Press Release: IMF Executive Board Approves US$2.1 Billion Stand-By Arrangement for Iceland

November 19, 2008

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The Executive Board of the International Monetary Fund (IMF) today approved a two-year SDR 1.4 billion (about US$2.1 billion) Stand-By Arrangement for Iceland to support the country's program to restore confidence and stabilize the economy. The approval makes SDR 560 million (about US$827 million) immediately available and the remainder in eight equal installments of SDR 105 million (about US$155 million), subject to quarterly reviews. The Stand-By Arrangement entails exceptional access to IMF resources, amounting to 1,190 percent of Iceland's quota, and was approved under the Fund's fast-track Emergency Financing Mechanism procedures.

There are three main objectives of the IMF-supported program: To contain the negative impact of the crisis on the economy by restoring confidence and stabilizing the exchange rate in the near-term; to promote a viable domestic banking sector and safeguard international financial relations by implementing a sound banking system strategy that is nondiscriminatory and collaborative; and to safeguard medium-term fiscal viability by limiting the socialization of losses in the collapsed banks and implementing an ambitious multi-year fiscal consolidation program.

Iceland's economic program envisages that the Fund's Stand-By Arrangement will fill about 42 percent of the country's 2008-2010 financing gap. The remainder will be met by official bilateral creditors.

Following the Executive Board discussion on Iceland, Mr. John Lipsky, First Deputy Managing Director and Acting Chairman, said:

"Iceland is in the midst of a banking crisis of extraordinary proportions. The three main banks, accounting for about 85 percent of the banking system, collapsed within a time span of less than one week. The krona fell sharply, the equity market plummeted, and severe disruptions in the external payments followed. As a result, Iceland is facing a severe recession, given the high debt level in the economy and significant dependence of the private sector on foreign currency and inflation-indexed debt.

"In response to these challenges, the authorities' program, supported by a Stand-By Arrangement and substantial access to Fund resources, has three key objectives: (i) to stabilize the exchange rate, (ii) to develop a comprehensive and collaborative strategy for bank restructuring, and (iii) to ensure medium-term fiscal sustainability.

"Exchange rate stabilization is an immediate priority in order to contain the negative impact of the crisis on output and employment. To this end, the program includes an appropriately tight monetary policy and continued restrictions on capital outflows in the near term.

"A comprehensive banking sector strategy will guide bank restructuring. The strategy contains measures to achieve fair valuation of assets, maximize asset recovery, strengthen supervisory practices, and ensure the fair and equitable treatment of depositors and creditors of the intervened banks. This is needed to promote a viable domestic banking sector and safeguard Iceland's integration into the international financial system.

"Medium-term fiscal sustainability will be restored. In 2009, the fiscal balance will be allowed to worsen due to the effects of the economic cycle. But the program also includes the development of a strong medium-term fiscal plan—to be launched in 2010—to cut expenditures and/or to raise taxes. This effort is needed to deal with the very substantial increase in public sector debt (of about 80 percent of GDP) due to bank restructuring.

"The road ahead is difficult. The program is subject to exceptionally large uncertainty and significant risks, reflecting the unprecedented magnitude of the banking sector collapse. With this in mind, the authorities remain committed to maintaining a resolute policy implementation, and stand ready to adjust policies as circumstances change, working closely with the Fund. At the same time, Iceland's long-term growth prospects remain favorable, buttressed by its very strong fundamentals of a highly educated labor force, a favorable investment climate, and a rich natural resource endowment," Mr. Lipsky said.

ANNEX

Recent Economic Developments

Iceland's highly leveraged economy was unprepared to withstand the global financial turmoil. Over the past several years, a number of underlying imbalances built up, making the economy vulnerable to adverse external shocks. A long home-grown, foreign-funded boom led to overstretched private sector balance sheets, with high corporate and household leverage and a large share of foreign exchange-linked and inflation-indexed debt. The current account deficit surged to over 15 percent in each of the past three years, and inflation soared. The banking sector relied on the availability of ample foreign funding to rapidly expand abroad and accumulated assets amounted to almost 900 percent of GDP by end-2007. At the same time, gross external indebtedness reached 550 percent of GDP, largely on account of the banks.

Pressures in international markets and the loss of confidence in Iceland's financial system in October 2008 led to the collapse of its three largest banks, Glitnir, Landsbanki, and Kaupthing. As a result, key asset prices plummeted: the onshore foreign exchange market dried up, the króna depreciated by more than 70 percent in the off-shore market, and the equity market fell by 80 percent. Severe disruptions in the external payments system threatened to quickly spread to the real economy. In response, the government took a number of initial actions while developing the comprehensive program that is now supported by the Stand-By Arrangement.

Program Summary

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

To achieve this outcome, the **program focuses on addressing the key challenges** at hand:

• **Preventing further sharp króna depreciation** by maintaining an appropriately tight monetary policy in the context of a flexible exchange rate policy. Restrictions on capital outflows will remain in the near term.

• **Developing a comprehensive and collaborative strategy for bank restructuring** by (i) putting in place an efficient organizational structure to facilitate the restructuring process, (ii) proceeding promptly with the valuation of banks' assets, (iii) maximizing asset recovery in the old banks, (iv) ensuring the fair and equitable treatment of depositors and creditors of the intervened banks, and (v) strengthening supervisory practices and the insolvency framework.

• **Ensuring medium-term fiscal sustainability**. While automatic fiscal stabilizers will be allowed to work in full during 2009, the program includes the development of a strong medium-term fiscal consolidation plan to be launched in 2010. This effort is needed to deal with the very substantial increase in public sector debt that is likely as a result of the budgetary cost of recapitalizing the banking system fulfilling the deposit insurance obligations to depositors in foreign branches of Icelandic banks.

Iceland joined the IMF on December 27, 1945; its quota is SDR 117.6 million (about US$173.6 million), and it has no outstanding use of IMF credits.

					Projection	
	2004	2005	2006	2007	2008	2009
Real Economy (change in percent)						
Real GDP	7.7	7.4	4.4	4.9	1.6	-9.6
Domestic demand	10.0	16.0	9.9	-1.5	-9.1	-19.7
CPI	3.2	4.0	6.8	5.0	12.7	14.3
Unemployment rate (in percent of labor force)	3.1	2.1	1.3	1.0	1.4	5.7
Gross domestic investment (in percent of GDP)	23.5	28.4	33.7	27.6	23.9	18.2
General Government Finances (in percent of GDP) 1/						
Financial balance	0.0	4.9	6.3	5.5	-0.2	-13.5
Structural overall balance	1.0	2.9	3.5	1.5	-3.4	-8.7
Gross debt	34.5	25.4	30.1	28.9	108.9	108.6
Money and Credit (change in percent)						
Domestic credit (end of period)	37.2	54.7	33.6	28.3	-19.1	-4.1
Broad money (end of period)	15.0	23.2	19.6	56.4	34.0	-4.4
CBI policy rate (period average, in percent) 2/	8.20	10.49	14.08	13.75	14.9	...
Balance of Payments (in percent of GDP)						
Trade balance	-5.5	-12.2	-17.7	-10.1	0.1	10.3
Current account balance	-9.8	-16.1	-25.4	-14.6	-10.7	1.0
Financial and capital account balance	12.7	13.7	36.5	13.4	-118.9	-11.4
Gross external debt 3/	179.1	285.7	445.9	551.5	670.2	159.5

Reserves 4/	2.1	1.8	3.4	3.3	11.0	9.9
Fund position (as of November 18, 2008)						
Holdings of currency (in percent of quota)					84.2	
Holdings of SDRs (in percent of allocation)					7.3	
Quota (in millions of SDRs)					117.6	
Exchange rate						
Exchange rate regime			Floating Exchange Rate			
Present rate (November 18, 2008) 5/					218.2	...
Nominal effective rate (change in percent) 6/	1.8	10.4	-10.7	2.8	-43.0	...
Real effective (change in percent) 6/	2.8	12.7	-6.8	5.7	-36.4	...

Sources: Statistics Iceland, Central Bank of Iceland, Ministry of Finance, and IMF staff estimates.
1/Assumes banking sector recapitalization in 2008, depositor insurance-related loans by the government in 2008, central bank recapitalization in 2009, and asset recovery in 2010 and 2011. National account basis.
2/January-October average for 2008.
3/From 2009 onward, excludes banking sector external debt, which is assumed to be paid off through asset recovery or written down in the bankruptcy process.
4/In months of imports of goods and services.
5/Broad trade weighted index of the exchange rate as kronur per unit of foreign currency (12/31/1991 = 100)
6/Exchange rate data as of end-October 2008.

Iceland: Selected Economic Indicators

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