

# The Icelandic Economic Situation

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- Status Report -



VIÐSKIPTARÁÐ ÍSLANDS

ICELAND CHAMBER  
OF COMMERCE

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## 1. INTRODUCTION

Since October 2008 the Icelandic economy has gone through dramatic changes due to the collapse of its financial sector. Despite these substantial difficulties, general economic activity is still well functional and many Icelandic businesses remain strong and prosperous. Due to inadequate external information flow, a lot of misconceptions have developed concerning the chain of events in the recent scenario and the current status of the Icelandic economy. This status report is meant to give further insight into these issues.

The status report is split into two main parts, part A and part B. Part A, consists of the first 7 chapters and focuses on the general historical background leading up to the collapse and immediate consequences. Part B, from chapter 8 through 20, focuses in more detail on more recent economic developments and policy actions.

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, both past and present, have taken measures and are tirelessly working towards resolving the situation. Iceland has been cooperating with its Nordic and European partners and is actively cooperating with the IMF on measures toward further stabilization of the Icelandic economy.

A timeline of the financial crisis in Iceland and the Icesave dispute can be found in **appendix 1 and 7**.

# PART A - HISTORICAL PERSPECTIVE

## 2. WHAT HAPPENED?

A globalized economy, and an active participant in the EU's common market through the EEA, Iceland is among the first nations to be seriously affected by the global financial turmoil. The situation has hit Icelandic households hard and many have lost a sizeable portion of their savings. Inflation was in double-digit numbers but has now come down to 7.5% and rapidly decreasing, unemployment is around 8% and on the rise. The domestic currency, the Icelandic Krona (ISK), has depreciated significantly, but has now stabilized, i.a. due to measures in the financial exchange markets.

The large size of the banking sector in comparison to Iceland's overall economy is undoubtedly a driving factor behind the current economic turmoil. However, it should be underlined that the Icelandic banks operated under Icelandic and European banking legislation 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 were several times larger than the total output of the Icelandic economy (around 10 times GDP), were no longer able to re-finance their operations.

As a response to these circumstances, the Icelandic Parliament (Althingi) passed a new law, the new Emergency Bank Act, allowing the Icelandic Financial Supervisory Authority (FSA) to take over the operations of the banks.

On the basis of this new law, all three banks have now been restructured and re-capitalized. More information on the new banks is provided in **chapter 9** and on the Emergency Act in **appendix 2**.

### 3. WHAT WAS DONE?

Progress in ensuring continued functioning of the Icelandic financial system was achieved at quite an early stage. The Icelandic government 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 was re-opened even though the operations are obviously limited considering that the turnover of the stock exchange consisted mostly of transactions related to the financial sector. See further information in see chapters 8 through 20 for a discussion of measures taken after the collapse.

Furthermore, Iceland was working closely and constructively with other countries to address problems that had arisen in connection with the government takeover of Iceland's three largest commercial banks. The government of Iceland had clearly stated that it intended to honor its legal commitments and seek close cooperation with other countries' authorities. See chapter 10 and appendix 7 and 8 on the Icesave Dispute.

In order to prevent a potential shortage of foreign currency, the Central Bank of Iceland implemented temporary restrictions on foreign exchange transactions with the Icelandic krona. These restrictions caused some initial frictions and problems with payments and settlements of international transfers between Iceland and other countries. However, there are no restrictions on currency transactions relating to the import and export of goods and services, see further information in **chapter 10** and **appendix 3**.

A Special Investigation Commission(SIC) of the Parliament was formed to investigate whether any public officials were responsible of misconduct. The report was published in April 2010. See **chapter 18** for more information.

### 4. INTERNATIONAL MONETARY FUND (IMF)

The Icelandic government reached an agreement with the International Monetary Fund (IMF), on 24th of October 2008, on a comprehensive stabilization program, which includes a \$2.1 billion loan from the IMF. The agreement has been approved by the IMF's executive board. There are three main objectives of the IMF program:

1. To contain the negative impact of the crisis on the economy by restoring confidence and stabilizing the exchange rate in the near-term.
2. To promote a viable domestic banking sector and safeguard international financial relations by implementing a sound banking system strategy that is nondiscriminatory and collaborative.
3. 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.

Significant progress was made towards attaining these goals as is confirmed in the IMF's first progress report, which was issued in the first week of February 2009. A statement from the IMF issued in March 2009 can be found [here](#) and further information on the Economic Program can be found [here](#). The most up to date statements from the IMF regarding Iceland can be found [here](#).

On 28th of October 2009 the IMF's Executive Board approved the 1st review of the Economic Recovery Program.

On 16th of April 2010 the IMF's Executive Board approved the 2nd review of the Economic Recovery Program. See **chapter 12**.

According to the IMF's economic forecast for Iceland, the Icelandic economy is expected to adjust further 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 2010. 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. See chapter 12. 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, fully funded pension scheme, favorable investment climate and rich natural resource endowment.

## 5. WHAT HAPPENED TO ICELANDIC BANKS ABROAD?

The Icelandic banks' operations abroad were inevitably affected by the restructuring of the Icelandic banking system. Some of the banks continued to operate abroad as before, like Glitnir in Norway and Kaupthing in Luxemburg, most under new names and owners. Others e.g., Landsbankin's operations in the UK, were shut down and their assets will be used to reimburse deposits and other outstanding liabilities – with the backup of the Deposit Guarantee Funds in the respective country according to EU/EEA regulations.

The deposits of foreign customers in Icelandic banks within the EEA 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 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 respective Government has stepped in and offered further 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 had a very damaging effect on the Icelandic banking sector and put 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. See **chapter 11** and **appendix 7 and 8** on the Icesave Dispute.

Further information about the old banks can be found [here](#) (for Kaupthing Bank), [here](#) (for Landsbanki) and [here](#) (for Glitnir Bank).

Re-capitalization and reconstruction of the banking system has been concluded. See **chapter 9** for more information.

## 6. FOREIGN EXCHANGE MARKETS

On November 28th 2008, the Icelandic Parliament approved an amendment of Act no. 87/1992 on Foreign Exchange. The Act gave the Central Bank temporary authorization to set rules limiting international capital movements, with the aim of restricting the outflow of foreign currency, for instance, by imposing obligations to repatriate foreign currency. The amended Act makes it clear that all transactions connected to import and

export of goods and services are - and will continue to be - unrestricted. It includes a temporary clause which will be in effect for two years and authorizes 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.

On April 4th 2009 the Parliament approved amendments to the Act on Foreign currency. The ISK exchange rate had been sliding steadily, and there were strong indications that the objective of building up strong foreign currency reserves through mandatory currency repatriation might be in jeopardy. This was attributed primarily to the fact that exporters were not obliged to receive payment for their products in foreign currency.

The amendment was intended to plug this loophole in the legislation. It adds a temporary provision to the Act on Foreign Currency, stipulating that exports of goods and services must be concluded in foreign currency. Following the amendment to the Customs Act, the price of exports recorded on export declarations must be in foreign currency and the enforcement of these provisions will be monitored

On 28th of November 2009 the Act was amended further. See **chapter 10** for a further discussion.

## 7. POLITICAL ENVIRONMENT: NEW GOVERNMENT

Due to strong social pressure and extraordinary circumstances, former Prime Minister Mr. Geir H. Haarde made an announcement in late January that national elections were to be held in May 2009. The coalition Government of the right-wing Independence Party and the Social Democratic Alliance came to an end a few days later.

A week later, a new Government of the Social Democratic Alliance and the Left-Green Movement was formed. According to its official announcement its goal was to assure an effective administration to carry out urgent measures, particularly for the benefit of households and businesses, for rebuilding the banking system, in the field of administrative reform and to carry out measures in favor of increased democracy.

The economic policy of the Government was based on the program already established by the authorities and the IMF. The Government announced it would conduct a prudent fiscal policy according to which the fundamentals of the welfare system would be protected. The two parties agreed on holding early elections, set for 25th of April 2009. The Progressive Party defended the Government in the event of motions of no-confidence.

Following the outcome of the national elections, the Social Democrats and Left-Greens now hold a majority of seats in the Parliament, 34 MP's against the oppositions 29 MP's. The parties decided to continue their coalition partnership and have formed a new Government. According to its announcement the central aim of the Government is to rebalance the state budget by 2013 while at the same time implementing an ambitious plan of job creation and innovation to restore Iceland's position among the most energetic and competitive states in the world by 2020.

A press release with further information on the agenda for the first 100 days of the new Government as well as the co-operation statement by the new Government can be found [here](#).

For more information on the fiscal policies and updated political framework see chapter in Part B of the report, see **chapters 8 through 20**.

There have also been made some amendments to the Act on the Central Bank of Iceland, which are outlined in **chapters 10, 13 and appendix 4**.

## PART B - SPRING '09 UNTIL APRIL '10

Significant progress has been made since spring 2009, both in terms of the financial sector and the Government's program with the IMF. The status of the most pressing issues summarized in the table below.

**Icesave dispute:** Referendum on March 6. (Ch. 11)

**The IMF Program:** Second review concluded in April 2010. (Ch. 12)

**The Capital Restrictions:** First stage of liberalization concluded. (Ch. 10)

**Policy Interest Rates:** Lowered from 10% to 9% in two steps since Jan. At 9% since Mar. (Ch.12)

**The Banks:** Reconstruction has been concluded. (Ch. 9)

**The European Union:** Application in Process (Ch. 14)

**The State Treasury:** Hit Hard by the Turmoil (Ch. 15)

**The NasdaqOMX:** Slowly picking up pace (Ch. 16)

**The Stability Pact:** Renewed in October (Ch. 17)

## 8. THE CURRENT ECONOMIC CLIMATE IN APRIL 2010

Following are the key events since the release of the last status report in January:

- » Icesave negotiation committee was formed in February 2010. It is lead by US attorney Lee C. Buchheit. See **chapter 11** for more information.
- » On 24th of February 2010, the European Commissioner for Enlargement and European Neighborhood Policy recommended to the Council of the European Union to start accession negotiations with Iceland. Iceland has not received candidate status yet. See **chapter 14** for more information
- » National referendum took place on the Icesave Act on March 6th. Only 1,5% voted in favor of the Act. See **chapter 11**.
- » Formal Icesave talks were adjourned on March 5th and only informal talks have taken place since the National referendum. See **chapter 11**
- » The release of the Special Investigation commission report on April 12th. The report is comprehensive and covers the actions of the banks and government officials leading up to the collapse. See **chapter 18**.
- » On 16th of April 2010 the IMF's Executive Board approved the 2nd review of the Economic Recovery Program. A new IMF staff report has been published and a renewed letter of intent as well. See **chapters 11 and 12**. Consequently, Moody's raised the outlook for Iceland from negative to stable on April 24th. See **chapter 11**.
- » A volcanic eruption started in Eyjafjallajökull in March and is still ongoing (as of April 28). Day-to-day life in Iceland is just as usual except for a small part of the country close to the volcano in southern Iceland. In other parts of the country, such as the capital city of Reykjavik, the daily life of Icelanders is proceeding quite normally. See **chapters 19** chapter and [here](#) for more information.

### 8.1. A FEW KEY PUBLICATIONS

Below you can find a few recent publications in English with the most up to date information available.

- » The minister of Economic Affairs, Dr. Gylfi Magnússon held a lecture in early April named The Icelandic Economy and Outlook. These slides are a good source of information on the economic environment in Iceland. The slides can be found [here](#).
- » Mr. Magnússon has also held another lecture *The Icelandic Economy: Recovering From a Very Hard Landing*, available [here](#). In that lecture he covers the background of the crisis leading up to the collapse, the first signs of trouble, the collapse and the recovery.
- » Information on Mr. Magnusson can be found [here](#).

- » After the second review of the IMF program a staff report was published. See [here](#).
- » An overview of Iceland's Economic Recovery program which is supported by the IMF can be found [here](#).
- » An overview of the reforms in the financial sector since October 2008 until April 2010 can be found here. See also chapter 9 and 10.
- » Information on the number of investigations and progress of those investigations can be found [here](#). See also chapter 17.
- » A fact sheet on the Icesave issue can be found in English [here](#) and in Norwegian [here](#).
- » Annual report of the Central bank and monthly economic indicators can be found [here](#) and here.
- » A few key economic figures can be found [here](#).
- » The latest inflation forecasts by the Central bank can be found [here](#).

## 9. BANK RESTRUCTURING CONCLUDED

Since the Icelandic FSA took over the operations of the banks in October 2008 they have been appointed Special Resolution Committees and new banks have been established around the old banks domestic operations, in accordance with the FSA's decision on the disposal of assets and liabilities between the old and new banks. The Government also appointed boards to govern the new state owned banks.

The decision of the FSA on the disposal of assets and liabilities can be found [here](#). Information about the resolution committees can be found [here](#) and various FAQ can be found [here](#).

In April 2009 Deloitte delivered its valuation of the assets that were moved from the old banks to the new banks and Oliver Wyman consulting firm also issued its independent assessment report, see here. The Government also engaged with the corporate advisory firm Hawkpoint to negotiate with creditors of the old banks the appropriate compensation for assets transferred and also to advice on the capitalization and the imbalance issues.

On 20th of July 2009 the Government, the boards of the new banks and the resolution committees of the three old banks announced that an agreement had been made on the initial capitalization of the new banks and the basis for the compensation payable to the creditors of the old banks for the transfer of assets into the new banks.

The Government provided both the Resolution Committee of Glitnir and Kaupthing with options to acquire the majority of the Government's shares in the new banks. The announcement can be found [here](#).

On 15th of October the Resolution Committee of Glitnir, on behalf of its creditors, decided to utilize that option and acquired 95% of the share capital in Islandsbanki The Government will continue to own 5%. See [here](#). Similarly, on December 1st ,the Resolution Committee of Kaupthing Bank decided to utilize the option to acquire 87% of common equity in Arion Bank. The Government will continue to own 13%. See [here](#).

On December 16th 2009 the Ministry of Finance and the Resolution Committee of Landsbanki Íslands hf announced that a final agreement had been reached on the settlement of assets and liabilities following the division of Landsbanki Íslands into old and new bank (NBI).

The government acquires 81% of the share capital in Landsbankinn (NBI hf, the new bank) and the Resolution Committee of Landsbanki, on behalf of creditors, will control 19% of NBI. The Icelandic Government's equity contribution will be ISK 122 billion, 5 billion lower than previously estimated. See [here](#).

More information and updates can be found [here](#) and [here](#). A good overview of the reforms in the Icelandic financial sector from October 2008 until April 2010 can be found [here](#).

### 9.1. OVERVIEW OF THE RESTRUCTURED BANKS

Following the restructuring of all three commercial banks the Ministry of Finance issued a press release outlining the contribution of the state in the bank restructuring. See [here](#).

The cost of capitalizing the new banks, ISK 135 billion, is significantly lower than the estimated commitment of ISK 385 billion at the time of the original transfer in October 2008. An overview of the state's contribution can be found below in table 1

The agreement reached between the Icelandic authorities and the new banks, on the one hand, and the Resolution Committees of all three Banks on behalf of their creditor on the other hand concerns the settlement of assets which were transferred from the old banks to the new ones established in October 2008.

**Table 1: Overview of the total contribution to the restructured banks**

	Total equity	State's equity (ISKbn)	State's holding (%)	Subordinated loans from the state (ISKbn)	Total state financing
Arion banki	72	9,36	13	24	33,36
Íslandsbanki	65	3,25	5	25	28,25
Landsbankinn	150	122,00	81	0	122
Total	287	134,61	-	49	183,61

In January the FSA authorized Kaupskil ehf., on behalf of the creditors of Kaupthing, to acquire a qualifying holding in Arion Bank hf. Similarly the FSA authorized ISB Holding ehf. on behalf of the creditors of Glitnir, to own a qualifying holding in Íslandsbanki. See [here](#) and [here](#).

### 9.2. THE ICELANDIC BANKING AGENCY

The Government has furthermore set up a Banking Agency (The Icelandic State Banking Agency-ISBA) which is intended to control the state's holding in financial undertakings in compliance with currently applicable law, good administrative and business practices, and the state's current ownership strategy, and provide them with funding on behalf of the state based on budget allocations. See more on ISBA [here](#). Further information on the ownership policy can be found [here](#). Further updates can be found on the ISBA website, see [here](#).

ISBA is set up in accordance with an expert report from the Coordination Committee led by Mr. Mats Josefsson, see [here](#) for further information. The Committee had the overall responsibility of developing, implementing and communicating a comprehensive strategy for bank restructuring. Another expert report, by Mr. Kaarlo Jännäri, on Banking Regulation and Supervision in Iceland was published in March, see [here](#).

A good overview of the reforms in the Icelandic financial sector from October 2008 until April 2010 can be found [here](#).

### 9.3. RESTRUCTURING OF THE SAVINGS BANKS

After a long restructuring process the Icelandic authorities have took over the operations Byr savings bank and Keflavik Savings Bank on April 23rd 2010. Both are small institutions compared to the old Icelandic banks.

The restructuring of a number of savings banks has been ongoing. The restructuring of the debt of a number of savings banks are in place and should be concluded soon. At the conclusion of this process these savings banks should therefore operate on a sound financial foundation. For more information see [here](#) and [here](#).

There is also a discussion on the recapitalization of the savings banks in the IMF status report see [here](#).

## 10. THE CAPITAL RESTRICTIONS AND FOREIGN EXCHANGE

The Central Bank did not see any reason to lift the capital restrictions in the first six months of 2009. The restrictions were put in place to prevent excessive short term volatility in the ISK. This was, among other things, due to the delay in receiving approval from IMF on the 1st review of the Economic Recovery Program, according to the Monetary Policy Committee, see [here](#).

On 5th of August the Central bank introduced a Capital Account Liberalization Strategy. The first step of the strategy was implemented on 1st of November 2009 allowing for foreign direct investments into Iceland. Liberalizing outflows will be initiated gradually at the Central Bank's discretion. No specific timeline has been set. See more information on the Liberalization strategy [here](#) and on the first step of the liberalization [here](#).

Simultaneously the surveillance on the foreign exchange rules was also been tightened. The Capital Controls Surveillance Unit within the Bank has been reorganized and fortified and the Central Bank's information gathering has been improved. In late October 2009 the rules on foreign exchange were tightened to hinder parties being able to exchange ISK abroad and import them at a more favorable exchange rate.

There has been a considerable difference between the off-shore and domestic exchange rate of the krona. Many have tried to gain from this arbitrage opportunity. The tighter regulation hinders bank deposits in ISK abroad being transported to an Icelandic bank. The ISK must be exchanged through the Central Bank. Consequently, the tighter regulation aided the MPC in lowering policy rates. See **chapter 12**. More information on this can be found [here](#).

In the MPC minutes in March 2010 it is stated that the Central Bank has not intervened in the foreign exchange market since early November 2009. See [here](#).

Guidelines on foreign exchange can be found [here](#) and in **appendix 3**. Information on the CB exchange rate can be found [here](#) and the off-shore exchange rate can be found [here](#).

## 11. THE ICESAVE DISPUTE

One part of the collapse of the Icelandic banking sector was the insolvency of Landsbanki in December 2008. A part of the bank was an online savings bank, called Icesave, operating in the United Kingdom (UK) and the Netherlands. See **appendix 7** for a timeline of the dispute and possible outcomes.

During the restructuring process of Iceland's financial system Landsbanki has been in moratorium and therefore creditors have not yet received reimbursements. Nevertheless, the governments of UK and the Netherlands reimbursed depositors of Icesave in their respective country. According to the European Economic Area legal framework the Depositors' and Investors' Guarantee Fund of Iceland is responsible for reimbursing the depositors up to certain amount, approximately 20.900 Euros. The reimbursement by the local governments (UK & Dutch) was therefore effectively a loan to the Depositors' and Investors' Guarantee Fund of Iceland. The Icesave dispute surrounds the terms of the loan and what conditions should apply to the state guarantee of the loan.

### 11.1. THE AUGUST ICESAVE ACT

On August 28th 2009 the Icelandic parliament passed an Act authorizing a state guarantee for the loans granted by the Governments of the UK and the Netherlands to the Depositors' and Investors' Guarantee Fund of Iceland. The law was signed with pre-conditions. The pre-conditions stipulated certain economic conditions for the repayments of the loans as well as legal rights regarding natural resources. A proposal of the preconditions can be found [here](#).

The president of Iceland signed the Act on 2 September 2009. His statement can be found [here](#).

## **11.2. THE DECEMBER ICESAVE ACT**

In light of the pre-conditions the Icelandic Government had to re-negotiate with the Governments of the UK and the Netherlands. The re-negotiations process was concluded on 18th of October with the Governments of the UK and the Netherlands accepting some of the conditions set by the Parliament. Further information can be found [here](#).

Since the agreement was not identical to the law passed in August a new law needed to be ratified as a successor to the earlier law. Many Icelanders felt that the key pre-conditions set forward in the Act that was passed in August had been removed and put tremendous pressure on the Icelandic parliament not to pass the bill. After several weeks of discussions in the Icelandic Parliament a new law was passed on December 30th 2009 with a majority of 33 votes against 30. Further information can be found [here](#).

## **11.3. THE ACT WAS NOT CONFIRMED BY THE PRESIDENT**

According to the Icelandic constitution the president needs to sign every law that is passed. If the president does not sign a law it must go under a national referendum as soon as possible. The president does not have the power to veto or block the law from going into force.

Over 60 thousand Icelanders, about a quarter of the electorate, signed a petition urging the president of Iceland not to sign the law that was passed on December 30th and calling for the Act to be subjected to a referendum. Further information can be found [here](#) (site only available in Icelandic).

On January 5th 2010 the President of Iceland declined to sign the law passed on December 30th. According to the constitution the law remains in force but is put under a national referendum as soon as possible. The Minister of Justice, Ms. Ragna Arnadóttir, set the date for the referendum which was held on 6th March. See [here](#). Further information on the president's decision can be found here, and on the national referendum can be found [here](#).

Following are a couple of articles written by Icelandic economist on the Icesave dispute that were written before the referendum. They contain useful information and statistics. See [here](#) and [here](#).

## **11.4. NATIONAL REFERENDUM ON MARCH 6 - A CLEAR "NO VOTE"**

The first national referendum in Iceland since the foundation of the Republic was held on March 6th. The referendum was on whether an amendment to the so-called December Icesave Act should stand or be repealed. The result was decisive and only around 1,5% voted in favor of the new amended act. The December Icesave Act was therefore repealed and the Act passed on August 28th will continue to be in force, recognizing that the government of Iceland acknowledges their obligations to the Governments of the UK and the Netherlands. For more information on the referendum and related information see the following links. For further information see [here](#) and [here](#).

The result of the vote has had minimal instant impact on the economic environment. The dispute received a great deal of attention following leading up to the vote and an increasing number of articles were written in Iceland's favor.

A fact sheets and key figures on the Icesave issue can be found in English [here](#). A fact sheet on the Icesave issue can be found in English [here](#) and in Norwegian [here](#). See also slide 16 in the following publication for the relative size of the Icesave debt relative to other sources, accessible [here](#).

## **11.5. WHAT WILL FOLLOW?**

A negotiation committee representing the Icelandic government was formed in February 2010 to meet with representatives of the UK and Dutch governments. Heading the negotiation committee is US attorney Lee C. Buchheit. Several meetings took place before the national referendum but talks were adjourned after the national referendum. No formal talks have taken place since then only informal contact (As of April 25th).

For more information on the negotiation committee see [here](#). The press release announcing that the Icesave talks had adjourned can be found [here](#).

Since the December Icesave Act was repealed the August Act is re-instated the Act passed on August 28th will continue to be in force, recognizing that the government of Iceland acknowledge their obligations to the Governments of the UK and the Netherlands. Work is still ongoing to find a mutually acceptable solution on this issue. See [here](#).

Because of the elections in Britain and Netherlands further discussions might be delayed until a new government has been formed. In the appendix some older information and links can be found regarding the Icesave dispute. Up to date information is released on the following website: [Iceland.org](http://Iceland.org).

### **11.6. IMPACT ON CREDIT RATING**

Following the decision of the president the credit rating of Iceland was lowered by Fitch ratings to BB+/BBB+; with a negative outlook. The lower credit rating does however not impact the ability or the cost of borrowing for Icelandic authorities since it is funded by the IMF and other loans from Nordic countries. Therefore the ratings have minimal effect on the cost of funding for the Icelandic Authorities. However, the decision could have some impact on Icelandic firms, in the short run, if the uncertainty surrounding the issue is not resolved.

The president was in an interview with Bloomberg business news network on January 7th 2010 where he explains the implications of his decision and his view on the impact on the credit rating of Iceland. See [here](#) (subscription required).

Other rating agencies put Iceland on a watch list with negative outlook. Like was mentioned before this has little practical significance for Iceland since it is funded by the IMF program and political lending from Nordic nations. Standard & Poor's placed Iceland on a watch list after the decision not to sign. See further information [here](#) and also again in February [here](#).

On March 31st 2010 Standard and Poor's confirmed the credit rating of Icelandic authorities in foreign currency but lowered it in domestic currency. See information on the decision here and a new report by Standard and Poor's on Iceland [here](#) and [here](#).

Moody's raised the outlook for Iceland from negative to stable on April 24th 2010 shortly after the IMF had concluded the 2nd review of the economic program. Moody's states in a press release that the change of outlook was driven by the improvement in Iceland's external liquidity due to the restoration of financing from the IMF and Nordic governments. "The successful passage of the IMF review and re-instatement of the Nordic credit line ensures that Iceland's external liquidity is now secure" says Kenneth Orchard, Vice-President/Senior Credit Officer in Moody's Sovereign Risk Group. "The resumption of official financial inflows into the country should also boost confidence and support the ongoing economic recovery." See the full press release [here](#).

## **12. THE IMF PROGRAM**

The 1st review of the Economic Recovery Program, which was scheduled to be concluded in May/June, was substantially delayed because of the Parliamentary debate over the Icesave Act. See [here](#).

On 28th of October 2009 the IMF's Executive Board approved the 1st review of the Economic Recovery Program, giving Iceland access to \$167,4 million from the IMF and also to \$675 million from the Nordic countries and Poland, see [here](#). The Governments statement regarding the approval and Letter of Intent can be found [here](#). In connection with the 1st review of the IMF program a staff report was published. See [here](#).

As a part of the 1st review of the IMF program the first tranche of Nordic loans was disbursed to Iceland on December 21st 2009. The first tranche amounted to 300 million euro's. See [here](#).

Representatives from the IMF visited Iceland from December 1-14th to undertake discussions for the 2nd review under the IMF program. In a statement following the visit the IMF anticipated that by January all policy actions for the 2nd review would be in place provided that financing assurances could be secured from Iceland's Nordic counterparts. See [here](#).

Some uncertainty was on whether financing from the Nordic counterparts would be available until after the referendum on the Icesave Act. Icelandic authorities deliberated with their Nordic counterparts on the issue in an effort to resolve some of the uncertainty which had arisen. See [here](#).

The Prime Minister of Iceland urged the IMF to continue the Economic Program in a press release regardless of the planned national referendum on the Icesave Act. See [here](#).

MR. Strauss-Kahn, Managing director of the IMF, answered a couple of questions in January 2010 on Iceland and the delay of the 2nd review. See [here](#).

The second review was scheduled in early spring 2010. Some discussions between Icelandic ministers and IMF took place before the second review in late March. See [here](#).

### **12.1. SECOND REVIEW OF THE IMF PROGRAM APPROVED IN APRIL**

On 16th of April 2010 the IMF's Executive Board approved the 2nd review of the Economic Recovery Program. Subsequently, USD 830 million in new funding from the IMF, the Nordic countries and Poland are available to strengthen the CBI's currency reserve. The IMF will release USD 160 million, while Poland makes USD 73 million available under the agreement and the Nordic countries an additional USD 600 million. For more information about the second review of economic program by the board of the IMF see [here](#) or [here](#).

An IMF staff Report that was written leading up to the Second Review under the IMF program. The report states that, "Indications are growing that Iceland's recession, while deep, will be less severe than expected. Program policies have contributed to this, and all relevant performance criteria for the second review have been met. A recovery is still expected to commence in 2010, but it will face headwinds from the private sector debt overhang and from fiscal consolidation." See the full report [here](#).

In connection with the second review of Iceland's economic program in collaboration with the IMF the government has issued an updated Letter of Intent. See [here](#).

An overview of Iceland's Economic Recovery program supported by the IMF can be found [here](#).

The third review will now be available on or after July 15, 2010, with quarterly reviews thereafter.

## **13. MONETARY POLICY - GRADUAL EASING**

### **13.1. SUMMER 2009 UNTIL EARLY JANUARY 2010**

The MPC of the Central Bank kept the collateral loan and deposit rates constant, at 12% and 9,5%, from June until November 2009. The MPC has lowered both the deposit and loan rates on two occasions in the fall of 2009 and early winter, first on November 5th to 11% and 9% and then on December 10th to 10% and 8.5%.

For more information on the November decision see here and [here](#). For more information on the December decision see [here](#) and [here](#).

Some uncertainty regarding further monetary easing arose after the President declined to sign the Icesave Act and put the Act under a national referendum. However, the governor of the Central bank, Mar Gudmundsson,

stated in an interview on Bloomberg that there is still room for monetary easing despite the uncertainty following the decision. See [here](#). See also **chapter 10** on the Icesave dispute. The rate has been lowered twice since then. See below.

### **13.2. PROGRESS FROM JANUARY UNTIL APRIL 2010**

The rate has been cut twice since December, in late January and in the middle of March 2010. After the second decision the rates on collateral loans and deposit rates are at 9% and 7,5%.

Information on the January decision can be found [here](#). Information on the March decision can be found [here](#). Up to date information on the decisions and releases by the MPC can be found [here](#).

### **13.3. ANNUAL MEETING OF THE CENTRAL BANK IN MARCH 2010**

The annual meeting of the Central bank of Iceland was held in February 2010. A speech by Central Bank Governor Mar Gudmundsson at the Bank's Annual General Meeting 2010 can be found [here](#).

Address by the Chairman of the Supervisory Board at the Central Bank's Annual General Meeting 2010 can be found [here](#) And the annual report in English can be found [here](#).

### **13.4. REVIEW OF THE MONETARY POLICY FRAMEWORK**

A review of the monetary policy framework is underway within the Central Bank of Iceland. The review is written to outline the options available to Iceland going forward. CBI governor, Mar Gudmundsson has spoken about the review, first at a conference held by the Iceland Chamber of Commerce in October and then again in a speech at the annual meeting of the CBI in February 2010. He has outlined that in principal there are two main options, first, some type of a currency union and second what he has nicknamed, "inflation target plus" which would include considerable macro prudential measures to accompany the inflation target. For more information see here and [here](#).

### **13.5. MONETARY EASING IN LATE 2009**

The decisions in late 2009 represent a gradual monetary easing process by the MPC. In the statement issued by the committee explaining the reasoning behind the December decision it is noted that the intervention in the foreign exchange intervention has been limited. Tighter regulation, enhanced surveillance, and more effective enforcement have made circumvention of the capital controls more difficult. Provided that the króna remains stable or appreciates and inflation continues to fall as forecasted the MPC expects that conditions for further easing of monetary policy should soon be in place.

There have also been other signs of improvement, e.g. lesser need for foreign exchange intervention by the Central Bank due to the ISK being broadly stable and the trade surplus was ISK 90 billion in 2009. In comparison compared to an ISK 6 billion deficit in 2008 and ISK 92 billion in 2007. Unemployment is forecast to average 8.6% in 2009 and reach 10.6% in 2010, but decline in 2011 to 9%.

### **13.6. ROOM FOR FURTHER GRADUAL MONETARY EASING**

Inflation did not come down as fast as expected in early 2009 due in part by the weakness of the exchange. Inflation was 18.6% at the beginning of 2009 but down to 7.5% by the end of the year. Inflation is expected to come down further in the coming months. The exchange rate is assumed to remain stable in 2010, and inflation to average 5.0 per cent for the year but approach 2.5 per cent by year end. For 2011, a 2.3 per cent inflation rate is forecasted. See also **chapter 14** on fiscal policy.

In the March 2010 MPC minutes it is stated that the preliminary quarterly national accounts figures indicate that the Icelandic economy was somewhat stronger in Q4/2009 than was assumed in the Central Bank's January forecast, which appeared in Monetary Bulletin 2010/1. Information on the decision can be found [here](#) and the latest Monetary Bulletin [here](#).

Additionally in the MPC minutes from March 2010 it is stated that if the ISK remains stable or appreciates, and if inflation continues to subside as forecast, there should be scope for continued gradual monetary easing. However, the MPC stressed that, as long as there is significant uncertainty about Iceland's future access to foreign capital markets, it will limit the Committee's room for maneuver. Furthermore, the MPC agreed that it should stand ready to adjust the monetary stance as required to achieve its interim objective of exchange rate stability and ensure that inflation is close to target over the medium term.

The next decision of the MPC will be announced on May 5th 2010. An issue of the next Monetary Bulletin will also be released simultaneously. See [here](#).

### **13.7. OTHER RELEVANT INFORMATION**

Information on Iceland's CDS spread can be found [here](#). The Central Bank of Iceland's report Financial Stability 2009 can be found [here](#).

More information on the monetary policy of the central bank and their current stance can be found in the Monetary Bulletin. See [here](#). A report on the work of the Monetary Policy Committee was published in December 2009. See [here](#).

The latest inflation forecasts by the central bank can be accessed [here](#).

Information on the Monetary policy and instruments can be found [here](#) and information on the next decision and publications by the MPC can be found [here](#).

## **14. THE EUROPEAN UNION: APPLICATION IN PROCESS**

The Icelandic Parliament voted on 16th of July 2009 in favor of applying for membership to the European Union (EU). Proposals from the Parliament's Foreign Affairs Committee regarding the application can be found [here](#).

Iceland's application was submitted to the Swedish Government, which held the EU presidency at the time, on 17th July and on 27th of July the Foreign Ministers of the EU invited the Commission to formulate an opinion on Iceland's application, see [here](#). A copy of the application can be found [here](#). The Commission questionnaire was formally presented to the Icelandic Prime Minister Ms. Johanna Sigurdardóttir by Mr. Olli Rehn, the European Commissioner for Enlargement on 8th of September and the answers were submitted on 22th of October. See the questionnaire and the answers [here](#).

The Minister for Foreign Affairs, Mr. Ossur Skarphedinsson, appointed Ambassador Mr. Stefan Haukur Johannesson on November 2nd to serve as Iceland's Chief negotiator in the upcoming accession negotiations with the European Union. Mr. Johannesson is an experienced international negotiator which has served as Iceland's Ambassador to the European Union in Brussels since 2005. See [here](#). More information on Mr. Johannesson and other members of the negotiation committee can be found [here](#). An interview with Mr. Johannesson can be found [here](#).

In November 2009 an agreement was signed on the establishment of a European Commission Delegation in Iceland. Information regarding new developments concerning Iceland can be found in the press corner of the European Commission Enlargement webpage. See [here](#) and [here](#).

In January 2010 the Foreign Minister of Iceland met with Mr. Miguel Ángel Moratinos, who holds the Presidency of the European Union, regarding the impact of the Icesave debate on Iceland's application. Mr. Moratinos stated that the Spanish EU Presidency viewed the Icesave issue and Iceland's EU application as separate issues, and that the new situation that has arisen in Iceland would not have any impact on EU's treatment of the application. See [here](#).

#### 14.1. CHANGES SINCE FEBRUARY 2010

The Prime Minister of Iceland met with Mr. José Manuel Barroso, President of the European Commission and Mr. Olli Rehn, Commissioner for Enlargement and Commissioner Designate for Economic and Monetary Affairs in early February. At the meeting the Prime Minister gave a detailed account of the state of affairs in Iceland. For more information see [here](#).

On 24th of February 2010, the European Commissioner for Enlargement and European Neighborhood Policy recommended to the Council of the European Union to start accession negotiations with Iceland. See [here](#).

See also [here](#) for the key findings of the commission's opinion on Iceland.

While it was expected that Iceland would be considered for official candidate status at the EU summit in March, this was delayed to allow the German national parliament, which has the authority to debate important EU policy such as enlargement before action is taken by the government, to consider the matter. For more information on the Accession of Iceland to the European Union see [here](#), parliament voted on favor of Iceland's application on April 22nd. Iceland should therefore be able to receive candidate status shortly. See [here](#).

#### 14.2. FURTHER INFORMATION ON ICELANDS' EU APPLICATION

The Ministry of Foreign affairs has dedicated a section on their website to Iceland's EU application process where up to date information and a timeline of events can be found. See [here](#) and [here](#).

- » Iceland's historic relations with the EU can be found [here](#).
- » Information on the Enlargement Strategy and Main Challenges of the EU for 2009-10 is accessible [here](#).
- » Iceland's country profile at the European Commission can be found [here](#).

### 15. THE STATE TREASURY: HIT HARD IN THE TURMOIL

The aftermaths of the financial crisis has hit the State Treasury and municipalities significantly, both in terms of revenue and expenditure: The Ministry of Finance released a press release on March 16th 2010 on total treasury debt, see [here](#).

- » Total Treasury debt at the end of 2009 corresponded to 78 per cent of GDP.
- » Net Treasury debt (i.e. debt less financial assets) amounted to 39 per cent of GDP at the same time.

The Ministry of Finance published a Macroeconomic forecast for 2009-2014 in the fall of 2009. A few highlights of the report are listed below. The report in its entirety can be found [here](#). Macroeconomic forecast is expected from the Central bank in early May 2010 and will be found [here](#). Measures to achieve a balance in fiscal finances 2009–2013 can be found [here](#).

**Net Government (and Central Bank) debt** has increased as a direct result of the failure of the banks by around 13% of GDP. Most of this figure reflects funds advanced to the banks by the CBI and, to a much lesser extent, the Treasury. In addition, the Government will incur debt to meet minimum EU deposit guarantee requirements on Landsbanki's Icesave accounts in the United Kingdom and the Netherlands. Assuming a 75% recovery ratio, (the Resolution Committee is expecting 90% recovery) the CBI estimates that the present value of the cost to the Icelandic Government of meeting this obligation is ISK 240 billion (17% of estimated GDP in 2009).

**Treasury revenues** contracted significantly towards the end of 2008 and in 2009 with most of the tax bases shrinking with increased bankruptcies in the private sector, especially company and capital taxes. Due to reduced private consumption revenues from VAT and excises taxes have also contracted. There has been a

major overhaul, and controversial, of the tax system in Iceland which was geared towards generating more revenue and closing the fiscal deficit.

**The 2010 budget** is based on the premises set out in, and aimed at achieving the objectives of, the report on Government plans for fiscal balance in 2009-2013 which is based on the IMF Economic Recovery Program. The Budget Highlights for 2010 from the Ministry of Finance can be found [here](#) and the Treasury finances for January-November 2009 can be found [here](#).

**The nation's gross foreign debt** is predicted to be about 320% of GDP at the end of 2010. However, out of that about 260% is private debt which the state is not responsible for. The foreign debt of the state and municipalities, which is about 60% of GDP, will decrease rapidly in the coming years and this will prove to be decisive.

**The growth in public debt** has slowed. A year ago the deficit was ISK 218 billion ISK but the 2010 budget estimates it at ISK 99 billion. The budget approved by Althingi is in line with the government's plan to return to surplus in 2013. At that point repayment of public debt will commence.

**Treasury cyclical expenditures** have increased with the sharp increase in unemployment which has put the unemployment benefit scheme under considerable pressure. The revenue balance amounted to 13% of GDP that year. In 2009, the deficit is estimated to reach 9% of GDP. The Government took various measures over its summer session to dampen the hit and it has also put forth legislation on the national budget for the year 2010 with further measures. The economic plan assumes considerable fiscal consolidation in coming years to bring about a surplus and debt reduction.

### 15.1. POLICY ACTIONS

The Government has put forward a series of policy actions initiative in response to the crisis. Some highlights of policy initiatives are listed below:

- » Personal income tax rates were increased by 1.25% and a temporary 8% surcharge was introduced on high incomes at the beginning of 2009. A new three bracket progressive tax system put in place for 2010.
- » Various benefits were decreased, such as maternity/paternity leave benefits, and income thresholds for others were lowered.
- » Social security contribution, paid by Icelandic companies, was increased to a level that is expected to balance the unemployment fund's accounts.
- » Government expenditure measures of restriction around 1.5% for the Ministries and their institution were introduced in June. The Icelandic National Audit Office issued a statement that this goal was not achieved.
- » The national budget for 2010 entails increased taxes, e.g. new energy, environmental and resource taxes, increased capital and income taxes, as well as changes to commodity taxes and a expansion of the VAT base and reclassification of VAT levels.
- » The national budget also entails expenditure measures of restriction around 10% in the Government's administration, 7% in educational matters and 5% in welfare matters. Public investments will be reduced and further decreases in benefits, such as child support benefits, have been introduced.
- » Various initiatives to guarantee partial payment relief for households have been adopted
- » Major debt restructuring is ongoing for individuals and firms. Freezing of auctions has also been in place for several months. Despite the efforts it is still estimated that around 12% of households are facing serious debt problems.

A general overview of the economic recovery can be found [here](#) and [here](#). An article from the Prime Minister at the end of 2009 stating some fiscal policy initiatives can be found [here](#). The new macroeconomic forecast from the Ministry of Finance can be found [here](#) and the forecast for 2009-2014 can be found [here](#).

## 15.2. OTHER INITIATIVES, REPORTS AND MEASURES

The Central Bank held a symposium at the Central Bank of Iceland in April 2010 on the position of Icelandic households and what debt restructuring measures can achieve. The results indicate that 23% of households, or 24,000 households, are still in financial distress in spite of the measures examined in the analysis. See [here](#).

The Icelandic government is working along with the IMF to identify fiscal measures that need to be taken for the years 2011-13. The authorities' medium-term plan already identifies additional revenue options, but the authorities have also requested technical assistance from the Fund to facilitate continued work to improve the underlying structure of taxation. Further information can be found [here](#) in the IMF staff report.

Icelandic Pension Funds Association recently published a report on the responsibilities of the funds leading up to the crisis. The report entitled "Lessons that the pension funds can learn from the crash of 2008-2009" (is. Lærdómur lífeyrissjóðanna af hruninu 2008-2009) The report can be found [here](#) (only in Icelandic). A news article on the report in English can be found [here](#).

On March 26th 2010 the government agreed on a bill which will give the Competition Authority broader powers to act in cases where a market dominant firm or market structure prevents or hinders competition. The Competition Authority will thus have the power to break up a market dominant firm even when no specific prohibitory provisions have been violated. For more information see [here](#).

The Nordic Economic Report 2009 was presented by The Minister of Economic Affairs, Dr. Gylfi Magnússon, at the Nordic finance ministers meeting in Copenhagen in December 2009. The Nordic Economic Report is a joint project by the Nordic countries and is published once each year. See the full report [here](#).

## 16. THE NASDAQ OMX: SLOWLY PICKING UP PACE

Before the financial crisis hit Iceland seriously, market cap on the equity market amounted to around 120% of GDP. This number has now been brought down to around 20% of GDP after the collapse of the three biggest banks, Glitnir, Landsbanki and Kaupthing. After trading was suspended for three trading days in the second week of October 2008 the OMX Iceland 15 index closed at 678.4, which corresponds to a plunge of about 77% compared with 3,004.6 closing on October 8th, 2008. This reflects the fact that the value of the three big banks, which formed 73.2% of the value of the OMX Iceland 15, had been set to zero.

On 2nd of January 2009 the OMX Iceland 15 index was replaced with a new index, the OMXI6. The new index comprised of 6 companies instead of 15, which have the most trading volume of the listed companies and which are mostly industry based. The index combination will be revised 1st of January and 1st of July each year.

### 16.1. OTHER INITIATIVES, REPORTS AND MEASURES

Despite the heavy blow the NasdaqOMX Iceland Stock Exchange is on a good recovering phase. The OMXI6 index has risen by nearly to 968 in late April 2010 from a low of 607 in March 2009. The year of 2009 was a record breaking year in the trading volume of bonds. More information on the NasdaqOMX Iceland Stock Exchange can be found [here](#). Information on the bond market can be found [here](#). General information on the Icelandic stock and bond market can be found [here](#).

## 17. STABILITY PACT: AN EXTENSION OCT 2009-NOV 2010

Near the end of June 2009 the Government, both central and local, and the Confederation of Employers and the Confederation of Employees signed an agreement, The Stability Pact. The Pact's aim is to secure broad social consensus for adjustment measures necessary to ensure economic recovery. Its aim is also to "create conditions for increased investment by both domestic and foreign parties, stronger growth, boosting employment and laying the foundation for improved living standards in the future."

The objective of the agreement was to deter a rise in inflation due to the interdependence of wage increases and inflation, i.e. hindering that a rise in wages due to collective wage agreements would lead to a rise in inflation. Additionally, the agreement was signed in an effort to secure stability in the labor market and create a foundation for further growth.

The Pact stipulates e.g. that collective wage agreements shall remain valid until the end of November 2010; that the balance in the national budget shall be attained with a suitable mix of cuts in expenditure and higher taxes; that the Government shall pave the way for major investment projects and seek co-operation with Icelandic pension funds to finance infrastructure projects. It also stipulated some monetary and economic conditions. See [here](#) and [here](#).

### **17.1. THE STABILITY PACT RENEWED**

In the Stability Pact certain economic and monetary objectives needed to be met before November 1st 2009. Since it was foreseen that some conditions, e.g. monetary condition, would not be met the Government and the Confederation of Employers and the Confederation of Employees signed an extension to the agreement on 28th October 2009 that secures the Pact will be in force until the end of November 2010. In the agreement modest wage increases were implemented from November 1st 2009 but a considerable part of previously agreed wage increases were postponed until 1st July 2010.

The pact is still in place but some uncertainty is regarding the future of the pact because of a disagreement on the policies taken by the current government.

## **18. ALTHINGI SPECIAL INVESTIGATION COMMISSION**

A Special Investigation Commission (SIC) of the Parliament was formed to investigate whether any public officials were responsible of misconduct. The report was published in April 2010. Following the release of the Special Investigation Commission report in April 2010 three congressmen, one of which a former minister took a leave of absence from congress. See [here](#) and [here](#).

The Icelandic government welcomed the report published by the Special Investigation Commission (SIC) of the Parliament on the causes of the collapse of the Icelandic banking system. Consisting of independent experts, the Investigative Commission was established by the Icelandic parliament in December 2008. The report is the first comprehensive analysis of the causes of the collapse of the three largest Icelandic banks in the midst of the global financial crisis of October 2008.

According to the report the main cause of the failure of the banks was the rapid growth of the banks and their size at the time of the collapse. The big three banks grew 20-fold in size in seven years.

The report also finds that Iceland's government, central bank governors and the head of the financial regulator authority in 2008 all showed negligence in breach of existing laws that allowed the collapse of Iceland's financial industry. Former Prime Minister Geir H. Haarde, former Finance Minister Arni M. Mathiesen, Jonas Fr. Jonsson, the former head of the Financial Supervisory Authority and David Oddsson, the former Governor of the central bank, all acted negligently according to the Committee.

Several criminal and white collar investigations are under way both in regular channels as well as the special prosecutor which was especially established following the collapse. The Special Prosecutor will investigate suspicions of criminal actions in the period preceding, in connection with or in the wake of the collapse of the Icelandic banks, whether this is connected to activities of financial undertakings, other legal entities or individuals, and as the case may be, follow up on these investigations by bringing charges in court against those concerned. More information can be found [here](#).

The government issued a press release following the release of the report welcoming the report. “This important report will enable us to look forward by understanding what took place here in the months and years leading up to the banking collapse” said Prime Minister Johanna Sigurdardottir. The press release can be found [here](#).

News articles on the report can be found in the archive of the Iceland review website, see [here](#). Note: Most articles relating to the report are dated on April 12th, the day of the release, or in the couple of weeks following the release.

A presentation in English from the press conference following the release of the report can be found [here](#). A video from the news conference following the release, in English, can be found on the following website, see [here](#). The report can be found on the following site: [sic.althingi.is](http://sic.althingi.is)

A good overview of ongoing investigations and what measures have been taken can be found in here. The overview lists the number of cases from the special prosecutor and as well as general information on the work by the SIC, accessible [here](#).

## 19. VOLCANIC ERUPTION IN EYJAFJALLAJÖKULL

An eruption started in Eyjafjallajökull in the southern part of Iceland on March 20th. A second, more powerful, eruption followed on April 14th. Even though the eruption has impacted the flight schedules of millions in Europe and around the world it has had minimal impact on daily life in Iceland. Only a small part close to the eruption has been affected by the volcanic ash and there are no signs are visible of the eruption in Reykjavík. No one knows how long the eruption can and will last. Updates on the eruption can be on the following sites.

- » Travelers’ in Iceland are safe and sound, see [here](#) and [here](#).
- » The information center by the government can be found [here](#).
- » Statement by the Government of Iceland can be found [here](#).
- » A few excellent images can be found [here](#) and [here](#).
- » A large archive of pictures can be found [here](#).

## 20. 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.

A sign of how technology driven the nations is that in April 2010 an international seed Forum and investment forum for Innovation Companies was held in Iceland. A speech from by the minister of Industry can be found [here](#).

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, Iceland’s future is bright and prosperous.

**Appendix 1: Timeline of the Icelandic Financial Crisis**

A timeline of events from October 2008 until May 2009 and corresponding news articles can be found [here](#).

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. 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.
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. 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.
November 19	The Icelandic Government enters into a program with the IMF which approves a two-year SDR 1.4 billion (about US\$2.1 billion) Stand-By Arrangement to support the country's program to restore confidence and stabilize the economy.
November 28	New foreign exchange regulation is implemented
<b>2009</b>	
January 1	OMX Iceland 15 index replaced with a new index, the OMXI6.
January 2	Mr. Geir H. Haarde, Prime minister at the time, announces that national elections will be held in May 2009. Coalition government of the Independence Party and the Social Democratic Alliance comes to an end. New government is formed - a coalition of the Social Democratic Alliance and the Left-Green Movement. The coalition does not have parliamentary majority but receives a neutrality support by the Progressive Party. Election date set for April 25th 2009.
February	Parliament passes new act on Central Bank, subsequently Mr. Svein Harald Øygard is appointed interim Governor of the bank and Mr. Arnór Sighvatsson is appointed interim Duputy Governor.
April 4	Parliament approved amendments to the Act on Foreign currency
April 24	National elections for Parliament, in the elections the Social Democrats and Left-Greens get majority of seats in the Parliament. Coalition Government of the two parties continued, now with parliamentary majority.
June	Local and central governments, Confederation of Employers and Confederation of Employees sign The Stability Pact
June 26	Prime minister appoints Mr. Már Guðmundsson as new Governor of Central Bank, for a five year term, and Mr. Arnór Sighvatsson as Deputy Governor, for a four year term.
July 16	Parliament votes in favor of applying for membership to the EU.
July 17	Iceland's application for the EU submitted to the Swedish Government, which holds EU presidency.
July 20	Agreement announced on the initial capitalization of the new banks.
August 2	Laws passed on the Icelandic Banking Agency
August 5	Central bank introduces Capital Account Liberalization Strategy – First step implemented November 1st.
August 28	IceSave - Parliament passes an Act authorizing a state guarantee for the loans granted by the Government of the UK and the Netherlands to the Depositors' and Investors' Guarantee Fund of Iceland
September 2	IceSave – President of Iceland signs IceSave act with a special reference to preconditions set by the Parliament.
October	Rules on foreign exchange tightened to hinder parties being able to exchange ISK abroad and import them at a more favorable exchange rate.

October 15	Resolution Committee of Glitnir acquires 95% of the share capital in Íslandsbanki against 5% held by the Government
October 18	IceSave – Re-negotiations concluded with Governments of the UK and Netherlands
October 22	Answers to EU Commission questionnaire formally presented to Olli Rehn, the EU Commissioner for Enlargement
October 28	IMF's Executive Board approves first review of the Economic Recovery Program for Iceland. Local and central governments, Confederation of Employers and Confederation of Employees sign an extension to The Stability Pact.
November 2	Minister of Foreign Affairs, Mr. Ossur Skarphedinsson, appoints Ambassador Mr. Stefan Haukur Johannesson to serve as Iceland's Chief negotiator in EU negotiations
November 5	Monetary Policy Committee (MPC) lowers the deposit and loan rates to 11% and 9%.
December	Representatives from the IMF visit Iceland to undertake discussions for second review
December 1	Resolution Committee of Kaupthing acquires 87% of common equity in Arion Bank against 13% held by the Government
December 10	Monetary Policy Committee (MPC) lowers both the deposit and loan rates to 10% and 8.5%.
December 16	Final agreement announced between Ministry of Finance and the Resolution Committee of Landsbanki Íslands hf. The government acquires 81% of the share capital in Landsbanki (NBI hf.) against 19% held by the Resolution Committee of Landsbanki Íslands hf.
December 30	IceSave – New law passed in the Parliament on conditions of the October re-negotiations
<b>2010</b>	
January	FSA authorizes ISB holding ehf on behalf of creditors of Glitnir to own a qualifying holding in Íslandsbanki. Similarly the FSA authorizes Kaupskil ehf. on behalf of creditors of Kaupthing to acquire a qualifying holding in Arion Bank.
January 5	IceSave - President of Iceland, Ólafur Ragnar Grímsson, declines to sign law passed on December 30th. Law will be put under national referendum as soon as possible.
January 19	Minister of Justice, Ragna Árnadóttir, sets a date on national referendum. The referendum is set for March 6 2009.
March 6	Scheduled date for the referendum on the Icesave Act

## Appendix 2: More on the new Bank Act

As previously mentioned the Icelandic parliament passed on October 6<sup>th</sup> 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 were dismissed.
2. Special Resolution Committees were appointed to take over board activities and management.
3. New companies were founded around the old banks domestic operations.
4. The FSA decides on disposal of assets and liabilities of the old banks to the new companies.
5. The Government, the Resolution Committees and the new banks came to an agreement on capitalization of the new banks and compensation to creditors of the old banks.
6. The Resolution Committee of Glitnir, on behalf of its creditors, decided to acquire 95% of the new bank, Íslandsbanki.
7. The Resolution Committee of Kaupthing, on behalf of its creditors, has a deadline until 31st October to decide on acquisition of the new bank, New Kaupthing.
8. NBI bank, built on the domestic operations of Landsbankinn, will be owned by the Government.
9. In January 2010 the FSA authorized Kaupskil ehf., on behalf of the creditors of Kaupthing, to acquire a qualifying holding in Arion Bank hf. Similarly the FSA authorized ISB Holding ehf. on behalf of the creditors of Glitnir, to own a qualifying holding in Íslandsbanki See [here](#) and [here](#).

### See also:

Competition authority to receive broader powers to break up dominant firms, accessible [here](#).

An overview of the reforms in the financial sector since October 2008 until april 2010 can be found [here](#).

Information on the number of investigations and progress of those investigations can be found [here](#).

## Appendix 3: Q&A 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, see [here](#).

## Appendix 4: The New Act on the Central Bank

Act no. 5/2009 amending the Act on the Central Bank of Iceland, no. 36/2001, was passed by Parliament in late February. The new Act provides for one Governor and one Deputy Governor within the Central Bank instead of a Board of Governors. Decisions on applying the Central Bank's monetary policy instruments will henceforth be taken by a Monetary Policy Committee. In other respects, the Bank's direction will be in the hands of the Governor.

According to the new law, the Board of Governors of the Central Bank of Iceland has been abolished, together with the positions of the three Governors who sat on the Board, including the position of Chairman of the Board of Governors.

Pursuant to the new law, the Prime Minister appointed Mr. Svein Harald Øygard to act as interim Governor and Mr. Arnór Sighvatsson, the Bank's Chief Economist, to act as interim Deputy Governor. Information on Svein Harald Øygard can be found [here](#). The interim Governor and Deputy Governor held these positions

until appointments were made by the Prime Minister on the basis of advertisements, in accordance with the provisions of the Act.

On 26<sup>th</sup> of June the Prime Minister appointed Mr. Már Guðmundsson as the new Governor of the Central Bank, for a term of five years, and Mr. Arnór Sighvatsson as Deputy Governor, for a term of four years. The Governor appointed on 15<sup>th</sup> of September Mr. Þórarinn G. Pétursson as the Chief Economist of the Central Bank. Information about the Central Bank's new Governors' and new Chief Economist can be found [here](#) and [here](#).

A report on the work of the Monetary Policy Committee was published in December 2009. See [here](#). Information on the decision by the MPC can be found [here](#).

Monetary policy instruments and transmission mechanism see [here](#) and [here](#).

### **Appendix 5: The IMF Loan Package**

On November 19<sup>th</sup> the IMF approved Iceland's request for a two year stand-by arrangement. Iceland will receive USD 2.1 billion from the IMF. Additional loans of up to USD 3 billion have been secured from Denmark, Finland, Norway, Sweden, and Poland. These loans are based on Iceland's agreement with IMF. The Faroe Islands have announced that they would lend Iceland USD 50 million.

The loans main purpose is to buttress Iceland's liquid foreign exchange reserves, and by doing so increasing the economy's credibility and its capabilities to address potential capital outflow, and protect the ISK, once the currency restrictions are lifted. The loans will up to some extent also be used by the Government to pay loans maturing in the near future.

#### **a) The IMF Loan**

On 19<sup>th</sup> of November the Executive Board of the IMF approved a two-year SDR 1.4 billion (about USD 2.1 billion) Stand-By Arrangement for Iceland.

The approval made SDR 560 million (about USD 827 million) immediately available and the remainder is available in eight equal installments of SDR 105 million (about USD 155 million), subject to quarterly reviews. Iceland has already drawn the initial USD 827 million and is now able to draw the first of eight installments as the 1<sup>st</sup> Review of the IMF Economic Program has been approved by IMF's Executive Board.

Further information on the IMF loan can be found [here](#), [here](#) and [here](#). Further information on the IMF program can be found [here](#). After the second review of the IMF program a staff report was published. See [here](#).

#### **b) The Nordic Loans**

In July 2009 the Nordic countries agreed to loan Iceland in total of EUR 1.775 billion, which is equivalent to USD 2.5 billion or ISK 317 billion. The loan agreements with Denmark, Finland, and Sweden are between the Icelandic Government and the governments concerned, while the agreement with Norway is between the two countries' central banks. The loans will be disbursed in four equal tranches tied to the IMF's reviews of the Icelandic economic program.

The loans will be disbursed in Euros with an overall maturity of 12 years, with installment payments of principal deferred for the first five years during which time interest will be paid quarterly. At the end of the five-year period, the principal amount will be repaid in equal quarterly installments for the remainder of the loan period. The loans will bear variable (floating) interest based on three-month EURIBOR rates, plus a 2.75% premium. Further information on the Nordic loans can be found [here](#).

As a part of the 1st review of the IMF program the first tranche of Nordic loans was disbursed to Iceland on December 21st 2009. The first tranche amounted to 300 million euro's. See [here](#).

### c) The Polish Loan

In October 2009 The Republic of Poland agreed to lend Iceland PLN 630 million, the approximate equivalent of USD 200 million. The loan's overall maturity of 12 years, with a grace period of five years. The loan will be disbursed in three equal tranches tied to the second, third and fourth reviews of Iceland's IMF program, with the payment of each tranche conditional on the approval of the respective review.

The loan will be denominated and disbursed in Polish z<sup>3</sup>oty (PLN). The net cost to the borrower will consist only of an interest margin to be paid simultaneously with interest payments on the Polish Treasury Bonds issued by the Polish Treasury. This interest margin will be 2% per annum until 31 December 2015 and 1.3% per annum thereafter. The loan will be repaid in four installments coinciding with the maturity dates of the selected Polish Treasury Bonds, in October 2015, 2017 and 2019, and in September 2022.

Further information on the Polish loan can be found [here](#).

### d) The Faroe Islands' Loan

A loan agreement was signed between the Government of the Faroe Islands and Iceland in March 2009. Under the agreement, the Government of the Faroe Islands will lend the Republic of Iceland DKK 300 million. The loan was the first bilateral loan of this type extended to Iceland, and it is not based upon the IMF economic program.

Further information on the Faroe Islands' loan can be found [here](#).

### e) The Russian Loan

The Russian Government indicated in November 2008 its willingness to lend up to 500 million dollars. The loan agreement negotiations have abolished.

## Appendix 6: Macroeconomic Forecasts

For further information on macroeconomic forecasts, please review:

- » Central Bank of Iceland, [Monetary Bulletin](#), Issued four times per year.
- » OECD [Economic Outlook](#), November 2008.
- » OECD [Economic Survey](#), September 2009.
- » OECD [Economic policy reforms](#): Going for growth in 2010
- » Ministry of Finance updated [macroeconomic forecast](#) for 2009.
- » Ministry of Finance [macroeconomic forecast](#) for 2009-2014.
- » On overview of [economic indicators](#) in Iceland.
- » Report on [financial stability](#) published in October 2009.
- » [Inflation forecast](#) by the Central bank
- » [Key economic figures](#) from Statistics Iceland

Statistics Iceland is the centre for official statistics in Iceland: [statice.is](#)

For information on the IMF stabilization program and the progress being made, please refer to the [IMF's website](#) and for the most recent publications on Iceland from the IMF please refer to the section on [Iceland](#).

## Appendix 7: Icesave timeline from fall 2009

Since the first agreement on Icesave was delivered to Parliament the development has been the following:

- » On August 28th the Icelandic parliament, Althingi signs a law authorizing a state guarantee for the loans granted by the Governments of the United Kingdom and the Netherlands to the Depositors' and Investors' Guarantee Fund of Iceland. The law was signed with certain preconditions.
- » The president of Iceland decided to sign the Act on 2 September 2009, with a special written reference to the preconditions set by the Althingi.
- » In light of the pre-conditions the Icelandic Government had to re-negotiate with the Governments of the United Kingdom and the Netherlands. The re-negotiations process was concluded on 18th of October with the Governments of the United Kingdom and the Netherlands accepting the principal points of the conditions set by the Parliament.
- » Since the agreement is not identical to the law passed in August a new law needed to be passed. After several weeks of discussions a new law was passed on December 30th 2009.
- » On January 5th 2010 the President of Iceland declined to sign the law passed on December 30th. According to the constitution the law remains in force but is put under a national referendum. Scheduled on March 6th.
- » The government appoints a negotiation committee to hold talks with the Britain and Netherlands. No agreement is made before the referendum.
- » Referendum is held on March 6th. Only 1,5% want the bill to be passed.
- » Formal talks have adjourned between Icelandic authorities and the Governments of Britain and the Netherlands.
- » No formal discussions are planned. They will most likely be postponed until after the elections in Britain and the Netherlands.

## Appendix 8: Icesave issue: Background material from older version

In a press release regarding the decision of the president the Government of Iceland emphasized that it remains fully committed to implementing the bilateral loan agreements with the UK and the Netherlands and thus the state guarantee provided for by the law. The Government views the loan agreements with the UK and the Netherlands as an integral part of Iceland's economic program. The Government economic recovery plan developed in cooperation with and supported by the International Monetary Fund and with financing from the IMF and governments of the Nordic countries and Poland, remains in effect. The press release can be found [here](#).

The Icelandic Minister of Finance conferred with his Nordic counterparts explaining the situation that arose following the denial of the President. The parties discussed the impact and repercussions this could have on the continuation of disbursements and the implementation of the loan agreements which are in place between Iceland and the Nordic countries, which are a key factor in Iceland's economic recovery program agreed with the IMF. See [here](#).

For information on the impact of the decision on Iceland's EU application. See chapter 13

The prime minister of Iceland wrote an article in the UK Observer explaining the commitment of the Icelandic government to honoring its obligations. See [here](#).

Another interview with the PM following the decision can be found [here](#).

The Icesave Act from August can be found [here](#).

The Ministry of foreign Affairs has published background information and some basic facts about the Icesave debate. See [here](#) and [here](#).

## Appendix 9: Further Information

For further information on this Status Report contact:

- » Mr. Finnur Oddsson - managing director - finnur@vi.is
- » Mr. Frosti Ólafsson - deputy managing director - frosti@vi.is
- » Mr. Haraldur I. Birgisson - general counsel - haraldur@vi.is
- » Mr. Björn Þór Arnarson - economist - bjorn@vi.is

For further information on the Iceland Chamber of Commerce visit: [www.vi.is/english](http://www.vi.is/english)

A general Q&A on the financial situation in Iceland can be found [here](#).

For further information on reports issued by the Central bank contact:

- » [sedlabanki@sedlabanki.is](mailto:sedlabanki@sedlabanki.is) or +354-569-9600

For further information on the Resolution Committees and the disposal of assets and liabilities between the old and new banks contact the FSA:

- » [fme@fme.is](mailto:fme@fme.is) or +354-525-2700