I. ECONOMIC ENVIRONMENT

(1) MAJOR FEATURES OF THE ECONOMY

1. Iceland is a developed economy situated in the north Atlantic with a current GDP per capita of approximately US$44,000. The economy is dominated by services, followed by fishing and aluminium manufacturing. The latter two were responsible for over 80% of Iceland's merchandise exports in 2010. Iceland's economy registered robust growth between 2003-07, with real GDP expanding by a cumulative 28% or an annual average of nearly 6%. Growth was driven by private consumption and large investments in the power-intensive industries, which in turn were underpinned by strong growth of disposable income, easy access to credit and sharp increases in asset values. However, the growth also resulted in large external imbalances, with net external debt (public and private) reaching 110% of GDP, gross international liabilities of 625% of GDP, a high current account deficit, and an appreciating currency. The global financial crisis in 2008 brought these issues to a head. Iceland was one of the countries worst affected by the crisis as the banking system collapsed (Chapter IV(4)(i)) and the country went into deep recession. Real GDP contracted by 6.8% and 4% in 2009 and 2010, respectively, with private consumption, public consumption, and gross fixed investment contracting markedly (Table I.1). However, despite the crisis, Iceland did not introduce protectionist measures. Indeed, the recovery from the crises has been export led, with total merchandise trade as a proportion of GDP rising from 47% in 2005 to 70% in 2011, partly due to increased competitiveness, due, in turn, to the depreciation of the krona.

Table I.1
Selected macroeconomic indicators, 2005-11

	2005	2006	2007	2008	2009	2010	2011[a]
Real GDP (ISK billion, 2005 prices)	1,025.7	1,074.0	1,138.3	1,152.8	1,074.3	1,031.1	1,062.5
Real GDP (US$ billion, 2005 prices)	31.8	28.6	31.3	22.8	16.2	16.4	17.3
Current GDP (ISK billion)	1,025.7	1,168.6	1,308.5	1,482.0	1,495.4	1,534.2	1,630.2
Current GDP (US$ billion)	16.3	16.7	20.4	16.9	12.1	12.6	14.1
GDP per capita at current market price (US$)	55,155.0	55,031.0	65,642.0	52,689.0	37,899.0	39,532.0	44,025.0
National accounts	*(% change based on constant figures, unless otherwise indicated)*						
Real GDP (2005 prices)	7.2	4.7	6.0	1.3	-6.8	-4.0	3.1
Consumption	9.9	3.7	5.2	-4.3	-10.7	-1.5	2.4
Private consumption expenditure	12.7	3.6	5.7	-7.9	-14.9	-0.4	4.0
Government consumption expenditure	3.5	4.0	4.1	4.6	-1.7	-3.4	-0.6
Gross fixed capital formation	34.4	24.4	-12.2	-20.0	-51.6	-8.1	13.4
Exports of goods and services	7.5	-4.6	17.7	7.0	6.6	0.4	3.2
Imports of goods and services	29.3	11.3	-1.5	-18.4	-24.0	4.0	6.4
XGS/GDP (%, at current market price)	31.7	32.2	34.6	44.4	52.7	56.1	58.4
MGS/GDP (%, at current market price)	44.0	50.5	45.3	47.1	44.3	46.1	50.2
Unemployment rate (%)	2.6	2.9	2.3	3.0	7.2	7.6	7.1
Prices and interest rates	*(%, unless otherwise indicated)*						
Inflation (CPI, % change)	4.0	6.7	5.1	12.7	12.0	5.4	4.0
Central Bank repo rate (yield, end period)	10.50	14.25	15.25	22.00	-	-	..
Three-month treasury bills	10.00	-	-	-	-	-	..

Table I.1 (cont'd)

	2005	2006	2007	2008	2009	2010	2011[a]
Exchange rate							
ISK/US$ (annual average)	62.98	70.18	64.06	87.95	123.64	122.24	115.95
Nominal effective exchange rate (% change, based on CPI)	10.3	-10.9	2.7	-27.2	-28.1	1.5	0.3
Real effective exchange rate (% change, based on CPI)	12.4	-7.0	5.5	-21.4	-19.2	5.0	1.4
	(% of current GDP, unless otherwise indicated)						
Fiscal policy of general government							
Total revenue	47.1	48.0	47.7	44.1	41.1	41.5	41.7
Tax revenue	37.4	38.1	37.5	33.8	30.8	30.9	31.6
Total expenditure	42.2	41.6	42.3	57.6	51.0	51.6	46.1
Overall balance	4.9	6.3	5.4	-13.5	-10.0	-10.1	-4.4
Government gross debt	24.7	29.1	27.7	65.3	84.7	92.2	96.2
Saving and investment							
Gross national saving	12.2	11.4	13.1	0.2	2.2	4.6	7.2
Gross domestic investment	28.2	35.6	29.0	24.7	13.9	12.6	14.4
Savings-investment gap	-16.0	-24.3	-15.9	-24.5	-11.7	-8.0	-7.1
External sector							
Current account balance	-16.2	-23.8	-15.7	-24.5	-11.7	-8.0	-7.1
Net merchandise trade	-9.1	-13.4	-6.7	-0.4	6.0	7.8	5.9
Merchandise exports	19.0	20.8	23.4	31.5	33.5	36.6	38.0
Merchandise imports	28.1	34.2	30.1	32.0	27.5	28.7	32.0
Services balance	-3.1	-4.1	-3.4	-1.9	2.4	2.2	2.2
Financial account	13.7	34.5	19.3	76.8	-16.6	22.9	6.0
Direct investment	-24.6	-10.2	-16.5	30.4	-18.2	20.7	8.1
Terms of trade (% change)	-0.3	6.8	-0.3	-6.1	-11.1	9.6	..
Merchandise exports							
% change - national currency	-3.7	24.9	25.7	52.6	7.3	12.0	10.3
% change in US$	7.4	12.1	37.7	11.1	-23.7	13.3	16.3
Merchandise imports							
% change - national currency	20.6	38.9	-1.5	20.2	-13.3	7.4	18.4
% change in US$	34.4	24.6	7.9	-12.5	-38.3	8.6	24.8
Service exports							
% change - national currency	12.4	2.5	10.6	28.2	54.5	4.5	10.8
% change in US$	25.2	-8.0	21.2	-6.6	9.9	5.6	16.8
Service imports							
% change - national currency	24.6	11.8	5.5	13.1	17.5	5.9	11.5
% change in US$	38.9	0.4	15.6	-17.6	-16.4	7.1	17.5
International reserves, excl. gold (US$ billion)	1,035.7	2,301.3	2,578.7	3,515.2	3,813.2	5,698.9	8,450.4
Total external debt (US$ billion; end-period)	46.6	74.0	116.0	168.2	122.7	113.4	117.3

.. Not available.

a Estimates.

Source: Statistics Iceland online information. Viewed at: http://www.statice.is. Central Bank of Iceland online information. Viewed at: http://www.sedlabanki.is. IMF online information, *International Financial Statistics Indicators.* Viewed at: http://www.imf.org/external/country/ISL.

2. The authorities' policy choices following the crisis, which included capital controls and fiscal consolidation, including limiting the cost of bank restructuring on public finances, helped the economic recovery. Additionally, funding from the IMF and other Nordic countries helped to shore

up the economy (Chapter IV(4)(i)). Real GDP growth is estimated to be 3.1% in 2011 and 2.4% in 2012.[1] Growth has been driven by exports, private sector consumption, and gross fixed capital formation.[2] Private sector consumption grew due to wage increases, temporary stimulus measures, such as debt relief because of illegal foreign-currency-indexed loans[3] and pre-payments from pension funds, which were allowed after the crisis. Unemployment has also declined marginally.

3. For the near term, the goal is to continue to continue fiscal consolidation and reduce public debt so that public finances are on a sustainable track. Capital controls may also need to be lifted gradually to avoid misallocation of resources. Debt restructuring needs to continue and the large overhang of non-performing loans reduced so that banks can resume their core lending activity.

4. In the longer term, the challenge would be to sustain growth. In this respect the authorities have identified certain sectors where they feel that Iceland has a competitive advantage. These include energy-intensive, land-intensive, and knowledge-based industries, as well as tourism. However, to attract investment in these sectors (both domestic and foreign), investor confidence in Iceland would have to be restored, especially following the banking sector restructuring.

(2) RECENT ECONOMIC DEVELOPMENTS

(i) Macroeconomic indicators

5. Leading up to the global financial crisis in 2008, a number of imbalances had developed in the economy, making Iceland susceptible to exogenous shocks. The private sector was overstretched with both corporations and households being highly leveraged. Furthermore, much of this debt was linked to foreign exchange and indexed to inflation.[4] Iceland was also running a large current account deficit, inflation was high, and the krona had appreciated significantly on the back of large capital inflows. In response, the Central Bank initiated a tightening of monetary policy in 2004. However, this only had a limited impact on domestic demand and inflation. The imbalances led to a significant rise in Iceland's foreign risk premium, which resulted in Icelandic banks being shut out of foreign wholesale funding. The global financial crisis in 2008 exacerbated an already precarious situation, resulting in the collapse of the banking system (Chapter IV(4)(i)(a)). The collapse resulted in an erosion of confidence, causing a sharp fall in asset prices, including the housing market, and a depreciation of the krona by more than 70%, which disrupted external payment systems and hampered trade. Against this backdrop, the Central Bank's objective shifted from inflation targeting to exchange-rate stability.

6. As Iceland did not have enough foreign exchange reserves to rely only on foreign exchange interventions, the Central Bank also tried to stabilize the krona through a combination of tighter monetary policy, liquidity management, and capital controls. Capital controls initiated in late 2008 included:

[1] IMF (2012).

[2] Gross fixed capital formation has been driven by one-off purchases such as airplanes and ships, as well as investment in an aluminium smelter.

[3] Iceland's Supreme Court issued a new ruling on the recalculation of illegal foreign-exchange-indexed loans (according to an earlier ruling, these loans must be recalculated retroactively in krona). Under the new ruling the interest rate charged retroactively on these loans should be the foreign currency interest rate rather than the krona interest rate, even though the loans will be denominated in krona.

[4] OECD (2011). Approximately 80% of the household debt was inflation indexed and 13% was denominated in foreign currencies. About 70% of corporate debt was foreign exchange linked.

- restrictions on capital transactions were imposed on residents and non-residents, which limited their ability to shift between the krona and foreign currencies;

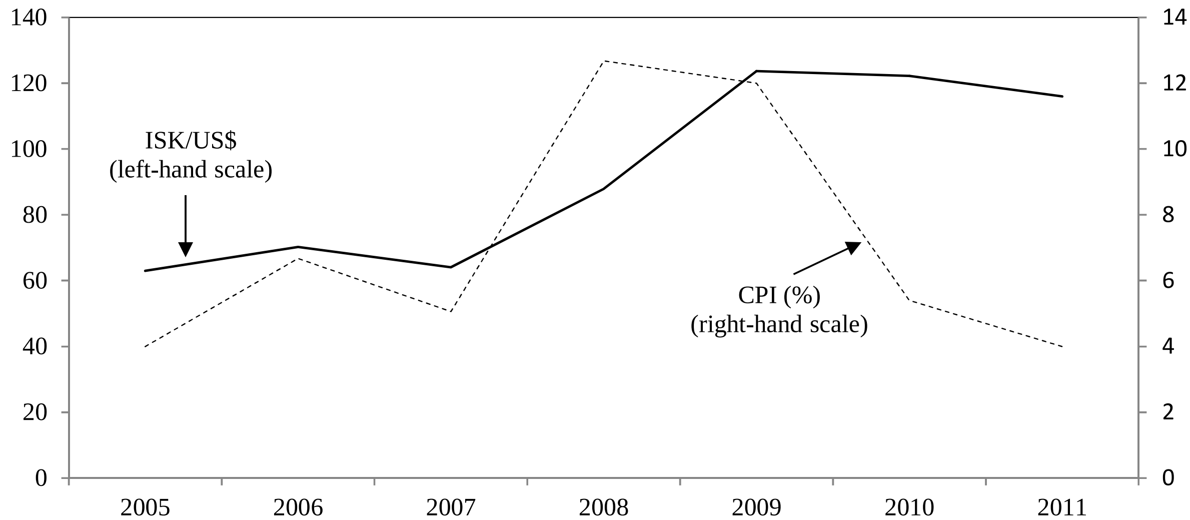
- upon maturity, krona-denominated proceeds of financial instruments were not allowed to be converted to foreign exchange, instead they had to be reinvested in other krona-denominated instruments; and

- residents were required to repatriate all foreign currency they had acquired. However, firms with significant international operations were exempted if they fulfilled certain criteria. Payments pertaining to current account transactions and inward FDI were permitted.

7. In November 2008, the Central Bank tightened monetary policy and raised the policy rate by 6% to 18%.[5] The above measures, coupled with funds from the IMF and Nordic countries, appear to have worked as the exchange rate stabilized and inflation declined sharply (Chart I.1 and Table I.1).

8. In order to stimulate demand in the economy, the Central Bank started to ease monetary policy in 2009, and the policy rate was below 5% by the end of 2010. This easing also facilitated debt restructuring. However, inflation picked up, due to rises in energy, food, and import prices and the Central Bank responded by shifted back to tightening monetary policy. The challenge for monetary policy would be the gradual easing of capital controls while ensuring exchange rate stability and low inflation.

Chart I.1
Exchange rate and inflation, 2005-2011



Source: **IMF, Iceland Country Report No. 12/89. Viewed at: http://www.imf.org/external/country/ISL.**

9. With regard to fiscal policy, Iceland ran a surplus between 2004 and 2007. However, it appears that revenues were "artificially elevated by booming domestic demand, buoyant construction and inflated asset prices, suggesting significantly weaker cyclically adjusted balances."[6] The financial

[5] The Central Bank had cut the interest rate by 3.5% just two weeks earlier.
[6] IMF (2012).

crisis exposed these vulnerabilities and a fiscal surplus of 5.4% of GDP in 2007 turned into a deficit of 13.5% in 2008, mostly due to increased expenditure on account of bank restructuring (Table I.1).

10. In the aftermath of the global financial crisis in 2008, the authorities faced the challenge of putting public finances on a sustainable path through a multi-year fiscal consolidation programme that would protect Iceland's welfare state. The problem was particularly acute as the cost of bank restructuring was considerable (according to initial estimates the cost would be 53% of GDP, this was subsequently reduced to 20%)[7], and pursuing a contractionary fiscal policy ran the risk of deepening the already severe recession.

11. As part of the Standby Arrangement with the IMF, the authorities pursued a supportive fiscal stance initially, in order to reduce the risk of the recession deepening. Since the second half of 2009, fiscal policy has been consolidated and the fiscal deficit was reduced by 9% in 2011 to 4.4% of GDP. The reduction in the fiscal deficit was achieved through adjustments in both revenue and expenditures. All major taxes, including social security contribution, were increased, while expenditure was reduced in many areas, including public administration, education, and healthcare, although social benefits were safeguarded. Despite tighter fiscal policy, public debt as a proportion of GDP rose from approximately 29% in 2007 to nearly 100% in 2011 due mainly to bank recapitalizations.[8]

12. Fiscal consolidation is continuing, albeit at a slower pace than envisaged. There have been expenditure overruns at the central government level. However, on the revenue front, legislation that will increase the fishing levy has recently been passed and is expected to raise US$110-120 million.[9]

(ii) Balance of payments

13. Iceland's current account deficit more than halved between 2005 and 2011, from over 16% of GDP to about 7% (Table I.2 and Chart I.2), reflecting a narrowing of the gap between gross national savings and gross national investment. In 2008, the deficit was nearly 25% of GDP as a result of the interest payments Icelandic banks had to make.

Table I.2
Balance of payments, 2005-11
(ISK million)

	2005	2006	2007	2008	2009	2010	2011
Current account	-165,756	-278,492	-205,921	-363,602	-174,857	-122,750	-116,101
Exports of goods and services	322,957	374,659	451,077	652,839	788,186	861,155	951,410
Imports of goods and services	448,257	579,175	583,061	687,445	661,867	706,883	818,536
Income and transfer, net	-40,456	-73,976	-73,937	-328,996	-301,176	-277,022	-248,975
Balance on goods	-93,100	-156,544	-87,977	-6,666	90,278	120,211	96,905
Merchandise exports fob	194,934	243,461	306,001	466,859	500,854	561,032	618,843
Merchandise imports fob	288,034	400,005	393,978	473,525	410,576	440,821	521,938

Table I.2 (cont'd)

[7] IMF *Country Reports*, 12/89, 12/90, 12/91, 08/367, 08/368 and 09/306. Viewed at: http://www.imf.org/external/country/ISL.
[8] Information provided by the authorities.
[9] Information provided by the authorities.

	2005	2006	2007	2008	2009	2010	2011
Balance on services	-32,200	-47,972	-44,007	-27,940	36,041	34,061	35,969
Exports of services, total	128,023	131,198	145,076	185,980	287,332	300,123	332,567
Transportation	67,748	58,655	64,294	80,821	130,680	145,190	154,101
Travel	26,041	33,803	38,181	53,731	67,709	67,985	81,953
Other receipts	34,234	38,740	42,601	51,428	88,943	86,948	96,513
Imports of services, total	160,223	179,170	189,083	213,920	251,291	266,062	296,598
Transportation	55,525	53,497	56,312	69,425	84,617	76,962	87,510
Travel	61,540	75,477	84,329	91,749	66,281	69,493	85,166
Other expenditures	43,158	50,196	48,442	52,746	100,393	119,607	123,922
Balance on income	-38,742	-71,511	-70,069	-325,508	-292,303	-268,427	-240,492
Receipts	91,131	181,405	284,842	126,614	94,618	59,921	120,739
Compensation of employees	4,639	5,033	1,584	1,458	2,441	2,698	2,456
Dividends and reinvested earnings	65,023	103,261	139,225	-48,876	46,931	27,235	86,843
Interest payments	21,469	73,111	144,033	174,032	45,252	29,988	31,440
Expenditures	129,873	252,916	354,911	452,122	386,927	328,348	361,231
Compensation of employees	1,533	2,728	3,443	2,493	2,260	797	696
Dividends and reinvested earnings	66,606	83,515	69,889	-51,000	71,778	108,254	115,651
Interest payments	61,734	166,673	281,579	500,629	312,889	219,297	244,884
Current transfer, net	-1,714	-2,465	-3,868	-3,488	-8,873	-8,575	-8,483
Capital and financial account	138,829	401,438	250,819	1,137,128	-250,354	350,541	97,276
Capital transfer, net	-1,697	-1,775	-1,900	-1,032	-1,451	-426	-33
Financial account	140,526	403,213	252,719	1,138,160	-248,903	350,967	97,309
Financial account excl. reserves	145,246	488,650	259,414	1,238,839	-218,838	588,945	436,101
Direct investment, net	-252,520	-118,627	-215,298	450,846	-272,748	318,217	132,214
Abroad	-446,548	-388,312	-652,435	370,171	-283,362	288,180	14,734
In Iceland	194,028	269,685	437,137	80,675	10,614	30,037	117,480
Portfolio investment, net	767,684	800,578	-574,534	225,267	1,192,527	1,315,240	-967,312
Assets	-294,985	-204,661	-606,577	431,295	151,468	-6,183	-112,855
Equities	-205,576	-67,382	-289,336	167,868	41,914	115,149	9,381
Debt securities	-89,409	-137,279	-317,241	263,427	109,554	-121,332	-122,236
Liabilities	1,062,669	1,005,239	32,043	-206,028	1,343,995	1,309,057	-854,457
Equities	5,267	81,205	12,543	-161,506	-1,488	-10,645	237
Debt securities	1,057,402	924,034	19,500	-44,522	1,342,507	1,298,412	-854,694
Financial derivatives, net	0	0	0	0	0	0	0
Other investment, net	-369,918	-193,301	1,049,246	562,726	1,246,437	1,585,968	1,271,199
Assets	-686,669	-777,756	1,077,575	-212,986	-117,570	282,287	517,511
Liabilities	316,751	584,455	2,126,821	775,712	1,364,007	1,303,681	753,688
Reserve assets	-4,720	-85,437	-6,695	-100,679	-30,065	-237,978	-338,792
Net errors and omissions	26,927	-122,946	-44,898	-773,526	425,211	-227,791	18,825

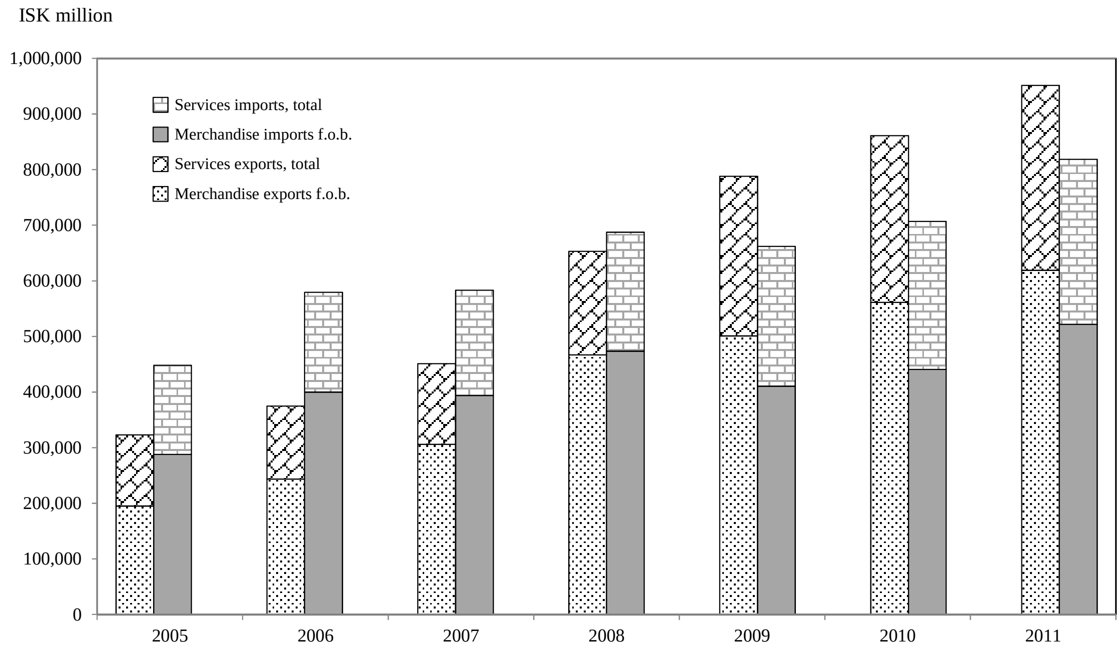
Source: Central Bank of Iceland online information. Viewed at: http://www.sedlabanki.is/?PageID = 548 [28/02/2012] .

14. The reduction in the current account deficit since 2008 is the result of the trade deficit turning into a surplus and, more importantly, interest payments being halved. The latter is due to the reorganization of the banking sector as Icelandic banks stopped making interest payments (Chapter IV(4)). At the same time exports of goods and services have been increasing (both in ISK and volume terms) steadily since 2005. The annual changes in the value of imports have been more volatile, with a sharp reduction in 2009 and relatively low growth since then.

15. The capital and financial account surplus declined from approximately US$2.2 billion in 2005 to US$839 million in 2011 although with considerable year-to-year fluctuations. The surplus peaked at nearly US$13 billion in 2008 before turning into a deficit in 2009. The reason for the surge in the surplus was an increase in net direct investment as well as portfolio investment. In the aftermath of the financial crisis, both direct investment and portfolio investment recorded outflows as investor confidence was eroded. Furthermore, in the case of the latter, bank restructuring resulted in repayment of debt securities.

16. Measures taken by the authorities (particularly capital controls, bilateral loans, and IMF funding) resulted in a rise in foreign exchange reserves, from slightly over US$1 billion in 2005 to nearly US$8.5 billion in 2011, which represents approximately two years of import cover.

Chart I.2
Imports and exports of goods and services, 2005-11



Source: Central Bank of Iceland online information. Viewed at: http://www.sedlabanki.is/?PageID=548.

(3) DEVELOPMENTS IN TRADE AND FOREIGN DIRECT INVESTMENT

17. Iceland's economy has always depended on trade, and trade has increased in importance over the past six years. Following a reduction in imports and exports in 2009, both started to recover in 2010, and exports exceeded their pre-crises level in krona terms in 2011. However, in U.S. dollar terms exports declined. In 2011, the share of merchandise exports in GDP was 38%, double the share in 2005. The share of merchandise imports also increased during the same period, albeit not as much as exports, to 32% of GDP from 28%. Furthermore, the services balance turned from a deficit of 3.1% of GDP to a surplus of 2.2%.

(i) Composition of trade

18. Despite the financial crisis, the composition of Iceland's exports did not change dramatically during the period under review: exports of primary products in total merchandise exports increased

from approximately 80% in 2005 to 85% in 2011 as a result of high prices for fish and aluminium (Chart I.3). Within primary products, the share of agricultural, fish, and food products declined, while the share of aluminium products more than doubled as a new aluminium plant came online in 2008 (Table AI.1). The share of manufactures declined from over 19% in 2005 to 14% in 2011. Within manufactures the decline was due to reduced exports of machinery and transport equipment.

19. The share of primary products in total merchandise imports nearly doubled from 22.6% in 2005 to 41.4% in 2011. Within primary products, both fishing and bauxite for aluminium production registered increases on account of raw material imports for the new aluminium plant (Table AI.2). In contrast, the share of manufacturing in total merchandise imports fell from over 77% in 2005 to 58.4% in 2011. Within manufactures, imports of automotive product declined sharply.

(ii) Direction of trade

20. Iceland's main export destination in 2011 remained the EU27 followed by other EFTA countries and the United States. The shares of the EU27 and EFTA increased during the review period, while the share of the United States halved, and that of Asia as a whole also declined (Chart I.4 and Table AI.3).

21. The EU27 remains Iceland's largest import supplier followed by EFTA and the United States. During the period under review, the EU27 share decreased, as did that of Asia as a whole, while the shares of Brazil and EFTA rose (Table AI.4).

(iii) Foreign direct investment

22. Inward FDI flows were volatile during the period under review. FDI inflows peaked at over ISK 437 billion in 2007 (33% of GDP) up from ISK 193 billion in 2005 (19% of GDP). However, FDI has declined drastically since then and was approximately ISK 30 billion in 2010 (2% of GDP). As a result, the stock of FDI in Iceland was ISK 1,356 billion in 2010 (88% of GDP). The surge in FDI was due to investment in the aluminium and related industries, which accounted for approximately 55% of the FDI stock in 2010. The other major recipients were holding companies, which benefited from the low corporate tax in Iceland. The decline in FDI flows is due mainly to loss of investor confidence after the 2008 financial crisis.

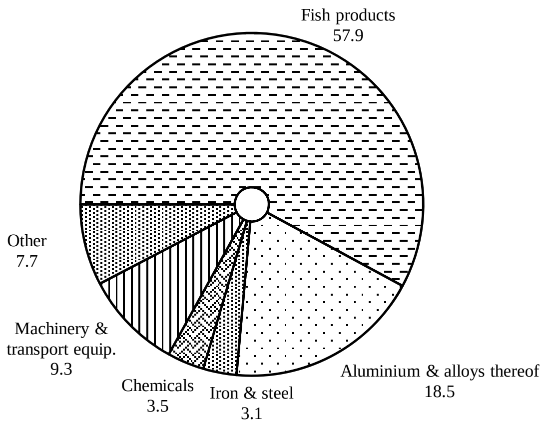
23. The main investor in Iceland is Luxembourg (81% of FDI stock), followed by other Nordic countries (Norway and Denmark), and the Netherlands. Most of the FDI in Iceland takes the form of inter-company loans; and Luxembourg has a large banking industry and a large cross-border fund administration industry.

Chart I.3
Product composition of merchandise trade, 2005 and 2011

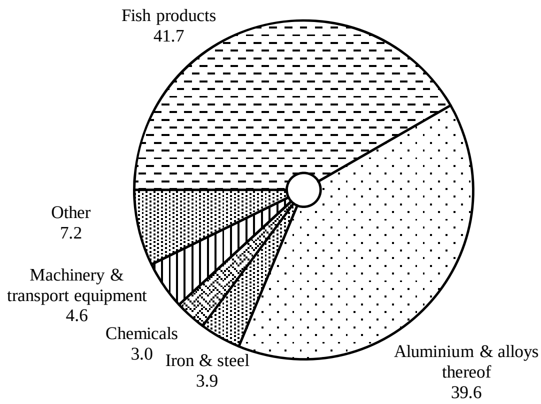
Per cent

2005	2011

(a) Exports (f.o.b.)

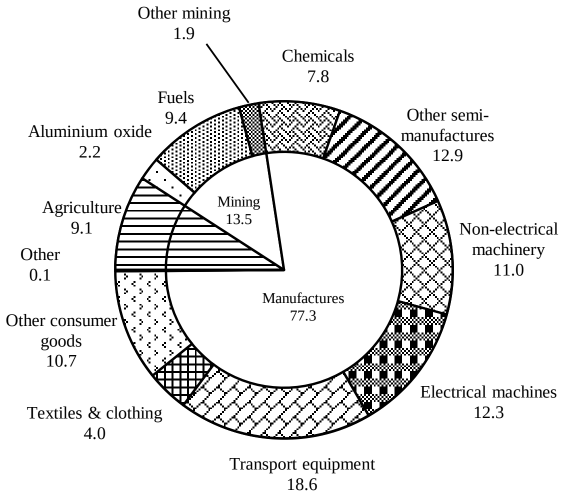


Total: US$3,090.5 million

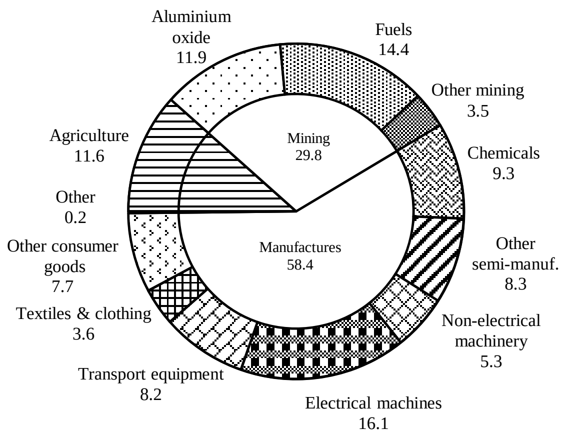


Total: US$5,348.8 million

(b) Imports (c.i.f.)



Total: US$356.8 billion



Total: US$524.4 billion

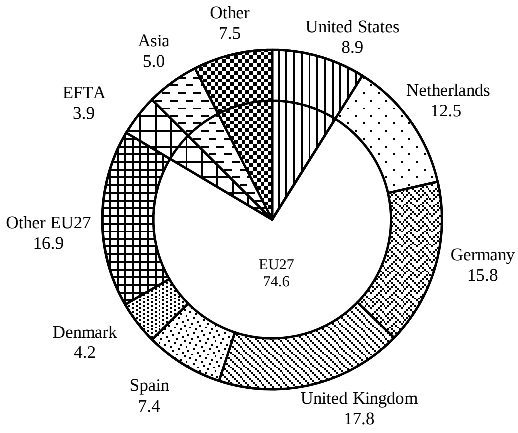
***Source*: UNSD, Comtrade database.**

Chart I.4
Direction of merchandise trade, 2005 and 2011

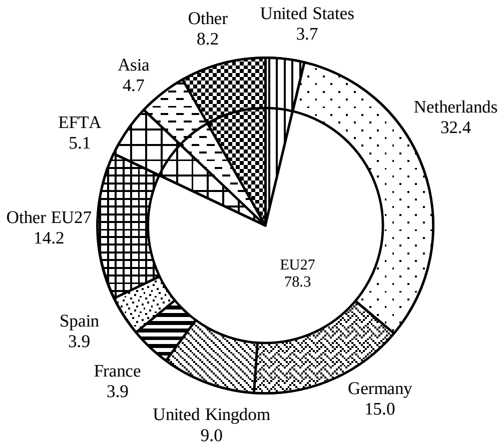
Per cent

2005 **2011**

(a) Exports (f.o.b.)

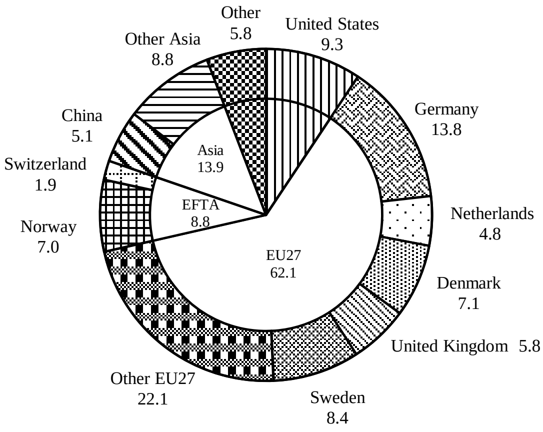


Total: US$3,090.5 million

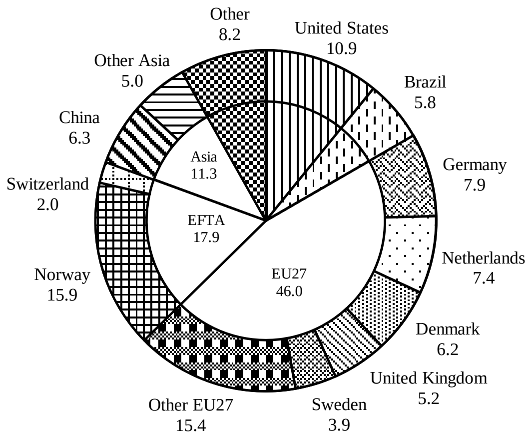


Total: US$5,348.8 million

(b) Imports (c.i.f.)



Total: US$4,978.9 million



Total: US$4,845.8 million

***Source*: UNSD, Comtrade database.**