



Iceland's Road to Recovery: What Lessons to be learned

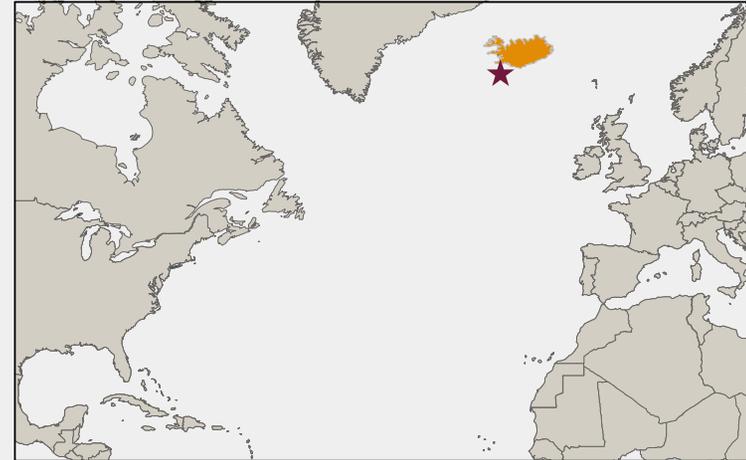
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May 26, 2011

MINISTRY OF FINANCE

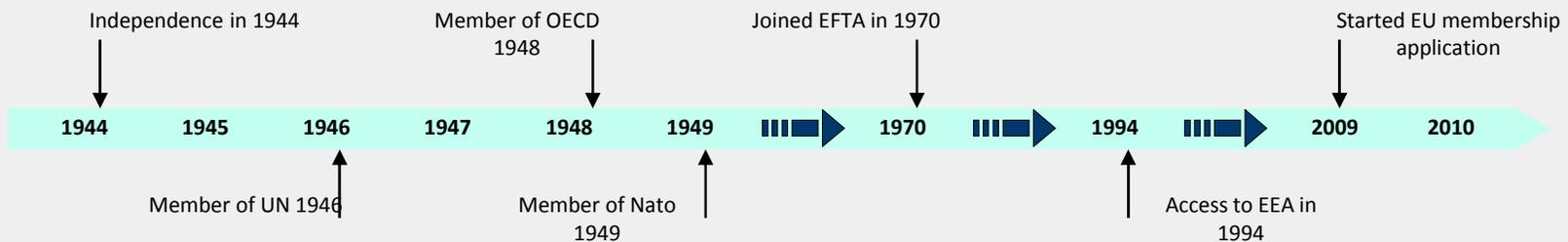
Iceland at a Glance

State and Government	Republic constitution with a democracy Coalition: Social Democrats and Left Green Parliament: Althingi established in 930
Capital	Reykjavik★
Population	318,000 as at January 2011
Currency	Icelandic Krona (ISK) USD = ISK115 EUR = ISK163
GDP per capita	USD 39,600 (2009 – top 25 World Bank)
Credit ratings	Moody's: Baa3 / Neg S&P: BBB- / Neg Fitch: BB+ / Stable



Location	Northern Europe Flying time: 5.5 and 3 hours from New York and London respectively
Area	103,000 km ² / 39,756 sq. miles

Fundamental Milestones



Iceland and Ireland

- Ireland and Iceland have a long history of friendship.
- A lot of Icelanders are Irish descendants. Obama is Irish and so am I.
- The struggle for existence in both countries has at times been immensely difficult.
- The Irish potato famine and natural disasters in Iceland the main cause of massive emigration from both countries to US/Canada (19th century).

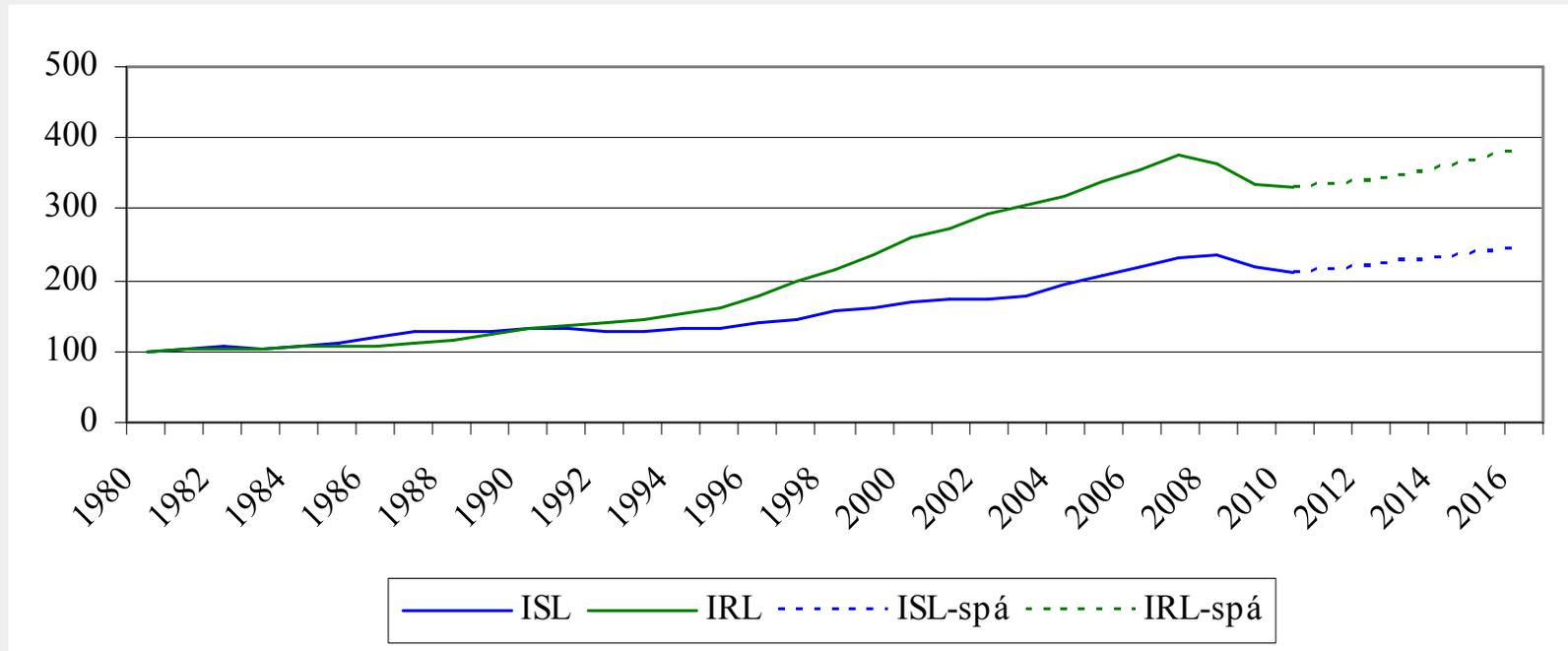
Iceland's growth

Overview of Gross Domestic Product and Gross National Product 1945-2010



11,55 1945	12,07 1946	13,4 1947	13,67 1948	13,4 1949	13,1 1950
12,83 1951	12,7 1952	14,65 1953	16,03 1954	17,59 1955	18 1956
17,99 1957	19,41 1958	19,79 1959	20,42 1960	20,41 1961	22,1 1962
24,38 1963	26,79 1964	28,75 1965	31,26 1966	30,86 1967	29,17 1968
29,87 1969	32,09 1970	36,29 1971	38,53 1972	41,15 1973	43,5 1974
43,78 1975	46,39 1976	50,48 1977	53,52 1978	56,12 1979	59,34 1980
61,87 1981	63,21 1982	61,85 1983	64,4 1984	66,52 1985	70,69 1986
76,73 1987	76,67 1988	76,86 1989	77,76 1990	77,59 1991	74,97 1992
75,96 1993	78,7 1994	78,79 1995	82,56 1996	86,62 1997	92,09 1998
95,86 1999	100 2000	103,92 2001	104,07 2002	106,57 2003	114,78 2004

Iceland and Ireland



Iceland and the banks

- Iceland started to privatize its banking system in the end of the 20th century.
- When privatized the banks ballooned and backed ventures of the Icelandic Finance Vikings.
- Consumption and the real estate market rose heavily in the beginning of the 21st century.
- The growth in Icelandic economy was fuelled by massive borrowing. When the access to easy loans halted the banks collapsed.
- They were completely unsustainable entities.
- In addition to the immense growth of the banks measure were taken at the time that further overheated the economy.
- Taxes on companies and capital lowered.
- In October 2008 the venture came to an end. The banks were then 10 times Iceland's total GDP. In 2004 this number stood at 2 times Iceland's total GDP.

Icelandic economic programme

- In order to deal with the collapse of the financial system Iceland entered into discussions with the IMF.
- Iceland has had a Stand-by Arrangement with the IMF since 19 November 2008. The programme is scheduled to end in August 2011.
- Three reviews are still left. The Icelandic authorities plan to request that two of them will be combined in order to complete the programme in August.

The initial prognosis was not good

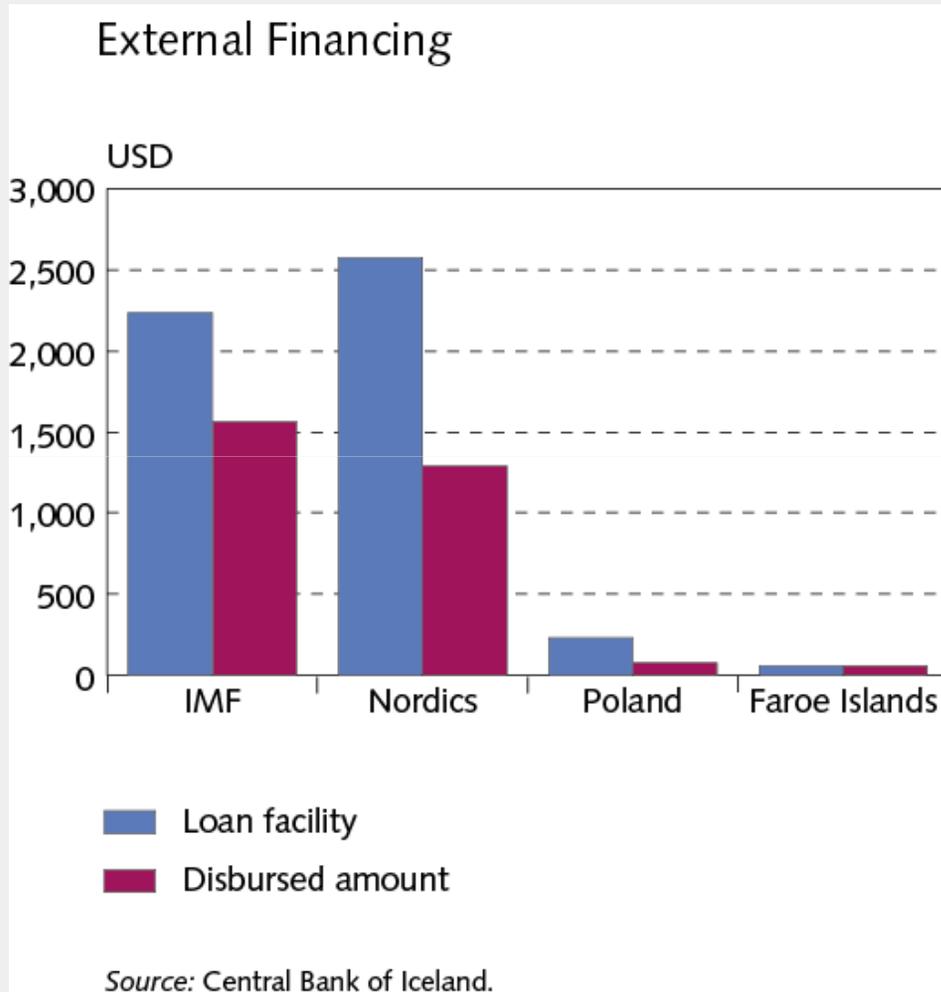
- “As you know, Iceland is in an unprecedented situation, having seen the collapse of a significantly oversized banking system relative to GDP. It amounts to about almost 1,000 percent of GDP. The three main banks, accounting for 85 percent of the banking system, collapsed within a span of less than a week, creating very significant turmoil in the financial markets, in effect shutting down the foreign exchange market, and causing a dramatic depreciation of the krona.”

(Paul Thomsen, 20th of November 2008)

Many things could have gotten even worse

- Unemployment forecasts were very bleak (10-12% official forecasts, the opposition even said 20%).
- Forecasts of mass emigration by some analysts.
- Double dip recession.
- Discussion of sovereign default (Iceland on the top 10 list of countries most likely to default in 2009).

External financing



- Total amount drawn so far is 2.9 billion USD
- Iceland has drawn on over 2/3 of the IMF multilateral financing
- Half of the amount pledged by the bilateral Nordic lenders has been drawn, equal to the amount released by the first two reviews.

Preventing collapse – the emergency law

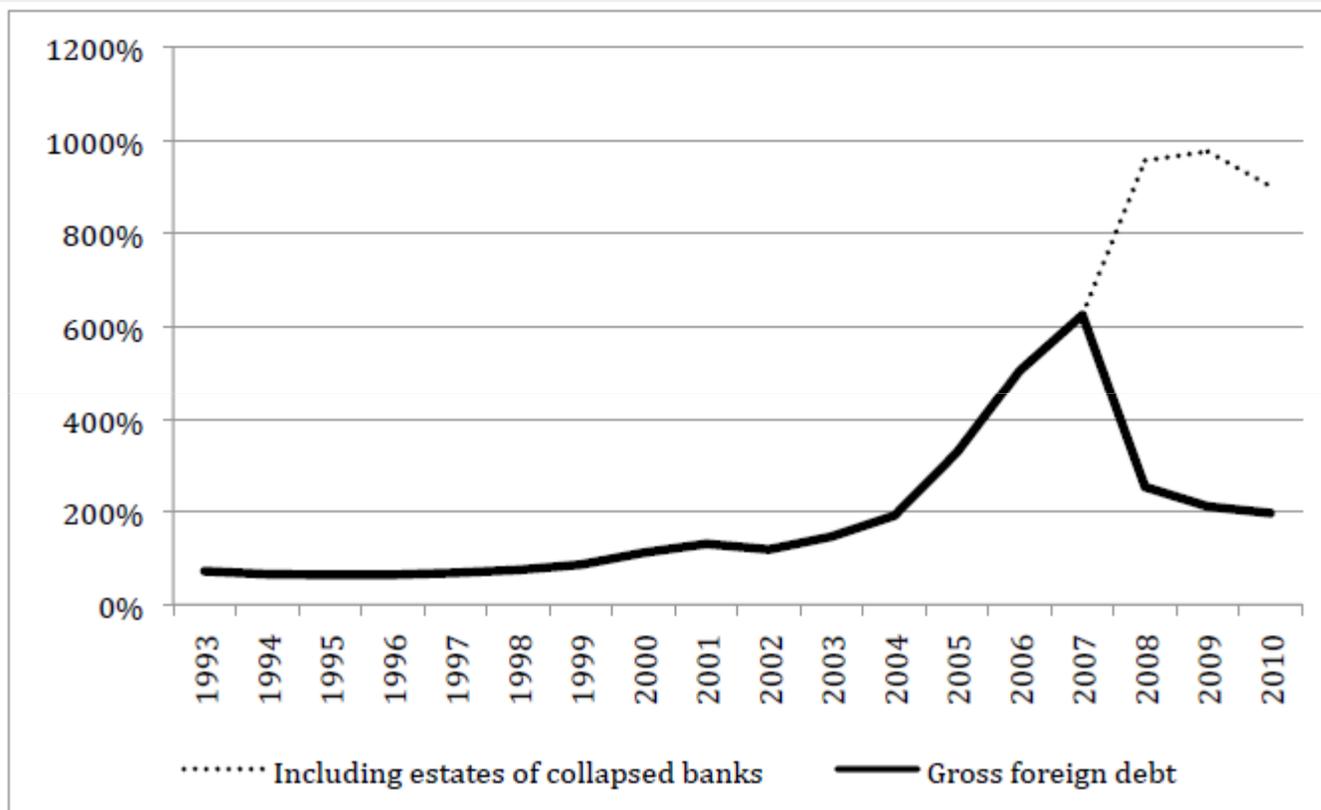
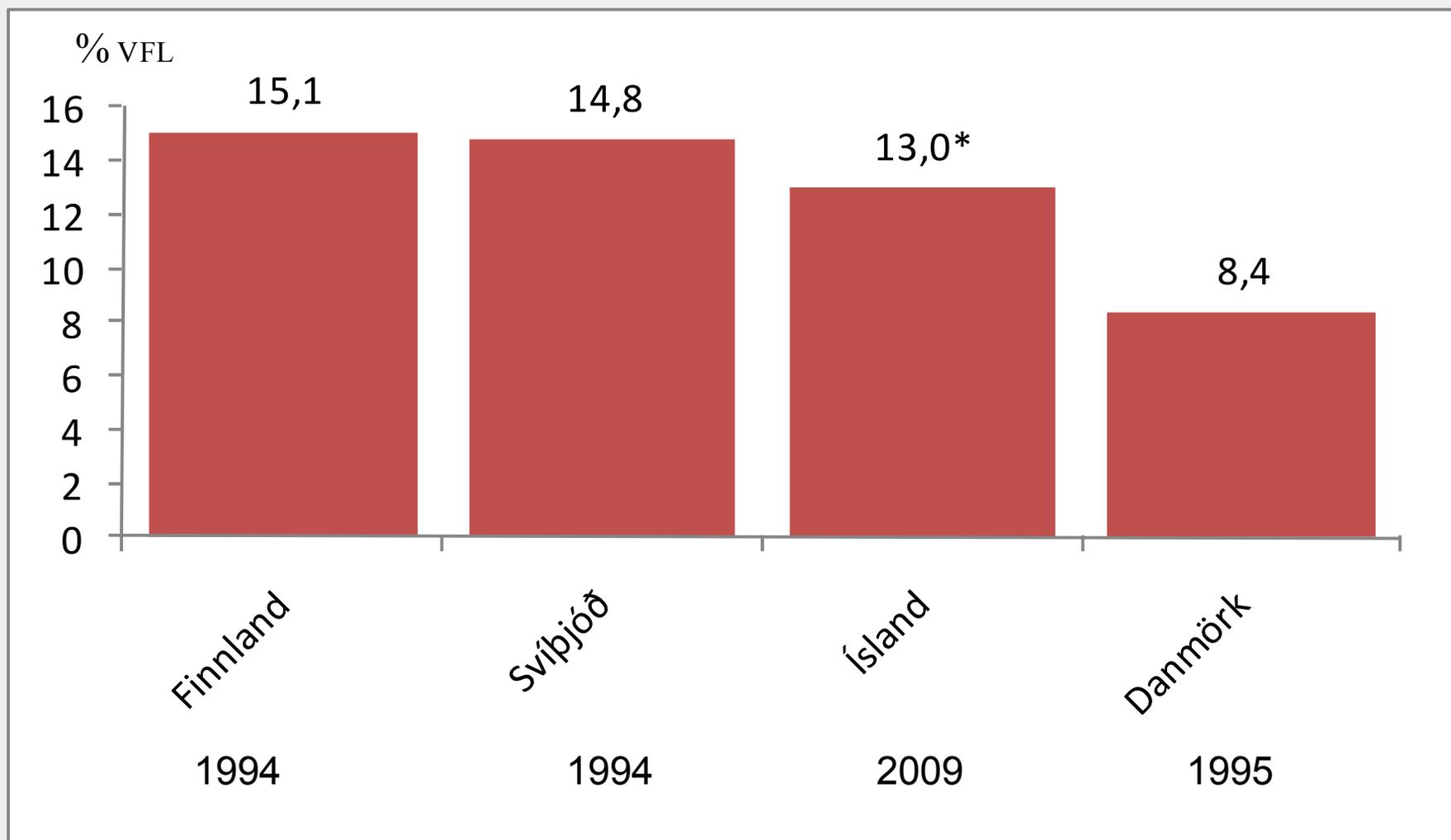


Fig. 8. Gross foreign debt as a percentage of GDP.
Source: Central Bank of Iceland.

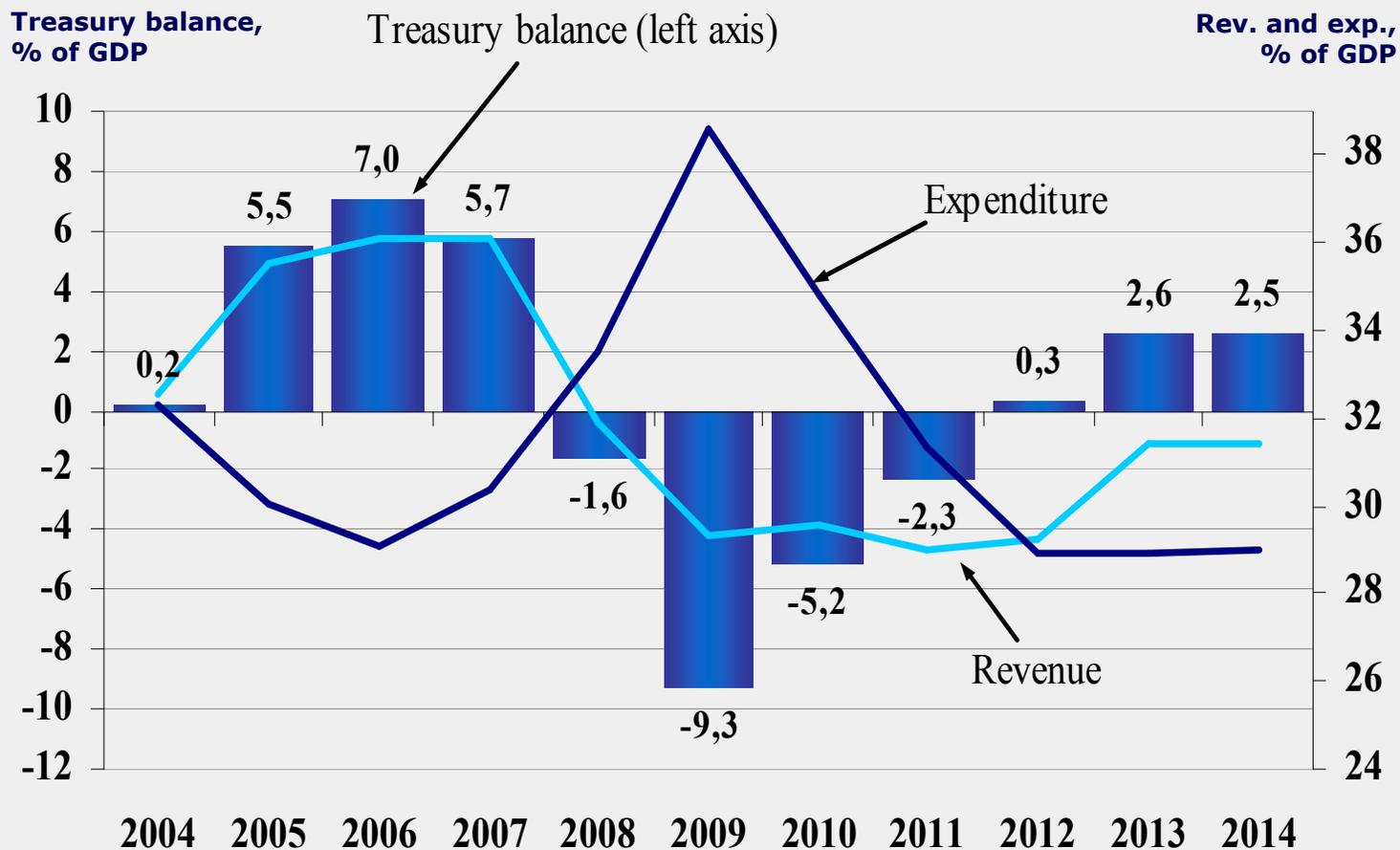
Iceland's fiscal measures compared to the Nordics



*Sveitafélög meðtalin

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Treasury budget 2011



* 192 bi.kr. in write-offs of outstanding CBI claims excl. in 2008 exp. and sale of Icelandic Telecom in 2005

* 17,5 bi.kr. Avens revenue not included in year 2010

Fiscal consolidation measures

Revenue measures:

- A three-bracket PIT system with increased tax-free allowance and an increase in the capital income tax
- Increase in the standard VAT rate
- New tax on wealthy individuals
- New environmental and carbon taxes
- Increase in social security contributions
- Excise taxes on petrol, diesel fuel, alcohol, tobacco, ect. increased

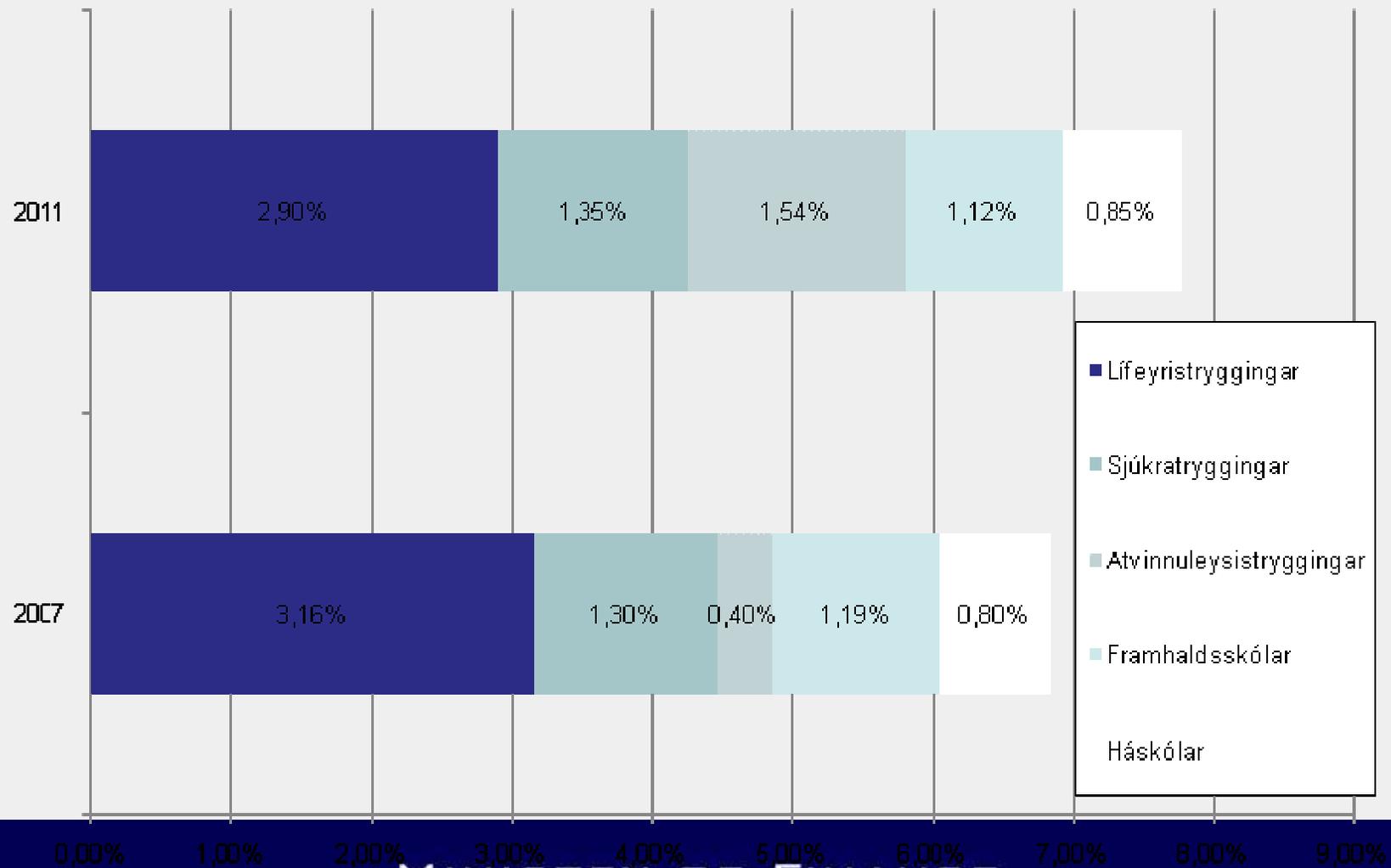
Expenditure measures:

- General cuts in current expenditure and wages formulated at the agency level
- Cuts in transfer payments
- Cuts in investment and maintenance projects to pre-boom levels
- Non-indexation of wages and benefits
- Reductions in discretionary spending items
- Previous plans for increased expenditure were abandoned

Iceland has focused on preserving the strong social welfare system

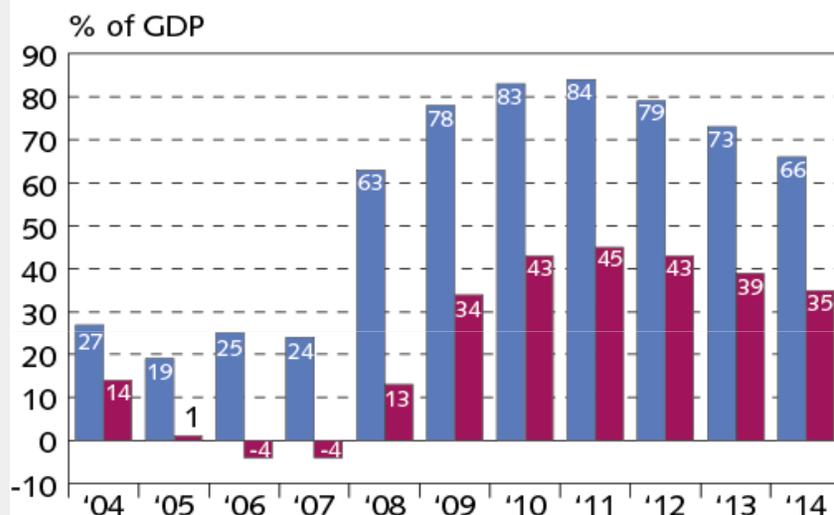
- QUESTION: “The progress has exceeded your expectations?”
- MS. KOZACK: “Yes, I think so. If you look back at the beginning of the program, the original program, Iceland has done very well. Fiscal adjustment has, you know, worked very, very well, and has been -- the authorities have taken significant measures to bring the debt to a sustainable level. Growth has been more or less in line with our projections. And the other key feature in Iceland, which has maybe not exceeded our expectations, but I think has worked very well, is that the fiscal adjustment has been able to be undertaken while still preserving Iceland’s social welfare system.”
- So there are fits and starts with any post-crisis recovery, but in Iceland, overall the progress has been really quite extraordinary.

Public welfare expenditure as % of GDP



Central Government debt ratios on declining path

Central Government Debt Ratios 2004-2014¹



■ Gross Debt
■ Net Debt

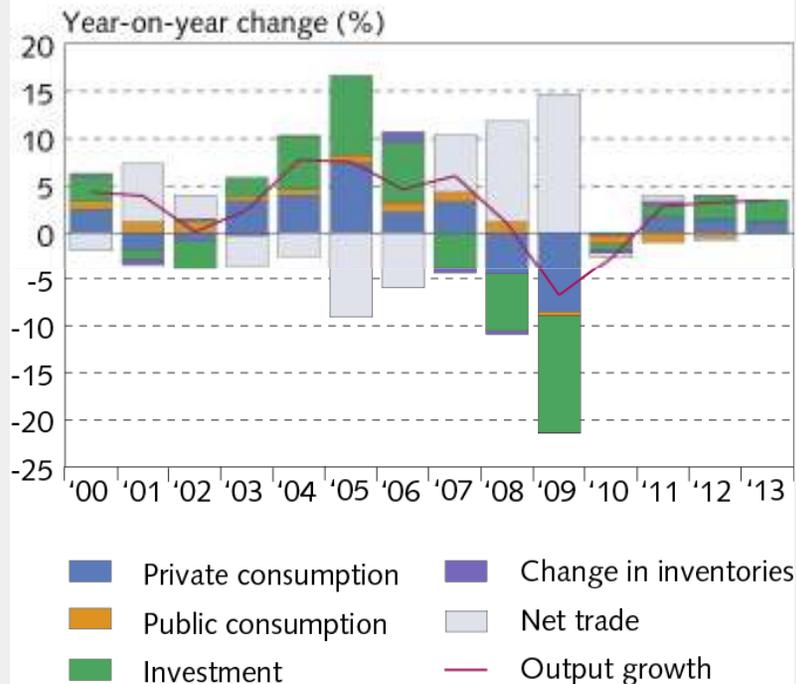
1. Figures exclude potential commitments arising from Icesave resolution; loans from IMF and Norway (Central Bank is the Borrower and held in Central Bank reserves); unfunded pension liabilities (ISK340 bn at year-end 2009); and value of shares owned by the State (not included in net debt)

Source: Ministry of Finance.

- Government debt increased substantially in wake of the collapse of the banks
- At the end of 2010 central government debt amounted to 83% of GDP
- Government debt is projected to follow a steadily declining path down to below 70% at the end of 2014
- Cash at hand and receivables are subtracted to arrive at net debt which is projected to reach 35% of GDP at year-end 2014

Growth turns positive...

Output growth and contribution of underlying components 2000-2013¹

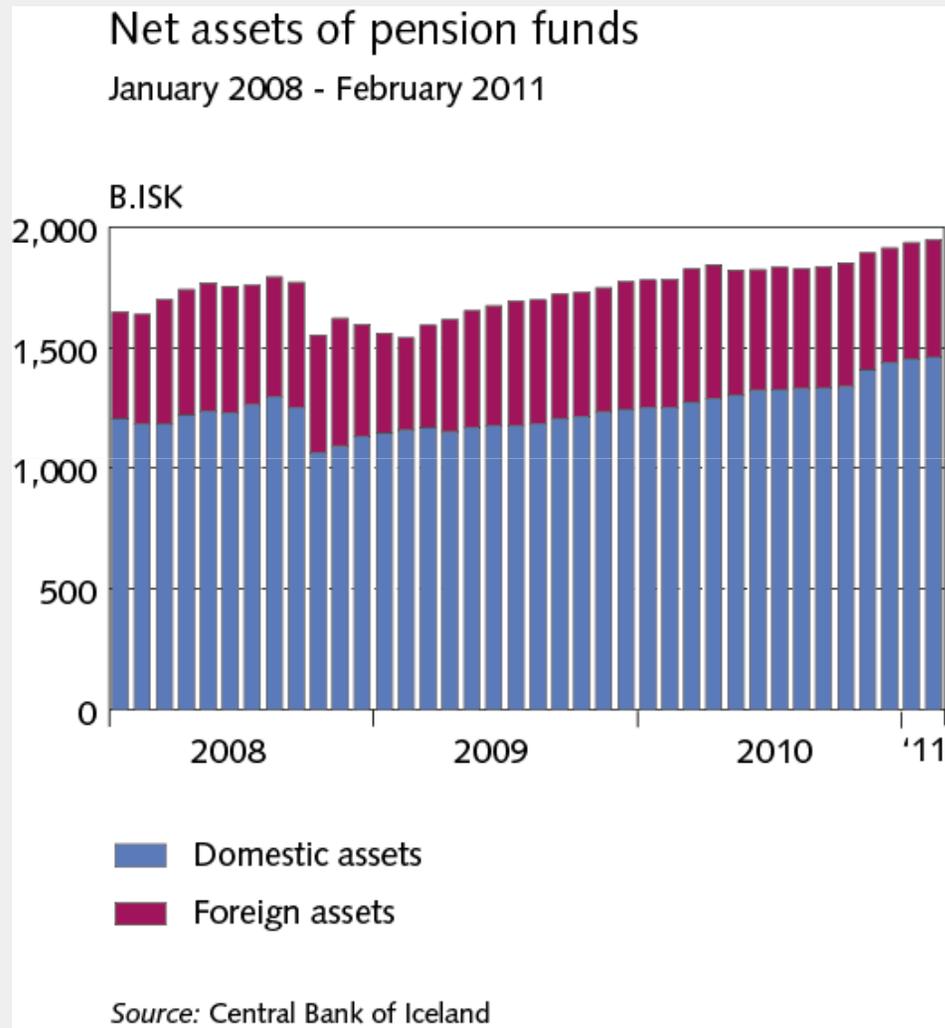


1. Central Bank baseline forecast 2010 - 2013.

Sources: Statistics Iceland, Central Bank of Iceland.

- GDP growth in 2011 is expected to be around 2.5%
- Stronger output growth of just over 3% is expected for 2012 and 2013
- Growth is expected to be driven by private consumption and investment in 2011 while investment is expected to be the main component in 2012
- The planned decrease in public consumption will be a drag on growth in 2011 and 2012

Pension funds have sizeable assets

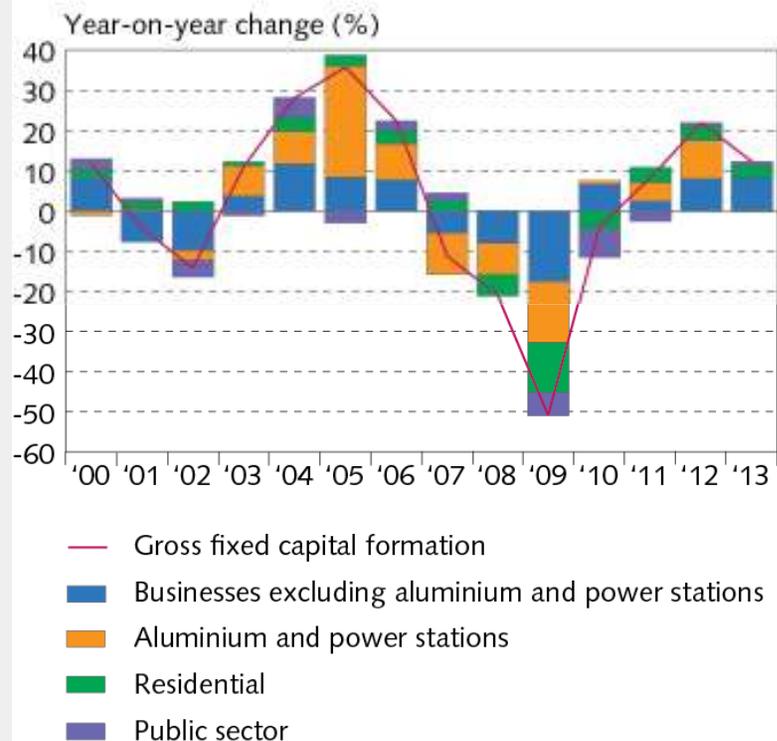


- Total assets of the pension funds amounted to almost 2,000 billion ISK at the end of February 2011, 125% of GDP.
- Foreign assets amounted to just under 500 billion ISK or 25% of total assets
- In the aftermath of the financial crisis, foreign assets amounted to approx. 30% of total assets until the Avens-deal when the ratio declined to 25%

Investment on the rise

Chart IV-13

Gross fixed capital formation and contributions of its main components 2000 - 2013¹

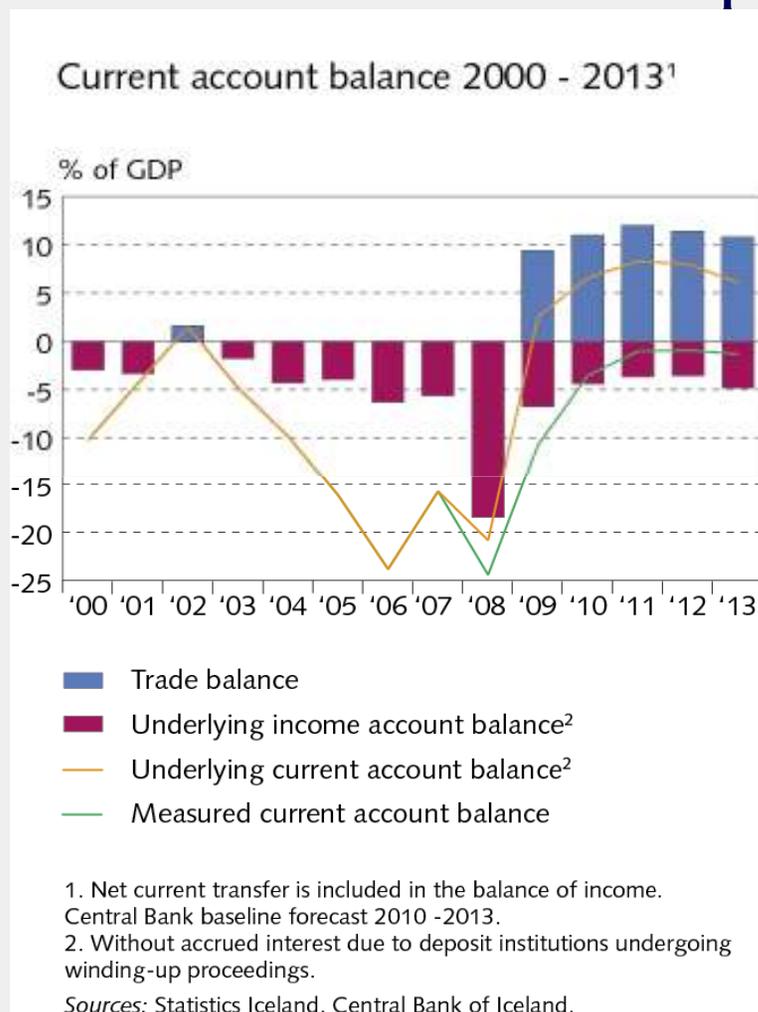


1. Central Bank baseline forecast 2010-2013.

Sources: Statistic Iceland, Central Bank of Iceland.

- Total investment is forecast to increase by nearly 10% in 2011
- New investment in heavy industry and power generating industries contracted by 4.5% in 2010 but is expected to increase by nearly 36% in real terms in 2011
- Aluminium and power stations are expected to be the most significant component of investment in 2012, replaced by other businesses in 2013

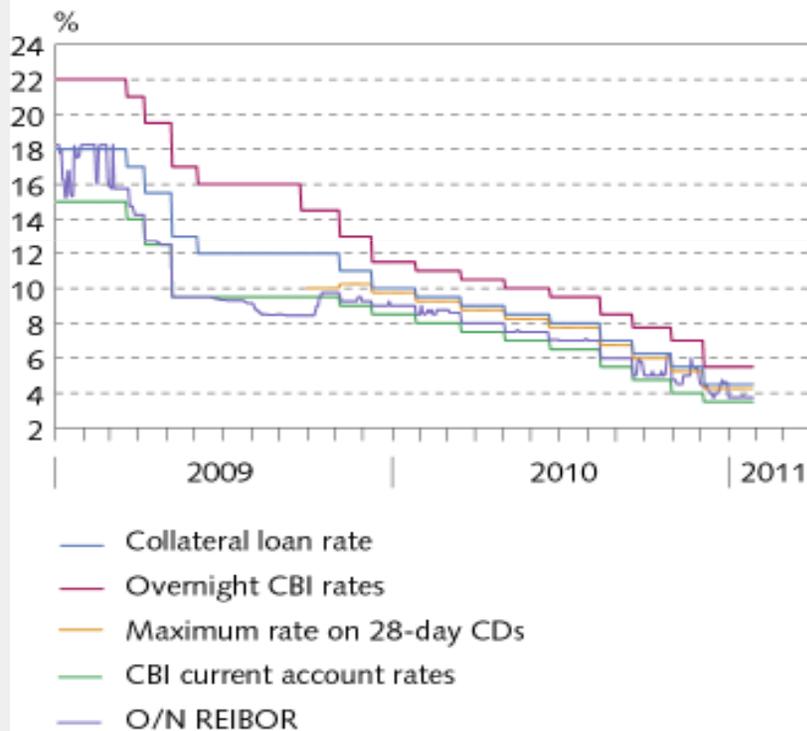
The underlying current account balance is positive..



- The current account balance at the end of 2010 amounted to -3.7% of GDP
- The underlying balance, based on calculated settlement of estates, on the other hand, was in the positive range at 6.4% of GDP
- Excluding the pharmaceutical company Actavis, which debt has a significant effect on the estimate of net IIP, the underlying balance is positive to the amount of 12.8% of GDP

Policy rates have been steadily lowered..

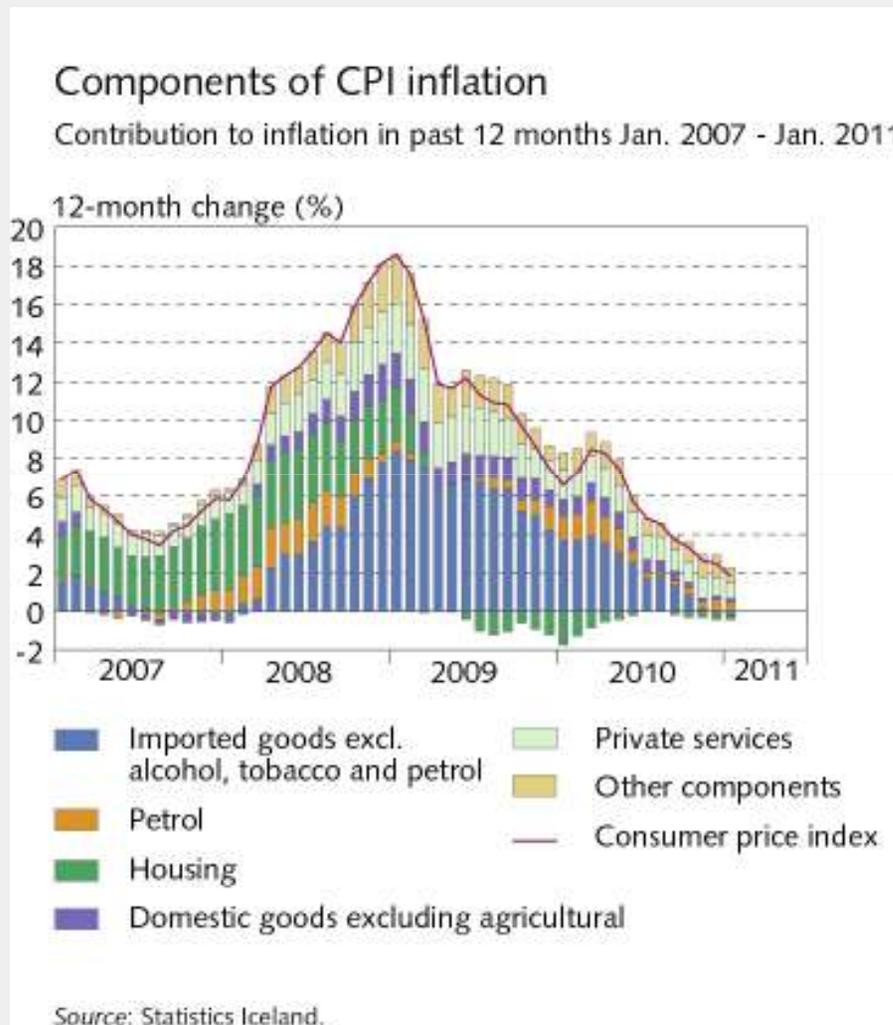
Central Bank of Iceland interest rates and short-term market interest rates
Daily data 1 January 2009 - 28 January 2011



Source: Central Bank of Iceland.

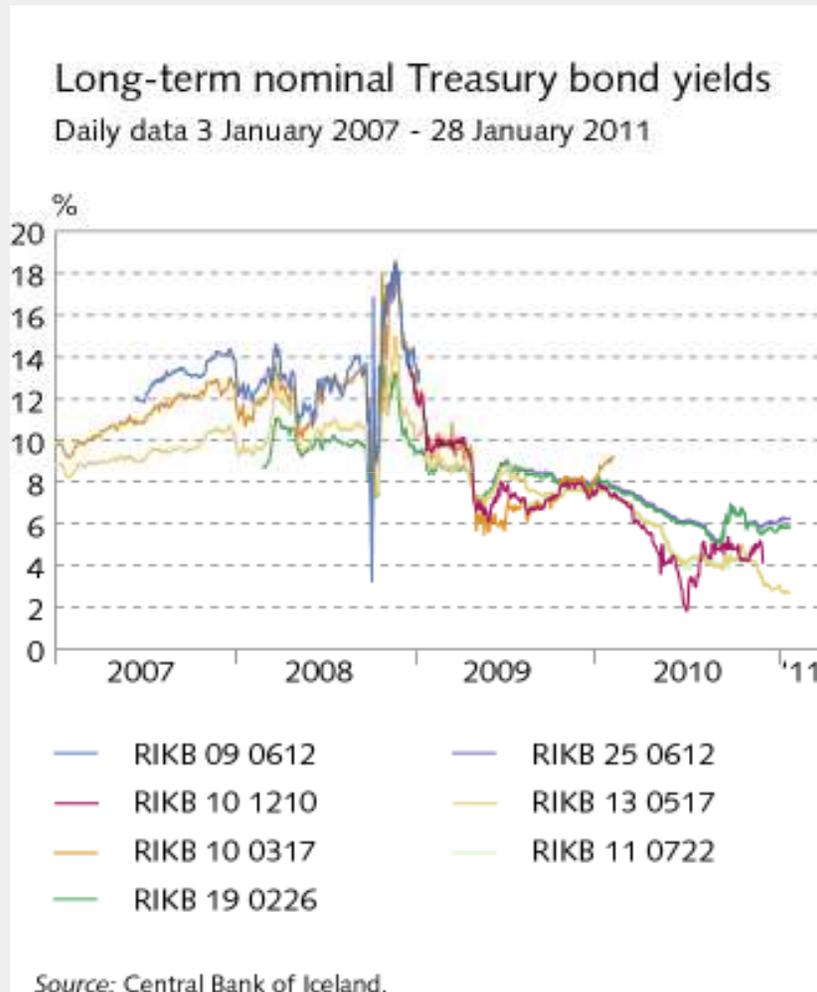
- Interest rates were gradually lowered throughout 2010
- Interest rates were lowered by 25 bp on 2 February 2011 although the MPC indicated less certainty about the direction of future interest rate decisions
- The next interest rate decision will take place on 20 April alongside the publication of the Central Bank's Monetary Bulletin 2011/2

...inflation has subsided,



- 12m inflation reached the Central Bank's inflation target in December 2010
- The import component has been a dominant factor in inflation but has subsided as the exchange rate has stabilised

..and interest rates have followed

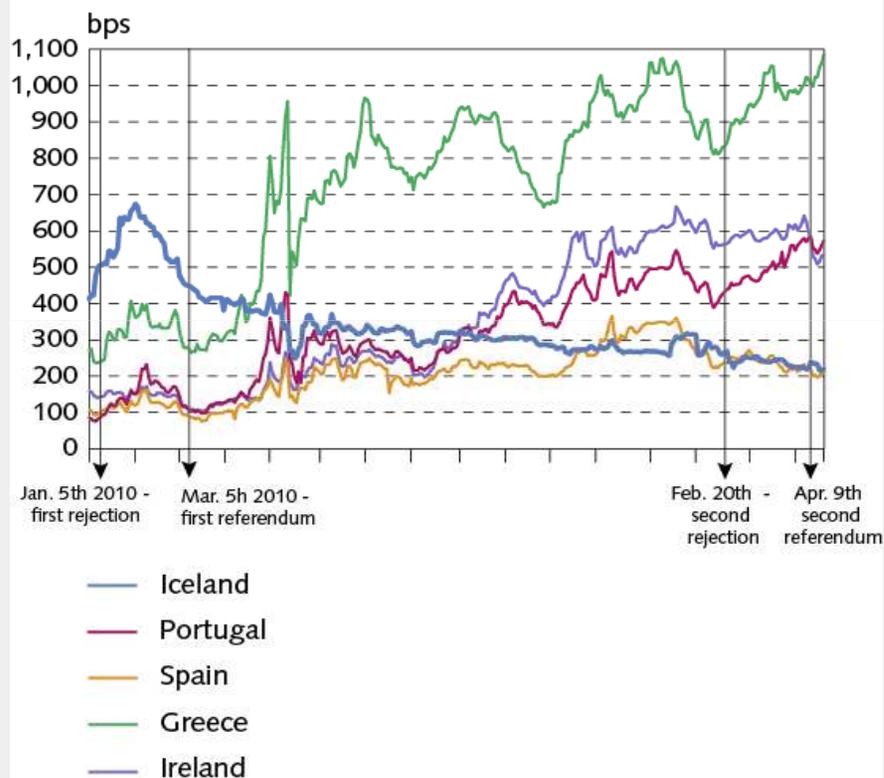


- Short-term interbank rates declined by 1-1½ percentage points between November and February
- During the same period yields on short nominal Treasury securities declined by almost 2 percentage points
- Yields on longer nominal Treasury bonds fell by as much as ½ percentage point, and yields on indexed HFF bonds by almost 0.2 percentage points

Iceland's CDS spreads have stabilised..

CDS spreads 1 January 2010 - 13 April 2011

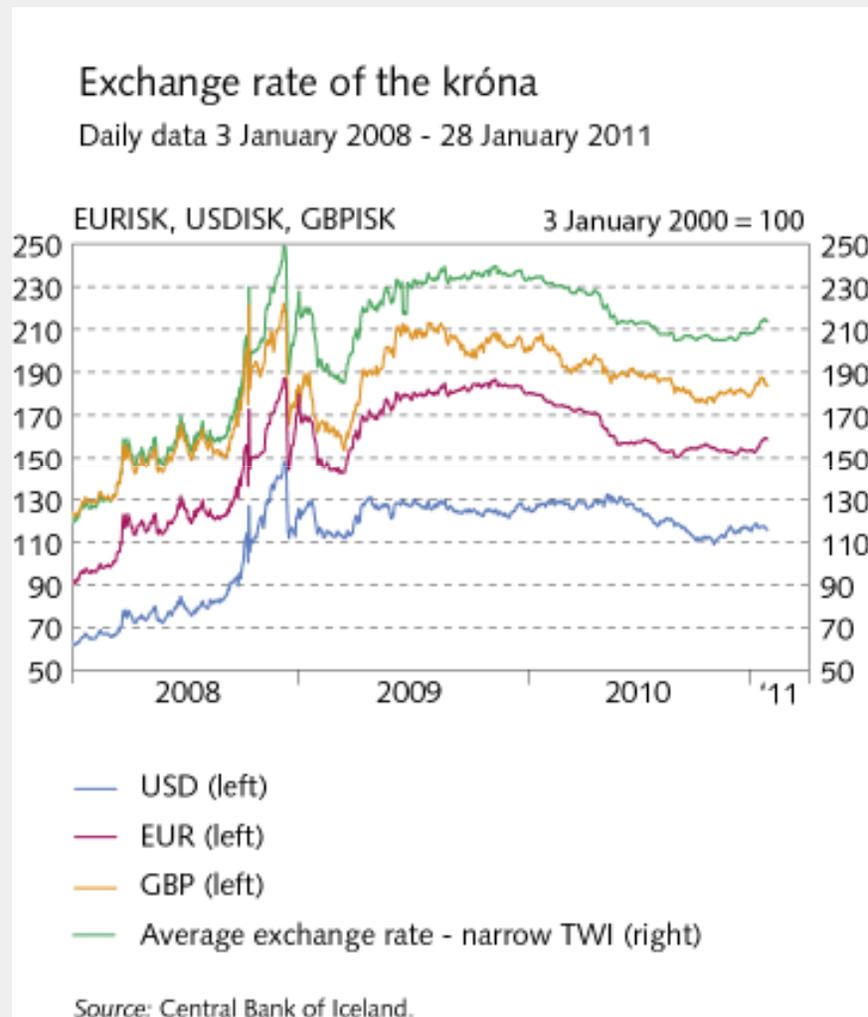
Iceland, Ireland, Greece, Portugal and Spain



Source: Bloomberg.

- The credit default swaps for the Icelandic treasury are illiquid and are therefore not an adequate measure of the situation..
- ..however, the spreads have been on a downward trend

..and exchange rate has been broadly stable



- Currency stability is still an interim objective of monetary policy
- The ISK has been broadly stable since mid-year 2010 and continues to be supported by capital controls
- From the beginning of 2010 until 14 April 2011, ISK has strengthened by 7.3% against Iceland's main trade currencies
- There has been no FX market intervention by the Central Bank since early November 2010

Long-term prospects

- **The key strengths of the Icelandic economy are still intact:**
 - Human capital, well educated workforce
 - Efficient infrastructure: energy, roads, harbours and airports, housing, communication systems etc.
 - Natural resources: sustainable energy and marine sector
 - Fully funded private pension system, assets are 125% of GDP
 - Flexible labour market with a high participation rate
 - Young population with lower age-related costs
- **These strengths will help Iceland tackle its present problems and provide for favorable long-term prospects**

Lessons from Iceland

- Resist the privatization of gains and socialising of losses.
- Public funds should be allocated towards the welfare of citizens and not towards banks.
- The market does not regulate itself. Iceland problems arose from market fundamentalism.
- The economy is set for recovery but the collapse has had an impact on public trust. Many years until that trust will be regained.
- A small economy like Iceland with it's own independent currency needs to take great care with its state finances. The government overspent during the boom years.
- The cooperation with the IMF and the programme has helped Iceland recover from the crisis that emerged in 2008.

Iceland and Ireland

- Countries with similar history that ran into similar problems. Although there are important differences. It's not just one letter and six months!
- Nations known for their resilience and have every potential to get passed the current crisis.
- Iceland got into economic trouble earlier than Ireland and is therefore further down the road of recovery.
- Iceland is hopefully graduating from a IMF standby arrangement programme this Autumn.

Thank you !