



MINISTRY OF FINANCE
AND ECONOMIC AFFAIRS



Iceland - Strong Recovery

Economic prospects, strengthened policy
frameworks, lifting of capital controls,
vulnerabilities and mitigating factors

October 2016

Key factors...

- Economy has rebounded strongly
- 2016 GDP 7-8% above pre-crisis peak
- Good internal and external balance
- Favorable economic prospects
- Inflation under the 2½% target for almost three years - inflation expectations have also come down and are now close to the target
- Responsible fiscal policy, surplus, repayment of outstanding debt resulting in a lower debt burden – stronger fiscal framework through organic budget law

...Key factors

- Deliberate and successful fiscal consolidation and reduction of leverage
- Sound public and private sector balance sheets
- Most favorable net international investment position (NIIP) for decades - at near zero
- Well capitalized banking system
- Ample foreign exchange reserves
- GDP growth expected to gradually ease towards long-term trend of about 2½%

High level monitoring of stability and risks

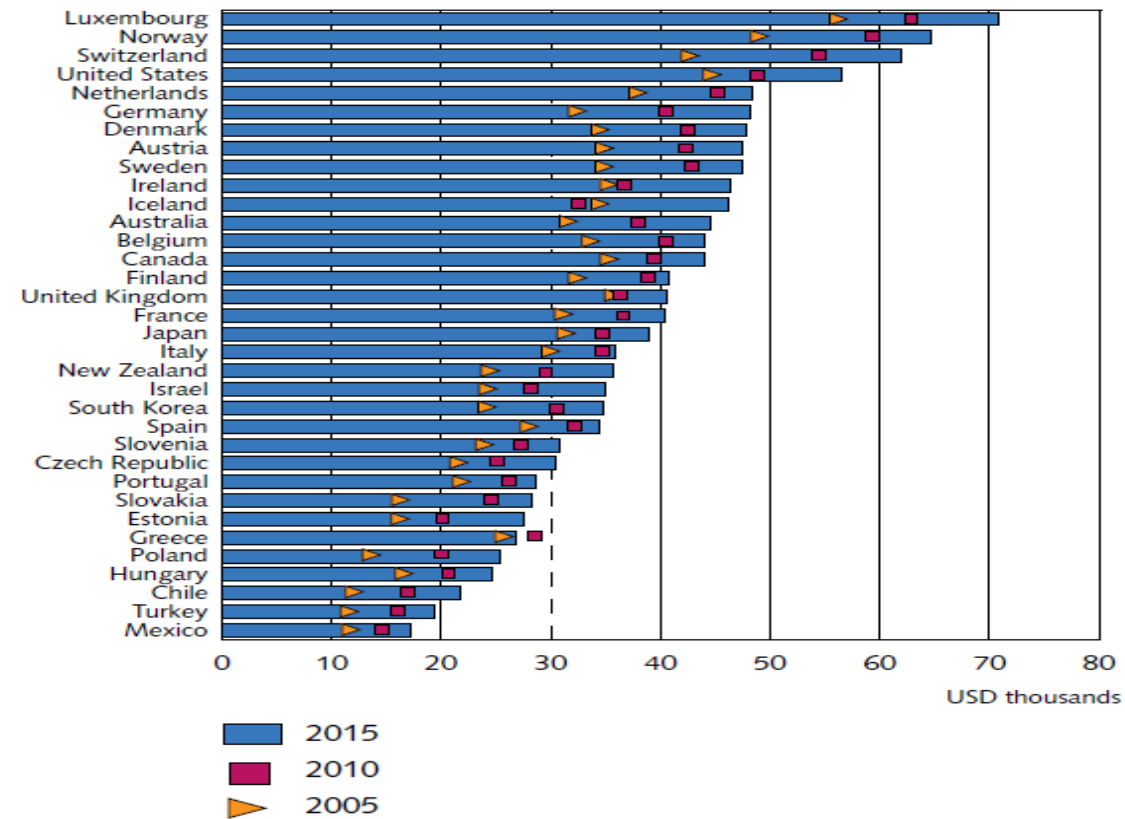
Strengthened oversight

- Financial Stability Council - Minister of Finance, Central Bank Governor, Director General of Financial Supervisor (FME)
- Systemic Risk Committee – Central Bank Governor and the Director General of the FME and their Deputies in addition to an outside expert appointed by the Minister of Finance

Favorable economic
prospects

High per capita GNI

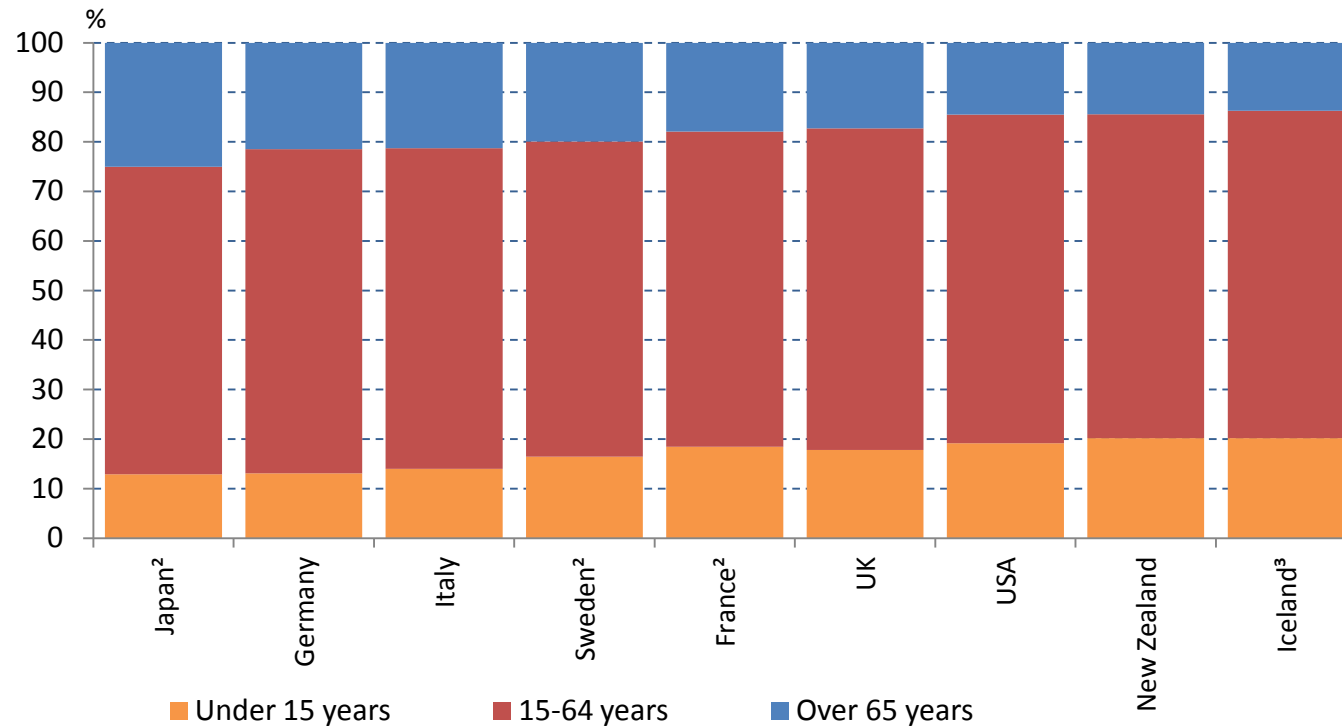
Gross national income per capita in OECD countries¹



1. Based on PPP.
Source: Macrobond.

Favourable age structure of the population

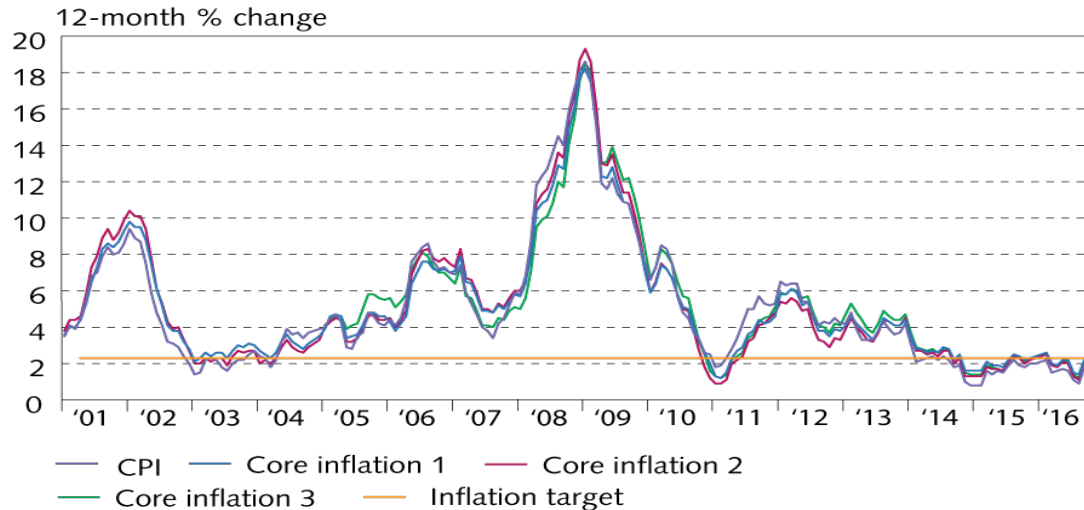
Chart 1.3
Age structure of the population in selected countries 2014¹



1. Ranked by share of population 65 and over. 2. Data for France, Sweden, and Japan are for 2013. 3. Data for Iceland are for 2015.

Inflation below target since early 2014

Consumer price inflation and core inflation

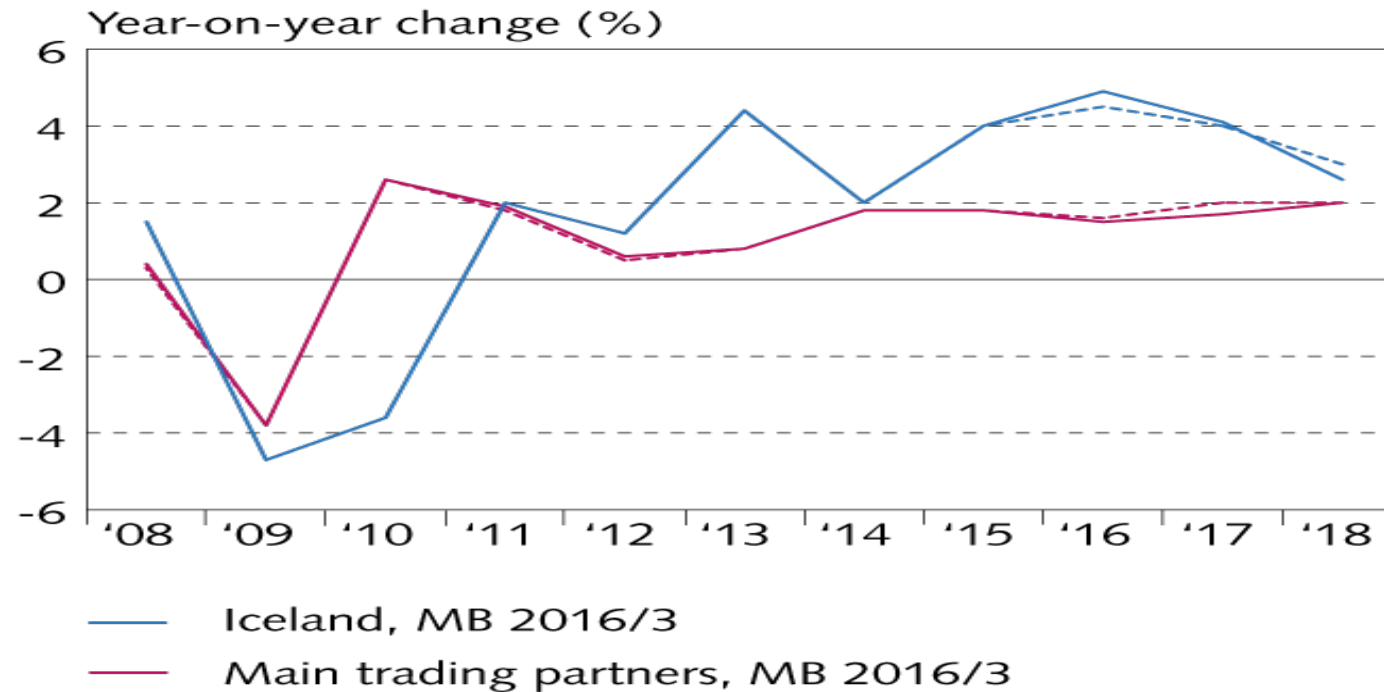


Overall index and measures of underlying inflation. Core index 1 excludes prices of agricultural products and petrol, and Core index 2 excludes prices of public services as well. Core index 3 is Core index 2 excluding the effects of changes in real interest rates on the housing component of the CPI. Monthly data.

Sources: Statistics Iceland, Central Bank of Iceland.

Stronger growth than among trading partners

GDP growth in Iceland and trading partners
2008-2018¹

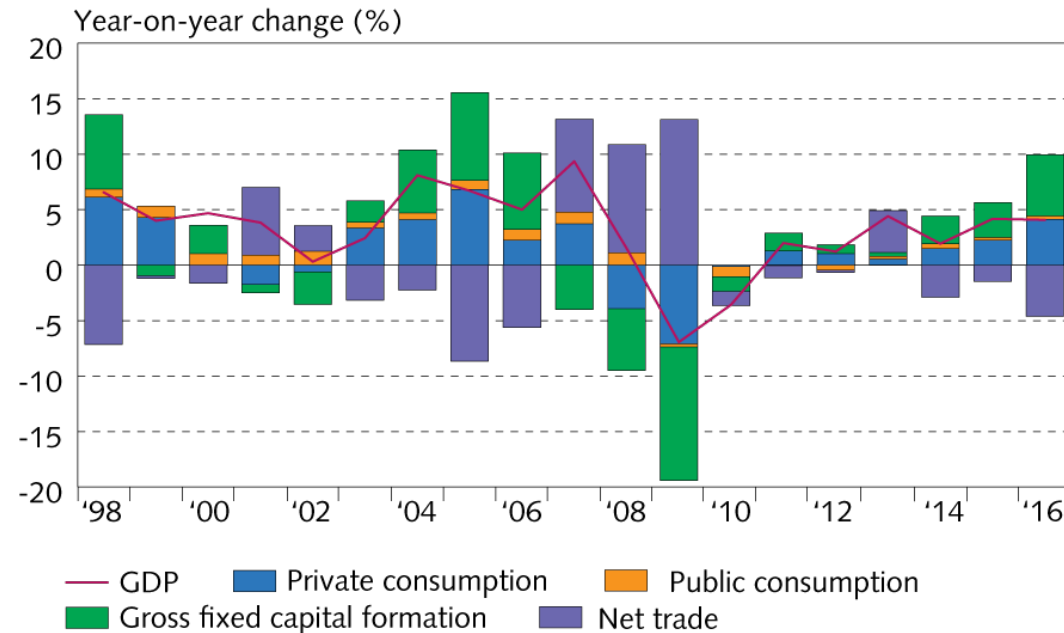


1. Central Bank baseline forecast 2016-2018. Broken lines show forecast from MB 2016/2.

Sources: Macrobond, Statistics Iceland, Central Bank of Iceland.

Balanced growth – diverse exports

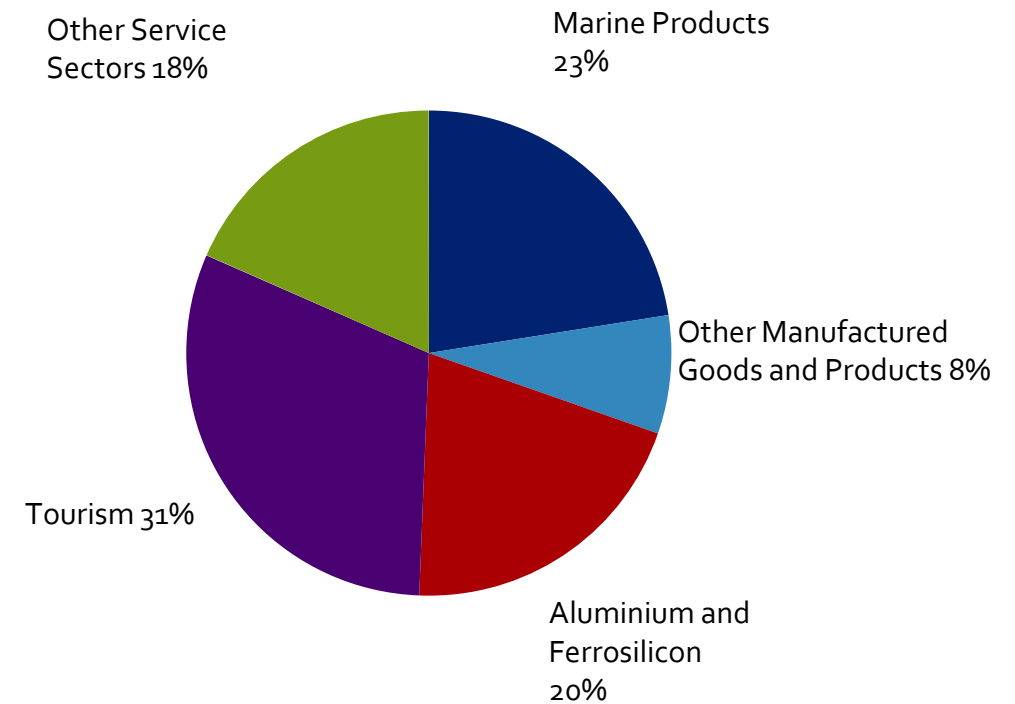
Contribution of individual components to output growth



Contribution of individual components to output growth. For 2016 the year-on-year change is between the first two quarters of 2015 and 2016. Annual data.

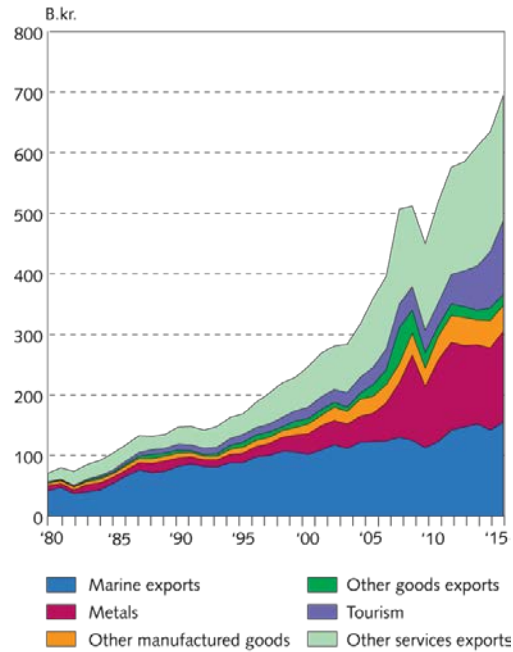
Sources: Statistics Iceland, Central Bank of Iceland.

Export of goods and services by type 2015



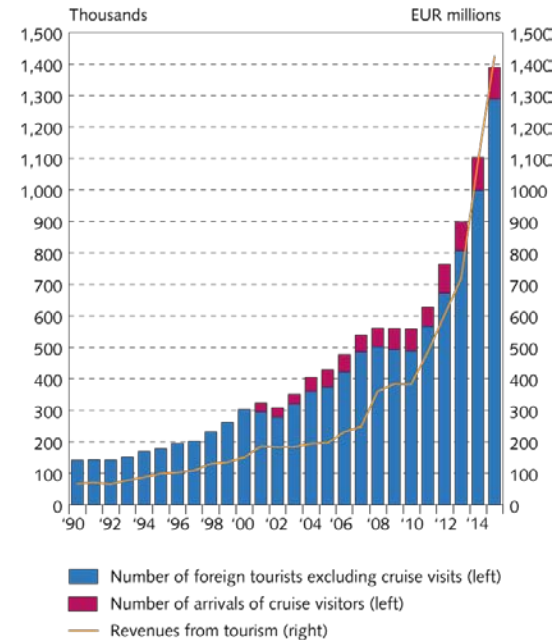
Export revenue growth – rapidly rising tourism

Exports of goods and services
At constant average exchange rates, based
on a trade-weighted basket of currencies



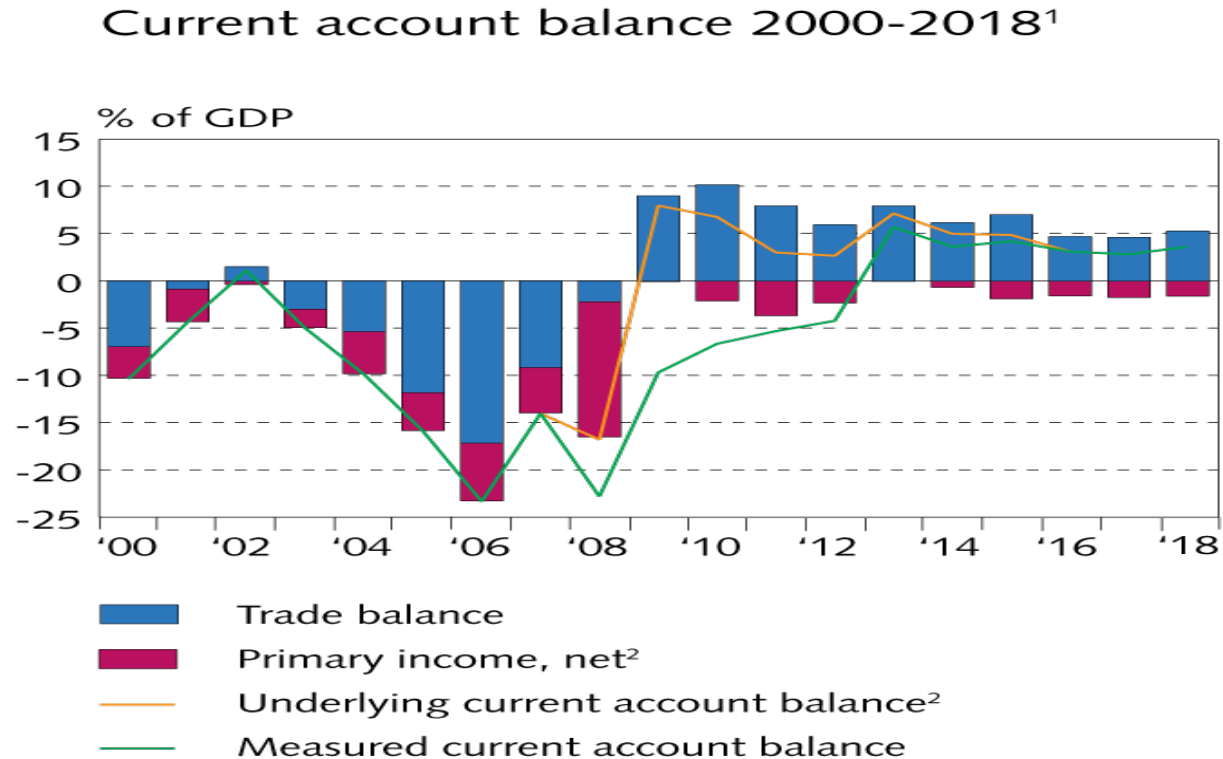
Source: Statistics Iceland.

Number of foreign tourists and revenues
from tourism
At constant exchange rate 2015



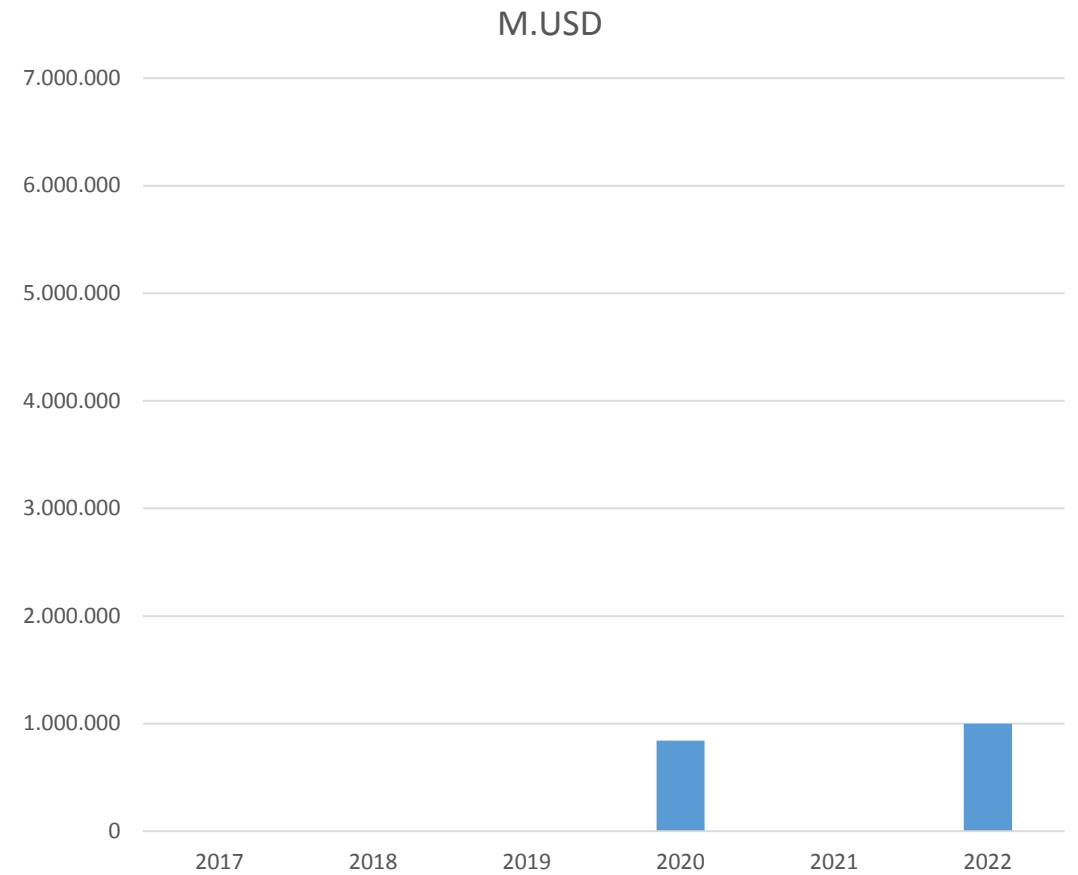
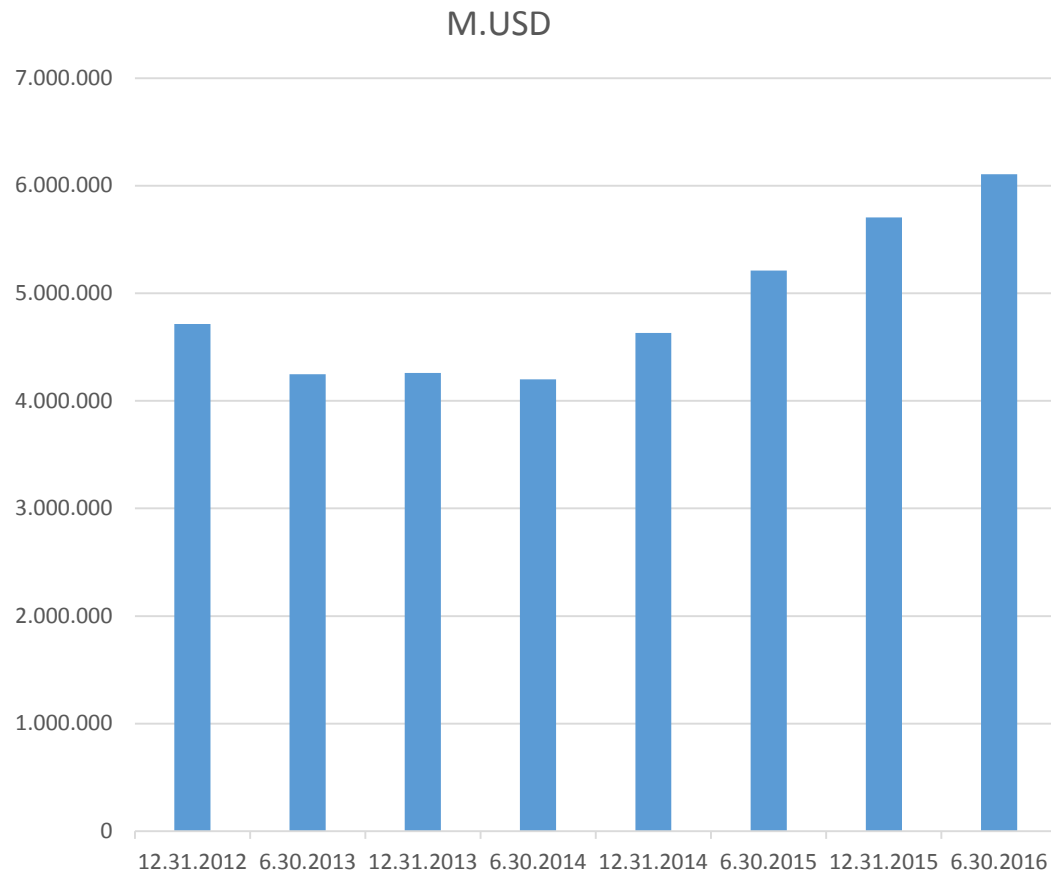
Sources: Icelandic Tourist Board, Central Bank of Iceland.

Significant current account surplus

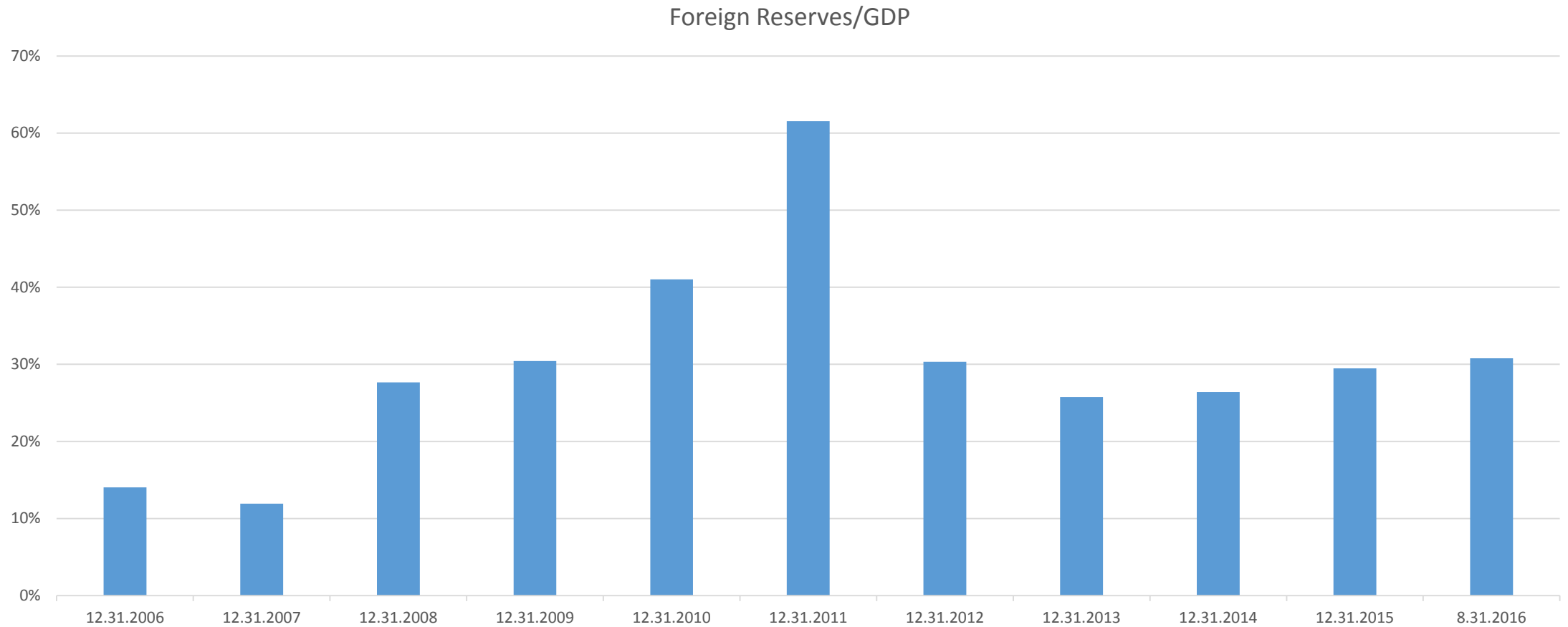


1. Including secondary income. Central Bank baseline forecast 2016-2018.
2. Excluding the calculated income and expenses of DMBs in winding-up proceedings and the effects of pharmaceuticals company Actavis on the balance on income until 2012. Also adjusted for the failed DMBs' financial intermediation services indirectly measured (FISIM). With the settlement of the failed banks' estates in year-end 2015, there is no longer any difference between headline and underlying current account numbers.
Sources: Statistics Iceland, Central Bank of Iceland.

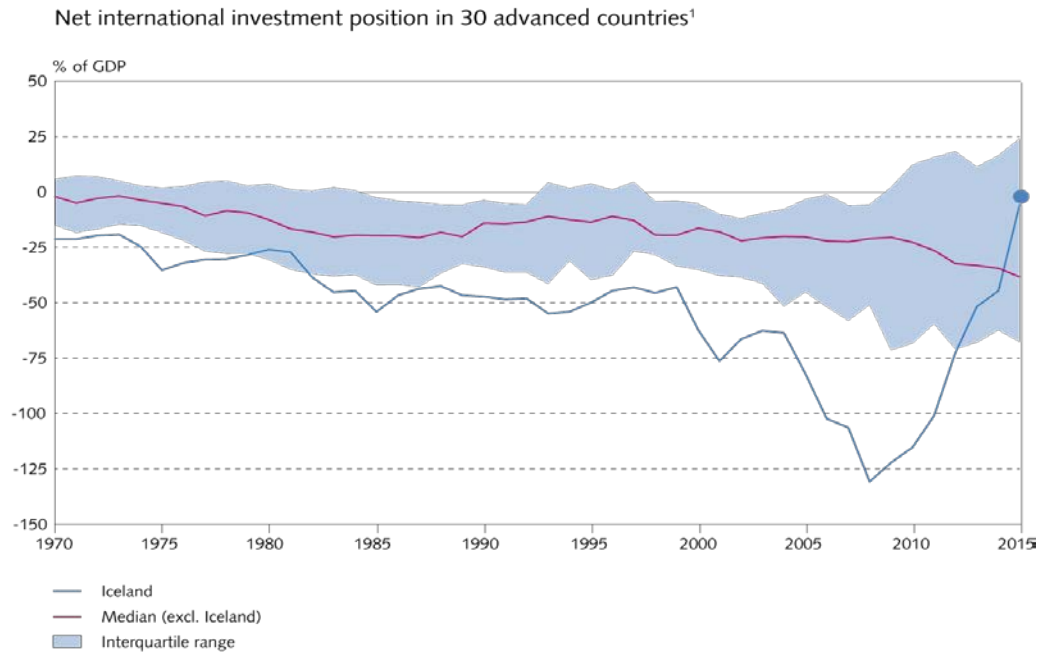
Foreign reserves – Treasury foreign debt repayments



Foreign reserves - % of GDP



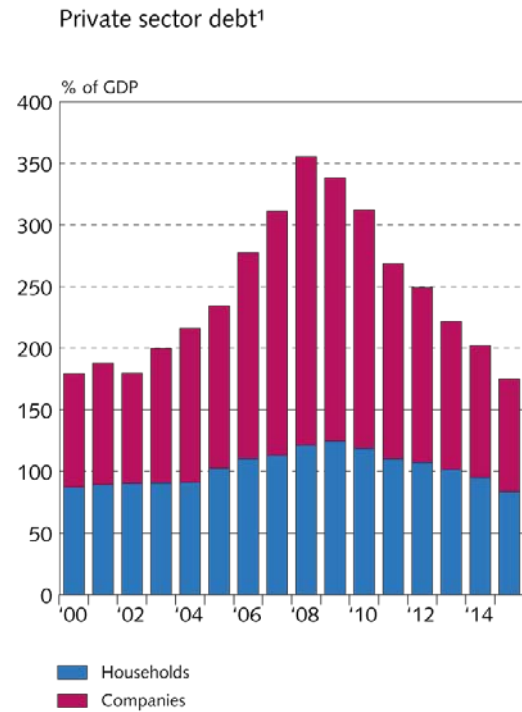
Net international investment position



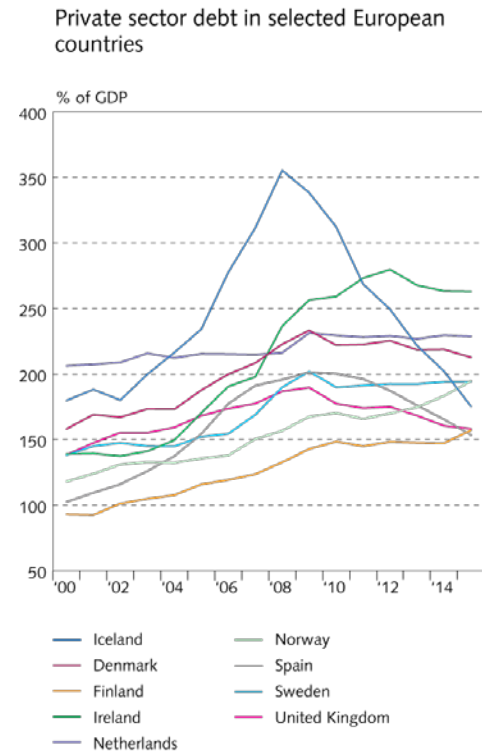
1. Figures for Iceland are from the National Economic Institute (1970-1994) and the Central Bank and Statistics Iceland (1995-2015) (data point shows preliminary figures for NIIP in Q2/2016), based on the underlying position during the period 2008-2014. Figures from the other countries are from the Lane and Milesi-Ferretti database for 1970-2011. Their data are extended through 2015 based on developments according to the IMF's international financial statistics (IFS) database.

Sources: IMF, Lane and Milesi-Ferretti (2007), National Economic Institute, Statistics Iceland, Central Bank of Iceland.

Private sector debt



1. Debt owed to financial undertakings and market bonds issued. Excluding debt owed by holding companies.
 Sources: Statistics Iceland, Central Bank of Iceland.



Sources: Eurostat, Statistics Iceland, Central Bank of Iceland.

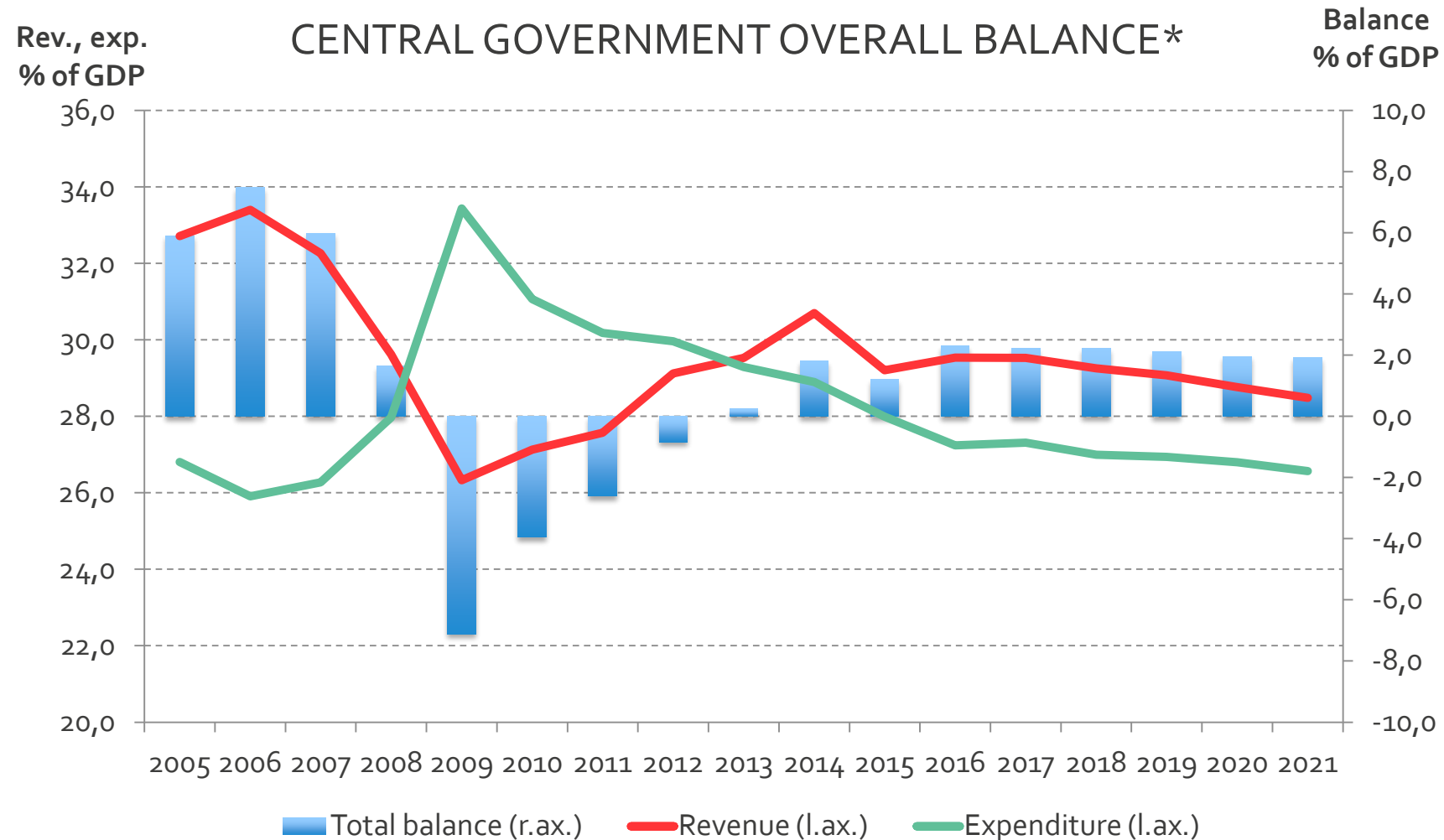
Recovery in public finances -
stronger fiscal framework

Key factors

Key factors...

- Reversal of public finances and fiscal consolidation established a basis for surplus policy
- Vast, one-off surplus in 2016 due to stability contributions from fallen financial institutions
- New law on public finances providing a stronger fiscal framework and fiscal rules
- Enactment of first parliamentary resolution on fiscal policy and fiscal strategy plan
- Public debt declining firmly
- Interest cost burden is still substantial
- Surplus on primary balance much higher than in any EU country

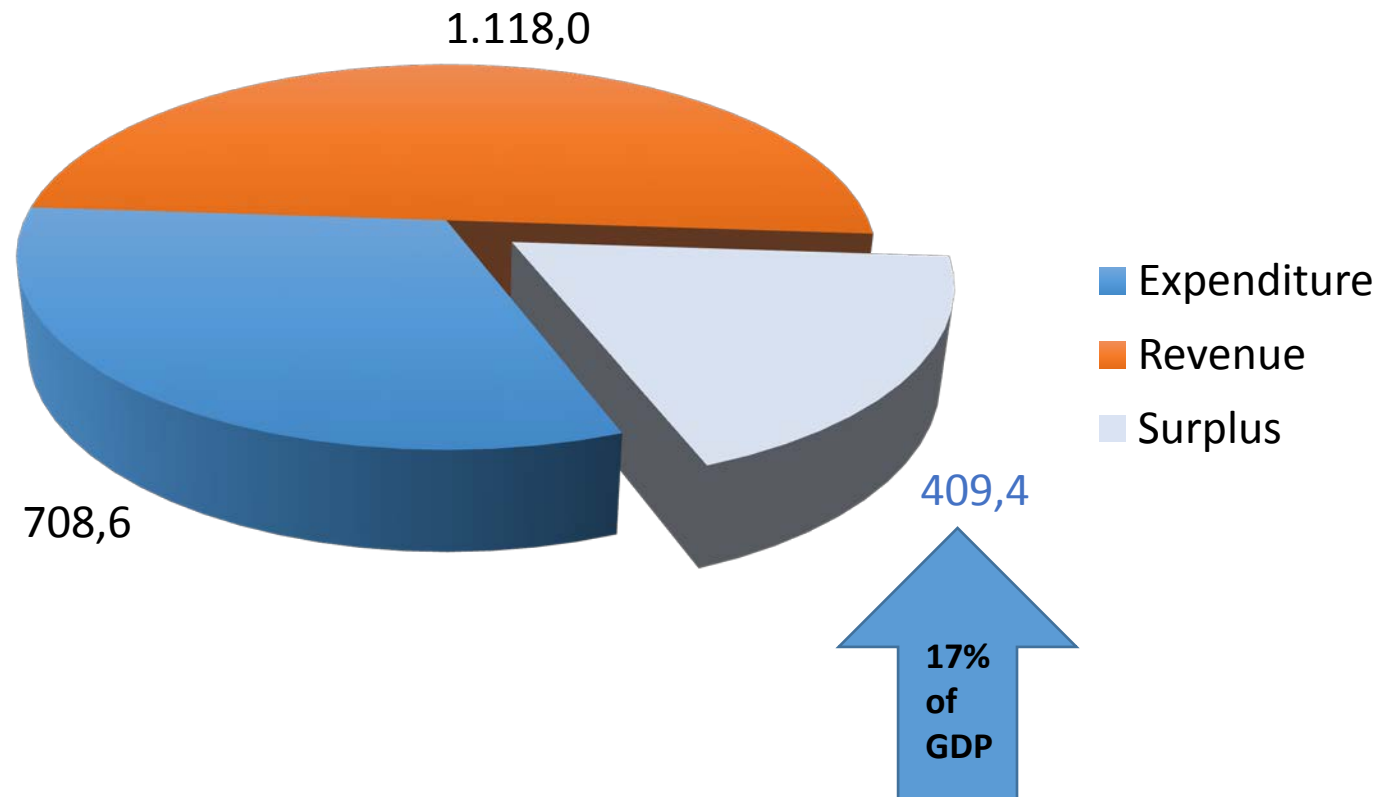
Recovery in central government finances



* excluding irregular items such as refinancing of CBI in 2009 and stability contributions from estates of fallen banks in 2016
 Treasury current semi-accrual budget and accounting basis, surplus is lower on new GFS basis for the years ahead or around 1%

Fiscal effect of stability contributions in 2016

Central gov't. overall balance* (bn.íkr)



* incl. 379,3 bn.íkr stability contributions from the estates of fallen financial institutions

New organic budget law

Coordinate and strengthen economic policy making and assessment of economic impact for both central and local governments

Strengthen the fiscal framework for strategic planning about public finances for the medium-term

Establish principles and procedures for macroeconomic forecasting and fiscal policy making with a clear link to the annual budget

Improve budget formulation and broaden Parliamentary budget discussions

Increase discipline and flexibility in budget execution

Timely information to prepare for and evaluate fiscal decisions

New organic budget law

Came into force January 1st 2016

Implementation ongoing

Two key Parliamentary resolutions on public finances:

- Statement of fiscal policy for the next five years
- Fiscal strategy plan for the next five years (rolling spring plan)

Fiscal rules and core values:

- Overall balance rule (5-year horizon)
 - Debt rule (30% of GDP)
 - Reduction rule (5%)
- **Sustainability-Prudence-Stability-Caution-Transparency**

Flexibility and ministerial responsibility

Independent fiscal council

International accounting standards

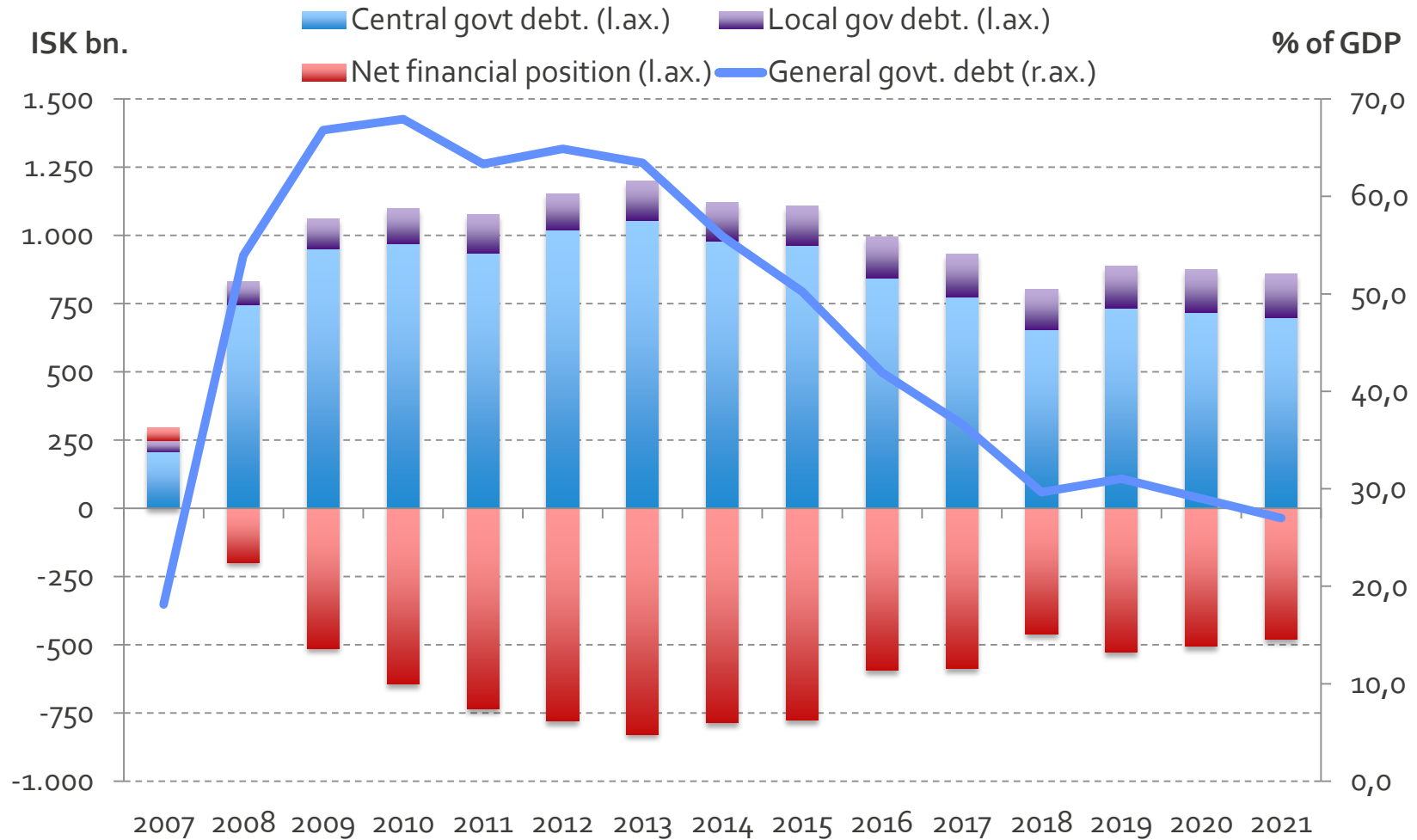
STATEMENT OF FISCAL POLICY 2017-2021

% of GDP	2017	2018	2019	2020	2021
General government:	%	%	%	%	%
Total balance	1,0	1,0	1,0	1,0	1,0
thereof central gov.	1,0	1,0	1,0	1,0	1,0
thereof local gov.	0,0	0,0	0,0	0,0	0,0
Total debt*	34	30	29	28	26
thereof central gov.	28	24	23	22	21
thereof local gov.	6	6	6	6	5

* On the basis of debt rule in new law on public finances: gross debt, excl. pension liabilities and accounts payable/receivable and deducting currency and bank deposit assets e.g. in CBI
GFS accounting basis



DECLINING PUBLIC DEBT

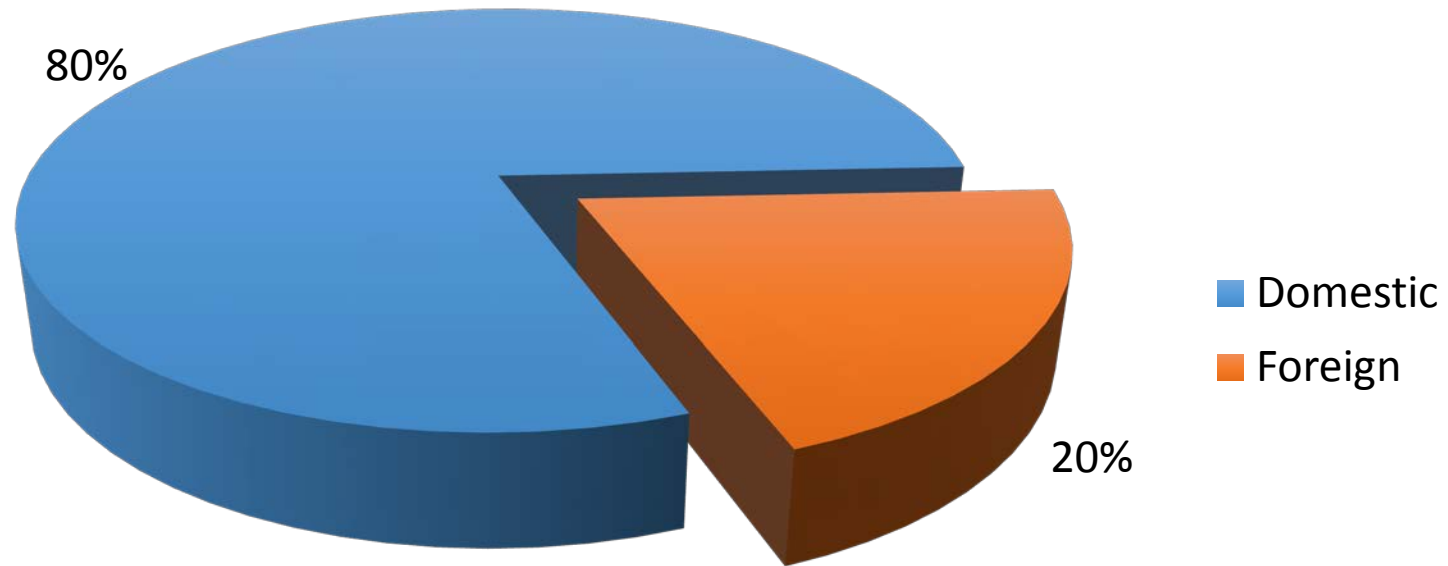


* Based on debt rule in the Act on Public Finances, i.e. the gross debt of central government excluding pension liabilities and accounts payable/receivable and deducting deposits in the CBI in addition to the gross debt of local governments deducting their deposits and cash on hand.

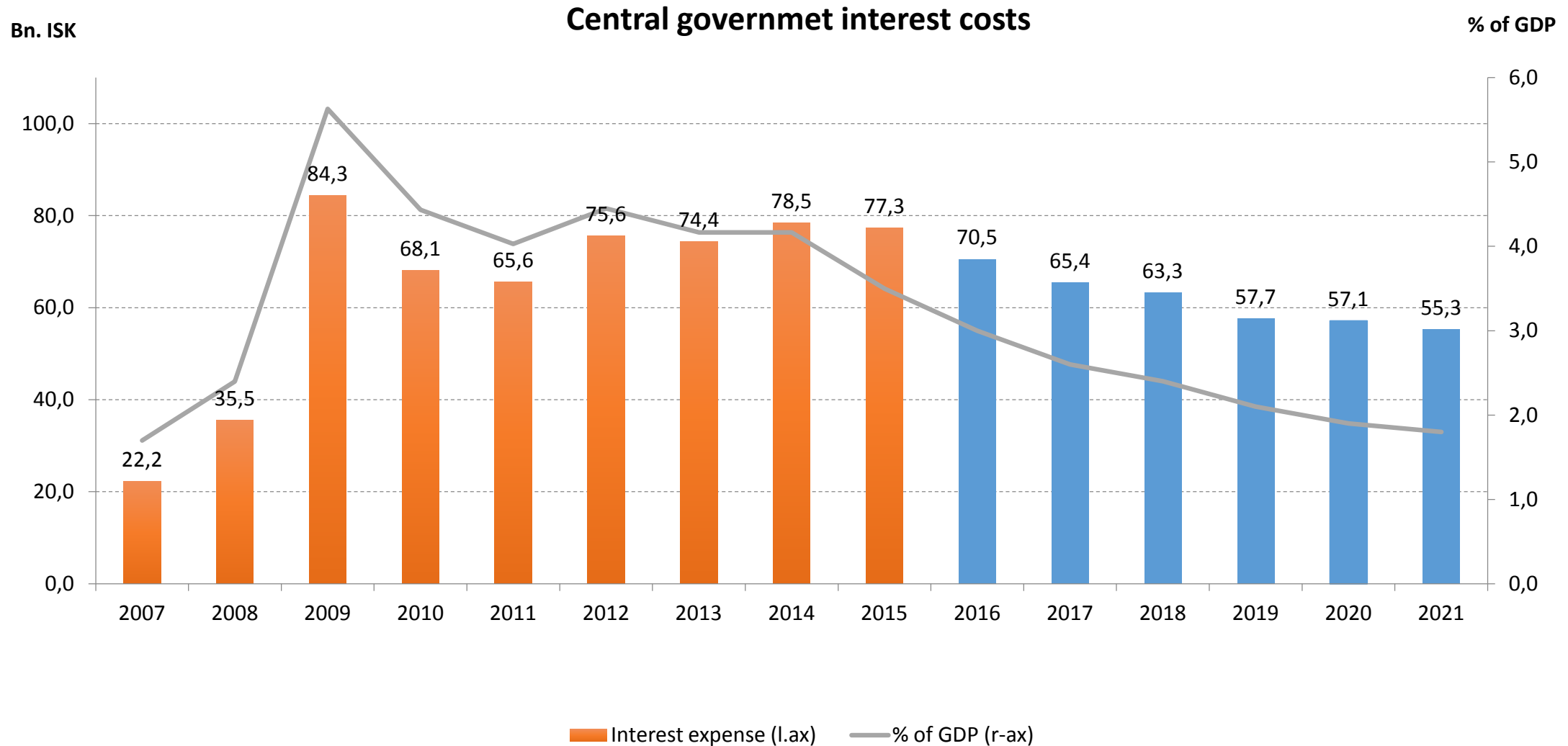


The bulk of outstanding debt is domestic

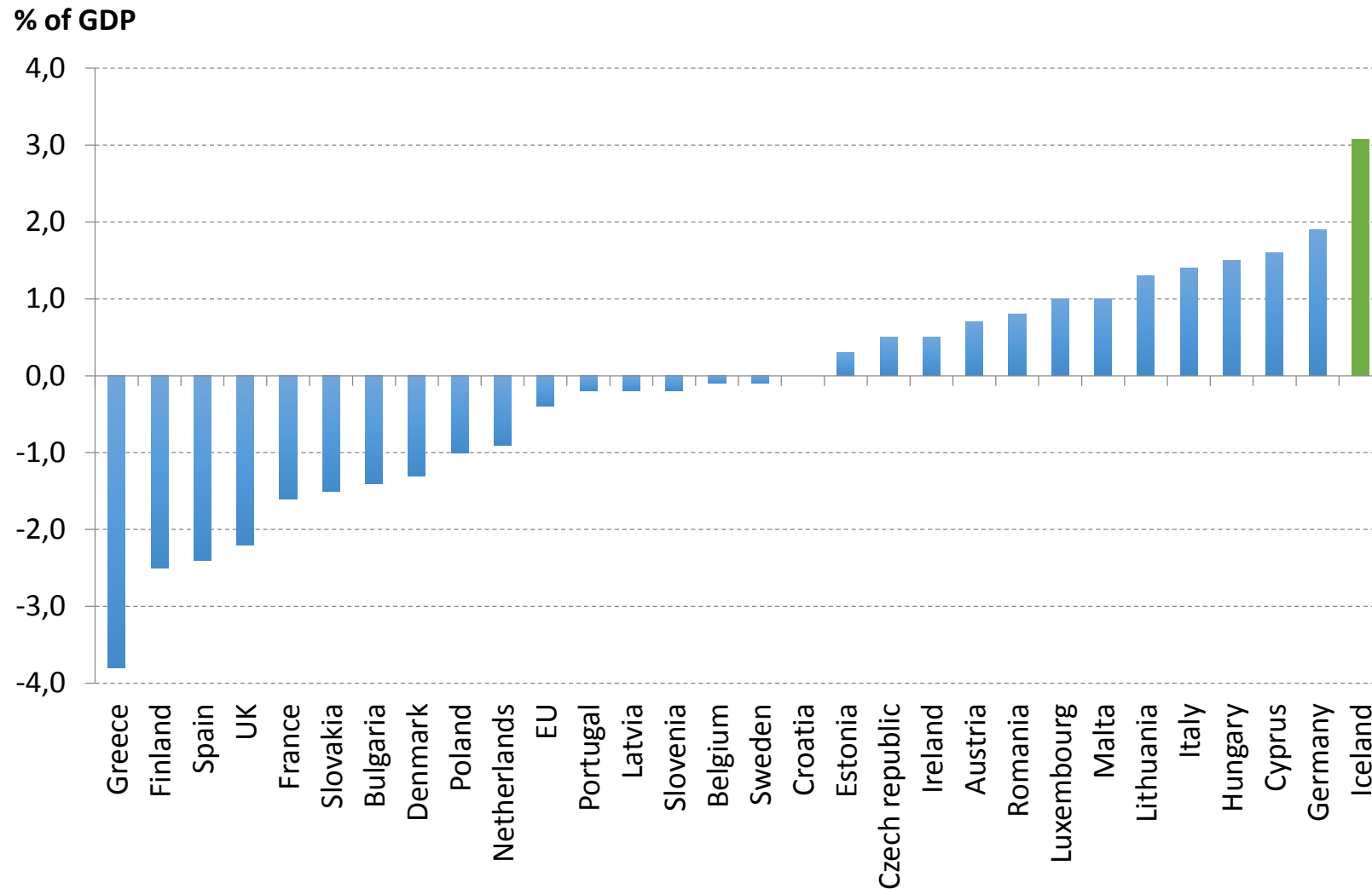
**Composition of estimated central gov't. gross debts
at end of 2016**



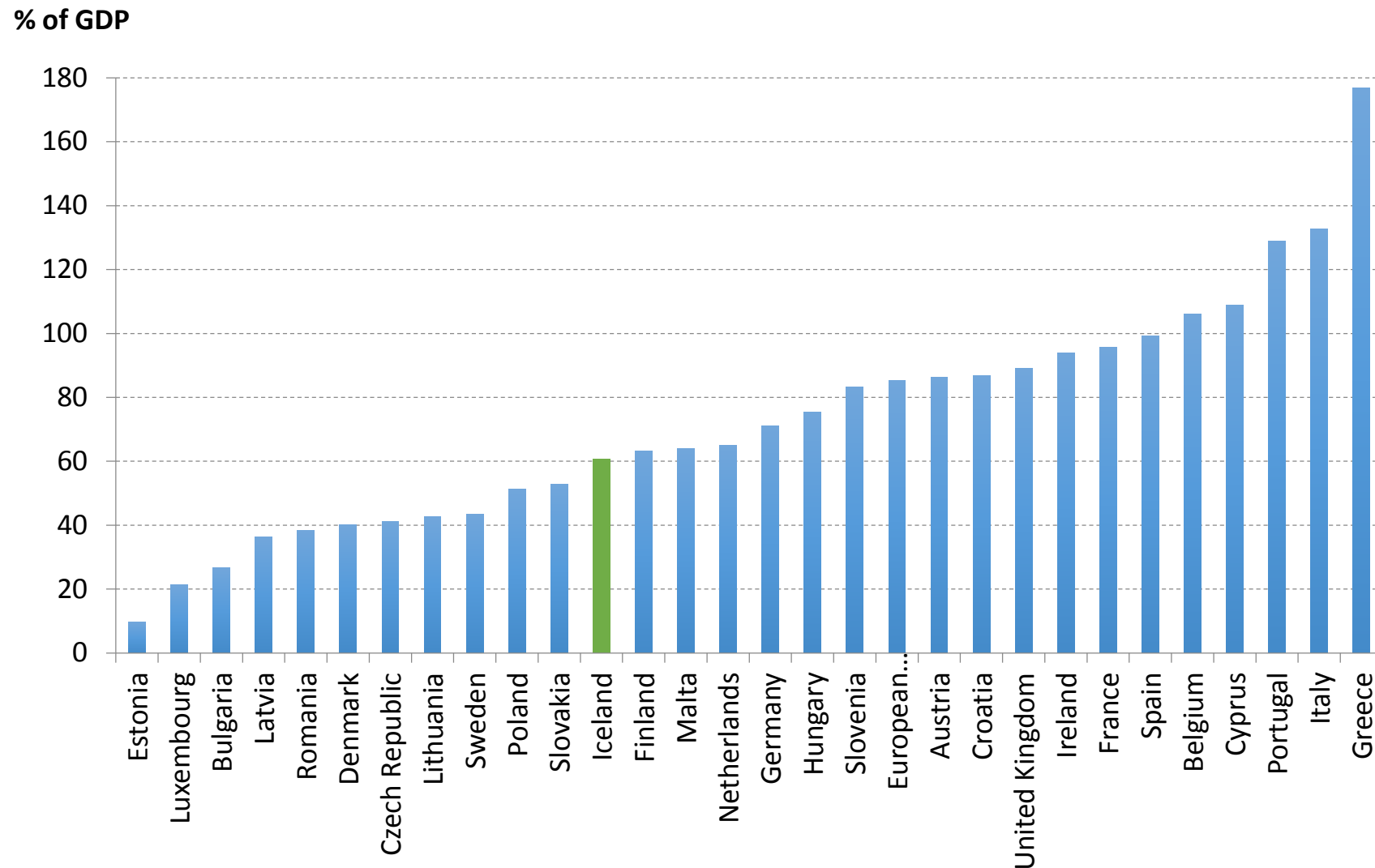
High but declining interest expenditure



Primary balance of general gov't.* – EU and Iceland 2015

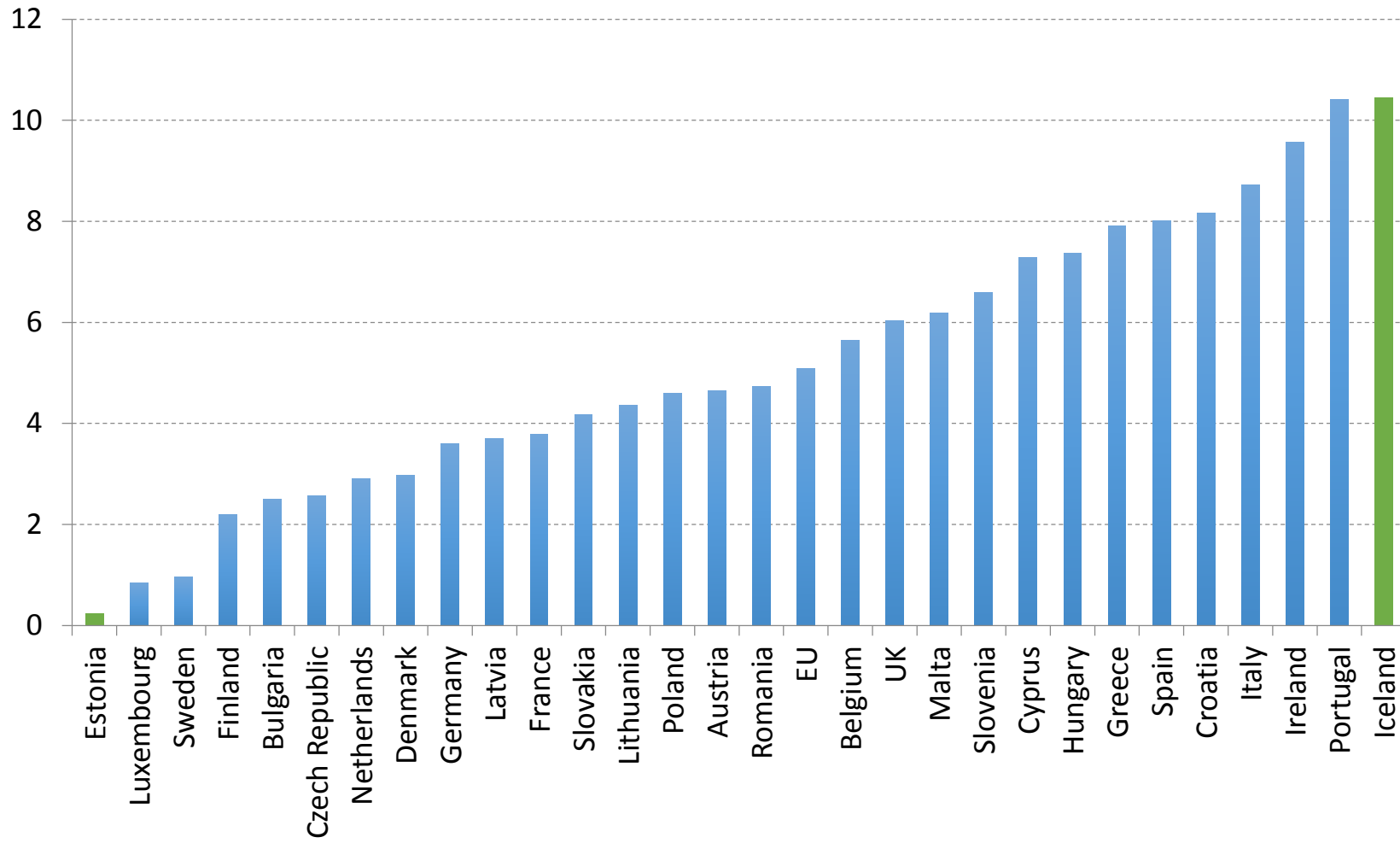


General government debt* – EU and Iceland 2015



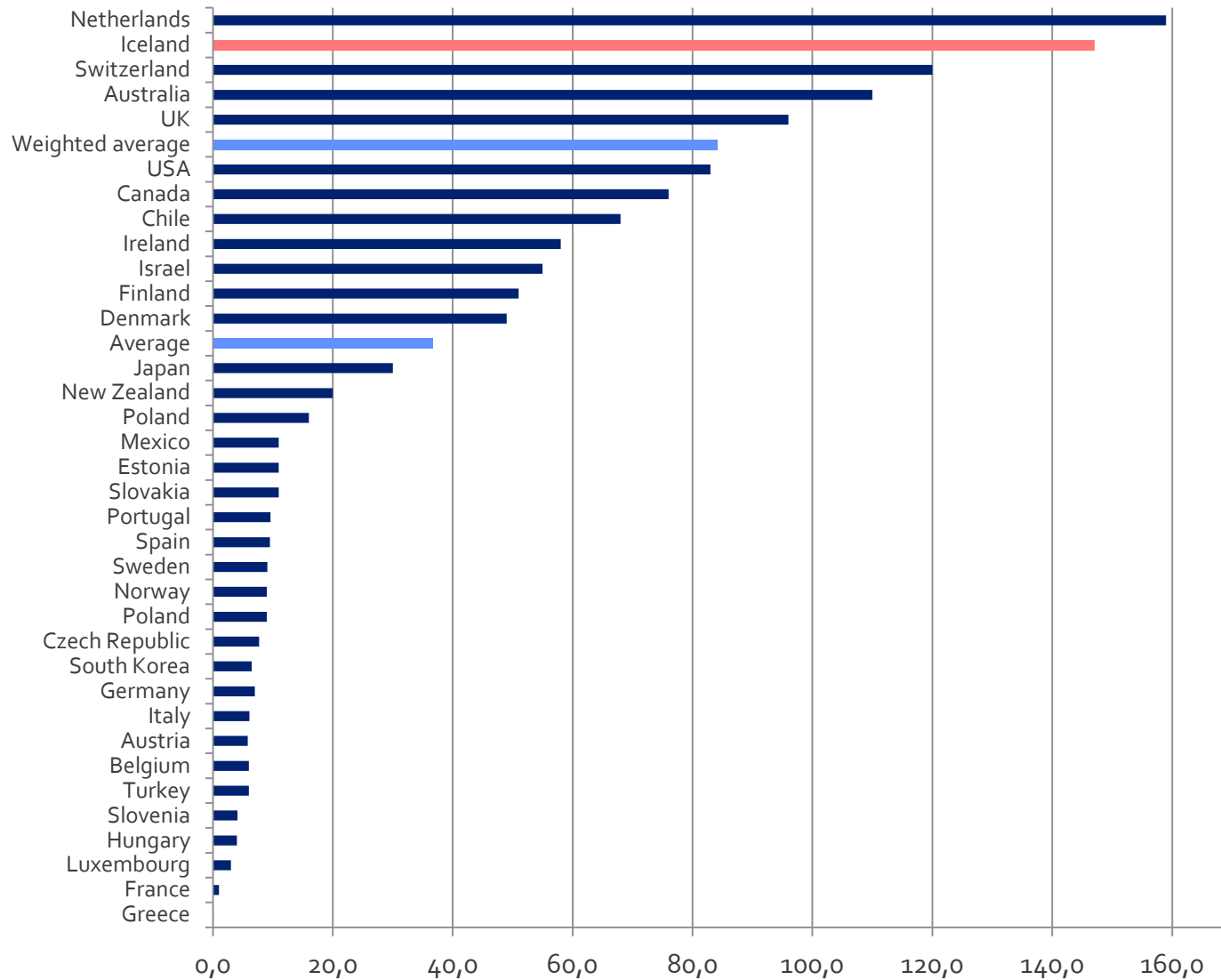
Interest expenditure of general gov't.* – EU and Iceland 2015

% of total revenues



Source: Eurostat

Pillar 2 and 3 Pension fund assets - % of GDP 2014



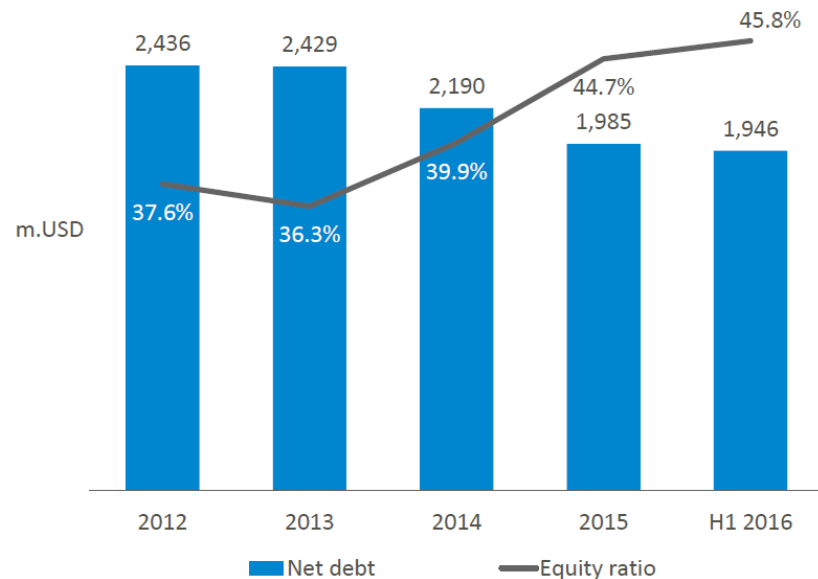
Contingent liabilities are being addressed

- Housing Financing Fund

- Outstanding state guarantees on loans amounted to 60% of GDP in 2015. Around 75% of the guarantees are due to bonds issued to finance the state-run Housing Financing Fund
- According to a bill submitted by the government, the fund will be wound-down and withdrawn from the market for general housing mortgages
- The fund will be given more responsibility for formulating policies and plans on housing matters and retain a limited role as lender on social premises
- Turnaround in the fund's operations with a sizeable surplus and an equity ratio of 6,45% - well above the stipulated 5% long term goal
- Healthier loan portfolio with a significant decrease in defaults
- The fund will no longer generate further state guarantees on debt and the older stock will be paid down in the coming decades

Contingent liabilities - Landsvirkjun

Significant debt reduction



Net debt continues to decrease

- › Net debt decreased by about 40m USD from 2015
- › Decreased by about USD 880m from 2009

Equity ratio highest in Landsvirkjun's history

- › At 45.8% and up by more than 1% since YE 2015

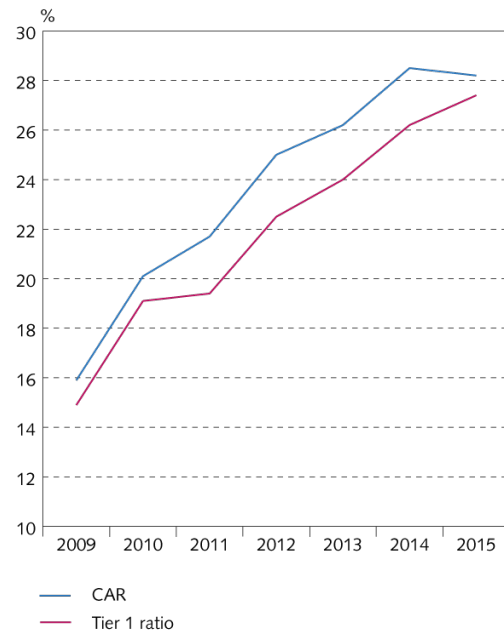
The financial system

The banks

- Restructuring the main commercial banks
 - Two commercial banks fully owned by government – will in due course be sold
 - Well capitalized, domestic oriented banks - prudential restraints on international activities
- Regulatory framework
 - Financial regulation and supervision continues to be strengthened, following EU model – prudential aspects

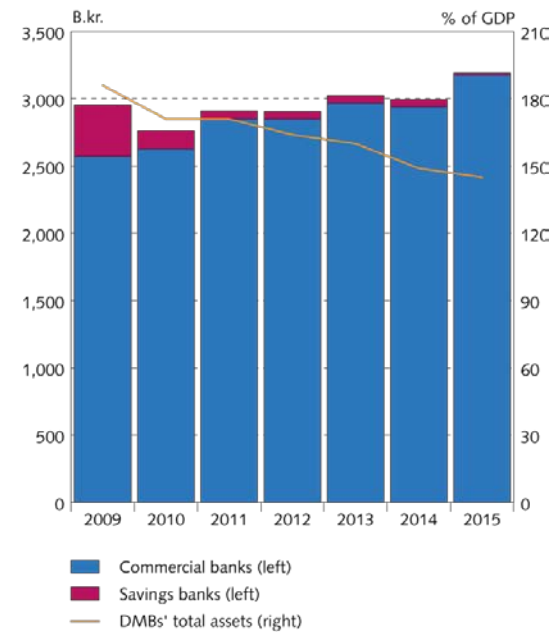
Banking system on solid footing

Commercial banks' capital adequacy ratios¹



1. Largest commercial banks, consolidated figures.
Source: Commercial banks' annual reports.

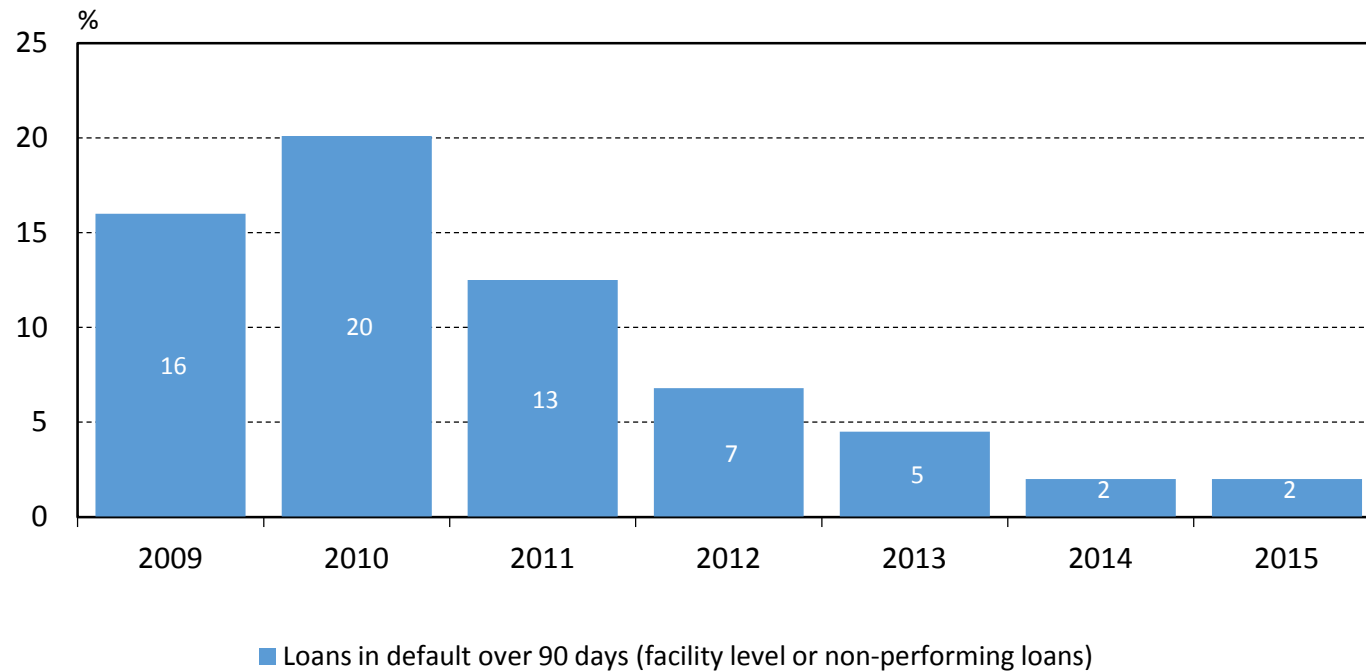
DMBs' total assets¹



1. Parent companies.
Sources: Statistics Iceland, Central Bank of Iceland.

Sharp fall in default ratios in the banks

Chart 3.4
Default ratios of the three largest commercial banks¹



1. Parent companies, book value.

Sources: Financial Supervisory Authority, Central Bank of Iceland.

Lifting capital controls

Lifting capital controls

- Detailed execution plan presented in mid-2015, based on a strategy which was defined in 2011 and underpinned by the IMF Integrated Approach to Capital Account liberalization
- Cautious design and execution. Sequenced lifting in three phases
- Rules on special reserve requirements (capital flow management measure) for new currency inflows introduced in June 2016 aimed at tempering and affecting the composition of capital inflows
- Favorable conditions for lifting controls
- Re-assessment in early 2017 of conditions for the removal of remaining restrictions

Three phased execution

1. Resolution of the failed banks' estates

- Completed in early 2016 resulting in significant stability contribution payments to the Government - used to retire liabilities

2. Resolution of offshore holdings of króna assets

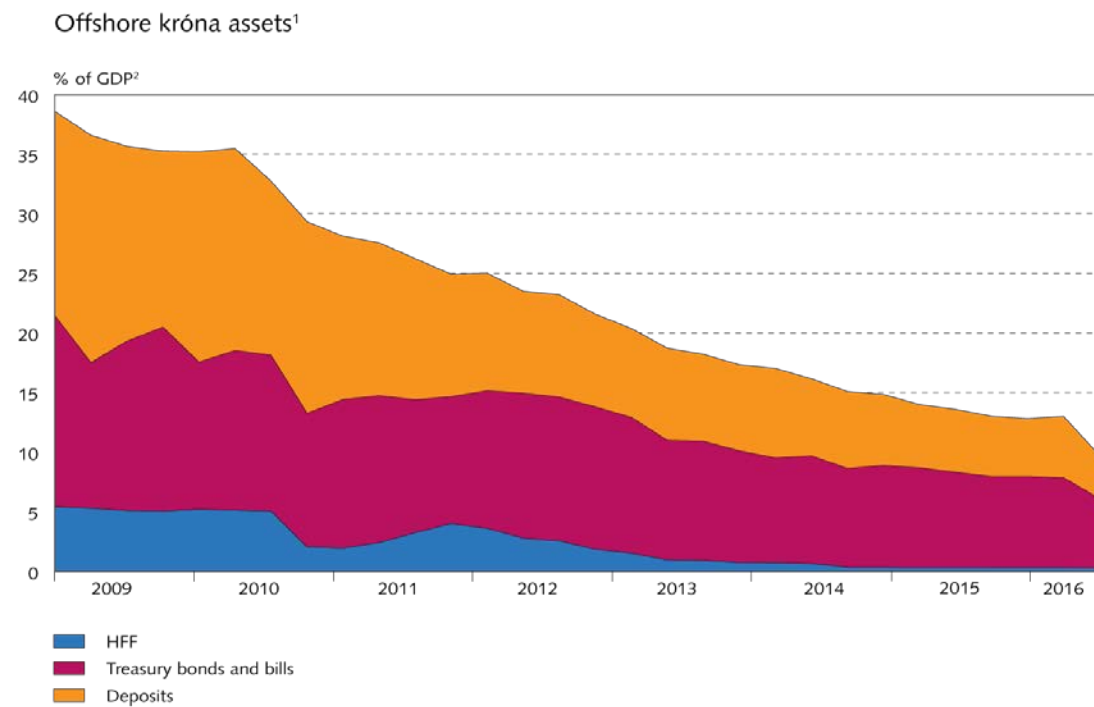
- Auction in June 2016 following a series of earlier ones - resulted in a sizeable reduction in the stock and an isolation of the remaining part for later resolution (40% of GDP at their peak; now 8%)

3. Removal of restrictions on businesses and households

- Comprehensive legislative bill due to be adopted by the Parliament in October 2016 entailing that at the beginning of 2017 restrictions applying to businesses and households will have been almost fully lifted.

Fresh assessment in early 2017 of conditions for the removal of remaining restrictions

Offshore krónur significantly reduced



1. End of quarter. 2. Per cent of sum of four-quarter seasonally adjusted GDP from Statistics Iceland.
Sources: Statistics Iceland, Central Bank of Iceland.

Legal issues

1. Failed banks' estates – no outstanding legal issues
2. Offshore ISK – two pending cases (same parties)
 - Complaint(s) before EFTA Surveillance Authority - alleged discrimination
 - Possible proceedings before Icelandic Court proceeding – tort case based on alleged devaluation of assets
 - Strong Icelandic legal position: certain assets remain under capital controls until economic circumstances allow for liberalisation
 - Ring-fencing of assets based on origin – necessary and justified
3. Households and businesses – no legal issues foreseen

Potential vulnerabilities and mitigating factors

Potential vulnerabilities?

- Overheating risks
- Market fluctuations and financial and economic stability threats following capital account liberalization
- Risk of policy slippages
- External risks, geopolitical, financial e.g.
- Political risks
- Litigation risks related to offshore krónur
- Contingent liabilities

Mitigating factors - 1

- Tight monetary policy and clear commitment to preserve price stability
- Large foreign exchange reserves
- Stability oriented fiscal policy, significantly strengthened framework for public finances; medium term framework for fiscal policy based on a procedural fiscal rule
- Capital flow management measure - special reserve requirements for new currency inflows aimed at tempering and affecting the composition of capital inflows

Mitigating factors - 2

- Strong financial regulatory framework, including prudential limits on the banks' international activities
- Well capitalized and liquid banks
- Significantly reduced public and private indebtedness
- High level monitoring of stability and risks:
 - Financial Stability Council
 - Systemic Risk Committee
- Largely funded pension system

Key takeaways

- High institutional strength
- Balanced economy – strong real economy and underlying fundamentals, sound macroeconomic policies
- Favorable public and private balance sheets
- Favorable prospects, based *inter alia* on strong export performance
- Iceland's situation favorable compared to many other countries
- Policies and structures in place to meet risks