The Icelandic Economic Situation: Status Report

The current economic turmoil in Iceland is part of a complex global financial crisis and is by no means an isolated event. Governments around the world have introduced emergency measures to protect their financial system and rescue their banks, as they suffer from a severe liquidity shortage. Thus far, Iceland has been hit particularly hard by this unprecedented financial storm due to the large size of the banking sector in comparison to the overall economy. The Icelandic Government has taken measures and is working hard to resolve the situation. Iceland is cooperating with its Nordic and European partners and is currently consulting with the IMF on measures toward further stabilization of the Icelandic economy.

What happened?

A modern globalized economy, and an active participant in the EU´s common market, Iceland is among the first nations to be seriously hit by the global financial crisis. The situation has hit Icelandic households hard and many have lost a sizeable portion of their savings. Inflation is in double-digit numbers, unemployment is on the rise and the currency, the Icelandic Krona, has fallen to historical lows.

The large size of the banking sector in comparison to Iceland's overall economy is doubtless a driving factor behind the current economic turmoil. However, it should be underlined that the Icelandic banks operated in full compliance with European banking laws and the strictest of international regulatory standards. Nevertheless, as the liquidity crisis deepened, Iceland's three largest banks, Glitnir, Landsbanki and Kaupthing, whose balance sheets are several times larger than the total output of the Icelandic economy, were no longer able to re-finance their operations. As a response to these circumstances, the Icelandic parliament passed a new law, allowing the Financial Supervisory Authority (FSA) to take over the operations of the banks. On the basis of this new law, all three banks are now being restructured and the domestic operations are being separated, re-capitalized and will be governmentally owned (at least for some period of time). More information on the new bank act is provided in appendix 2.

What is being done?

Progress has been achieved in ensuring continued functioning of the Icelandic financial system. The Icelandic government has prioritized the tasks facing the economy based on their importance for the general public. The first task was to secure the functioning of the domestic banking, payment and settlement systems. The stock market has been re-opened even though the operations are obviously limited considering that the financial companies were the majority share of the total market capitalization of the stock exchange. The next priority is to stabilize and secure the functioning of international payments and settlement system as well as the foreign exchange market.

Furthermore, Iceland is working closely and constructively with other countries to address problems that have arisen in connection with the government takeover of Iceland's three largest commercial banks. The government of Iceland has clearly stated that it intends to honor its legal commitments and seeks close cooperation with other countries' authorities.

In order to prevent a potential shortage of foreign currency, the Central Bank of Iceland has implemented temporary restrictions on foreign exchange transactions with the Icelandic krona. These restrictions have inevitably resulted in problems with payments and settlements of international transfers between Iceland and other countries. In an effort to restore balance in the currency market, the Central Bank has drawn on its swap facility arrangements with the Central Banks of Norway and Denmark, a total of €400 million.

IMF stabilization program

Recently, Iceland's prime minister announced that the government had reached an agreement with the International Monetary Fund (IMF) on a comprehensive stabilization program, which will include a 2.1 billion dollar loan from the IMF. The deal has now been approved by the IMF's executive board. There are three main objectives of the IMF-supported program: To contain the negative impact of the crisis on the economy by restoring confidence and stabilizing the exchange rate in the near-term; to promote a viable domestic banking sector and safeguard international financial relations by implementing a sound banking system strategy that is nondiscriminatory and collaborative; and to safeguard medium-term fiscal viability by limiting the socialization of losses in the collapsed banks and implementing an ambitious multi-year fiscal consolidation program.

According to the IMF's economic forecast for Iceland, the Icelandic economy is expected to adjust sharply in the near term under the program. Given the high leverage in the economy and significant dependence of the private sector on foreign currency and inflation-indexed debt, the economy is expected to enter into a serious recession in 2009-10. The anticipated large import compression will, however, lead to a rapid swing of the current account into surplus, providing significant support to the exchange rate going forward. Once confidence is restored and balance sheets readjusted, domestic demand—both investment and consumption—is projected to rebound strongly in 2011. Long-term growth prospects are favorable, in line with Iceland's very strong fundamentals, not least its highly educated labor force, favorable investment climate and rich natural resource endowment.

What will happen to Icelandic banks abroad?

The Icelandic banks' operations aboard are inevitably affected by the restructuring of the Icelandic banking system. Some of the banks may continue to operate abroad as before, but more likely they will be sold to other parties, such as foreign financial institutions. Others may be shut down and their assets used to reimburse deposits and other outstanding liabilities – with the backup of the guarantee funds in the respective country according to EU/EEA regulations.

The deposits of foreign customers in Icelandic banks are generally guaranteed according to EU rules. Depending on whether the bank is operated as a subsidiary or a branch, different deposit-guarantee schemes may come into play if assets do not cover commitments. Any foreign subsidiary of an Icelandic bank is fully covered by the deposit-guarantee scheme in the country it operates. All branches of Icelandic banks that have been nationalized (taken over by the FSA) are covered by the Icelandic Depositor's and Investor's Guarantee Fund, which operates according to the EU-directive relating to these issues. According to the directive, the amount covered is €20,887 for each depositor in each financial institution. These are the basic rules that apply throughout the EU and the EEA, of which Iceland is a part.

One of the provisions approved in the new Emergency Bank Act, is that deposits are to be considered a priority claim on the bank's estates. This was done in order to secure the interests of depositors in the foreign branches. Ideally, a bank's assets will be worth enough to cover all or most outstanding deposits.

In several countries, the government has stepped in and offered support to their banks, including Icelandic owned subsidiaries. In Sweden and Norway, for example, measures have been taken by the government to ensure the ongoing operation of banks. This is the best way to safeguard assets and investments, which might otherwise be sold prematurely or liquidated at a price well below true value.

However, the assets of Landsbanki in the UK were frozen via provisions in the Anti Terrorism, Crime and Security Act from 2001. This has been forcefully opposed through diplomatic channels with British authorities, as this clearly has a very damaging effect on the Icelandic banking sector and puts Icelandic companies in Britain in a difficult situation. Iceland has also taken the issue up for discussion within NATO and Icelandic authorities have considered legal action. This is also one of the main factors leading to disruptions in Iceland's international payments and settlements system.

Access to foreign currency and transfer of payments

On November 28th, the Icelandic Parliament approved an amendment of Act no. 87/1992 on Foreign Exchange. The amended Act makes it clear that **all transactions connected to import and export of goods and services are - and will continue to be - be unrestricted**. It includes a temporary clause which will be in effect for two years and authorises the Central Bank to impose rules that prohibit foreign exchange related to capital account transactions. The purpose is to prevent excessive short term volatility in the ISK and is in line with the conditions of the IMF Stand-by Arrangement.

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Iceland's future is bright

Despite the current economic setbacks, Iceland's future is bright. Iceland is a dynamic, technology-driven society with a young and well educated workforce. The country is endowed with abundant natural resources, which include rich fishing grounds, vast renewable energy sources (of which only a third has been harnessed), a plentiful supply of clean water and a natural environment and culture that draw an increasing number of tourists to the country each year. Other major strengths of the economy include diverse export industries, a flexible labor market, a strong fiscal position, an efficient pension system and an excellent education system. Armed with these strengths, it is expected that Iceland will emerge from the current turmoil as an economy with a prosperous future.

Appendix 1: Timeline of the Icelandic Financial Crisis

September 29	Government announces takeover of 75% share in Glitnir and EUR 600 m equity injection S&P downgrades Glitnir to BBB; Sovereign to A-
September 30	Fitch downgrades sovereign to A-; Landsbanki to BBB;Kaupthing to BBB;Glitnir to BBB- Moody's downgrades sovereign to Aa1;Landsbanki to A2;Kaupthing to A1;Glitnir to Baa2
October 4-5	Government evaluates crisis in an attempt to save banking sector.
October 6	Emergency law is introduced and passed by parliament; government guarantees all domestic deposits Icelandic FSA seizes control of Landsbanki under terms of emergency law S&P downgrades sovereign to BBB
October 7	Assets of Landsbanki seized by UK authorities;Landsbanki Luxembourg goes into administration FSA seizes control of Glitnir under terms of emergency law Central Bank extends EUR 500 m loan to Kaupthing; announces intentions to negotiate EUR 4 bn loan with Russian government Central Bank announces exchange rate peg and starts by selling EUR 6 m. at ISKEUR 131 Fitch downgrades sovereign to BBB-;Landsbanki to B;Glitnir to B S&P downgrades Glitnir to CCC
October 8	Central Bank announces intention to maintain currency peg; later announces that peg is not sustainable and has been abandoned. Swedish Central Bank extends SEK 5 bn loan to Kaupthing Sweden British authorities put Kaupthing Edge and Kaupthing Singer & Friedlander into administration

	British PM threatens to sue Icelandic government to claim guarantee for Icesave deposits Icelandic PM states that sale of Landsbanki assets will be used to refund Icesave depositors Fitch downgrades sovereign to BBB-;Landsbanki to D;Kaupthing to CCC;Glitnir to D Moody's downgrades sovereign to A1 and puts on review for further downgrade;Kaupthing to Baa3;Glitnir to Caa2 Board of Kaupthing requests FSA to assume control of bank
October 9	New Landsbanki starts operations with Dutch finance minister threatens to sue Icelandic government over Icesave deposit guarantee; British PM reiterates threats Fitch downgrades Kaupthing to CC Moody's downgrades Kaupthing to Caa2 S&P downgrades Glitnir to D
October 10	Dutch delegation arrives in Reykjavik; initiates talks with treasury department about Icesave Central Bank announces limits on currency outflow; low amounts for travel and import restricted to necessities, companies must apply for currency to the CB
October 11	British delegation initiates talks with treasury department about Icesave deposits Accord signed with Dutch government on loan to guarantee a refund of Icesave deposits Outlines of an accord with British government on loan to guarantee refund of Icesave deposits
October 14	Central Bank delegation starts talks in Moscow with Russian Finance Ministry on loan to Iceland Central Bank draws on swap facility arrangements with Denmark and Norway, each by EUR 200 m. Moody's confirms sovereign credit rating issued on October 8 (A1)
October 15	Central Bank lowers policy rate by 350 bp to 12% Central Bank introduces auction system to meet demand for foreign currency, resulting in an allocation of EUR 25m. at a ISKEUR rate of 150. Fitch issues credit update for sovereign debt holding rating steady at BBB- on negative watch. Iceland and Russia agree to continue discussions on a possible loan. New Glitnir starts operations with ISK 110 bn in capital
October 16	Central Bank announces that it guarantees that all payments will reach ultimate beneficiaries' accounts with local banks in an attempt to revitalize payment system.
October 22	New Kaupthing starts operations with capital of ISK 75 bn Norwegian delegation arrives in Iceland to gather information about the the situation.

October 24	Government announces an agreement ad referendum with an IMF mission of USD 2 bn stand-by-facility programme. Government formally requests assistance from the Nordic countries, the ECB and the FED. Delegation from the US Treasury Department arrives in Reykjavik.
October 27	High-level Nordic committee established to present proposals for Nordic assistance to Iceland in cooperation with the IMF.
October 28	Central Bank raises policy rate by 600 bp to 18%. Faroe Islands pledge DKK 300 million loan for Iceland.

Appendix 2: More on the New Bank Act

As previously mentioned the Icelandic parliament passed on October 6th a new law, allowing the Financial Supervisory Authority (FSA) to take over the operations of the banks in unusual and extraordinary circumstances in order to limit damage or the risk of damage in the financial markets.

These unusual and extraordinary circumstances are stipulated further in art. 1 ph. 2. This list of circumstances is however not exhaustive; the FSA can thus, in other circumstances, apply its authority given by the law as long as the board of the FSA approves. The Central bank, which monitors liquidity status of financial institutions, appoints one member to the FSA board. The Central bank therefore has first hand information about the status of financial institutions and probable FSA actions in that regard.

The FSA has, on basis of this new law, taken over Iceland's three biggest banks and the procedure has been as follows:

1. The boards are dismissed
2. Special Resolution Committees are appointed to take over board activities and management
3. New companies are founded
4. The FSA decides on disposal of assets and liabilities of the old banks to the new companies

Appendix 3: Questions and answers about foreign exchange matters

The Central Bank of Iceland has published questions and answers about the recent changes in the Foreign Exchange Act of 1992 and the Bank's new Rules on Foreign Exchange.

Q: What is the purpose of the Rules on Foreign Exchange?

A: The purpose of the Rules is to stop, on a temporary basis, capital outflows that could result in immoderate weakening of the króna when restrictions on foreign exchange transactions related to commercial activities are lifted. It is foreseeable, however, that the inflow of foreign exchange from exports will soon exceed the outflow due to imports. Therefore, an excess of foreign reserves will gradually accumulate, and it will be possible to sell this to foreign parties and thereby enable them to close their króna positions.

Q: What is meant by the term "movement of capital"?

A: Movement of capital refers to the transfer or conveyance of money between countries in connection with:

1. Transactions with and issuance of securities, unit share certificates in UCITS and investment funds, money market instruments, and other transferable financial instruments.

2. Deposits to and withdrawals from accounts with credit institutions.

3. Lending, borrowing, and issue of guarantees not related to cross-border trade with goods and services.

4. Importation and exportation of securities and foreign and domestic currency.

5. Futures contracts, derivatives contracts, options contracts, currency and interest rate swap agreements, and other related foreign exchange transactions involving the Icelandic króna as the only currency or one of the currencies.

6. Gifts and subsidies and other capital movements comparable to those listed in Items 1-5.

Q: Are there any restrictions on the importation or exportation of goods?

A: No

Q: Are there any restrictions on the importation or exportation of services?

A: No

Q: Are there any limitations on foreign exchange for travel purposes?

A: No, but banks are free to decide to limit the sale of foreign currency in cash if their supply of banknotes is not sufficient. However, it is permissible to sell foreign currency in cash for a maximum of 500,000 kr. per calendar month per individual party

Q: What is the obligation to submit foreign currency?

A: All foreign currency that domestic parties acquire, either from the sale of goods and services or in another manner, must be submitted to a domestic financial institution within two weeks of the time the foreign currency was acquired or could have been acquired by the owner or his agent or representative. If the party in question cannot submit the foreign currency within this time limit, he or she must explain the reason to a financial undertaking. The obligation to submit foreign currency according to the first sentence above can be fulfilled by depositing the currency to a foreign currency account with a financial institution in Iceland. This requirement does not apply to domestic parties that have a fixed residence abroad for purposes of work or study.

Q: What is a foreign currency account?

A: A foreign currency account is an account at a commercial or savings bank where the deposit balance is listed in foreign currency.

Q: Are there any restrictions on deposits to foreign currency accounts?

A: No, but it is not possible to purchase foreign currency in order to deposit it to a foreign currency account.

Q: Are there any restrictions on withdrawals from foreign currency accounts?

A: Withdrawals from foreign currency accounts in Iceland are subject to the requirement that the party in question demonstrate that the funds will be used in accordance with the Rules on Foreign Exchange. It is prohibited to withdraw foreign currency in cash from a foreign currency account without demonstrating that the funds will be used to pay for goods or services, including travel.

Q: Is it absolutely forbidden to invest abroad?

A: No. It is permissible to invest in real estate and other assets not listed below. Domestic parties are prohibited from investing in securities, unit share certificates in UCITS and investment funds, money market instruments, or other transferable financial instruments denominated in foreign currency. However, domestic parties that have invested in such financial instruments prior to the entry into force of these Rules are permitted to reinvest abroad. Domestic parties are prohibited from settling, in foreign currency, transactions with securities or other transferable financial instruments denominated in Icelandic krónur.

Q: May foreigners invest in Iceland?

A: It is prohibited to invest in securities, unit share certificates in UCITS and investment funds, money market instruments, or other transferable financial instruments, if such investments involve the movement of capital to Iceland. It is prohibited to carry out foreign exchange transactions or other movement of capital in foreign currency through withdrawals from króna-denominated bank accounts at domestic financial institutions or the Central Bank of Iceland. Movement of capital due to the transfer or conveyance of funds out of Iceland in connection with the sale of direct investments is prohibited.

Q: Is it forbidden to take out a loan in another country?

A: It is generally prohibited if the amount borrowed is greater than 10 million Icelandic krónur. Exceptions to this are loans related to trade in goods and services and loans between companies in the same conglomerate.

Q: Why is it forbidden to provide guarantees over a specified amount?

A: It is considered extremely easy to create simulated contracts in order to circumvent the Rules. Guarantees related to trade with goods are permissible, as are guarantees between companies in the same conglomerate.

Q: Is all trading with derivatives forbidden?

A: Derivatives trading is limited if the Icelandic króna is one of the currencies involved in the derivative contract. This does not apply, however to derivatives related solely to trade with goods and services.

Q: May I no longer purchase foreign currency to pay a foreign loan?

A: Yes, this is possible. Interest, indexation, dividends, capital gains on investments, and contractual payments are not considered movement of capital in the sense of the Rules on Foreign Exchange. Therefore, it is possible to purchase foreign currency in order to make payments on foreign-denominated loans. Wages are not considered movement of capital in the sense of the Act; therefore, it is permissible to purchase foreign currency to pay wages abroad. However, prepayment of loans is considered movement of capital and is therefore prohibited.

Q: What about subsidies and charities?

A: Individuals and legal entities are prohibited from moving capital out of the country for gifts, subsidies, or other purposes, in amounts exceeding 10,000,000 kr. per calendar year.

Q: Is it possible to get an exemption from the Rules?

A: The Central Bank may authorise exemptions in exceptional cases, but an application for such an exemption must be submitted to the Bank, together with the relevant documentation, through the intermediation of a financial institution.

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Appendix 4: Further information

For further information on macroeconomic forecasts, please review:

- Central Bank of Iceland, Monetary Bulletin, November 2008 (http://sedlabanki.is/?PageID=969)
- OECD Economic Outlook, November 2008 (http://www.oecd.org/dataoecd/6/16/20212577.pdf)

International Monetary Fund – Iceland (http://www.imf.org/external/pubs/ft/scr/2008/cr08362.pdf)