ICELAND

PRE-ACCESSION ECONOMIC PROGRAMME 2012

Ministry of Economic Affairs

January 2012

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1. Overall policy framework and objectives

The objective of the Icelandic Government's policy in the near term remains to secure a sustainable economic recovery following the collapse of the banking sector in October 2008. At that time Iceland was hit by a threefold crisis: a financial, currency, and economic crisis, as a result of the predictable adjustments of the economy, in the wake of the economic boom that spanned 2004-2007. Priority areas of economic policy include increased emphasis on maintaining fiscal coherence in order to restore business and household confidence and revitalise investment spending across economic sectors with particular emphasis on environmental sustainability. Efforts to conclude private sector debt restructuring are well under way, as well as rebuilding the financial and the appropriate redesign of the monetary policy framework. Finally, there will be increased emphasis on the integration of education with employment, particularly in order to tackle the negative effects of long-term unemployment.

All of these priorities are important for promoting greater and sustainable economic growth. However, the public sector debt is still large and the access of Icelandic firms to financial markets is limited, despite the Treasury's successful issuance of bonds on foreign markets last year and the passage of the 2012 Budget Law. To ensure a sustainable fiscal policy, the balance of payments needs to be positive to pave the way for reducing the foreign debt that inevitably mounted in the wake of the financial crash.

Innovation is important in cultivating sustainable growth. Companies with a strong knowledge base and those competing on international markets are more likely than others to stand at the forefront of innovation, as has been the case in Iceland. Support needs to be provided to boost the competitiveness of companies in order to achieve the objective of greater diversification and economic growth. It is therefore vital to remove some of the hindrances that have been created by the current situation, particularly with regard to access to foreign credit markets and capital controls. An emphasis on education and research, as well as social infrastructure investments, can also fuel the growth of companies of this kind.

The current economic policy as presented in the Pre-Accession Programme is based on an economic growth model that largely differs from the one that has been followed over the past decades. Instead of the volatility of demand-driven growth, the aim is to strengthen the supply side of the economy and to be guided by principles of sustainability and eco-friendly economic growth. Growth of this kind increases the stability of the economy and creates long-lasting prosperity, supporting the Government's policy of maintaining Iceland as Nordic welfare society based on equality and fairness.

This Pre-Accession Economic Programme was prepared by the Ministry of Economic Affairs with the participation of relevant ministries and agencies. The economic policy presented is based on Iceland's Economic Programme, introduced by the Government in November 2011.

2. Economic Outlook

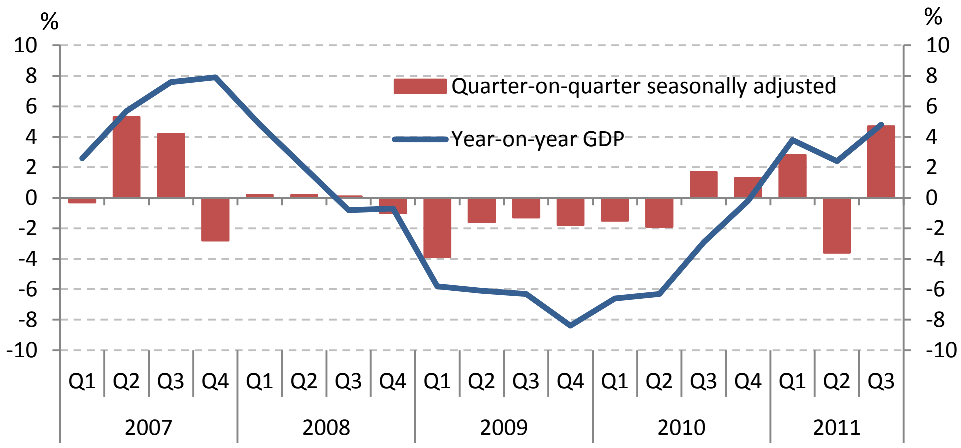
The macroeconomic assumptions underpinning the medium-term economic forecast and 2012 fiscal budget are developed by an independent department within Statistics Iceland. The most recent forecast was made in November 2011.

External assumptions underlying the forecast are based on the most recent IMF and OECD global forecasts. It assumes moderate economic growth among Iceland's main trading partners as GDP world growth has weakened and uncertainty has increased as a result of unrest in financial markets due to the debt burden of banks and high sovereign debt, especially in Europe. Averaged GDP growth for Iceland´s main trading partners is forecast 1.5 percent in 2012 and 2.1 percent in 2013. CPI inflation in Iceland´s main trading countries is also expected to be moderate, 1.9 percent in both years. A large share of Iceland´s merchandise exports is marine products and aluminium. Price increases in USD for aluminium are expected to be moderate in 2012 and 2013 following a substantial increase in the last two years. Price increases for marine products in foreign currency are expected to be about 5 percent in 2012 in the wake of almost 10 percent increase 2010 and 2011 each year.

2.1 Recent economic developments

The Icelandic economy returned to 3.7 percent growth in the first three quarters of 2011 following a 4 percent decline in 2010. This is more growth than the latest forecast from Statistics Iceland (SI) assumed for the year (2.4 percent) and which indicates that economic growth in 2011 will be closer to 3.5 percent.

Figure 1: Gross domestic product growth



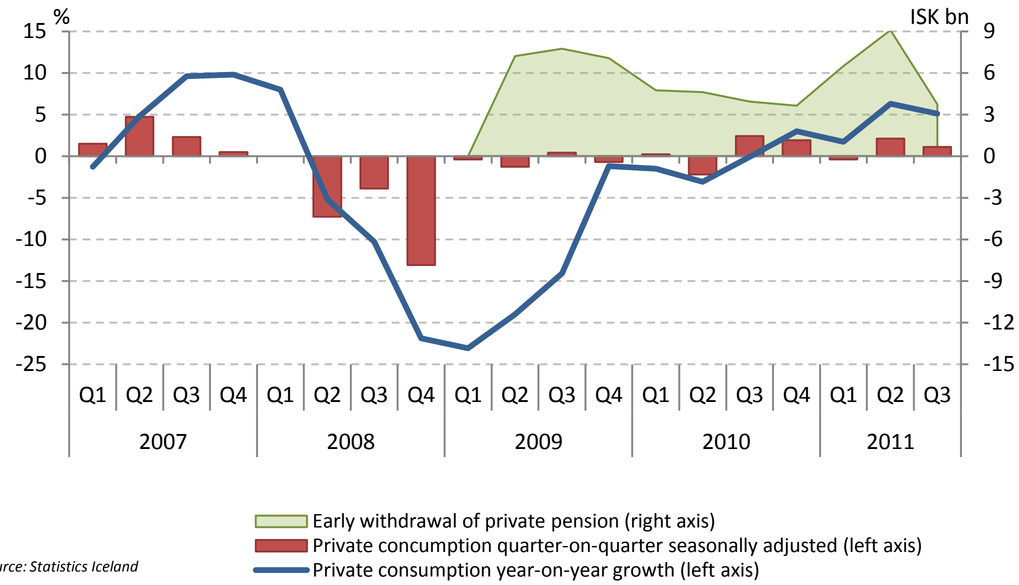
Source: Statistics Iceland

This increased growth is mainly due to more private consumption than expected, supported by higher wages, social benefits, temporary interest rate subsidy and a number of policy initiatives undertaken, such as the freezing of payments on loans and the imbursement of private pension savings. Furthermore, growth in certain export sectors and pickup in investments, although from very low levels, also support growth. In the first three quarters of 2011 private consumption increased by

4.4 percent and for the year the growth could be close to 4 percent instead of 3.1 percent forecast by SI in November.

Low exchange rate, increased economic growth in Iceland's main trading partners and higher prices in foreign currency for both aluminium and marine products have increased export value substantially since the economic crisis and turned the trade balance to surplus of approximately 10 percent of GDP. Increased national expenditure in 2011 calls for import growth again, forecast 4 percent in 2011, substantially higher than export growth (2.7 percent). External trade will therefore have a negative effect on economic growth in 2011 as it did in 2010. Current account balance on the other hand is still negative by over 10 percent of GDP as high net interest costs cause the balance of factor income to offset the substantial surplus on the trade balance. Large share of that interest cost is accrued net interest cost from the old banks in bankruptcy proceedings and will be written off when the winding-up proceedings are finished. The Central Bank of Iceland (CBI) estimates the underlying current account (without the old banks) to be in minor surplus for 2011.

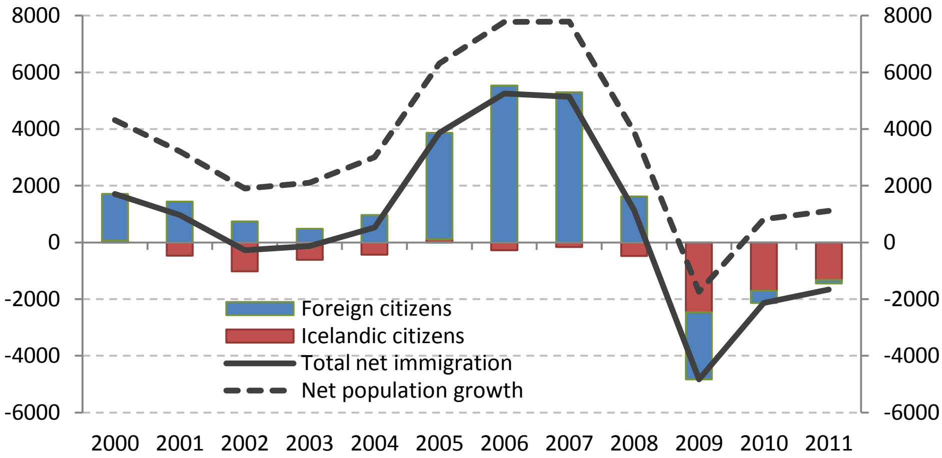
Figure 2: Private consumption growth and withdrawal of private pension



Source: Statistics Iceland

The Icelandic population was 319,560 on 31 December 2011. In 2010, the number of people who emigrated from Iceland exceeded those who immigrated by 2,134, although 20 percent were foreign citizens. Last year emigration exceeded immigration by 1,404 of which 7 percent were foreign citizens. Preliminary figures for 2011 indicate that a turnaround has taken place.

Figure 3: Net immigration and population growth



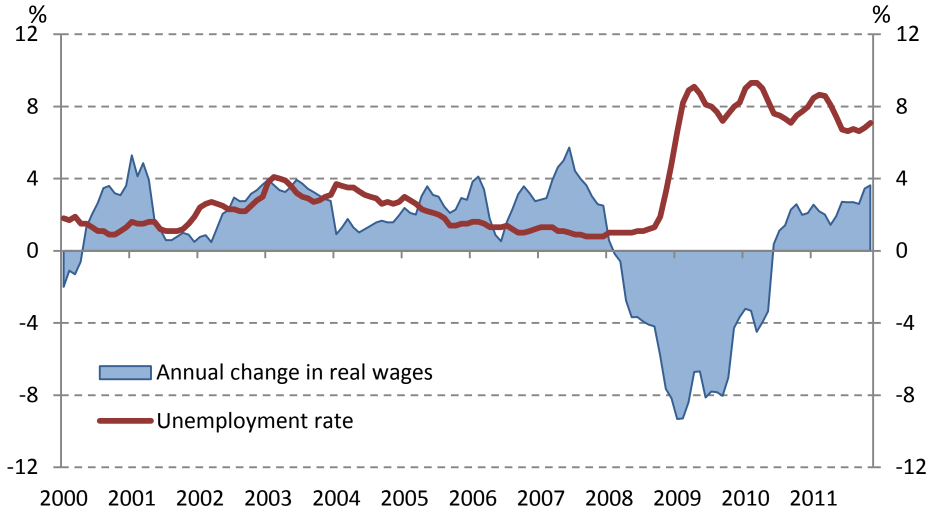
Source: Statistics Iceland

The activity rate in Iceland is high by international standards or 81.1 percent in 2010 and 80.4 percent in 2011. The activity rate in EU-countries was in comparison 63 percent in 2010. The rate is higher among men than among women, 84.5 percent among men in 2010 and 77.6 percent among women. The activity rate has been stable in recent years and is expected to remain stable in the medium-term. Full-time employment is expected to increase and part-time employment to decrease, with an increase in working-hours.

The labour market situation has improved gradually since 2009. Average measured unemployment in 2011 was according to Statistics Iceland's labour market survey 7.1 percent compared to 7.6 percent in 2010. In registered unemployment rates, from the Directorate of Labour, the rate has dropped further, from 8.1 percent in 2010 to 7.4 percent in 2011. Statistics Iceland expects unemployment to decrease gradually in the coming years. Registered rates are expected to drop from 7.4 percent of labour force in 2011 to 5.5 percent in 2014. The registered unemployment rate in December was 7.3 percent. At the same time last year the unemployment rate was 8 percent. The average rate in 2011 was 7.4 percent compared to 8.1 percent in 2010. The rate dropped to 6.6 percent in mid-summer, but has since then increased slightly because of the yearly fluctuations with a peak in mid-winter.

Real wages dropped dramatically in the last quarter of 2008 and were weak until the turnaround of the economy commenced in late 2010. In 2011 real wages have risen, due to new wage agreements and a return to economic growth.

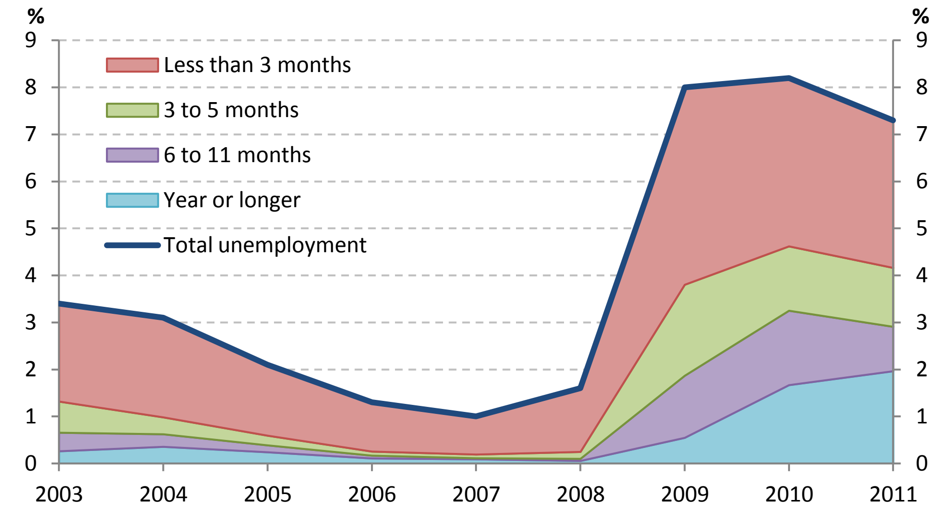
Figure 4: Real wages and registered unemployment



Source: Statistics Iceland, Directorate of Labour

Long-term unemployment has been a concern for the last few years. In the last quarter of 2011 long-term unemployment decreased and expectations are for continued reduction, as great effort has been made to combat this trend.

Figure 5: Long term registered unemployment



Source: Directorate of Labour

2.2 Medium-term macroeconomic scenario

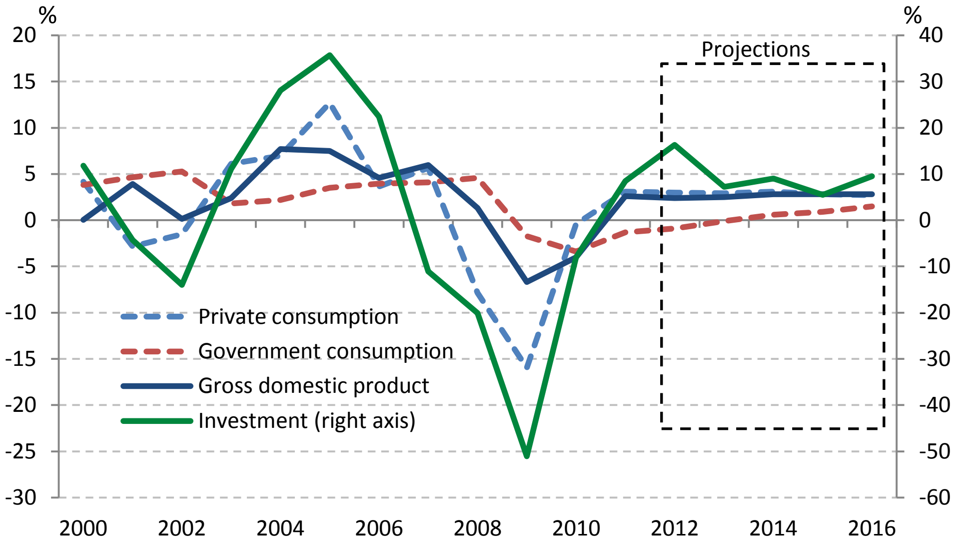
2.2.1 Real sector

The economic growth policy for the next years aims to strengthen the supply side of the economy and be guided by principles of sustainability and eco-friendly economic growth. The purpose is to increase the stability of the economy and create greater and more long-lasting prosperity. As the economy hit bottom in the second half of 2010, a turnaround commenced with positive growth, lower unemployment and higher purchasing power. Projections assume this development will continue in the medium term with average growth around 2.7 percent.

Economic forecasts support the prospects for job creation and reduced unemployment in next two years, especially in retail, travel service and transport, and other service industries. It is also to be expected that construction and related industries start to pick-up after three years of recession. Average increase in nominal wages was 6.8 percent in 2011 and is forecast to continue by 6.5 percent in 2012 and 4.9 percent in 2013.

Investment levels, whether in industry, housing or public investment, remain low. Total investments amount to 13.8 percent of the GDP 2011 and are set to amount to 15.6 percent in 2012, a little lower than earlier expected.

Figure 6: Annual real growth



Source: Statistics Iceland

Corporate investment reached an all-time low in 2010, but is expected to grown by a total of over 35 percent in real terms in 2011 and 2012, and to continue to grow substantially over the next two years. Energy-intensive projects remain preeminent, including the enlargement of the Straumsvík aluminium smelter and the Búðarháls power plant. Production at the silicon factory in Helguvík is also expected to start in the latter part of this year and to carry on into the next. Corporate investments in general are only expected to increase slightly, depending on how the restructuring of corporate balance sheets progresses. Residential investment is also at a minimum, although it is expected to increase somewhat this and next year, as financial undertakings are slowly but surely freeing themselves of the volume of residential property they have taken over. There have been few new construction projects so far, however, and this is likely to remain the case in the quarters ahead, since there is still an ample supply of uncompleted residential property.

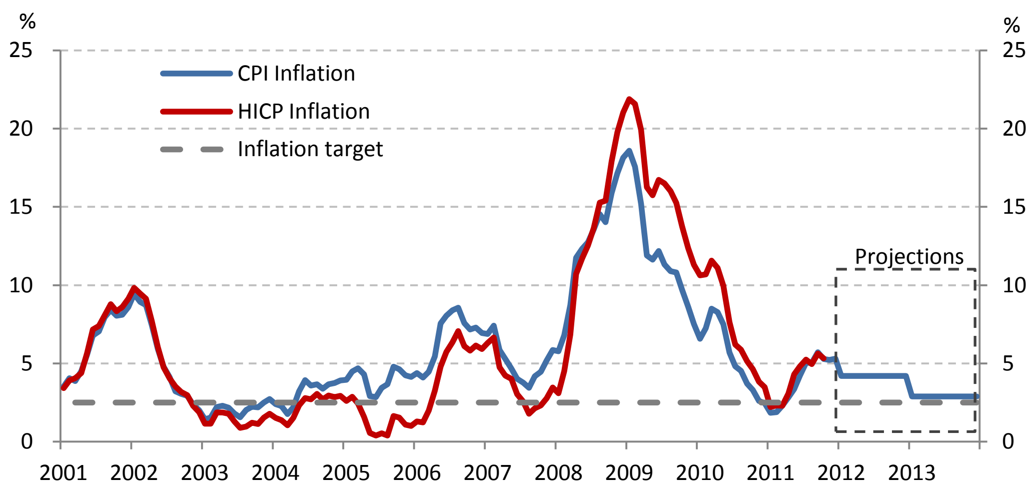
There has been a veritable transformation in the trade balance following the depreciation of the real exchange rate of the ISK and the surplus currently amounts to 10 percent of GDP. This surplus is likely to remain unchanged over the next year. The ample surplus offsets the high factor income deficit. Exported goods and services are expected to increase slightly this and next year and there is likely to be a minor increase in marine product exports and commission income. On the other hand, increased production at the Straumsvík plant is not expected to result in a rise in export revenue until 2013. With increased domestic demand, the trade surplus is expected to diminish somewhat.

A low real exchange rate generally leads to greater competitiveness and supports growth in the part of the export sector which is not capacity constrained. In 2008, the ISK exchange rate plummeted and the real exchange rate swiftly dropped. The competitiveness of the export sector has therefore been good in recent quarters, while at the same time, the low real exchange rate caused a contraction in imports, creating a positive trade balance. Historically the real exchange rate tends to rise as the economy recovers, eroding the competitive edge gained during the downturn. At the same time, this generates the risk of increasing debt and a trade deficit, which hampers export-driven growth and the development of sustainable debt. Economic policy must take this into account.

2.2.2 Inflation

Since March 2001 the main objective of monetary policy in Iceland has been price stability, further defined as an inflation target of 2.5 percent, measured in terms of the twelve-month CPI inflation, with a ±1.5 percent tolerance band.

Figure 7: Inflation and inflation target



Source: Statistics Iceland

Inflation soared after the banking and currency crisis struck, driven by cost hikes fuelled by the 42 percent depreciation of the ISK in 2008. By year end inflation had reached 18 percent. Inflation slowed down noticeably in 2009, owing to the slack in the economy and a relative stability of the exchange rate. The ISK started to recover in late 2009, which contributed to a rapid disinflation in 2010, as the effects of the prior depreciation petered out from twelve-month inflation measurements. In December 2010, year-on-year headline inflation reached the CBI's inflation target.

Inflation has increased significantly in 2011. In January, annual headline inflation as measured by the consumer price index was 1.8 percent. At the same time, annual core inflation 3[1] measured 1.2 percent. In December 2011, headline inflation had risen to 5.3 percent and annual core inflation 3 to 5 percent. Although inflation has declined somewhat recently, annual core inflation has continued to rise.

The main reasons for the rapid increase in inflation were steep rises in global commodity and oil prices in the first half of 2011 in addition to increases in housing costs and effects of high wage increases following the wage settlements in May 2011. Price increases have, however, become more widespread in the last couple of months. Inflation expectations have also risen considerably over the course of the year.

According to the latest CBI forecast, published in the November 2011 *Monetary Bulletin*, inflation will peak in the first quarter of 2012. Inflation is then expected to subside rapidly, supported by lower global oil and commodity prices and a stronger ISK, and fall to 3 percent during the latter half of 2012. Average inflation of just over 4 percent is forecast for 2012, reaching the inflation target in the latter half of 2013.

Given the inflation and wage increases in the first half of 2011, there is a risk that inflation will become entrenched if inflation expectations remain at their current level. High profits in the traded goods sector resulting from weak ISK in combination with elevated inflation expectations may affect wage- and price-setting decisions. On the other hand, there is considerable uncertainty as to how much spare capacity remains and how effective it is in containing underlying inflationary pressures. With the central wage agreements recently extended, there is less uncertainty surrounding future wage developments.

2.2.3 Monetary and exchange rate policy

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, exchange rate stability became an interim objective of monetary policy. As the programme progressed, the inflation outlook regained more importance in monetary policy decisions, in accordance with the legally mandated long-term monetary policy regime.

Future changes to monetary policy framework

On 20 December 2010 the CBI published a report on domestic monetary policy and submitted it to the Minister of Economic Affairs. The report summarises the CBI'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, macroprudential tools, and improvements in

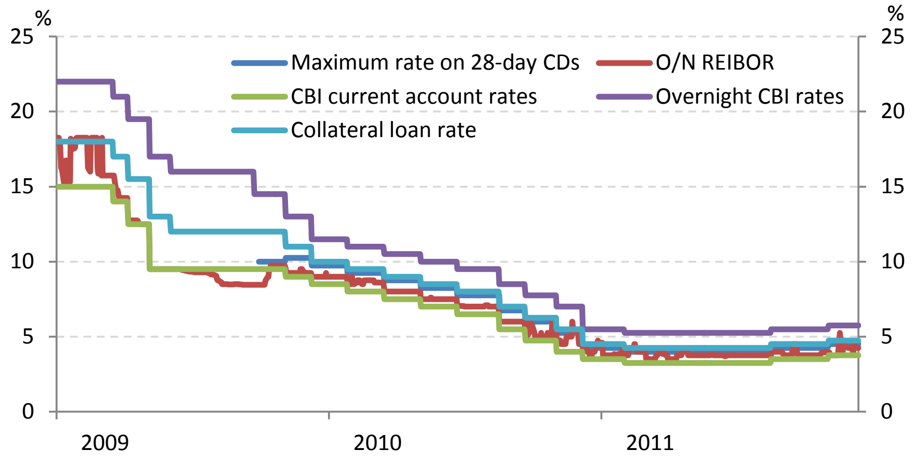
[1] CPI inflation excluding tax effects, volatile items such as food and petrol, public services and real interest rates on mortgages.

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 report, entitled "*Monetary Policy in Iceland after Capital Controls*", can be found on the website of the CBI. The CBI is preparing a new report that will examine the pros and cons of different exchange rate regimes for Iceland with focus on the adoption of the euro, through EMU membership, as a main alternative to the ISK.

Interest rate developments

The capital controls permitted a more rapid lowering of interest rates than otherwise possible. Monetary easing continued throughout 2010 and into mid 2011 when a slight monetary tightening began. Interest rates remained unchanged at 4.25 percent from February until August when they were raised with a further increase following the November decision. Following the Monetary Policy Committee's (MPC) December meeting, the current account rate was 3.75 percent, the maximum bid rate on 28-day certificates of deposit was 4.50 percent, the seven-day collateralised rate was 4.75 percent and the overnight lending rate was 5.75 percent.

Figure 8: Central Bank of Iceland interest rates and short-term market interest



Source: Central Bank of Iceland

Latest: 12 December

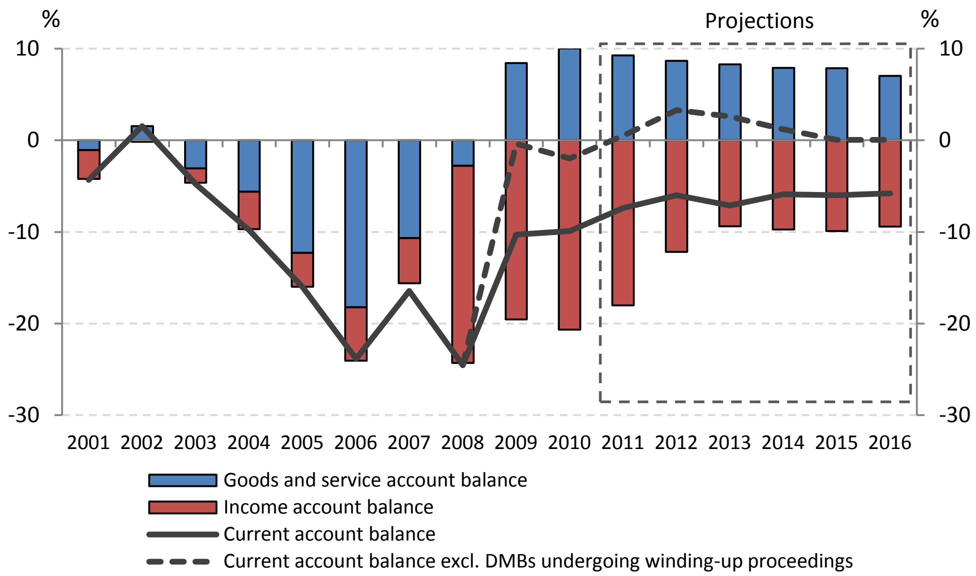
2.2.4 External sector and its medium-term sustainability

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 has grown steadily and remained positive each month since early 2009.

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 ISK and a large contraction in domestic demand. From March 2010 imports have been on the rise again. Despite imports growing faster than exports there was a substantial merchandise trade surplus in the first eleven months of the year 2011. 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. The global recession in 2008-2009 had a limited effect on Icelandic export volumes. Both marine and aluminium production (the largest share of Icelandic exports) has been at full capacity, and given the weak ISK the traded goods sector has been highly competitive. Export values continued to increase in 2011, especially in the second half, largely driven by increased exports of marine products. Furthermore, revenues from tourism grew despite the global recession in 2008-2009 while outlays of residents contracted, contributing to 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 and 2011 with tourism in Iceland increasing substantially each year. This can be attributed to multiple factors, including the low ISK exchange rate and strong promotion work, such as the "Inspired by Iceland" campaign, the new concert house *Harpa* and increased supply of flights to and from Iceland. Further campaigns are being planned for the tourist industry, for example, the "Iceland all year round" campaign, which is focused on boosting health tourism services and off-season tourism.

Figure 9: Current account balance components, % of GDP



Source: Statistics Iceland, CBI

The current account deficit increased enormously in the period of 2003-2008, in large part due to a substantial deficit on factor income, which peaked at almost 25 percent of GDP in 2008. Measured deficit on the factor income balance has remained quite large in 2009-2010 and in the first three quarters of 2011. The deficit in the balance on factor 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 be written off and 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 factor income excluding these DMBs. If that balance is adjusted for accrued income and expense of DMBs in winding-up proceedings, the deficit on the factor income balance was much lower in 2009 than in the previous year, increased slightly in 2010, but has declined somewhat again in the first three quarters of 2011.

Excluding accrued interest of DMBs in winding up proceedings the current account for the year 2011 should be in surplus according the latest CBI forecast. Furthermore, it should be noted that a single multinational company with headquarters in Iceland but limited domestic activity accounts 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. Excluding this company and the DMBs in winding-up proceedings the current account was in substantial surplus in 2010 and in the first three quarters of 2011.

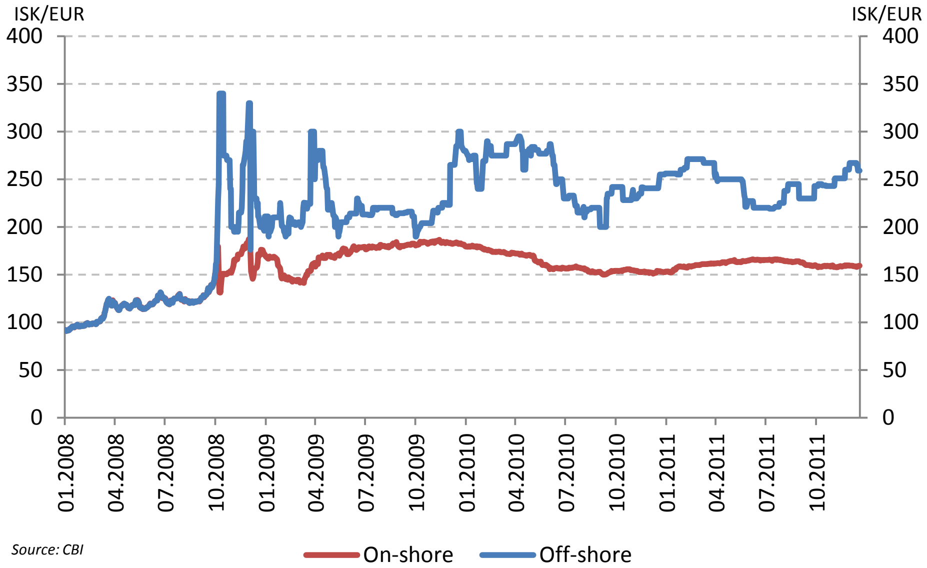
It is expected that the factor income deficit will decline in 2012 and 2013, as the effects of the DMBs in winding-up proceedings diminishes and also due to lower interest rates in 2012. Excluding DMBs in winding-up proceedings the factor income will improve again in 2013 on the back of interest rates normalising. The surplus on the goods and service account is expected to strengthen given a positive outlook for improved terms of trade and increasing tourism. The current account surplus, adjusted for accrued income and expense of DMBs in winding-up proceedings, will therefore increase in 2012 before gradually declining again.

Temporary capital controls

Temporary capital account restrictions were imposed in November 2008. While the removal of the capital controls is a priority, it will be done gradually and appropriately sequenced to preserve the stability of the ISK during the phase of capital account liberalisation. The EFTA Court confirmed in December 2011, that capital account restrictions as those in effect in Iceland are in accordance with the EEA Agreement.

The first steps in the removal of the capital controls were taken at the end of October 2009, when inflows of foreign currency for new investments and related potential outflows were permitted. In March 2011, the Government approved a revised strategy for the lifting of capital controls developed by the CBI in cooperation with ministries and the FSA and in consultation with the IMF. The strategy is focused on reducing the pressure from foreign holdings of ISK, currently estimated at around 30 percent of GDP. The strategy is in three main phases, with the first two already under way. During the first two phases, the CBI holds auctions to purchases offshore ISK, which are subsequently auctioned to investors willing to purchase a long-term CPI-indexed government bond or other domestic assets and hold them for a pre-defined time-period. In the second phase, which was launched in November 2011, the initiative offers investors, who wish to invest in Iceland using foreign currency, to buy ISK originally from offshore holders of ISK for up to 50 percent of the investment amount through auctions at the CBI. The condition is that the investors buy at least the same amount of ISK from domestic financial institutions and that the entire amount be used for investment domestically.

Figure 10: On-shore and off-shore ISK/EUR rate



Source: CBI

The difference between the official exchange rate and the exchange rate on the unofficial offshore market should make such transactions feasible for investors despite the long-term nature of their subsequent holdings. The final step will include an exit levy and/or the issuance of a long-term government bond in foreign currency. Only when the stock of these offshore ISK has been reduced and the offshore exchange rate has converged towards the official rate, will capital controls on domestic actors be liberalised.

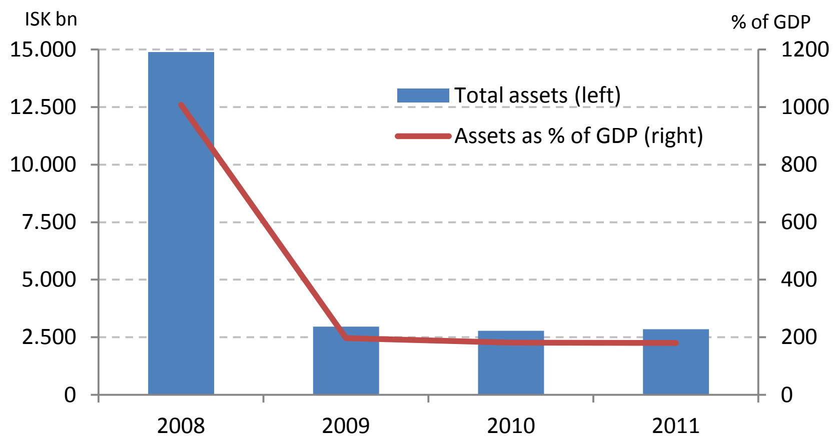
Before the controls can be fully lifted, there is a need to rebuild trust in the financial system and the CBI. The Minister of Economic Affairs has announced a programme for his ministry to this effect. First, a new trans-partisan committee has been established to discuss the future capital controls framework. Second, a bill of law on required changes to the law on the CBI will be presented to Althingi in 2012. This will give Althingi the opportunity to discuss the monetary policy's legal framework. Third, there is a need to build a framework for macroprudential policies. The Minister of Economic Affairs will present a report to Althingi in early 2012 on future policy and framework for the financial system. A substantial debate is expected in the competent parliamentary committee. An expert group will, on the basis of this report, formulate the required legislative changes, including on the financial sector framework and the governance of the CBI and the FSA. A bill of law to this effect will be presented to Althingi in the fall of 2012. Fourth, the required macroprudential tools and framework need to be developed. The Minister of Economic Affairs will present a report to Althingi in 2012 on this issue. This work will also be reflected in Iceland's ongoing negotiations on membership to the European Union.

In September 2011, the Althingi approved amendments to the Foreign Exchange Act, the Customs Act and the Act on the Central Bank of Iceland. These changes extended the authority to maintain capital controls beyond September 2011, when the enabling legislation had been set to expire, to the end of 2013. The amendments included in the law the regulations that had previously been issued by the CBI with the approval of the Minister of Economic Affairs. The amendments also opened the possibility for progressive discretional relaxation of the controls. A temporary provision in the Foreign Exchange Act grants authority to the CBI to carry out business transactions with individuals and companies, provided that the relevant transactions are deemed necessary by the CBI for liberalisation of the restrictions which have been placed on capital movements and foreign exchange transactions.

2.2.5 Financial sector

The total assets of financial undertakings amounted to roughly ISK 8,000 bn by end-September 2011. Banks and savings banks, collectively referred to as deposit money banks (DMBs), are the largest entity in the financial system. At the end of Q3/2011, DMBs' assets were slightly less than 200 percent of GDP. The banks' operations are restricted almost entirely to domestic activities. The state owned Housing Financing Fund (HFF) and the three largest commercial banks have a market share of 86 percent among credit institutions. Since year-end 2010, the largest commercial banks' assets have grown, mainly through mergers and acquisitions of other (failed) financial companies. The most important change was the merger of Landsbanki and SpKef on the one hand and the merger of Íslandsbanki and Byr on the other hand.

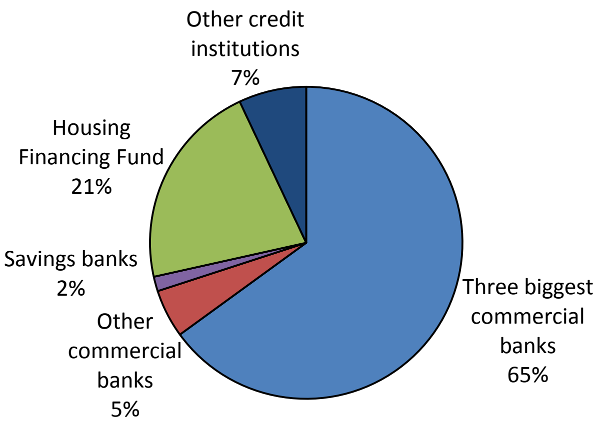
Figure 11: Deposit money banks' total assets



1. Parent companies, September 2008, December 2009 and 2010, September 2011.
Source: Central Bank of Iceland.

The HFF's total assets have grown in line with increased lending. The savings bank system has shrunk markedly in recent years, and its total assets account for less than 2 percent of total credit institution assets. The long-term role of the remaining savings banks will probably be determined in the near future. Their operating conditions are difficult, partly due to limited lending capacity and the proportionally high IT and back office costs.

Figure 12: Credit institutions total assets

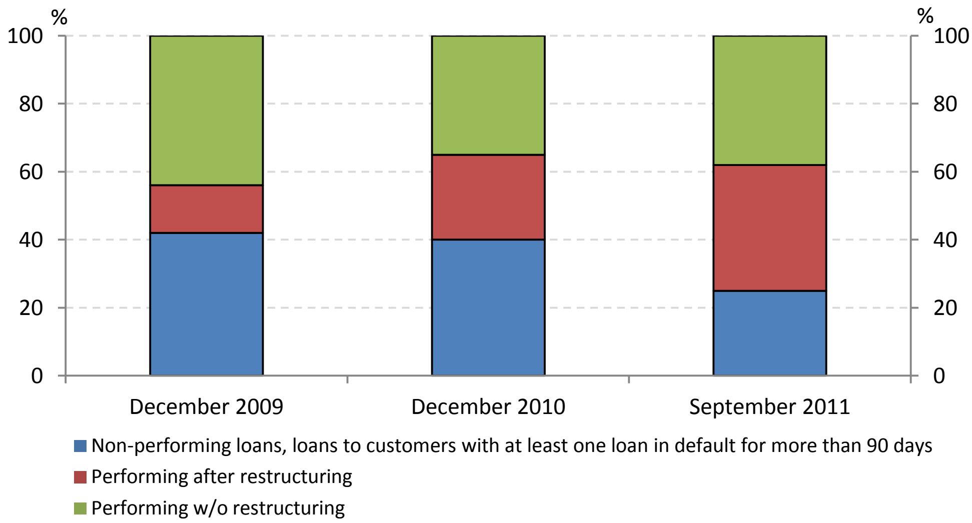


1. Parent companies, September 2011.
Source: Central Bank of Iceland.

Default ratios

Private sector debt restructuring is a crucial factor in the recovery process. It is important for the financial institutions that their loan portfolios are sound and the risk attached to them is reduced. Although restructuring has proceeded more slowly than originally hoped, significant progress was made in 2011.

Figure 13: Status of loans from three largest banks, book value (cross-default method)



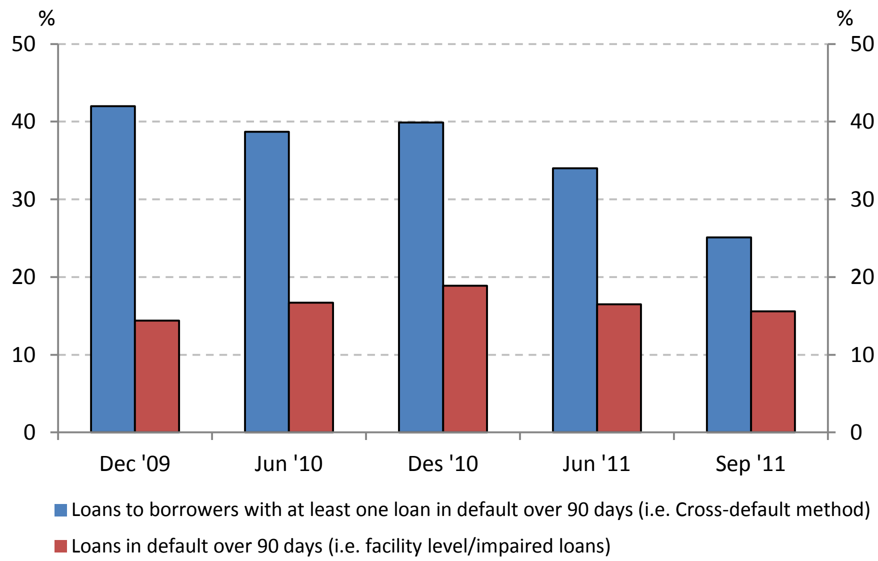
1. Parent companies. 2. Non-performing loans are defined as loans that have been in default for more than 90 days or deemed unlikely to be paid. If one loan taken by a customer is non-performing, all of that customer's loans are considered non-performing, i.e. cross-default method is used.
Source: Financial Supervisory Authority.

The share of non-performing loans has fallen sharply during the year. For example, around 25 percent of the large commercial banks' loans were non-performing as of end-September 2011, down from 40 percent at the beginning of the year (see Figure 13). Of that total, about 5 percent were undergoing document processing and will be transferred to the "performing loans" category when restructuring is complete. These figures are based on book value, and they assume that all of a customer's loans are in default if one is in default or if payment is considered unlikely (cross-default). There is no single international definition of non-performing loans. However, it is common that even though a customer has one loan in arrears by 90 days or more, that customer's other loans are not considered to be non-performing. According to this criterion, some 16 percent of the Icelandic banks' loans are non-performing. This ratio has changed relatively little in the past two years. Foreign banks with strong loan portfolios commonly have a non-performing loan ratio of 1-2 percent. But whether cross-default is assumed or not, the three Icelandic commercial banks' non-performing loan ratios are still too high.

Loan portfolios: developments and composition

The bulk of the DMBs' assets is in the form of lending. The book value of loans was ISK 1,760 bn at the end of October 2011, after having declined by almost 2 percent during the year. At the same time, overdraft loans were unchanged, non-CPI-indexed loans were up 55 percent, CPI-indexed loans were unchanged, and exchange rate-linked loans declined by almost 40 percent. The Supreme Court ruling on the illegality of exchange rate linked loans in September 2010 is presumably a major cause of these changes. The proportion of leasing contracts, mostly related to automobile purchases, also rose markedly within the DMBs, mainly due to the merger of Avant and SP Financing with Landsbanki and the transfer of their loan portfolios. DMBs' loans have therefore been affected primarily by loan portfolio transfers (i.a. Landsbanki's takeover of SpKef), exchange rate differences and inflation, changes in assessed loan values, and retirement of debt. Credit creation has been limited, with many new loans probably taken to refinance previously existing household and business loans. Furthermore, a number of loans have been paid off, as low deposit interest rates provide an incentive to retire debt. In comparison, HFF lending has been on the rise, with total lending for the first 10 months of 2011 amounting to ISK 19.2 bn, up from ISK 14.9 bn over the same period in 2010.

Figure 14: Serious default ratios



1. Parent companies, book value.
Source: Financial Supervisory Authority.

As of end-October 2011, loans to domestic companies constituted about 65 percent of total DMBs' lending, and loans to non-residents accounted for another 5 percent. The majority of corporate loans were to companies in the services sector. The distribution of credit among sectors has remained relatively unchanged in the past two years. Almost half of DMBs' corporate lending was denominated in foreign currencies. Loans to households accounted for 28 percent of the banks' loan portfolios. CPI-indexed loans are the most common, at 58 percent of total household lending by the banks. If the HFF is included, the share of CPI-indexed loans rises to 83 percent. However, the share of non-CPI-indexed household loans has risen sharply in the past two years, to 14 percent of total bank and HFF lending. This trend is expected to continue. From a financial stability standpoint, further diversification of loan types is a positive development.

Foreign currency mismatches

The foreign exchange imbalances in the financial system have been reduced considerably in the recent term, as have imbalances between individual currencies. Capital requirements due to foreign exchange risk have therefore declined accordingly. The largest commercial banks' foreign exchange balance was about 33 percent of their capital base at mid-year 2011 and has been reduced still further in the wake of court rulings on the illegality of foreign exchange linked loans. The three banks' adjusted foreign exchange imbalances have also declined steadily, to about 3 percent of their capital base at mid-year 2011.[2] It is important to continue reducing the uncertainty about these foreign assets, but there is still legal risk attached to them.

Funding

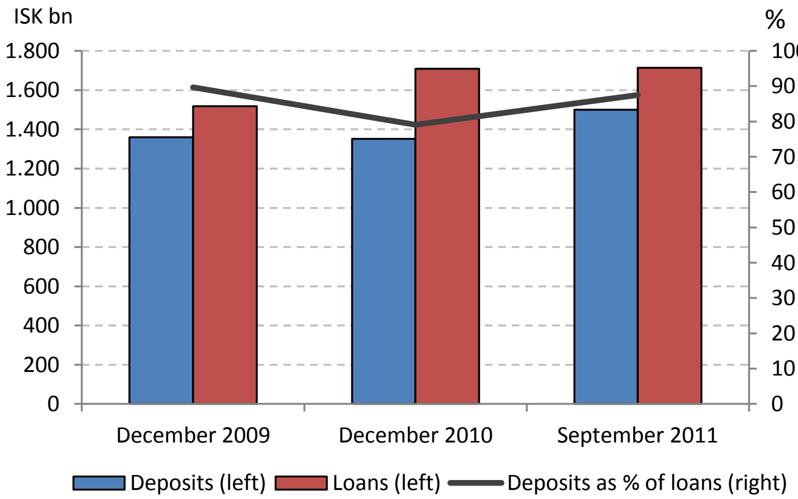
The majority of the commercial banks' funding comes from deposits. However, deposits have declined as a share of total funding and now account for just under 2/3 of the total. Over 80 percent of the banks' deposits are sight deposits. The banks' other borrowings are relatively limited, and subordinated loans account for only 2 percent of total funding. Íslandsbanki and Arion Bank have recently been authorised by the Financial Supervisory Authority (FSA) to issue covered bonds in order to fund their mortgage loans. In order to facilitate other domestic market funding, the banks must complete debt restructuring, and non-performing loans must be within appropriate limits. Government declarations fully guaranteeing all deposits in Iceland and the prioritisation of deposits during bankruptcy proceedings may continue to impede the banks' market funding activities. Consequently, the banks might face difficulties in obtaining funding from abroad for the time being.

[2] Method used to calculate foreign exchange balance, which takes account of whether value and recovery are dependent on exchange rate movements. This method has been called the delta correction, the balance has been called the effective foreign exchange balance, and the exchange rate-linked assets not included in the effective balance have been called ineffective exchange rate-linked assets (so-called FX/ISK assets). This balance should therefore be closer to the balance the bank would have if uncertainty were eliminated and restructuring of foreign assets entirely complete. Only the three largest commercial banks are authorised to use this method.

Potential withdrawals of deposits and liquid assets

The banks' liquidity risk is related primarily to potential withdrawal of deposits. With over 80 percent of the banks' deposits in sight deposits, the banks must be prepared for sizeable withdrawals at any given time. The capital controls currently in effect prevent depositors from transferring funds out of Iceland. However, they can transfer funds between banking institutions or move them into other assets, such as marketable securities. When the capital controls are lifted, the banks must be prepared for the possibility that a portion of deposits, particularly those owned by non-residents, will be expatriated. As of end-September, non-residents held about 9 percent of all deposits in Icelandic commercial banks. A large portion of these deposits are in ISK. The first phase of the capital account liberalisation strategy focuses on these assets, on releasing them in stages or placing them in the hands of residents or non-residents interested in long-term investment in the Icelandic economy.

Figure 15: Deposits as % of loans



1.Parent companies. Deposits from customers as % of loans to customers and leasing contracts.
Byr included 2010 and SpKef 2011.
Source: Central Bank of Iceland.

According to the FSA, the banks can withstand sizeable withdrawals of deposits, as they hold ample secure liquid assets. As of the end of October 2011, secure liquid assets held by the largest commercial banks amounted to ISK 640 bn, or 41 percent of their total deposits. About half of secure liquid assets are in Icelandic Treasury bonds that can be used as collateral for Central Bank facilities, and about one-third are in foreign currencies. It is important that the banks prepare themselves for the possibility of substantial outflows of deposits, with the associated impact on liquidity and foreign exchange market flows. Consequently, they must have ample liquid assets and must increase their proportion of term deposits.

Operations of commercial banks and Housing Financing Fund (HFF)

The three large commercial banks' combined calculated return on equity was 16 percent in the first nine months of 2011, and their return on total assets was just under 3 percent. During the period, net interest income totalled ISK 66 bn, and the combined interest rate margin was 3.4 percent. For the first nine months of the year, commissions and fees totalled ISK 15 bn and income from financial activities ISK 13 bn, due in particular to sizeable capital gains at Landsbanki. During the period, there was significant income from the assessed increase in loan portfolio values. The banks' combined income entries from assessed increases in loan values, after adjusting for new impairment and value changes in contingent bonds, totalled just under ISK 4 bn. Profit from discontinued operations totalled just below ISK 5 bn, due primarily to Landsbanki's sale of appropriated companies. Excluding income from financial activities and other sources, including write-ups of transferred loans, the banks' operating expenses constituted 56 percent of their total regular income and 2.3 percent of total assets. Levies on the banks are increasing. For example, the premium they pay to the Depositors' and Investors' Guarantee Fund has risen, as they now pay a special financing tax. Furthermore, a special tax on bank payroll costs has recently been levied. Banks' operating expenses are therefore on the rise, calling for streamlining of operations to offset the cost increase. With debt restructuring near completion, expenses should decline.

Equity and capital adequacy ratios

The three large commercial banks' capital position has strengthened considerably during 2011 and is now well above the FSA's 16 percent required minimum. The capital base of the large commercial banking groups totalled about ISK 500 bn in September 2011. It has risen by ISK 48 bn, or 10 percent, since the beginning of the year as a result of operating profits. The banks' capital ratios have risen by 3 percentage points year-to-date, to about 24 percent as of end-September 2011. The increase is due to a stronger capital base and reduced market risk following the unwinding of their foreign exchange imbalances. The three large banks' Tier 1 capital increased as well during the year, from just over 19 percent at year-end 2010 to almost 22 percent by end-September 2011. The HFF's capital position has strengthened in 2011, and its equity totalled just over ISK 10 bn at the end of June, an increase of ISK 1.5 bn since the beginning of the year. The Fund's capital ratio was slightly above 2.4 percent at the end of June, although well below its long-term target of 5 percent.

3. Public Finance

3.1 General government balance and debt

3.1.1 Policy strategy and medium-term objectives

The Government Coalition Platform states that the programme for restoring balance to the finances of the Treasury is a priority issue. The programme of action was drafted in consultation with the IMF, with the aim of attaining a surplus in the primary balance in 2011 and surplus in the total balance in 2013 and restoring equilibrium to the economy as a whole. The purpose of the programme was to halt the accumulation of public debt, reduce interest expense and strengthen the base of social welfare on a sustainable basis for the future.

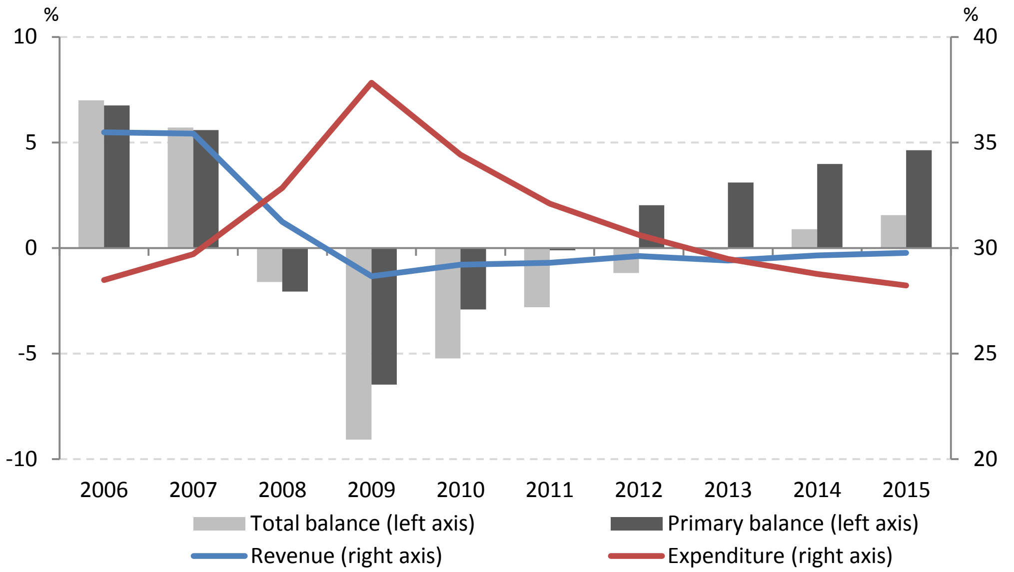
Currently, the turnaround in the primary balance is estimated at 10-11 percent of GDP instead of 16 percent in the original programme, proposed in 2009. The goals of the original programme have been modified slightly, taking into account several factors. The goal of achieving a surplus in the primary balance has been time-adjusted until 2012 and the goal of achieving surplus in total balance until 2014, in addition to which it is projected to be lower than originally envisaged. The revised programme on medium-term fiscal objectives 2012-2015, published in October 2011, thus assumes that the adjustment will be milder than in the original programme. The goal of bringing Treasury finances back onto a sustainable basis remains unchanged.

The main reasons for a milder adjustment path are as follows. First, the debt of the Treasury is considerably lower than originally envisaged, partly because the Treasury's cost of refinancing the banking system turned out lower than planned. Second, the implementation of the fiscal adjustment programme has been favourable and the Treasury cash deficit has been substantially lower in 2009 and 2010 than had been projected. Third, economic growth was seen as reviving more slowly and than earlier envisaged. A tighter fiscal policy could have exerted a sharp contractionary impact and thus delayed the recovery. Fourth, the ratio of tax revenue to GDP does not appear to be increasing to the same extent as envisaged in the earlier programme. Fifth, the confidence in Treasury finances and the underlying fiscal policy has improved, which is in part reflected in the declining credit default swap rate for Treasury debt as well as the fact that the Treasury issued debt abroad in June 2011. Finally, it should be noted that the improvement in Treasury finances has enabled the Treasury to increase social security payments and unemployment compensation in line with the recently concluded wage agreements in the general labour market, in addition to which wage agreements have been concluded with public employee unions calling for comparable wage increases. These increases are considerably higher than had been assumed in the earlier programme.

The cornerstones of the Government's economic policy include realistic goals for eliminating budget deficits. One of the main premises of the economic programme is to improve the operating conditions of enterprises and create conditions for economic growth based on sound and profitable investments. This would strengthen the revenue base of the Treasury and local governments, thus reducing the need for restraint and budget cuts. Balance in public finances would be attained without threatening the basis of the welfare system. Sustainable fiscal finances are a key prerequisite for enabling Iceland to remain in the ranks of Nordic welfare states, an explicit goal of the Government. Treasury debt will be reduced to 45-50 percent of GDP in 2016-2019 and the aim for general government debt reduction is currently set at 60 percent of GDP.

At present the improvement in the primary balance for 2011 is now estimated at 2.8 percent of GDP and at 2.1 percent for 2012. For the years 2013 and 2014 the improvement is estimated at close to 1 percent of GDP a year due to improved revenue prospects, and by 0.7 percent in 2015.

Figure 16: Central government finances, % of GDP



Irregular items such as the CBI lost claims (2008), sale profits from the Avens deal (2010) and capital injection to the Housing Financing Fund (2010) are excluded. Figures for 2006-2010 have also been adjusted for the transfer of services for disabled people from the central government to local government.
Source: Ministry of Finance

The main change from the underlying assumptions of the last medium-term programme, originally proposed in 2009,[3] is that the ratio of tax revenue to GDP is unlikely to increase as sharply in 2012 and 2013 as had been projected. At present, the ratio of tax revenue to GDP is estimated at close to 27 percent in 2011 and is expected to remain stable for the remainder of the forecast period. Earlier projections had placed the ratio in excess of 29 percent. New revenue measures, higher dividends and sales of assets are estimated to increase Treasury revenue by ISK 20.7 bn in 2012, increasing to ISK 28.5 bn in 2013, ISK 32.5 bn in 2014 and ISK 41.3 bn in 2015.

At present, the interest balance is estimated to be in deficit by 2.8 percent of GDP in 2011. For 2012, the interest balance is expected to be in deficit by 3.3 percent of GDP, declining thereafter by 0.1 percent over the next two years and ending at 3.1 percent towards the end of the forecast period.

The total Treasury balance, i.e. the primary balance as well as the interest balance, is estimated to be in deficit of 2.8 percent of GDP for 2011, but is expected to steadily improve to a surplus of 0.9 percent of GDP in 2014 and 1.6 percent of GDP in 2015.

3.1.2 Actual balances and medium-term perspectives

One of the main tasks of economic policy in Iceland during the last few years has been to adjust the fiscal situation of general government to post-crisis reality, as was emphasised by the Government in the Stand-by Arrangement with the IMF. The benchmark goals of the programme were set for the general government, however, the share of the central government in the necessary measures was

[3] http://www.ministryoffinance.is/media/Utgefin_rit/Measures_to_achieve_a_balance.pdf

much larger than that of local governments, or 11 percent of GDP compared to 1 percent. The first part of the following chapter covers central government finances and the second covers local governments.

3.1.2.1 Central government finances

The projected outcome for the year 2011 shows an estimated deficit in the primary balance of ISK 1.1 bn. On cash basis, the outcome is less favourable, a deficit of 11.5 bn ISK. The primary balance is expected to reach a surplus already in 2012 and remain positive for the forecast period. The total balance is forecast to be -0.1 percent of GDP in 2013 and reach a surplus in 2014. By 2015, it is projected that the primary surplus will amount to 4.6 percent of GDP or 4 percent on a cash basis. The finances of local governments are also expected to improve, leaving a primary surplus for the public sector as a whole of 5 percent at the end of the forecast period. The following table, Table 1, lays out the projected balance of the Treasury.

Table 1: Estimated Treasury finances

Accrual basis, ISK bn	Budget 2012	Estimate 2013	Estimate 2014	Estimate 2015
Total revenue	**522.9**	**545.3**	**579.1**	**610.8**
of which: Tax revenue	472.5	491.9	522.7	551.3
Total expenditure	**543.7**	**546.6**	**561.8**	**578.9**
Current expenditure	214.6	215.1	221.0	225.5
Interest expense	77.8	81.9	86.2	92.4
Transfers payments	230.6	229.2	233.5	239.7
Maintenance	8.0	8.2	8.3	8.5
Capital outlays	12.7	12.3	12.7	12.9
Total balance	**-20.8**	**-1.3**	**17.4**	**31.9**
as percent of GDP	-1.2	-0.1	0.9	1.6
improvement from last year	1.7	1.1	1.0	0.7
Primary revenue	501.8	522.2	553.2	581.8
Primary expenditure	465.9	464.7	475.6	486.6
Primary balance	**35.9**	**57.5**	**77.7**	**95.2**
as percent of GDP	2.0	3.1	4.0	4.6
improvement from last year	2.1	1.1	0.9	0.7
Interest income	21.1	23.1	25.9	29.0
Interest expense	77.8	81.9	86.2	92.4
Interest balance	**-56.7**	**-58.8**	**-60.3**	**-63.4**
as percent of GDP	-3.2	-3.2	-3.1	-3.1

Source: Ministry of Finance

Primary revenue as a percentage of GDP is projected to rise slightly over the period or by about 0.4 percent from the 2011 estimate to 28.4 percent by 2015. This compares to an average ratio of primary revenue to GDP of 32.6 percent in the years 2001-2007, the last seven years before the collapse.[4]

On the other hand, primary expenditure is projected to decline in the 2011-2015-period by 4.2 percent of GDP, mostly attributable to an expected drop in unemployment compensation payments, along with continued expenditure restraint as GDP growth resumes. Based on this, the operations of the central government will increase modestly over the coming years, allowing other sectors of the economy to grow. Nevertheless, public consumption will be kept at an acceptable level in order to maintain the welfare system.

The turnaround in the primary balance of the Treasury over the 2009-2015-period is expected to be close to 11 percent of GDP, i.e. from a deficit of 6.5 percent in 2009 to a surplus of 4.6 percent in 2015. The overall fiscal impact, since mid-2009 to 2015, is estimated to be 13.6 percent of GDP.[5]

The interest balance is estimated to be in deficit by ISK 45.3 bn in 2011, deteriorating further by ISK 11.4 bn in 2012 to amount to ISK 56.7 bn in that year. The higher interest balance deficit in 2012 is primarily due to higher interest payments. The interest balance is expected to remain similar in 2013 and slightly higher in 2014 and 2015. Although the interest balance is expected to be fairly stable in 2013-2015, both interest income and expenditure are expected to increase, mainly due to expected increases in interest rates.

Revenue measures

Numerous changes have been made to the tax system ever since December 2008 in order to strengthen the revenue procurement of the Treasury and resist the erosion of the main tax bases due to the economic contraction. The changes in the tax system have been based on the Government's policy of supporting a more even income distribution and a revision of natural resource taxation policies, in addition to supporting economic growth. New forms of taxation, both environmental taxes and special taxation of financial undertakings, have been adopted to ensure a more equitable tax burden.

Table 2: Cumulative revenue and expenditure measures

Accruals basis, ISK bn	**2009**	**2010**	**2011**	**2012**
Revenue				
Tax system changes	23.7	68.7	83.0	95.0
Other revenue measures	-	6.1	7.0	13.1
Total	**23.7**	**74.8**	**90.0**	**108.0**
Total, % of GDP	**1.6**	**4.9**	**5.5**	**6.1**

Source: Ministry of Finance

[4] It should be noted that the figures through 2012 are based on the 2012 budget. Figures for the years 2013-2015 are based on the Report on fiscal consolidation plan published alongside the budget proposal in October 2011. They have not been updated to conform to the latest official economic forecast from November 2011.

[5] The primary balance figures are from the Ministry of Finance and differ somewhat from Statistics Iceland National Accounts figures for 2009 and 2010.

Income taxes, the social security tax and other direct taxes have been revised to a larger extent than indirect taxes. Unemployment is forecast to decline in 2012 and the social security tax has been lowered correspondingly. Alternative revenue measures, which have so far been minimal, will be of more importance in 2012 and going forward.

Table 3: Revenue measures

Cash basis, ISK bn	2012	2013	2014	2015
Revenue				
Revenue measures enacted 2011	10.2	7.4	7.4	4.5
Revenue measures proposed but not enacted	1.5	9.8	9.1	10.3
Dividends	2.0	2.0	2.0	2.0
Asset sales	7.0	8.0	8.0	8.0
Other revenue measures	-	1.3	5.0	16.5
Total	**20.7**	**28.5**	**32.5**	**41.3**
Total, % of GDP	**1.2**	**1.5**	**1.7**	**2.0**

Source: Ministry of Finance

Some of the revenue measures up until 2011 will expire and others have been shortened. Instead more emphasis will be put on non-tax measures and new revenue measures will be undertaken. Table 3 shows revenue measures on a cash basis in the medium-term programme 2012-2015.[6]

Expenditure measures

From the offset, the Government has emphasised that the implementation of restraint measures and expenditure cutbacks in public spending should affect households and social welfare services as little as possible, especially health and social services. The main goals have been met through rationalisation in current expenditure, along with organisational simplification in addition to synergy efficiencies of related activities. The 2012 budget envisages further cuts in Treasury expenditure, although not to the same extent as in the past three years.

The medium-term fiscal programme for 2012-2015 outlines the main elements of Treasury expenditure. The premises are in part based on demographics as well as on expectations for changes in the expenditure commitments of ministries over the period.

For 2012 and 2013, it is assumed that the wages of central government employees will increase in accordance with the recent wage agreements. The wages component of the central government is expected to increase by 3.7 percent in 2012 and by 3.5 percent in 2013. In 2014 and 2015, the wages of central government employees are forecast to increase by 3 percent, or by 0.5 percent over and above the rate of inflation forecast for this period. It is assumed that social security benefits will increase in line with the percentage increases agreed to in the latest wage agreements, and the social security benefits will increase by 3 percent each year in 2014 and 2015. Unemployment compensation is forecast to develop according to the forecast on unemployment, and interest expenditure is forecast to develop according to the composition of debt and interest categories.

[6] It is to be noted that the revenue projections from 2013 onward are based on an economic forecast from July 2011.

Most other current expenditure, earmarked revenue, as well as transfer payments will increase with inflation. Other increases in real terms in the expenditure categories of ministries are not foreseen, except regarding the expenses related to an aging population, disability benefits and in the cost of medicine. An unallocated appropriation will be included in order to meet unexpected developments.

Table 4: Total expenditure frame and irregular items

Accrual basis, ISK bn	Budget 2012	Estimate 2013	Estimate 2014	Estimate 2015
Total expenditure	543.7	546.6	561.8	578.9
Irregular items				
Pension fund liabilities	5.4	5.5	5.7	5.8
Governments capital gains tax	2.6	2.4	2.8	2.6
Tax write-offs	10.0	10.0	10.0	10.0
Unemployment	20.2	17.0	17.0	16.4
Municipal equalisation fund	14.9	15.9	15.6	16.9
State guarantees	0.0	0.0	0.0	0.0
Write-offs	0.1	0.1	0.1	0.1
Interest expense	77.8	81.9	86.2	92.4
Total irregular expenditure	**131.1**	**132.8**	**137.3**	**144.1**
Expenditure frame	**412.6**	**413.8**	**424.5**	**434.8**

Source: Ministry of Finance

The above table, Table 4, shows forecast total expenditure of the Treasury to 2015, and irregular items that are not part of normal operations and may fluctuate between years. For 2012, irregular expenditures are estimated at ISK 131.1 bn in the medium-term programme, and the expenditure frame for the year is set at ISK 412.6 bn, excluding these items. The increase in expenditure in the 2012 budget is mainly due to the rise in benefits and wages that took place in 2011 and the weaker exchange rate in the course of the year. Expenditure in 2012, excluding irregular items, will fit into the frame set in earlier projections, after having taken account of wage, exchange rate and price changes in 2011 that were not anticipated in earlier calculations. In the years 2013 and 2014, the expenditure frame will amount to ISK 413.8 and 424.5 bn, respectively.

As observed earlier, the 2012 fiscal budget law presents a far milder expenditure adjustment than in the past three years. In general terms, the room for cuts and savings has been considerably narrowed, following severe restraint measures in government operations in the past three years. Nonetheless, it cannot be assured that the final goal of adjusting central government operations has been attained. The 2012 budget law sets criteria for goals in cutting expenditure, such as in health services, benefit systems and health insurance as well as in schools, research funds and law enforcement. The measures all take account of a restraint goal presented in the 2012 budget will reduce the expenditure of the Treasury in 2012 by close to ISK 8.1 bn, equivalent to 0.5 percent of GDP.

Table 5: Restraint measures, economic breakdown

Accrual basis. ISK bn	Current expenditure	Transfers	Maint. Investm.	Freezing of wages/benefits	Total	percent of GDP
2009						
Turnover	181.1	167.1	46.5		394.7	
Restr. meas.- Budget	-13.5	-6.3	-13.3	-5.5	-38.6	-2.6%
Restr. meas.- Suppl. Budget	-1.8	-3.0	-4.4		-9.2	-0.6%
Total	**-15.3**	**-9.3**	**-17.7**	**-5.5**	**-47.8**	**-3.2%**
Cuts in percent	-8.4%	-5.6%	-38.1%		-12.1%	
2010						
Turnover	198.9	206.0	43.7		448.6	
Restr. meas.- Budget	-14.0	-15.9	-13.9	-11.0	-54.8	-3.6%
Cuts in percent	-7.0%	-7.7%	-31.8%		-12.2%	
2011						
Turnover	204.8	211.5	27.7		444.0	
Restr. meas.- Budget	-11.2	-7.8	-3.9		-22.9	-1.4%
Cuts in percent	-5.5%	-3.7%	-14.1%		-5.2%	
2012						
Turnover	189.6	208.0	20.8		418.4	
Restr. meas.- Budget	-4.0	-3.9	-0.2		-8.1	-0.5%
Cuts in percent	-2.1%	-1.9%	-0.9%		-1.9%	
Total	**-44.5**	**-36.9**	**-35.7**	**-16.5**	**-124.4**	**-8.0%**

Source: Ministry of Finance

Table 5 shows a summary of expenditure cuts and restraint measures as estimated for the period 2009-2012. The table shows that restraint measures have become less severe over the period, since the room for rationalisation has been reduced, unless services are curtailed. All told, measures have been implemented that are estimated to reduce Treasury expenditure by a cumulative total of ISK 124.4 bn in the years 2009-2012, excluding the cuts presented in the 2009 supplementary budget, the full-year effect of which are in part being implemented in the 2010 budget.

In weighing the restraint measures, it is important to bear in mind that the adjustment process shown in the above table does not show the development of primary and total expenditure of the Treasury over the period. Since the collapse, the Treasury has had to undertake increased commitments that may largely be directly attributed to the economic collapse. This includes, for example, the interest cost and expenditure due to unemployment and general spending increases because of the decline in the exchange rate. The restraint measures are therefore intended to offset these increases, at the same time reducing the budget deficit. Altogether, both the primary and total expenditure of the Treasury has declined by more than 15 percent over the period. At the same time, the implementation of the cuts has been such that the level of government services and social welfare support has been maintained essentially unchanged, as was intended in the Government's programme.

The adjustment path on the expenditure side is expected to become more modest in the years 2013-2015, with ministries and agencies expected to reduce their spending by ISK 5 bn each year through special measures.

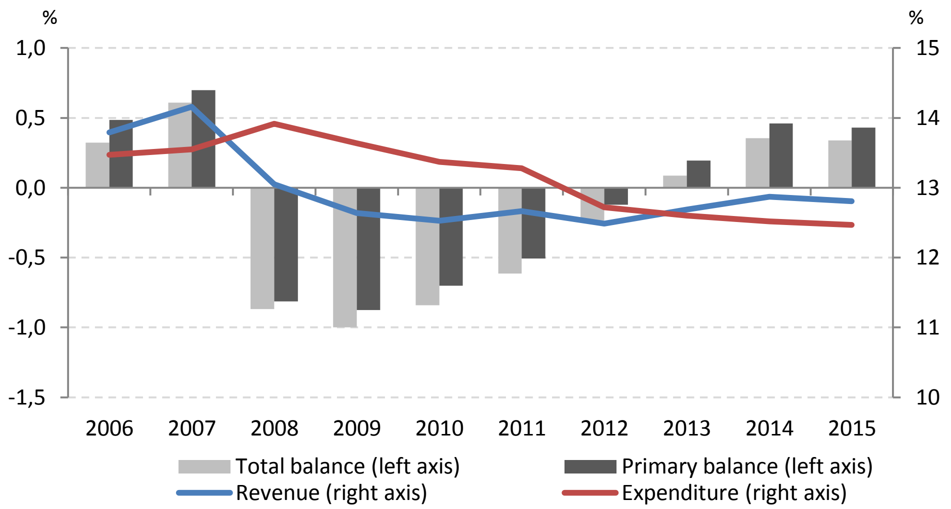
3.1.2.2 Local government finances.

In 2007 total income of local governments peaked at 14.2 percent of GDP but since the economic crisis the income has declined at the same time as operating expenditure has risen. The income balance, which was in surplus of 0.6 percent of GDP in 2007, declined to a 1 percent deficit in 2009 and a 0.8 percent deficit in 2010. In 2011, the income of municipalities is expected to increase again to approximately 12.7 percent of GDP as economic growth has picked up with substantial growth in private consumption as household´s balance sheets have improved and unemployment declined. Increased tax revenue in the first three quarters of 2011 is approximately 10 percent compared with the same period 2010.

Part of the municipalities' income increase in 2011 is due to an increased role of municipalities in welfare expenditure, as disability issues were transferred from central to local government in the beginning of the year. This transfer is financed with an increased local income tax rate (1.2 percentage point) and a temporary contribution in the budget.

Local government debt levels have risen in the wake of the crisis, partly as a result of foreign currency denominated loans taken by municipalities. This mostly applies to bigger municipalities close to the capital which invested heavily before the crisis. Further discussion on the debt burden of larger municipalities can be found in chapter 3.1.3.2.

Figure 17: Local government finances, % of GDP



Source: Statistics Iceland, The Associtation of Local Authorities, Ministry of Economic Affairs

The estimated deficit on the income balance is 0.6 percent of GDP in 2011 according to a preliminary estimate from The Association of Local Authorities in Iceland. For the municipalities to reach the fiscal target set in the initial economic programme of the Government and the IMF, which assumes that the primary balance of the local governments improves by 1 percent of GDP from 2009 to 2013, improvement is needed. The recently approved act on local governments will increase the possibility that the goal in question will be obtained. The fiscal rules included in the act are discussed further in chapter 3.5.4.

Table 6: General government finances

In ISK bn	2007	2008	2009	*Pre.* 2010	*Est.* 2011	*Budget* 2012	2013	*Forecast* 2014	2015
Total income	623.8	653.6	614.3	637.3	688.6	743.1	780.7	831.6	875.5
Total expenditure	553.1	853.7	763.3	791.9	745.0	768.0	780.4	807.3	836.6
Total balance	70.7	-200.2	-149.0	-154.6	-56.4	-24.9	0.3	24.3	38.9
Interest income	29.5	49.6	47.0	32.1	27.0	26.6	28.6	31.5	34.7
Interest expenditure	33.9	49.5	98.6	84.8	74.1	85.9	89.4	93.8	99.9
Primary balance	75.1	-200.3	-97.5	-101.8	-9.3	34.4	61.1	86.6	104.2
% of GDP									
Total income	47.7	44.1	41.0	41.5	42.0	42.1	42.1	42.4	42.4
Total expenditure	42.3	57.6	51.0	51.5	45.4	43.6	42.1	41.2	40.5
Without interest cost	39.7	54.3	44.4	46.0	40.9	38.7	37.2	36.4	35.6
Total balance	5.4	-13.5	-10.0	-10.1	-3.4	-1.4	0.0	1.2	1.9
Primary balance	5.7	-13.5	-6.5	-6.6	-0.6	1.9	3.3	4.4	5.0

Source: Statistics Iceland, Ministy of Finance, The Association of Local Authorities, Ministry of Economic Affairs

3.1.3 Debt levels and developments

3.1.3.1 Institutional structure

The Act on the National Debt Management 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 CBI on the provision of advice and the execution of the Treasury's debt management. The agreement ensures that the CBI's monetary policy has no impact on the Treasury's debt management and vice versa.

3.1.3.2 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.

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 percent 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.

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 CBI. 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 structure of the marketable series will be designed so that each one 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 CPI-linked bonds will be issued irregularly, depending on the Treasury's financing needs.

Issuance of Treasury bills is mainly 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 2012 will be ISK 75 bn. Issuance is expected to be below ISK 100 bn in the period 2013-2015.

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, with the exception that when a bond is issued for only two years, the final size of the series will be a minimum of ISK 15bn. 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, a 10-year CPI-linked Treasury bond in 2010 and a 20-year Treasury bond in 2011 for that purpose.

Foreign borrowing

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 CBI 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 minimise fluctuations in the value of the CBI's net assets in foreign currencies. This is in broad terms an asset and liability strategy where the Government's and CBI's balance sheets are looked at on consolidated basis.

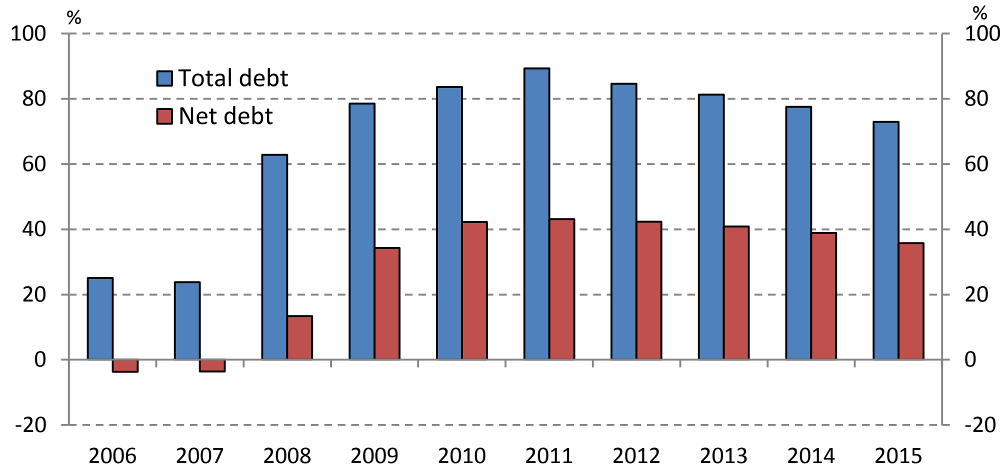
Central government debt portfolio

Marketable securities comprise Treasury bonds, Treasury bills and marketable bonds to refinance financial institutions. At the end of 2011, total outstanding marketable securities amounted to approximately ISK 789 bn. The Treasury issued a special government bond to finance capital contributions and subordinated loans to financial institutions, in the wake of bank recapitalisation following the financial crisis. The series´ maturity is in 2018. Outstanding amount at year-end 2010 is ISK 194 bn. Non-marketable debt consists of bond issued to refinance the CBI and other domestic liabilities. In 2008, the government issued a 5-year CPI-linked bond to recapitalise the CBI after the collapse of the banks. At year-end 2011, outstanding amount is ISK 172 bn. Other non-marketable debt is mostly attributable to the Treasury's acquisition of municipalities' stakes in Landsvirkjun, a state-owned energy company. These are CPI-linked annuity loans with a maturity in 2034.

Loans, taken in connection with the Stand-by Arrangement with the IMF, have been used to strengthen the currency reserves of the CBI. The bilateral loans, from Denmark, Finland, Sweden, the Faroe Islands and Poland, amount to ISK 220 bn at year-end 2011 (EUR 1.38 bn). They were disbursed directly to the CBI. EUR 1.3 bn are from the Nordic countries. At the end of 2014, the repayment of bilateral loans from the Nordics will commence and will be paid in equal instalments over a period of 7 years. The loans from the IMF amounting to ISK 268 bn (SDR 1,400 million) were also lent directly to the CBI. Furthermore, the CBI is the borrower of the bilateral loan from Norway amounting to ISK 76 bn (EUR 480 million). These loans are used to strengthen the currency reserves of the bank and are not part of the central government debt.

Other foreign currency loans to strengthen the foreign currency reserves amount to ISK 173 bn. These loans are a Eurobond issue of USD 1 bn and a Eurobond of EUR 311 million. The Treasury has contracted other foreign loans in previous years, which currently amount to approximately ISK 56 bn.

Figure 18: Central government debt, % GDP



Debt without pension liabilities and short term payables.
Source: Ministry of Finance

Financial institutions are the largest investors of domestic Treasury securities, with 29 percent of outstanding Treasury securities. The new banks were capitalised with a special Treasury bond issue, RIKH 18 1009, for ISK 194 bn, which mostly explains the large ownership of financial institutions. Pension funds hold approximately 22 percent of domestic Treasury securities and foreign investors are the third largest group of investors, holding approximately 21 percent of outstandings.

Local governments

In recent years local governments' debt and liabilities have increased gradually. Many of the larger municipalities around the capital invested considerably in the years before the crisis when population and economic growth in the area was substantial. Share of debt in foreign currency increased and when the exchange rate of the ISK fell and inflation picked up many municipalities were in difficulties. By the end of 2010 share of debt and liabilities of local governments, including related companies and utilities, amounted to just over 250 percent of total income. However, the debt of Reykjavík Energy (Orkuveita Reykjavíkur), which is in 95 percent ownership of Reykjavík City, skews the picture considerably. Excluding Reykjavík Energy debt, local governments debt ratio in 2010 falls to 150 percent and scales down to 140 percent in 2011 according to the fiscal budget. In the period from 2002 to 2007 the same ratio averaged 160 percent.

New fiscal rules for local governments, which are discussed in more detail in chapter 3.5.4, state that total debt and liabilities should not exceed 150 percent of total income. In the end of 2010, 29 municipalities (about one third) had debt ratios above 150 percent of total income and thereof 10 municipalities had ratios above 250 percent. About 78 percent of the population live in municipalities with debt ratios above 150 percent if the debt of Reykjavík Energy is included.

Municipalities with debt ratio above 150 percent are expected to bring the ratio below that benchmark within 10 years. For some municipalities this will be a difficult task and an additional adjustment period could be necessary. Many of the municipalities are contingent upon refinancing both domestic and foreign debt in the coming years. Increased fiscal adjustment with positive operating results in the coming years is therefore essential for the municipalities in question to reduce the risk related to refinancing the debts.

Table 7: Local government debt end-2010

	A part			A + B part		
% of income	% of debt	% of population	No. of LGs	% of debt	% of population	No. of LGs
< 100	23	46	40	2	6	33
101 - 150	16	17	16	8	15	14
151 - 250	39	29	14	16	23	19
> 250	21	9	6	74	55	10

The A part of local government finances covers regular operations. The B part covers institutions, companies and off-balance sheet items.
Source: The Association of Local Authorities, Ministry of the Interior

3.1.4 Budgetary implications of "major structural reforms"

The reduction of the number of ministries from twelve to ten, with plans to further reduce the number to nine or eight is discussed in chapter 4.2.5. These measures will result in expenditure savings as a result of improved efficiency in the medium-term.

A new bill on fisheries management, discussed in chapter 4.2.4, is expected to be put forth in Althingi in the spring of 2012. One aim of the bill is to secure an equitable contribution by the fisheries sector for the utilisation of common Icelandic natural resources. The passing of such a law will result in significant revenue increases.

3.2 Sensitivity analysis and comparison with previous programme

Regarding sensitivity analysis, the focus has been on regular analyses of the main risk components of fiscal finances.

Any divergence from budget expectations induces financial risk. The direct liabilities of the Treasury include outstanding debt and pension fund commitments, whereas the largest contingent liability consists of state guarantees. The main other contingent liabilities are implicit and arise because of the legal uncertainty surrounding the Icesave issue and uncertainties due to the weak financial state of local governments.

3.2.1 Direct liabilities

The total debt of the Treasury at the end of 2011 is estimated at ISK 1,465 bn of which ISK 1,016 bn is domestic debt and ISK 449 bn foreign debt.

The net pension commitments of the Treasury for central government employees amounted to ISK 345 bn at the end of 2010. About 84 percent of the pension commitments are for the B-division of the Government Employee Pension Fund (GEPF) and 10 percent for the Nurse Pension Fund. The Treasury bears no direct commitments for the A-division of the GEPF, although the net actuarial cumulative deficit of the A-division was 12 percent or ISK 47.4 bn at the end of 2010. This actuarial deficit of the A-division will need to be corrected.

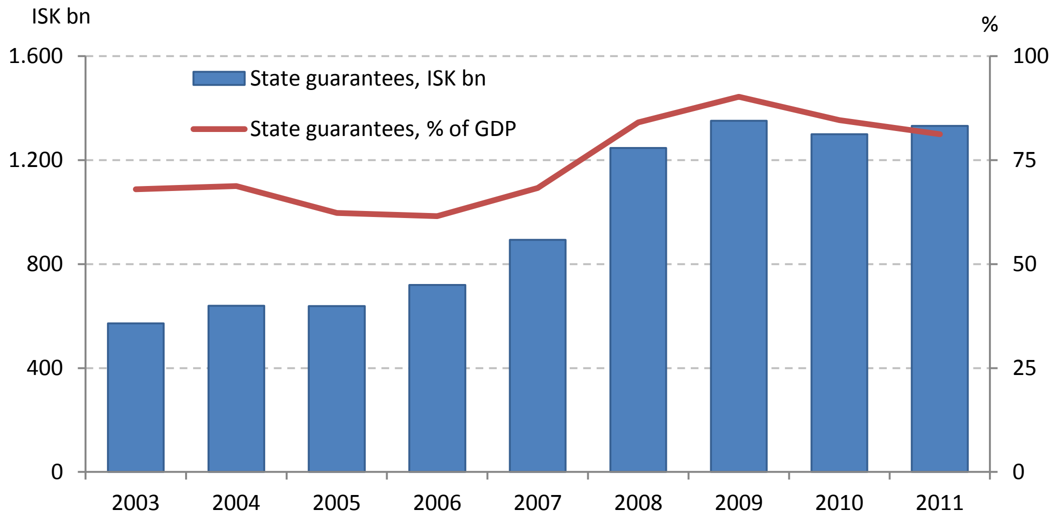
3.2.2 Treasury contingent liabilities

The first subsection of this chapter, 3.2.2.1, covers state guarantees, which is the main explicit contingent liability of the Treasury. The next subsection, 3.2.2.2, covers the implicit contingent liabilities of the Treasury.

3.2.2.1 State guarantees

The principal contingent liabilities of the Treasury are state guarantees, which are subject to Act no. 121/1997. The Althingi issues state guarantees, having received the proposals of the Ministry of Finance.

Figure 19: State guarantees



Source: Government Debt Management

The State Guarantee Fund administers state guarantees. The fund gathers information on the condition of companies receiving state guarantees and assesses the risk of providing a state guarantee. The CBI acts as fiscal agent for state guarantees according to the provisions of a special agreement with the Ministry of Finance. Table 8 shows the amounts of outstanding state guarantees at the end of October 2011.

Table 8: State guarantees

	ISK bn	Share	Change 2010-2011
Housing Financing Fund	947.2	71.1%	3.9%
Landsvirkjun	344.8	25.9%	-1.0%
Other	39.8	3.0%	-3.3%
Total	1.331.7	100.0%	2.4%

**** Provisional figures end-October 2011***

Source: Government Debt Management

Outstanding state guarantees amounted to ISK 1,332 bn on October 31st 2011, equivalent to 81 percent of 2011 GDP, increasing by ISK 31.5 bn from the previous year. Of this amount, 71 percent consists of guarantees for the Housing Financing Fund and 26 percent for Landsvirkjun, the National Power Company.

The Housing Financing Fund

According to the Housing Act no. 44/1998, the Housing Finance Fund (HFF) is entrusted with the task of providing loans for home purchases in Iceland. The Fund is subject to the supervision of the FSA. According to the interim account of the HFF for the first half of 2011, there was a turnaround in the operations of the Fund from the beginning of the year, yielding a profit of ISK 1.6 bn. The equity of the Fund amounted to ISK 10.1 bn at the end of June and the equity ratio was 2.4 percent. The entire profit is due to reversed loan impairment, as actual impairment was much less than originally estimated. The number of residential properties owned by the HFF has risen steadily, to 1,377 as of end-June. Some 42 percent of these properties are being rented out. In the first half of the year, the HFF appropriated 388 properties and sold 80. The appropriation of the Treasury in the 2010 supplementary fiscal budget of ISK 33 bn was mainly used to meet the planned write-down of personal mortgage. The equity ratio remains below the required 5 percent.

The elements of risk of the HFF pertain to its lending, liquidity, interest and inflation, repayments, refinancing and current operations. The lending risk of the Fund is by far the most important risk element, which is reflected in the fact that the Fund's loss last year is largely due to the decline in the value of its lending book by ISK 34 bn at the end of June 2011. However, the lending risk of the HFF is smaller than that of the banks because of stricter lending rules. The maximum loan is ISK 20 million or 80 percent of the assessed value according to the official property register. All the loans of the HFF are made in ISK. The interest risk is also an important element, since net interest income is a large item of the Fund's operation statement. The low equity ratio of the Fund makes it more difficult to meet risk elements in the Fund's operation, and the financial risk of the Fund is therefore commensurably greater.

Landsvirkjun

The financial situation of Landsvirkjun is satisfactory. The consolidated operating profit before depreciation amounted to USD 179.2 million for the first six months of 2011, and the equity ratio was 34.9 percent. The company's liquidity was strong, its cash and revolving credit lines were adequate and the consolidated company was in a good position to meet repayments of loans for the next several years. The company is expected to be able to meet its commitments until the end of 2012, even if no access to new borrowing were available. The financial risk of Landsvirkjun consists of market risk, liquidity risk and counterparty risk. The market risk of the company towards the price of aluminium was diminished to some extent by a new contract between Landsvirkjun and Alcan of Iceland. The linkage to the price of aluminium in the earlier contract is thereby abolished and all sales of electric power to Alcan are linked to the US consumer price index. The share electricity sales of Landsvirkjun that are linked to the price of aluminium are therefore reduced significantly, or from 76 percent to about 50 percent in 2011. The operations of the company continue to be sensitive to aluminium prices, but good risk protection and a broader income base will ensure a good cash flow in coming years. The risk of refinancing has been reduced through the spread of repayments and interest and with long maturities of outstanding debt. The weighted average maturity of outstanding loans is about 7.5 years at the end of June 2011. It is therefore seen as unlikely that the state guarantee will have to be activated over the next several years.

3.2.2.2 Other indirect liabilities of the Treasury

A number of indirect liabilities of the Treasury may be classified as implicit contingent liabilities. Such liabilities are not legally binding and will only be activated under certain conditions where it would be considered advantageous for the economy as a whole that the Treasury would step in and provide financing in order to safeguard the national interest. An example of such liabilities that are not legally binding pertains to the Icesave issue before the EFTA Court. A certain risk is also associated with the weak financial situation of local governments.

Icesave

Following the rejection of the so-called Icesave agreement in a national referendum on Act no. 13/2011 on 9 April 2011, the Icelandic Government sent the EFTA Surveillance Authority a response to the Authority’s Letter of Formal Notice on 2 May 2010. In the response the Government maintained that it did not fail to comply with its obligations under Directive 94/19/EC and urged the Authority to conclude the matter without further action. On 10 June 2011 the EFTA Surveillance Authority sent its reasoned opinion to the Icelandic Government on the Icesave issue and gave the Government three months to take suitable measures to comply with the opinion. The Authority´s opinion was answered on 30 September 2011 where the demand was reiterated that the Authority should drop the case. On 14 December 2011 the Authority decided to take Iceland to the EFTA Court over its breach of the Deposit Guarantee Directive.

The uncertainty surrounding the final outcome of this court case makes it impossible to estimate the cost that may fall onto the Treasury. Some uncertainty has been eliminated with the verdict of the Supreme Court on the constitutionality of the Emergency Act last October.

According to the revised asset valuation of the resolution committee of Landsbanki Íslands as of 17 November 2011 the recovery of assets of the bankrupt estate continues to improve. There is an overwhelming likelihood that the assets of the estate will suffice to pay all the claims that the resolution committee has defined as priority or senior claims, including the claims of general depositors, which currently are to a large extent the property of the deposit insurance funds of the UK and the Netherlands. In the beginning of December, the winding-up committee of Landsbanki paid out approximately one third of outstanding priority claims. The payment of the remaining priority claims will be distributed over the coming years in line with the recovery of assets of the estate.

The cooperation of the public and private sectors

Public-private partnerships can embody some financial risk for the Treasury even if no state guarantee is involved. Although such partnerships embody limited risk for the Treasury, however, situations may arise where projects need more capital than anticipated in the planned fiscal budget. The main partnerships are the construction and operation of the *Harpa* Concert Hall, large scale infrastructure investment projects and the construction of Landspítali, a new state hospital.

Ríkiskaup, the State Trading Centre, administers and monitors purchasing by public agencies and provides guidance and assistance on purchase contracts. The financial aim of this arrangement is to increase purchasing efficacy in order to strengthen and maintain competition in the market and build markets where they do not exist.

According to the Financial Reporting Act, Althingi must approve contracts of this type. The Ministry of Finance can also issue instructions on the preparation of service contracts and contracts on public-private partnerships.

Authorisations in the fiscal budget

The largest item of authorisation to the Minister of Finance is due to the settlement of accounts of Landsbanki and SpKef savings bank in March 2011. According to the agreement between the Treasury and Landsbanki, the latter was entrusted with the valuation and a due diligence review of the assets and liabilities of SpKef. The agreement stipulates that the parties can review the asset valuation and provide reasoned proposals for amendment. Due to a disagreement on the asset valuation, the matter was referred to an arbitration panel. The decision of the panel is binding for both parties regarding the financial settlement of the agreement. The likely payment to Landsbanki on account of the settlement of the difference between assets and liabilities of SpKef Savings Bank is estimated between ISK 15-30 bn. Still, it is evident that with the takeover of Landsbanki of SpKef Savings Bank, that the Treasury will not be obligated to provide about ISK 8 bn in an equity contribution, which it had otherwise been forced to. Had SpKef not been taken over, such a contribution would have been necessary to satisfy the minimum equity requirement of the FSA.

3.3 Quality of public finances

A proposal for a new organic budget law (OBL) is being formulated by the Ministry of Finance, in order to improve the quality of central government finance and budgetary proposals. The OBL is further discussed in chapter 3.5.

Central government investment

The Government has developed a National developement programme for financing infrastructure projects needed to make the *Iceland 2020* policy succeed[7].

The programme is intended to provide a comprehensive overview of public investment for the coming years. In the programme a funding priority is defined within the expenditure framework in force. The Government's target for investment is set in the medium-term fiscal plan for 2012-2015.

The programme supports the development of infrastructure, such as the construction of buildings, transport and equipment for sectors including health care, education and safety at sea. Some of these projects can be implemented within a year while others take years to conclude.

Total investment is estimated to range between 1 to 1.4 percent of GDP a year. The majority of public investments concerns transportation, construction and maintenance. Total public investment in 2011 was close to ISK 23 bn. Several projects were added during the year, including road construction in the Westfjords, maintenance of government building and office space, additional expenses for avalanche and landslide safeguards.

Costs for additional projects are either funded by budgetary appropriations from previous years or supplementary budgets. Around 60 percent of funding for investment is directed through the Ministry of the Interior.

Table 9: Central government investment (construction and maintenance) divided by ministries

Ministries	Expenditure 2011 (ISK m)	Budget 2012 (ISK m)
Government Offices	34	58
Prime Minister's Office	198	91
Ministry of Economic Affairs	-	-
Ministry of Finance	4,081	2,890
Ministry of Industry		69
Ministry of the Interior	13,138	12,232
Ministry of Education, Science and Culture	2,280	1,921
Ministry of Fisheries and Agriculture	144	141
Ministry for the Environment	878	1.187
Ministry for Foreign Affairs	76	74
Ministry of Welfare	2,135	2,013
Total expenditure	**22,965**	**20,676**

Source: Ministry of Finance

Major investments

Several large scale investment projects are underway in 2012. Only some of the projects are fully funded by the central government, however, the central government remains an integral part in their development. These include a new national hospital project, a new state prison and major road, tunnel and harbour projects.

Furthermore, the Government is involved in several other projects, for example to increase the number of nursing homes nationwide. Construction work has already begun in five municipalities.

[7] Iceland 2020 is a policy statement for an efficient economy and society, further discussed in chapter 4.2.5.

The Treasury will finance these projects with rent payments to the municipalities. Preparation is also underway for the construction of five additional nursing homes, with the estimated construction cost of all the homes around ISK 10 bn.

3.4 Sustainability of public finances

The Icelandic authorities are presently not conducting quantitative analysis of the long-term sustainability of public finance. However, this topic is gaining focus in European countries in light of the envisaged trends in pension and health care expenditures. The Icelandic pension system differs in many respects from those of other European countries and 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. This is different from the pay-as-you-go pension schemes which are more common in other European countries. Furthermore, the imbalance between generations is lower in Iceland, in part because of a higher birth rate and a retirement age of 67 from the labour market. However, to enable scenario analysis and long-term projections, with the purpose of supporting the development of long-term fiscal policies, a long-term public finance sustainability model is necessary. Preparation for such a programme is ongoing between relevant ministries and institutions.

3.5 Institutional features of public finances

According to the medium-term fiscal plan, proposed in 2009, public entities have been forced to search for new and improved ways to fulfill their obligations given the fiscal consolidation efforts of the last few years. Within the central government the focus has been on strategy, rules and regulations to support this goal.

Four main developments are taking place. First, a plan has been formed to achieve a balance in Treasury finances. Second, a complete review on the law on public finances is taking place, set to end by May 2012. Third, in relations with Iceland´s application for EU membership a thorough gap analysis is currently being implemented to register any discrepancies between Icelandic public internal financial control and external audit and EU standards, and to analyse best practices. Finally, new local government act includes a provision on fiscal rules for local government.

3.5.1 Treasury finances

The Government’s plan to achieve a balance in Treasury finances is primarily based on four pillars:

1. Numerical goals to guide the adjustment of central government finances until 2015 (further discussed in chapters 3.1.1 and 3.1.2.).
2. The strengthening of the framework of Treasury finances. With the passage of the 2011 budget, a fixed expenditure frame in nominal terms was for the first time set for two years. For the years 2011 and 2012, the frame for total expenditure was 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, which will therefore not be amended at a later stage. Any increase that may be decided for individual expenditure categories must be offset with commensurate cuts in other categories. When formulating this policy, it was assumed that the guidelines for expenditure frames for 2013 and 2014 might be revised in the spring of 2012 given, for example, various changes in wage and price assumptions. 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. The National Audit Office issues reports to the Althingi each year on the implementation of the budget, including whether and how institutions and agencies have followed the Government Financial Reporting Act and Regulations on the implementation of the budget. Furthermore, the budget forecast is now based on macroeconomic assumptions put forward by an independent research department at Statistics Iceland, previously handled by the Ministry of Finance.
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 2012 in line with previously published plans.
5. The financial framework of local governments has been strengthened.

3.5.2. Comprehensive review of the law on public finances

In 2011, the Government launched an overhaul of current budget processes with the purpose of drafting new organic budget laws (OBL). This includes the re-evaluation of laws, regulations and procedures that directly and indirectly shape fiscal decision-making. The purpose is to improve the quality of public finances by establishing a holistic institutional thinking to the budget process and ultimately acquire a long-term equilibrium between public expenditures and revenues. The Ministry of Finance supervises this overhaul and plans to introduce a new bill on OBL to the Cabinet and Althingi by May 2012.

Fiscal policy in Iceland has for many years been characterised by pro-cyclicality, relatively weak budget discipline, lack of accurate coordination between levels of government, and a somewhat inadequate surveillance and management of fiscal risks. The current budget framework encompasses a relatively fragmented budget formulation process and includes loopholes allowing the governments to overspend with limited if any impunity. The scope of current laws lacks a more holistic approach to budget formulation and monitoring of public funds, the law is relatively silent on procedures regarding the making of economic policy and its relevance to fiscal policy, the coverage of the law is limited to the central government thus excluding municipalities and their corporations, the laws do no state clearly principles and procedures for macroeconomic forecasting and fiscal policy making and how it should be linked to the annual budget´s premises, and Althingi surveillances needs to be improved. Finally, the presentation of state budget and final accounts needs to be more comparable allowing for increased transparency.

New OBL may likely incorporate a set of fiscal responsibility provisions that oblige each new government to articulate and adhere to a comprehensive, legally binding and independently monitored fiscal strategy. Another key component of the planned OBL will be a comprehensive and realistic set of rules that guide fiscal decision making. It will ensure an inherent link between government medium- and long-term economic objectives, establish timely discussions in Althingi about government fiscal strategy, ensure proper cash management of both central and local governments, support clear and concise presentation of public accounts that follow international standards, and finally guarantee ex-ante surveillances to ensure proper use of public funds.

The aforementioned overhaul of laws and regulations on the budget procedures serves as a tool to provide a firm legal foundation for sustainable fiscal policy and strengthen the overall image of public finances in Iceland.

3.5.3. Gap analysis on Icelandic and EU standards

In relation with the application for EU membership a thorough gap analysis is being executed to compare the Icelandic public internal financial control and external audit with EU standards and analyse where and how best practices are taking place. As the discussions on chapter 32 of the *acquis communautaire* covering financial control started, it became apparent that Iceland would need to explain how financial control is handled and how it will be comparable to EU standards.

Before the bilateral meeting on chapter 32 Iceland made an initial gap analysis and identified internal audit to be a weak point, in addition to a few other areas. As a consequence it became evident that a more thorough gap analysis would have to be performed. Iceland requested assistance within the TAIEX program and in December 2011 two experts visited Iceland. Their analysis will result in a report on the gaps identified and recommendation on where Iceland must strengthen its financial control system.

3.5.4. Fiscal rules for local governments

In September 2011 Althingi passed a new act on local governments, act no. 138/2011. In this new act there are two main fiscal rules for local governments, a balance rule for current operation and a debt rule.

According to the first rule, local governments are obligated to balance total revenue and expenditure over each three year period. This means that the room for manoeuvre in the budget for the following year will depend on the operation results of the previous year and the estimated outturn for the current year.

According to the second rule, local governments should limit their total debt and liabilities to 150 percent of total revenue. Local governments with debt and liabilities above 150 percent are expected to bring the debt ratio under the 150 percent benchmark in 10 years. Local governments with total debt exceeding 250 percent of revenue are prohibited from raising new debt except for refinancing. One exception of the rule is for the City of Reykjavík due to high debt of Reykjavík Energy, due to investment in the energy sector being by its nature finance-intensive and with a long repayment period. The local governments with the most robust finances are given more flexibility than those that are worse off. Municipalities are divided into three groups depending on their standing:

1. Local governments with debt below 150 percent of total revenue and with a surplus on operations for the past three years combined. The monitoring of these municipalities is largely unchanged from how it was before the new act.
2. Local governments with debt in the range of 150 to 250 percent of total revenue or a deficit on operations over the past three years combined. These municipalities must prepare a careful financial plan and firmly implement it. Outside monitoring is in place regarding borrowing and investment possibilities.
3. Local governments with debt in excess of 250 percent of total revenue or those that have not followed the repeated instructions of the monitoring committee regarding their finances. These municipalities must make a binding agreement with the authorities or be placed under financial management.

4. Structural reform objectives

4.1 Obstacles to growth and structural reform agenda

The reform agenda with regard to structural issues is mainly set out in the Government's *Iceland 2020* programme, further discussed in chapter 4.2.5, with overriding focus on wide ranging infrastructure reform. Innovation, job creation along with human capital and regional development are key concepts on which the programme is based, following a democratic dialogue throughout Iceland during the last two years. It should however be underlined that proposed growth and structural reform agenda will need to address important obstacles which remain unsolved.

One obvious obstacle is the international environment which is extremely fragile at the moment, making investment decision in export sectors such as tourism riskier than before even though Iceland has gained considerable attention in the global arena recently partly due to exceptional geological events. Given the current negative outlook for global demand and continued uncertainties surrounding financial and sovereign debt issues, particularly in Europe, Iceland's recovery could well be negatively affected. Other important obstacles to growth in the short term are mostly related to the ongoing restructuring tasks, particularly in the financial sector. With non-performing loans still accounting for 25 percent of the total loan-portfolio of the largest banks, the financial sector cannot properly fulfil its function. Also, with capital restrictions still in place, proper functioning capital markets remain lacking. However, assuming that ongoing debt restructuring efforts will continue as planned, the balance sheet position of the household and corporate will improve in the interim paving the way of increased investment activity in the short to medium term.

In the long-term, Icelandic companies will need to maintain competitiveness on a global scale in order to secure economic prosperity on par with neighbouring countries. The issue of export sector diversification and reliance on natural resource based exports has resurfaced as an overriding issue of economic policy and structural reform agenda. This is particularly relevant, now that the conditions in the export sector have become extremely favourable as the real exchange rate has plummeted in the wake of the banking crisis. For other domestic sectors competing with export companies for labour and capital the current situation may prove untenable if proper policies and structural reforms are not in place. The most important reform area in this respect relates to the fishing sector issues and resource rent taxation. In essence, this means that the Government has to be particularly attentive to the disparities that high real exchange rates can create between the various sectors. If a satisfactory equilibrium cannot be struck between the tradable and the non-tradable sectors, there is a danger that the competitive advantage Iceland gained with its low exchange rate will rapidly fade away. If this were to happen, investment would be less likely to increase to the level required. This would undermine the Government's objective of achieving sustainable growth and recreate a climate of instability and debt accumulation.

4.2 Key areas of structural reform

4.2.1 Enterprise sector

In 2010, two public- owned companies, Keflavik, International Airport and Flugstoðir ohf. (operating Icelandic airports and air navigation services) were merged into one public- owned company, ISAVIA. In the same year, a new state ownership company was established around the new national hospital building. No other changes have been made regarding the public ownership from the last PEP 2011, except in relation to the banks restructuring, and there are no plans for privatisation.

Upon the collapse of the banks in October 2008, Althingi passed the so-called Emergency Act, no. 125/2008. Shortly thereafter the Treasury took over all Icelandic commercial banks, new banks were founded and the FSA 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, see chapter 4.2.2. On the other hand, the Treasury became the largest shareholder in Landsbanki and a minority owner in both Íslandsbanki and Arion Bank. 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, which together compose a miniscule share of the banking sector. Today, the Icelandic State Financial Investments is developing a study on the future status of the savings banks sector. The Ministry of Finance, the Ministry of Economic Affairs and the Prime Minister's Office are also working on a new ownership policy for the public holdings in the financial sector, with a special focus on the future of the savings banks system. Currently, the Government plans to generate significant revenue in the medium-term from its holding of financial undertakings, either from asset sales or collecting dividends. In the beginning of January this year, state ownership in commercial banks and savings banks was as following:

Table 10: State ownership in commercial banks and savings banks in January 2012

Commercial banks and savings banks	Public ownership %
Arion Bank	13.0
Íslandsbanki	5.0
Landsbankinn	81.3
Sparisjóður Bolungarvíkur	99.9
Sparisjóður Norðfjarðar	49.5
Sparisjóður Vestmannaeyja	55.7
Sparisjóður Þórshafnar og nágrennis	75.8

Source: Icelandic State Financial Investments

Regional plan

The Government will implement a Strategic Regional Plan for 2010-2013. The strategy is based on measures in innovation and economic development, in keeping with other strategies pertaining to the preparation of the governmental policy on development, *Iceland 2020*. The principal objective of the plan is to improve conditions for residence, innovation, and sustainable development in all parts of Iceland, and to strengthen the education, culture, communities, and competitive position of towns and communities nationwide through a variety of measures. In order to achieve the objectives of the regional plan, the following measures will be taken. They are divided into nine key areas:

1. **Employment strategy.** At the core of the employment strategy are the improved competitiveness, innovation, and sustainability of the economy, based on the strength and uniqueness of each region or economic sector, as well as education, research, and a variety of cultural and societal characteristics.
2. **Integration of strategies and enhanced co-operation.** The integration of government strategies, including those in regional development, education, energy, transportation and communications, and cultural affairs, is conceived with the aim of improving performance for the benefit of the economy and of general living conditions, as well as utilising funds more efficiently.
3. **Strengthening of economic support systems.** This aims, among other things, at simplification and enhanced efficiency in the economy. It is accomplished in part by emphasising *growth pacts* based on clusters and regional knowledge centres that integrate interdisciplinary fields and local emphases, characteristics and strengths, and are likely to enhance success in innovation and economic development.
4. **Innovation and start-up companies.** There will be three types of support for innovation and start-up companies. First, through the educational system and the economic support system, such as the Icelandic Regional Development Institute and the regional industrial development agencies, Innovation Center Iceland, and funds for the support of innovation, economic development, and start-up companies. Second, through tax incentives for investment in innovation companies and reimbursement of research and development expense. Third, through defined projects, clusters, or official emphases, such as increasing the share of domestic environment-friendly energy used in transport or developing methods to utilise or sequester carbon dioxide from industrial emissions.
5. **New foreign investment in the domestic economy.** In addition to domestic innovation and economic growth, which can be called "organic growth", it is important to contribute systematically to new foreign investment in Iceland. Framework legislation on incentives for investment will cover areas defined on the EFTA Surveillance Authority Icelandic regional aid map. It is important that economic regional development agencies collaborate with the Invest in Iceland Agency in promoting the salient advantages and strengths of their regions.
6. **Promotion of tourism.** After several years of rapid growth, product development, and innovation, tourism is one of the pillars of the Icelandic economy, generating one-fifth of the nation’s foreign exchange revenues. It is important to build on existing strengths and market them to foreign tourists in particular, while ensuring quality and engaging in further product development. Special attention should be given to areas such as health and lifestyle tourism, which emphasise the uniqueness of Icelandic wilderness, products, and natural resources.
7. **Social capital.** The social capital of each region is the foundation for its economy, services, and general participation in community-building. Social capital is therefore a major determinant of general living conditions and competitiveness. Education, culture, social activities, democratic participation in policy-making and vision for the future are all factors of importance. Equal rights and the participation of both sexes in the economy and community-building merit particular attention.
8. **Promotion of cultural activities and creative sectors.** Culture and arts play an increasingly important role in innovation and economic development nationwide and therefore make a positive impact on regional development. Regional cultural agreements have proven successful. They support cultural and artistic diversity in regional Iceland and strengthen the ties between the arts and cultural tourism. It is important to strengthen the foundations of creative sectors by increasing the emphasis on education in creative fields. Cultural and growth agreements can be used to this end, and extensive collaboration can be established among local knowledge and

cultural centres, upper secondary schools, and continuing education centres so as to promote education in creative disciplines.

9. **Equalisation of living conditions.** Particular emphasis shall be placed on maintaining the same standard of living throughout the country. The first measures in support of this will focus on equalisation of the cost of home heating and the transport of goods for households and businesses in regional Iceland.

Regional transporting aid

In December 2011, Althingi passed a new Act No. 160/2011 on Regional Transporting Aid Scheme. This scheme is designed to fall under the *de minimis rules* of the EEA Agreement and is therefore exempt from the notification requirement of Article 1(3) in Part I of Protocol 3 to the Surveillance and Court Agreement. The Act is however, largely based on the regional transport aid scheme in Norway, approved by the EFTA Authority (Dec. No. 143/07/COL) and the regional transport aid scheme in Sweden, approved by the European Commission (State aid No. N 637/2005).

The aim of the transport aid scheme in Iceland is to promote the manufacturing industry and support growth in regions situated far from central areas, in accordance with the Icelandic version of NACE rev.2, that suffer from competitive disadvantages due to higher direct transport costs. The scheme will apply to manufacturers located in regions within the area eligible for the National Regional Aid for the period of 2007-2013 as defined in the Authority's Decision of 6 December 2006 No. 378/06/COL on the regional aid map of assisted areas for Iceland. The stretch of the journey must however, exceed 244 kilometres and is differentiated into two geographical zones. Zone 1 will receivea 10 percent grant and for Zone 2, 10 percent and 20 percent.

The Act will expire on 31 December 2012 but before that time, the scheme will be re-evaluated and new calculations of transport cost made.

Competition policy

In February 2011, Althingi adopted changes to Article 16 of the Competition Act No 44/2005, with the aim of strengthening competition. After the amendments made, the Competition Authority can take action against circumstances or conduct which prevents, limits or affect competition to the detriment of the public interest. The actions of the Competition Authority may include any measures that are necessary to enhance competition, including structural remedies of a company that has a dominant position in a given market, even though the company is not in violation of the Act's ban provisions. According to the explanatory memorandum of the Act, a company can have such a dominant position in a given marked that its mere existence prevents or distorts competition to a considerable degree and that such a distortion can be just as serious for consumers as a breach of the Act's ban provisions.

Energy policy

A new Energy Strategy for Iceland was formulated in 2011. The task was undertaken by a steering group, appointed by the Minister of Industry, Energy and Tourism. The steering group concluded its work and delivered a report to the minister in November 2011, which was subsequently submitted to Althingi as a ministerial report. The report establishes a comprehensive policy for Iceland. The key objectives of Iceland's Energy Strategy are to reduce the use of fossil fuels by cutting down on the need for imported fuels to the extent possible. In addition, the aim is to increase the lifetime of fuel stocks, exploring the costs and benefits of joining the International Energy Agency (IEA) and the contingency plan for disruption in oil supply, and preparing a contingency plan on prioritisation of use and rationing of fossil fuel if disruption occurs in imports.

Oil amounts to 20 percent of Iceland's primary energy consumption. It is expected that Iceland's energy stemming from imported fossil fuels will decrease considerably in the coming years. Systematic steps have been taken to this effect, i.a. with various incentives programmes.

The share of renewable energy in the transport sector is currently less than 1 percent. However, an ambitious goal of 10 percent for transport, for the year 2020 in line with Directive 2009/28/EC, has been put forward by the Government in two recent Government documents, the Energy Strategy and the "*Green Energy – Ecological Energy in Transport and Communication*". As stated above, one of the primary objectives of Iceland's Energy Strategy is that renewable energy sources in general replace imported energy, mainly fossil fuels in the transport sector. In accordance with the Energy Strategy and the Green Energy, an action plan is currently being formulated and will stipulate in detail how the target of 10 percent will be achieved, year by year until 2020. It should be noted that the Ministry of Industry, Energy and Tourism along with the Ministry of Finance, have already introduced economic incentives and active programmes to promote the objective of increasing alternative fuels in the transport sector. The first phase of the project is therefore already underway but a more detailed action plan is in process in line with the recent policy documents referred to. Furthermore, the preparation of the action plan is in accordance with the obligation under Directive 2009/28/EC of setting up a National Renewable Energy Action Plan (NREAP) and is foreseen to be finalised in the first half of 2012. The action plan will i.a. contain milestones and progress will be monitored on a regular basis.

Utilities and network industries

Electricity networks are owned by Landsnet, a publicly owned company. Legally, public entities must be majority owners of any distribution company (public utilities), which distributes energy and/or hot or cold water. The National Energy Authority (Orkustofnun) monitors distribution networks, pricing and competition in the energy sector.

4.2.2 Financial sector

Substantial progress has been made over the past three years in rebuilding and restructuring the financial sector, its regulatory framework and supervision. Laws and regulations have been reformed, cooperation between supervisory agencies has been strengthened, and the number of staff at the Financial Supervisory Agency has been increased substantially.[8]

In addition, the banks have been recapitalised and now possess sufficient resources to carry out the required debt restructuring for households and firms. Additional actions need to be taken to allow the banking sector to fully serve its financial intermediation role. The current priorities for the Government are to secure increased rationalisation in the banking sector, more effective intermediation of savings to profitable investment projects and strengthening of the financial markets. Financial conditions of households and firms have been improving in recent months and credit has started to ease again with debt restructuring progressing and asset prices rising. Limited lending for new projects, however, suggests that financial conditions remain tight nonetheless.

The Minister of Economic Affairs will in early 2012 present to Althingi a report on the future structure of the Icelandic financial system. This report will look into such questions as the possible separation of investment and retail banking, potential governance structure for the use of macroprudential tools and comprehensive legislation for the financial market. On the basis of this report, a group of domestic and international experts will draft possible legislative proposals that are to be submitted to Althingi before year-end 2012. At the same time, macroprudential tools are being considered by the Central Bank of Iceland and the Ministry of Economic Affairs.

Extensive rationalisation is taking place in the banking sector, with the former savings bank Byr merging with Íslandsbanki, thus leaving four commercial banks in the system: Landsbanki, Íslandsbanki, Arion bank, each with around a 1/3 of total assets and MP bank, which is much smaller than the other three. All the commercial banks are "universal banks". Althingi's Special Investigation Commission regarding the banking crisis noted that the banks had all moved their focus increasingly towards their investment banking operations from the traditional commercial banking foundations. The Government is therefore considering some form of separation between the two. The operational costs of the Icelandic banks remain high in international comparison and the Government favours further operational restructuring in the sector. High costs are associated with extensive debt restructuring currently being carried out in the Icelandic banks. In other large systemic banking crises, it has taken the banking sectors 3 to 5 years to overcome the effects of the crises. However, the high concentration in the banking sector needs to be taken into account for the importance of the active competition in the sector. The Icelandic banking sector measures at around 3,000 points according to the Herfindahl-Hirschman Index, according to which sectors with over 1,800 points are considered highly concentrated. The Competition Authority has stated that it "is of the opinion that extremely serious competition problems can result from the merger of commercial banks, at least in the instances where one or more of the larger banks are party to such merger."[9]

The government owned Housing Financing Fund continues to play an important role, both from the viewpoint of social and financial sector policies. To secure the social policy role of the fund, the maximum loan to value (LTV) (either purchase value or building cost) is set at 80 percent and maximum loan amount at ISK 20 million. In addition, a minimum LTV is also to be set at 40 percent to prevent lending for housing over ISK 50 million. The HFF's lending to companies will also cease while lending to rental companies will be allowed in certain instances. The high costs from refinancing of

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[8] The total number of staff is expected to be 143 by end 2012, up from 87 in 2010.
[9] http://en.samkeppni.is/published-content/news/nr/1757

the HFF following the crisis have underlined the importance of strengthening the regulatory and supervisory framework for the fund, in order to safeguard the fiscal interests of the state, financial stability and the fund's important social role.

Deposit taking institutions have in recent months been increasing their market share in mortgage lending, up from around 10 percent in 2009 and 2010 to 27 percent on average in the first eleven months of 2011 (even 65 percent in November). This development is in part due to the banks' offer of long-term non-indexed loans. The Althingi has passed a law allowing the HFF to offer non-indexed loans.

Capital positions

The currently high capital ratios within the banking sector, discussed in chapter 2.2.5, will ease the transition to Basel III. Both the FSA and the CBI have begun preparations for the implementation of Basel III requirements. The authorities would, however, favour increased flexibility compared with the current CRD IV proposal for the development and implementation of firm macro-prudential tools required for Iceland's large banking sector compared with the small economy.

Return on capital of the banks' core business of the commercial banks has been around 10 percent and below the requirements made by Icelandic State Financial Investments. The interest margin has increased since 2009 and is currently around 3.4 percent. The increased margin can partly be attributed to lower deposit rates. The low turnover on the Icelandic stock market also affects the banks' possible revenues. The FSA and the Icelandic State Financial Investments have been working with the banks to increase the transparency and comparability of the banks' financial statements. This process is important to re-establish trust in the domestic banking sector.

Legal, regulatory and supervisory framework

Extensive amendments have been made to the banking sector's regulatory and supervisory framework over the past three years. 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. Increased demands are also made regarding qualification requirements of directors, managing directors and directors of pension funds. Rules have also been set on bonuses and employment termination agreements (golden handshakes). The legal framework for internal and external auditors has been strengthened and the role of auditors has been clarified further. These legal changes support regulatory amendments by the FSA, regarding related parties and large exposures, which the supervisor is currently finalising.

A Cooperation Agreement between the FSA 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 CBI 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 FSA.

Further changes in the rules and legal framework of financial companies are being concluded, including rules on equity capital, calculations of financial strength and operational authorisations for the individual types of financial companies.

A new tax on financial companies has been levied since 1 January 2012. The tax is 5.45 percent of their wage bill. The financial sector is not subject to VAT. The tax will therefore allow for a more level playing field between these firms and the remainder of the services sector. Banks also pay a tax of 0.0875 percent of total liabilities to finance their share in the special interest rebate for indebted households (ISK 6 bn for 2011 and 2012). A total of ISK 2 bn will be paid by the financial undertakings in November and December 2011.

4.2.3 Labour market

Unemployment insurance fund – benefit payments and amendments

The Unemployment Insurance Fund paid ISK 21 bn in unemployment benefits in 2011 compared to ISK 24 bn in 2010 and ISK 25 bn in 2009. In 2011, 24,900 people received unemployment benefits compared to 26,300 from the previous year. The number of recipients is expected to decrease to 21,500 in 2012 and to 16,500 in 2013. This is a positive sign, but it should also be taken into consideration that a number of those who received benefits have emigrated from Iceland.

The fund is financed by an employment insurance fee, paid by employers as a ratio of wage earners' total wages. In 2009, the fund could not cope with the increased number of unemployed. Therefore the Treasury had to make up the difference amounting to a total of ISK 14.4 bn. In 2010 and 2011, the fund however, generated a surplus resulting in a reduction of the insurance fee in correspondence with the reduced funding needs of the fund.

The fund paid special leave payments to the unemployed on two occasions in 2011, amounting to just over ISK 1 bn. One payment occurred in the summer, according to a provision in the wage contracts, and another in December.

In December 2011, Althingi accepted a new transition provision to Act no. 5/2009 on Unemployment Insurance by extending the maximum benefit period to four years or to 31 December 2012 instead of 30 June 2012. However, a provision authorising benefits for reduced work percentage was not renewed and expired on 31 December 2011.

Labour market measures and special programmes

In 2011, 11,500 recipients participated in special labour market programmes (approx. 46 percent of those who received benefits in the same year), including on-the-job training programmes, educational programmes and other measures offered by the Directorate of Labour. About 1,400 recipients participated in job training or similar training involving innovation projects, 2,500 recipients signed an apprenticeship agreement for up to one semester and 2,000 participated in language courses, specially offered to foreigners to learn Icelandic. Other programs were more linked to short occupational courses.

Recently the Directorate of Labour conducted a survey, which illustrates that over 60 percent of participants deregistered from the unemployment registry within three months of participating. The survey also shows that participation in job training and innovative projects were the most productive programmes. 60 percent of participants who started such programmes were deregistered three months later. Moreover, between 40 to 50 percent of those who signed an apprenticeship agreement in the beginning of the year 2011, were deregistered three months later. In comparison, the rate of deregistered from other programs ranged from 30 to 40 percent.

In order to stimulate on-the-job training, a programme was put in place, which provides employers with a grant amounting to basic unemployment benefits for each long-term unemployed recipient whom they hire for a period of up to twelve months. The aim is to offer 1,500 recipients jobs in 2012 in addition to other training activities.

In autumn 2011, a special educational initiative programme, organised in relation to the *Iceland 2020* policy, was launched in order to combat long-term unemployment. The aim of this programme is to encourage those who have been unemployed for six months or longer to sign up for studies and receive benefits during the first semester. Around 1,000 recipients registered for either college or university level education when the programme was implemented. The drop-out rate was low after the first semester and it is expected that some 800 of those who registered in the autumn 2011, will continue for the spring semester of 2012. They will therefore be deregistered, but can apply to the Icelandic Student Loan Fund if attending courses at university level or a special support grant from the Unemployment Insurance Fund.

Strengthening education

In accordance with the *Iceland 2020* policy, actions are currently being undertaken to boost education. In this context, secondary schools are expected to cater to all young people seeking education opportunities and to facilitate job seekers and companies’ access to job-related schemes. If successful, these measures will enable young job seekers to adapt to the labour market and increase the country´s educational standard.

In 2011, a committee was established by the Prime Minister to work on proposals to integrate the industrial policy and educational policy with a special focus on the creative sector, innovation and vocational training among young people. In this context, a longer-term education strategy will also be formed with regard to, among other things, the needs of the economy and investment policy priorities. The Ministry of Education, Science and Culture has started to review the Icelandic Student Loan Fund, consulting with the social partners. The goal is to establish a development fund for the purpose of strengthening job-related studies at various educational levels and develop shorter study programmes. The Workplace Study Fund will be set up with a contribution of ISK 150 m in 2012 to meet the costs of vocational training. Certified training and a quality control system are scheduled to be developed shortly to facilitate the evaluation of courses so that students' studies can be more easily evaluated in secondary schools. Collaboration will be sought with universities to achieve the same objective.

4.2.4 Agricultural sector

Iceland's agricultural policy and support instruments differ substantially from those in the European Union. Whereas in the EU, support payments have been decoupled from production, such payments in Iceland are largely linked, directly or indirectly, to production factors or quantities. Furthermore, the structure for administration of agricultural support is not in line with EU norms. These differences, as well as the divergent nature of agriculture in Iceland, will be core issues in the accession negotiations ahead.

The Government places strong emphasis on the sustainability and self-sufficiency of agricultural production in Iceland, as well as environmentally friendly production methods. Furthermore, a strong emphasis is placed on rural sustainability.

Fisheries management policy is being revised by the Ministry of Fisheries and Agriculture. The aim is to retain the efficiency and environmental objectives of the existing policy, while securing an equitable social contribution from the fisheries sector's utilisation of common Icelandic natural resources. A bill is expected to be put forth in Althingi during the spring 2012 session.

4.2.5 Administrative reform

In September 2011, Althingi passed a new legislation on the central government. The new law will have an impact on civil servants within the central government, facilitating the transfer of employees between ministries and enhancing cooperation between ministries. The changes within the ministries will positively affect administrative capacity.

Prior to the new legislation, the number of ministries was reduced from twelve to ten. A new ministerial committee is looking into further reducing the number of ministries to either nine or eight. The expected outcome is a merger of the Ministry of Industry and the Ministry of Agriculture and Fisheries into a new Ministry of Industries. Alongside this change the aim is to charge the Ministry of Environment with new tasks, making it the Ministry of the Environment and Natural Resources. Furthermore, the committee is evaluating the Ministry of Economic Affairs, which will either be strengthened or merged with another ministry.

The central government has also been taking measures to more constructively utilise project management and governance networks. Recently a committee on project and quality management with representatives of all ministries proposed various changes and harmonisation measures across the central government structure.

In December 2010 the Government published the policy statement *Iceland 2020*. The aim of the statement was to establish a future vision and objectify it with 20 goals and indicators and at the same time address the urgent need of cooperation between ministries within the government towards these goals with 29 common projects. Some of these have been implemented through joint governance networks. These networks and the cooperation around them have in the pilot year enhanced the governmental administration capacity to address public procedures and public projects as one.

4.2.6 Additional reform areas

4.2.6.1 Private debt restructuring

The restructuring of household and corporate debt has been one of the Government's most important tasks to restart investment and private consumption in the wake of the collapse of the banks.

The restructuring of private debt is now at a final stage, despite the fact that these measures are often complex and time-consuming, as the experience of other nations has demonstrated. Current figures indicate that substantial results have been achieved in the restructuring of debt. The write-downs stemming from the recalculation of loans denominated in ISK, linked to the exchange rates of foreign currencies, have now been completed, as far as households are concerned, with some rare exceptions.[10] Financial institutions expect that by mid-2012 they will have completed corporate debt restructuring to all eligible clients. Uncertainty still surrounds a number of court cases regarding foreign exchange loans, which could influence proceedings. Following the completion of debt restructuring, it is important to ensure that the framework for households and businesses can adapt to evolving circumstances. This will be based on the guiding principle of ensuring equal treatment of people on the residential property and rental market.

In December of 2010, the Government, credit institutions and pension funds signed a declaration on measures for households with debt problems. It is estimated that the total write-down of household loans will amount to ISK 200 bn, around 12 percent of GDP. By the end of November 2011, household loans had been written down by ISK 193 bn. ISK 143 bn of this amount was due to the recalculation of foreign currency-linked loans, which were divided between mortgages amounting to ISK 104 bn and car loans amounting to ISK 39 bn.

Corporate debt has decreased significantly, due to restructuring and bankruptcy proceedings. The FSA and the Competition Authority strive to ensure that corporate debt problems are solved efficiently. The FSA has defined capital adequacy ratios and improved its collection of data on defaults on loans in order to be able to better analyse the results of debt solutions and risk factors. The Competition Authority will continue to ensure that financial undertakings do not overburden companies with debt in the debt restructuring proposals they offer. Furthermore, the Authority has applied strict terms for the selling of companies financial institutions have acquired. Overloading companies with debt could incur fines and penalties in accordance with the Competition Act. The Ministry of Economic Affairs will continue to monitor corporate debt solutions and exert pressure on financial institutions to accelerate debt restructuring initiatives.

In order to monitor and analyse household and corporate debt, Statistics Iceland has been given the task to establish a permanent database and collect sources to provide statistical information for the public about the trends in household and corporate debt, equity and payment difficulty. Statistics

[10] The Supreme Court of Iceland ruled these loans illegal in September 2010.

Iceland will take into account the marital status, family structure, age, income and equity regarding households, and property, legal form, size, age and industry regarding corporate. The first figures will be published before year-end 2012 and then on a quarterly basis.

4.2.6.2 FDI performance

Foreign direct investment in the Icelandic economy has been small compared with neighbouring countries. In 2010, foreign direct investment flow was ISK 30 bn or 2 percent of GDP, primarily due to investments in energy. Table 11 contains information on foreign direct investment flows in 2010, by sector and their share in GDP.

Table 11: Foreign direct investment flow

ISK millions	2005	2006	2007	2008	2009	2010
Industrial sector:						
Agriculture, fishing, mining and quarrying	-4	-5	-4	-134	230	809
Manufacturing	42,988	83,427	-64,342	-680	-21,770	15,797
Electricity, gas and water	-	-	-	-	15,520	18,317
Construction	194	1,058	1,820	424	1,199	-786
Trade, repairs, hotels and restaurants	53	13726	554	-4469	196	186
Transportation and storage	1,241	3,297	30,206	-32,056	11,852	1,516
Information and communication	1748	-1576	1347	-1672	831	15
Financial and insurance activities	146,898	166,169	185,524	68,697	1,761	137
Holding companies	3997	9773	285991	52233	195	-6,494
Professional, scientific and technical activities	-3,696	-6,160	-3,933	-1,450	-275	469
Total amount	**193,419**	**269,709**	**437,163**	**80,883**	**9,739**	**29,966**
Share of FDI in GDP	**18.9%**	**23.1%**	**33.4%**	**5.5%**	**0.7%**	**1.9%**

Source: Central Bank of Iceland

The environment for investment has been criticised for being complex and inaccessible. Investment is however, paramount for economic growth in Iceland, following the financial crisis. In December 2011, the Government agreed on a proposal for a parliamentary resolution on foreign investment. The proposal emphasises the importance of investment in the Icelandic economy and calls for transparent administration regarding foreign investment and clear and unambiguous regulations, concerning the subject. Neighbouring countries focus on a dependable and secure legal environment for foreign investment and strong fundamentals support new foreign investment. If the proposal is passed by Althingi, it will commission the authorities to seek investment which:

1. Supports economic diversification
2. Supports environmental protection and sustainable utilisation of resources
3. Uses new technologies
4. Secures the maximum added value through the chain of production
5. Supports relatively high job creation and creates a high rate of high worth jobs
6. Supports research and development and the acquisition of new knowledge
7. Is profitable and provides relatively high tax revenue
8. Creates new opportunities or opportunities which are considered desirable to support current domestic activity

Annex: Statistical Appendix

Annex Table 1: Macroeconomic prospects

Percentages unless otherwise indicated	ESA Code	Year 2010	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
		Level (bn EUR)	Rate of change				
1. Real GDP at market prices	B1*g	5.233	-4.0	2.6	2.4	2.5	2.8
2. GDP at market prices	B1*g	9.479	2.6	6.7	7.5	5.2	5.7
Components of real GDP							
3. Private consumption expenditure	P3	2.678	-0.4	3.1	3.0	2.9	3.1
4. Government consumption expenditure	P3	1.258	-3.4	-1.3	-0.9	-0.1	0.6
5. Gross fixed capital formation	P51	0.600	-8.0	8.5	16.3	7.2	9.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+ P53	0.060	- 0.055	0.045	-0.025	-0.003	-0.003
7. Exports of goods and services	P6	2.405	0.4	2.7	1.4	2.1	2.2
8. Imports of goods and services	P7	1.768	4.0	4.0	3.5	2.7	3.5
Contribution to real GDP growth							
9. Final domestic demand		4.5	-2.0	2.3	3.3	2.5	3.0
10. Change in inventories and net acquisition of valuables	P52+P53	0.1	-1.0	0.5	-0.3	0.0	0.0
11. External balance of goods/services	B11	0.6	-1.1	-0.1	-0.5	0.0	-0.2

Real GDP is calculated at year 2000 constant prices

Annex Table 2: Price developments

Percentage changes. annual averages	ESA Code	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
1. GDP deflator		6.9	4.0	5.0	2.7	2.8
2. Private consumption deflator		3.4	4.2	4.5	2.7	2.5
3. HICP		7.5	4.2	-	-	-
4. National CPI change		5.4	4.0	4.2	2.9	2.5
5. Public consumption deflator		4.0	4.3	4.1	3.0	2.6
6. Investment deflator		3.7	4.1	5.0	2.6	2.6
7. Export price deflator (goods & services)		8.8	7.2	3.7	1.8	3.0
8. Import price deflator (goods & services)		2.7	8.2	2.5	1.8	2.4

Annex Table 3: Labour market developments

	ESA Code	Year 2010	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
		Level	Level/Rate of change				
1. Population (thousands)		-	318.0	318.0	319.0	320.7	323.0
2. Population (growth rate in %)		-	-0.39	0.01	0.31	0.53	0.70
3. Working-age population (persons) [1]		-	208.3	208.2	208.5	209.0	209.6
4. Activity rate		-	76.1	76.9	77.3	77.5	77.7
5. Employment, persons [2]		-	145.3	148.0	150.8	152.7	154.1
6. Employment, hours worked [3]		-	39.5	40.0	-	-	-
7. Employment (growth rate in %)		-	-1.2	1.8	1.9	1.3	0.9
8. Public sector employment (persons)		-	36.5	-	-	-	-
9. Public sector employment (growth in %)		-	-1.4	-	-	-	-
10. Unemployment rate [5]		-	8.4	7.6	6.4	5.8	5.4
11. Labour productivity, persons [6]		5,840.4	-2.9	0.7	0.5	1.2	1.9
12. Labour productivity, hours worked [7]		-	-	-	-	-	-
13. Compensation of employees	D1	827.9	3.5	8.6	8.5	6.2	6.1

[1] Age group of 15-64 years
[2] Occupied population, domestic concept national accounts definition

[3] Average hours per week.

[4] Harmonised definition, Eurostat; levels

[5] Real GDP per person employed

[6] Real GDP per hour worked

Annex Table 4: 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	-28.4	14.6	-	-	-
of which:						
- Balance of goods and services		8.4	10.0	-	-	-
- Balance of primary incomes and transfers		-20.1	-18.0	-	-	-
- Capital account		-16.7	22.6	-	-	-
2. Net lending/borrowing of the private sector	B.9/ EDP B.9	-18.3	17.8	-	-	-
3. Net lending/borrowing of general government		-10.1	-3.2	-	-	-
4. Statistical discrepancy		0.0	0.0	-	-	-

Annex Table 5: GDP, investment and gross value added

	ESA Code	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
GDP and investment						
GDP *level* at *current* market prices (in domestic currency)	B1g	1,537.1	1,640.0	1,763.4	1,855.2	1,961.3
Investment ratio (% of GDP)		13.0	13.8	15.6	16.4	17.3
Growth of Gross Value Added. percentage changes at constant prices						
1. Agriculture		-	-	-	-	-
2. Industry (excluding construction)		-	-	-	-	-
3. Construction		-	-	-	-	-
4. Services		-	-	-	-	-

Annex Table 6: External sector developments

Billion Euro unless otherwise indicated		Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
1. Current account balance (% of GDP)	% of GDP	-11.2	-9.3	-4.1	-1.7	-2.4
2. Export of goods		3.460	3.868	4.026	4.192	4.361
3. Import of goods		2.719	3.183	3.315	3.475	3.670
4. Trade balance		0.741	0.684	0.711	0.717	0.690
5. Export of services		1.852	2.001	2.035	2.127	2.266
6. Import of services		1.642	1.744	1.817	1.907	2.012
7. Service balance		0.210	0.257	0.219	0.219	0.253
8. Net interest payments from abroad		-0.325	-0.295	-0.361	-0.371	-0.379
9. Other net factor income from abroad		-1.635	-1.534	-0.944	-0.691	-0.779
10. Current transfers		-0.053	-0.058	-0.066	-0.070	-0.074
***11. Of which* from EU**		-	-	-	-	-
12. Current account balance		-1.062	-0.945	-0.441	-0.196	-0.288
13. Capital and financial account		2.138	-	-	-	-
14. Foreign direct investment		1.962	-	-	-	-
15. Foreign reserves		4.114	6.497	-	-	-
16. Foreign debt		84.913	84.656	-	-	-
***17. Of which*: public**		-	-	-	-	-
***18. O/w:* foreign currency denominated**		-	-	-	-	-
***19.O/w:* repayments due**		-	-	-	-	-
20. Exchange rate vis-à-vis EUR (end-year)	NCU/EUR	153.4	160.1	164.1	164.4	165.6
21. Exchange rate vis-à-vis EUR (annual average)	NCU/EUR	162.2	161.5	164.4	164.0	164.5
22. Net foreign saving	% of GDP	-	-	-	-	-
23. Domestic private saving	% of GDP	-	-	-	-	-
24. Domestic private investment	% of GDP	-	-	-	-	-
25. Domestic public saving	% of GDP	-	-	-	-	-
26. Domestic public investment	% of GDP	-	-	-	-	-

Annex Table 7: General government budgetary prospects

	ESA code	Year 2010	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
		Level	% of GDP				
Net lending (B9) by sub-sectors							
1. General government	S13	-154.591	-10.1	-3.4	-1.4	0.0	1.2
2. Central government	S1311	-143.621	-9.3	-2.8	-1.2	-0.1	0.9
3. State government	S1312	-	-	-	-	-	-
4. Local government	S1313	-12.926	-0.8	-0.6	-0.2	0.1	0.4
5. Social security funds	S1314	2.000	0.1	-	-	-	-
General government (S13)							
6. Total revenue	TR	637.289	41.5	42.0	42.1	42.1	42.4
7. Total expenditure	TE	791.880	51.5	45.4	43.6	42.1	41.2
8. Net borrowing/lending	EDP.B9	-154.591	-10.1	-3.4	-1.4	0.0	1.2
9. Interest expenditure	EDP.D41 incl. FISIM	84.823	5.5	4.5	4.9	4.8	4.8
10. Primary balance		-101.839	-6.6	-0.6	1.9	3.3	4.4
11. One-off and other temporary measures		-	-	-	-	-	-
Components of revenues							
12. Total taxes (12 = 12a+12b+12c)		474.064	30.8	31.7	31.6	35.8	35.9
12a. Taxes on production and imports	D2	0.000	-	-	-	-	-
12b. Current taxes on income and wealth	D5	0.000	-	-	-	-	-
12c. Capital taxes	D91	0.000	-	-	-	-	-
13. Social contributions	D61	63.599	4.1	-	-	-	-
14. Property income	D4	39.990	2.6	-	-	-	-
15. Other (15 = 16-(12+13+14))		59.636	3.9	-	-	-	-
16 = 6. Total revenue	TR	637.289	41.5	42.1	42.1	42.1	42.4
p.m.: Tax burden (D2+D5+D61+D91-D995)		537.663	35.0	31.7	31.6	35.8	35.9

	ESA code	Year 2010	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
		Level	% of GDP				
Selected components of expenditures							

16. Collective consumption	P32	398.618	25.9	25.0	24.0	23.4	22.9
17. Total social transfers	D62 + D63	120.619	7.8	-	-	-	-
17a. Social transfers in kind	P31 = D63	120.619	7.8	-	-	-	-
17b. Social transfers other than in kind	D62	-	-	-	-	-	-
18 = 9. Interest expenditure (incl. FISIM)	EDP.D41 + FISIM	84.823	5.5	4.5	4.9	4.8	4.8
19. Subsidies	D3	27.500	1.8	-	-	-	-
20. Gross fixed capital formation	P51	44.701	2.9	-	-	-	-
21. Other (21 = 22-(16+17+18+19+20)		115.619	7.5	15.7	14.7	13.8	13.5
22. Total expenditures	TE	791.880	51.5	45.4	43.6	42.1	41.2
p.m. compensation of employees	D1	-	-	-	-	-	-

Annex Table 8: General government expenditure by function

Percentages of GDP	**COFOG Code**	**Year 2010**	**Year 2011**	**Year 2012**	**Year 2013**	**Year 2014**
1. General public services	1	8.8	-	-	-	-
2. Defence	2	0.0	-	-	-	-
3. Public order and safety	3	1.4	-	-	-	-
4. Economic affairs	4	7.0	-	-	-	-
5. Environmental protection	5	0.6	-	-	-	-
6. Housing and community amenities	6	2.5	-	-	-	-
7. Health	7	7.9	-	-	-	-
8. Recreation. culture and religion	8	3.7	-	-	-	-
9. Education	9	8.3	-	-	-	-
10. Social protection	10	11.2	-	-	-	-
11. Total expenditure (item 7 = 22 in Table 2)	TE	51.5	45.3	43.6	42.1	41.2

Annex Table 9: General government debt developments

Percentages of GDP	ESA code	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
1. Gross debt		92.9	98.4	93.2	89.4	84.8
2. Change in gross debt ratio		5.0	5.5	-5.1	-3.8	-4.6
Contributions to change in gross debt						
3. Primary balance		6.6	0.3	-1.9	-3.3	-4.4
4. Interest expenditure (incl. FISIM		5.5	4.5	4.9	4.8	4.8
5. Stock-flow adjustment		-7.2	0.4	-8.1	-5.3	-5.0
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		6.4	5.2	-	-	-
Other relevant variables						
6. Liquid financial assets		-	-	-	-	-
7. Net financial debt (7 = 1 - 6)		92.9	-	-	-	-

Annex Table 10: Cyclical developments

Percentages of GDP	ESA Code	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
1. Real GDP growth (%)	B1g	-4.0	2.6	2.4	2.5	2.8
2. Net lending of general government	EDP.B.9	-10.1	-3.2	-1.4	0.0	1.2
3. Interest expenditure	EDP.D.41	5.5	4.5	4.9	4.8	4.8
4. One-off and other temporary measures		-	-	-	-	-
5. Potential GDP growth (%)		-	-	-	-	-
Contributions:						
- labour		-	-	-	-	-
- capital		-	-	-	-	-
- total factor productivity		-	-	-	-	-
6. Output gap (in % of potential output)		-	-	-	-	-
7. Cyclical budgetary component		-	-	-	-	-
8. Cyclically-adjusted balance (2-7)		-	-	-	-	-
9. Cyclically-adjusted primary balance (8+3)		-	-	-	-	-
10. Structural balance (8-4)		-	-	-	-	-

Annex Table 11: Divergence from previous programme

	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
1. GDP growth (% points)					
Previous update	-3.0	1.9	2.9	3.0	-
Latest update	-4.0	2.6	2.4	2.5	2.8
Difference	-1.0	0.7	-0.5	-0.5	
2. General government net lending (% of GDP)					
Previous update	-6.0	-2.6	0.1	2.8	-
Latest update	-10.1	-3.2	-1.4	0.0	1.2
Difference	-4.1	-0.6	-1.5	-2.8	-
3. General government gross debt (% of GDP)					
Previous update	96.3	100.8	94.4	88.7	-
Latest update	92.9	-	-	-	-
Difference	-3.4	-	-	-	-