



ECONOMY OF ICELAND

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In *Economy of Iceland*, monetary figures are generally presented in euros; however, in certain instances, amounts are expressed in US dollars or Special Drawing Rights (SDR). The amount in Icelandic krónur is included in parentheses, as most figures are originally in krónur. Stocks at the end of the period are calculated using the period-end exchange rate, whereas flows are calculated using the average exchange rate for the period.

Icelandic letters:

ð/Ð (pronounced like *th* in English *this*)

þ/Þ (pronounced like *th* in English *think*)

Symbols:

- * Preliminary or estimated data.
- 0 Less than half of the unit used.
- Nil.
- ... Not available.
- . Not applicable.

Republic of Iceland

People

Population	325,671 (1 January 2014)
Capital	Reykjavík, population 121,230 (1 January 2014)
Language	Icelandic; belongs to the Nordic group of Germanic languages
Main religion	Evangelical Lutheran (75.1%)
Life expectancy	Females: 84 years; Males: 82 years

Governmental system

Government	Constitutional republic
Suffrage	Universal, over 18 years of age; proportional representation
Legislature	Althingi, with 63 members
Election term	Four years; last election 27 April 2013

Economy

Monetary unit	Króna (plural: krónur); currency code: ISK
Gross domestic product	11 billion euros (1,786.244 b.kr., 14.62 billion dollars) in 2013
International trade	Exports of goods and services 58% and imports of goods and services 50% of GDP in 2013
Per capita GDP	33.98 thousand euros in 2013 (5.5 m.kr, 40 thousand dollars in terms of PPP)

Land

Geographic size	103,000 sq.km (39,768 sq.miles)
Highest point	2,110 m (6,923 ft)
Exclusive economic zone	200 nautical miles (758,000 sq.km / 292,680 sq.miles)
Climate	Cool temperate oceanic; highly changeable, influenced by the warm Gulf Stream and Arctic currents

Republic of Iceland credit ratings

	<i>Affirmed</i>	<i>Foreign currency</i>		<i>Local currency</i>		<i>Outlook</i>
		<i>Long-term</i>	<i>Short-term</i>	<i>Long-term</i>	<i>Short-term</i>	
Moody's	July 2014	Baa3	P-3	Baa3	P-3	Stable
Standard & Poor's	July 2014	BBB-	A-3	BBB-	A-3	Positive
Fitch	August 2014	BBB	F3	BBB+		Stable

Central Bank of Iceland publications in English

Annual Report

Monetary Bulletin

Financial Stability

Economy of Iceland

Economic Affairs

Informational Reports

Special Publications

Central Bank of Iceland *Working Papers*

These publications are available on the Central Bank website. Also available on the website are regularly updated Central Bank statistics and *Economic Indicators*, a snapshot of the Icelandic economy in charts and tables.

Useful websites

Central Bank of Iceland

Parliament of Iceland (Althingi)

Government of Iceland

Statistics Iceland

OMX Nordic Exchange in Iceland

Government Debt Management

Trade Council of Iceland

National Association of Pension Funds

Invest in Iceland Agency

Financial Supervisory Authority

The Official Gateway to Iceland

www.sedlabanki.is

www.althingi.is

www.government.is

www.statice.is

www.nasdaqomx.com

www.bonds.is

www.icetrade.is

www.ll.is

www.invest.is

www.fme.is

www.iceland.is



Introduction

Economy of Iceland has been published by the Central Bank of Iceland since 1987. It is mainly intended for an international readership. This includes international institutions that deal with Icelandic economic matters on a regular basis, rating agencies, financial institutions, foreign investors, embassies and, more generally, everyone who is interested in the Icelandic economy. We also hope that Icelandic readers will find this survey useful. It is published every other year.

This publication focuses on the structure of the Icelandic economy. It is intended to serve as background material for understanding the evolution of the economy, but it does not provide a detailed account of recent developments. A more up-to-date analysis of recent developments is provided in the Central Bank's *Monetary Bulletin* and *Financial Stability* reports. The Bank's *Annual Report* describes the Central Bank of Iceland's general activities during the year.

The outline of this booklet is as follows: Chapter 1 presents basic facts about Icelandic geography, population and society. Chapter 2 deals with the structure of the economy. It discusses size and income levels, the composition of GDP, foreign trade, main economic sectors, the labour market, and the Icelandic pension system. Chapter 3 provides an account of the financial system and discusses the various challenges during the recovery following the financial crisis. Chapter 4 surveys the public sector, including division of tasks, central and local government finances, expenditure structure, and the tax system. Chapter 5 describes the frameworks for monetary policy and financial stability. It explains the objectives and main instruments of monetary policy, as well as the role of the Monetary Policy Committee. It also elaborates on financial stability policy and the Central Bank's role in promoting an efficient and safe financial system. Chapter 6 presents Iceland's external debt position. It elaborates on the accumulation of debt in the years preceding the financial crisis and developments in its aftermath. It discusses changes in foreign direct investment and provides estimates of net foreign debt levels once the failed private banks have been wound up. Chapter 7 describes government, corporate and household balance sheets. It discusses the position of the government, households and businesses and debt restructuring following the financial crisis. A number of tables are provided in an appendix.

We are constantly making efforts to improve this publication. Hence we would be grateful for any comments and suggestions that might increase the usefulness of this booklet. If you feel that important information is missing and should be added, or if you see other scope for improving this publication, please e-mail your suggestions to: sedlabanki@sedlabanki.is.

1 Country and people

This chapter focuses on the country of Iceland with regard to its geography and the main characteristics of the Icelandic nation and society, in addition to elaborating on Iceland as a welfare state. Iceland's political structure is also described, as well as its external relations and status in the global context.

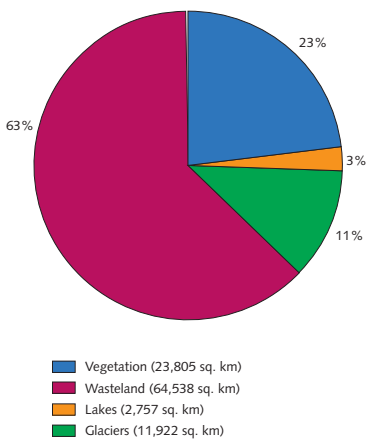
Geography

Iceland is located in the North Atlantic, between Norway, Scotland and Greenland. It is the second-largest island in Europe and the third-largest in the Atlantic Ocean, with a land area of some 103 thousand square kilometres, a coastline of 4,970 kilometres and a 200-nautical-mile exclusive economic zone (EEZ) extending over 758 thousand square kilometres in the surrounding waters.

Iceland enjoys a warmer climate than its northerly location would indicate because a part of the Gulf Stream flows around the southern and western coasts of the country. In the capital, Reykjavík, the average temperature is nearly 13°C in July and just above 2°C in January.

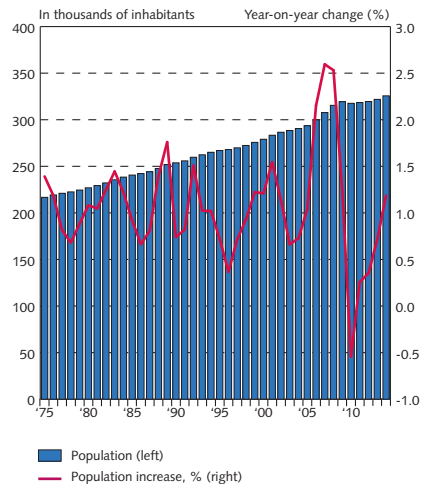
Iceland is mostly mountainous and of volcanic origin, with the highest peak reaching 2,110 metres. Lowlands stretch from the coast towards the interior, mainly in the south and the west. Several glaciers, one of them the largest in Europe, distinguish the landscape. The coasts are

Chart 1.1
Geography of Iceland¹



1. The size of Iceland is 103,000 square kilometers.
Sources: Icelandic Geodetic Survey, National Energy Authority, Science Institute, University of Iceland.

Chart 1.2
Population of Iceland 1975-2014¹



1. Population 1 January each year. The figures for 1 January 2008 have been revised upwards.
Source: Statistics Iceland.

rocky and of irregular outline, with numerous fjords and inlets, except for the south, where there are sandy beaches with no natural harbours. Only around 20% of the total land area is classified as arable land, most of it located in the southern and western part of the country and several fertile valleys stretching from the coast.

Iceland is endowed with abundant natural resources. These include the fishing grounds around the island, within and outside the country's 200-mile EEZ. Furthermore, Iceland has abundant hydroelectric and geothermal energy resources.

People

Iceland was settled in the ninth century A.D. The majority of the settlers were of Norse origin, with a smaller Celtic element. A general legislative and judicial assembly, the Althingi, was established in 930, and a uniform code of laws for the country was established at the same time. In 1262, Iceland entered into a union with the Norwegian monarchy. When the Kalmar union was dissolved in 1523, Iceland came under Danish rule, which lasted for more than five hundred years. Iceland was granted a new constitution in 1874 and obtained home rule in 1904. With the Act of Union in 1918, Iceland became a sovereign state in a monarchical union with Denmark. In 1944, Iceland terminated this union with Denmark and founded a Republic. The native language, Icelandic, belongs to the Nordic group of the Germanic languages.

With only 3 inhabitants per square kilometre, Iceland is one of the least densely populated countries in Europe. On 1 January 2014, Iceland's population was almost 326 thousand. In 2000–2013, annual average population growth was 1.1% and the natural increase (births less deaths) 1.4%. Around 63% of the population (some 200 thousand) live in the capital city of Reykjavík and its surrounding municipalities. The largest town outside the capital area is Akureyri, located in North Iceland, with a population of 17,827. Most of the remaining inhabitants live in small towns along the coast.

As in other advanced countries, the population of Iceland is ageing, but at a relatively slower pace than in most OECD countries. In 2012, despite high life expectancy, the ratio of the total population aged over 65 to the population of working age was 19%, eighth-lowest in the OECD.

Society and the welfare state

Iceland is a modern welfare state that guarantees its citizens access to universal health care, education, and a high degree of social security. Spending on health, education, social security, welfare, and other social affairs amounted to 31.3% of GDP in 2012.

Life expectancy, which is among the highest in the world, and one of the world's lowest infant mortality rates (0.9 per 1,000 live births in 2013) testify to the advanced status of health care in Iceland, both primary health care and hospitals. The Icelandic health care system is a tax-financed universal system for all persons who have had legal residence in Iceland for more than 6 months. Healthcare services are provided mainly free of charge, although user charges have been on the rise. The main exception is dental health care, where adult patients are charged the full cost of service, while children under 18 years of age have most of the cost refunded.

The standard of education is high, and public education is compulsory between the ages of 6 and 16. Good command of English and the Scandinavian languages is widespread. Education is offered free of charge or for a nominal fee at three levels. First, there are ten years of compulsory

education at the primary level (age 6-16). This is followed by four years at the upper secondary level, which provides general education and vocational training in a wide range of fields. Finally, higher education is offered at several universities.

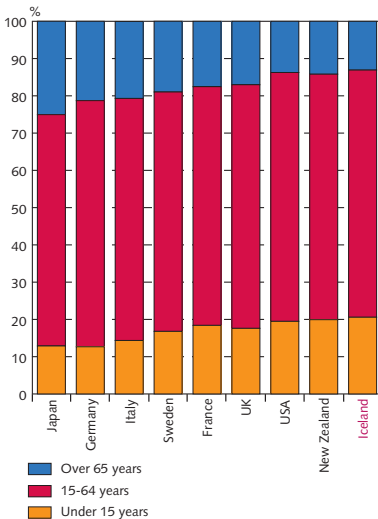
In Iceland, as in most OECD countries, university enrolment of those completing secondary education has increased substantially in recent years. In 2013, 35% of the population held a university degree, up from 24% in 2000. The ratio of pre-school enrolment is also one of the highest among OECD countries.

Institutional framework: the political, judicial, monetary, and financial supervisory structure

The present Constitution was adopted on 17 June 1944, when the Republic was established. Iceland has a parliamentary system of government. Legislative power is vested in Parliament (Althingi) and executive power in a cabinet headed by the Prime Minister. The Government must be supported by a majority of Parliament in order to remain in power. The 63 members of Parliament are elected from six constituencies on the basis of proportional representation, for a term of four years. Over the past 30 years, women's participation in politics has increased significantly and their share of seats in Parliament has increased from 15% to roughly 40%. A parliamentary bill becomes law when it is passed by Parliament and signed by the president. The president is the head of state and is elected for a term of four years by a direct vote of the electorate.

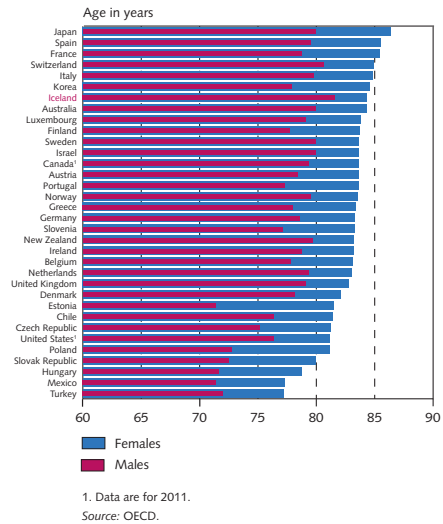
Since Iceland gained autonomy from Denmark in 1918, its governments have normally been formed by a coalition of two or more political parties that have held a majority in Parliament. The most recent elections were held on 27 April 2013. The results of the elections were as follows: the

Chart 1.3
Age structure of the population in selected countries 2012¹



1. Ranked by share of population older than 65. Data for Germany, Iceland, Japan and New Zealand are for 2013.
Sources: OECD, Statistics Iceland.

Chart 1.4
Life expectancy at birth 2012¹



1. Data are for 2011.
Source: OECD.

Chart 1.5
General government expenditure by function in 2011¹

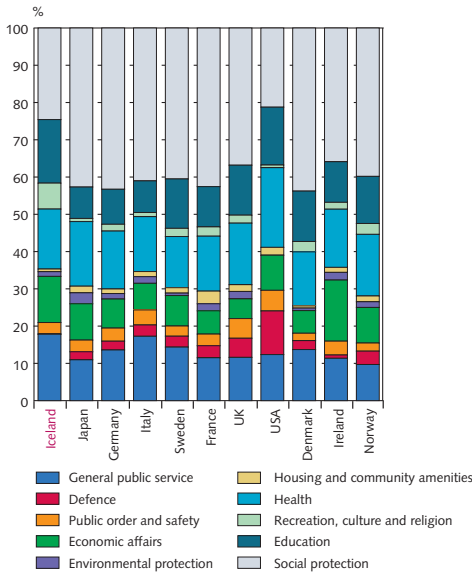
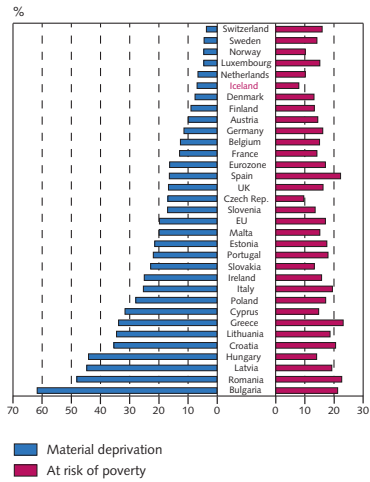


Chart 1.6
Material deprivation and risk of poverty in Europe 2012



Independence Party obtained 26.7% of votes and 19 seats, the Progressive Party 24.4% and 19 seats, the Social Democratic Alliance 12.7% and 9 seats, the Left Green Party 10.9% and 7 seats, and two new parties, Bright Future and the Pirate Party, obtained 6 seats and 3 seats, respectively, with 8.3% and with 5.1% of the vote. Others received a total of 8.7% of the vote and no seats. A coalition government between the Independence Party and the Progressive Party (with 38 seats) took office in May 2013. The next general election is to be held in 2017.

Iceland’s court system is divided into two levels: district courts, which are the courts of first instance, and the Supreme Court, which holds the highest judicial power in Iceland. The Constitution provides for the courts’ independence, according to which judges have the judicial power, shall only abide by the law in their official duties, and cannot be discharged from office except by judicial decision.

The Central Bank of Iceland was established by an Act of Parliament in April 1961. According to the Act, the Central Bank is an independent institution owned by the State but under separate administration. The Ministry of Finance and Economic Affairs has issues pertaining to the Central Bank in its portfolio, insofar as they belong to the political sphere. An inflation target and an exchange rate regime are specified by the Central Bank and ratified by the Minister of Finance and Economic Affairs. The Bank is provided with the necessary means and instruments for achieving the primary objective of price stability, independent of any other authority, by the 2001 Central Bank Act. The Bank is supervised by a seven-member Supervisory Board elected by Parliament.

Decisions on the use of monetary policy instruments are taken by a five-member Monetary Policy Committee chaired by the Governor. The Governor takes decisions not allocated to the Monetary Policy Committee, the Supervisory Board, or the Minister (e.g., the design of new banknotes), but some of these decisions require endorsement by the Supervisory Board.

The Financial Supervisory Authority (FME) is charged with the task of supervising financial enterprises. Its mission is to safeguard the integrity and sound operation of the financial market. The Act on Official Supervision of Financial Activities states that the FME is an independent institution with the administration entrusted to a board of directors. The FME falls under the auspices of the Ministry of Finance and Economic Affairs, but according to the Act, the Minister does not have the power to affect decision-making within the institution.

External relations

Iceland has participated actively in international cooperation. It belongs to the group of Nordic countries that includes Denmark, Sweden, Norway and Finland, as well as Greenland and the Faeroe Islands. The Nordic countries have established wide-ranging cooperation in a variety of fields, including economic affairs and international representation, in which the Baltic countries have been taking an increasingly active part. Iceland is a member of the Nordic Council and specialised institutions such as the Nordic Investment Bank.

Iceland became a member of the United Nations in 1946 and is an active participant in most of its affiliated agencies. It is a founding member of the Bretton Woods institutions established in 1945, the International Monetary Fund (IMF), and the International Bank for Reconstruction and Development (World Bank).

Iceland is one of the original members of the Organisation for Economic Cooperation and Development (OECD) and of the European Bank for Reconstruction and Development (EBRD). It joined the Council of Europe in 1950 and has participated in the Organisation for Security and Cooperation in Europe since the organisation's inception in 1975.

In 1964, Iceland became a party to the General Agreement on Tariffs and Trade (GATT), the predecessor to the World Trade Organization (WTO). Iceland joined the European Free Trade Association (EFTA) in 1970 and entered into a free trade agreement with the European Economic Community in 1972. In May 1992, the member states of EFTA and the European Union signed an agreement to establish a zone for the free movement of goods, services, capital and persons, the European Economic Area (EEA), which took effect on 1 January 1994. Iceland participates in numerous Free Trade Agreements (FTAs) with other countries through its EFTA membership. Furthermore, Iceland has enacted bilateral Free Trade Agreements with China, Greenland, and the Faeroe Islands.

Iceland is a founding member of the North Atlantic Treaty Organization (NATO), established in 1949. The United States maintained a permanent military presence at a base in Iceland from 1951 until 2006; however, the bilateral defence agreement between Iceland and the United States remains valid. In July 2009, Iceland submitted a formal application for accession to the European Union after Parliament voted in favour of applying for membership. Iceland's accession negotiations with the European Union were formally opened in July 2010. The Government decided in June 2013 to put negotiations on hold, and in February 2014 it presented before Parliament a proposal to withdraw the application for accession to the European Union.

Table 1.1 Iceland's membership in international organisations

	<i>Year of association</i>
International Monetary Fund (IMF)	1945
International Bank for Reconstruction and Development (World Bank)	1945
United Nations (UN)	1946
North Atlantic Treaty Organization (NATO)	1949
Organisation for Economic Cooperation and Development (OECD)	1949
Council of Europe	1950
Nordic Council	1952
International Finance Corporation (IFC)	1956
International Development Association (IDA)	1961
General Agreement on Tariffs and Trade (GATT)	1964
European Free Trade Association (EFTA)	1970
Organization for Security and Cooperation in Europe (OSCE)	1975
European Bank for Reconstruction and Development (EBRD)	1990
Western European Union (WEU)	1992
European Economic Area (EEA)	1994
World Trade Organization (WTO)	1995

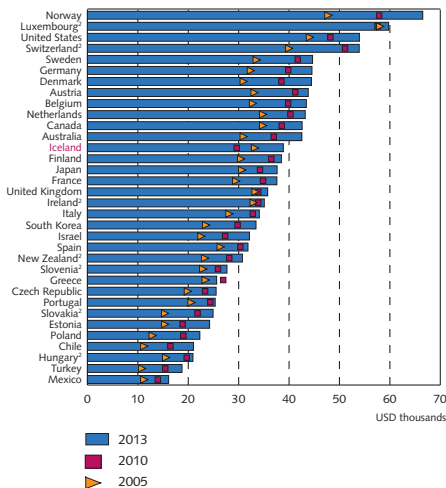
2 Structure of the economy

This chapter focuses on the structure of the Icelandic economy, mainly with regard to size, composition of output and expenditure, and foreign investment. Different sectors of the economy are analysed, particularly to include recent developments and the contribution of each sector to GDP. Finally, the labour market and pension system in Iceland are discussed. The Icelandic economy displays the characteristics of an advanced economy, with high income levels and a relatively large services sector. Its distinguishing features are its large marine and energy sectors based on ample resources, and a high labour participation rate.

Size and income level

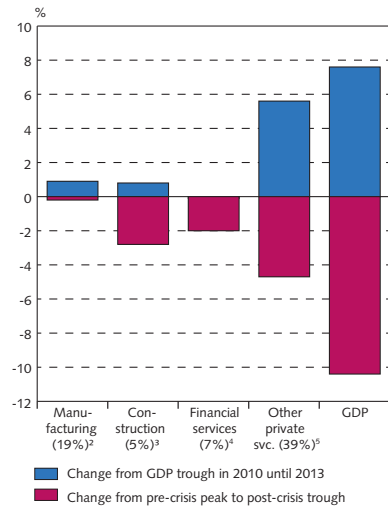
The Icelandic economy is the smallest within the OECD, generating GDP of 14.7 billion US dollars (1,786 b.kr) in 2013. This amounted to around 1/1000 of the US economy, 1/25 of the Danish economy, and 1/4 of the economy of Luxembourg, while it is more than 50% larger than the economy of Malta. The small size of the Icelandic economy mainly reflects the country's small population, which was just over 325 thousand on 1 January 2014. Iceland has all the characteris-

Chart 2.1
Gross national income per capita in
OECD countries¹



1. Based on PPP. 2. Data is for 2012.
Source: Macrobond.

Chart 2.2
Individual sectors' share in economic
contraction and recovery¹



1. Each sector's contraction and recovery, weighted with its share in gross factor income during the relevant period (2013 share in parentheses). 2. Manufacturing, mining, utilities, and waste handling. 3. Building and construction. 4. Financial and insurance activities. 5. Wholesale, retail, transportation and storage, hotels and restaurants, IT and communications, real estate, and miscellaneous specialised services.
Source: Statistics Iceland.

tics of a modern welfare state. GNI per capita measured in terms of Purchasing Power Parities (PPP), according to World Bank data, amounted to nearly 39 thousand US dollars in 2013, the twenty-second highest in the world and the thirteenth highest among the OECD countries. Iceland's GNI per capita is lower than that in Denmark, Norway, and Sweden but marginally higher than in Finland and slightly above the EU average.

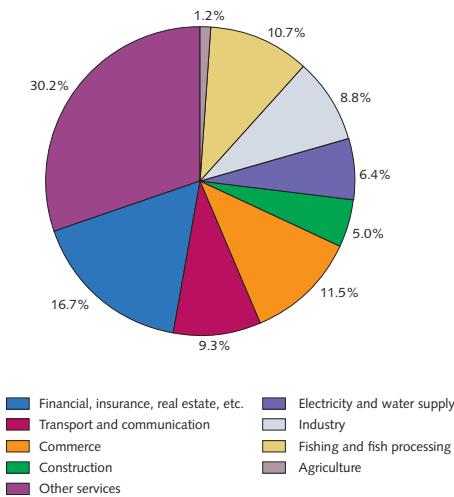
Drivers of growth

Historically, Iceland's prosperity has been built largely on its comparative advantages in abundant marine and energy resources, with investment and services the main drivers of growth. In the few years leading up to the twin currency and banking crisis of 2008, the financial services and construction sectors were the main drivers of economic growth. The contraction following the financial crisis was in turn most pronounced within those sectors. After GDP growth resumed in 2010, however, the contribution from the services sector has been driven by the recovery of domestic demand and growth in tourism-related services, supported by a competitive real exchange rate (Chart 2.2). This is also reflected in the national accounts expenditure figures, which show that services exports have contributed a sizeable share of the GDP growth during the recovery period.

Composition of output and expenditure

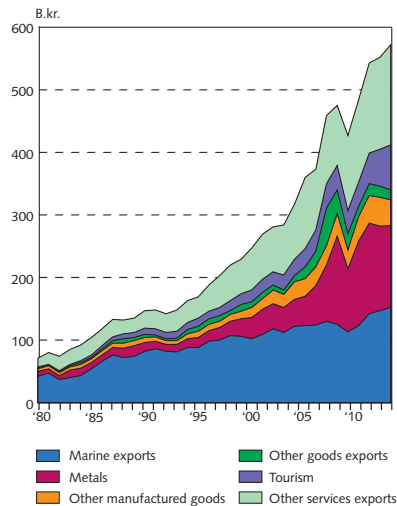
As in other developed economies, services form the bulk of economic activity, accounting for approximately 3/4 of GDP in 2013. The marine sector accounted for roughly 10.5% of GDP in 2013 and remains one of the most important sources of export revenues. Manufacturing (excluding marine goods) accounted for roughly 15% of GDP in 2013. Its share has increased from nearly

Chart 2.3
Breakdown of GDP by sector 2013



Source: Statistics Iceland.

Chart 2.4
Exports of goods and services 1980-2013
At constant average exchange rates, based on a trade-weighted basket of currencies



Source: Statistics Iceland.

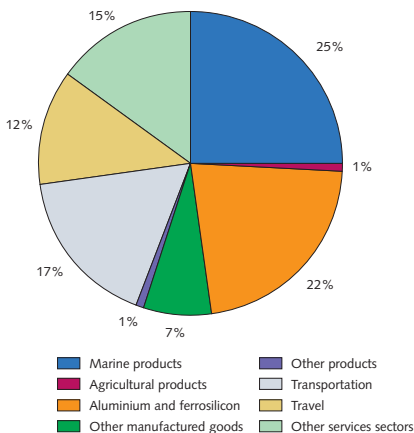
12% of GDP in 2005, reflecting both investment in energy-intensive sectors and the declining share of the sectors that were the main drivers of growth in the pre-crisis years. Financial services (other than insurance services and pension funds) accounted for roughly 4% of GDP in 2013, roughly half of the sector's contribution at the height of the boom (2004-2008).¹

Private consumption contributed, on average, about 53% of GDP in 2010-2013, and public consumption and gross fixed investment contributed 26% and 14%, respectively. Since the crisis struck, the investment-to-GDP ratio has been well below the long-term average of 20% of GDP, although it has been edging up recently and was 13.6% in 2013. The ratio of public consumption to GDP, which had been broadly stable since the turn of the century, declined at the height of the boom, as private sector activity outpaced public sector activity. Since the financial crisis, however, the ratio has increased again, as the private sector has contracted more than the public sector. Despite the increased share of public consumption, it contracted by just below 1% on average in 2010-2013, whereas the average long-term growth rate is 2.8%.

Foreign trade

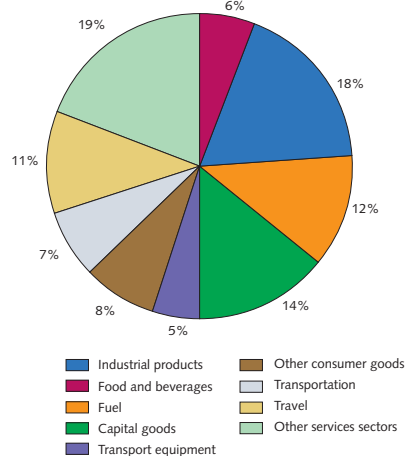
Iceland is a fairly open economy, with imports and exports of goods and services amounting to 50% and 58% of GDP, respectively, in 2013. In the period 2000–2013, trade openness, measured as the ratio of imports and exports of goods and services to GDP, averaged 87%, just above the OECD average. Although trade still involves a relatively large share of primary products and commodities, exports have diversified significantly in the past twelve years. Certain factors restrict openness, however, such as geographic distance from major population centres, limited intra-industry and transit trade, and protection of domestic agriculture.

Chart 2.5
Exports by sector 2013
Percentage of total exports



Source: Statistics Iceland.

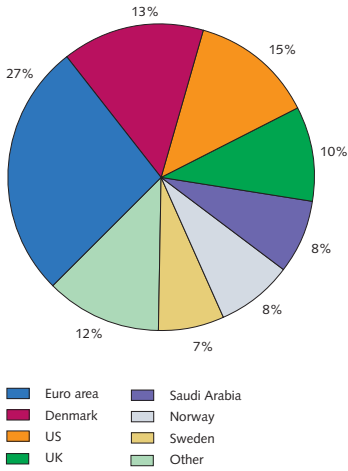
Chart 2.6
Imports by sector 2013
Percentage of total imports



Source: Statistics Iceland.

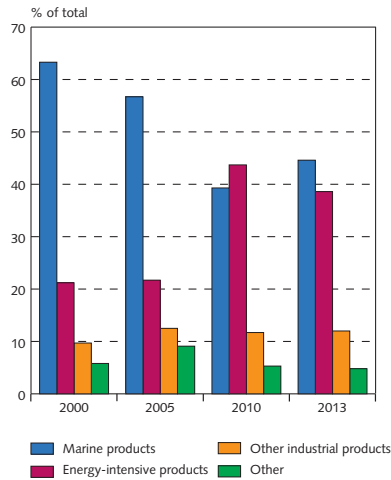
1. Total financial services accounted for nearly 6½% of GDP in 2013, down from a share of 2/3 at the height of the boom in 2005-2008 but close to the 1999-2002 level.

Chart 2.7
Currency area share in services exports 2013



Source: Statistics Iceland.

Chart 2.8
Composition of goods exports by product categories



Source: Statistics Iceland.

Fish and other marine products have been the mainstay of goods exports, although they have been declining as a share of total exports since the turn of the century. In 2013, fish and other marine products accounted for 45% of goods exports and 27% of total exports, down from 63% and 41%, respectively, in 2000. Exports of manufactured goods have been growing rapidly in importance, led by aluminium smelting and medical and pharmaceutical products, and accounted for 51% of goods exports in 2013 (up from 31% in 2000) and 30% of total exports. Exports of services have also increased as the economy has grown and become increasingly service-oriented. Tourism has soared over the past few years and has been one of the main engines of export growth, contributing to 61% of the growth during the post-crisis period. Services now account for almost 46% of total export revenues, up from 37% in 2000.

Iceland imports a wide range of manufactured goods and commodities, reflecting both the small size of the economy and the limited range of natural resources. Imports of industrial supplies accounted for 30% of total goods imports and 18% of total imports in 2013. Capital goods and consumer goods each constituted around 23% of total goods imports and around 14% of total imports in 2013, while services contributed around 40% of total imports.

Iceland's ratio of services trade to total trade was 40% in 2013, one of the highest in the OECD. Data on the direction of services trade are not as reliable as goods trade data; however, service exports accounted for an average of 36% of total exports over the period 2000-2013. The euro is by far the most common currency used for services exports in Iceland, with 27% of total services exports. Besides the euro, only three currencies have a share of 10% or larger: the US dollar (15%), the Danish krone (13%), and the pound sterling (10%).

Free trade arrangements with Europe have stimulated Iceland's trade with the region, causing the share of North America to fall. In 2013, 79% of goods exports went to European Economic Area member countries, which were also the source of 61% of imports. Currently, Iceland's larg-

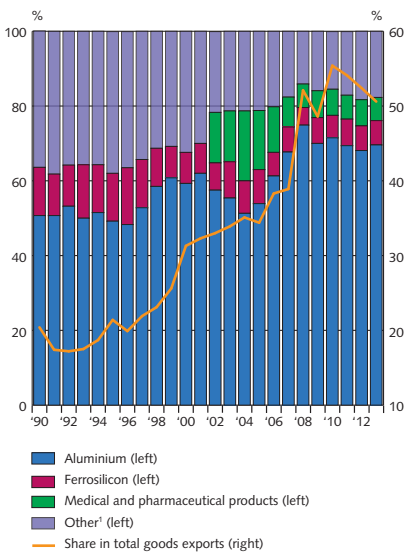
est trading partner countries are the Netherlands, Germany, Norway, the US, and the UK. Trade with China has increased dramatically over the past few years, and China is now Iceland's sixth-largest trading partner country. In terms of currency, the euro area constitutes the largest trading area, accounting for 36% of imports and 27% of exports. In recent years, Iceland has generally had a trade surplus with the Netherlands, the UK, Germany, Russia, France, Nigeria, Japan, and the Iberian countries, but a deficit with the US, Brazil, China, and its Nordic neighbours.

Manufacturing and energy-intensive industries

The production structure of Iceland's manufacturing sector is unique in many respects. First, the manufacturing sector is dominated by two sub-sectors, food processing and aluminium production, which together account for roughly 3/4 of total manufacturing. Second, production of machinery and other investment goods is relatively small. Food production is directed partly at the domestic market, but a larger share, or 2/3, is in seafood production for export. Other important sub-sectors are machinery equipment production (8%), building materials production (4%) and pharmaceuticals/chemical products (3%).

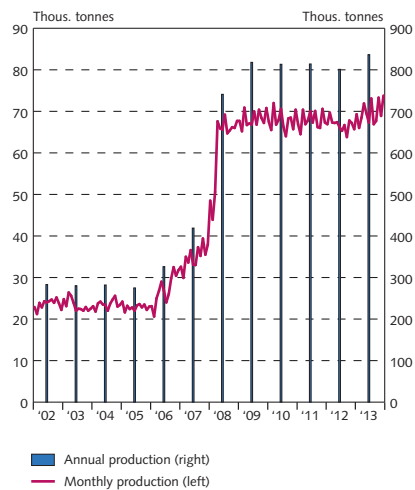
Iceland's largest manufacturing industry by far is the energy-intensive industry (mainly aluminium), which has increased substantially over the past decade, generating 41% of goods exports in 2013, up from 21% in 2000. Iceland's aluminium industry is based primarily on competitive energy costs, strategic location, and a skilled labour force. Production has risen sharply since the turn of the century, from 210,000 metric tonnes per year (mtpy) in 2000 to an estimated

Chart 2.9
Composition of manufacturing exports and share in total merchandise exports 1990-2013



1. Medicinal and pharmaceutical products are included until 2002.
Source: Statistics Iceland.

Chart 2.10
Aluminium production 2002-2013



Source: Statistics Iceland.

845,000 mtpy in 2014. Iceland's share of world aluminium production (excluding China) has increased from 1% in 2000 to 3% in 2014.

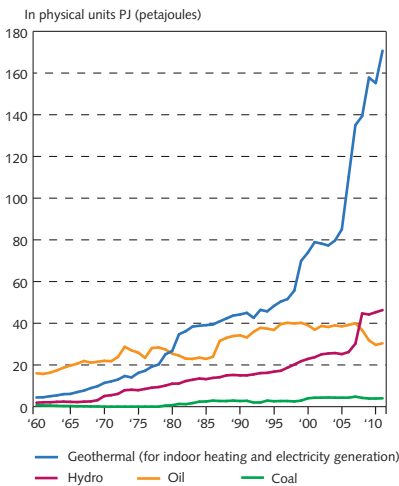
A number of export-oriented manufacturing companies have emerged in the last 20 years. Most of these companies are founded on product innovation, R&D, information and communication technologies (ICT), and strategic marketing. Three of these companies have grown from being small or medium-sized companies to become key international players in their field, holding a relatively large market share worldwide in medical equipment, pharmaceuticals, and food processing and fishery equipment. Exports from these companies amounted to 9% of goods exports in 2013, compared to 6.5% in 2000.

Energy

Iceland is at the forefront in the use of renewable energy resources. Of the total primary energy supply in Iceland, 85% is from renewable resources, compared to an average of 34% in other Nordic countries. Iceland has one of the largest potential sources of renewable energy in the world; on the one hand, the country is located on the volcanically active Mid-Atlantic Ridge, a potent source of geothermal energy, and on the other hand, one-tenth of the landmass is covered by glaciers, a major source and reservoir of water power for generating electricity. Iceland's hydropower and geothermal resources have only been partly harnessed, and Iceland is the only country in Europe that still has a considerable amount of large-scale, competitively priced power from these sources.

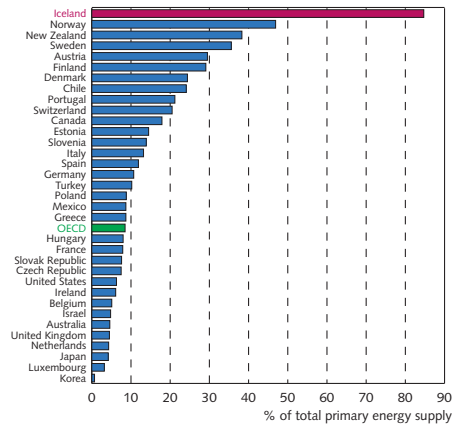
Electricity production per capita is the highest in the world, at 56 megawatt hours (MWh) per capita, more than twice that in Norway (26 MWh), which comes second. In 2013, total installed hydropower was 1,984 MW in 63 power plants with a combined capacity of 12,661 gigawatt

Chart 2.11
Primary energy consumption by source
in Iceland 1960-2013



Source: Statistics Iceland.

Chart 2.12
Contribution of renewables to energy supply
in OECD countries 2012



Source: OECD.

hours, or 70% of generated electricity. At year-end 2013, combined installed geo-power for electricity generation was 663 MW from six plants.

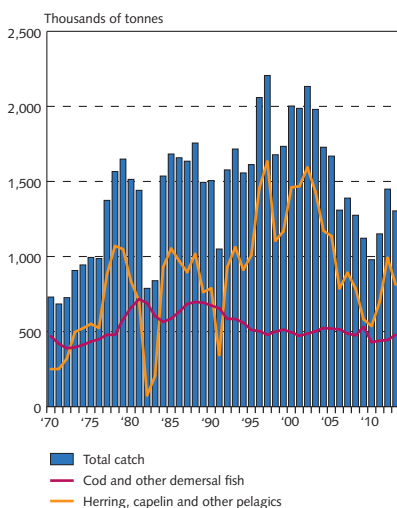
Iceland has been in the lead globally in the use of geothermal energy for purposes other than generating electricity. Geothermal energy accounts for 68% of primary energy used in Iceland. Nearly half of that energy is used for space heating, roughly 37% for energy generation, and the rest for commercial use (industry, aquaculture, greenhouses, and public swimming pools). The total primary energy supply per unit of GDP is the highest in the world, nearly four times higher than the OECD average. Well over 90% of all homes are heated by geothermal energy in the form of hot water at a cost far below the cost of heating with fossil fuel. For the general public, the price of electricity is one of the lowest in the world, about half of the price to consumers in the European Union (EU27).

Marine sector

Throughout most of the 20th century, the marine sector was of key importance to the Icelandic economy. To a large extent, economic growth was generated by the marine sector. Fisheries and fish processing are still one of the main pillars of export activities in Iceland: in 2013, 45% of goods exports and roughly 1/4 of all export earnings from goods and services came from fisheries. However, as exports of manufactured goods have been growing rapidly since the turn of the century, the share of the marine sector in goods exports has fallen from around 63% in 2000 to 45% in 2013. Despite this, the sector's contribution to GDP has remained relatively constant in recent years, at around 10%, which is similar to that in 2000.

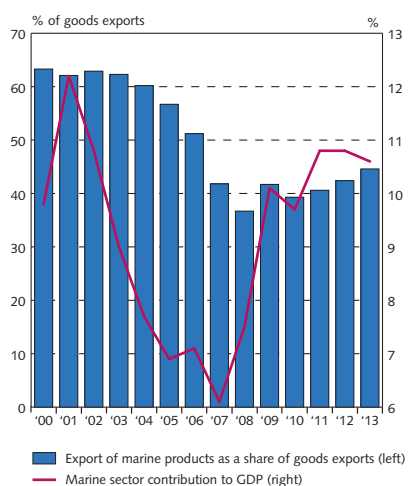
The marine sector is highly diversified in terms of species, modes of processing, and markets. Fishing and processing of groundfish – primarily cod, but also haddock, saithe, redfish,

Chart 2.13
Fish catch by Icelandic vessels 1970-2013



Source: Statistics Iceland.

Chart 2.14
Marine exports 2000-2013



Source: Statistics Iceland.

Box 2.1

The ITQ system

Fishing of all commercially important marine species is regulated under the individual transferable quota (ITQ) system. The current quota system is based on the following factors:

- Each year, the total allowable catch (TAC) is set by the Minister of Fisheries, after the Minister has received advice from the Marine Research Institute based on a biological assessment of the stocks and forecasts for their development in the near future.
- The quota shares that determine each year's quotas must be registered to a fishing vessel.
- A vessel's annual quota for a species is equal to its quota share for that species multiplied by the TAC, after adjusting for special allocations; e.g., for regional support and coastal fisheries of small vessels.
- Quota shares and annual quotas are transferable and can be traded on the quota market. There are some restrictions on trade in quota shares and quotas.

The law prescribes maximum holdings of quotas by individual fishing companies. Regulations cover both quota holdings for individual species and aggregate quota holdings.

In 1995, a harvest control rule (HCR) for cod was introduced, setting the TAC for the next consecutive quota year (September through the following August) at 25% of the mean of the fishable biomass in the assessment year and the following year. This share was lowered to 20% in 2007. HCRs have been used for capelin and herring for many years. More recently, HCRs have been introduced for haddock, saithe, and golden redfish, and the aim is to introduce HCRs for all important species.

All fisheries are subject to an annual fishing fee that is levied on allocated quota or landed catches based on calculated average earnings from catching each species during an earlier period. In 2014, Parliament passed a temporary one-year law under which the fee is determined as the sum of a fixed amount and a special fee based on the above earnings. The fee is part of the State budget. The fishing fee for the quota year 2014/2015 is estimated at approximately 52 million euros (8 b.kr.).

and pelagic species (mackerel, herring, and capelin) – are the principal focus of Iceland's marine sector. The introduction of value-added processing techniques has helped to offset stagnant or reduced groundfish catch volumes in recent years. Value has also been boosted by a shift towards fresh seafood products, which yield higher prices in the markets. The importance of the pelagic species has increased significantly in the last five years, from 15.5% of the total export value of fish and seafood products in 2008 to 30% by 2013. The relative importance of cod has diminished gradually since the turn of the century, from over 40% of all marine exports to the current 17%.

The comprehensive fisheries management system (FMS) based on the individual transferable quota (ITQ) system was implemented in 1990 to manage the fish stocks and promote sustainability and economic efficiency (see Box 2.2). The FMS adopted in Iceland is science-based and market-driven. A key role has been assigned to marine research, as the use of available knowledge is fundamental. Another pillar of the FMS is the commitment to take into account the effects of various measures or policies on the ecosystem.

In the last two decades, fisheries companies have been actively seeking to enhance efficiency and benefit from economies of scale through mergers, acquisitions, and vertical integration of

Box 2.2

Sectoral limitations on foreign direct investment

The only restrictions on investment by non-residents in Iceland apply to foreign direct investment in fisheries and primary processing of fish, energy production and distribution, aviation companies,¹ and real estate.² Restrictions on investment in the fisheries sector, the only restrictions applying to European Economic Area (EEA) residents, have the purpose of protecting the nation's exclusive rights to the fishing grounds surrounding Iceland. Direct foreign ownership of fisheries companies is prohibited, but companies that are up to 25% foreign-owned (33% in certain circumstances) may own fisheries companies. Combined direct and indirect ownership of up to 49% is possible, however. Energy harnessing rights and production and distribution of energy are restricted to EEA entities. Entities domiciled outside the EEA may not own more than 49% of the shares in Icelandic aviation companies.

1. Act on Foreign Investment in Enterprises, no. 34/1991.

2. Act on the Right of Ownership and Use of Real Property, no. 19/1966. Exemptions may be granted.

all parts of the value chain. The largest fisheries and processing companies – mainly vertically integrated firms with harvesting, processing, and marketing within the same company – have expanded, and the concentration of quota holdings has risen. The 10 and 15 largest fisheries companies in terms of quota holdings owned 53% and 66%, respectively, of total quota holdings as of August 2014.

Financial sector

Iceland's financial services sector grew substantially in the first decade of the 21st century, catalysed by financial globalisation and deregulation in the 1990s and, in particular, the privatisation of two commercial banks, which was completed in 2003. By year-end 2007, the banking system's assets were roughly 10 times GDP. In autumn 2008 and early 2009, roughly 97% of the banking system (measured in terms of assets) collapsed (see Box 3.1).

The financial system has changed radically since then. Three new banks were established and took over the domestic operations of the collapsed banks. Other smaller financial institutions have also undergone financial restructuring or lost their operating licences. Four commercial banks and seven savings banks are currently operating in Iceland. The State is the major owner of one of Iceland's commercial banks and holds a minority stake in two others. At almost two times GDP as of year-end 2013, the banking system is still relatively large (see Chapter 3 for further discussion of the financial system). Six other credit institutions currently operate in Iceland: one investment bank; two payment card companies; two investment funds; an asset financing company; and the State-owned mortgage lender, the Housing Financing Fund (HFF). Total assets in the financial system amounted to roughly five times GDP, or 54 billion euros (8,614 b.kr.), at year-end 2013.

Tourism

Tourism has been among the fastest-growing industries in Iceland in recent years and has established itself as the third pillar of the Icelandic economy. Over the past decade, the number of

foreign tourists has increased from 320 thousand in 2003 to 807 thousand in 2013. Tourist arrivals by cruise vessels (not included in the aforementioned figures) totalled 227 thousand in 2013, up from 57 thousand in 2003. The number of incoming tourists by air and ferries is projected to exceed 1 million in 2014.

The ratio of tourism-generated foreign exchange revenues to total export revenues averaged 27% in 2013, compared to 12% in 2000. At the same time, the tourism industry's contribution to GDP rose from 4% to 15%. Tourists from Central and Southern Europe constitute the largest group, followed by tourists from North America. The number of tourists from other parts of the world has also increased rapidly in recent years.

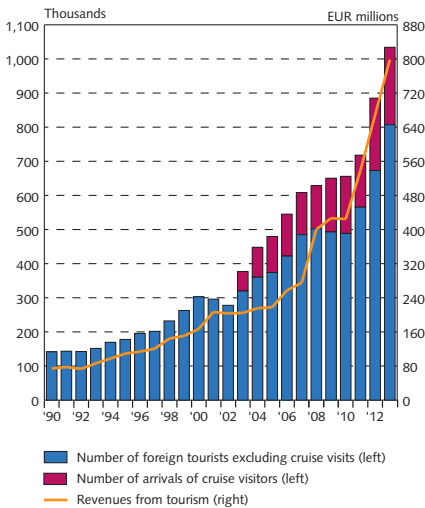
Technology and communications

The technological sector of the services industry, the software industry in particular, has diversified and grown significantly in the last 10 years. Around 50 companies of all sizes are active in the software sector, specialising in medical, ICT, computer games, logistics, and operating management systems. Most of the businesses in software technology are engaged in export activities, owing to the small size of the home market.

Exportation of expertise in the development of renewable energy is growing, and a number of Icelandic companies are engaged in exporting geothermal and hydropower expertise and consultancy to a number of areas, including the US, China, Germany, Central America, and Southeast Asia.

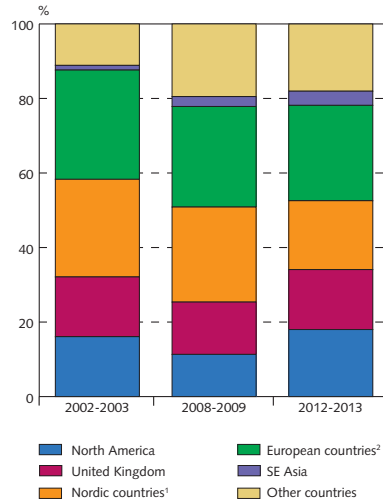
Iceland's telecommunications infrastructure is extensive and reaches all parts of the country, with fibre optic cables, broadband networks, and an extensive mobile phone system with widespread geographical coverage reaching nearly 100% of the population. International connec-

Chart 2.15
Number of foreign tourists and revenues from tourism 1990-2013
At constant exchange rate 2013



Sources: Icelandic Tourist Board, Central Bank of Iceland.

Chart 2.16
Nationality of tourists



1. Norway, Denmark, Sweden, Finland. 2. France, Netherlands, Italy, Spain, Switzerland, Germany. Two-year average.
Source: Icelandic Tourist Board.

tions are based on satellite earth stations and three intercontinental cables enabling and facilitating efficient high-speed international connections.

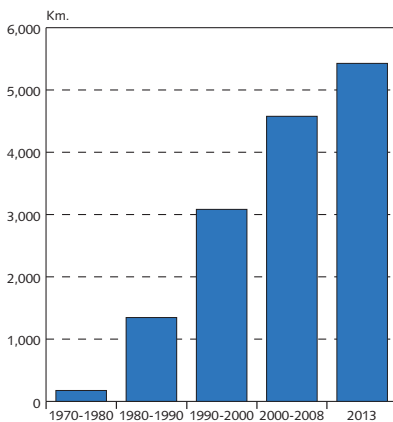
In 2013, 96% of Icelandic households were Internet-connected, the highest percentage in Europe, compared with 79% in other European countries (EU27) and 92% in the other Nordic countries. Nearly all internet connections are high-speed connections, and around 95% of connected households are regular users, compared to 91% in other Scandinavian countries and 72% in the EU27.

Transport

The domestic transportation network consists of roads and air transportation. The road system totals 13,000 km, some 5,400 km of which are primary (paved) roads. Between 2003 and 2010, 22 km of tunnels have been built, bringing the total length of tunnels to 43 km, and two tunnels of 15 km are under construction. Private motor vehicle ownership is widespread, the second-highest in the world after the United States, with 745 passenger cars per 1,000 inhabitants. A weekly ferry connection for passengers, private vehicles, and cargo operates between East Iceland and two Nordic countries.

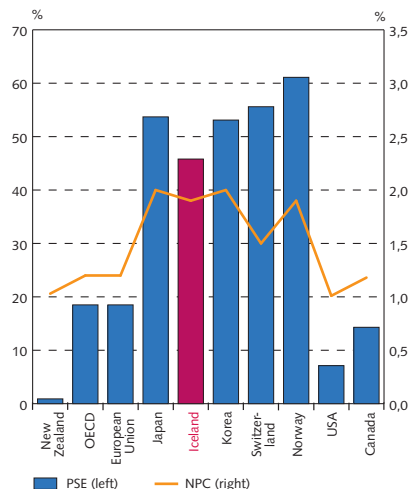
The air traffic infrastructure in Iceland covers all parts of the island. Four international airfields are operated, and three major international AOC (aircraft operating certificate) holders operate in Iceland, offering passenger service, international cargo service, and charter operation. During summer 2014, direct passenger service between Iceland and Europe and North America was offered by 21 air carriers to 81 destinations in Europe and North America, and in the winter, service was offered by 7 companies to 54 destinations. Roughly 80% of all passenger destinations were in Europe.

Chart 2.17
Paved roads 1970-2013



Source: The Icelandic Road Administration (ICERA).

Chart 2.18
Support to agriculture 2011-2012¹



1. PSE measures the transfers as a share of gross farm receipts. NPC is the ratio between the average price received by producers and the border price. Average 2011-2012.

Source: OECD.

Iceland's two main shipping lines operate scheduled services to major ports in Europe and the east coast of the US. Both of them operate transport networks on land and sea in Iceland, Europe, and North America, as well as offering freight forwarding around the world.

Agriculture and farming

Approximately $\frac{1}{3}$ of the total land area of Iceland is arable land or pasture. Less than 5% of this area is cultivated, with the remainder used for grazing or left undeveloped. Meat and dairy products are mainly for domestic consumption, and the principal crops are hay, cereals for animal feed, root vegetables, and green vegetables, which are cultivated primarily in greenhouses heated with geothermal water. Imports of meat, dairy products, and some vegetables that compete with domestic production are subject to tariffs, import quotas, and non-tariff import restrictions.

Icelandic agriculture is heavily subsidised, with total on-budget transfers to farmers amounting to 0.7% of GDP in 2013. In terms of the OECD Producers Support Estimate (PSE), Iceland was fifth-highest in the OECD in 2011-2012, with a PSE of 45.8% compared to 18.5% in the European Union (15) and an average of 18.4% in the OECD.

Environment

Sustainable use of fish stocks and other natural resources is an important part of Iceland's environmental policies. Iceland is relatively unpolluted compared to other developed countries, owing to its sparse population and heavy reliance on renewable energy. The marine environment surrounding Iceland is relatively unpolluted as well.

Although air pollution is generally low, some pollution occurs in the greater Reykjavík area; i.e. particulate matter. Acidification is not considered a problem in Iceland because of limited domestic emissions of pollutants and the country's geographical distance from acidification-causing pollutants.

Soil erosion has been a longstanding problem due to the cutting of woodlands and overgrazing on sensitive volcanic soil. The intensity of grazing has been falling, however, and a concerted effort is made to reclaim eroded land and plant trees.

Under the Kyoto Protocol, Iceland was allowed a 10% increase in greenhouse gas emissions from 1990 levels for 2008-2012 and will comply with its Kyoto commitments. Furthermore, Iceland has specified a target in the second commitment period, 2013-2020, and will fulfil its commitments jointly with the European Union (EU) and its Member States, in accordance with Article 4 of the Kyoto Protocol. Over 40% of Iceland's greenhouse gas emissions are regulated under the EU Emissions Trading Scheme (ETS), due to the European Economic Area (EEA) agreement. Joint fulfilment of Kyoto targets with the EU implies that greenhouse gas emissions from Icelandic industry are regulated in a manner comparable to that applying to EU Member States.

Because almost 100% of Iceland's stationary energy comes from renewable sources, actions taken to reduce net emissions focus on decreasing emissions from transport and fisheries and increasing carbon uptake through afforestation and revegetation. Nature-based tourism has grown markedly in recent years, and funding for tourism infrastructure and nature conservation has increased. A new Master Plan on hydro and geothermal energy has been put in place in an attempt to strike a balance between new renewable energy projects and nature conservation concerns.

Labour market

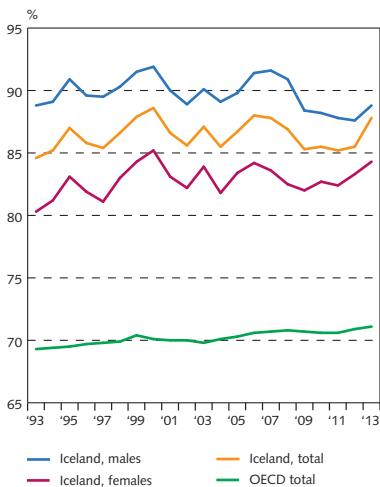
Over the past 10 years, the Icelandic labour market has had a participation rate consistently well above 85%, one of the highest among OECD countries. The participation rate among women has also been very high by international comparison. In 2013, female participation was one of the highest in the OECD countries, with women accounting for 48% of the labour force. Participation rates among the young and the elderly have also been quite high. Furthermore, Icelanders tend to work long hours.

The Icelandic labour market is quite flexible, with substantial labour mobility, flexible hours, and variable participation and wages. This has been clearly manifested during the last cycle. A comparison with other OECD countries shows that Icelandic companies have considerable flexibility to lay off workers. Companies can easily adjust to changed demand by expanding or reducing staffing levels or by raising or lowering the number of hours worked by those already employed; furthermore, the number of part-time and full-time employed varies with the business cycle.

There is also some flexibility in labour force supply. In particular, there is a strong connection between net emigration of Icelandic nationals and output growth; moreover, migration of foreign nationals in tandem with the business cycle has increased substantially with the expansion of the pan-European labour market. Moreover, even in the case of significant shifts in sectoral or regional employment, a high degree of labour mobility prevents large differences in regional unemployment from emerging.

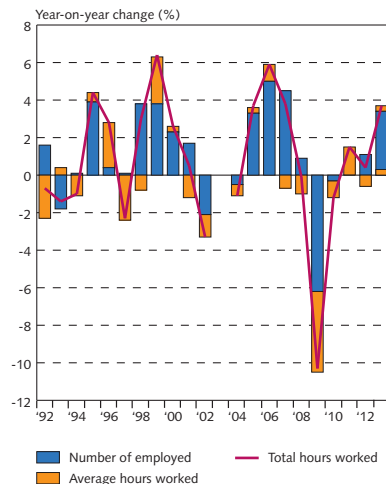
Some 85% of the labour force is unionised, and employers are highly organised as well. This has given rise to wage setting that is characterised by high centralisation and co-ordinated bargaining, most frequently by national federations. This leads to more or less nationwide settle-

Chart 2.19
Labour force participation rate in Iceland and OECD countries 1993-2013



Source: OECD.

Chart 2.20
Changes in employment and hours worked 1992-2013



Source: Statistics Iceland.

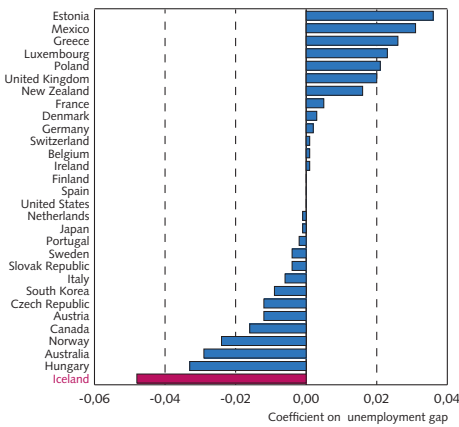
ments that provide for the minimum wage increases. In addition, the tailoring of national framework pay agreements in sectoral and firm-level negotiations makes it possible to take specific local conditions into account. Government has frequently been involved in wage settlements, either through tax concessions and social transfers or through legislative acts aimed at accomplishing moderate settlements. Notwithstanding the high degree of centralisation, real wages are flexible in comparison with other OECD countries (see Chart 2.21).²

Pension system

In the decades to come, Iceland will face fewer problems due to an ageing population than most other developed nations. There are three main reasons for this. First, the population is younger and will continue to be so during coming decades. The old-age dependency ratio – i.e., over-65-year-olds as a ratio of 15- to 64-year-olds – was 20% in 2013, slightly less than in the US (21%) but significantly below the average in the EU (29%). Second, labour participation rates among the elderly are high, and the pension system does not give special incentives for early retirement. While the official retirement age is 67, 34% of 65- to 74-year-olds worked at least one hour a week in 2013. Third, membership of a fully funded occupational pension fund is mandatory for all employees and self-employed persons.

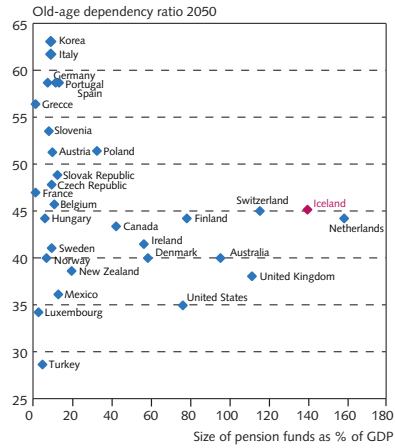
The Icelandic old-age pension system is composed of a tax-financed public pension scheme, mandatory funded occupational pension schemes, and voluntary pension saving with tax incentives. Public pensions are fully financed by taxes. The public pension system provides an old-age pension, disability pension, and survivors’ pension. In most cases, the old-age pension

Chart 2.21
Real wage flexibility 1997-2011¹



1. Quarterly data.
Sources: OECD, Statistics Iceland, Central Bank of Iceland.

Chart 2.22
Size of pension funds in 2012 and old-age dependency ratio in OECD countries 2050¹



1. Population aged 65 years and over per 100 persons aged 15-64 years 2050.
Source: OECD.

2. Chart 2.21 reports the coefficient on the unemployment gap; i.e., the deviation of unemployment from the nonaccelerating inflation rate of unemployment (NAIRU), in a regression of a change in real wages on a constant, the unemployment gap, a change in productivity, and a lagged change in real wages.

is paid from the age of 67. It is divided into a basic pension and a supplementary pension. Both are means-tested, but pensions received from other sources are treated differently from other income, as the level at which they begin to reduce the supplementary pension is higher than for other income. The basic pension amounts to approximately 11% of the average earnings of unskilled workers, while the maximum total old-age pension amounts to around 72% of the same earnings.

Many of the occupational funds were established through a collective labour agreement in the late 1960s, and most are managed jointly by representatives from trade unions and employers. Occupational pension funds have been increasing their share in pensions relative to the public system as they approach maturity and means-testing reduces the public pension. Payments of the pension funds totalled 556 million euros (90.3 b.kr.), or 5.1% of GDP, in 2013, whereas public system payments totalled 214 million euros (35 b.kr.), or 1.9% of GDP.

It is mandatory to pay at least 12% of total wages and salaries to pension funds. Formally, this 12% is split between a 4% contribution from the employee and an 8% contribution from the employer. The funds have grown by leaps and bounds in recent decades, as their coverage has become almost total and the return on their assets has been strong, although fluctuating with the economic cycle. Assets were equivalent to 149% of GDP at the end of 2013. By international comparison, pension funds in Iceland are large relative to GDP. In 2012, they were the second-largest in the OECD (after the Netherlands).

At the end of 2013, there were 27 fully operational pension funds in Iceland, including seven with employer guarantees from the State government, municipalities, or banks. Under current legislation, funds without an employer guarantee must be fully funded. The ten largest pension funds held about 81% of the net assets of all pension funds in 2013, and the two largest funds accounted for 35%. The average fund had net assets of around 607 million euros (98.5 b.kr.), while the largest had assets of almost 3 billion euros (485 b.kr.).

The benefits paid by occupational pension funds without an employer guarantee will ultimately depend on their net returns and will therefore vary from one fund to another. However, the investment risk is borne collectively by the members of each fund, and there are no individual accounts, as in pure defined-contribution plans (DC plans). It has been estimated that, at full maturity, a typical general occupational pension fund will be able to pay a pension amounting to 50-60% of full-time earnings, giving a total replacement ratio of 60-70% when the basic public pension is added.

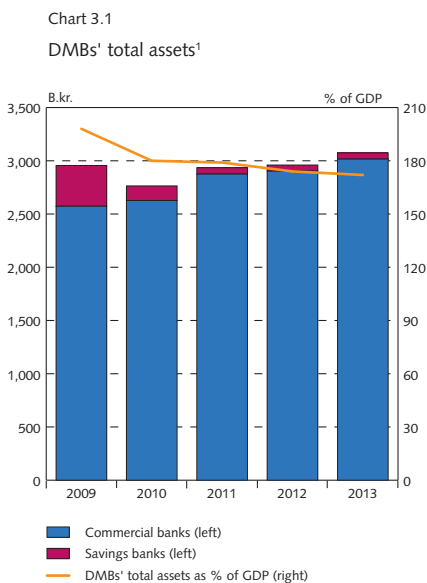
In the third pillar of pension savings, employees are allowed to deduct from their taxable income a contribution to authorised individual pension schemes ranging up to 4% of wages. Employers must match the supplementary contribution up to a limit of 2%. The pension schemes must be authorised by the Ministry of Finance and Economic Affairs. In most cases, they are defined-contribution individual accounts. The pension savings are redeemable at the age of 60. Around 60% of wage earners were paying into such schemes in 2013.

3 Financial system

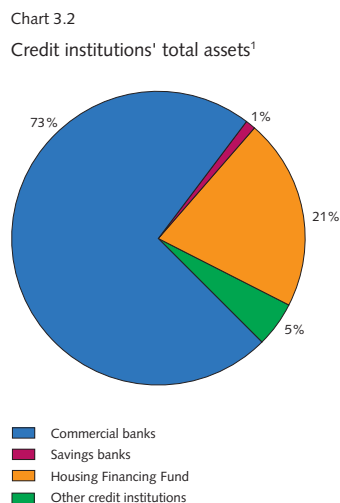
This chapter describes the Icelandic financial system. It covers the credit system, including deposit money banks (DMBs), commercial banks' financial position, and the Housing Financing Fund (HFF), along with the bond, equity, and foreign exchange markets in Iceland. Also discussed in Boxes are the financial crisis in Iceland in 2008 and the capital controls imposed after the crisis struck.

Overview of the credit system

At year-end 2013, total assets in the credit system¹ amounted to roughly five times Iceland's GDP, or 54 billion euros (8,614 b.kr.). The combined assets of DMBs were just over 19 billion euros (3,074 b.kr), or less than twice GDP, down from about ten times GDP in September 2008. Assets owned by credit institutions² other than DMBs totalled 6.7 billion euros (1,062 b.kr). The



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



1. Parent companies. December 2013.
Source: Central Bank of Iceland.

1. The credit system in Iceland consists of the banking system, pension funds, insurance companies, mutual funds, investment and institutional funds, state loan funds, and other credit institutions, the largest of which is the Housing Financing Fund (HFF).
2. Credit institutions are commercial and savings banks (DMBs) and other credit institutions. Other credit institutions consist of the Housing Financing Fund (HFF), investment banks, investment credit funds, leasing companies and payment card companies.

Table 3.1 Credit system assets

Assets, EUR billions (b.kr.)	31.12.2008	31.12.2009	31.12.2010	31.12.2011	31.12.2012	31.12.2013
Banking system ¹	27.2 (4,632)	22.1 (3,967)	25.2 (3,878)	27.7 (4,402)	22.7 (3,862)	24.4 (3,874)
- Central Bank of Iceland	2.6 (447)	5.6 (1,011)	7.2 (1,114)	9.2 (1,466)	5.3 (902)	5.1 (800)
- commercial banks	20.1 (3,417)	14.3 (2,573)	17.1 (2,627)	18.1 (2,875)	17.1 (2,903)	19.0 (3,016)
- savings banks	4.5 (768)	2.1 (383)	0.9 (137)	0.4 (60)	0.3 (57)	0.4 (58)
Other credit institutions	7.6 (1,284)	6.6 (1,194)	7.3 (1,129)	6.9 (1,097)	6.3 (1,076)	6.7 (1,062)
- Housing Financing Fund	4.3 (733)	4.4 (795)	5.4 (836)	5.4 (864)	5.2 (876)	5.4 (859)
Pension funds	9.8 (1,665)	10.3 (1,849)	12.9 (1,989)	13.7 (2,169)	14.4 (2,439)	17.0 (2,695)
Insurance companies	0.7 (122)	0.7 (131)	0.9 (138)	0.9 (145)	0.9 (155)	1.0 (165)
Mutual funds, investment and institutional funds	1.2 (212)	1.1 (195)	1.8 (284)	3.3 (516)	3.4 (583)	3.9 (618)
State loan funds	0.7 (125)	0.8 (146)	1.0 (161)	1.1 (171)	1.1 (192)	1.3 (199)
Total assets	47.3 (8,040)	41.6 (7,483)	49.3 (7,579)	53.5 (8,500)	48.9 (8,306)	54.3 (8,614)

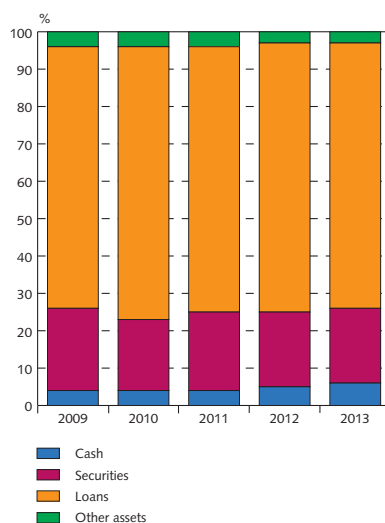
1. The banking system consists of commercial banks, savings banks, and the Central Bank of Iceland. Internal trades between the Central Bank of Iceland and other parties are excluded.

Source: Central Bank of Iceland.

vast majority of these are the State-owned Housing Financing Fund's (HFF) assets, which amounted to 5.4 billion euros (859 b.kr.) and consisted mostly of real estate-backed loans. Together, the DMBs and the HFF account for 95% of all credit institution assets, a figure that has remained relatively stable in recent years.

At the end of June 2014, there were four commercial banks and seven savings banks operating in Iceland. Two of the commercial banks, Arion Bank hf. and Íslandsbanki hf., are majority-owned by the winding-up boards of the old commercial banks (Kaupthing and Glitnir). Icelandic State Financial Investments (ISFI) has a minority stake in them, 13% in Arion Bank and 5% in Íslandsbanki. ISFI also administers the Treasury's 98% holding in Landsbankinn hf., while the other owners are Landsbankinn hf. and employees of the bank. The activities of the commercial banks are directed primarily towards serving the domestic economy. Iceland's savings banks are small

Chart 3.3
Commercial banks' assets¹



1. Parent companies.

Source: Central Bank of Iceland.

Chart 3.4
Default ratios of the three largest commercial banks¹

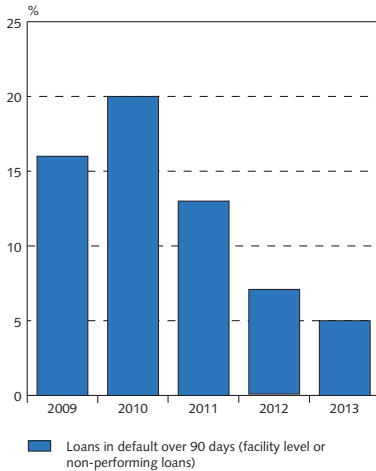
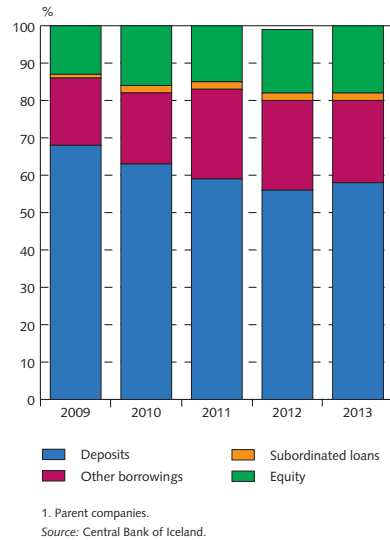


Chart 3.5
Commercial banks' funding¹



compared to the commercial banks; their total assets amount to only 2% of DMBs' assets. The Government has been the single largest shareholder of the savings banks since 2010, when most of them were restructured.

Commercial banks' financial position

The commercial banks' assets consist largely of lending. At year-end 2013, total lending and receivables amounted to roughly 13.6 billion euros (2,148 b.kr). The vast majority of lending was to resident borrowers, with 40% indexed to the CPI, 42% non-indexed, and around 18% foreign-denominated. Foreign-denominated loans have contracted substantially in recent years, in response to the Supreme Court judgments declaring exchange rate-linked loans illegal.³ Loans to domestic firms comprised nearly half of total lending, while household lending amounted to one-fourth. About 11% of lending was to non-residents, underscoring the domestic orientation of the financial system.

Since the financial crisis in 2008, strong emphasis has been placed on restructuring private sector debt, and demand for new credit has been weak.⁴ In recent years, private sector debt restructuring has been proceeding apace and is now well advanced. The objective has been to enable the largest possible number of borrowers to service their debt without sacrificing lenders' interests. The Icelandic banks have made significant progress in reducing their non-performing loan ratios. At the end of 2013, 4.5% of the three large commercial banks' loans were non-performing, down from the end-2010 peak of 20%.

3. See Box 3.2 in *Economy of Iceland 2012*.

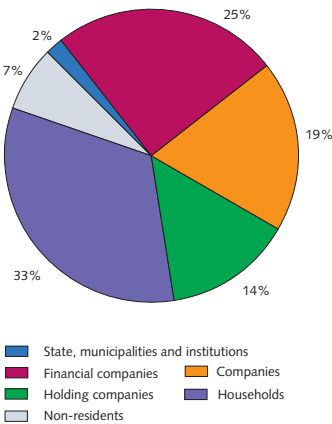
4. See the discussion of private sector balance sheets in Chapter 7.

The Icelandic commercial banks are funded mainly by customers' deposits. At the end of 2013, deposits comprised 58% of their total funding and their deposit-to-lending ratio was 82%. The vast majority of deposits (76%) are denominated in Icelandic krónur and held by Icelandic residents; however, some 6% of deposits are denominated in Icelandic krónur and are foreign-owned. About 18% of deposits are denominated in foreign currencies; 17% are held by Icelandic residents but only 1% are owned by non-residents. The majority of deposits (72%) are payable on demand or within a month, whereas 84% can be withdrawn within three months and 92% within six months.

Borrowings other than deposits still account for a relatively small share of the banks' total funding, but in recent years there have been signs of increased funding diversity. The three large commercial banks have all issued covered bonds to fund mortgage lending, but these constitute only a small part of their total funding. One commercial bank has issued bills. In 2013, two of the largest commercial banks issued foreign bonds abroad. These issues, the first foreign bonds issued by Icelandic banks since 2008, are listed on foreign securities exchanges. Other borrowings still consist primarily of the settlement bonds between Landsbankinn and LBI and Arion Bank's takeover of a covered bond portfolio from Kaupthing. The three large commercial banks received credit ratings from Standard & Poor's in the first half of 2014. These are the first ratings the new banks have received from international rating agencies. The banks were assigned ratings of BB+, which is one notch below Iceland's sovereign rating.

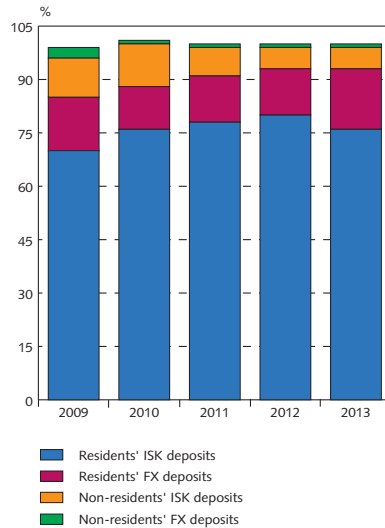
The large banks have been profitable in recent years and their capital position has strengthened. At the end of 2013, their capital adequacy ratios were just over 26%, including 24% in Tier I capital, which is well above the Financial Supervisory Authority's (FME) required minimum.

Chart 3.6
Deposit owners¹



1. Commercial banks, parent companies. December 2013.
Source: Central Bank of Iceland.

Chart 3.7
Deposits with commercial banks in FX and ISK¹



1. Parent companies.
Source: Central Bank of Iceland.

Nonetheless, revaluation of loans and various irregular items have made a sizable impact on the large banks' financial statements since 2009. For example, total net changes in loan values from 2009 to 2013 amount to roughly 900 million euros (143 b.kr.), excluding charges for contingent bonds. In general, corporate loans have risen in value, while household loans have fallen. Due to differences in balance sheet structure from one bank to another, changes in loan portfolio values have had varying effects within the banks. Challenges in the banks' operating environment, specifically to include the forthcoming liberalisation of the capital controls, require that the banks continue to maintain strong capital positions.

The Central Bank of Iceland sets rules on credit institutions' minimum liquid assets in Icelandic krónur and foreign currencies. The rules are based on the liquidity coverage ratio (LCR), which is issued by the Basel Committee and used as an international liquidity reference. The rules assume that banks must always have sufficient high-quality liquid assets to cover net outflows for the next 30 days under stressed conditions. The banks must fulfil requirements for both liquidity in foreign currency and overall liquidity. All of Iceland's commercial banks met the liquidity requirements at the time this publication went to press. Furthermore, the banks' foreign-denominated liquidity is strong, and their liquid assets exceed their total foreign currency deposits. Rules on credit institutions' minimum net stable funding ratio (NSFR) in Icelandic krónur and foreign currency are currently in preparation.

The Central Bank of Iceland sets rules on credit institutions' foreign exchange balance to limit foreign exchange risk by preventing credit institutions' foreign exchange balances from exceeding defined limits. The permissible open foreign exchange balance is 15% of equity. All of Iceland's commercial banks met the foreign exchange requirements as of this writing.

Chart 3.8

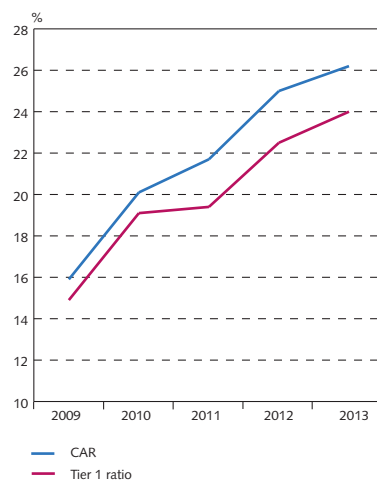
The three largest banks' profit and revaluation of loans and receivables¹



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

Chart 3.9

Commercial banks' capital adequacy ratios¹



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

Box 3.1

The financial crisis in Iceland and its aftermath

Early in October 2008, Iceland's three large cross-border banks, Glitnir, Kaupthing and Landsbanki Íslands (now named LBI) failed, bringing down over nine-tenths of the country's banking system.

In the run-up to the international financial crisis that began in August 2007, the Icelandic banking system grew in size to roughly ten times Iceland's GDP by exploiting easy access to cheap foreign credit. The banks' gross foreign debt burden rose from 43% of GDP in 2002 to over 700% of GDP by the end of September 2008.

As the international financial crisis escalated, the Icelandic cross-border banks' access to foreign financing became limited and they experienced increasing liquidity problems. The combination of poor asset quality due to unsustainable lending growth and the loss of access to foreign financial markets amplified the loss of confidence, which resulted in a run on deposits and other short-term funding in foreign currency.

The banks failed in the beginning of October 2008, shortly after the collapse of the US investment bank Lehman Brothers. The Parliament of Iceland passed Act no. 125/2008, the so-called Emergency Act, authorising the Financial Supervisory Authority (FME) to take control of financial undertakings in extraordinary financial and/or operational difficulties. The FME intervened in the operations of Landsbanki Íslands and Glitnir on 7 October, and of Kaupthing two days later.

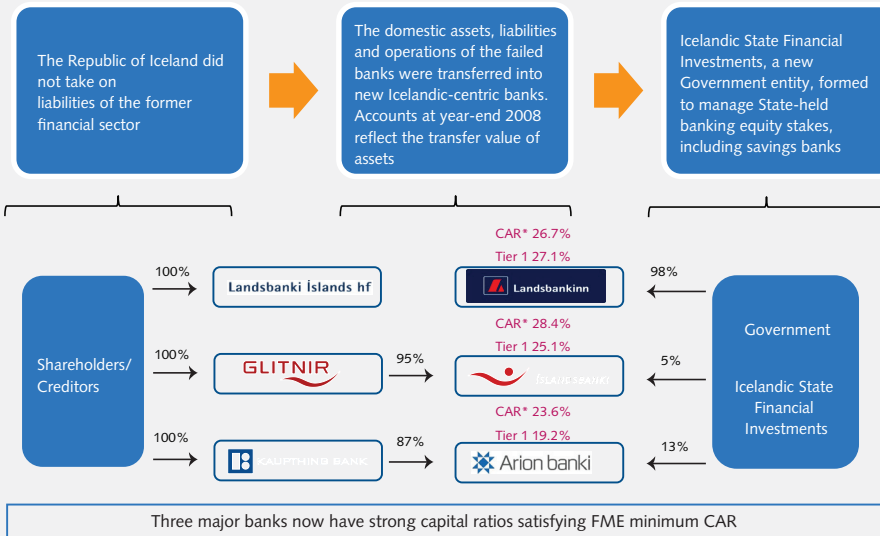
Crisis management emphasised maintaining uninterrupted domestic banking operations. Three new banks – Íslandsbanki, Arion Bank, and Landsbankinn – were established and took over the domestic activities of the three old banks. The Government announced that all deposits in Iceland were guaranteed in full. In November 2008, following a steep depreciation of the króna, the Government introduced capital controls in order to stabilise the króna and prevent excessive capital outflows.

The financial system has undergone radical changes since 2008, and its activities have shrunk in scope. At the end of 2013, total banking system assets amounted to nearly twice GDP, as opposed to ten times GDP in 2008. Following the crisis, the State became a majority owner of Landsbankinn and a minority owner of Íslandsbanki and Arion Bank.¹ It injected share capital into the three new banks and several smaller financial institutions and, along with the Central Bank, took on losses due to collateralised lending to the financial system. These costs combined were equivalent to roughly a third of year-2008 GDP.

The winding-up committees of the old banks' estates have been working to maximise recoveries on their assets since 2008, as is provided for by law. Under the current statutory framework, the estates will be placed in composition or in liquidation after priority claims have been paid. Glitnir paid all of its priority claims in 2012, Kaupthing completed paying its priority claims in 2013, and by mid-year 2014 LBI had made four partial payments totalling about 51% of its priority claims. The winding-up committees of both Glitnir and Kaupthing have requested exemptions from the Foreign Exchange Act in order to conclude composition agreements, and the LBI winding-up committee intends to do the same after its priority claims have been paid. No exemptions had been granted when this publication went to press.

1. The three large commercial banks were established based on domestic assets that were transferred to the new banks along with domestic deposits. The assets were then evaluated by an independent international firm that determined the book value of the assets in the new banks. Negotiations with the resolution committees and creditors of the old banks were concluded, with the result that the creditors hold majority stakes in two of the new banks.

Chart 1
Financial sector reconstruction



Note: The remaining 2% equity in Landsbankinn is held by its personnel and in the form of own shares. Landsbankinn has issued a bond to LBI with a face value equal to the net difference between assets and liabilities transferred into the new bank.
* Year-end 2013.

The Housing Financing Fund

The largest single entity among the group classified as “other credit institutions” is the Housing Financing Fund (HFF), whose assets constituted more than 80% of the total assets of other credit institutions. The HFF is an independent Government institution granting mortgage loans to individuals, municipalities, companies, and organisations to finance house purchases and construction work. The HFF finances mortgage lending by issuing indexed HFF bonds. The Fund issues bonds in four series (HFF14, HFF24, HFF34 and HFF44). All of its issued securities are backed by a Government guarantee. In recent years, the HFF’s lending has contracted and uncertainty about loan quality has adversely affected the Fund’s equity. Since 2010, the Treasury has provided HFF with capital contribution of 319 million euros (50,5 b.kr). At year-end 2013 the HFF’s capital ratio was 3.4%, well below its long-term target of 5%.

Payment intermediation

Currently there are three systemically important payment and settlement systems operated in Iceland: the Central Bank Real Time Gross Settlement (RTGS) system, the retail payment system (netting system) of Greiðsluveitan ehf., a subsidiary of the Central Bank of Iceland, and the securities settlement system of the Icelandic Securities Depository (ISD). The RTGS system is most important systemically because of its primary function of settling high-value interbank payments. It settles individual payment instructions amounting to at least 65 thousand euros (10 m.kr., or 87 thousand US dollars) between participants, with immediate finalisation. The RTGS

system is also used by the other two systemically important systems to settle their net interbank positions at predefined intervals: the retail payment system twice a day (at 8:30 and 16:30 hrs. GMT) and the securities settlement system twice a day (at 11:45 and 15:00 hrs. GMT), with delivery of securities versus payment (DvP). All three systems therefore use Central Bank money during the settlement process. A graphic representation of system turnover relative to annual GDP and the number of transactions in all three systems can be seen in Chart 3.10.

The Central Bank is responsible for systemic oversight and the operational soundness of systemically important payment and settlement systems. Its work in this area is based on the Bank for International Settlements' (BIS) principles for financial market infrastructures and related regulatory instruments. The Icelandic FME is responsible for supervising individual payment service providers and their infrastructure.

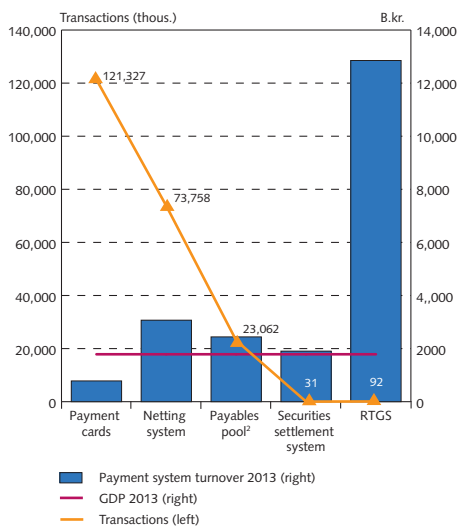
The Central Bank of Iceland has the exclusive right to issue banknotes and coin in Iceland. The currency is called the króna (pl. krónur). A total of five denominations of banknotes (10,000, 5000, 2000, 1000 and 500 kr.) and five denominations of coins (100, 50, 10, 5 and 1 kr.) are valid as legal tender in Iceland.

NASDAQ OMX Iceland and the Icelandic Securities Depository

Iceland currently has one authorised stock exchange in operation, the NASDAQ OMX Iceland, where public securities listing and securities trading are carried out. NASDAQ OMX Iceland is a part of the NASDAQ OMX Group Inc. and is licensed to operate a regulated market as well as a multilateral trading facility (MTF), the First North Iceland market. Both issuer rules and trading rules are largely harmonised with the sister exchanges run by NASDAQ OMX Group in the Nordic countries (Stockholm, Helsinki, and Copenhagen).

The Icelandic Securities Depository (ISD) is one of five depositories owned by NASDAQ OMX. The ISD is a registry, depository, and clearing house for securities in dematerialised (electronic) form. The main role of the ISD is to act as a centralised registration and a notary of dematerialised securities in the Icelandic market and to maintain securities accounts at the top level. The ISD is responsible for securities settlement for dematerialised securities. It also provides shareholder registry services to issuers, processes corporate actions, and provides information services. Settlement is done in Central Bank money. The ISD is a National Numbering Agency assigning ISIN (International Securities Identification Number) codes to instruments issued in

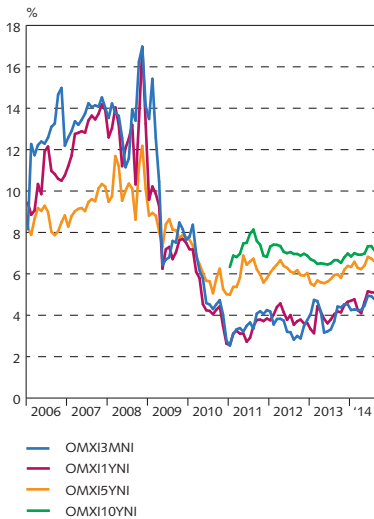
Chart 3.10
Payment systems¹



1. Banknotes and coin in circulation at year-end 2013 amounted to 41.6 b.kr.
2. The payables pool includes unpaid claims in the Icelandic banking system; e.g., general claims, bonds, bills and giro remittance slips.
Sources: System operators, Central Bank of Iceland.

Chart 3.11

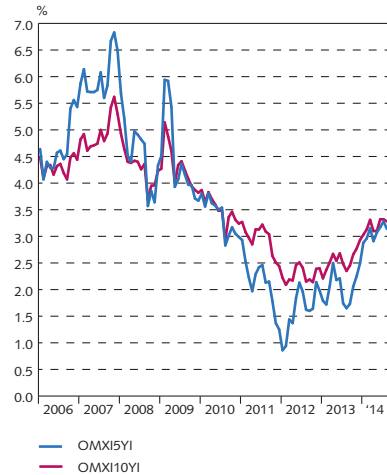
Yield on non-indexed bond indices
At month-end January 2006 - August 2014



Source: OMX Nordic Exchange in Iceland (OMX ICE).

Chart 3.12

Yield on indexed bond indices
At month-end January 2006 - August 2014



Source: OMX Nordic Exchange in Iceland (OMX ICE).

Iceland. It operates two National Market Practice Groups that aim to develop and harmonise procedures in the Icelandic post-trade environment. Effective 6 October 2014, settlement of all transactions with instruments tradable on NASDAQ OMX Iceland will take place two days after the trade is executed (T+2).

Bond market

The Icelandic bond market consists of a primary market and a secondary market that is operated primarily on the NASDAQ OMX Iceland exchange. Icelandic bond issues can be divided into three broad categories:

1. Nominal and inflation-indexed Treasury bonds. These are the largest bond series in the Icelandic market, amounting to 45% of the total market value at the end of June 2014 (5.3 billion euros, 817 b.kr).
2. Housing Financing Fund (HFF) bonds are inflation-indexed annuities carrying fixed interest of 3.75%, payable semi-annually. Their market share was 30% at the end of June 2014, and their market value was 3.5 billion euros (538 b.kr.).
3. Bonds issued by Government agencies, private corporations, or institutions such as banks. Their share of the market was 23% at the end of June 2014 (2.8 billion euros, 425 b.kr.).

The Icelandic bond market has several features that set it apart from bond markets in other countries. First of all, public entities are the largest issuers of listed bonds. As of mid-2014, the market value of bonds issued by public entities or firms owned by them amounted to 83% of total issuance. Second, indexed issues are prominent in Iceland's domestic market (40%), as all HFF bonds are indexed to the CPI. However, indexed bond issuance has diminished in recent

Table 3.2 Bond market — market value 30.6.2014

	<i>Value in EUR millions</i>	<i>Share %</i>
Treasury securities	5,458	47
Treasury bills (3m and 6m)	152	
Treasury bonds (2, 5 and 10 years)	4,083	
Treasury bonds – CPI-indexed	1,223	
Housing Financing Fund	3,493	30
Municipal bonds	736	6
Financial institution securities	390	3
Corporate bonds	1,018	9
Foreign bonds	617	5
Total value	11,712	

Source: OMX Nordic Exchange in Iceland (OMX ICE).

years. Third, secondary market turnover is concentrated in bonds carrying a Treasury guarantee. Fourth, yields on the Icelandic bond market have been high in international comparison. In the first half of 2014, 10-year inflation-indexed bond yields fluctuated between 2.7% and 3.5%, while 10-year nominal bond yields fluctuated between 6.6% and 7.3%. Bond market turnover amounted to 11.2 billion euros (1,822 b.kr.) in 2013.

Equity market

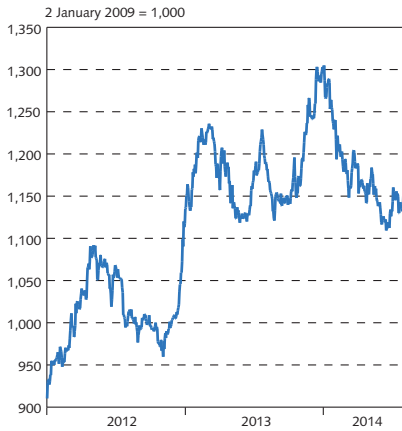
The number of companies listed on the Icelandic equity market has risen in recent years, and total market capitalisation has increased. After a total collapse in autumn 2008, the market has grown again, and confidence and investor interest are on the rise. As of end-July 2014, a total of 14 companies were on the NASDAQ OMX Iceland Main List and another three were listed on the First North market. At that time, the market value of Main List companies was 3.9 billion euros (604.4 b.kr.), or approximately 34% of year-2013 GDP. In comparison, the market value of Main List companies was 2.2 billion euros (376.6 b.kr.) at the beginning of 2013. The OMXI6 index stood at 1,144 points at the end of July 2014. In July 2014 the index was expanded from six companies to eight, and it is now called the OMXI8. It is revised every six months and includes the eight listed companies with the largest turnover at the time it is compiled.

Money market

The money market consists of the interbank loan market and a secondary market. Secondary market trading is concentrated largely in very short-term Treasury bonds, Treasury-guaranteed bonds, and Treasury bills. Treasury bill turnover in the secondary market totalled just over 102 million euros (16.6 b.kr.) in 2013.

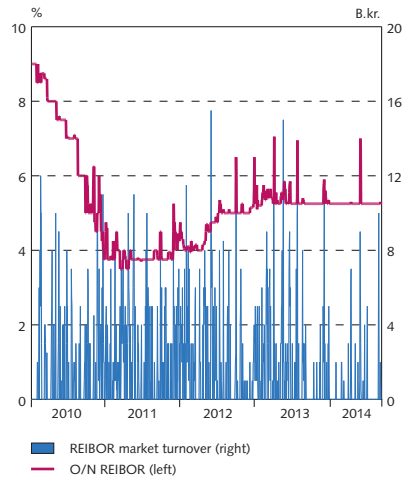
The Central Bank of Iceland oversees the interbank market for krónur, where trading consists of unsecured loans between market makers. Members must submit indicative bid and ask quotes on various maturities ranging from overnight to 12-month loans. The vast majority of the trading is done on an overnight basis, as has been the case since the market was established. Once a day, the Central Bank fixes REIBID and REIBOR rates for the market. As of this writing, there are three participants in the market: Arion Bank, Landsbankinn, and Íslandsbanki. Market turnover totalled 2.3 billion euros (376.5 b.kr.) in 2013.

Chart 3.13
Equity market, OMXI8 price index
Daily data 1 January 2012 - 29 August 2014



Source: OMX Nordic Exchange in Iceland (OMX ICE).

Chart 3.14
REIBOR interest rate (O/N) and
REIBOR market turnover
Daily data 4 January 2010 - 29 August 2014



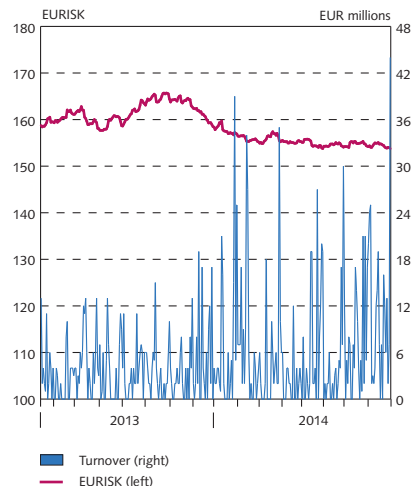
Source: Central Bank of Iceland.

Foreign exchange market

At present, there are three market makers in the foreign exchange market for Icelandic krónur: Arion Bank, Íslandsbanki, and Landsbankinn. Market makers conduct foreign exchange transactions among themselves during market hours and pledge to maintain continuous bids and offers in euros. Prices are quoted in krónur per euro, and each bid submitted is in the amount of one million euros. The market is open from 09:15 hrs. to 16:00 hrs. on weekdays. On 28 November 2008, new Rules on Foreign Exchange were adopted and capital account restrictions imposed. Turnover in the foreign exchange market plummeted with the collapse of the banks and the imposition of the capital controls. It rose somewhat between 2009 and 2014 but has remained well below pre-crisis levels.

The Central Bank oversees the interbank foreign exchange market, can trade with market makers, and publishes the daily exchange rate of the króna based on the market price from market makers. The Central Bank is not a market maker, however, and is therefore not obliged to conduct transactions with other market makers, even if requested to do so.

Chart 3.15
Foreign exchange market
Daily data 15 May 2013 - 29 August 2014



Source: Central Bank of Iceland.

In May 2013 the Central Bank's Monetary Policy Committee (MPC) announced intentions to step up the Bank's foreign exchange market activity in an attempt to mitigate short-term exchange rate volatility. According to the announcement, the long-term goal of expanding the domestic financing of foreign exchange reserves would remain in place, with implementation of the intervention policy depending on both exchange rate level and volatility. Exchange rate volatility subsided markedly in the wake of the announcement, and the Bank's share of market turnover rose. In June 2014, the Central Bank announced that it would resume its previously announced programme of regular foreign currency purchases in the interbank market, although the policy of intervening in the market with the aim of mitigating exchange rate volatility would remain in place.

Box 3.2

Capital controls

In Iceland, restrictions on capital movements and related foreign exchange transactions affect cross-border movement of capital. These restrictions, commonly referred to as capital controls, were introduced due to outstanding balance of payments mismatches. The controls are classified as protective measures as provided for in Article 43 of the EEA Agreement. Foreign exchange transactions and cross-border movement of capital falling under the capital and financial account are restricted unless explicitly authorised and generally require an exemption from the Central Bank of Iceland. Cross-border capital flows are not restricted in their entirety, however. Investment-related inflows are permitted, as are outflows of interest income and sales proceeds deriving from such investments. Furthermore, foreign exchange transactions and payments that fall under the current account – e.g., external trade and factor payments – are generally permitted unless explicitly prohibited. Steps towards further easing of the capital controls are expected in the near future.

Reasons for introducing capital controls

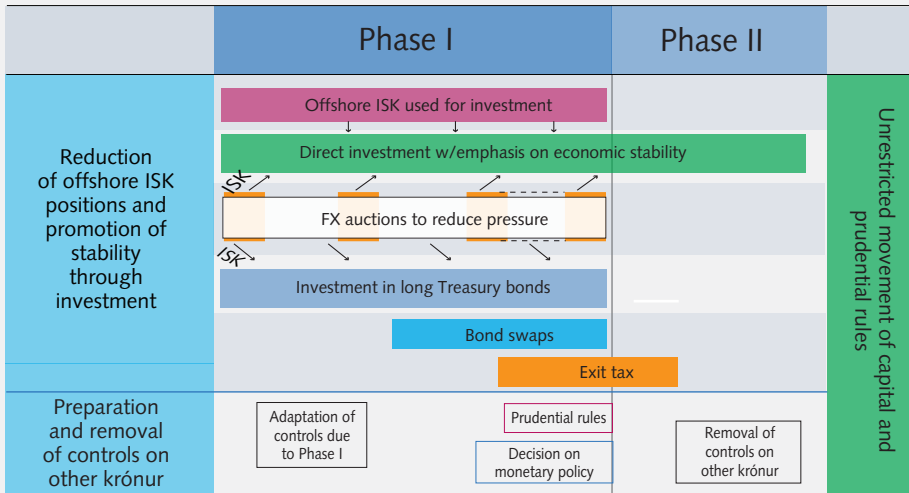
In October 2008, Iceland suffered a banking crisis of extraordinary proportions. By that time, the exchange rate of the króna had fallen by 40% since the beginning of the year, after Iceland lost access to foreign liquidity and the global financial crisis escalated. By the end of November 2008, the króna had fallen by 50% since the beginning of the year.

Iceland experienced significant capital inflows in the period 2005-2008. International capital was attracted by expected good growth prospects and large interest rate differentials between Iceland and other developed economies. In October 2008, non-residents' ISK positions totalled roughly 3.9 billion euros, or 40% of GDP.

At the onset of the financial crisis, the loss of confidence triggered large capital outflows, with severe effects on the exchange rate, inflation, and indebted households and firms. Because private sector balance sheets were highly leveraged, with a large proportion of foreign currency-denominated and inflation-indexed debt, this could have set off a wave of default, with escalating macroeconomic repercussions.

Supporting the currency through conventional measures – interest rates and foreign exchange market intervention – would have required steep interest rate hikes, as the Central Bank did not have sufficient foreign exchange reserves to counter the surge in capital outflows. Because of the negative side effects of such actions and the doubt that they alone would suffice, it was deemed necessary to impose temporary restrictions on movement of capital to and from Iceland in order to provide room for the real economy to recover.

Chart 1
Capital account liberalisation: Phases and steps



The current capital controls regime

The capital controls were adopted on 28 November 2008. Parliament extended a provision in the Foreign Exchange Act (the Act) authorising the Central Bank of Iceland to set rules limiting international capital transactions, the Rules on Foreign Exchange (the Rules). The Act was to remain in force for the duration of the Stand-By Arrangement with the IMF, or until December 2010. In 2010 it was extended, alongside the IMF programme, until September 2011. In spring 2011, Parliament incorporated the Rules into the Act.

Since the capital controls were imposed, capital transactions have been blocked but current transactions have been permitted, with specific exemptions. This has allowed Icelandic residents to carry out international trade in goods and services, including using credit cards while travelling abroad in order to buy goods and services. Furthermore, cross-border movement of capital and foreign exchange transactions related to contractual instalment payments and dividend and interest payments are exempt from the controls, with a few exceptions. The controls place broad-based restrictions on foreign exchange transactions and movement of capital between countries. This includes investment in foreign assets, such as transferable financial instruments issued in foreign currency, real estate, or other assets in foreign currency, irrespective of whether these assets are sold by residents or non-residents. For instance, investment in bonds issued by a domestic party but denominated in foreign currency is restricted under the Foreign Exchange Act.

With effective controls in place, exchange rate developments have been determined largely by current account flows (i.e., exports, imports, interest payments, and dividends) and debt repayments, instead of by capital flows, as was the case for the three to five years before the controls were imposed.

Lifting the capital controls

In late October 2009, the Central Bank took the first step in the sequenced removal of the capital controls by permitting potential outflows of capital that may derive from the sale of new investments. Thus investors were authorised to convert into foreign currency the sales proceeds from assets in which they invested with currency imported after 1 November 2009.

The primary objective of subsequent steps in the capital account liberalisation strategy has been to unwind non-residents' offshore króna holdings, currently held in local banks' deposit accounts and short-term Treasury or HFF bonds, and channel them into long-term investment in Icelandic businesses, real estate, Treasury bonds, or other long-term assets. This involves a trade between investors entering the Icelandic market and offshore króna holders seeking to exit. On one side of the trade, this strategy focuses on increasing long-term portfolio and foreign direct investment. Investors have therefore been given the option of participating in foreign currency auctions in connection with long-term investment in Iceland. They can purchase krónur at the Central Bank of Iceland's auction exchange rate for 50% of the intended investment amount, provided that the other 50% is exchanged in the onshore foreign exchange market. Under this programme, referred to as the Central Bank of Iceland Investment Programme, participating investors pledge to hold their investment for at least five years. Investors participating in the Central Bank's auctions are also offered the option of purchasing Icelandic Treasury bonds in exchange for euros. Under this option, investors can sell foreign currency to the Central Bank in exchange for the bonds, which they pledge to hold for five years. In this process, the Central Bank's role is to pair parties interested in long-term investment in Iceland together with impatient investors wishing to unwind their króna positions, without affecting exchange rate stability.

Once economic objectives have been met, the auction programme will be concluded, initiating the final two steps of the liberalisation process, outlined in the March 2011 capital account liberalisation strategy: a bond swap programme and an exit levy. The bond swap will offer remaining offshore ISK holders the option of exchanging their offshore krónur for a long Government bond, after which an exit levy will be imposed in order to taper outflows over the course of liberalisation.

As a part of the capital account liberalisation strategy, the Central Bank has published a set of prudential rules designed to protect the financial system against the risk that could accompany unrestricted capital flows. The pertinent ministries, the Central Bank, and the Financial Supervisory Authority (FME) have begun finalising such rules and proposals for legislative amendments where appropriate.

In mid-2014, the Ministry of Finance and Economic Affairs engaged foreign and local advisors to assist the Icelandic authorities in removing the capital controls. The advisors' focus is on proposing alternatives for a comprehensive solution that addresses all potential sources of pent-up capital flows, including the settlement of the failed banks' estates.

4 Public sector

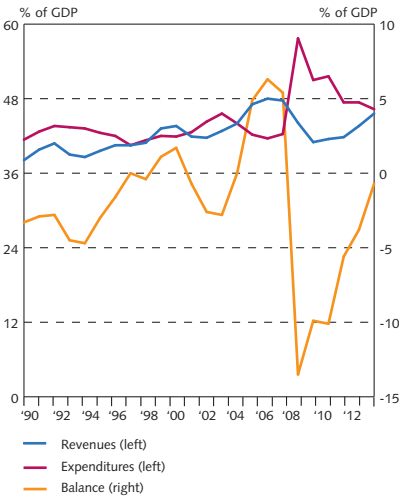
This chapter describes the public sector in Iceland, focusing on the division of responsibilities, central and local government finances, and the structure of the tax system. Recent developments in Iceland's sovereign credit ratings are discussed as well.

The size of the government sector

Icelandic general government expenditure amounted to 46% of GDP in 2013 and has been declining towards the pre-crisis twenty-year average of 43% of GDP after peaking at 58% of GDP in 2008, when the crisis culminated. Iceland's expenditure ratio is at the lower end of the Nordic countries' range, together with Norway. It is at a level similar to that in the UK and the euro area,¹ but higher than that in Japan and the US, whose levels are around 41%.

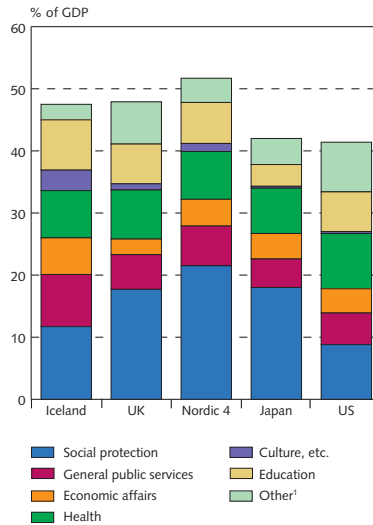
Several factors have allowed Iceland to function efficiently with a relatively small government sector: comparatively limited spending on social affairs, in part due to a relatively young population; historically low unemployment; and the historical absence of defence expenditure.

Chart 4.1
General government finances¹



1. Revenues for 2013 adjusted for reevaluation of the Treasury's share in Landsbankinn. The reevaluation implies an increase in revenues of 1.4% of GDP.
Source: Statistics Iceland.

Chart 4.2
General government expenditures 2011



1. Public order and safety, defence, environment production and housing.
Source: OECD National accounts.

1. The 11 original EMU participants, plus Greece, Slovenia, Cyprus, Malta, and Slovakia.

Furthermore, fully funded private pension funds, organised by occupation, have overtaken the social security system's pay-as-you-go system in terms of benefit pay-outs, accounting for over 70% of pension payments in 2013, whereas public pensions are the dominant pillar in many other OECD countries (see Chapter 2). The relatively young population and high retirement age also help to lower overall pension expenditures.

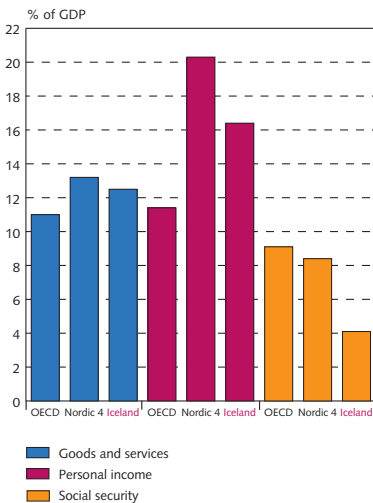
On the revenues side, there was rapid growth during the pre-crisis upswing, bringing the revenue ratio up to the euro area average of around 45% of GDP. The ratio fell back to 2000 levels of 41-42% of GDP in the wake of the crisis but began to inch upwards after the economic recovery started to take hold, measuring 44% of GDP in 2013.

The composition of government revenues in Iceland differs noticeably from that in the other Nordic countries and the euro area. Social security contributions are low by international standards, partly because of the strength of the second-pillar pension system. Taxes on goods and services have been higher in Iceland than in comparison groups, with value-added tax carrying most of the weight. Revenues from taxes on individual income rose throughout the 1990s, however, and are now approaching the rates in the Nordic countries.

Division of responsibilities

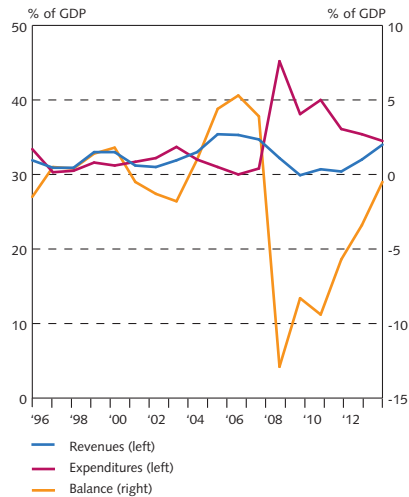
Iceland's government sector is organised on two levels, central and local. Separate sets of social security accounts are maintained, but social security expenditures and revenues are authorised through the central government budget. From the early 1990s through 2013, local government expenditures and revenues rose from 8% to 14% of GDP, with a commensurate decline in central government expenditures and revenues, in large part because of the transfer of school expenditures and the care of disabled persons from the central government to the local governments.

Chart 4.3
Importance of tax categories 2011



Sources: OECD, Central Bank of Iceland.

Chart 4.4
Central government finances¹



1. Revenues for 2013 adjusted for reevaluation of the Treasury's share in Landsbankinn. The reevaluation implies an increase in revenues of 1.4% of GDP.
Source: Statistics Iceland.

The central government regulates local governments and their authority to collect revenues, and it actually collects around two-thirds of local government revenues for municipalities, mostly through income taxes. It also administers and finances the social security sector of government.

The central government is responsible for police, courts, foreign affairs, upper secondary and higher education, health services, institutional care for the elderly, general support and services for industry, and most infrastructure construction and maintenance not obviously specific to particular municipalities. It administers benefit programmes for elderly and disabled persons, unemployment benefits, mortgage interest subsidy payments for owner-occupied housing, child benefits, and parental leave at childbirth. The programmes are generally means-tested, although to varying degrees.

Local governments are responsible for local planning, most local infrastructure, day care and education from pre-school through the lower secondary level, care of disabled persons, and welfare services of various kinds, in particular services for the elderly apart from health care. They are also responsible for meeting the housing needs of low-income households. Local governments provide supplementary assistance to general programmes of pensions and income support run by the central government, notably by paying benefits to people who have exhausted their unemployment benefits or who for other reasons are ineligible for them.

General government finances

General government finances were in relatively good order between 2000 and 2007. Gross general government debt as a share of GDP, as defined by the Maastricht criteria, fell from 44% in 2001 to 29% in 2007. The Government assumed large liabilities, and substantial consolidation became necessary after the financial crisis culminated in autumn 2008. As a result, general government gross debt rose to 100% of GDP in 2011 but has since fallen and was 90% of GDP in 2013.

According to the initial fiscal consolidation plan in the three-year Government-IMF Stand-By Arrangement (SBA) negotiated in autumn 2008, the main fiscal policy goals were to balance the general government primary budget (i.e., excluding interest paid or received) by 2012 and balance the overall budget a year later. Reviews of the SBA in 2010 and 2011 showed that all relevant performance criteria had been met and a better outlook for general government debt allowed for more easing of fiscal consolidation than was envisioned in the programme. A primary surplus was achieved in 2012, as initially planned, and the overall surplus will likely be attained in 2014, according to the revised plan.

Central government finances

Central government revenues were fairly stable during the period 1980-2004, fluctuating between 28-33% of GDP, in tandem with the business cycle. After having been relatively strong during the pre-crisis upswing, revenues fell to an average of 30½% of GDP in 2009-2011 but had risen to around 32% of GDP in 2013.

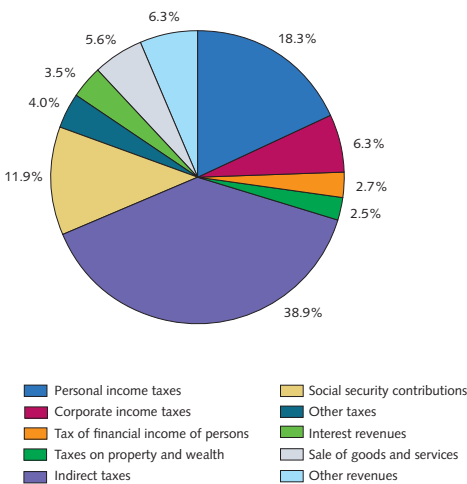
The composition of central government revenues in 2013 is shown in Chart 4.5. Revenues from direct taxes generate almost half of total revenues, while indirect taxes constitute 40%. By design, Iceland's central government revenues are strongly cyclical for three main reasons. First, the state personal income tax, which accounts for some 20% of central government revenues, has a progressive predetermined bracket structure, including a sizable personal exemption, or

zero bracket (see Box 4.1). This implies that greater-than-expected income growth translates into a higher-than-expected ratio of taxes to total income. Second, 40% of central government revenues come from taxes targeting consumption goods and services. These taxes fall most heavily on durables, most of which are imported. Such consumption has proven very sensitive to the business cycle, balance sheet effects, and the cyclical real exchange rate. Third, revenues from taxes on corporate profits, households' financial income, and certain financial transactions, as well as the net wealth tax, are by nature sensitive to the business cycle. These revenues grew from just under 4% of GDP in the pre-crisis years to almost 5½% at the height of the upswing, but fell to below 3½% of GDP in 2009-2012 despite significantly increased tax rates. Combined central government revenue from taxes on consumption fell from 15½% in 2005-2007 to around 12% of GDP in 2009-2013. The payroll tax, or social security contributions, is far more stable, except for the implicit understanding that it needed to rise to cover unemployment costs.

The composition of central government expenditures is shown in Chart 4.6. Health and social protection accounts for almost half of expenditures. The financial crisis increased expenses on social protection, chiefly through unemployment costs, which rose from 0.4% of GDP in 2008 to 1.7% of GDP in 2009 before starting to taper off again, and were down to 1% in 2013.

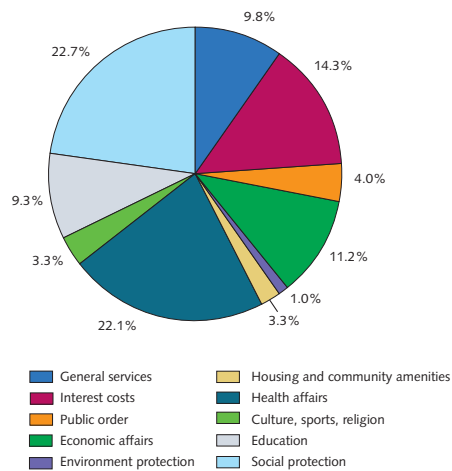
With falling debt, central government interest expense fell from 3½% of GDP in the mid-1990s to around 2% in 2005-2007, in spite of steep increases in interest rates beginning in 2004. As a result of the debt burden imposed by the banking crisis, central government gross interest expense rose to 5% of GDP in 2009 and remained at that level in 2013. The new foreign debt was used primarily to build up the Central Bank's foreign exchange reserves, however. Deposits in the Central Bank accrue interest income that must be deducted from interest expense in order to determine the net interest burden.

Chart 4.5
Composition of central government revenues in 2013



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 4.6
Composition of central government expenditures in 2012



Sources: Statistics Iceland, Central Bank of Iceland.

Privatisation revenues along with central government surpluses reduced Treasury lending activity, and strong economic growth contributed to a decline in gross central government debt from 50% of GDP in 1995 to around 23% in 2007, while net debt was reduced from 33% of GDP to an estimated positive net of 4% at the end of 2007 (see Chapter 7).²

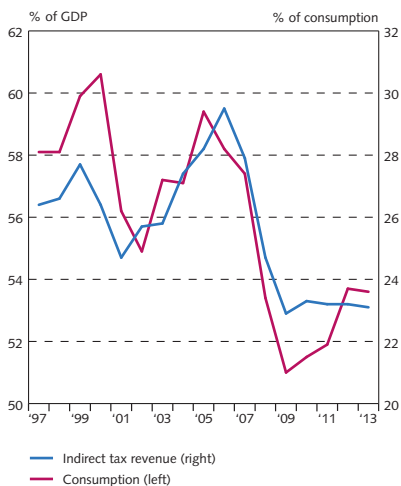
Furthermore, beginning in 1997, the central government made an effort to pre-fund civil service pension liabilities, which are not classified as debt under the Maastricht definition. Adding pension liabilities and short-term payable accounts raises the debt figure by 27 percentage points to 109% of GDP in 2013.

Local government finances

Expanded responsibilities for education, increased services at the pre-school level, and expanded support for sports, youth recreation, and care for the disabled have led to a rise in local government expenditures from 8% of GDP in 1990 to nearly 14% in 2013. Education, from pre-school to age 16, accounts for more than one-third of expenditures, with culture and recreation and welfare expenditures accounting for about 20% each.

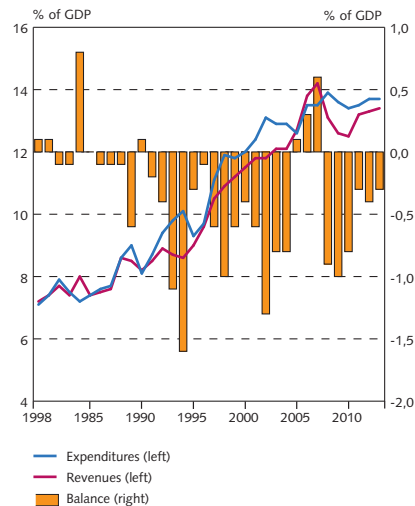
After implementing spending cuts in the 2001-2002 contraction, the local government sector broke a 14-year string of deficits in 2005 and remained in surplus in 2006 and 2007, but has returned a slight deficit since then. With the 2008 crisis, local government revenue relative to GDP fell back to the 2005 level and has remained there since.³ The two largest local government revenue sources, the flat municipal personal income tax that contributed 59% of local government revenues (8% of GDP) in 2013 and a property tax contributing 13% of revenues (1.7% of GDP), have remained stable, however.

Chart 4.7
Procyclicality of indirect taxes



Source: Statistics Iceland.

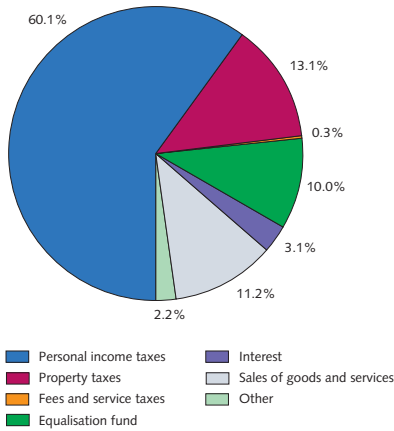
Chart 4.8
Local government finances 1980-2013



Source: Statistics Iceland.

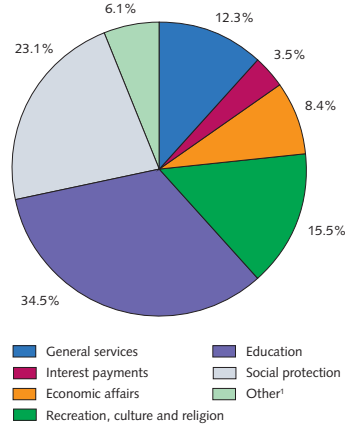
2. Debt as defined by the Maastricht criteria. Central government deposits with the Central Bank are included as assets.
3. This number is adjusted for the cost associated with taking over the care of the disabled in 2011.

Chart 4.9
Local government revenues in 2013



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 4.10
Local government expenditures in 2012



1. Health, housing, environment, public order.
Sources: Statistics Iceland, Central Bank of Iceland.

The financial crisis and the depreciation of the króna in 2008 led to an increase in local government debt from just under 5% of GDP in 2007 to 9.5% of GDP in 2009. The debt level subsided to 8.5% of GDP in 2013.⁴ Adding pension liabilities and short-term payable accounts raises the debt figure to 14½% of GDP in 2013.

In addition to the direct effects of the crisis on local government balance sheets, several local governments operate utilities or other necessary infrastructure through separate corporations. Some of these accumulated significant foreign-denominated debt before the crisis, whereas their revenue base was domestic. In the most important cases, including Orkuveita Reykjavíkur (Reykjavik Energy), the shortfall has been covered through service charges. Orkuveita Reykjavíkur and other utilities have managed to recover to a large extent from the 2008 financial crisis; for instance, Orkuveita Reykjavíkur’s equity ratio has risen from 12% in 2009 to 25% in 2013.

Parliament passed a new Local Government Act in September 2011. The new Act tightened budget procedures considerably, introduced the annual publication of multi-year budgets, and required formal board passage of any deviation from a year’s budget. In addition, there is now more stringent financial oversight by an external committee authorised to impose various sanctions if the municipality does not comply with the rule-based fiscal framework. The Act introduces two fiscal rules: first, a budget balance fiscal rule stipulating that the combined expenditures of a local government and its direct subsidiaries may not exceed regular revenues in any three-year period, and a debt rule stating that combined debt and liabilities may not exceed 150% of regular revenues. The Act also provides for a ten-year adaptation period.

4. Debt as defined by the Maastricht criteria.

Box 4.1

The tax system

In 2013, the central government derived around 86% of its revenues (28.5% of GDP) from taxes and social security contributions, while the comparable numbers for local government was 73.5% (9.7% of GDP).

The personal income tax is levied jointly by the central and local governments. The local government tax, a flat percentage of total taxable income, varies slightly by municipality, averaging just below 14½% in 2014. It yielded 60% of local government revenue (8% of GDP) in 2013.

The central government tax is progressive, with a rising marginal rate and a zero tax bracket structured as a rebate on taxes due. The result is a four-rate overall tax structure. Its rates and thresholds are shown in Table 1.

In principle, taxes are levied on each individual, but a couple may share the rebate (i.e., the zero bracket) and a higher-earning spouse may utilise up to half of the unused part of the 25.3% bracket of a lower-earning spouse, subject to a maximum of 18,500 euros (2.8 m.kr.). The central government income tax yielded 6.5% of GDP and 19.5% of central government revenue in 2013.

Table 1 Main features of the Icelandic tax system in 2014

	2014 ¹	Revenue 2013 % of GDP
Central government personal income tax ²		6.5%
Bottom bracket/starts at ³	22.9%/9,100 euros (1.4 m.kr.)	
Middle bracket/starts at	25.3%/22,400 euros (3.5 m.kr.)	
Top bracket/starts at	31.8%/60,600 euros (9.4 m.kr.)	
Local government personal income tax		8.0%
min/average/max ⁴	12.44%/14.44%/14.52%	
Zero bracket for combined income tax ³	9,100 euros / 1.4 m.kr.	
Tax on individuals' financial income ⁵	20.0%	1.2%
Payroll taxes	7.59%	4.1%
Corporate income (=profit) tax	20.0%	2.4%
Net wealth tax ⁶	1.5%/2.0%	0.52%
Lower rate starts at (singles/couples)	482,500/643,300 euros (75 m.kr./100 m.kr.)	
Higher rate starts at (singles/couples)	964,900/1,286,600 euros (150 m.kr./200 m.kr.)	
Property taxes		1.7%
Residential property, average/max	0.286%/0.625%	
Hospitals, schools and related, avg./max	1.32%	
Commercial property, average/max	1.638%/1.650%	
Value-added tax		8.3%
General rate	25.5%	
Reduced rate ⁷	7.0%	

1. Based on average EURISK exchange rate year-to-date. 2. Couples are taxed individually, except that a) a couple may share their rebates or double zero brackets, and b) a person may utilise up to half of a spouse's unused 25.3% bracket up to a maximum of 18,000 euros (2.8 m.kr.). 3. The zero bracket is due to the 530 thousand kr. Treasury rebate against the combined income tax rate of 22.9% +14.44%. 4. Maximum rate 14.48% (temporary maximum 14.52% in 2014). Municipalities under financial duress may raise their rate by an extra 10%. 5. Interest income up to 811 euros (125 thousand kr.) and 30% of rental income from residential housing is exempt. 6. Levied on net wealth at the end of year 2009-2013, payable the following year. Expires at year-end 2014. 7. For items in the 7% category and items exempt from the tax, see main text.

Sources: Association of Local Authorities, Internal Revenue Directorate, the website of the Parliament of Iceland, www.althingi.is.

The central government taxes individuals' financial income – dividends, rental income, interest and capital gains – at a rate of 20%, with an exemption for interest income up to 811 euros per person per year (125 thousand kr.) and an exemption for 30% of rental income earned by individuals. The tax yielded 1.2% of GDP and 2.7% of central government revenue in 2012.

The corporate income tax, currently 20% of profits, yielded 2.5% of GDP and 7.4% of revenues in 2013. There is a payroll tax of 7.6% of the applicable wage bill. The payroll tax is earmarked for financing unemployment benefits, maternity leave, and similar expenses. It was raised in increments from 5.34% to 8.65% in the wake of the 2008 crisis in order to finance unemployment benefits, but was reduced slightly in 2012-2014. Along with other taxes on payrolls, it yielded 4.1% of GDP and 12.4% of revenue in 2013.

Since the 2008 crisis, Parliament has introduced three measures of taxation on financial enterprises: i) a tax based on the debt of financial enterprises, introduced for 2011 at 0.041%. In 2014 the rate was raised to 0.376% and the tax was extended to include financial institutions in winding-up proceedings in order to finance the Government's household debt relief program. ii) An additional payroll tax on financial enterprises, introduced for 2012 at 5.45%, now 5.5%. iii) An additional 6% charge on profits in excess of 1 b.kr., also introduced for 2012. Along with older taxes financing the Financial Supervisory Authority (FME) and the Debtor's Ombudsman, special taxes on the financial sector yielded 0.5% of GDP and 1.5% of State revenues in 2013.

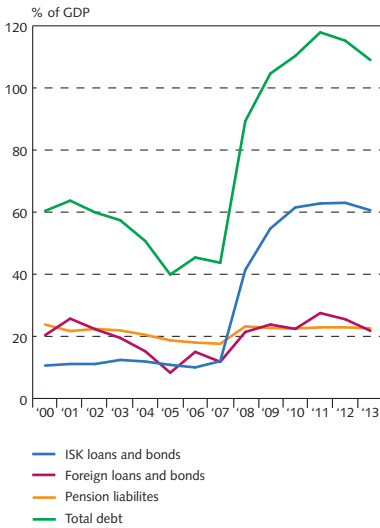
Taxation of property and financial transactions is in four main parts: i) local governments levy property taxes on the assessed value of real estate. In 2014, property taxes averaged 0.286% on residential property; 1.320% on schools, health care centres, and other like institutions; and 1.638% on commercial property. The combined yield was 1.7% of GDP in 2013 and 13% of local government revenue. The central government collects ii) a stamp tax yielding around 0.2% of GDP. After a simplification in 2014, it only applies to transfer of deeds and is 0.8% of the value if the deed-holder is a natural person, but 1.6% for corporations and other legal entities; iii) an estate tax with a main rate of 10% (0.1% of GDP); and iv) a tax on individuals' net wealth (see Table 1). The three state taxes yielded 0.9% of GDP in 2013 and 2.8% of central government revenue.

The largest source of central government revenue is the value-added tax on domestic business, yielding 8.3% of GDP and 25% of revenue in 2013. A rate of 25.5% is charged on most goods and services, while food, accommodation, road tolls, books, newspaper and media subscriptions, audio recordings, indoor heating, and some services are taxed at 7%. Some categories of goods and services are exempt, including financial services, travel agencies, health services, daycare, education, cultural and athletic events and services, passenger transportation, postal services, the activities of writers and composers, and the services of priests and funeral parlours.

There are central government excise taxes and customs duties on imports of motor vehicles and on fuel (earmarked in part for road construction), as well as an annual licence tax on vehicles. In total, these levies yielded 1.9% of GDP in 2013. A general excise tax is levied on a range of goods at three rates of 15%, 20% and 25%, while unit fees are charged on some goods. Alcoholic beverages and tobacco are also taxed. Customs duties range from 0% to 30% of the cif value, although most imports from the EU as well as Iceland's EFTA partners (Norway, Liechtenstein, and Switzerland) are exempt under the European Economic Area Agreement. Higher duties apply to various agricultural products. Central government excise taxes (including those on motor vehicles and fuel), tariffs, and user taxes accounted for around 4.4% of GDP and 13.3% of central government revenues in 2013.

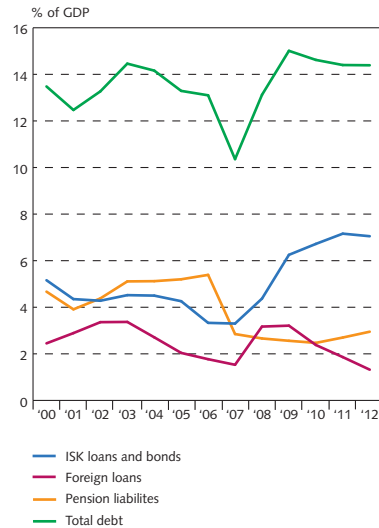
In total, the central and local government taxes and social security contributions described above accounted for 83% of general government revenues and over 99% of tax revenues in 2013. As for the remaining 17% (7.6% of GDP), other taxes accounted for 1% of revenue, dividends for 4%, interest income for 3%, sales of goods and services for 8%, and miscellaneous income for the remaining 1%.

Chart 4.11
Central government liabilities 2000-2013



Source: Statistics Iceland.

Chart 4.12
Local government liabilities 2000-2012¹



1. The Maastricht definition of gross government debt does not include pension liabilities and is more akin to loans and bonds.
Source: Statistics Iceland.

Government holdings in the business sector

In the period 1997-2007, the central government pursued an extensive programme of privatisation. After the privatisation process came to an end, the State's most important business holdings were in Landsvirkjun, the Housing Financing Fund (HFF), and a few smaller financial institutions, which were responsible for a combined 10% of credit in the economy at the end of 2007.

After the financial collapse in October 2008, the State recapitalised the banking system by establishing new banks (see Chapter 3). The original plan was that the new banks would initially be Government-owned, but according to agreements reached with the estates of the old banks, the estates took a significant equity stake in the new banks. Currently, the State holds 98% in Landsbankinn, 13% in Arion Bank, and 5% in Íslandsbanki, at a cost of 1.3 billion euros (196 b.kr.), or 12% of GDP (see Box 3.1). The State also owns shares in several savings banks.

Local government holdings are mainly in geothermal production of heating and electricity, as the municipalities own almost all of the geothermal power companies, which supply heating to most homes in Iceland and, on an increasing scale, electricity to the aluminium industry. Several local governments also own operating companies for harbours.

Government guarantees

State guarantees must be authorised explicitly by special legislation and are generally confined to government enterprises and institutions related to government. Local governments, on the other hand, are prohibited by law from granting loan guarantees except to their own subsidiary institutions.

In October 2008, in connection with the collapse of the banks, the Government made a declaration that all deposits in banks located in Iceland were fully guaranteed. This declaration has

not yet been revoked. "Deposits" refers to all bank balances of general customers and companies that are covered by the Deposit Division of the Depositors' and Investors' Guarantee Fund. At the end of 2013, these deposits amounted to 89% of GDP.

Central government accounts for 2013 show that the Government has outstanding guarantees equivalent to 71% of GDP, in addition to the State guarantee of all deposits in domestic banks. Some 73% of this represents Government backing of residential mortgages through the HFF, a State-owned investment fund with a sizeable share of household mortgage lending in Iceland. Another 24% of the guarantees are for the debt of Landsvirkjun, the national power company.

Treasury foreign debt

The Republic of Iceland was a modest borrower in international markets before the financial crisis of 2008. Fiscal surpluses and proceeds from privatisation had contributed to a gradual reduction in Treasury foreign debt relative to GDP in the years prior to the crisis. Since then, the Treasury has made systematic efforts to rebuilt confidence in foreign credit markets and has held three successful bond issues. The first, held in 2011, was the issue of a five-year 1 billion dollar (115 b.kr.) bond maturing in 2016. The second bond, issued in 2012, also in the amount of 1 billion dollars (115 b.kr.), matures in 2022. The third, issued in 2014 in the amount of 750 million euros (115 b.kr.), was the first issuance in euros since 2006. It matures in 2020. All of the bonds have been used to refinance other foreign debt. The Treasury aims to hold regular foreign bond issues to refinance its foreign debt.

Table 4.1 Republic of Iceland foreign bond issues¹

<i>Amount in millions</i>	<i>Issue date</i>	<i>Maturity</i>	<i>Currency</i>	<i>Loan amount</i>	<i>Outstanding amount</i>
Bond	1981/1983	2016	GBP	30	28
Eurobond (MTN)	2010	2025	EUR	402	222
Eurobond (MTN)	2011	2016	USD	1,000	1,000
Eurobond (MTN)	2012	2022	USD	1,000	1,000
Eurobond (MTN)	2014	2020	EUR	750	750

1. Figures are as of 31 July 2014.

Source: Central Bank of Iceland.

At the end of July 2014, the Treasury's foreign debt amounted to 2,557 million euros (394 b.kr.). Foreign borrowing falls into two categories: bilateral loans and marketable bonds. Marketable bonds amounted to 2,507 million euros (386 b.kr.).

Table 4.2 Treasury, bilateral loans¹

<i>Amount in millions</i>	<i>Maturity</i>	<i>Currency</i>	<i>Loan facility amount</i>	<i>Prepayments</i>	<i>Outstanding loans</i>
Denmark	2021	EUR	480	480	0
Finland	2021	EUR	320	320	0
Sweden	2021	EUR	495	495	0
Poland	2022	PLN	630	0	210
Faeroe Islands	2015	DKK	300	300	0

1. Figures are as of 31 July 2014.

Source: Central Bank of Iceland.

In 2008, the Government of Iceland negotiated a Stand-By Arrangement with the IMF. The programme, which concluded in 2011, provided Iceland with access to loan facilities from the IMF, the Nordic countries, and Poland. Bilateral loans from the treasuries of Denmark, the Faeroe Islands, Finland, Poland, and Sweden were granted to the Treasury. The loans from the IMF and Norway were granted to the Central Bank of Iceland.⁵ The total amount pledged was 3,659 million euros (564 b.kr.). The Treasury's share was 1,485 million euros (229 b.kr.), and the Central Bank's share was 2,174 million euros (335 b.kr.).

Table 4.3 Central Bank of Iceland, IMF loan and bilateral loans¹

<i>Amount in millions</i>	<i>Maturity</i>	<i>Currency</i>	<i>Loan facility amount</i>	<i>Prepayments</i>	<i>Outstanding amount</i>
IMF	2017	XDR	1,400	888	512
Norway	2021	EUR	480	480	0

1. Figures are as of 31 July 2014.

Source: Central Bank of Iceland.

In spring 2012, the Treasury and the Central Bank prepaid 1,760 million euros (271 b.kr.) of the IMF loan and the bilateral loans from the Nordic countries. In December 2012 the loan from the Faeroe Islands was prepaid in full, and in July 2014 the Treasury and the Central Bank fully prepaid all of the Nordic loans. As of this writing, the outstanding loans are 37% of the IMF loan and the bilateral loan with the Polish government, which is a credit line in the amount of 210 million zlotys (7.8 b.kr.).

Under a special agreement with the Minister of Finance and Economic Affairs, the Central Bank is responsible for the implementation of both domestic and foreign borrowing for the Treasury. The Republic of Iceland has never failed to honour its financial obligations and has always paid when due the full amount of principal, interest, and sinking fund instalments for all internal and external obligations.

Credit ratings

The first formal long-term ratings for Iceland were issued in 1994, in the single-A category. Over the following decades, Iceland's credit ratings steadily improved, and until 2008 they were in the

Table 4.4 Republic of Iceland credit ratings

	<i>Affirmed</i>	<i>Foreign currency</i>		<i>Local currency</i>		<i>Outlook</i>
		<i>Long-term</i>	<i>Short-term</i>	<i>Long-term</i>	<i>Short-term</i>	
Moody's	July 2014	Baa3	P-3	Baa3	P-3	Stable
Standard & Poor's	July 2014	BBB-	A-3	BBB-	A-3	Positive
Fitch	August 2014	BBB	F3	BBB+		Stable

Source: Central Bank of Iceland.

5. These facilities are not included in official Treasury debt statistics but are recognised in the Central Bank of Iceland balance sheet.

AA - AAA categories. In the run-up to the banking crisis in 2008, the ratings were lowered, and in the wake of the crisis they suffered significantly before starting to improve again.

In February 2013, Moody's affirmed Iceland's Baa3 local and foreign currency government bond ratings and changed the government bond rating outlook to positive. The rating was kept unchanged in its latest report, issued in July 2014. In the July report, Moody's stated that "Iceland's Baa3 rating with stable outlook is supported by the country's high levels of wealth, the return to reasonably strong economic growth as well as the government's declining debt ratio on the back of improving public finances. Iceland's key credit challenge is to maintain macroeconomic and financial-sector stability as and when the stringent capital controls in place since the crisis are lifted."

In its most recent credit report, published in July 2014, Standard & Poor's (S&P) affirmed Iceland's local and foreign currency rating of BBB- and the short-term A3 rating. In its report, S&P revised Iceland's outlook from stable to positive. In the rating rationale, S&P stated that "[t]he ratings are supported by high productivity and income levels and positive long-term growth prospects, as well as Iceland's generally strong institutional and governance effectiveness. The ratings are constrained by high external and public-sector debt, weak monetary flexibility, and uncertainties and risks related to the eventual lifting of ongoing capital controls."

In February 2012, Fitch upgraded Iceland's long-term foreign issuer default rating to BBB- and affirmed the long-term local currency rating at BBB+. The short-term foreign currency rating was upgraded to F3 from B and the country ceiling to BBB- from BB+. In addition, the outlook was rated stable. In February 2013, Fitch revised Iceland's long-term foreign issuer default rating to BBB from BBB-. In August 2014, Fitch affirmed all ratings and the outlook remained stable. In a press release from August 2014, Fitch stated that "Iceland's ratings are underpinned by its high level of income per capita, and indicators of governance and human development akin to the highest-rated sovereigns."

5 Monetary and financial stability policies

This chapter describes the frameworks for monetary policy and financial stability in Iceland. It explains the objectives and the role of the Monetary Policy Committee and describes the main monetary policy instruments. It also elaborates on financial stability policies and the Central Bank's role in promoting an efficient and safe financial system.

The objective of monetary policy

The Central Bank of Iceland was established as a separate institution in 1961. The current Act on the Central Bank of Iceland entered into force in May 2001 and included substantial changes from the previous Act. In the new Act, maintaining price stability was defined as the Bank's single main objective. The Bank was also granted policy instruments and financial independence, and any direct access by the Government to Central Bank financing was prohibited.

In a joint declaration issued by the Government and the Central Bank of Iceland on 27 March 2001, the price stability goal was further defined as an inflation target of 2½%, measured in terms of the twelve-month rate of change in the consumer price index (CPI). The declaration requires the Central Bank to keep inflation as close to the target as possible, on average. If inflation deviates from the target by more than 1½% in either direction, the Bank is obliged to submit a report to the Government, explaining the causes for the deviation, how the Bank intends to respond, and when it expects the inflation target to be reached again. The report shall be made public.

Following the financial crisis in 2008, further monetary policy reforms have been introduced, including more active intervention in the foreign exchange market (see Table 5.1).

The Monetary Policy Committee

Amendments made to the Central Bank Act in 2009 provided for the establishment of a five-member Monetary Policy Committee (MPC) that takes decisions on the application of monetary policy instruments, whereas a three-member Board of Governors previously decided the policy interest rate. The amended Act also provided for one Governor and one Deputy Governor within the Central Bank instead of the previous three-member Board of Governors. The MPC must comprise the Governor of the Central Bank, the Deputy Governor, one Bank executive responsible for formulating monetary policy, and two outside experts in the field of economic and monetary policy appointed by the Minister of Economic Affairs.

According to the amended Act, decisions by the MPC must be based on the Bank's objectives and a thorough assessment of the current situation and the outlook for the economy, monetary issues, and financial stability. In implementing monetary policy, the MPC bases its decisions in part on an appraisal of economic affairs and the outlook for the domestic economy as presented in the Bank's quarterly *Monetary Bulletin*.

Table 5.1 Monetary policy arrangements in Iceland since 1970

1970-1973	After the collapse of the Bretton Woods system, the Icelandic króna followed an adjustable peg against the US dollar.
1974-1983	Implementation of exchange rate policy became increasingly flexible and can be described as a managed float. The króna was first pegged against the US dollar and then against various baskets of trading partner countries' currencies.
1984-1989	Exchange rate policy became more restrictive, with increasing emphasis on exchange rate stability. In 1989, however, the króna was devalued ten times in small increments.
1990-1995	More emphasis was placed on exchange rate stability as the anchor of monetary policy. Until 1992, the currency peg was specified against a basket of 17 currencies, weighted according to merchandise trading shares, with $\pm 2\frac{1}{4}\%$ fluctuation bands. The basket was redefined in 1992, with the ECU given a weight of 76%, the US dollar 18% and the Japanese yen 6%. The króna was devalued twice in this period, by 6% in November 1992 and by $7\frac{1}{2}\%$ in June 1993. In September 1995, the fluctuation band was widened to $\pm 6\%$, in response to the abolition of capital controls. The currency basket was also changed. The new basket contained 16 currencies, weighted by their share in Iceland's trade in goods and non-factor services.
1996-2000	Fluctuation of the króna within the bands increased as the foreign exchange market deepened and the emphasis on price stability relative to exchange rate stability increased. Reflecting this, the exchange rate band was widened to $\pm 9\%$ in February 2000.
2001-2008	The exchange rate target was abolished in March 2001 and a formal $2\frac{1}{2}\%$ inflation target adopted. The Central Bank was granted full independence in the application of its monetary policy instruments. The currency is allowed to move freely, with limited intervention in the foreign exchange market.
2008-	Following the financial crisis, and as a part of Iceland's IMF programme, monetary policy emphasised exchange rate stability together with the inflation target as a key ingredient in re-establishing nominal stability and securing low and stable inflation. This has become an important part of post-crisis monetary policy reform, dubbed "inflation targeting plus". ¹

1. For further discussion, see the Central Bank report "Monetary policy in Iceland after capital controls", *Special Report* no. 4, 2010.

Source: Central Bank of Iceland.

In order to enhance transparency, the 2009 amendment to the Central Bank Act also stipulated that the minutes of meetings of the MPC shall be made public and an account given of the Committee's decisions and the premises upon which they are based. Furthermore, the MPC is required to submit a written report on its activities to Parliament twice a year. The contents of the report shall be discussed in the Parliamentary Committee of the Speaker's choosing.

Monetary policy instruments

The Bank's monetary policy instruments are its interest rates on transactions with credit institutions, open market operations, decisions on minimum reserve requirements, and intervention in the foreign exchange market. Financial institutions subject to reserve requirements – commercial banks, savings banks, and credit institutions – are eligible for Central Bank facilities. Icelandic branches of foreign financial institutions are eligible as well. According to the Rules on Central Bank Facilities for Financial Undertakings, securities issued in Icelandic krónur by the Republic of Iceland are the primary instruments eligible as collateral for Central Bank facilities.

Financial institutions' regular transactions with the Central Bank can be divided into two categories: standing facilities and open market operations. Financial institutions may avail themselves of standing facilities at any time and on their own initiative. The facilities offered by the Central Bank are deposits and overnight loans against acceptable collateral. Interest on overnight loans forms the ceiling of the Central Bank's interest rate corridor, while current account interest determines the floor.

The Central Bank's market operations take place once a week on Wednesdays. Since 2009, the Bank's counterparties have had abundant liquidity. From autumn 2009 through May 2014, the Bank offered 28-day certificates of deposit (CDs) for sale; however, in May 2014 the Bank made modifications to its monetary policy conduct without changing the monetary stance. Instead of issuing CDs, the Bank now offers two types of term deposits: one-week term deposits and one-month term deposits issued at the beginning of each month. The objective of these changes was to enhance the effectiveness of liquidity management and to increase efficiency from the standpoint of the Bank's balance sheet. Another aim was to prepare for changes in the monetary policy environment upon the sale of Central Bank of Iceland Holding Company (ESÍ) assets and the liberalisation of the capital controls. As long as financial institutions have adequate liquidity, the Bank sees no reason to offer seven-day collateralised loans. The Bank steers the amount of money used in transactions with its counterparties and, as a rule, does not offer deposits and loans at the same time.

The Central Bank interest rate that is most important in determining short-term market rates may vary from time to time. Owing to abundant financial system liquidity, the simple average of Central Bank current account rates and the one-week and one-month term deposit rates is currently the best approximation of the effect of Central Bank rates on money market rates.

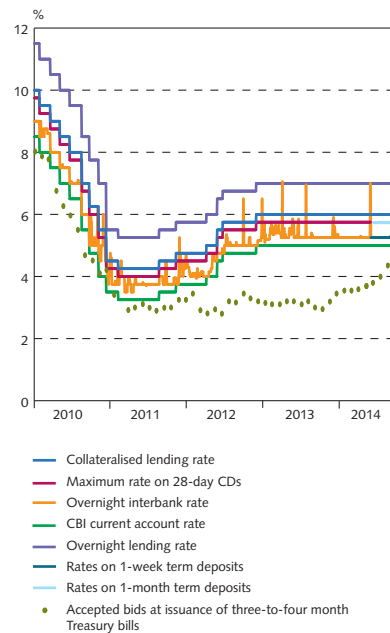
Foreign exchange reserves

One of the Central Bank of Iceland's legally mandated functions is to manage Iceland's foreign exchange reserves. The Central Bank's foreign exchange reserves enable it to achieve its goals and fulfil its duties according to the Central Bank Act. The reserves limit risk and mitigate the effects of external risks related to changes in access to foreign credit and fluctuations in capital flows to and from Iceland. They enable the Bank to help the Treasury meet its need for foreign currency and fulfil its foreign debt obligations. Adequate reserves create in the market the confidence that Iceland is able to service its foreign debt. They can also be used to support monetary policy.

The size of the reserves is determined with reference to the scope of external trade, the exchange rate and monetary regime, regulatory provisions on capital movements and foreign exchange transactions, and Iceland's foreign liabilities. At any given time, the necessary size of the reserves is also determined by the balance of payments outlook. The Governor issues instructions on the desirable size of the reserves, based on the above-mentioned factors.

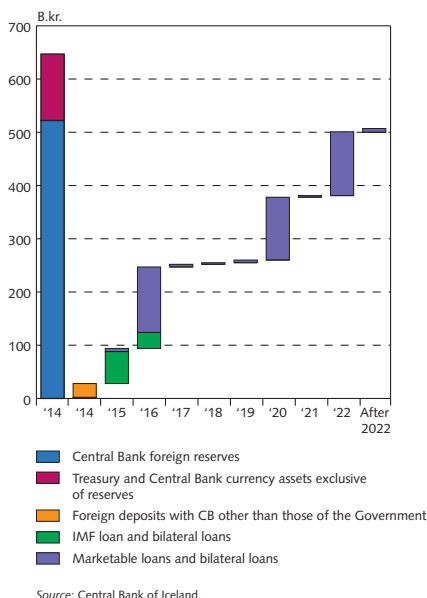
Chart 5.1

Central Bank of Iceland interest rates and short-term market interest rates
Daily data 1 January 2010 - 29 August 2014



Source: Central Bank of Iceland.

Chart 5.2
 Repayment profile of Central Bank and
 Treasury foreign debt
 Position 31 August 2014



From 2008 onwards, the Central Bank has emphasised expanding its foreign exchange reserves. With loans from the International Monetary Fund (IMF), bilateral loans from the Nordic countries and Poland, market issuance, and prepayment of shorter loans, the net foreign exchange reserves (i.e., foreign exchange reserves net of predetermined short-term net drains on foreign currency assets) have nearly trebled in size since end-2008. No loans were taken to expand the reserves in 2013.

Since May 2013, the Bank has been more active in the foreign exchange market than it was previously, intervening in the market so as to mitigate exchange rate volatility and expand its nonborrowed reserves. In the first eight months of 2014, the Bank's net foreign exchange purchases totalled 456 million euros (72.8 b.kr., the equivalent of 4% of year-2013 GDP). On 31 August 2014, the Central Bank's foreign exchange reserves amounted to 3.4 billion euros (522 b.kr., the equivalent of 29% of year-2013 GDP and

32% of M3), which covered 12 months of goods imports. Furthermore, they are sufficient to service all outstanding Treasury and Central Bank foreign debt.

Financial stability and the Central Bank

In performing its role of promoting financial stability and a sound and efficient financial system, including domestic and cross-border payment systems, as is stipulated in the Central Bank Act, the Central Bank of Iceland focuses on assessing risks among systemically important financial institutions, external imbalances, and securing safe and sound operations of the payment and securities settlement systems. The Bank regularly analyses the risks and threats to the stability of the Icelandic financial system in order to detect changes and vulnerabilities that could lead to a serious crisis, and it communicates its overall assessment to markets and decision-makers through the publication of its semi-annual *Financial Stability* report. The bank also publishes an annual report entitled *Financial Infrastructures*.

To promote financial stability, the Central Bank sets prudential rules on credit institutions' liquidity and foreign exchange balance. Prudential rules on funding are currently in preparation. In its work on financial stability, the Central Bank takes into account international agreements and other standards for best practice.

Supervision and cooperation

The Financial Supervisory Authority (FME) supervises financial undertakings and entities operating in the financial and insurance sectors, while the Central Bank's role centres on oversight and

prudential regulation. The FME and Central Bank of Iceland have entered into a cooperation agreement whose main aim is to strengthen cooperation and exchange of information between the two institutions.

A new Act on a Financial Stability Council (FSC) entered into force in 2014. The Council serves as a forum for cooperation, information sharing, and policy-making regarding financial stability, and it coordinates Government responses in the event of a financial crisis. The Council makes recommendations concerning macroprudential policy to the appropriate authorities, which are legally bound to comply or explain. Members of the Council are the Minister of Finance and Economic Affairs (chair), the Governor of the Central Bank of Iceland, and the Director General of the FME.

A Systemic Risk Committee (SRC) works for the FSC. The SRC evaluates the current situation and outlook for the financial system, systemic risk, and financial stability. It examines the interaction of the application of the FSC member institutions' policy instruments that affect financial stability, with the exception of the Central Bank of Iceland's monetary policy instruments, and presents proposals to the FSC. The SRC comprises five members appointed for a term of five years: the Governor of the Central Bank; the Director General of the FME; the Deputy Governor of the Central Bank; the Deputy Director General of the FME; and one expert who is appointed by the Minister of Economic Affairs.

The Central Bank collaborates with other central banks and international institutions, including sharing information and expertise. The Nordic and Baltic countries have entered into a cooperation agreement on cross-border financial stability and crisis management and resolution.

6 External position

This chapter presents Iceland's external assets and liabilities positions, both gross and net. It discusses pre-crisis debt accumulation and post-crisis developments, describes changes in foreign direct investment, and provides estimates of net foreign debt levels once the failed private banks have been wound up.¹

International investment position

Iceland's external indebtedness has risen sharply since the mid-1990s and is high by international comparison, although it has fallen from its 2009 peak. From 2003 until the banks collapsed in October 2008, the foreign assets of the Icelandic economy grew swiftly, far outpacing annual output growth, yet foreign debt grew still more rapidly. The net international investment position (IIP) therefore became extremely negative, rising from 65% of GDP in 2003 to 111% of GDP by the end of 2007 (16 billion euros, 1,451 b.kr.). The IIP continued to worsen as a result of the depreciation of the króna and the collapse of the banks in 2008, peaking at -708% of GDP in 2009, but had subsided to -427% of GDP (48 billion euros, 7,624 b.kr.) by year-end 2013.

Official accounting figures give a misleading view of the country's underlying IIP, as the majority of the liabilities still recognised officially as Icelandic liabilities are related to the estates of the failed banks. According to the Central Bank's estimate of the IIP that will result when the estates' domestic and foreign assets have been sold and the proceeds distributed among domestic and foreign creditors, it will be much more favourable than before the financial crisis. The IIP

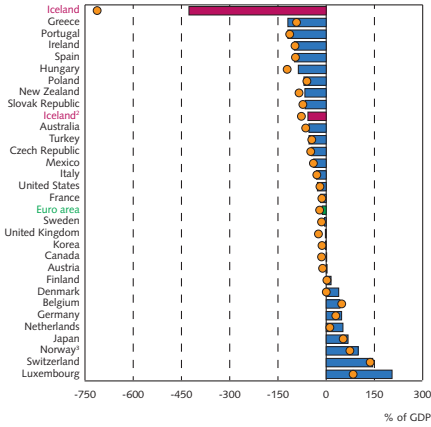
Table 6.1 Iceland's debt position (% of GDP)

	2007	2012	2013
Total liabilities	-658	-787	-730
- excl. DMBs in winding-up proceedings	.	-204	-208
- based on calculated settlement of DMBs in winding-up proceedings	.	-255	-258
- underlying debt based on calculated settlement of DMBs in winding-up proceedings, and excl. Actavis	.	-212	.
International investment position	-111	-486	-427
- excl. DMBs in winding-up proceedings	.	-29	-13
- based on calculated settlement of DMBs in winding-up proceedings	.	-75	-57
- underlying position based on calculated settlement of DMBs in winding-up proceedings, and excl. Actavis	.	-65	.

Sources: Statistics Iceland, Central Bank of Iceland.

1. The Central Bank has analysed Iceland's underlying international investment position in *Special Publication* no. 9, entitled "Iceland's underlying external position and balance of payments", published 18 March 2013.

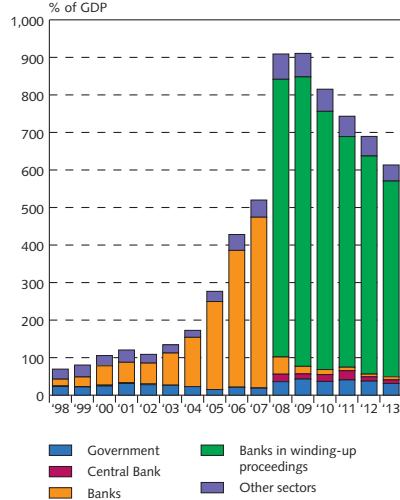
Chart 6.1
International investment position
of OECD countries 2013¹



1. The dots show the IIP for Q4/2009. 2. Figures are for Q4/2013 and show IIP based on calculated settlement of DMBs undergoing winding-up proceedings. 3. Figures are for 2012.

Sources: Macrobond, Central Bank of Iceland.

Chart 6.2
Estimated foreign debt by sector 1998-2013¹



1. External debt position, excluding FDI and portfolio equities. Sources: Statistics Iceland, Central Bank of Iceland.

based on the calculated settlement of DMBs in winding-up proceedings, the underlying IIP, was negative by 57% of GDP at the end of 2013, or about 1/8 of the official figure.² In comparison with other OECD countries, Iceland's underlying IIP is similar to that of Australia, Turkey, and the Czech Republic.

Foreign assets and liabilities

Iceland's total foreign debt soared prior to the collapse of the banks, rising to 658% of GDP by the end of 2007. The debt level peaked at 1,027% in September 2009 but tapered off in 2010 and 2011 due to the appreciation of the króna and repayment of the priority claims against the old Landsbanki Íslands estate.³ According to official statistics, it measured 730% of GDP at year-end 2013.

Although Iceland's external assets grew rapidly during the pre-crisis period, they did not grow as fast as external liabilities. Furthermore, their value deteriorated more abruptly than foreign debt, owing to the collapse of the banks and the króna, and amounted to 303% of GDP in 2013, down from 547% of GDP in 2007.

Foreign debt burden of deposit money banks (DMBs) in winding-up proceedings

The increase in the country's gross external debt during the pre-crisis years stemmed from two main sources. The first was a large increase in investment in foreign assets financed with foreign

2. The settlement of the DMBs in winding-up proceedings is based on the book value of their assets, approved claims according to the estates' claim registers, and the exchange rate of the króna at year-end 2013. The present analysis is subject to some uncertainty, however. A large number of claims are still in dispute, the market value of the assets is uncertain, and it is not known at what exchange rate the estates will be settled.

3. See Box 4.2 in *Economy of Iceland* 2012.

loans, mainly through the Icelandic banks. A large part of this investment centred on the banks' acquisition of foreign financial institutions. Furthermore, the banks also became important mediators of foreign capital to the domestic market, both to the Icelandic corporate sector and to households (see Chapter 7). Therefore, a large share of the Icelandic economy's external debt is that of the failed banks.

In 2013, banks (including those in winding-up proceedings) accounted for 73% of total foreign debt (530% of GDP), with DMBs in winding-up proceedings accounting for 98% of that total. Offsetting this debt are substantial assets, even though their value deteriorated sharply after the financial collapse. DMBs in winding-up proceedings accounted for 35% of total foreign assets at year-end 2013 (about 107% of GDP), down from 38% at the end of September 2008.

The liabilities of the DMBs in winding-up proceedings will remain in official statistics and accumulate interest that will not be paid because asset values will only support a portion of the claims against the estates. It is estimated that when the banks have been wound up, the assets sold, and the liabilities in excess of asset values written off, Iceland's net position could improve from -427% of GDP to -57% of GDP (see footnote 2 in this Chapter).

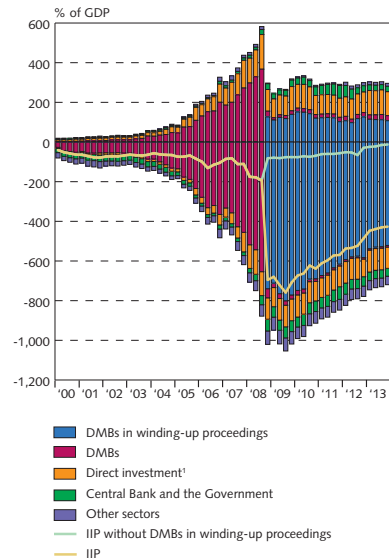
Public sector foreign assets and liabilities

While the now-defunct DMBs' operations were the main reason for the rise in the net debt position of the economy, the public sector retired a substantial amount of its debt in the years before the crisis. The depreciation of the króna in 2008 and the need to strengthen the Central Bank's foreign exchange reserves (see Chapters 5 and 7) increased the external liabilities of the general government and the Central Bank from 19% of GDP at year-end 2007 to their post-crisis peak of 64% of GDP at year-end 2011. By year-end 2013, however, they had fallen to 40% of GDP, primarily due to prepayments of the long-term loans from the Nordic countries and the IMF to the Treasury and the Central Bank (see Chapter 7). Only a portion of the increase in foreign debt between 2007 and 2013 had a direct effect on the IIP, however, as loans taken to expand the reserves were mostly offset by assets. The gross reserves more than doubled between 2007 and 2013, from 12% to 27% of GDP.

Private sector excluding DMBs in winding-up proceedings

The private sector excluding the DMBs in winding-up proceedings has deleveraged rapidly since 2010, when its net position bottomed out at -57% of GDP. At year-end 2013, the net position had turned positive for the first time since the turn of the century, measuring roughly 2% of GDP,

Chart 6.3
International investment position (IIP)
Q1/2000 - Q4/2013



1. Excluding special purpose entities.

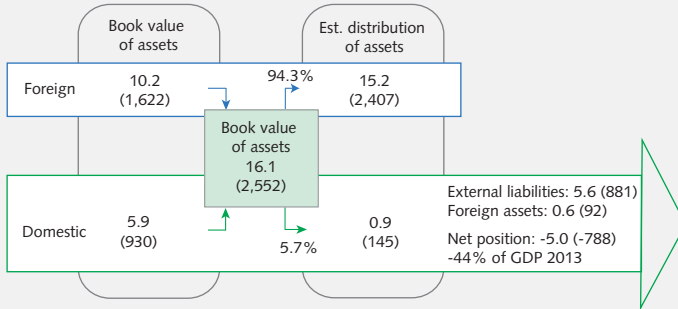
Sources: Statistics Iceland, Central Bank of Iceland.

Box 6.1

Settlement of the failed banks' estates¹

In order to estimate Iceland's net foreign debt position after the failed banks' bankruptcy proceedings are completed, it is necessary to consider the settlement of their estates caused by an imbalance in the proportion of assets and claims between residents and non-residents. At the end of 2013, book value of the three failed banks' estates assets was estimated at 16.1 billion euros (2,552 b.kr.), including 10.2 billion euros (1,622 b.kr.) in foreign assets and 5.9 billion euros (930 b.kr.) in domestic assets. Furthermore, it is estimated that 5.7% of creditors are residents and 94.3% non-residents. Based on the above estimate of the estates' assets and the division between creditor groups, it can be expected that 15.2 billion euros (2,407 b.kr.) will revert to non-residents and 0.9 billion euros (145 b.kr.) to residents when the estates are settled. If current domestic and foreign assets are divided among domestic and foreign creditors according to the percentages listed above, 5.6 billion euros (881 b.kr.) of domestic assets will revert to non-residents and create external debt. In addition, 0.6 billion euros (92 b.kr.) of foreign assets will revert to residents and create an external asset. The result is net external debt in the amount of 5.0 billion euros (788 b.kr.), or 44% of year-2013 GDP (see Chart 6.1).

Chart 6.1
Estimated impact of DMBs in winding-up proceedings on the IIP



Amounts in EUR billions, amounts in parentheses are in b.kr. Based on portfolio balances as of end-2013. Deposits with Central Bank and domestic assets that have foreign collateral are considered foreign assets. Sources: Financial information and creditor registers of Glitnir, Kaupthing and LBI, Central Bank of Iceland.

1. The settlement of the DMBs in winding-up proceedings is based on the book value of their assets, approved claims according to the estates' claim registers, and the exchange rate of the króna at year-end 2013. The present analysis is subject to some uncertainty, however. A large number of claims are still in dispute, the market value of the assets is uncertain, and it is not known at what exchange rate the estates will be settled.

primarily because of the restructuring of the pharmaceuticals company Actavis and its purchase by Watson Pharmaceuticals in 2012. Actavis' impact on Iceland's external balance changed radically as a result of the Watson acquisition, from -46% of GDP in Q4/2011 to -10% of GDP a year later.⁴ At year-end 2013, the total foreign assets of the private sector excluding DMBs in

4. Although it is no longer essential to exclude the company when assessing the IIP, Actavis continues to weigh heavily in Iceland's gross external debt position, as foreign companies owned by Actavis Iceland before the change of ownership are still owned in Iceland. In Q4/2012, Actavis owed its owner the equivalent of 43% of GDP.

winding-up proceedings amounted to 135% of GDP, while the debt of the same group was 133% of GDP.

The largest subgroup in this category is the pension funds, which own substantial assets abroad but whose foreign liabilities are negligible. The pension funds' foreign portfolios stood at 35% of GDP (5 billion euros, 458 b.kr.) at year-end 2007. In 2010 and 2011, however, the value of their portfolios declined in krónur terms because of foreign asset sales and the appreciation of the króna, and stood at 29% of GDP at year-end 2011. In 2012 and 2013, the value of their portfolio rose again, to 3.8 billion euros (597 b.kr.), or 33% of GDP by year-end 2013. In 2013, the pension funds owned 11% of Icelandic residents' total foreign assets and 48% of foreign portfolio holdings.

The rest of the private sector, excluding financial institutions in winding-up proceedings and the pension funds, had a net external position of -31% of GDP at year-end 2013, up from the post-crisis trough of -88% of GDP at the end of 2010.⁵

Table 6.2 Foreign assets and liabilities

<i>EUR billions (b.kr.)</i>	2007	2011	2013	2004-2007 (average change per year in ISK)	2011 (change from prev. year in ISK)	2013 (change from prev. year in ISK)
Outward FDI	20 (1,826)	9.9 (1,566)	13.6 (2,156)	91%	6%	22%
Foreign capital equities	14.0 (1,276)	3.6 (572)	4.3 (688)	55%	3%	9%
Foreign debt securities	7.1 (652)	0.8 (126)	0.2 (24)	170%	49%	23%
Foreign lending	23.1 (2,104)	4.2 (673)	3.2 (507)	98%	-17%	-35%
Total assets	78.5 (7,159)	29.3 (4,661)	34.1 (5,412)	79%	8%	6%
Total assets (% of GDP)	547	286	303			
Inward FDI	14.1 (1,288)	10.7 (1,706)	12.1 (1,919)	89%	13%	27%
Total liabilities	94.4 (8,610)	87.7 (13,933)	82.2 (13,035)	63%	-1%	-2%
Total liabilities (% of GDP)	658	856	730			

Sources: Statistics Iceland, Central Bank of Iceland.

5. This group also includes holding companies, which increased their foreign debt substantially in 2005-2006 but financed themselves more and more in the domestic market when access to foreign credit grew tighter. Holding companies were quite prominent in the books of the Icelandic banks at the time they collapsed. For further breakdown of private sector IIP, see *Financial Stability* 2014/1.

Lending by domestic credit institutions to foreign borrowers

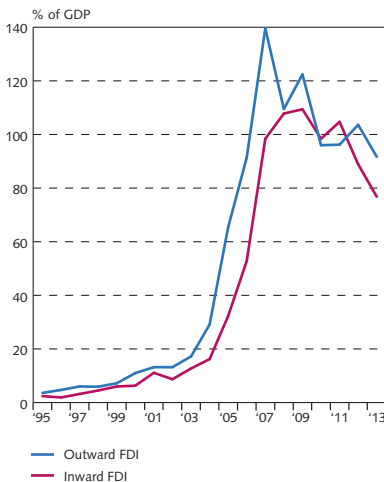
Lending by domestic credit institutions to foreign borrowers was one of the largest single contributors to the rise in foreign assets in 2003-2007. The stock of foreign lending increased from 19% of GDP in 2003 to 160% of GDP at year-end 2007. Due in part to valuation effects from the depreciation of the króna, the stock of foreign lending skyrocketed in the months leading up to the crash, rising by 66% between Q4/2007 and Q3/2008 and measuring 235% of GDP by end-September 2008.

By the end of 2008, the failed banks owned 77% of total foreign loans. This share increased to 90% at year-end 2009 but had fallen to 76% by the end of 2013. Between 2009 and 2013, the stock of foreign lending by the DMBs in winding-up proceedings dropped from 67% of GDP to 22% of GDP. The main reason for this decline is that some of the loans were reclassified as foreign direct investment (FDI) at the end of 2009 because of financial difficulties among the banks' debtors, prompting a takeover of the companies concerned.

Investment in equities and debt securities

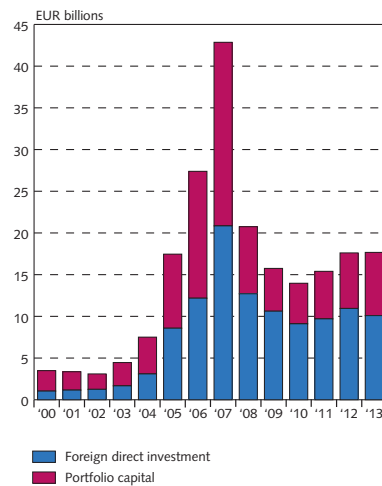
Investment in foreign equities and debt securities also grew substantially between 2003 and 2007. The total stock of foreign equities and debt securities rose sharply until Q3/2008, when foreign equities peaked at 104% of GDP and debt securities peaked at 52% of GDP, up from 27% and 2%, respectively, in 2003. They plunged during the financial crisis, and by year-end 2013, residents' foreign equities amounted to 39% of GDP and debt securities totalled 30% of GDP.

Chart 6.4
Outward and inward FDI 1995-2013¹



1. Excluding special purpose entities.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 6.5
Foreign direct investment and portfolio capital owned abroad by residents (at year-end) 2000-2013



Source: Central Bank of Iceland.

Outward foreign direct investment

The Icelandic banks played a major role in brokering foreign capital for domestic investors, as well as investing extensively abroad on their own account. In addition, a sizeable share of foreign debt was used to fund domestic lending, some of which was then used to invest abroad. Outward foreign direct investment (FDI) grew by an average of 80% per year in 2003-2007. The stock of outward FDI amounted to 175% of GDP at the end of Q3/2008, up from 17% of GDP in 2003. As a result of the financial crisis, it decreased dramatically, falling to a new low of 94% of GDP in Q1/2009, but had fallen to 92% of GDP by year-end 2013. Furthermore, the composition of the capital has changed during the post-crisis period; lending to subsidiaries has increased while the share of foreign equity has declined. In 2013, lending to subsidiaries accounted for about 70% of outward FDI, whereas lending to Actavis subsidiaries constituted 23% of total outward FDI.

Inward foreign direct investment

Inward FDI also grew during the years prior to the crisis, with the stock peaking at 124% of GDP in mid-2008. It then declined steadily, to a low of 98% of GDP at the end of 2010. After an increase in the following year, inward FDI peaked at 109% in Q1/2012 but had fallen back to 78% of GDP at year-end 2013 because of the Actavis restructuring. This restructuring also explains the turnaround in the net FDI position from having been negative in 2010 to being positive in 2012. By year-end 2013, outward FDI exceeded inward FDI by 1.5 billion euros (242 b.kr.). Furthermore, non-residents' equity as a share of inward FDI had been roughly 12% in 2011 but fell to 2% by year-end 2013 due to the Actavis restructuring.

Table 6.3 Foreign assets

<i>% of total foreign assets</i>	1999	2003	2007	2009	2011	2013
Reserves	14	8	2	10	22	9
Trade credit	5	1	0	1	1	1
Foreign lending	4	22	29	23	14	9
Foreign equity	49	31	18	15	12	0

Source: Central Bank of Iceland.

Table 6.4 Foreign liabilities

<i>% of total foreign liabilities</i>	1999	2003	2007	2009	2011	2013
Icelandic equity investment	1	2	4	0	0	1
Short-term lending	8	9	13	20	20	20
Long-term lending	43	20	12	12	15	12
Icelandic bonds	39	58	39	43	41	43

Source: Central Bank of Iceland.

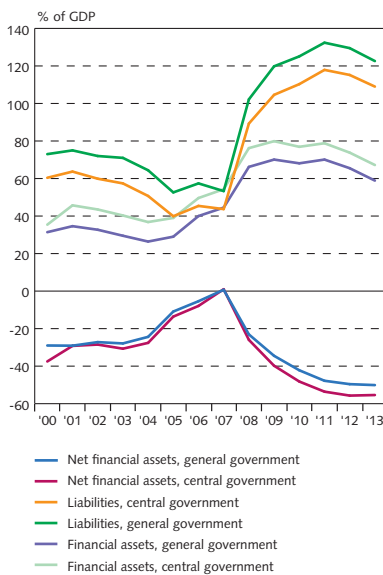
7 Government, corporate, and household balance sheets

This chapter describes Government, corporate, and household balance sheets in Iceland; the position of the Government, households and businesses; and debt restructuring following the financial crisis.

Government balance sheets

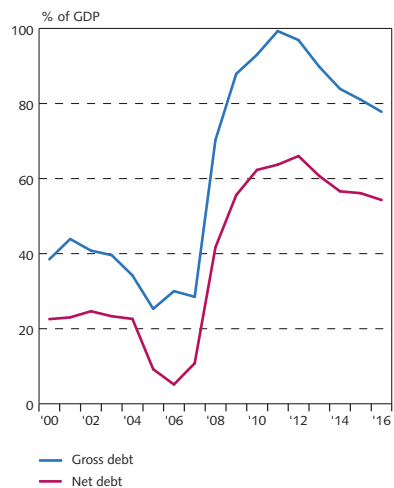
The public sector's balance sheet and budgets suffered a severe shock with the collapse of the financial system and the large depreciation of the króna in 2008, as both general government and public enterprises had significant foreign-denominated debt. Furthermore, a substantial amount of debt was shifted from the private to the public sector when private enterprises, mostly banks, became insolvent. The net debt burden of the economy will continue to diminish over the next few years as banks and large holding companies continue to be wound up; however, the opposite will be true for the public sector, as nominal debt will remain high despite falling as a share of GDP, owing to nominal GDP growth.

Chart 7.1
Financial assets and liabilities 2000-2013



Source: Statistics Iceland.

Chart 7.2
General government debt 2000-2016¹



1. Central Bank baseline forecast 2014-2016 from *Monetary Bulletin* 2014/3. Gross debt according to Maastricht criteria.
Sources: Ministry of Finance, Statistics Iceland, Central Bank of Iceland.

Central government

Iceland's fiscal position was strong when the financial crisis struck. Record surpluses in 2004-2007 had enabled the central government to retire a large portion of its debt while simultaneously accumulating cash deposits in the Central Bank of around 10% of GDP. The central government's net financial assets even turned marginally positive in 2007. As a result of the financial crisis, net financial assets became negative by 34.5% of GDP in 2009 and had deteriorated further, to 50% of GDP, in 2013.

The depreciation of the króna in 2008 led to a rapid weakening of the gross debt position, as 33% of central government debt was denominated in foreign currency. The need to strengthen the Central Bank's foreign exchange reserves led to a further increase in the gross debt position. Consequently, central government gross foreign debt rose from 12% of GDP to 28% of GDP in 2011, but it has since declined, mainly due to prepayments of the IMF and bilateral loans taken to strengthen the Bank's reserves. It measured 22% of GDP at year-end 2013.

All foreign loans taken by the central government since 2006 have been used to expand Iceland's foreign exchange reserves. The reserves themselves constituted 29% of GDP at the end of August 2014, and the net reserves (the foreign exchange reserves less predetermined short-term outflows) were positive by 24% of GDP at that time. Following the Treasury's international bond issuance in 2011, 2012 and 2014, the Treasury and the Central Bank have a relatively strong near-term foreign liquidity position (see Chapter 4). The loans originally extended to Iceland by the IMF and the Nordic countries under the IMF Stand-By Arrangement (SBA) have been prepaid or, in the case of the Nordic loans, paid in full. Only 37% of the original loan extended by the IMF remains to be paid. The net effect of all the prepayments on the central government debt position is a decrease in gross debt, while the effect on net debt is limited.

In the wake of the financial crisis, fiscal deficits were financed primarily in domestic financial markets, at somewhat favourable interest rates because of the capital controls. The result was an increase in króna-denominated debt from as low as 12% of GDP in 2007 to around 60% in 2013. Domestic government bonds were issued in connection with the recapitalisation of

Table 7.1 Central government financial assets and liabilities 2005-2013

% of GDP	2005	2006	2007	2008	2009	2010	2011	2012	2013
Financial assets	29.0	40.0	44.5	66.2	70.1	68.1	70.1	65.5	58.9
Currency and deposits	5.0	7.9	8.0	12.4	15.1	20.7	32.8	28.4	22.6
Loans	7.0	14.5	13.3	31.9	24.1	16.2	9.1	9.5	9.2
Shares and other equity	8.5	8.8	14.7	13.4	22.3	22.3	20.4	19.2	18.6
Other accounts receivable	8.6	8.8	8.5	8.6	8.6	8.9	7.9	8.4	8.6
Liabilities	39.9	45.4	43.7	89.3	104.6	110.3	117.9	115.2	109.0
Securities other than shares	10.4	9.7	9.6	20.8	41.7	47.0	48.4	49.4	48.5
Loans	8.7	15.3	14.1	42.0	36.8	36.9	42.0	39.2	33.9
Domestic loans	0.4	0.3	2.4	20.6	13.0	14.5	14.4	13.6	12.1
Foreign loans	8.3	15.0	11.8	21.4	23.8	22.4	27.5	25.5	21.8
Insurance technical reserves	18.7	18.0	17.6	23.2	22.7	22.5	22.9	22.9	22.6
Other accounts payable	2.2	2.5	2.4	3.3	3.4	3.9	4.6	3.8	3.9
Net financial assets	-10.9	-5.4	0.7	-23.1	-34.5	-42.2	-47.8	-49.6	-50.1

Source: Statistics Iceland.

the banking system and the Central Bank, which amounted to 14% and 10% of year-2009 GDP, respectively. At year-end 2013, króna-denominated liabilities, including pension liabilities, amounted to 87% of GDP, compared to 32% of GDP in 2007. Overall, total central government liabilities amounted to 109% of GDP in 2013 (82% as defined by the Maastricht criteria), as opposed to 44% in 2007, after peaking at 118% in 2011.

Because borrowing has been used to acquire assets, net debt has increased less as a result of the financial crisis than has gross debt. For example, the Government took equity stakes in the new banks. It currently holds a 98% stake in Landsbankinn, 13% in Arion Bank, and 5% in Íslandsbanki. In addition, the Treasury extended subordinated loans to the latter two banks. The Treasury's total contribution to the new banks' recapitalisation was 1.3 billion euros (196 b.kr.), or about 11% of GDP. An additional 145 million euros (22 b.kr.) were injected into the savings banks, both in the form of debt forgiveness and in exchange for equity. This, plus the fact that the Treasury needed to keep more deposits to finance the deficit and the foreign exchange reserves, explains why financial assets rose from 45% of GDP in 2007 to as high as 70% in 2009. They have since declined to 59% of GDP (see Table 7.1).

Local government

Prior to the financial crisis, the local government balance sheet was quite strong. Gross debt had fallen to 4.8% of GDP in 2007, and the net liabilities position to 1.4% of GDP. With the onset of the crisis, local governments' gross debt as a share of GDP rose to 9.5% of GDP in 2009, while net liabilities rose to 5.7% of GDP. Since 2009, local government debt has been on a declining path, falling to 8.5% of GDP in 2013, helped by a new fiscal debt rule that stipulates that debt may not exceed 150% of regular revenues.

Local governments' foreign debt had also declined considerably in the years before the crisis, from 3.4% of GDP in 2002 to 1.5% in 2007, but local governments had to realise a loss equivalent to 1% of GDP on their foreign debt in 2008 because of the depreciation of the króna.

Table 7.2 General government financial assets and liabilities 2005-2013

% of GDP	2005	2006	2007	2008	2009	2010	2011	2012	2013
Financial assets	39.0	49.6	54.3	76.2	79.9	76.9	78.8	73.8	67.2
Currency and deposits	6.0	9.1	10.2	14.8	17.6	23.8	34.9	30.1	24.0
Loans	8.9	15.8	15.0	33.6	26.5	17.7	10.9	11.3	11.5
Shares and other equity	12.8	12.8	17.3	15.6	24.6	24.7	22.6	21.5	20.7
Other accounts receivable	11.3	11.9	11.8	12.2	11.2	10.8	10.4	10.8	11.0
Liabilities	52.6	57.4	53.3	102.2	119.8	125.1	132.4	129.5	122.6
Securities other than shares	10.4	9.7	9.6	20.8	41.7	47.0	48.4	49.4	48.5
Loans	14.9	20.3	18.9	49.5	46.2	46.0	50.9	47.4	41.3
Domestic loans	4.5	3.6	5.6	24.9	19.2	21.2	21.5	20.6	18.4
Foreign loans	10.4	16.8	13.3	24.6	27.0	24.8	29.4	26.8	23.0
Insurance technical reserves	23.9	23.4	20.5	25.8	25.2	24.9	25.6	25.8	25.9
Other accounts payable	3.5	4.1	4.3	6.0	6.6	7.2	7.4	6.8	6.9
Net financial assets	-13.6	-7.9	1.0	-26	-39.8	-48.2	-53.6	-55.7	-55.4

Source: Statistics Iceland.

As is the case with the central government, local governments have financed their deficit spending primarily in the domestic credit market, increasing their króna-denominated debt from 3.3% of GDP in 2007 to 7% in 2012. However, local governments' financial assets have been stable for the past seven years, at approximately 8-9% of GDP.

General government

The central government has by far the largest balance sheet, with assets and liabilities constituting 89% of the general government balance sheet, while the local government share is about 11%. Social security accounts thus constitute only a marginal share of general government accounts in comparison with central and local government. As a result, general government financial assets and liabilities are largely those of the central and local governments.

Iceland's general government gross debt was among the lowest in the OECD in 2007 (Chart 7.3). It rose substantially in the wake of the crisis, peaking in 2011, but has tapered off since and was below the euro area average in 2013.

General government financial assets remained at around 80% of GDP between 2008-2011, up from 54% of GDP in 2007, but have declined since then to 67% in 2013, as cash and foreign-denominated deposits accumulated in the aftermath of the financial crisis have been used to prepay loans taken to expand the Central Bank's foreign exchange reserves. Furthermore, shares and equity held by the Government declined by 4 percentage points as a share of GDP between 2010-2013. This is due

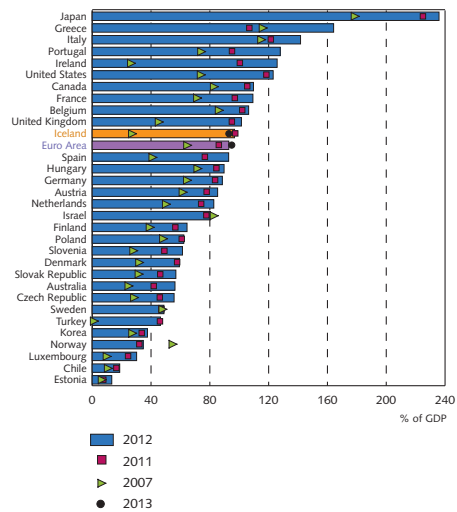
mainly to nominal GDP growth, as the nominal value of shares and other equity has not declined. Financial liabilities, which bottomed out at 53% of GDP in 2005, soared after the financial collapse, reaching a high of 133% of GDP in 2011, but have fallen to 123%.

Private sector balance sheets

Iceland's private sector debt as a share of GDP was similar to that in other developed countries until 2004, when it increased rapidly, outpacing neighbouring countries. However, the increase in debt in the run-up to the crisis was due mainly to a surge in corporate debt, led by a few large holding companies.

In comparison with other countries, Iceland's share of foreign-denominated debt was high at the start of the financial crisis, measured as a share of both GDP and exports. With the collapse of the króna in 2008 and the resulting surge in inflation, the value of both foreign-denominated and CPI-indexed loans rose sharply, weakening the balance sheets of many households and businesses. Private sector debt peaked at 510% of GDP in Q3/2008, up from 200% of GDP at

Chart 7.3
General government debt



Sources: OECD, Central Bank of Iceland.

the beginning of 2004 (Chart 7.4). As a result of write-offs, financial restructuring, bankruptcy, deleveraging, court rulings, and Government-sponsored restructuring programmes, it stood at just below 250% of GDP at year-end 2013, falling by more than half from its peak.

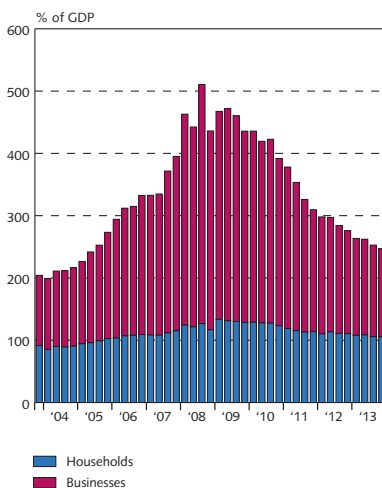
In recent years, private sector financial conditions have improved significantly, in line with rising asset prices (Chart 7.5), reduced debt, and improved economic activity, although debt is still high in international context. Private sector financial restructuring is moving forward, as can be seen for example in the three large commercial banks' non-performing loan ratios, which have fallen from 20% at year-end 2010 to 4.5% at year-end 2013.

Corporate balance sheets

Corporate balance sheets grew considerably during the pre-crisis years, as companies stepped up acquisitions and accumulated debt. In 2007, corporate assets were almost seven times GDP, up from 243% of GDP in 2003. By that time, the balance sheets of Iceland's 100 largest non-financial firms were roughly six times GDP, after having doubled since 2004.

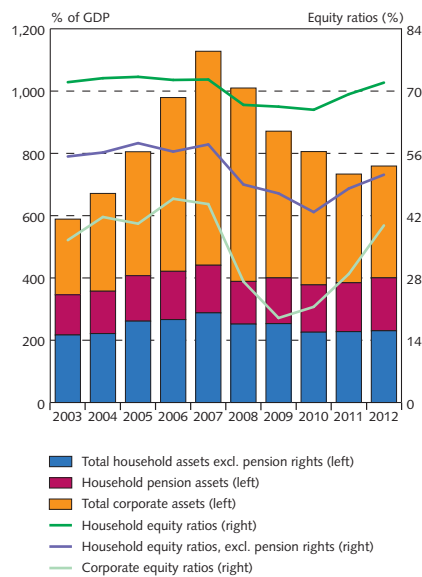
Following the collapse of the banking system, the position of many companies deteriorated severely. Corporate equity ratios declined by more than half in two years, from 45% in 2007 to 19% in 2009 (Chart 7.5). The debt position and debt service burden of overleveraged firms increased considerably, due especially to the depreciation of the króna, as a large share of corporate debt was foreign-denominated and many firms did not have revenues in foreign currency. Corporate bankruptcies and unsuccessful distraint actions against firms increased. The bankruptcy rate was at its highest in several decades, with around 4.6% of firms declared insolvent in 2011, as opposed to 2.3% in 2008.

Chart 7.4
Private sector debt as % of GDP
Q4/2003 - Q4/2013



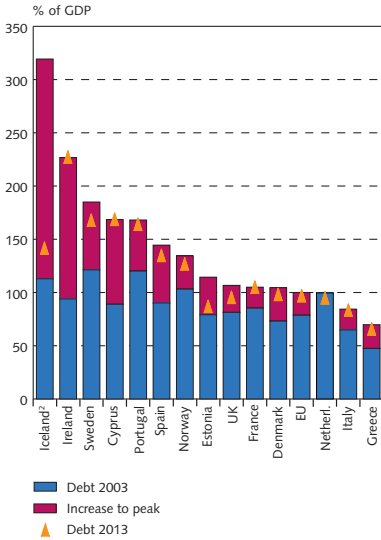
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 7.5
Private sector assets as % of GDP and equity ratios 2003-2012



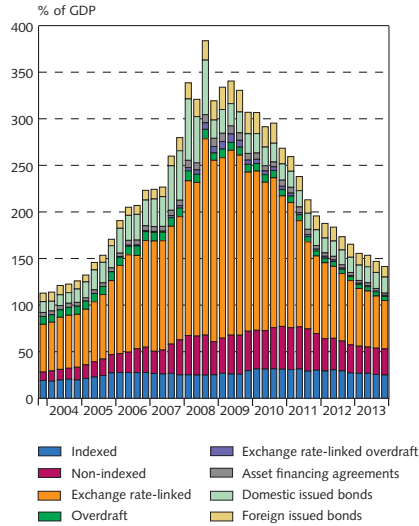
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 7.6
Corporate debt in selected European countries¹
2003 and 2013



1. The blue columns show household and corporate debt at year-end 2003. The red columns show the increase in debt to the highest year-end value, and the triangles show the position at year-end 2013. Data for 2012 used if 2013 data are not available. Non-consolidated.
2. Only debt owed to financial undertakings and market bonds issued according to figures from the Central Bank of Iceland.
Sources: Eurostat, Central Bank of Iceland.

Chart 7.7
Composition of corporate debt¹
Q4/2003 - Q4/2013



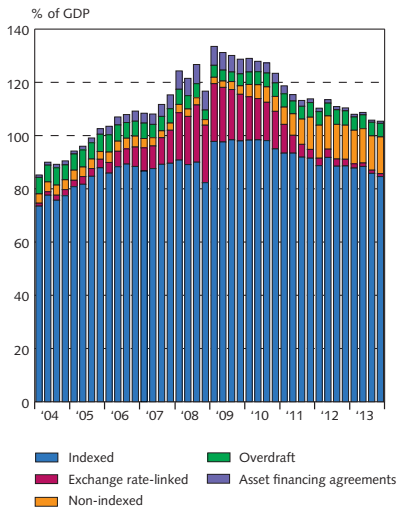
1. Debt to domestic and foreign financial institutions and issued marketable bonds.
Sources: Statistics Iceland, Central Bank of Iceland.

Relatively strong economic growth since 2011 (average 2.5%), along with financial restructuring, has helped to strengthen the position of many firms. Corporate assets as a share of GDP had risen to the pre-crisis average (2005-2008) of approximately 360% of GDP by year-end 2012. Corporate equity ratios have also risen and are estimated to have surpassed their pre-crisis level in 2013.¹ In contrast to the pre-crisis situation, higher corporate equity ratios and increased corporate sector wealth are primarily the result of deleveraging and declining debt, not higher asset prices, as was the case in 2005-2008.

After peaking at nearly 385% of GDP in the third quarter of 2008, firms' debt-to-GDP ratio has fallen considerably. Businesses' debt to domestic and foreign financial institutions, including their issued marketable bonds, measured 141% of GDP at year-end 2013. The reduction in corporate debt is due mainly to a decline in foreign-denominated debt, from 210% of GDP in 2008 to 52% in 2013. Furthermore, domestic issued bonds have declined from about 60% of GDP to 17%, since both foreign financial markets and the domestic bond market have mostly been closed to companies since the collapse of the banking system. In the same period, there has been a modest decline in non-indexed and overdraft loans denominated in krónur, but indexed loans

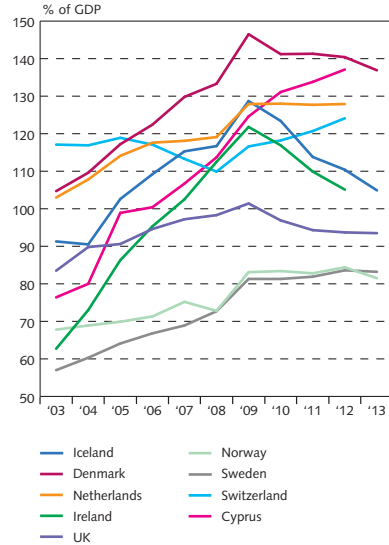
1. The value of fixed operational assets is estimated from Statistics Iceland's corporate balance sheet summaries. Figures are only available for 2011.

Chart 7.8
Household debt as % of GDP
Q1/2004 - Q4/2013



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 7.9
Household debt in selected European countries 2003-2013



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

in krónur are broadly unchanged. Despite debt restructuring and write-offs, Iceland's ratio of corporate debt to GDP still remains high in international comparison (Chart 7.6). Non-performing loan ratios have declined, and the bankruptcy rate had fallen to 2.6% by 2013.

Household balance sheets

As in most Western countries, growth in household debt in Iceland exceeded GDP growth during the first decade of the 21st century (Chart 7.9). Household debt as a share of GDP grew rapidly between 2004 and 2007, as credit became more accessible, real lending rates dropped, loan duration increased and debt service fell. The rise in debt was driven by low unemployment and expectations of a continued increase in real disposable income and asset prices.

By 2008, Icelandic households ranked among the most indebted in the world, surpassed only by Denmark. In the wake of such large-scale debt accumulation, household balance sheets sustained severe damage from the collapse of the banking system and the króna in 2008 and the resulting surge in inflation, as 90% of household debt was either inflation-indexed or foreign-dominated. Debt as a share of GDP peaked at 133% in mid-2009. Research on households' position in the financial crisis in Iceland indicates that the share of indebted households in financial distress grew from 12½% in early 2007 to 23½% on the eve of the banks' collapse, and is estimated to have peaked at 27½% in autumn 2009, before declining to 20% at year-end 2010.² Debt restructuring and write-offs due to Supreme Court judgments on the illegality of exchange rate-linked loans have reduced Iceland's household indebtedness, which had fallen to 105% of

2. See Thorvardur Tjörvi Ólafsson and Karen Áslaug Vignisdóttir (2012), "Households' position in the financial crisis in Iceland". Central Bank of Iceland *Working Paper*, no. 59.

GDP as of year-end 2013, or by nearly 30% of GDP from its peak. This is a dramatic change in comparison with other countries with high household debt levels. Of the countries included in Chart 7.9, the household debt-to-GDP ratio has also fallen in two other countries: Ireland and the UK. As the Icelandic Government's debt relief package (see Box 7.1) will reduce the principal of indexed household loans, the household debt ratio should continue to fall in coming years.

Households' financial position has improved considerably since 2011. Real disposable income has increased and the recovery of the labour market has been strong. Households' equity position has also improved. According to figures from Statistics Iceland, total household assets, financial assets, real estate, and motor vehicles measured around 400% of GDP at year-end 2012, up by nearly 23 percentage points since 2010 (Chart 7.5). Furthermore, households' equity ratio – i.e., the ratio of net assets to total assets – was about 72% at year-end 2012 and had risen by some 6 percentage points from the 2010 trough. Rising real estate prices have also strengthened households' equity position, as real house prices had risen by 11.4% between Q4/2010, when they bottomed out, and the end of Q2/2014. The reduction in household debt has also reduced debt service. Furthermore, as a result of the Government's debt relief measures, scheduled to take effect in late 2014, households' financial position is expected to strengthen still further.

Box 7.1

The 2014 debt relief measures

In accordance with the current Government's policy statement and a Parliamentary resolution from June 2013, the Government enacted a general debt relief programme in 2014, aimed at households that had indexed mortgage debt during a period of elevated inflation. The programme is in two parts: a direct reduction of households' indexed mortgages, and tax-free withdrawals of third-pillar pension savings used to pay down mortgage debt. As of 1 September 2014, a total of 69,000 households applied for a write-down of mortgage debt, and 27,500 opted to use part of their future pension savings to pay down their mortgages.

Mortgage write-down

The mortgage write-down is intended for households that held inflation-linked mortgages in 2007-2010. The write-down will be based on the difference between the accumulated effects of indexation on the loan and similarly calculated effects, using a new, lower index value. Mortgage write-downs per household according to this method will be subject to a maximum of 4 m.kr. Previous reductions of principal will be deducted, including write-downs from relief measures such as the 110% option, special mortgage interest subsidies, debt mitigation, and problem debt restructuring measures.

Pre-payment through third-pillar pension savings

The second part is an optional channelling of third-pillar pension savings into prepayments of mortgages. It is permissible to allocate up to 4% of wages, plus a 2% matching contribution, tax-free to the reduction of mortgage principal from July 2014 through June 2017. The annual tax-free threshold will be limited to 500,000 kr. per individual and 750,000 kr. per couple. Those who do not own property during the period in question are permitted to use their third-pillar pension savings, subject to the same maximum amount, to purchase property no later than 30 June 2019.

The scope of the measures

The reduction of indexed mortgage principal could total 72 b.kr. over four years, with the final amount depending on the number of applications, and prepayment of mortgages with tax-free pension savings could amount to another 70 b.kr. According to an assessment of the economic impact of these measures, an increase in private consumption and domestic demand will most likely accompany them because households' financial position will improve. To a degree, the increase in demand will be directed at imports, dampening the impact on GDP growth. Increased demand, together with negative effects on the trade surplus, will cause inflation to rise higher than it otherwise would in the next few years.¹

1. See Appendix 2 in *Monetary Bulletin* 2014/1.

8 Appendix

Table A1 Economic development¹

	2013		2013
Population size at year-end (thousands)	321.9	Labour force participation rate, males (%) ²	84.2
<i>Average annual population growth (%)</i>		Labour force participation rate, females (%) ²	78.5
in last 10 yrs.	1.1	Rate of unemployment (% of labour force) ²	5.4
in last 20 yrs.	1.0	Infant mortality (% of 1,000 live births)	0.9
in last 30 yrs.	1.0	Life expectancy (males)	80.8
GDP in ISK billions	1,786	Life expectancy (females)	83.7
GDP in EUR billions	11.0	Live births per 1,000 inhabitants	13.4
GDP in USD billions	14.6	Energy consumption per 100,000 inhabitants (PJ) (2012)	73.6
GDP/capita in EUR thousands	34.0	Physicians per 1,000 inhabitants (2012)	3.6
GDP/capita in USD thousands in terms of PPP	40.0	Passenger cars per 1,000 inhabitants (2012)	655.0
Rank among OECD countries	11.0	Access to Internet (% of population)	96.5
<i>Average annual growth rate of GDP (%)</i>		Exports as a share of GDP	57.5
in last 10 yrs.	2.1	International investment position at year-end as a share of GDP	-426.8
in last 20 yrs.	2.5	Government revenue as a share of GDP	44.2
in last 30 yrs.	2.4	Government expenditures as a share of GDP	46.3
<i>Average annual inflation rate (%)</i>		General government gross debt as a share of GDP	89.8
in last 10 yrs.	6.1		
in last 20 yrs.	4.6		
in last 30 yrs.	8.7		

1. Data refer to 2013 unless otherwise indicated.

2. Age 16-64.

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

Table A2 Structure of the economy

A Components of GDP	At current prices (EUR millions)			% of GDP			Average volume change (%)	
	1990	2000	2013	1990	2000	2013	1973-2013	1993-2013
Private consumption	2,990	5,708	5,896	59.8	60.6	53.6	2.4	2.2
Public consumption	996	2,206	2,803	19.9	23.4	25.5	3.6	2.5
Gross capital formation	973	2,154	1,498	19.5	22.9	13.6	0.7	1.3
National expenditure	4,934	10,102	10,187	98.7	107.3	92.6	2.3	2.1
Exports of goods and services	1,682	3,162	6,329	33.6	33.6	57.5	3.9	4.3
Imports of goods and services	1,617	3,847	5,515	32.3	40.9	50.1	2.5	3.2
GDP	5,000	9,416	11,000	100.0	100.0	100.0	2.9	2.7
Current account balance	-104	-956	452	-2.1	-10.2	4.1	.	.

B GDP by sector	% of GDP				
	1997	2000	2007	2009	2013
Agriculture, forestry and fishing	9.6	8.4	5.3	7.2	8.0
Mining and quarrying	0.2	0.1	0.1	0.1	0.1
Manufacturing	15.8	13.0	10.3	13.3	12.6
Electricity, gas, steam and air conditioning supply	3.6	3.2	3.2	4.5	5.3
Water supply; sewerage, waste management and remediation activities	0.6	0.6	0.9	1.0	1.1
Construction	8.8	9.3	11.6	5.2	5.0
Wholesale and retail trade; repair of motor vehicles and motorcycles	11.6	11.2	10.5	9.5	8.9
Transportation and storage	6.1	5.9	5.5	5.7	5.2
Accommodation and food service activities	1.6	1.9	1.8	2.0	2.6
Information and communication	5.1	5.6	4.5	4.1	4.1
Financial and insurance activities	4.6	6.0	6.4	5.4	6.4
Real estate activities	7.1	7.4	10.3	10.9	10.3
Professional, scientific and technical activities	3.2	3.8	4.3	4.3	3.9
Administrative and support service activities	1.8	2.1	2.4	2.8	3.7
Public administration and defence; compulsory social security	4.9	5.8	5.3	7.8	8.9
Education	5.1	5.2	5.5	5	4.3
Human health and social work activities	7.9	8.3	9.3	8.1	6.8
Arts, entertainment and recreation	0.9	0.9	1.2	1.4	1.1
Other services activities	1.3	1.3	1.5	1.7	1.5
Activities of households as employers; undifferentiated goods- and services-producing activities of households for own use	0.1	0.1	0.1	0.1	0.1
Activities of extra-territorial organisations and bodies	0.0	0.0	0.1	0.0	0.1
Total	100.0	100.0	100.0	100.0	100.0

Table A2 (continued) Structure of the economy

C Breakdown of employment by industry	Thous.	Percentage breakdown ¹						
	man-years	1963	1970	1980	1990	1997	2000 ¹	2013 ¹
Agriculture	5,207	13.4	12.4	7.9	4.9	4.0	2.8	3.0
Fisheries	6,115	6.6	6.4	5.3	5.7	4.7	4.0	3.1
Fish processing	7,598	9.7	7.8	9.1	6.1	5.9	4.3	2.3
Manufacturing industry	15,282	15.6	15.2	15.2	12.5	11.9	12.1	9.1
Construction, electricity and water	11,638	11.1	11.4	11.0	10.8	9.0	8.0	6.9
Wholesale & retail trade, restaurants & hotels	20,118	13.7	13.5	13.4	14.5	15.6	17.8	18.3
Transport, storage and communication	8,817	9.6	8.5	7.3	6.7	6.8	7.3	6.8
Finance, insurance, real estate, business services	11,537	2.7	4.0	5.4	8.1	9.0	11.3	15.7
Producers of government services	25,300	9.5	12.4	15.7	18.2	19.6	6.8	4.2
Other services	9,202	7.0	6.9	7.2	7.4	7.1	5.9	7.4
Other	8,018	1.0	1.4	2.4	4.9	6.2	19.6	23.3
Total employment ²	128,832	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1. Figures for the period 1963-1997 show number of man-years by industry. Since 2000, data have been compiled from PAYE returns and show number of employed persons by industry. 2. Unemployed are not included.

Sources: Statistics Iceland, Central Bank of Iceland.

Table A3 Structure of foreign trade

A Exports and imports by basic category 1990-2013

	At current prices (EUR millions)				% of total exports or imports			
	1990	1995	2000	2013	1990	1995	2000	2013
Exports of goods and services	1,684	1,925	3,161	6,326	100.0	100.0	100.0	100.0
Imports of goods and services	1,615	1,728	3,837	5,515	100.0	100.0	100.0	100.0
Merchandise exports (fob value)	1,247	1,392	2,056	3,761	74.0	72.3	65.0	59.4
Marine products	941	1,001	1,301	1,678	55.9	52.0	41.2	26.5
Manufacturing goods	255	298	643	1,904	15.1	15.5	20.3	30.1
Other goods	51	92	112	179	3.0	4.8	3.5	2.8
Merchandise imports (fob value)	1,180	1,233	2,572	3,334	73.1	71.3	67.0	60.5
Consumption goods	.	418	817	422	.	24.2	21.3	7.7
Capital goods	.	321	795	312	.	18.6	20.7	5.7
Industrial supplies	.	493	960	2,600	.	28.6	25.0	47.1
Services exports	437	533	1,105	2,565	26.0	27.7	35.0	40.6
Transportation	174	207	533	1,176	10.3	10.8	16.9	18.6
Travel	119	143	247	793	7.0	7.4	7.8	12.5
Other services	145	183	324	596	8.6	9.5	10.3	9.4
Services imports	435	495	1,265	2,181	26.9	28.7	33.0	39.5
Transportation	132	160	450	654	8.2	9.2	11.7	11.9
Travel	224	217	511	635	13.9	12.6	13.3	11.5
Other services	79	118	304	893	4.9	6.8	7.9	16.2

Sources: Statistics Iceland, Central Bank of Iceland.

B Merchandise exports by commodity group (fob value) 1990-2013

	At current prices (EUR millions)				% of total exports or imports			
	1990	1995	2000	2013	1990	1995	2000	2013
Total merchandise exports	1,247	1,392	2,056	3,761	100.0	100.0	100.0	100.0
Marine products	941	1,001	1,301	1,678	75.5	71.9	63.3	44.6
Salted and/or dried fish	177	161	280	197	14.2	11.6	13.6	5.2
Fresh fish	161	81	151	299	12.9	5.9	7.3	8.0
Whole-frozen fish	70	149	130	317	5.6	10.7	6.3	8.4
Frozen fish fillets	349	278	376	347	28.0	20.0	18.3	9.2
Frozen shrimp	60	184	137	57	4.8	13.2	6.7	1.5
Fish meal	42	56	128	164	3.4	4.0	6.2	4.4
Fish oil	14	29	26	102	1.1	2.1	1.3	2.7
Other marine products	67	63	73	196	5.4	4.6	3.5	5.2
Agricultural products	24	25	35	81	1.9	1.8	1.7	2.2
Manufacturing products	255	298	643	1,904	20.4	21.4	31.3	50.6
Aluminium	129	147	381	1,326	10.4	10.6	18.6	35.3
Ferrosilicon	33	38	53	123	2.6	2.8	2.6	3.3
Other manufacturing products	93	113	0	455	7.4	8.1	0.0	12.1
Other products	27	68	76	98	2.2	4.9	3.7	2.6
Ships and aircraft	16	49	43	21	1.3	3.5	2.1	0.6
Other products	11	19	33	77	0.9	1.3	1.6	2.0

Sources: Statistics Iceland, Central Bank of Iceland.

Table A3 (continued) Structure of foreign trade

C Merchandise imports by economic category (fob value) 1990-2013

	At current prices (EUR millions)				% of total merchandise exports			
	1990	1995	2000	2013	1990	1995	2000	2013
Total merchandise imports	1,186	1,236	2,579	3,513	100.0	100.0	100.0	100.0
Food and beverages	90	123	207	327	7.6	10.0	8.0	9.3
Primary, mainly for industry	4	29	64	16	0.4	2.4	2.5	0.4
Primary, mainly for household consumption	25	16	21	84	2.1	1.3	0.8	2.4
Processed, mainly for industry	10	11	12	46	0.8	0.9	0.5	1.3
Processed, mainly for household consumption	52	67	110	181	4.4	5.4	4.3	5.2
Industrial supplies not elsewhere specified	311	344	597	993	26.2	27.9	23.2	28.3
Primary	12	14	28	42	1.0	1.2	1.1	1.2
Processed	299	330	569	950	25.2	26.7	22.1	27.1
Fuels and lubricants	117	87	238	681	9.9	7.1	9.2	19.4
Primary	3	3	6	16	0.2	0.3	0.3	0.4
Motor spirits	25	18	50	100	2.1	1.4	1.9	2.8
Other	89	66	182	565	7.5	5.4	7.1	16.1
Capital goods (except transport)	219	264	611	765	18.5	21.3	23.7	21.8
Capital goods (except transport)	136	169	417	367	11.5	13.7	16.2	10.4
Parts and accessories	83	94	193	398	7.0	7.6	7.5	11.3
Transport equipment	218	154	440	292	18.4	12.4	17.0	8.3
Passenger motor cars (excl. busses)	42	55	168	111	3.5	4.4	6.5	3.2
Transport equipment (excl. ships, aircraft)	24	17	67	38	2.1	1.4	2.6	1.1
Other, non-industrial	3	3	6	8	0.3	0.2	0.2	0.2
Parts and accessories	36	35	63	83	3.1	2.8	2.5	2.4
Ships	19	35	80	22	1.6	2.9	3.1	0.6
Aircraft	94	10	54	29	7.9	0.8	2.1	0.8
Consumer goods not elsewhere specified	229	261	484	450	19.3	21.1	18.8	12.8
Durable	51	54	117	84	4.3	4.3	4.5	2.4
Semi-durable	92	104	189	170	7.7	8.4	7.3	4.8
Non-durable	85	103	178	196	7.2	8.4	6.9	5.6
Goods not elsewhere specified	2	3	3	5	0.2	0.2	0.1	0.1

Sources: Statistics Iceland, Central Bank of Iceland.

Table A3 (continued) Structure of foreign trade

D Geographic distribution of foreign trade (fob value) 1970-2013¹

<i>Merchandise exports</i>	<i>Share of total</i>					<i>EUR millions</i>
	1970	1980	1990	2000	2013	2013
European Union	52.8	52.3	70.7	67.4	74.4	2,794.0
Euro area	25.4	30.2	37.6	42.3	57.4	2,153.5
Other EU countries	27.4	22.0	33.1	25.1	17.0	640.5
United Kingdom	13.2	16.5	25.3	19.3	9.5	356.5
Other Western European countries	2.8	2.3	3.4	7.8	5.8	219.0
Eastern Europe and former Soviet Union	9.6	8.8	2.9	1.4	9.4	353.4
Russia	6.8	5.4	2.5	0.4	3.4	126.5
United States	30.0	21.6	9.9	12.2	4.7	176.5
Japan	0.1	1.5	6.0	5.2	1.9	70.5
Other OECD countries	0.5	0.6	0.5	2.0	1.8	67.4
Developing countries	4.2	12.9	5.5	3.0	12.3	461.7
Other countries	0.0	0.0	1.1	1.0	2.5	92.3
Total	100.0	100.0	100.0	100.0	100.0	3,761.5
<i>Merchandise imports</i>						
European Union	64.9	58.0	59.9	57.0	45.3	1,605.4
Euro area	32.0	33.2	35.5	33.5	25.9	883.4
Other EU countries	33.0	24.8	24.4	23.6	19.4	721.9
United Kingdom	14.3	9.5	8.1	9.0	4.7	168.0
Other Western European countries	5.4	8.1	5.2	9.7	16.6	624.5
Eastern Europe and former Soviet Union	10.4	10.9	6.5	5.7	5.7	213.2
Russia	7.2	9.7	5.0	1.8	0.7	25.4
United States	8.2	9.4	14.4	11.0	9.9	357.4
Japan	2.9	4.0	5.6	4.9	1.5	52.3
Other OECD countries	0.4	5.8	3.7	4.5	2.7	102.9
Developing countries	7.2	2.7	3.1	5.6	22.9	862.0
Other countries	0.6	1.1	1.4	1.5	2.7	99.9
Total	100.0	100.0	100.0	100.0	100.0	3,593.4

1. In data prior to 2000, country groups are based on the year 2000.

Sources: Statistics Iceland, Central Bank of Iceland.

Table A4 National accounts overview

	At current prices (EUR millions)					Volume change year-on-year (%)				
	2009	2010	2011	2012	2013	2009	2010	2011	2012	2013
Private consumption	4,425	4,885	5,234	5,680	5,896	-15.0	0.1	2.6	2.4	1.2
Public consumption	2,299	2,462	2,562	2,678	2,803	-1.8	-3.4	-0.3	-1.4	1.3
Gross fixed capital formation	1,199	1,203	1,419	1,542	1,498	-51.4	-9.2	14.1	5.4	-3.5
Industries	679	731	957	1,054	948	-55.8	-1.5	28.0	8.2	-10.2
Housing	232	220	248	279	313	-55.6	-18.2	5.6	6.8	33.6
Public works and buildings	288	253	214	208	237	-29.9	-21.8	-18.4	-23.7	34.9
National expenditure	7,923	8,551	9,214	9,899	10,197	-20.4	-2.6	4.1	1.7	0.1
Exports of goods and services	4,586	5,348	5,959	6,280	6,329	7.1	0.5	3.7	3.9	5.3
Exports of goods	2,901	3,466	3,842	3,938	3,761	2.4	-2.0	1.3	3.1	2.8
Exports of services	1,685	1,882	2,117	2,342	2,567	18.4	5.0	8.3	5.3	9.6
Imports of goods and services	3,837	4,390	5,115	5,634	5,515	-24.0	4.6	6.6	4.8	-0.1
Imports of goods	2,378	2,723	3,240	3,457	3,334	-27.3	1.8	5.6	1.3	-1.0
Imports of services	1,460	1,667	1,875	2,176	2,182	-17.0	8.8	8.6	10.5	1.4
Gross domestic prod. (GDP)	8,675	9,488	10,088	10,573	11,000	-6.6	-4.1	2.7	1.5	3.3
Current account balance	-996	-760	-640	-563	431	.	.	.	.	.
Current acc. balance, % of GDP	.	.	.	.	.	-11.5	-8.0	-6.3	-5.3	3.9

Source: Statistics Iceland.

Table A5 Financial sector indicators

<i>Financial institutions (number, unless otherwise indicated)</i>	2000	2005	2009	2013
Commercial banks	4	4	5	4
Savings banks	25	24	10	8
Number of employees in commercial banks and savings banks, year-end ¹	3,046	3,884	3,541	...
Total assets of commercial and savings banks (EUR billions) ¹	10	52	18	19
Credit undertakings	12	11	8	6
Undertakings engaged in securities	11	11	10	10
Pension funds	56	45	33	27
Insurance companies	12	12	10	13
<i>Financial markets</i>				
Listed companies on Iceland Stock Exchange (ICEX), now OMXI	75.0	24.0	8.0	14.0
Market capitalisation of listed companies at end of period (EUR billions)	5.0	24.3	0.9	3.6
Market capitalisation of listed companies at end of period (% of GDP)	59.0	182.3	12.5	30.0
Annual turnover in listed equities (EUR billions)	2.7	15.2	0.1	1.6
Annual turnover in listed bonds (EUR billions)	4.6	16.7	17.9	11.5
Annual turnover on the Icelandic interbank market for foreign exchange (EUR billions)	10.6	26.3	0.3	1.1
Annual turnover on the interbank currency swap market (EUR billions)	.	0.6	0.0	0.0
Annual turnover on the interbank market for krónur (EUR billions)	7.2	20.0	2.5	2.4

1. Parent company basis.

Sources: Financial Supervisory Authority, OMX Nordic Exchange Iceland, Central Bank of Iceland.

Table A6 Government sector indicators

General government revenues and expenditures

<i>% of GDP</i>	2007	2008	2009	2010	2011	2012	2013
Revenue	47.7	44.1	41.0	41.5	41.8	43.6	44.2
Taxes	40.5	36.6	33.8	35.0	35.9	36.8	37.1
on income and wealth	21.6	20.6	19.1	20.0	20.9	21.0	21.5
on production/imports/consumption	19.0	16.0	14.7	15.0	15.0	15.7	15.7
Interest	2.3	3.3	3.1	2.1	1.5	1.5	1.4
Sales of goods and services	3.1	3.2	3.1	3.2	3.1	3.4	3.4
Other income	1.7	0.9	1.0	1.2	1.3	1.9	2.3
Expenditure	42.2	57.7	50.9	51.5	47.4	47.4	46.2
Wages	14.8	14.6	15.0	14.8	14.5	14.8	14.9
Purchases of goods and services	10.8	11.6	12.5	12.2	11.8	11.8	11.8
Interest	2.6	3.3	6.6	5.5	5.2	5.6	5.3
Subsidies	1.8	1.8	1.9	1.8	1.8	1.8	1.8
Current transfers	6.3	6.7	8.9	8.6	9.2	8.6	8.2
Fixed investment	4.2	4.5	3.5	2.9	1.8	2.0	2.2
Capital transfers	0.6	13.7	1.2	4.6	1.8	1.5	0.8
Other	1.2	1.4	1.4	1.2	1.3	1.3	1.2
Memorandum item: Public consumption	5.4	-13.5	-9.9	-10.1	-5.6	-3.8	-2.1

*Government expenditure by function**General government, % of GDP*

Administration, safety, defence ¹	4.3	4.6	4.8	4.7	4.7	4.9	...
Education	8.1	8.4	8.6	8.3	8.1	8.0	...
Health services	7.9	7.9	8.3	7.9	7.6	7.7	...
Social security	8.5	8.9	11.3	11.2	11.7	11.1	...
Other social affairs ²	4.9	5.0	4.9	6.8	4.2	5.1	...
Economic services	5.8	19.5	6.3	7.0	5.9	4.9	...
Interest expenditure	2.7	3.5	6.8	5.6	5.3	5.7	...

Central government, % of GDP

Expenditure	30.8	45.2	38.1	40.0	36.1	35.4	...
Administration, safety, defence ¹	4.3	4.5	4.7	4.6	4.7	4.9	...
Education	3.3	3.4	3.5	3.5	3.2	3.3	...
Health services	7.7	7.7	8.5	8.0	7.7	7.8	...
Social protection	7.3	7.1	8.2	8.9	9.2	8.1	...
Other social affairs ²	1.8	1.7	1.8	3.8	1.6	2.3	...
Economic services	4.3	18.0	5.2	6.2	5.0	4.0	...
Interest expenditure	2.1	2.8	6.1	5.0	4.6	5.1	...

Local government, % of GDP

Expenditure	13.5	13.9	13.6	13.4	13.5	13.7	...
Administration and safety	1.0	1.1	1.0	1.1	1.1	1.2	...
Education	4.9	4.9	5.0	4.9	4.9	4.7	...
Health services	0.1	0.1	0.1	0.1	0.1	0.1	...
Social protection	2.1	2.2	2.5	2.6	3.1	3.2	...
Other social affairs ²	3.2	3.3	3.1	3.1	2.7	2.8	...
Economic services	1.6	1.6	1.2	1.0	0.9	1.2	...
Interest expenditure	0.6	0.7	0.7	0.6	0.6	0.6	...

1. Excluding interest expense. 2. Culture, religion, recreation, housing and community affairs, environment protection.

Source: Statistics Iceland.

Table A7 Balance of payments

<i>EUR millions</i>	1995	2000	2005	2008	2013 ¹
Current account	12	-998	-2,135	-2,767	650
Goods	138	-637	-1,439	-516	51
Goods exports	1,393	1,977	2,327	3,158	3,455
Goods imports	1,255	2,614	3,767	3,675	3,404
Services	52	-36	-156	262	910
Services exports	533	1,162	1,793	1,847	2,973
Services imports	481	1,199	1,949	1,585	2,062
Primary income	-174	-310	-543	-2,486	-213
Receipts of primary income	44	117	1,157	1,068	741
Expenditures of primary income	218	427	1,699	3,554	954
Secondary income - Balance on secondary income	-3	-15	3	-26	-98
Receipts of secondary income	17	17	57	67	55
Expenditures of secondary income	20	32	54	93	154
Capital account	-3	-3	-5	-8	-8
Receipts	0	0	0	0	0
Expenditures	3	3	5	8	8
Financial account ²	-28	-1,162	-1,816	-9,060	954
Assets	27	1,058	18,323	-3,779	707
Direct investment	19	427	5,715	-2,904	460
Portfolio investment	49	599	3,773	-3,384	953
Financial derivatives, net	.	.	.	1	3
Other investment	-45	112	8,776	1,720	-716
Reserve assets	3	-79	60	789	7
Liabilities	54	2,220	20,140	5,281	-247
Direct investment	-7	185	2,483	633	349
Portfolio investment	169	1,288	13,599	37	97
Other investment	-107	747	4,057	4,611	-692
Net errors and omissions	0	-161	324	-6,285	312

1. Preliminary figures. 2. Positive number represents inflow of capital due to foreign borrowing or decrease in assets. Negative number accounts for outflow of capital, debt repayment, or increase in assets.

Source: Central Bank of Iceland.

Table A8 Projected external debt service¹

<i>EUR millions</i>	2014	2015	2016	2017	2018	2019	<i>Principal thereafter</i>	<i>Total</i>
Government								
Principal	742	444	984	12	0	12	1,517	3,712
Interest ²	63	124	85	65	64	64	.	.
Total	805	568	1,069	77	64	76	.	.
Monetary Authorities & Treasury								
Principal	738	404	984	12	0	12	1,517	3,668
Interest ²	62	122	85	65	64	64	.	.
Total	801	527	1,069	77	64	76	.	.
Local government								
Principal	3	40	0	0	0	0	0	43
Interest ²	1	1	0	0	0	0	.	.
Total	4	41	0	0	0	0	.	.
Banks								
Principal	1	3	164	90	3	0	0	262
Interest ²	6	11	6	4	0	0	.	.
Total	7	14	170	94	3	0	.	.
Other credit institutions								
Principal	20	38	42	35	28	5	26	193
Interest ²	1	2	1	1	0	0	.	.
Total	20	40	43	35	28	5	.	.
Other sectors								
Principal	804	429	362	389	330	307	1,163	3,783
Interest ²	24	39	30	27	25	22	.	.
Total	827	468	392	416	355	329	.	.
Grand total								
Principal	1,566	914	1,552	526	361	324	2,707	7,949
Interest ²	93	176	123	97	90	86	.	.
Total	1,659	1,090	1,674	623	450	410	.	.

1. Based on debt outstanding at end of July 2014. 2. Floating interest rate is assumed according to latest market rates available.

Source: Central Bank of Iceland.