Government of Iceland

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The Icelandic Government's program with the IMF

In the wake of the recent international financial turmoil, Iceland's economy is facing a banking crisis of extraordinary proportions. The economy is heading for a deep recession, a sharp rise in the fiscal deficit, and a dramatic surge in public sector debt – by about 80%. Potentially substantial capital outflows could lead to a further large loss in the value of the króna. In the context of the high leverage in the economy, this would produce massive balance sheet effects and a substantial contraction in domestic activity. The immediate challenges are, therefore, to restore a functioning and viable banking system, and to stabilize the króna. Looking further ahead, the challenge will be to reduce a very high level of public debt, by embarking on a process of sustained fiscal consolidation.

Banking sector restructuring and insolvency framework reform

The Icelandic government is committed to progressing a sound and transparent process as regards depositors and creditors in the intervened banks. Constructive work is being carried out towards comparable agreements with all international counterparts for the Iceland deposit insurance scheme in line with the EEA legal framework. Under its deposit insurance system Iceland is committed to recognize the obligations to all insured depositors. This is done under the understanding that prefinancing for these claims is available by respective foreign governments and that Iceland as well as these governments is committed to discussions within the coming days with a view to reaching agreement on the precise terms for this prefinancing. Furthermore, it is recognized that the payment by the new banks of the fair value for the assets transferred from the old banks is a key factor in the fair treatment of depositors and creditors in the intervened banks. Accordingly, we have instituted a transparent process involving two sets of independent auditors to establish the fair value of the assets. More generally, the fair, equitable and non-discriminatory treatment of depositors and creditors will be ensured in line with applicable law.

The bank regulatory framework and supervisory practice will be reviewed to strengthen the safeguards against potential new crises. Previous senior managers and major shareholders in intervened banks who are found to have mismanaged the banks should not assume similar roles for at least three years.

The insolvency framework to manage deleveraging and recovery in the banking, corporate and household sectors in an efficient manner will be reviewed.

Fiscal policy

Preliminary estimates suggest that the gross cost to the budget of honoring deposit insurance obligations and of recapitalizing both commercial banks and the Central Bank of Iceland could amount to around 80 percent of GDP and the general government deficit will be 13.5 percent of GDP in 2009. Overall, gross government debt could rise from 29 percent of GDP at end-2007 to 109 percent of GDP by end-2009. The net cost will be somewhat lower on the assumption that money can be recovered by selling assets from the old banks.

In order not to exacerbate the recession, the fiscal deficit will be allowed to widen to the extent that this is driven by higher expenditures and lower revenues due to the effects of the economic cycle. But given the high financing need and the dramatic increase in public sector debt, a planned discretionary fiscal relaxation in 2009 will be significantly scaled back.

The intention is to reduce the structural primary deficit by 2–3 percent annually over the medium-term, with the aim of achieving a small structural primary surplus by 2011 and a structural primary surplus of 3½-4 percent of GDP by 2012. A thorough analysis of the fiscal framework will be conducted and recommendations made, including on how local government finances can be better aligned with the governments' overall fiscal plans.

Monetary and exchange rate policy
The immediate challenge facing the Central Bank of Iceland is to stabilize the króna and set the stage for a gradual appreciation. It can be expected that the króna will face near-term risks of pressure when the normal functioning of the foreign exchange market is restored. Extraordinary measures are therefore needed to deal with short-term risks and prevent substantial capital outflows.

In the very short-run, we intend to adopt the following pragmatic mix of conventional and unconventional measures:

> To raise the policy interest rate to 18 percent. The Central Bank stands ready to increase it further, but it is unclear that higher interest rates alone will suffice to stem capital outflow.
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> Tight control over banks' access to Central Bank credits will be maintained to avoid

excessive liquidity being drawn down through this route.
The Central Bank stands ready to use foreign reserves to prevent excessive króna volatility.
Furthermore, the Central Bank is willing to temporarily maintain restrictions on capital account transactions. Such restrictions have considerable adverse implications and the intention is to remove them as soon as possible.

This process of normalization and lower inflation and interest rates can start as soon as the króna stabilizes in the foreign exchange market, all demand for foreign exchange in respect of current account transactions is met in the foreign exchange market, and there is no longer need to support the market by drawing on the reserves. Following the above mention actions, the króna could strengthen quickly and annual inflation will have fallen to 4½ percent at end-2009. Additional strengthening of the króna and further disinflation is expected in 2010. This will allow us to begin to ease control over Central Bank's credit volume and increasingly rely on the policy interest rate as the primary monetary policy instrument, in the context of a flexible exchange rate policy.

Incomes policy

It will be important to have a national consensus consistent with the objectives of the macroeconomic program. Historically, income policy in Iceland has been very effective, with past agreements supporting the economic adjustment when difficult circumstances demanded it. Social partners recognize the need to enter an agreement that is commensurate with the severity of the situation.

Publishing and Parliamentary Procedure

A Letter of intent was sent to the IMF on November 3, signed by the Minister of Finance and the Chairman of the Board of Governors of the Central Bank. The Executive Board of the IMF will put Iceland's plan on its agenda on Wednesday November 19. At the same time IMF's Staff Report will be published.

Today, November 17, the plan was put before the Parliament and will be discussed there later this week.

A special information Web Page has been opened as a part of the Web Page of the Prime Minister's Office, www.forsaetisraduneyti.is/Aaetlun_um_efnahagsstodugleika/. Among its contents are the Letter of intent in Icelandic and English, explanatory texts on every article of the LOI and other relevant information.

Related Links

- Letter of Intent (pdf file)
- IMF - Staff Report (pdf file)
- Iceland and the IMF (imf.org)
- Joint statement from the Ministers of Finance in Denmark, Finland, Norway and Sweden regarding help to Iceland (Nov. 19/20)