To Whom It May Concern **August 2009**

REFORMS PROVIDING FOUNDATION FOR ICELAND'S ECONOMIC RECOVERY

- *Following the onset of a severe financial and currency crisis in October 2008, the Icelandic Government is taking comprehensive measures to restructure the economy.*

- *The Economic Recovery Programme prepared and implemented in collaboration with the IMF consists inter alia in restructuring the banking system as well as stabilising the currency.*

- *Following the conclusion of a stability pact with social partners in June 2009, broad national support has been reached for arduous adjustment measures, including a tough fiscal consolidation plan, and labour market uncertainty has been removed.*

- *Iceland intends to fulfil its legal obligations under the EEA Agreement with respect to deposit insurance guarantees and is working constructively with other countries to that end.*

- *Given the steep fall in demand and low exchange rate of the króna as well as difficult financial circumstances in general, the business climate for Icelandic enterprises will be extremely hard in most sectors in the upcoming winter. There is nevertheless determination on their part to safeguard their international commercial relations the best way they can.*

- *The economy is forecast to bottom out in the beginning of 2010 and economic activity is expected to pick up in the second half of 2010. Despite the current crisis, the foundations of Iceland's economy remain strong. This, together with the already agreed economic reform measures, will ensure good, long-term prospects for Iceland.*

Serious Economic Challenges

In the fall of 2008 and in the wake of a global financial crisis, Iceland experienced wide-spread financial difficulties. In early October, Iceland's three largest private banks were taken into government administration due to liquidity problems. At the same time the UK authorities decided unilaterally to freeze the assets of Landsbanki and place the bank, and for a while Iceland's government, alongside terrorist organisations on their list of entities subject to asset freezing. Despite initial difficulties, the Central Bank succeeded in securing largely uninterrupted cross-border payment intermediation with respect to import and export of goods and services.

The Icelandic economy was at the time already on a downward path, but the collapse of the banks and the associated currency crisis have lead to a severe contraction with profound negative implications for the business sector and the population at large. Gross domestic product (GDP) in 2009 is expected to fall by 9% from previous year. Unemployment has escalated to a record level of 9%. The Icelandic króna (ISK) exchange rate has fallen dramatically; in August 2009 the price of Euro in terms of ISK was 105% higher than on average in 2007 and 38% higher than in September 2008. This has hiked up inflation to 18% in the beginning of 2009, while the current rate is 11%. The fiscal balance has deteriorated sharply and external public debt has increased substantially. Action is required to secure a sustainable debt burden.

The sharp adjustment in the economy reflects both the severity of the crisis and the flexibility of the economy. The decline in domestic demand exceeds the drop in output. Private consumption is expected to fall in 2009 by almost a quarter (23½%) and investments by half (48%) on previous year. On top of 18% reduction in 2008, imports are falling by a third this year and a surplus has emerged on the trade balance. This will service the external debt burden and economic growth will be export-led. The ISK exchange rate has stabilised, but is expected to strengthen gradually as reform measures take hold. The business climate for Icelandic enterprises will generally be exceptionally hard in the upcoming winter, but they are determined to safeguard their international commercial relations the best way they can. The economy is forecast to bottom out in 2010 and economic activity is expected to pick up in the second half of 2010.

Economic Recovery Programme
The Icelandic Government is taking comprehensive measures to restructure the economy. This will eventually bring about an improved business climate. Here is a summary of some major steps:

- **Securing banking services**. On 6 October 2008, the Parliament passed an emergency law, allowing the Financial Supervisory Authority to take over the operations of the banks. On the basis of the law, all three banks are now being restructured and the domestic operations are being separated, re-capitalized and will be governmentally owned for some period of time. However, this arrangement will be temporary, as the Government has more recently spelt out its ownership policy implying that non-Icelandic parties, who were the major creditors of the private banks, including large international banks, will be encouraged to acquire holdings in the new banks. This will facilitate access to international credit markets.

- **Agreement with IMF.** On 24 October, the Icelandic Government finalized an Economic Recovery Programme in collaboration with the International Monetary Fund (IMF). On 19 November, the IMF approved Iceland's request for a two-year stand-by arrangement. Iceland will receive a USD 2.1 billion loan from the IMF. Additional loans of up to USD 3 billion have been secured from the other Nordic countries and other trading partners. This will enable Iceland to rebuild its currency reserves and stabilise the exchange rate of its currency as well as refinancing the banking system. The programme also focuses on an overhaul of public finances aimed at securing a sustainable level of public debt as well as resolving problems related to the government's temporary takeover of Iceland's largest commercial banks.

- **Deposit guarantees.** Iceland is working constructively with other countries to address issues that have arisen in connection with the banking crisis, including the state's backing of deposit guarantee schemes, in line with relevant provisions of the European Economic Areas (EEA) Agreement. On 18 November 2008, the Government of Iceland and several EU Member States reached a common understanding on the interpretation of legal obligations with respect to deposit guarantees. On 6 June 2009, the Iceland Depositors' and Investors' Guarantee Fund signed agreements with the Netherlands and UK Governments to reimburse UK and the Netherlands for monies paid to eligible depositors in the Dutch and UK branches of Landsbanki with respect to so-called Icesave deposit accounts. The agreements are currently under debate in the Icelandic Parliament Althingi as the implicit state guarantee involved requires its approval.

- **Temporary capital controls.** Following rationing of foreign currency that started on 10 October and in line with advice of the IMF, temporary capital restrictions were introduced on 20 November. This was found necessary to stem capital flight and prevent shortage of foreign currency, given *inter alia* foreign carry-trade investments in Iceland in past years. However, regular currency transactions for payment of imported goods and services are not affected by these restrictions. It has been possible to maintain such foreign exchange payment intermediation uninterrupted.

Stability Pact with social partners

On 26 June 2009 an agreement was signed by leaders of central and local government, employers' and employees' federations on a so-called Stability Pact. The Stability Pact reinforces the government's reconstruction plan. The aim of the Pact is to promote economic recovery and it will serve as a cornerstone to support further rebuilding of the economy and secure broad social consensus for necessary adjustment measures. It seeks to achieve specific economic benchmarks similar to the Maastricht entry criteria for the EMU. Implementation of the pact should allow the Central Bank of Iceland to ease monetary control and lower its currently exceptionally high policy rate of interest. The pact will thus create conditions for increased investment by both domestic and foreign parties, stronger growth, boosting employment and laying the foundation for improved living standards in the future. Among the highlights of the pact are the following:

- **Removal of labour market uncertainty.** The social partners concluded collective wage agreements in the private sector valid until the end of November 2010, which emphasize improving the situation of lowest income groups. Agreements are being concluded with public sector employees in a similar vein.

- **Fiscal consolidation plan.** A joint understanding was reached on a fiscal restraint plan until 2013. It is important to balance the national budget as soon as possible, with a suitable mix of cuts in expenditure and higher taxes. Taxes will comprise a decreasing portion of the restraint measures and a maximum of 45% of the amount of such measures during the period 2009-11.

- **Stimulate investments to promote employment.** The Government will pave the way for major investment projects, including in power-intensive industry. Despite setbacks due to the financial crisis, the Icelandic occupational pension fund system is exceptionally strongly financed with total net assets now amounting to 122% of GDP. The Government will seek the co-operation of pension funds to finance infrastructure projects, possibly also involving public-private partnership.

- **Reconstruction of banks.** The state's ownership policy regarding the banks will allow for the possibility of foreign parties acquiring a majority holding in the new banks. This represents, in part, an attempt to ensure normal access to foreign credit. Restructuring of the banks' ownership will be concluded by 1 November 2009. This is expected to result in improved banking services for households and the business sector.

- **Removal of capital controls**. The Confederation of Employers strongly objected to the introduction of capital controls in November 2008 as it believes that measure to be counterproductive. On 5 August 2009, the Government and the Central Bank introduced a strategy to remove these restrictions in stages, with the aim of stabilising the exchange rate of the Icelandic króna.

Application for EU Membership.

On 16 July 2009 the Icelandic Parliament approved a resolution for Iceland to apply for membership of the European Union. As a democratic and Nordic welfare state and a member of the European Economic Area and Schengen Cooperation, Iceland is well prepared to discuss the conditions and terms for full membership with EU Member States and institutions.

Strong Economic Foundations and Good Long-term Prospects

Despite the current economic crisis, the foundations of Iceland's economy remain strong. Iceland is a modern and dynamic, technology-driven society with a young and well-educated workforce. The country has vast potentials in well-managed marine resources, natural renewable energy sources, a thriving tourism and cultural sector together with innovative manufacturers and service providers. While the adjustment process of upcoming months will clearly be hard for Icelandic businesses, the underlying foundations together with the broad economic reform measures underway provide a firm basis for good long-term prospects.

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