent, the maximum cost to calculate a deduction doubled from ISK 50 m to ISK 100 m, and the maximum cost for purchased services from acknowledged parties doubled from ISK 75 m to ISK 150 m. Also, rules were put in place on how high a combined grant from public parties, including a tax deduction, may be as a proportion of the cost of an individual research or development project for small, medium-sized and large companies. Smaller companies are authorised to accept a higher proportion of the cost of a project from the government than the larger companies.

4.6.3 Information society

Iceland is below the average in EU states regarding the supply of electronic information available from the government, according to measurements of the Cap Gemini Survey conducted for the European Union, but Iceland ranks high when it comes to the use of information.

TABLE 30: INFORMATION SOCIETY, 2009

	Iceland
E-Government availability, percent of total	75
E-Government supply, percent	55

Source: Eurostat

In 2008, the policy "Netríki Íslands" was launched, and became the government's signpost for development of electronic administration and utilisation of information technology for 2008-2012. The policy is three-pronged, focusing on services, efficiency and development and comprised of a total of 65 measures. Implementation of the policy is going somewhat slower than planned as a result of the economic crisis and expenditures have decreased.

One of the biggest projects that the government is now launching to improve electronic information services is public certification. Usages of such certificates are seen as a key enabler for the information society and one of the most important projects within e-governent. The Icelandic Government cooperates with Icelandic banks were certificates for authentication and qualified signatures are being distributed on bank cards. In the beginning of 2011 around 55 thousand bank cards have been issued to citizens and it is estimated that around 200 thousand cards will have been issued at the end of the year.

4.6.4 Telecommunications

The PFS (Post and Telecommunication Administration) in Iceland monitors with regular intervals operation and services of all telecommunication service providers according to the legal framework for electronic communications and postal services as influenced by directives of the EU and domestic legal acts and regulations. PFS regularly publishes a special statistical report on the electronic communications market. The report contains information on the principal figures pertaining to the electronic communications market and the companies operating in the market. The intention is to improve the quality of information disclosure and to increase transparency in this market, in line with recent demands to this effect.

A parliamentary bill to amend Act no. 81/2003 on Telecommunications is now before Althingi. The goal of the bill is to harmonise all action plans on telecommunications under a single communications plan. The plan is to cover all telecommunications, postal affairs and electronic communications. The approach of the communications plan is thus intended to be broader than a telecommunications plan since it will provide a comprehensive overview of different communication modalities in Iceland and their interaction; in addition the communications plan takes into account the goals of the Government's Strategy 20/20, which was mentioned earlier in this paper.

Annex: Statistical Appendix

TABLE 31: MACROECONOMIC PROSPECTS

Percentages unless otherwise indicated	ESA Code	Year 2009	Year 2009	Year 2010	Year 2011	Year 2012	Year 2013
		Level (bn EUR)	Rate of change				
1. Real GDP at market prices	B1*g	7.402	-6.8	-3.0	1.9	2.9	3.0
2. GDP at market prices	B1*g	11.569	1.5	3.6	4.8	6.0	5.7
Components of real GDP							
3. Private consumption expenditure	P3	4.013	-16.0	-0.2	2.6	2.9	3.7
4. Government consumption expenditure	P3	1.686	-1.7	-3.7	-4.3	-2.2	-0.3
5. Gross fixed capital formation	P51	1.678	-50.9	-4.6	14.8	23.2	14.6
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+ P53	0.003	0.021	-0.004	-0.005	-0.005	-0.005
7. Exports of goods and services	P6	2.860	7.4	-0.1	1.0	2.0	2.4
8. Imports of goods and services	P7	2.851	-24.1	2.7	2.0	6.0	5.9
Contribution to real GDP growth							
9. Final domestic demand		7.4	-20.8	-1.6	2.1	4.3	4.3
10. Change in inventories and net acquisition of valuables	P52+P53	0.0	-0.024	-0.025	-0.001	-0.001	-0.001
11. External balance of goods/services	B11	0.0	12.1	-0.9	-0.2	-1.1	-1.0

TABLE 32: PRICE DEVELOPMENTS

Percentage changes, annual averages	ESA Code	Year 2009	Year 2010	Year 2011	Year 2012	Year 2013
1. GDP deflator		9.2	6.4	2.7	2.7	2.3
2. Private consumption deflator		15.4	4.9	2.9	1.7	1.9
3. HICP		16.2	7.5	-	-	-
4. National CPI change		12.0	5.4	2.5	2.6	2.4
5. Public consumption deflator		10.0	3.3	1.8	2.9	2.7
6. Investment deflator		17.7	3.3	2.3	2.4	2.2
7. Export price deflator (goods & services)		12.5	8.4	2.8	3.0	1.9
8. Import price deflator (goods & services)		24.8	4.5	2.3	1.9	1.6

TABLE 33: LABOUR MARKET DEVELOPMENTS

	ESA Code	Year 2009	Year 2009	Year 2010	Year 2011	Year 2012	Year 2013
		Level	Level/Rate of change				
1. Population (thousands)		-	319.2	318.0	317.0	316.8	318.2
2. Population (growth rate in %)		-	0.0	-0.4	-0.3	-0.1	0.5
3. Working-age population (persons)		-	209.5	207.1	206.1	206.4	207.3
4. Participation rate		-	76.6	77.4	77.6	77.7	77.9
5. Employment, persons		-	147.6	147.3	148.4	151.5	154.2
6. Employment, hours worked		-	-	-	-	-	-
7. Employment (growth rate in %)		-	-9.8	-0.2	0.7	2.1	1.8
8. Public sector employment (persons)		-	-	-	-	-	-
9. Public sector employment (growth in %)		-	-0.8	-1.4	-	-	-
10. Unemployment rate		-	8.0	8.1	7.2	5.6	4.5
11. Labour productivity, persons		-	1.5	-2.3	1.5	0.8	1.2
12. Labour productivity, hours worked		-	-	-	-	-	-
13. Compensation of employees	D1	-	-7.0	6.9	5.1	6.9	6.9

TABLE 34: SECTORAL BALANCES

Percentages of GDP	ESA code	Year 2009	Year 2010	Year 2011	Year 2012	Year 2013
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	9.9	-	-	-	-
of which:						
- Balance of goods and services		9.2	9.7	9.3	8.1	6.7
- Balance of primary incomes and transfers		-11.0	-12.6	-13.0	-12.9	-12.2
- Capital account		-8.1	-	-	-	-
2. Net lending/borrowing of the private sector	B.9/ EDP B.9	19.8	-	-	-	-
3. Net lending/borrowing of general government		-9.9	-6.0	-2.6	0.1	2.8
4. Statistical discrepancy		-	-	-	-	-

TABLE 35: GDP, INVESTMENT AND GROSS VALUE ADDED

	ESA Code	Year 2009	Year 2010	Year 2011	Year 2012	Year 2013
GDP and investment						
GDP *level* at *current* market prices (in domestic currency)	B1g	1502.2	1551.0	1622.9	1715.7	1808.5
Investment ratio (% of GDP)		13.8	13.2	14.8	17.7	19.7
Growth of Gross Value Added, percentage changes at constant prices						
1. Agriculture		-	-	-	-	-
2. Industry (excluding construction)		-	-	-	-	-
3. Construction		-	-	-	-	-
4. Services		-	-	-	-	-

TABLE 36: EXTERNAL SECTOR DEVELOPMENTS

Billion Euro unless otherwise indicated		Year 2009	Year 2010	Year 2011	Year 2012	Year 2013
1. Current account balance (% of GDP)	% of GDP	-2.2	-2.9	-3.6	-4.9	-5.8
2. Export of goods	bn NCU	2.9	-	-	-	-
3. Import of goods	bn NCU	2.4	-	-	-	-
4. Trade balance	bn NCU	0.5	-	-	-	-
5. Export of services	bn NCU	1.7	-	-	-	-
6. Import of services	bn NCU	1.4	-	-	-	-
7. Service balance	bn NCU	0.3	-	-	-	-
8. Net interest payments from abroad	bn NCU	-0.9	-1.158	-1.296	-1.372	-1.378
9. Other net factor income from abroad	bn NCU	-	-	-	-	-
10. Current transfers	bn NCU	-0.1	-0.046	-0.040	-0.043	-0.046
***11. Of which* from EU**	bn NCU	-	-	-	-	-
12. Current account balance	bn NCU	-0.193	-0.279	-0.376	-0.540	-0.674
13. Foreign direct investment	bn NCU	6.7	-	-	-	-
14. Foreign reserves	bn NCU	2.8	4.116	-	-	-
15. Foreign debt	bn NCU	87.3	-	-	-	-
***16. Of which*: public**	bn NCU	-	-	-	-	-
***17. O/w:* foreign currency denominated**	bn NCU	-	-	-	-	-
***18.O/w:* repayments due**	bn NCU	-	-	-	-	-
19. Exchange rate vis-à-vis EUR (end-year)	NCU/EUR	172.7	162.0	157.5	156.4	155.3
20. Exchange rate vis-à-vis EUR (annual average)	NCU/EUR	179.9	153.8	-	-	-
21. Net foreign saving	% of GDP	-	-	-	-	-
22. Domestic private saving	% of GDP	-	-	-	-	-
23. Domestic private investment	% of GDP	-	-	-	-	-
24. Domestic public saving	% of GDP	-	-	-	-	-
25. Domestic public investment	% of GDP	-	-	-	-	-

TABLE 37: GENERAL GOVERNMENT BUDGETARY PROSPECTS

	ESA code	Year 2009 Level	Year 2009	Year 2010	Year 2011	Year 2012	Year 2013
					% of GDP		
		Net lending (B9) by sub-sectors					
1. General government	S13	-200.100	-9.9	-6.0	-2.6	0.1	2.8
2. Central government	S1311	-191.684	-8.2	-5.6	-2.3	0.4	2.7
3. State government	S1312	0.000	0.0	-	-	-	-
4. Local government	S1313	-12.876	-1.0	-0.4	-0.3	-0.2	0.1
5. Social security funds	S1314	4.400	-0.7	-	-	-	-
		General government (S13)					
6. Total revenue	TR	653.600	40.9	43.2	41.9	43.7	45.9
7. Total expenditure	TE	853.700	50.8	49.2	44.5	43.6	43.0
8. Net borrowing/lending	EDP.B9	-200.100	-9.9	-6.0	-2.6	0.1	2.8
9. Interest expenditure	EDP.D41 incl. FISIM	49.497	6.6	5.0	5.1	5.3	5.1
p.m. 9a. FISIM		0.000	0.0	0.0	0.0	0.0	0.0
10. Primary balance		-200.187	-6.5	-3.0	0.9	3.9	6.1
		Components of revenues					
11. Total taxes (11 = 11a+11b+11c)		500.772	30.6	30.8	31.1	31.9	32.5
11a. Taxes on production and imports	D2	230.100	13.9	-	-	-	-
11b. Current taxes on income and wealth	D5	269.500	16.7	-	-	-	-
11c. Capital taxes	D91	0.500	0.0	-	-	-	-
12. Social contributions	D61	41.644	3.1	4.0	4.0	4.0	4.1
13. Property income	D4	57.047	3.6	2.4	2.1	2.0	2.1
14. Other (14 = 15-(11+12+13))		54.137	3.7	6.0	4.7	5.8	7.1
15 = 6. Total revenue	TR	653.600	40.9	43.2	41.9	43.7	45.9
p.m.: Tax burden (D2+D5+D61+D91-D995)		542.400	33.7	-	-	-	-

TABLE 37: (CONTINUED)

	ESA code	Year 2009 Level	Year 2009	Year 2010	Year 2011	Year 2012	Year 2013
					% of GDP		
Selected components of expenditures							
16. Collective consumption	P32	367.309	26.4	24.8	22.9	21.2	20.5
17. Total social transfers	D62 + D63	89.778	8.1	-	-	-	-
17a. Social transfers in kind	P31 = D63	89.778	8.1	7.5	7.5	6.9	6.5
17b. Social transfers other than in kind	D62	-	-	-	-	-	-
18 = 9. Interest expenditure (incl. FISIM)	EDP.D41 + FISIM	49.500	6.6	5.0	5.1	5.3	5.1
19. Subsidies	D3	27.326	1.9	1.7	1.6	1.5	1.4
20. Gross fixed capital formation	P51	66.002	3.5	2.6	2.3	2.4	2.5
21. Other (21 = 22-(16+17+18+19+20)		253.785	4.3	-	-	-	-
22. Total expenditures	TE	853.700	50.8	49.2	44.5	43.6	43.0
p.m. compensation of employees	D1	216.2	14.9	14.0	13.0	12.1	11.8

TABLE 38: GENERAL GOVERNMENT EXPENDITURE BY FUNCTION

Percentages of GDP	COFOG Code	Year 2009	Year 2010	Year 2011	Year 2012	Year 2013
1. General public services	1	10.2	-	-	-	-
2. Defence	2	0.0	-	-	-	-
3. Public order and safety	3	1.6	-	-	-	-
4. Economic affairs	4	6.0	-	-	-	-
5. Environmental protection	5	0.7	-	-	-	-
6. Housing and community amenities	6	0.5	-	-	-	-
7. Health	7	8.3	-	-	-	-
8. Recreation, culture and religion	8	3.7	-	-	-	-
9. Education	9	8.5	-	-	-	-
10. Social protection	10	11.3	-	-	-	-
11. Total expenditure (item 7 = 22 in Table 2)	TE	50.8	49.2	44.5	43.6	43.0

TABLE 39: GENERAL GOVERNMENT DEBT DEVELOPMENTS

Percentages of GDP	ESA code	Year 2009	Year 2010	Year 2011	Year 2012	Year 2013
1. Gross debt		92.5	96.3	100.8	94.4	88.7
2. Change in gross debt ratio		22.4	3.8	4.5	-6.4	-5.8
Contributions to change in gross debt						
3. Primary balance		6.5	3.0	-0.9	-3.9	-6.1
4. Interest expenditure (incl. FISIM		6.6	5.0	5.1	5.3	5.1
5. Stock-flow adjustment		9.3	-4.2	0.4	-7.8	-4.8
of which:						
- Differences between cash and accruals		-	-	-	-	-
- Net accumulation of financial assets		-	-	-	-	-
of which:						
- Privatisation proceeds		-	-	-	-	-
- Valuation effects and other		-	-	-	-	-
p.m. implicit interest rate on debt		9.5	5.6	5.5	5.6	5.7
Other relevant variables						
6. Liquid financial assets		-	-	-	-	-
7. Net financial debt (7 = 1 - 6)						

TABLE 40: CYCLICAL DEVELOPMENTS

Percentages of GDP	ESA Code	Year 2009	Year 2010	Year 2011	Year 2012	Year 2013
1. Real GDP growth (%)	B1g	-8.5	-2.5	2.2	2.9	3.0
2. Net lending of general government	EDP.B.9	-9.9	-6.0	-2.6	0.1	2.8
3. Interest expenditure (incl. FISIM recorded as consumption)	EDP.D.41 + FISIM	6.6	5.0	5.1	5.3	5.1
4. Potential GDP growth (%)		-	-	-	-	-
Contributions:		-	-	-	-	-
- labour		-	-	-	-	-
- capital		-	-	-	-	-
- total factor productivity		-	-	-	-	-
5. Output gap (in % of potential output)		-22.0	2.1	2.1	5.6	5.4
6. Cyclical budgetary component		-	-	-	-	-
7. Cyclically-adjusted balance (2-6)		-	-	-	-	-
8. Cyclically-adjusted primary balance (7-3)		-	-	-	-	-

TABLE 41: DIVERGENCE FROM PREVIOUS PROGRAMME

	Year 2009	Year 2010	Year 2011	Year 2012	Year 2013
1. GDP growth (% points)					
Previous update	-	-	-	-	-
Latest update	-	-	-	-	-
Difference	-	-	-	-	-
2. General government net lending (% of GDP)					
Previous update	-	-	-	-	-
Latest update	-	-	-	-	-
Difference	-	-	-	-	-
3. General government gross debt (% of GDP)					
Previous update	-	-	-	-	-
Latest update	-	-	-	-	-
Difference	-	-	-	-	-

TABLE 42: LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

Percentages of GDP	2000	2005	2010	2020	2030	2040	2050
Total expenditure	286.2	433.3	-	-	-	-	-
of which:	-	-	-	-	-	-	-
- Age-related expenditures	-	-	-	-	-	-	-
- Pension expenditure	-	-	-	-	-	-	-
- Social security pension	-	-	-	-	-	-	-
- Old-age and early pensions	-	-	-	-	-	-	-
- Other pensions (disability, survivors)	-	-	-	-	-	-	-
- Occupational pensions (if in general government)	-	-	-	-	-	-	-
- Health care	54.8	82.9					
- Long-term care (this was earlier included in the health care)	-	-	-	-	-	-	-
Education expenditure	51.2	85.6	-	-	-	-	-
Other age-related expenditures			-	-	-	-	-
Interest expenditure	23.0	22.5	-	-	-	-	-
Total revenues	297.8	483.5	-	-	-	-	-
***of which*: property income**	18.1	26.2	-	-	-	-	-
***of which*: from pensions contributions (or social contributions, if appropriate)**	-	-	-	-	-	-	-
Pension reserve fund assets	-	-	-	-	-	-	-
***of which*: consolidated public pension fund assets (assets other than government liabilities)**	-	-	-	-	-	-	-
Assumptions							
Labour productivity growth	2	3.1	-	-	-	-	-
Real GDP growth	4.3	7.5	-	-	-	-	-
Participation rate males (aged 20-64)	-	-	-	-	-	-	-
Participation rates females (aged 20-64)	-	-	-	-	-	-	-
Total participation rates (20-64)	-	-	-	-	-	-	-
Unemployment rate	1.3	2.1	-	-	-	-	-
Population aged 65+ over total population	-	-	-	-	-	-	-

TABLE 43: BASIC ASSUMPTIONS ON THE EXTERNAL ECONOMIC ENVIRONMENT

Variable	**Assumptions for**									**Comments**
(annual growth rates in %, if not otherwise stated)	**Year 2009**	***change****	**Year 2010**	***change****	**Year 2011**	***change****	**Year 2012**	***change****	**Year 2013**	
Interest rates (in % p.a., annual averages)										
- Short-term interest rate (annual average)	-	-2.6	-	-6.6	-	-2.4	-	0.1	-	
- Long-term term interest rate[3] (annual average)	-	-2.6	-	-2.2	-	-0.4	-	0.5	-	
Exchange rates (annual average “-“: depreciation)										
Exchange rate vis-à-vis €	-	-35.3	-	6.2	-	3	-	0.6	-	
USD / €	-		-		-		-		-	
Nominal effective exchange rate	-	-34.2	-	3	-	2.1	-	0.6	-	
Real effective exchange rate **	-	-18.4	-	6.4	-	2.9	-	1.5	-	
GDP (in real terms) (trading partners)	-	-3.9	-	1.5	-	2.3	-	2.4	-	Trading partners
- World, excluding EU	-	-	-	-	-	-	-	-	-	
- EU 27	-	-	-	-	-	-	-	-	-	
World trade (in real terms)										
Country export markets	-	-	-	-	-	-	-	-	-	
World imports	-	-10.5	-	5.7	-	3.9	-	2.9	-	
International prices										
World import prices (trading partners) (goods, in €)	-	0.1	-	1.7	-	1.5	-	1.7	-	
Oil Prices (Brent – USD per barrel)	-	-35.8	-	25.0	-	4.5	-	5.2	-	

TABLE 44 MATRIX OF POLICY COMMITMENTS

Description of policy	Year 2010	Year 2011	Year 2012	Year 2013
Increased interest rebate				
A. Implementation profile*	x	x	x	-
B. Net direct budgetary impact (if any)	ISK 2 bn	ISK 2 bn	ISK 2 bn	-
B.1 Direct impact on budgetary revenue	-	-	-	-
B.2 Direct impact on budgetary expenditure	-	-	-	-
Total net budgetary impact				
Total impact on budgetary revenue	-	-	-	-
Total impact on budgetary expenditure	ISK 2 bn	ISK 2 bn	ISK 2 bn	-