ICELAND

ECONOMIC PROGRAMME 2014

Ministry of Finance and Economic Affairs

February 2014

Table of contents

Figures

Tables

Annex Tables

1. Overall policy framework and objectives

The fundamental objective of the economic strategy is to increase the economy's growth potential and lay the foundations for sustained economic growth. It is due time to revert our eyes forward and focus anew on laying foundations for economic growth with the benefit of the experience acquired during the years of boom and bust. Increased growth potential based on improved productivity, economic stability and a fair and effective tax system will boost employment and general prosperity.

Increased economic growth should be founded on increased investment and exports, which lead to improved productivity and a trade surplus. The central role of the government's economy policy is to create an environment that can enable this to happen. In this respect, the robust export driven growth in the third quarter of 2013 is a good indication of the economy's potential.

Responsible economic management, not least through the continued reduction of government debt, facilitates exchange rate stability and allows for lower interest rates, which should lead to increased investment and an improved fiscal position for both households and firms. With this in mind, the first balanced budget for seven years was passed in December 2013. Throughout this process, increased attention will be given to public sector productivity and increased infrastructure investment. With regards to productivity, the shortening of secondary school towards the OECD average is being considered as it could both lead to savings and increase the economic productivity. As the tight fiscal position restrains infrastructure investment, increased use of public-private partnerships might be considered.

Continued reduction of government debt, while not stifling economic growth, will remain the guiding light for the government's fiscal policy. The focus on fiscal responsibility is to be codified through a new organic budget law to be presented to parliament in March 2014. The bill strengthens the fiscal policy framework, i.a. through a more holistic approach to government finances and a longer-term horizon in policymaking.

The focus on an improved budget outcome will be accompanied by a review of the tax system with a view to increasing its efficiency, reducing its negative effects on economic growth and generating incentives for value creation.

Further deleveraging is also required from households and firms, although debt levels vary between corporate sectors. Reduction in private sector debt levels should be accompanied by an increase in household savings in light of the low national savings. In this respect, the tax exemption limit on capital income tax has been increased while other measures to reduce the negative effects of taxes on savings are being considered.

The removal of capital controls will also be important in fuelling increased business sector investment, as renewed free-movement of capital and broader access to international capital markets should open the economy to new productive investment opportunities. The removal of capital controls should not, however, pose a threat to economic and financial stability. A return to excessively volatile exchange rate markets and the whims of unchallenged capricious international capital markets should be resisted. In this respect, the financial sector framework is being improved both through a new financial sector legislation based on European Union acquis and an establishment of a Financial Stability Council. A draft legislation establishing the council will be presented to parliament in March 2014. It will create the framework for the third element of economic management along with fiscal and monetary policy. On the basis of this, macro-prudential tools can be developed and enhanced to facilitate greater financial and economic stability, including exchange rate and price stability.

Increased price stability requires lower inflation expectations. The focus on real rather than nominal wage improvements in the collective wage agreements approved in early 2014 bode well for better times ahead. These agreements were accompanied by restraint on the side of both levels of government with regards to price increases. In the case of the central government, proposed increases to government fees and taxes were reduced by ISK 460 million. The government puts great emphasis on continued focus on wage growth in real terms on the basis productivity increases that will lead to increased economic stability.

There is a need to support increased exports alongside the focus on productivity and investment with the aim to strengthen the sustainability of economic growth and bolster the trade surplus. Existing export sectors should expand further while foundations are laid for new ones. The corporate sector needs to be able to avail of the opportunities that arise with the improved competitive position granted by a lower real exchange rate. Increased exports help to improve the balance of payments and reduce the likelihood of exchange rate fluctuations and price increases due to the rise in imports when domestic consumption increases.

2. Economic Outlook

The economy is showing signs of clear increased vigour following the financial crisis, with recent data indicating that growth surpassed expectations by a substantial margin in the third quarter of 2013. At the same time, forecasts indicate a moderate growth of the global economy while price developments for Iceland's main export products, particularly aluminium and marine products, remain unfavourable. Economic policy is therefore confronted with the challenging task of balancing the composition of economic growth in a situation in which the growing contribution of foreign trade is in the foreground while, at the same time, the terms of trade continue to deteriorate. A sustained trade surplus is important in light the challenging balance of payment position forecast resulting largely from legacy problems following the financial crisis.. This chapter presents a more detailed discussion of recent economic developments and then focuses on the medium-term forecast underpinning the fiscal strategy.

The short and medium-term economic assumptions of the budget and medium-term fiscal strategy are derived from the macroeconomic forecast published Statistics Iceland. The most recent forecast was published in November 2013. The assumptions for economic development at a global level and in Iceland's main trading partners are based on forecasts from the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD).

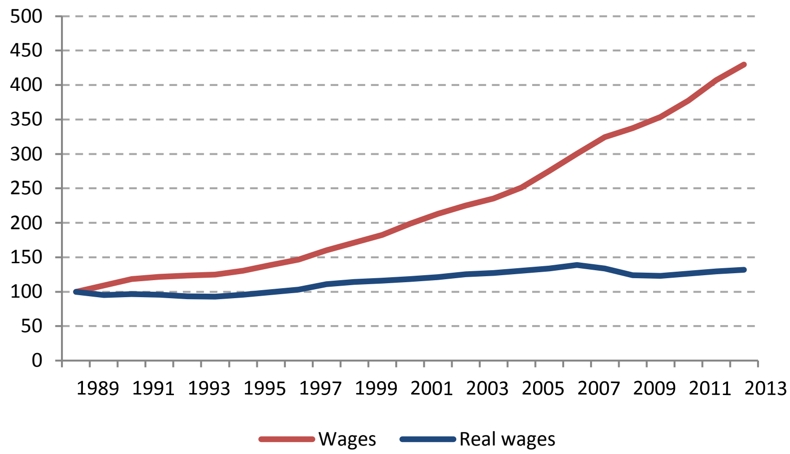
2.1 Recent economic developments

The economy grew by 3% in the first nine months of 2013 compared with the same period a year before, according to the preliminary figures. This growth was mainly driven by the rising contribution of foreign trade and, to a lesser extent, private consumption. Investment, on the other hand, declined by 7.1%, although this development can be attributed to the distorting effects of large aircraft imports during the previous year. On the basis of the most recent indicators, including positive GDP figures for the third quarter of 2013, annual growth may have exceeded the 2% forecast by Statistics Iceland last November. This growth comes in the wake of 1.4% growth in 2012, which was fuelled by a rise in investment and private consumption. On the other hand, the contribution of foreign trade to growth was negative that year, despite a significant increase in exports. The economy expanded therefore by a total of 6% between 2011-2013, following a contraction of almost 10.5% between 2009 and 2010. The relatively modest growth in wake of the crisis is largely in line with the experience of other economies coming out of a deep financial and currency crises.

Growing purchasing power boosts private consumption

Private consumption grew by 1.3% and public consumption by 1.4% in the first nine months of 2013 compared with the previous year. Short-term economic indicators suggest that private consumption may have grown by more than the 1.6% forecast by Statistics Iceland over the year as a whole. Private consumption has been driven by the persistent recovery of the labour market and rising wages. The wage index rose by 5.7% in 2013, not least in the wake of collectively negotiated wage increases in the first quarter. Real wages rose by 1.8% in 2013 for a total growth of 6% over the past three years. Private consumption rose by 2.4% in 2012, but one-off measures, such as the disbursement of private pension savings and special interest rebates, have helped to boost private consumption.

Figure 1: Wage and Real Wage indices, 1989=100



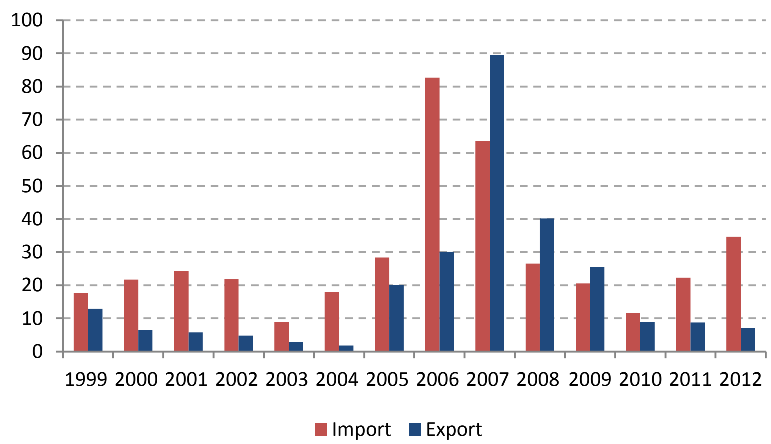
Source: Statistic Iceland

Twelve-month CPI inflation was 4.2% in December 2013 but average CPI inflation in 2013 measured 3.9%. The increased inflation in December was due mainly to rising housing costs, as excluding the housing component the CPI had increased by 3.3%. Service prices also rose well in excess of other prices, although this was offset by a mere 1.2% increase in the price of imported goods.

Investment levels still considerably below historical average

Contraction in business investment in the first half of the year led to an overall drop in investment in 2013, with a contraction of 7.1% recorded in the first three quarters. Business investment grew by 7.8% in 2012, amounting to 9.9% of GDP, on the back of large-scale investment in ships and aircraft, while general business investment stagnated. Preliminary figures indicate an 11.8% contraction in business investment in the first nine months of 2013, with investment in the aluminium and energy sectors disappointing due to less investment in the Straumsvík aluminium plant. Excluding the impact of power-intensive industries and ships and aircrafts, general business investment grew moderately in 2013. Housing investment has been rising since 2010 after a sharp contraction in the previous three years. Following 2.6% growth in 2012 housing investment grew by a further 5% in the first nine months of 2013 according to preliminary figure.

Figure 2: Import and Export of ships, aircrafs and associated equipment, bn ISK



Source: Statistic Iceland

A sharp increase in service exports

Exports of goods and services grew by 4.2% in the first nine months of 2013, after a 3.8% growth in 2012. Service income has risen on the back of a depreciated real exchange rates and increased tourist income. Imports contracted by 1.9% in the first nine months of 2013, not least because of the steep increase in ship and aircraft imports in the first half of 2012, which played a major role in driving the 4.7% growth in imports that year at the same time as service charges rose due to increased foreign travel by Icelanders.

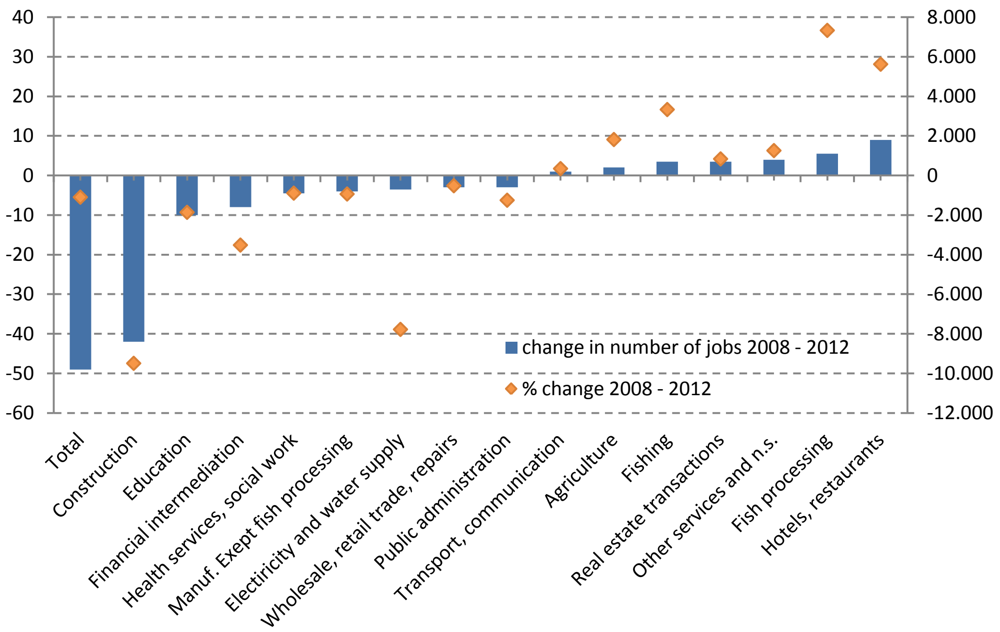
The balance of trade in goods and services has been decreasing as the economy gains momentum and the real exchange rate appreciates. The goods balance showed a surplus of 3.4 of GDP in 2013 according to preliminary figures, compared to a 4.6% surplus in 2012. The service balance was on the other hand stronger in 2013. This is will likely lead to a trade balance close to the 6.1% of GDP recorded in 2012.

Strong rebound in the labour market

The labour market has rebounded strongly in recent quarters. Registered unemployment fell from 5.8% in 2012 to 4.4% in 2013, with most people returning to paid employment although some have exhausted their entitlement to unemployment benefits. The labour market survey tells a similar story, with unemployment falling from 6% in 2012 to 5.4% in 2013 and the number of employment persons rising by around 5,800, or 3.4%, between years.

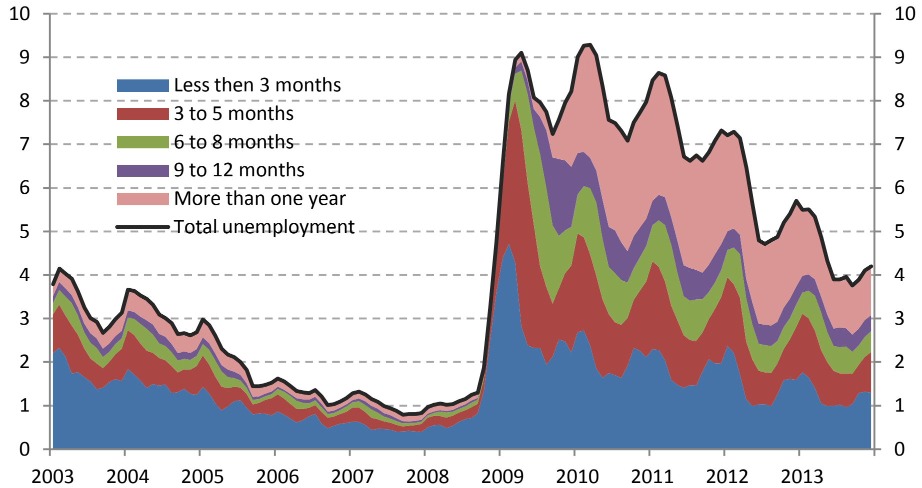
Changes in the economy over the past five years have resulted in significant alterations to the composition of the labour force. As can be seen from the graph below, the number of jobs has increased in the fisheries as well as in hotel and restaurant sector. At the same time, the amount of people in the construction sector diminished by close to a half and also fell in the financial and insurance sector, educational activities, public administration and health and social services.

Figure 3: Change in the number and percentage of workers per sector from 2008 to 2012



Source: Statistics Iceland

Figure 4: Registered unemployment according to duration (%)



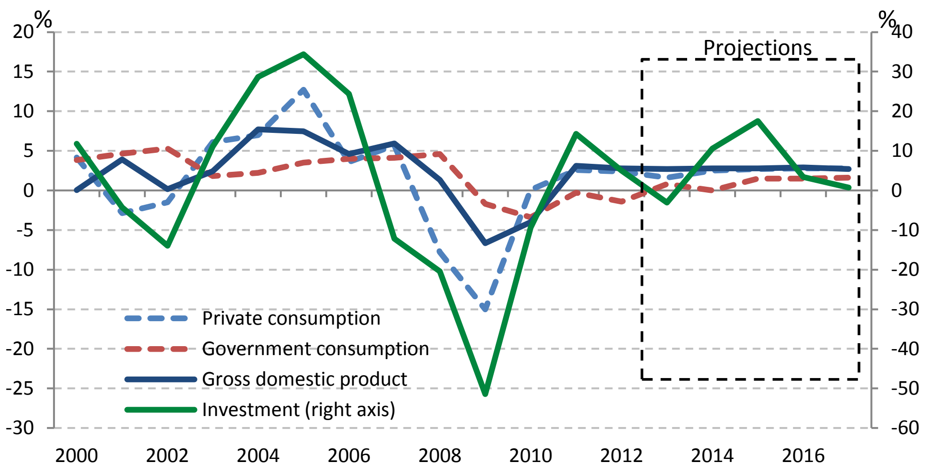
Source: Directorate of Labour

2.2 Medium-term macroeconomic scenario

2.2.1 Real Sector

Growth is forecast at 2.5% in 2014 in November forecast from Statistics Iceland. This growth is to be driven by a rise in private consumption and investment while the effect of net exports is assumed to be negative. Growth is forecast at 2.8% for 2015 and 2.6% in 2016.

Figure 5: Development and outlook for domestic demand



Source: Statistics Iceland

The ongoing labour market recovery and rise in real wages is expected to drive continued growth in private consumption. The mortgage debt relief announced in late 2013 may further boost private consumption as it was presented after the forecast was made. If the assumptions of the budget prove to be correct, private consumption will account for 54% of the GDP in 2014. This is somewhat below the average from 1980 to 2012 of 57.5%, but nevertheless higher than in other Nordic countries.[1] Even though private consumption is set to grow further over the coming years it is unlikely that this is where the necessary driving force for economic growth is to be found in light of the economy's tight balance of payments position and the need to improve competitiveness in many sectors.

The responsible restraint exercised in fiscal policy means that public consumption will remain virtually unchanged in 2014 from the previous year. Growth will therefore not be driven by public consumption over the coming years, despite a 6.7% contraction between 2009 and 2012. It is important that government debt be reduced further from the current high levels that lead to both high costs and risks. Moreover, it is important for a small and volatile economy to have fiscal space for counter-cyclical policy, not least when shocks occur, such as the one in the wake of the crash when the Treasury was run with a deficit of ISK 400 bn and the sovereign's debt was increased by ISK 420 bn to restore the financial system. Recent studies indicate that the efficiency of public management can be improved and that services can be improved without increased expenditure.[2] Public consumption is expected to grow moderately over the coming years and then to steadily drop as a percentage of GDP from 25% in 2014 to 23% in 2018.

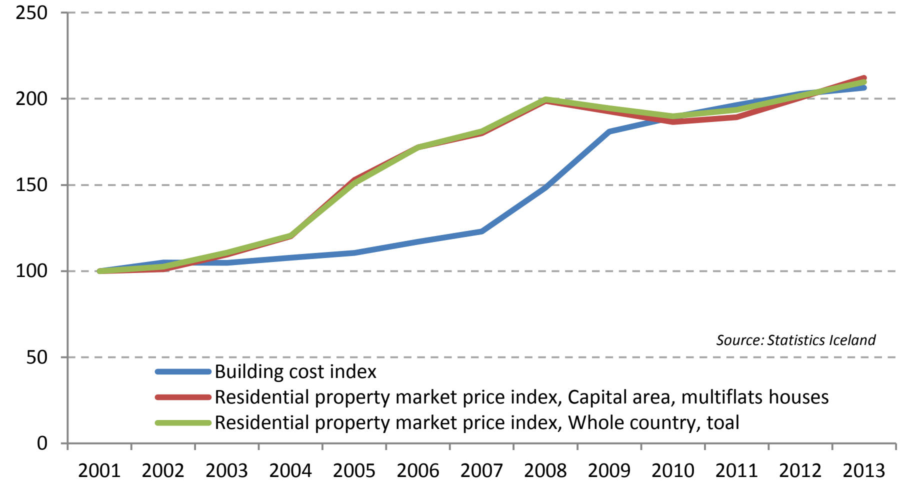
Investment is expected to grow by 10.6% in 2014 with business investment growing by 8.0%. Considerable uncertainty remains regarding investment in the aluminium and energy. Other investment continues to grow, particularly in tourism, although the high levels of indebtedness and low yields in parts of the domestic service sector remain a concern. Big export companies, not least in the fishing sector, are the main exception as their financial positions have improved over the past quarters. During the boom years the level of business investments was very high and Icelandic companies were net borrowers, whereas today that trend has been reversed and companies use their operating capital to pay down their debt rather than investing. It is a cause for concern that there are indications that many companies remain over-leveraged despite going through financial restructuring as high debt levels hinder their investment capacity.

The forecast assumes a 20.6% increase in housing investment in 2014, with high-frequency indicators such as cement sales suggesting considerable activity. Looking at longer-term prospects, housing investment is expected to steadily grow from about 3% of GDP in 2013 to 5.2% in 2018 as house prices continue to rise faster than building costs.

[1] The percentage of private consumption in the GDP is 38.4% in Norway, but if oil production is excluded it amounts to 59.2%. The percentage is highest in Finland (56.4%), but 49.4% in Denmark and 46.9% in Sweden in 2012.

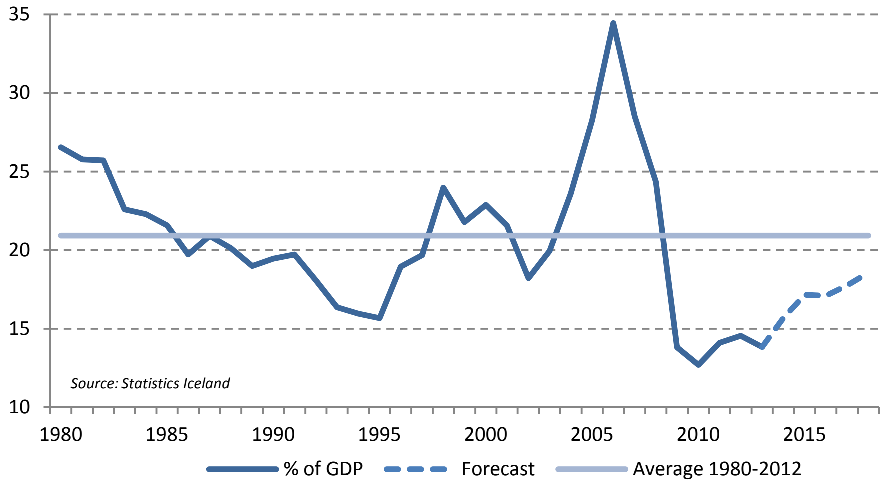
[2] OECD, IMF and the Consultative Forum.

Figure 6: Residential property market price index and building cost index, 2001=100



Public investment reached a historically low level of 2% of GDP in 2012.[3] Public investment is expected to grow by 7.8% in 2014, with a number of new big investment projects being launched this year.

Figure 7: Development and outlook for investment (% of GDP)



In the same way that the high levels of indebtedness in the economy's main sectors hamper growth, the tight balance of payments position can affect the composition of growth. The difficult balance of payments position is due both to the high level of national foreign debt accumulating during the boom years and the limited ability of private entities to refinance foreign loans in the wake of the crash and deteriorating terms of trade. This tight balance of payments position means that economic growth needs to be increasingly driven by productive investment and exports rather than consumption. The economy's external position is further discussed in chapter 2.2.4.

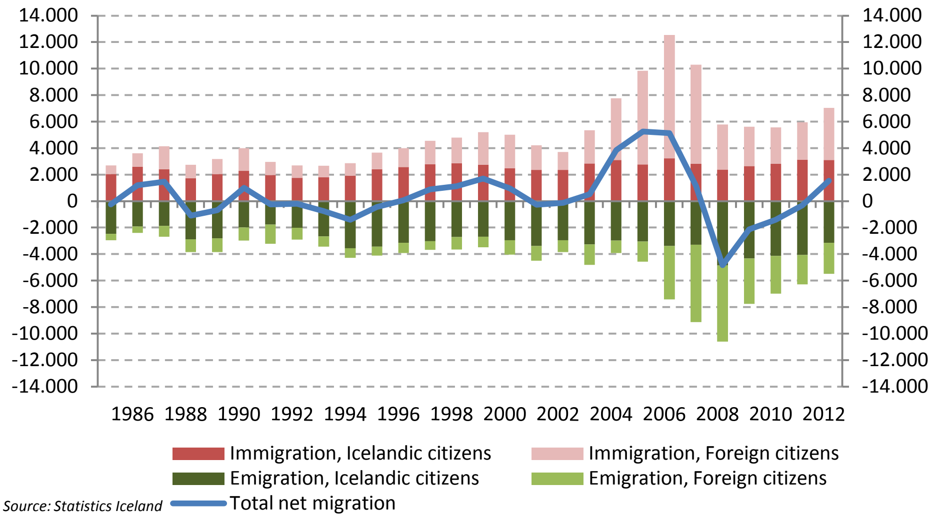
[3] The discussion on public investment is not fully consistent with the budget proposal for 2014. Only new public investments have been taken into account here and not new public investments plus government acquisitions and sales, as the discussion on public investments in the budget proposal does.

Exports growth is forecast at 2.8% in 2014 and 2% in 2015 while imports will track domestic demand. The price of fish and aluminium, Iceland's main export goods, decreased towards the end of 2012 and during 2013. Fish prices are expected to decrease slightly in 2014 while aluminium prices are expected to rise. Terms of trade for 2015 and later in the forecast period are expected to be stable, contingent on improving economic conditions of main trading partners. A trade surplus is expected during the forecast period with a continued growth in the tourist sector.

A marked improvement in the labour market

Statistics Iceland forecasts 4.4% unemployment in 2014 and 4.1% in 2015. 2013 was the first year when net migration was positive since the financial crisis. The number of people moving to Iceland exceeded those emigrating by 1,530. 1,560 foreign nationals immigrated to Iceland in 2013, whereas 40 more Icelandic nationals emigrated from the country than returned.

Figure 8: Net migration, thousund foreign and Icelandic citizens



Source: Statistics Iceland

2.2.2 Monetary and Exchange Rate Policy and Inflation

The Central Bank of Iceland's main objective is price stability, defined as a 12-month rise in the CPI (Consumer Price Index) of 2½ percent. The experience of recent years has revealed that, for a very small open economy, successful inflation targeting needs a framework that includes tools to limit destabilising effects from the exposure of a relatively large banking system with overseas operations as well as large short term capital flows e.g. carry trades. Macro-prudential rules are on the agenda in international fora, but the Central Bank has taken some steps in this direction by including more focus on exchange rate stability and stricter rules on the banking system's foreign exchange exposure. The MPC statement of May 2013 indicated that the Central Bank would be more active in the foreign exchange market during latter half of 2013 for stabilisation purposes.

Inflation fell to 3.1% in January 2014 as consumer price index increased by a mere 0.72%. Inflation is forecast to continue its downward path and subside gradually to its target over 2016 according to the November Monetary Bulletin from the Central Bank of Iceland, despite the somewhat elevated inflation expectations. The relatively modest wage increases included in the collective bargaining agreements in late 2013 were positive for the inflation outlook. Wage and exchange rate developments remain nonetheless the main risks to the inflation outlook. Household debt relief measures could stimulate demand, but the effects will emerge over a period of time

During 2013 the Monetary Policy Committee kept the main policy interest rate unchanged (7 day collateral lending rate at 6%). The Monetary Policy Committee's statement from December 2013 states that a stronger economic recovery and some government measures will require more rapid monetary tightening than previously expected. The degree to which such tightening takes place through changes in nominal Central Bank rates will depend on future inflation developments, which in turn will depend on wage developments and exchange rate movements.

Figure 9: Contribution of food, petrol and energy costs to annual inflation

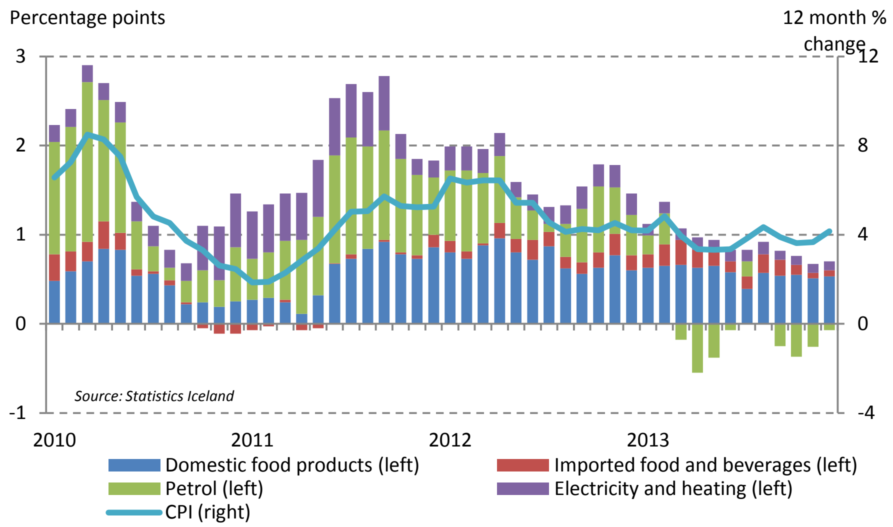
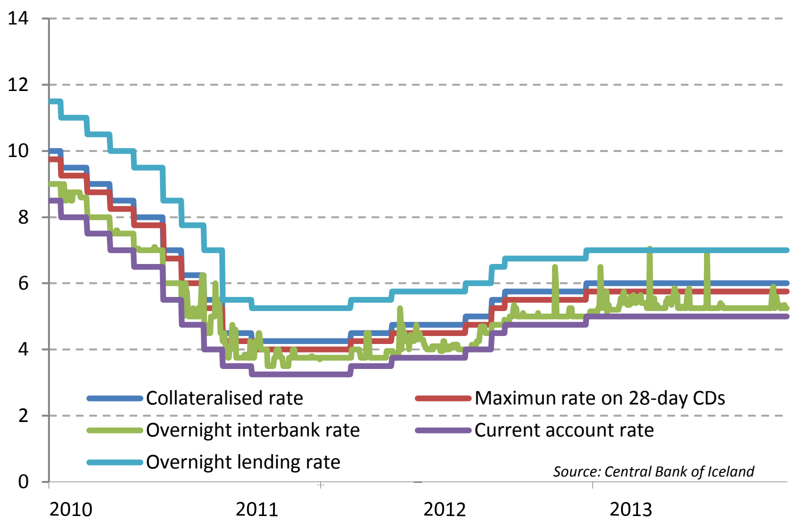
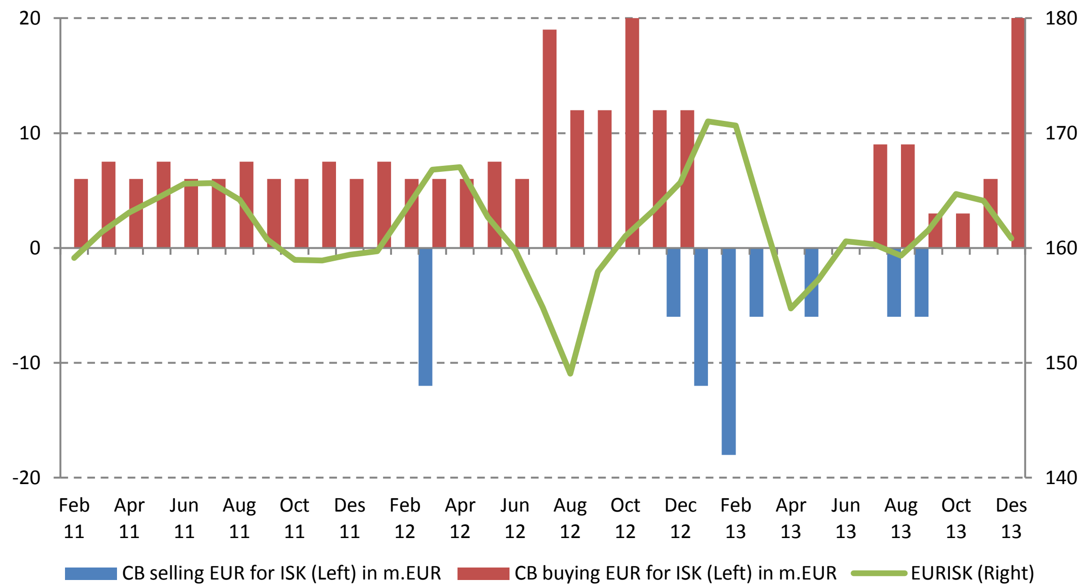


Figure 10: Central Bank interest rates and short-term interbank rates



The króna appreciated by nearly 11% in trade-weighted terms in 2013. Early in 2013, after a period of marked ISK depreciation in the final months of 2012, the króna started to appreciate helped by the Central Bank decision to suspend its program of regular foreign currency purchases. Generally, the MPC's new policy of more active FX market interventions appears to have contributed, among other factors, to reduced exchange rate volatility for the remainder of the year. The Bank's net foreign exchange purchases totalled 9 million Euros, or just over ISK 1 bn in 2013. Some of the forward agreements concluded at the end of 2010 in order to reduce foreign currency imbalances in the banking system were settled, strengthening the Bank's foreign exchange position by over ISK 29 bn. Also concluded during the year were foreign exchange agreements entailing foreign currency outflows in the amount of 6 bn ISK.

Figure 11: Central Bank FX interventions



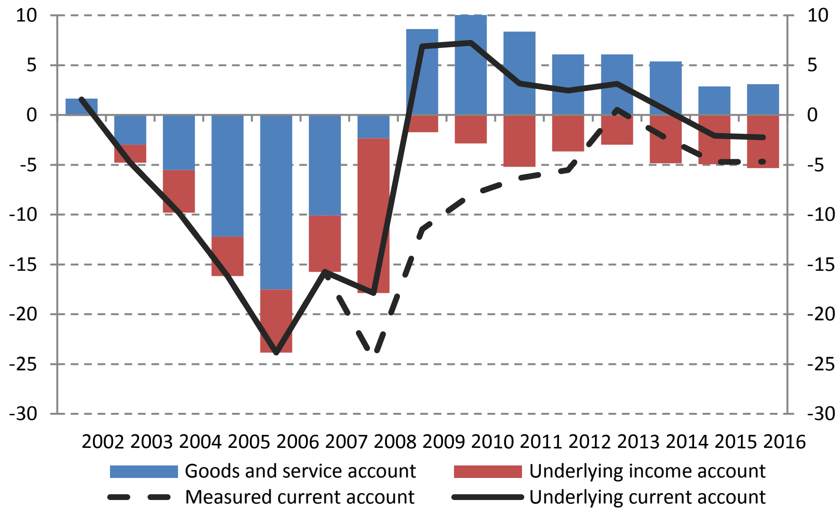
Source:Central Bank of Iceland

2.2.4 External sector and its medium-term sustainability

Iceland has been running a relatively large positive trade balance since 2008 following several years of large negative balances. The positive trade balance is vital in light of the economy's short-term external position following the crisis. . The large exchange rate depreciation compressed domestic demand but prices for main exports have also been very favourable, leading exports as percentage of GDP to reach a historic high of 59.1% in 2012. With real exchange rates very competitive the outlook for the export sector continues to be favourable despite worsening terms of trade as discussed below.

Evaluation of Iceland's external position and the current account outlook is complicated by the impact of deposit money banks (DMBs) undergoing winding-up proceedings. While headline current account numbers continue to report relatively large deficits, these numbers are misleading. Estimates of the underlying balance suggest a significant declining underlying surplus on the current account, suggesting that the external debt of the economy is on a sustainable path. In the following figure the current account balance is shown both measured and underlying.

Figure 12: The current account balance and its subcomponents[4]



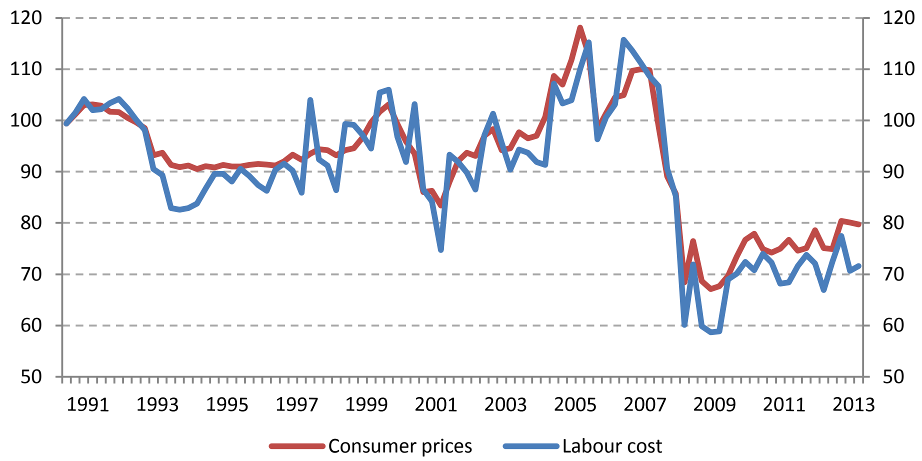
Source: Statistic Iceland, Central Bank of Iceland

Iceland's international investment position was negative by 436% of GDP at end of the third quarter of 2013. Excluding assets and liabilities of the failed banks it stood at an estimated -14% of GDP. Terms of trade have continued to deteriorate in 2013 by 2-3% and CBI projects it to worsen by around 0.7 % in 2014. The deteriorating terms of trade can hardly be countered by volume increases in primary export production of fish or aluminium due to capacity constraints. However, the service sector has been expanding with a record number of tourists visiting the country every year. The main risks to the external balance include lack of demand in main trading partner countries.

The delicate balance of payments position is reflected in, among other things, the fact that the contractual payments of domestic entities, other than the Treasury and Central Bank of Iceland, on foreign loans between 2013 and 2018 are considerably higher than the forecast underlying trade surplus for the same period.[5] The lion's share of these contractual payments is due to Landsbanki and energy companies. The extension and refinancing of these loans could create significantly more leeway in the balance of payments. Negotiations are already taking place between the old and new Landsbanki to extend the maturity of the bond between them. The balance of payment situation needs to be considered carefully as the winding-up of the estates of the old banks is concluded and the capital controls are lifted.

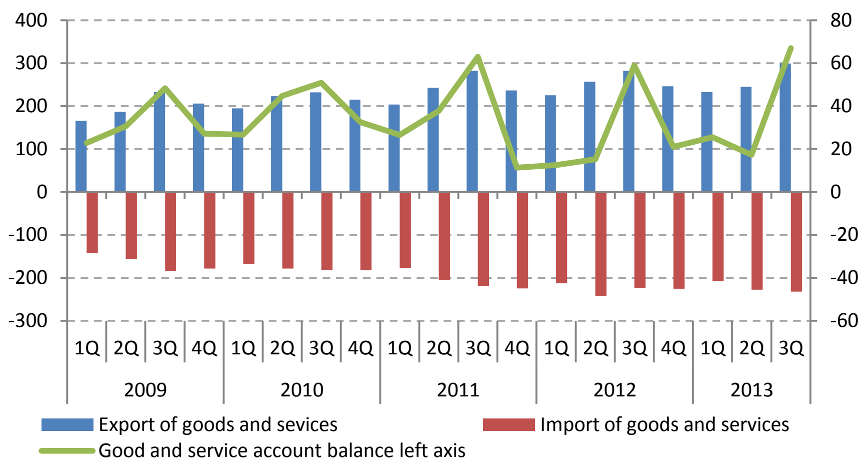
[4] Calculated according to IMF standards. Balance on income plus transfers. Adjusted for the calculated income and expenses of banks in winding-up proceedings and the effects of the settlement of their estates.
[5] See Financial Stability 2/2013. Central Bank of Iceland.

Figure 13: Real exchange rate, indices



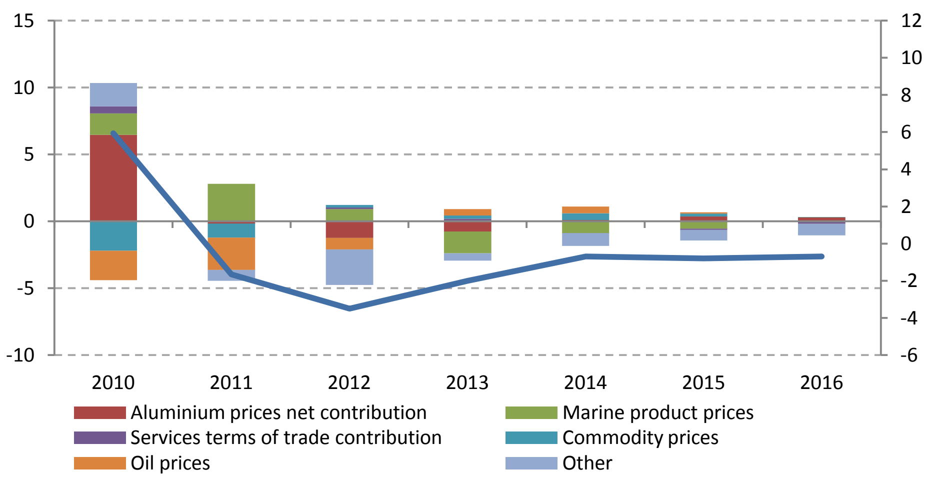
Source: Central Bank of Iceland

Figure 14: Trade balance, ISK bn.



Source: Statistic Iceland

Figure 15: Terms of trade and their main components 2010 – 2016, year on year change (%)



Sources: Statistics Iceland, Central Bank of Iceland

The current capital controls regime

The capital controls regime and the authorities' strategy on lifting capital controls has been detailed in Iceland's Pre-Accession Economic Programme 2013.[6] Further information can found on the CBI's website.[7] The removal of capital controls is further discussed in chapter 4.

According the Foreign Exchange Act, the Ministry of Finance and Economy will publish a report on the process towards lifting of capital controls in March 2014.

2.2.5 Financial sector

The financial system and deposit money banks (DMBs)

The total assets of the financial system at the end of June 2013 amounted to ISK 8,419 bn and increased by ISK 113.4 bn since the beginning of the year. This is due primarily to increase in pension funds' assets, but assets held by the Central Bank of Iceland have declined markedly. Total assets held by deposit money banks (DMB) have increased by 0.8% in real terms since the beginning of the year. As a share of GDP, total DMB assets are unchanged year-on-year, while they have shrunk from 200% of GDP in 2009 to 173% as of end-June 2013.

[6] http://www.fjarmalaraduneyti.is/media/frettir/Pre-Accession-Economic-Programme-2013_FINAL.pdf
[7] http://www.cb.is/the-bank/foreign-exchange/capital-controls-liberalisation-strategy/

Table 1: Credit system assets

Assets, ISK bn.	*30.9.2008*	*31.12.2008*	*31.12.2009*	*31.12.2010*	*31.12.2011*	*31.12.2012*	*30.6.2013*	*Δ 2012/ 2013m6*	*Δ 2012/ 2013m6*
The banking system	**15,086.7**	**4,631.6**	**3,967.4**	**3,877.7**	**4,401.7**	**3,861.5**	**3,823.8**	**-1%**	**-37.8**
proportion due to Central Bank of Iceland	191.6	473.1	652.7	509.1	1,465.9	901.8	816.2	-9%	-85.6
proportion due to commercial banks	14,153.2	3,416.5	2,572.8	2,626.7	2,875.4	2,903.0	2,951.4	2%	48.4
proportion due to savings banks	741.9	767.7	383.4	136.6	60.3	56.8	56.2	-1%	-0.6
Other credit institutions	1,321.0	1,284.2	1,194.5	1,129.3	1,097.1	1,076.3	1,073.7	0%	-2.6
portion due to Housing Financing Fund	699.0	732.8	794.7	836.0	864.0	875.9	873.0	0%	-2.9
Pension funds	1,870.6	1,665.3	1,849.3	1,988.9	2,169.1	2,439.1	2,545.8	4%	106.7
Insurance companies	160.5	122.2	130.7	138.1	145.4	154.6	166.7	8%	12.1
Mutual, investment and institutional funds	666.7	212.1	195.2	284.2	516.3	582.6	604.4	4%	21.8
Government credit funds	103.4	124.8	145.8	160.8	170.7	191.7	205.0	7%	13.3
Total assets	**19,208.9**	**8,040.2**	**7,482.9**	**7,579.1**	**8,500.3**	**8,305.9**	**8,419.3**	**1.37%**	**113.4**

1. The banking system consists of commercial banks, savings banks and the Central Bank of Iceland.

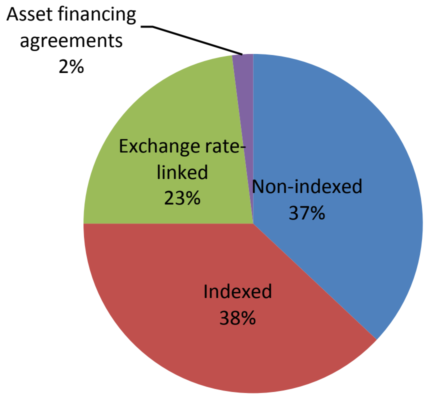
Internal trades between the Central Bank of Iceland and other parties are excluded.

Source: Central Bank of Iceland

Loans constitute the lion's share of the DMBs' assets, or 63% of the total and 1,899 bn, as of mid-year 2013. Loans as a share of total assets have declined by about 3% in the past 12 months and by about 2% since the beginning of the year. In real terms, the book value of loans has declined by 3.7% in 2013 and by 4.3% in the past 12 months. The relative sharp decrease in book value of loans so far in 2013 indicates strongly that demand for new credit is limited. Bonds are the second-largest class of DMBs assets, at 19% of the total, and cash is the third-largest, at 9%. In the past 12 months, DMBs have added substantially to their holdings of bonds (ISK 90 bn) and cash (ISK 82 bn) but have reduced their equity holdings in related companies (ISK 24 bn). The banks liquidity position has strengthened during this period.

Exchange rate-linked loans continue to shrink in importance, accounting for 23% of the DMBs' total loan portfolios at the end of June 2013, as opposed to 27% a year earlier. The decline in exchange rate-linked loans is offset by an increase in CPI-indexed and non-indexed loans, which accounted for 38% and 37% of the mid-year total, respectively, as compared with 36% each at the end of 2012.

Figure 16: DMBs loans, June 2013

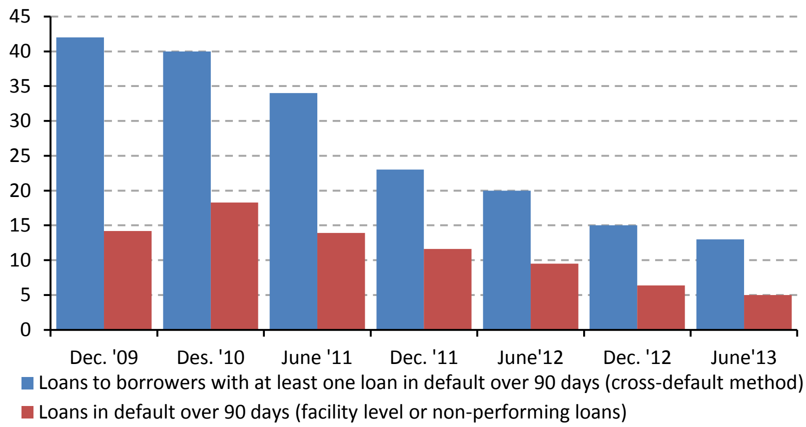


Sources: Central Bank of Iceland

Assets restructuring and defaults

Household and corporate debt restructuring continued in 2013. As of end-June, 5.1% of the banks' loans were 90 days in arrears, a decline of about 4.4% year-on-year.[8] The share of arrears fell by only 1% in the first half of 2013, however, indicating a slowdown in the decline in default ratios. In terms of the more conservative cross-default method, however, which includes all loans taken out by borrowers in arrears, the default ratio was 13% at the end of June 2013, as opposed to 20% a year earlier. Default has declined more slowly in 2013 than in 2012, probably reflecting the fact that resolution of more difficult cases has been postponed.

Figure 17: Default ratios of the three largest commercial banks (%)



Sources: Finacial supervisory Authority, Central Bank of Iceland

Banks' funding

The commercial banks' principal source of funding is deposits, which have grown since the beginning of 2013, in a reversal of the trend of recent years. As of June 2013, the commercial banks' deposits had increased by over ISK 50 bn since the beginning of the year. The rise is due largely to investment and mutual funds, whose deposits have grown by almost 50% since the beginning of the year.

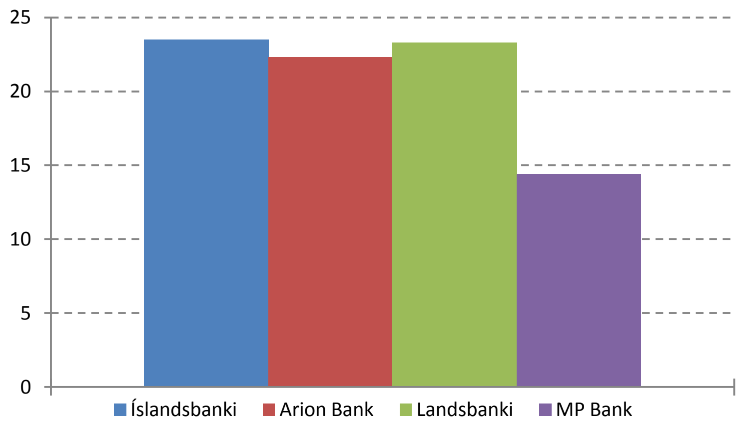
[8] Including only those loans that are 90 days in arrears or more, which is the most common measure of non-performing loans used in international financial reporting and annual accounts.

Landsbankinn's secured bonds to the old bank constitute the bulk of the three commercial banks' bond issuance and explain most of their repayment profile for the next several years. In December 2013 Landsbankinn made an optional and partial early redemption of the secured bonds outstanding to LBI. The prepayment was made in foreign currencies and is equivalent to approximately ISK 50 bn. The banks are gradually stepping up market funding. The three largest commercial banks have all issued domestically covered bonds to fund mortgage lending and one of them has held commercial paper auctions. In 2013, Arion Bank and Íslandsbanki issued FX bonds in Norwegian and Swedish kroner equivalent to approximately ISK 20 bn in total.

The banks' liquidity risk is linked primarily to potential withdrawals of deposits, a high proportion of which are demand deposits that the banks must be able to repay at any given time. Capital controls prevent depositors from transferring funds out of Iceland, but the banks need to be prepared for the removal of the controls.

The Central Bank announced new liquidity rules in late 2013 based on an amendment to the Central Bank legislation passed earlier in the year. The rules are based on the standards developed by the Basel Committee on Banking Supervision which were issued in 2010 and their incorporation into European law this year via the so-called CRD IV package. The Central Bank Rules are therefore based on international rules but are adapted to Icelandic conditions, in part through the inclusion of requirements on foreign currency liquidity and the consideration given to risks related to the winding-up of the old banks.

Figure 18: Banks' capital adequacy ratios end-June 2013 (%)



Sources: Commercial banks iterim financial statements

Banks' operations and equity position

The commercial banks seem to perform well within the capital control regime. Their operating performance has been good, and their equity position is strong. The aggregate profit of the commercial banks in the first half of 2013 amounted to ISK 32.6 bn, down by 2 bn from the same period in 2012. Return on total assets (ROA) was 2.3% and ROE just over 13%, which is lower than in the same period of the previous year. The equity of the large commercial banks totalled ISK 522 bn as of end-June 2013 or 30% of GDP. Over the same period, the ratio of net debt to equity decreased somewhat, to 450% at the end of June. The banks' capital base as a proportion of their risk-weighted asset base was 25.9% at the end of June 2013 and their Tier 1 ratio was 23.5 percent. The large commercial banks' capital ratios are currently at their highest since the banks were established and fulfil the pillar two capital adequacy requirements set by the Financial Supervisory Authority.

The banks' operating environment still reflects a number of legal and political uncertainties. Among these are uncertainties concerning removal of the capital controls, which could affect loan valuation and funding. Furthermore, many borrowers remain highly leveraged and could need further debt restructuring. The banks must adapt their business models to the current operating environment and at the same time prepare for capital account liberalisation. They are faced with the problematic task of increasing their good loans; or else shrink their balance sheets as they cut costs.

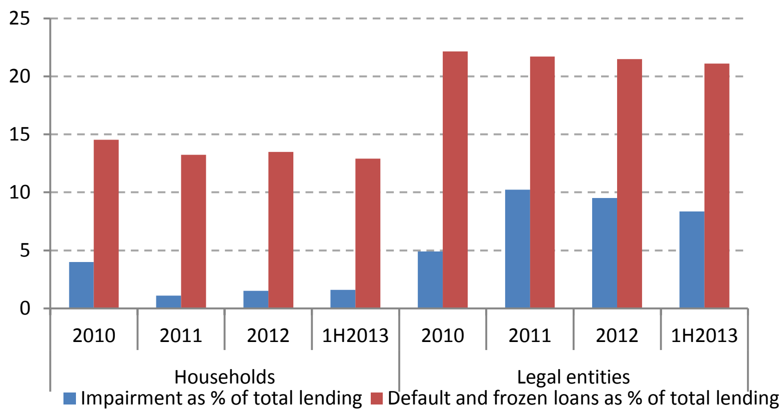
Miscellaneous credit institutions and HFF

Miscellaneous credit institutions – that is, credit institutions other than deposit money banks (DMBs) – held assets amounting to some ISK 1,074 bn as of end-June, as opposed to ISK 1,069 bn a year earlier. The value of these assets is therefore virtually unchanged in nominal terms over the past 12 months but has fallen by 2.9% in real terms. Housing Financing Fund (HFF) assets account for the vast majority of miscellaneous credit institutions' assets, totalling ISK 873 bn as of end-June 2013, including mortgage loans amounting to ISK 777 bn.

According to its profit and loss account, the HFF recorded a loss of ISK 3.0 bn in the first six months of 2013. At the end of June, its capital ratio was approximately 2.5%. The Fund's operational viability depends in part on the Treasury guarantee of all of its obligations.

HFF lending continues to contract due to increased competition. The Fund is faced with substantial refinancing risk, as borrowers are permitted to prepay their HFF loans while the HFF bonds issued by the Fund are not pre-payable. Prepayments totalled just below ISK 8.5 bn in the first six months of the year, roughly ISK 1 bn less than in the first half of 2012. An in-depth analysis of the HFF's prepayment problem can be found in the Parliamentary Investigation Commission's report on the Housing Financing Fund, published on 2 July 2013.[9]

Figure 19: Impairment defaults and frozen loans as a % of total lending



Sources: Central Bank of Iceland

The underlying loan value of loans frozen or in default was ISK 113.2 bn, or 14.1% of all HFF loans, as of end-August, as opposed to 14.7% at the beginning of the year. Loans frozen or in default accounted for just under 12.4% of loans taken by individuals and households, as opposed to just over

[9] http://www.rna.is/ibudalanasjodur/skyrsla-nefndarinnar/ (in Icelandic).

21% for legal entities. Households in arrears on their loans have declined in number by 420, or almost 10%, year-to-date. Just under 3.5% of all households nationwide were in arrears with the HFF in August, based on the number of households at year-end 2012.

The Minister of Social Affairs and Housing has decided to appoint a task force on the future structure of housing affairs. At the same time, the Minister will appoint a collaborative group on the future structure of housing affairs, which will act as advisor to the task force. The task force is expected to submit its report in the first quarter of 2014.

Financial system risk outlook

In recent years, financial system risk has declined in tandem with overall improvement in the economy, the progress of household and corporate debt restructuring, stronger capital position of financial undertakings, and reduced balance sheet mismatches. As before, the main risk factors are linked to the potential impact of capital account liberalisation on the ISK exchange rate, the banks' liquidity and Treasury funding; the resolution of the banks currently in winding-up proceedings and its interaction with capital controls and effects on the new banks; heavy debt service on foreign debt of parties still lacking access to foreign capital markets, quality of credit institutions loan portfolios and uncertainty about global economic environment. Some other risks posed to the financial system by feedback loops from the real economy are estimated to be modest. However, non-performing loan ratios still remain high, in both historical and international contexts, and credit growth remains subdued.[10]

[10] See also Financial Stability 2013/2, The financial system: outlook and main risks, p. 5-6.

3. Fiscal policy

The core objective of fiscal policy is to continue lowering the general government debt level, thus saving interest costs, freeing up room for more growth-enhancing public expenditures and allowing for counter-cyclical policy when warranted. A clear fiscal policy and greater discipline in financial management will facilitate this objective. Greater discipline in public finances also better supports the Central Bank's monetary policy, which in turn creates greater stability in the economy in the form of lower interest rates, less inflation and thus more investment. All measures that reduce economic uncertainty aid the process of capital account liberalisation and create a sounder environment for long-term economic growth.

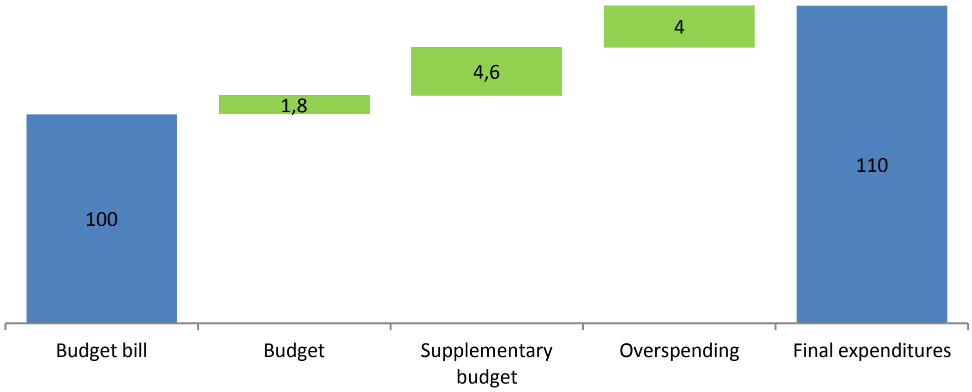
The fiscal balance has been in deficit since 2008. The government's accumulated debt as a result of this deficit amounts to over ISK 350 bn (20% of the GDP in 2013) and, although a slight surplus is expected in 2014, it is clear that the fiscal framework needs to be tightened. Since 1992, budget proposals have been drafted on the basis of a framework. Almost without exception, however, there have been deviations from the government's initial decisions regarding the expenditure framework in the budgetary process. Considerable amounts of funds were authorised through supplementary budgets each year, leading to further deviations from the initial expenditure framework. Changed procedures for the making and implementation of fiscal policy, such as those laid out in a new bill on public finances, referred to as the *Organic Budget Law*, which the Minister for Finance and Economic Affairs will present to Parliament in the first quarter of 2014, significantly strengthens the fiscal framework anchors fiscal policy in the short and medium- to long-term.

The government's revenue base also needs to be strengthened by simplifying the tax system, lowering tax bases and reducing tax evasion. The government's goal is to create a simple and efficient tax system which encourages investment and increases households' disposable income thus boosting demand and long-term economic growth.

Good results by international standards

Since the collapse of Iceland's banking system a broad range of measures have been undertaken on both the revenue and expenditure sides of fiscal finances. In the IMF's most recent *Fiscal monitor*, Iceland is ranked second after Greece on the list of countries that have done the most in the period 2009-2013, when it comes to both restraint and revenue measures on a cyclically adjusted basis. The IMF also estimates that government debt as a whole will fall well below 60% of GDP by 2030, a similar level to what is being predicted for Austria and Germany and not far from what is being predicted for Iceland's Nordic peers. Moreover, the IMF estimates that the government's financing requirements over the coming years will be quite moderate compared to those of other advanced economies.

Figure 20: Development of expenditure through parliamentary procedures and implementation of budget. Average 2001-2011, Budget proposal = 100[11]



3.1 Fiscal policy objectives

Over the past years the aim has been to achieve a balanced between expenditures and revenue as originally laid out in the Stand-by Arrangement between the Icelandic government and the International Monetary Fund (IMF) towards the end of 2008. The initial plan was laid out during times of great uncertainty regarding the ultimate economic impacts of the financial crisis and its direct and indirect costs to the Treasury to restore the financial system and more. In the following years, it was felt that there was a need to review and adjust the arrangement in light of economic developments and other considerations. Following a revision of the estimates in the autumn of 2011, a decision was made to slow down the fiscal adjustment process since, among other things, it was felt that the financial position of the Treasury had not been hit has hard as initially feared and that an excessively sharp adjustment might hamper the delicate economic recovery.

The main objective of the plan was to halt the Treasury's accumulation of debt and turn around the deficit in order to reduce the Treasury's interest expense burden and, in doing so, reinforce its operations in the long term. By slowing down the plan, the fiscal objective was set aside for a year with the aim of achieving a positive primary balance in 2012 and a positive overall balance, including interest balance, in 2014. The outlook is for this objective to be achieved, if the projections laid out in the 2014 budget materialize as planned.

3.2 Budget implementation in 2013

In the 2013 budget, approved in December 2012, the aim was to reduce the toal treasury deficit to just ISK 3.6 bn[12], corresponding to 0.2% of the GDP. the aim was furthermore to achieve a primary balance that would be positive by ISK 60 bn, i.e. 3.4% of GDP. After the new government came to power, following the general election last spring, the fiscal strategy was reviewed and it became clear that the targets of the 2013 budget would not be met. The reasons for this can primarily be attributed to the fact that the pace of the economic recovery turned out to be somewhat slower than expected and weaknesses on the revenue side in the 2013 budget.

[11] Source: Consultative Forum for Increasing Prosperity.
[12] All numbers are on accrual basis, unless otherwise specified.

Weaknesses on the revenue side included, among other things, estimated earnings of ISK 4 bn from the sale of assets which would not be realised. The budget had also assumed there would be a steep increase in the payment of dividends from state-owned companies, particularly financial undertakings, but those expectations proved to be too high. Moreover, it estimated an increase in revenue of over ISK 3 bn from special fishing levies on fishery companies, but this never materialized because the new government felt that the new fishing fees were too high for the fisheries industry to handle confortably. Furthermore, several other revenue bases, particularly consumption taxes, failed to yield the envisaged revenues, since their collection is closely linked to activity in the economy, which turned out to be less than the macroeconomic forecasts had projected at the time the budget was drafted in the latter half of 2012.

The revised Fiscal Plan was reflected in the supplementary budget for 2013, which was approved shortly before the end of the year.[13] It estimated a deficit of ISK 19.7 bn (1.1% of GDP) in the overall balance, which was a more than ISK 16 bn poorer result than had been projected in the 2013 budget. The supplementary budget shows a surplus of ISK 36.1 bn in the primary balance (2.0% of GDP), which is more than ISK 24 bn less than had been estimated in the budget. Primary revenue was ISK 17.5 bn lower and primary expenditure ISK 6.6 bn higher.[14] The table below shows the main changes made in the revenue and expenditure items between the 2013 budget and supplementary budget.

Table 2: Main changes from budget to supplementary budget 2013

Revenues	
Revenues from sales of assets	-3.8
Fisheries levy	-3.2
VAT	-3.0
Tax on central gov't capital gains	-1.5
Dividends	-1.2
Other	-4.8
Total changes in primary revenue	**-17.5**
Expenditures	
HFF contribution	4.5
Tax on central gov't capital gains	1.5
Health insurance	1.4
Reduction of gender pay gap - health institutions	1.2
Social security benefits	1.2
Investment plan 2013-2015	-4.0
Interest cost rebates of housing loans	-2.0
IPA grants from EU	-0.6
Other	3.3
Total changes in primary expenditures	**6.6**
Interest balance	
Interest revenue	-2.1
Interest cost	-10.2
Total	**8.1**
Change in total balance	**-19.7**

[13] 2013 budget: http://www.althingi.is/altext/143/s/0427.html

[14] Primary revenue is revenue excluding interest revenue; primary expenditure is expenditure excluding interest payments.

3.3 2014 budget and the medium term outlook

In addition to the fiscal plan in the 2013 budget, a plan was drafted for 2014. As has been mentioned above, the Treasury's surplus in 2013 was considerably lower than had been assumed which had negative baseline effects for 2014. All else equal, the worsening outlook following the revaluation of 2013 would have led to an ISK 27 bn deficit in 2014. This would have been an unacceptable result, which would have meant that the envisaged improved fiscal balance would have been shattered.

This situation called for decisive measures in the budget proposal for 2014 to regain control of the fiscal position and reverse the trend towards the objective of delivering a positive overall balance.[15] In this context considerable discipline was exercised on the expenditure side and ways of boosting the Treasury's revenue were devised. In addition to submitting a budget proposal, a bill was also submitted regarding revenue measures in the budget proposal, which entailed necessary changes in legislation, in particular tax laws, in accordance with the declared performance targets for 2014 and the proposed policy changes.[16]

Below there will first be a discussion of the principal measures that were presented in the budget proposal for 2014, followed by the changes that were made between the budget proposal and the final processing of the budget. All figures are on accrual basis, unless otherwise specified.

Budget proposal for 2014

In response to the deteriorating fiscal outlook, measures were tailored on the revenue side of the budget proposal for 2014, which were designed to increase the Treasury's revenue by close to ISK 7 bn per annum. The most important measure consisted of increasing and broadening the so-called bank tax, which is levied on the total debt of credit institutions. It was expected to rise from 0.041% to 0.145% and to also include legal entities undergoing winding-up proceedings, which had previously been exempted from the levy. The impact of these revenue measures was estimated at over ISK 14 bn and it had been calculated that over ISK 11 bn would come from legal entities undergoing winding-up proceedings. On the other hand, the plan was to reduce the general Financial Activities Tax (FAT), which is levied on wages and other taxable benefits enjoyed by the employees of financial undertakings from 6.75% to 4.5%, which would have curbed the Treasury's revenue by over ISK 1 bn.

On the other hand, measures were provided to reduce the tax burden of households and commercial enterprises. One can first mention a decrease in Personal Income Tax (PIT) where the plan was to cut the middle tax bracket from 25.8% to 25.0%, which would have reduced the Treasury's revenue by up to ISK 5 bn. Then there were plans to reduce the combined percentage of social security contributions and payments to the Wage Guarantee Fund by 0.1 percentage points, which would have reduced the Treasury's revenue by a further ISK 1 bn. Other small measures, which were mostly connected to price changes, had a negligible impact on the balance. The total revenue of the Treasury for 2014 was estimated at ISK 587.6 bn in the budget proposal, i.e. 30.1% of GDP, which is a similar ratio to the one in the state accounts for 2012 and the revised estimate for 2013.

[15] Budget proposal for 2014: www.fjarlog.is
[16] Revenue measures in the budget proposal for 2014: http://www.althingi.is/dba-bin/ferill.pl?ltg=143&mnr=2

Table 3: Fiscal balance 2012-2014 on an accrual basis

Table 1	Treasury operating statement				
Accruals basis, millions of krónur	Accounts 2011	Accounts 2012	Estimate 2013	Proposal 2014	Budget 2014
Tax revenue	**442.028**	**473.565**	**503.787**	**534.255**	**560.907**
Personal income tax	114.350	117.937	129.200	130.400	131.900
Corporate income tax	33.449	38.172	42.900	45.600	45.600
Social security taxes	64.847	62.299	66.425	72.614	72.315
Taxes on payroll and workforce	4.475	7.561	8.920	5.818	6.346
Net wealth taxes	11.065	15.345	16.129	16.950	16.770
Value added tax	131.404	142.648	150.000	156.700	160.000
Other taxes on goods and services	70.730	75.306	75.401	77.794	76.760
Other taxes	11.707	14.298	14.812	28.378	51.216
Other current revenue	**34.980**	**48.968**	**52.735**	**50.335**	**48.707**
Dividends income	2.038	7.041	15.203	11.406	11.106
Interest income	19.369	21.769	18.649	20.490	18.996
Levy on fisheries	3.901	9.849	10.525	9.965	9.965
Other property income	141	1.104	71	71	71
Other revenue	9.532	9.205	8.286	8.402	8.568
Revenue from sales of assets	7.876	1.204	795	600	1.300
Revenue and cost sharing transfers	1.642	2.139	2.376	2.365	2.149
Total revenue	**486.526**	**525.876**	**559.693**	**587.554**	**613.063**
The Presidency, Althingi and Supreme Court	3.703	4.301	4.585	4.008	4.134
Office of the Prime Minister	2.825	2.480	4.974	2.970	3.007
Ministry of Education, Science and Culture	58.355	62.273	66.627	66.710	67.161
Ministry for Foreign Affairs	10.119	10.027	11.316	12.001	11.389
Ministry of Industries and Innovation	39.104	29.069	26.264	27.320	27.737
Ministry of the Interior	64.858	66.520	72.953	71.665	72.377
Ministry of Welfare	230.859	241.381	246.620	253.069	258.305
Ministry of Finance and Economic Affairs	91.490	60.806	65.800	63.442	82.665
Ministry for the Environment and Natural Resources	9.049	9.239	10.467	9.948	9.855
Interest expenditure	65.588	75.625	74.434	75.963	75.506
Total expenditure [1]	**575.950**	**561.721**	**584.041**	**587.096**	**612.136**
Primary balance	**-43.205**	**18.011**	**31.437**	**55.931**	**57.437**
Interest balance	**-46.219**	**-53.856**	**-55.785**	**-55.473**	**-56.510**
Total balance	**-89.424**	**-35.845**	**-24.348**	**459**	**927**

Firm restraint on the expenditure side

A variety of measures were implemented on the expenditure side of the budget proposal to rein in the increase in expenditure and move further towards the objective of a deficit-free fiscal position. The most important measures revolved around reducing the Treasury's interest burden by reviewing the covenants of bonds that were issued in the wake of the collapse of the commercial banks to recapitalise the Central Bank of Iceland, which amounted to ISK 170 bn at year end 2012. This measure reduces the Treasury's interest payments by ISK 10.7 bn in relation to the interest payments estimated in the 2013 budget. These large payments are no longer deemed necessary considering the sound financial position of the bank.

Decisions were also made to cancel various projects within the so-called investment plan of the 2013 budget and various other envisaged projects, e.g. parental leave. These measures prevented the Treasury’s expenditure from rising by ISK 5.8 bn. These were mostly projects which were meant to be financed through the generation of special revenue, earnings from asset sales, increased dividend payments and raising special fishing levies on the fishing industry. However, these revenue measures never materialised as has already been discussed above.

Furthermore, the budget proposal imposed a 1.5% across-the-board restraint requirement which reduced government expenditure by ISK 3.6 bn. In addition to this, several austerity measures were taken to reduce Treasury expenditure by ISK 2.6 bn. On the whole, these special measures on the expenditure side were expected to improve the Treasury's balance by ISK 23 bn, but these savings were offset by an increase in expenditure obligations that were estimated at ISK 17 bn. The most important factors here were the estimated financing needs of the Housing Financing Fund, expenditure connected to social security and increases in old-age and disability pensions.

Overall, the plan was to increase the Treasury’s total expenditure by just ISK 4 bn compared with the 2013 budget, including general price adjustments. Total expenditure was estimated at ISK 587.1 bn in the budget proposal, which corresponded to 31% of GDP, 1.5% lower than in 2013 budget. The reduction in primary expenditure was estimated to be somewhat less or approximately 1% of GDP.

Target of positive overall balance has been reached

The above measures and plans in the budget proposal for 2014 resulted in a positive total balance amounting to ISK 0.5 bn on accrual basis. This was an important result considering that it marked the first deficit-free budget since 2007. The primary balance was forecasted to to strengthen by ISK 30 bn compared to the previous year, reaching ISK 56 bn, corresponding to 3% of GDP. The budget proposal also assumed that the interest balance would improve by ISK 1.5 bn from the revised estimate for 2013. The interest balance would therefore be negative by ISK 55.5 bn or 2.9% of GDP, which was a slightly lower amount than the surplus in the primary balance.

Approval of the 2014 budget

A number of amendments were made to the budget proposal while it was being processed by parliament, although the fundamental goal of a positive overall balance was safeguarded. The amendments entailed considerable increases both in revenue and expenditure, which were mostly connected to the ISK 80 bn write-downs of indexed house loans as well as shifts in certain priorities. The final budget that was approved showed a positive overall balance of ISK 0.9 bn, which is a slightly better outcome than assumed in the budget proposal. In the 2014 budget, the annual revenue is estimated at ISK 613 bn or 32.6% of GDP, which is an ISK 25.5 bn increase from the budget proposal. Total expenditure is estimated at ISK 612.1 bn or 32.5% of GDP, which is an ISK 25 bn increase from the budget proposal.

Most of the measures on the revenue side of the budget proposal, which are discussed above, made their way into the budget, albeit with certain changes. The biggest individual change was a further increase in the levy on banks, which was raised from 0.041% to 0.376% at the beginning of the year.

During the second and third readings of the budget proposal a decision was made to raise the levy further and to utilize the revenue to fund the write-downs of indexed housing loans, as will be described in greater detail below. Furthermore, the plan to cut personal income tax was changed so that the middle bracket of PIT was cut from 25.8% to 25.3% and the threshold for the lower bracket was increased by 20%, substantially more than regular price level adjustments would require. This change was made in connection with collective wage agreements and designed to support people with the lowest incomes. The cut in the general Financial Activities Tax was also slightly reduced and was ultimately reduced from 6.75% to 5.5%. Various other small changes were made, but a more detailed discussion of those can be found in the budget proposal.

The revenue forecast was entirely reassessed before the final approval of the budget in line with the revised macroeconomic forecast published by Statistics Iceland at the end of November and better information regarding tax receipts in 2013. This revision resulted in some increases in revenue estimates, particularly in VAT receipts and the capital gains tax.

On the expenditure side, the most significant amendment was a roughly ISK 20 bn increase in expenditure in connection with the write-downs of indexed house loans. Other changes included an ISK 4.7 bn increase in health care expenditures, including to the National Hospital. In addition to this, restraint measures amounting to about ISK 2 bn were placed on various state-run operating units, including the Government Offices. The main changes that were made to the 2014 budget proposal before its final approval are outlined in the table below.

Table 4: Main amendments made to the 2014 budget

Revenues	
VAT	3.3
Capital Gains Tax	2.8
Other	-0.3
Total	**5.8**
Expenditures	
Increase in health spending	4.6
Price effects	1.1
Restraint measures /spending cuts	-1.8
Other	1.1
Total	**5.0**
Debt relief of indexed housing loans	
Revenues	21.2
Expenditures	20.4
Total	**0.8**
Interest balance	
Interest revenue	-1.5
Interest cost	-0.5
Total	**-1.0**
Total balance	**0.9**

Medium-term fiscal strategy

The discussion below on the fiscal strategy for the next four years focuses on the long-term plan laid out in the budget proposal for 2014. These projections are based on simple extrapolations and as such the point towards a rather slow recovery. It will be revised in detail in the spring, namely in April, as stipulated by parliamentary law, particularly in line with the changes that were made to the 2014 budget when it was being processed by Althingi before the final passing of the budget. This revision will lead to some improvements in the long-term forecast. Authorities are committed not to deviate from the fundamental objective of maintaining a positive overall balance and continuing the paying down of debt. Any opportunities to accelerate further the amelioration of public finances and falling debt levels will be explored and fully exploited.

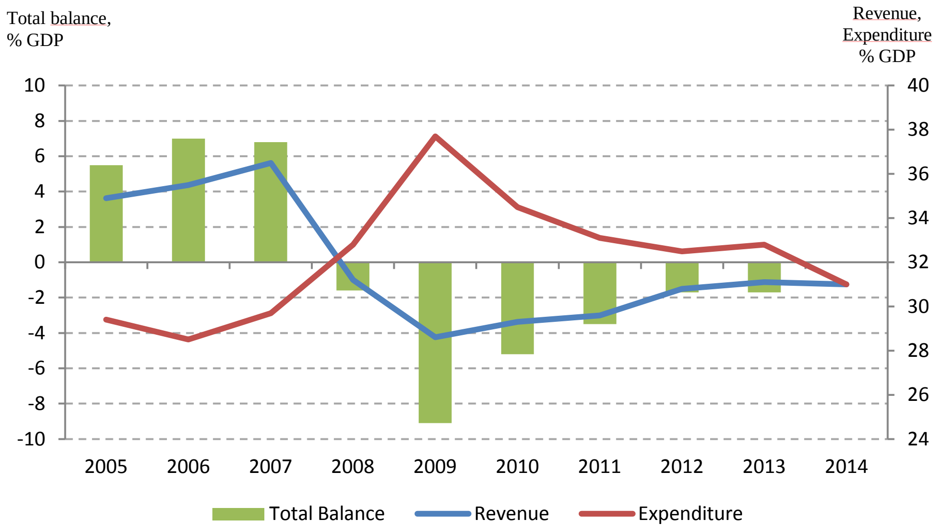
Previous medium-term plan based on weak foundations

As has been mentioned above, certain weaknesses were exposed in fiscal projections of the 2013 budget. Similarly, the long-term fiscal plan that was submitted in the budget proposal in 2013 (for the period from 2013-2016) was founded on a number of assumptions that it is now clear will not be realised. These included the expectation that temporary measures to generate revenue would be extended or substituted by others. The most significant envisaged measures were an extension of the wealth tax and the energy tax on electricity. The plan also assumed that fishing levies would increase substantially over the coming years, as spelled out in the fishing levy legislation that was then in effect. In addition, the plan comprised unfunded revenue-generating plans amounting to ISK 3 bn per annum that were meant to come into play as of 2014. Moreover, the macroeconomic conditions were more favourable towards the end of 2012 than they were when the plan was revised in connection with the budget proposal for 2014 at the end of last year.

The graph below shows the fiscal balances from 2005 to 2012, according to the results of the state accounts and the estimated balances for 2013-2017, on the basis of the medium-term assumptions of the 2014 budget proposal. The chart shows the Treasury's revenue and expenditure as a percentage of GDP on the right axis and its balance as a percentage of GDP on the left axis. To shed light on true underlying developments, both revenue and expenditures have been adjusted for irregular items.

The projections in the medium-term fiscal plan are based on the aforementioned assumptions regarding economic developments, the Treasury's estimated revenue and the projected growth in expenditure based on demographic assumptions which affect old age and disability pensions. A simple extrapolation yields a surplus of ISK 2.6 bn in the overall balance on an accrual basis for 2015 and a surplus of ISK 0.3 bn in 2016. The balance will be slightly better in 2017, however, when a surplus of ISK 19 bn is expected in the overall balance. The primary balance is expected to be positive by ISK 61.2 bn in 2015 and ISK 62.2 bn in 2016, corresponding to 3% of GDP, but then to rise to ISK 79.7 bn in 2017, i.e. 3.6% of GDP.

Figure 21: Fiscal balance 2005-2017 (estimate in 2014 budget proposal)



Sources: Ministry of Finance and Economic Affairs

The recovery according to current projections is too slow although it does imply a firmer grasp on fiscal policy in the sense that deficit accumulation has been halted. As the fiscal strategy will be revised in the coming months, the government‘s main task is to further strengthen balances and thus speed up the process of paying down government debt. In this respect there is a need to look at both expenditure and revenue. On the expenditure side there is a need to continue streamlining management as well as increase efficiency and re-evaluate expenditure priorities in various categories. Ultimately, higher investment levels, greater economic activity and stronger growth will strengthen tax bases and lead to faster improvement in public finances than the projections laid out in the 2014 budget announce. As already mentioned, a comprehensive review of the long-term fiscal plan will be conducted in April and all possible means will be sought to accelerate the recovery of Iceland’s fiscal situation.

Pension liabilities

In the context of the long-term fiscal plan it is important to bear in mind the state’s obligations towards the pension funds of its employees. Without any interventions, the B sections of the Pension Fund for State Employees and the Pension Fund for Nurses will be insolvent in 2027. With the depletion of these funds, other things being equal, the Treasury, as the guarantor, will have to pay out over ISK 20 bn per annum over the 10 years following and including 2027, after which the payments will start to decline. In addition to this, increases in pension disbursements will need to be paid, amounting to approximately ISK 13 bn per annum during this period. It is therefore clear that the long-term fiscal plan not only needs to make it possible to reduce Treasury debt and interest costs, but also to find ways of addressing the problems that lie ahead as a result of the state’s pension obligations by, for example, making changes to the pension and wage schemes for state employees and perhaps resuming the practice of making special pre-payments into the funds.

3.4 Revision of the tax system

Extensive changes have been made to government revenue systems in the past few years. Most of these have come in the form of tax increases and the adoption of new taxes and fees. It is not time to conduct a comprehensive evaluation of the new tax environment and to shape a new policy for the future. In this respect it could be argued that the Treasury was well prepared to meet the urgent need to increase revenue in the wake of the collapse of the banks precisely because tax rates were low and the tax system was relatively simple. However, the question must always be how far one can go in generating extra revenue before one undermines its original purpose, reversing its effect. The 2014 budget sets a milestone in that regard, since it marks the first steps towards a simpler tax system with lower tax rates.

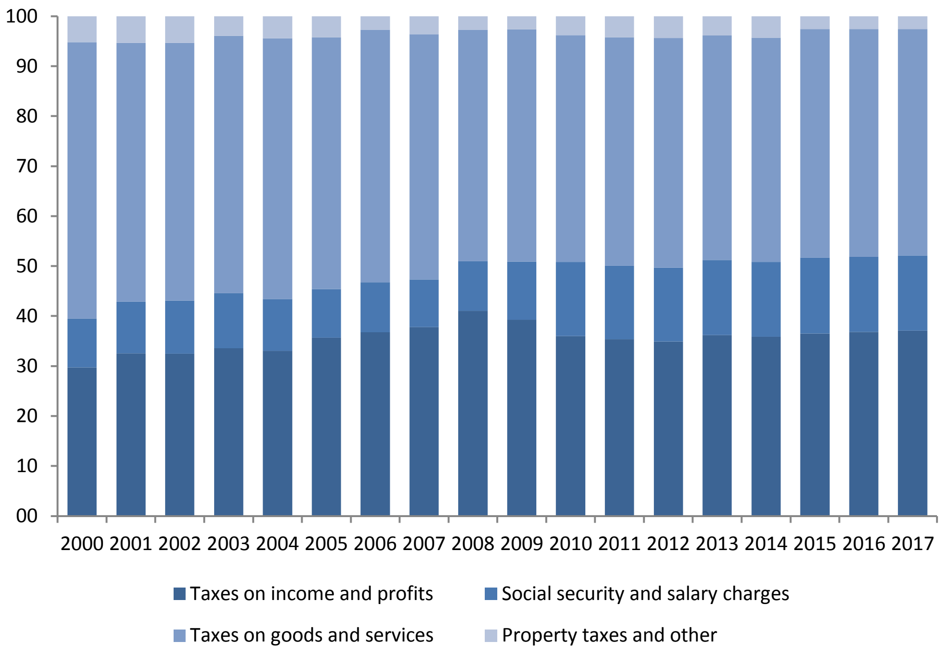
The objective of the tax system is to generate revenue to sustain state expenditure in an efficient manner. An efficient tax system helps to ensure that the factors of production in the economy are allocated in such a way as to guarantee the greatest benefits to society. In this context it is generally argued that one should aim for moderate tax rates and broad tax bases. Furthermore, it is considered desirable to have a simple tax system and to minimise exemptions and other deviations. During its term of office, the government intends to appraise and revise the tax system with the aim of increasing its efficiency, reducing dampening effects and generating clear incentives for value creation.

The composition of tax revenue has changed considerably

In recent years the weight of direct taxes has increased considerably, while the weight of indirect taxes (consumption tax/ turnover tax) has contracted slightly. Indirect taxes accounted for up to 55% of the Treasury's tax revenue about a decade ago, whereas that percentage is now around 45%. This can partly be attributed to the lowering of the lower of Value Added Tax (VAT) rate from 14% to 7% in 2007, but in addition to this consumption taxes have suffered in the wake of the economic crisis as they are very much linked to overall economic activity. An indication of this is that revenue from indirect taxes in 2012 amounted to ISK 24 bn, which is 12.1% less than in 2008 in real terms. Moreover, the revenue-generating measures taken by the government over the past years have mainly been in direct taxes, such as income tax, social security contributions and property taxes, which have increased proportionately. The graph below shows the composition of the Treasury's tax revenue between 2000 and 2013.

The weight of property taxes increased somewhat in the wake of the economic crash. This trend can almost entirely be attributed to the wealth tax, which was first introduced and collected in 2010. It should be pointed out that revenue from stamp duties is also considered as property tax, although revenue from that tax base has contracted substantially in recent years. In 2009, property tax accounted for 1.4% of the Treasury's tax revenue, compared to 3.2% in 2012, despite the contraction in stamp duty revenue. The Treasury's revenue from property tax grew by 150% in real terms from 2009 to 2012. The ministry's long-term forecast takes into account the fact that wealth tax will be abolished as of 2014 and the weight of property tax can therefore be expected to diminish substantially as of 2015.

Figure 22: Composition of tax revenue 2000-2013



The aim is for a more transparent VAT system

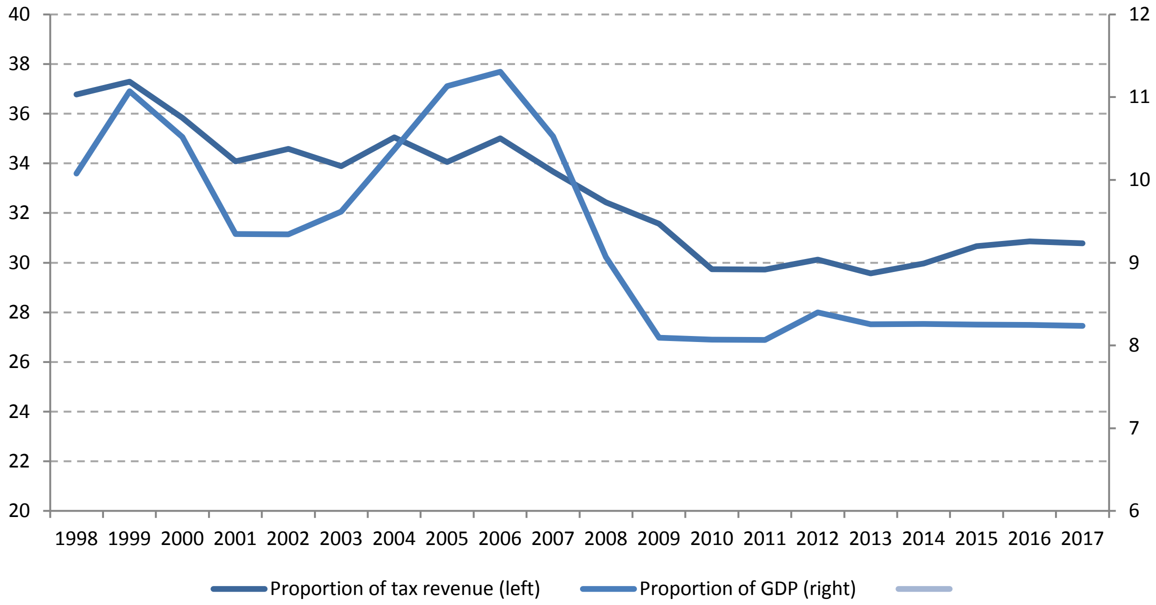
Over the years VAT has been the Treasury's most important tax base. From the year 2000 onwards it has accounted for more than one third of tax revenue. Since before the crash the weight of VAT has diminished somewhat, i.e. from 35.0% in 2007 to 29.7% in 2012. As a percentage of the GDP, VAT revenue diminished from 11.3% to 8.4% during the same period. This can be attributed to the tight financial position of Icelandic households since the crash, as the collection of this tax is closely linked to private consumption, which has contracted substantially. Part of the explanation is also that the lower VAT rate was reduced in 2007, while on the other hand the higher threshold was raised slightly in 2010. At fixed prices, the Treasury's revenue from value added tax in 2012 was about ISK 24 bn, i.e. 17.7% less than in 2008, despite the increase in the upper rate by one per cent in 2010.

The time has now come to revise the VAT system. In this regard, there is a particular need to ensure that the gap between the two VAT rates is narrowed. This measure would equalise the competitive situation across different sector, in particular in the factor markets, thereby promoting a more efficient allocation of production factors in the economy. The measure would also be of benefit to households, since it would more than likely entail a lowering of the upper VAT rate, which would permit companies to lower prices.

In Iceland the lower VAT rate has been applied for social purposes with the aim of lowering the prices of certain goods and services. Lower-income households generally spend a higher proportion of their disposable income on goods and services on which the lower rate of value added tax is applied, particularly food. Higher-income households, however, spend more on these goods in absolute terms. It can therefore be said that the lower VAT rate on certain types of goods benefits high-income households more than low-income households.

It is a generally accepted view that value added tax is an effective way of generating revenue for the state, but not necessarily for achieving social objectives such as income equalisation. For that purpose it is more suitable to apply other methods, such as general income tax cuts along with a systematic benefits scheme, which supports those who are in greater need in a cost effective manner. With these considerations in mind the new government intends to thoroughly review the VAT system during its term. In the long run there are arguments for adopting a single value added tax rate.

Figure 23: Treasury revenue from VAT 1998-2014



Personal income tax lowered and simplified

Transparency needs to be increased in personal income taxation. The complex interplay between municipal income tax, income tax with personal tax allowances and three different tax brackets, in addition to various compensation schemes, such as interest rebates and child allowances with complicated rules regarding restrictions, mean that it almost impossible for anyone but experts to understand the tax system. The first steps towards addressing this were taken in the 2014 budget. The middle income tax bracket has been lowered by 0.5% and this change came into effect at the beginning of 2014. The cut brings the middle income tax bracket closer to the lowest bracket. Over 80% of tax payers pay tax in the middle income bracket and this measure therefore covers the vast majority of tax payers.

The aim is to narrow the gap between the two lower income tax brackets even further during the term and to eventually merge them into a single bracket. This will simplify the income tax system considerably, boost its effectiveness and increase household disposable income.

Lower levies on companies

A business environment needs to be created for companies which encourages investments, job creation and provides the scope for higher wages. In this context, a particular focus will be placed on lowering taxes on companies. The first steps in that direction were taken in connection with the 2014 budget and consist in lowering social security contributions and the general Financial Activities Tax levied on the wages of the employees of financial undertakings. There is a plan to lower social security contributions by 0.34% in various phases until 2017, a measure which will save Icelandic companies four bn in wage costs per annum. The general Financial Activities Tax was cut from 6.75% to 4.5% and this measure is designed to strengthen the operational capacity of small financial companies. Other levies on companies will be reviewed during the current electoral term with a view to boosting the competitiveness of the Icelandic economy as much as possible.

3.5 Public debt, contingent liabilites and debt management

Every year the Ministry of Finance and Economic Affairs publishes its medium-term debt management strategy in which it presents its debt-financing and debt-management plans for the next four years. The principal objective of the strategy is to ensure that the Treasury's financing needs and financial obligations are met at the lowest possible cost that is consistent with a prudent degree of risk. A sustainable debt service profile, consistent with the government's medium-term payment capacity, needs to be ensured. The aim of the strategy is also to promote further development of efficient primary and secondary markets for domestic government securities. The objective is to broaden the government's investor base and diversify funding sources.

Looking at the composition of the debt portfolio, excluding loans that are taken for the specific purpose of boosting currency reserves, the greatest emphasis is placed on the issuance of nominal Treasury bonds, since these issues form the basis of an efficient bond market. The aim is for 60–80% of the debt portfolio to be in nominal bonds. The Treasury also issues inflation-linked bonds, but their issuance is irregular and based on circumstances in each case. The aim is for 10-40% of the debt portfolio to be in inflation-linked bonds.

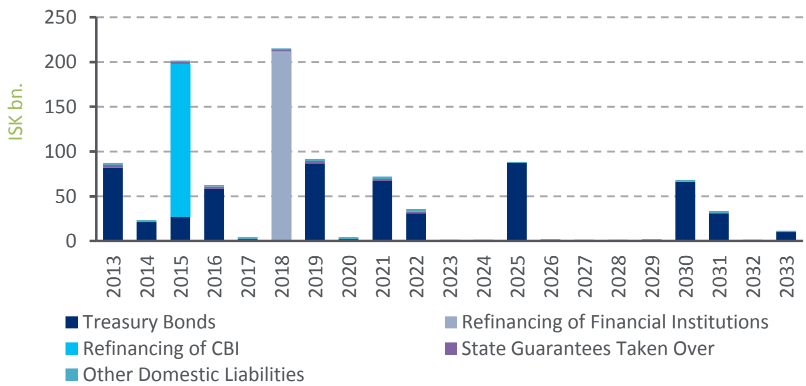
In the medium-term strategy, the Ministry of Finance and Economic Affairs sets forth the guidelines to be observed in the management of borrowing. The main guidelines concern the redemption profile, benchmark series, proportion of short-term financing and average time to maturity. The redemption profile of Government securities should be as smooth as possible over time, with similar final size of individual issuances. The proportion of the Treasury's foreign debt which matures within a twelve month period, minus any undrawn credit facilities, shall not exceed 30% of the Treasury's total outstanding debt. The average time to maturity of the debt portfolio shall be at least 4 years.

Domestic debt

The financing needs of the Treasury will be funded through the issuance of Government securities in the domestic market and by drawing on the Treasury's deposits at the Central Bank of Iceland (CBI). The aim is for deposits to amount to an average of ISK 80 bn The structure of the benchmark series will be designed so that each series is large enough to ensure effective price formation in the secondary market. The Treasury's debt shall be taken into account when determining the number of issues and their size. The aim is to issue a relatively stable amount of Treasury bonds throughout the year with varying maturities. To fulfil these objectives, the benchmark Treasury bond series will be issued each year with maturities of 2, 5 and 10 years. The issuance of inflation-linked and longer nominal Treasury bonds will be irregular and take into account the borrowing requirements of the Treasury and market conditions. The objective is for the final size of each series to be in the range of ISK 40-100 billion, except in the case of the 2-year series, however, where the final size of the series shall be no less than ISK 15 bn. In addition to this, Treasury bills will be issued on a monthly basis, for an amount that will be determined by the Treasury's financing requirements at any given time.

As can be seen in the Treasury's annual debt management strategy for 2014, the aim is to issue Treasury bonds for a sale value of ISK 50 bn. The Treasury bill position shall be increased by ISK 8 bn between years and, at the end of 2013, amounted to approximately ISK 22 bn. The proposal is to leave the Treasury's deposits in the Central Bank unchanged, since its balance at the end of 2013 was ISK 87 bn. In 2013, the issuance of Treasury bonds amounted to a nominal value of ISK 94 bn, some ISK 87 bn of which were issued in public auctions and ISK 7 bn in the foreign currency auctions of the CBI. Over the past years the debt accumulated as a result of the deficit amounted to ISK 390 billion. Because of the positive overall balance estimated for 2014, domestic issuance will be substantially reduced this year.

Figure 24: Redemption profile for domestic loans



According to the medium-term debt-management strategy, the aim is to keep the redemption profile as even as possible. The accompanying graph shows the redemption profile for the Treasury's domestic loans over the coming years. The biggest domestic maturity dates are in 2015 and 2018. 2015 will see the maturing of a bond, which was issued to strengthen the capital position of the Central Bank of Iceland, but the bond is expected to be refinanced before the end of the year. In 2018, bonds which were issued to recapitalise the financial institutions shall be maturing. In 2014 Treasury bonds amounting to ISK 25 bn shall be maturing.

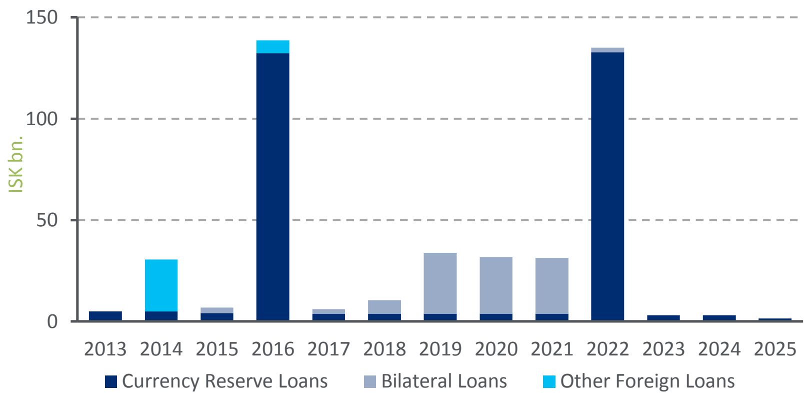
External debt

The Treasury's borrowing in foreign currency is primarily intended to boost the Central Bank's currency reserves. The foreign currency borrowing strategy is aimed at securing regular access to international capital markets and maintaining a well-diversified investor base. To achieve this, the government aims to regularly issue marketable bonds on global markets to refinance outstanding marketable bonds and loans related to the government's economic programme.

In 2011 an important step was taken when the Treasury regained access to international financial markets for the first time since the crash. On that occasion the Treasury issued a 5-year bond for USD 1 billion. Access to global markets was then reaffirmed with a new bond issue in 2012, which was also for USD 1 billion. That bond, however, was for 10 years. Investors showed a great deal of interest in both issues and the Treasury bonds were significantly oversubscribed. For much of the period since Iceland regained access to the global markets the Treasury's borrowing terms have been improving. Terms have been on a par with countries with similar credit ratings, although developments have been slightly more favourable for Iceland. The stated intention of the governor of the US Federal Reserve to reduce its accommodative monetary stance, in May 2013, reversed that trend. Initially it had no visible impact on the foreign-currency denominated Treasury bond yield, but it then started to rise in line with the market.

This year a loan from 2004 will be maturing for the amount of USD 200 million. According to this year's plan, it is expected to be refinanced. The next big individual maturity date is in 2016 when a bond issued in US dollars in 2011 will be maturing. Then there is the outstanding balance of the loans that were taken from the Nordic countries in connection with the government's economic plan, which will be maturing between 2018 and 2021. The Treasury has already pre-paid 59% of those loans. Then a bond which was issued in US dollars in 2012 will be maturing in 2022.

Figure 25: Redemption profile of foreign loans

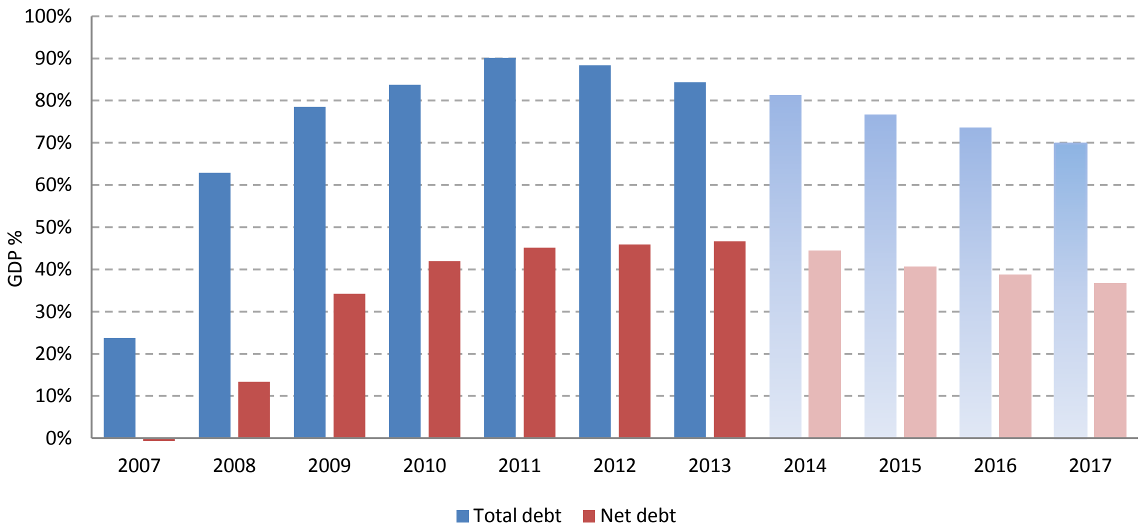


Debt trajectory

The graph below shows the development of the Treasury's total debt and net debt between 2008 and 2013 and estimates until 2017. Total debt, as a percentage of GDP, is estimated to have peaked at 90% at the end of 2011 and is expected to drop over the coming years to 70% by 2017. At the end of 2013 it is expected to amount to 84% of GDP. Of the total debt, ISK 171 bn is due to the recapitalisation of the Central Bank, ISK 213 bn to capital contributions to the new financial institutions, and ISK 383 bn to foreign loans, which the Central Bank took out to boost its currency reserves.

The net debt position as a percentage of GDP is estimated to have peaked at 47% at the end of 2013 and is then expected to drop to 37% by the end of 2017. The net debt position is defined as total debt, excluding interest-bearing assets, which comprise issued loans, short-term claims and the Treasury's cash in hand.

Figure 26: Development of debt as percentage of GDP 2008-2017



The estimated currency composition of debt at the end of 2013 is shown in the next graph. The largest part of the debt is in ISK, i.e. 71%. Nominal loans are expected to make up 45% of total debt, indexed loans 26%, and foreign currency loans 29%.

As has been mentioned, the Treasury's net debt position is estimated at 45% for the end of 2014. This only takes into consideration interest-bearing assets, whereas share capital in, among other things, financial institutions, is excluded. The Treasury is therefore well prepared to pay down its debts over the coming years and there is no need for further borrowing. If market conditions permit and it is beneficial for the Treasury, the possibility of refinancing the loan programme shall be examined. The Treasury may also opt to avail of buybacks and swap auctions before the maturity date to ensure that the average time to maturity of the debt portfolio is maintained at its minimum period, which is 4 years.

Contingent liabilities

Contingent liabilities are financial obligations that could fall on the Treasury; for example, due to state guarantees or administrative decisions that entail involvement in the financing of municipalities or undertakings that play a key role in Icelandic society. The Treasury's main indirect obligations are in State guarantees. Treasury guarantees are governed by Act no. 121/1997. Icelandic Parliament issues State guarantees upon receiving requests from the Ministry of Finance and Economic Affairs.

Table 5: State guarantees

Outstanding 30.11.2013	Amount in m. ISK	%
Housing Financing Fund	931,590	73%
Landsvirkjun	311,891	24%
Other bodies	31,935	3%
Total	1,275,416	

The position of State guarantees at 30 November 2013 was ISK 1,275 bn, corresponding to 74% of GDP. The largest entities to enjoy State guarantees on their loans are the Housing Financing Fund (HFF) with 73% of the total amount of State guarantees and Landsvirkjun with 24%.

Housing Financing Fund

Pursuant to Housing Act no. 44/1998, the role of the Housing Financing Fund (HFF) is to provide loans for the purchase of housing in Iceland. The fund is supervised by the Financial Supervisory Authority (FME).

Since 2010 the Althingi has approved the allocation of ISK 46 bn to the fund to increase its capital base. Other things being equal, the Fund will require further capital contributions in the coming years. The risk factors of the Housing Financing Fund are lending risk, liquidity risk, interest and inflation risk, payment risk, refinancing risk and operational risk. Of these, prepayment and credit risks are the two greatest risk factors, which are reflected in the fact that the Fund's operational losses in recent years stem primarily from loan impairment and an increase in prepayments.

Interest risk is also an important risk factor, since net interest income is a major component in the Housing Financing Fund's income statement. The HFF's low equity ratio makes it more difficult for it to cater for the risk factors in the operation of the fund and the Treasury's exposure to risk is therefore higher than it would be otherwise.

Landsvirkjun

Landsvirkjun is a state-owned energy company. Its obligations are covered by a simple State guarantee. Landsvirkjun produces electricity from renewable energy sources, hydropower and geothermal energy.

Landsvirkjun's liquidity position is sound because of its strong cash position and undrawn revolving credit facilities, and the group is well prepared to service its debt in coming years. The net debt of the company continues to decline and currently amounts to USD 30 million and Landvirkjun's net debt position has therefore dropped by a total of USD 418 million over the past four years, which is positive news. Nevertheless, it is important to carry on along the same track, in light of the company's indebtedness.

Landsvirkjun's financial risk consists of market risk, liquidity risk, and counterparty risk. Landsvirkjun has systematically reduced its market risk. With a new agreement negotiated between Landsvirkjun and Alcan Iceland in 2010, the aluminium price linkage in the previous contract was revoked and all sale of electricity to Alcan linked to the US consumer price index. The proportion of Landsvirkjun's electricity sales linked to the price of aluminium has therefore declined sharply, i.e. from 70% to 45%.

The operation of the company will remain sensitive to changes in aluminium prices and interest rates. The company's refinancing risk has been reduced through an even distribution of repayments and interest and with long maturities on outstanding loans. The average maturity period of the loan portfolio was 6.5 years at the end of 2013, compared to 7.6 years at the end of 2012. The last bond issuance of the company, which was in August 2013, was without a State guarantee.

Municipalities

There are no mandatory state guarantees on the debt of municipalities, but their financial positions can entail general risks that can hamper each individual municipality from performing their role, in addition to which their debt position as a whole can pose a risk to the economy and the Treasury. The high debt levels of certain municipalities and their weak financial positions are therefore a cause for concern.

The Althingi approved a new Local Government Act in 2011, which imposes greater discipline and clearer rules regarding the fiscal management of municipalities, in addition to increased supervision and the provision of more information on their finances. Firstly, it recommends ensuring that there is a balance between the income and expenditure of municipalities every three years. Secondly, the debt and obligations of the group shall be limited to 150% of the income. It is clear that many municipalities need several years to be able to fix their debt positions within the maximum period allowed by the Act, which is 10 years. It is important to use this time well and to ensure that the municipalities' finances be based on a sustainable foundation as soon as possible. Under the terms of this Act, local governments that wish to make decisions regarding investments, construction or entering into other binding contracts amounting to more than 20% of the tax revenue of the current year, are required to have an evaluation of its financial impact conducted by an independent party.

Public-private partnerships

Public-private partnerships can entail financial risk for the Treasury, even when there are no state guarantees on the project. Joint projects generally pose little direct financial risk to the Treasury, although situations can arise when projects require more funds than those allocated in the current budget. The principal partnerships that are currently in force are the management of the Harpa Concert Hall and the Vaðlaheiðargöng tunnel.

3.6 Quality of public finances and the effectiveness of public management

A new bill on an Organic Budget Law will be submitted to parliament in the coming weeks. Endeavours will be made to strengthen the entire budgeting process and to ensure a substantive debate on total contributions to the various fields rather than a debate on the allocation of funds to specific institutions and issues that have often turned out to be time-consuming and unfocused. In this manner the ground will be laid to enhance fiscal strategies, not least in an economic context. The objective is to ensure the meticulous preparation of strategies in fiscal policy, to change and clarify the accountability of judicial and executive powers, tighten discipline and firmness in public financial management, improve supervision and have a clearer vision of the long-term objectives of fiscal policy.

A simpler presentation of budgets will be recommended, as well as compliance with accepted international reporting and supervision standards. This will increase transparency in the preparation, shaping of and approval of budgets and will enable both individuals and companies to acquire detailed information on the development of fiscal policy. Clearer procedures and a better dissemination of information on fiscal policy reduce the uncertainty of companies and households and in this manner promote economic stability in the form of Lower interest rates among other things.

Integration of central and municipal fiscal policy

The weight of municipalities in the economy has increased in recent years and it is therefore vital that central government and municipalities further integrate their strategies in the field of fiscal policy in order to meet the economic objectives that have been approved by parliament. The weight of municipalities in the overall economy is for exampe reflected in the fac that in 2013 the revenue of municipalities is expected to make up about one third of the total revenue government revenue and municipalities' expenditure will amount to 29% of total expenditure.

The Organic Budget Law provides for a targeted long-term strategy in the field of fiscal policy, including municipalities, and a clearer definition of municipalities' involvement in the shaping and execution of this policy. Fiscal policy regulations have been harmonised in the recent Local Government Act and Public Finances bill. Clearer policy making and more systematic long-term budget estimates should help to ensure that the objectives of the policy are achieved.

Efficient public management

Over the past years, various reforms of the public sector have been undertaken with a particular focus on improving the management of state institutions, and strict streamlining requirements have been imposed as a result of diminishing funds. Considerably less attention has been paid to the systemic and organisational shortcomings of state management. There have been profound social changes since the main service and administrative system of the state was initially established. The organisation, management and services of the state have not taken these changes sufficiently into account. The structure of the state system needs to be examined with a critical eye and the necessary changes have to be made to meet the needs and requirements of the community in each case.

One of the priorities highlighted in the government's policy statement is to increase the efficiency of the administration and improve services. A special Group has been established to follow up on this issue. The group is expected to submit its proposals on how to increase productivity and better utilise funds to a ministerial committee for fiscal policy. The group has already presented several proposals. The group focuses primarily on tackling multifarious systemic faults or non-cost efficient elements and on promoting more dynamic and up-to-date public management. Preparations for wide-ranging systemic changes have already begun in many ministries and will mainly be focused on state services and administration. The government is dedicated to responding to the changed environment of public management and to avail of every opportunity to improve services and enhance cost-effectiveness and performance.

More efficient administration and reformed public management

The government aims to carry out substantial reforms in the interest of the public by reshaping the structure, management and services of the state. As stated in the government's policy statement, this will be achieved through, among other things, organisational changes, the integration of support services and the merging of institutions. These reforms are designed to ensure dynamic and transparent administration, good and cost-effective services, and to facilitate the advancement of the following objectives:

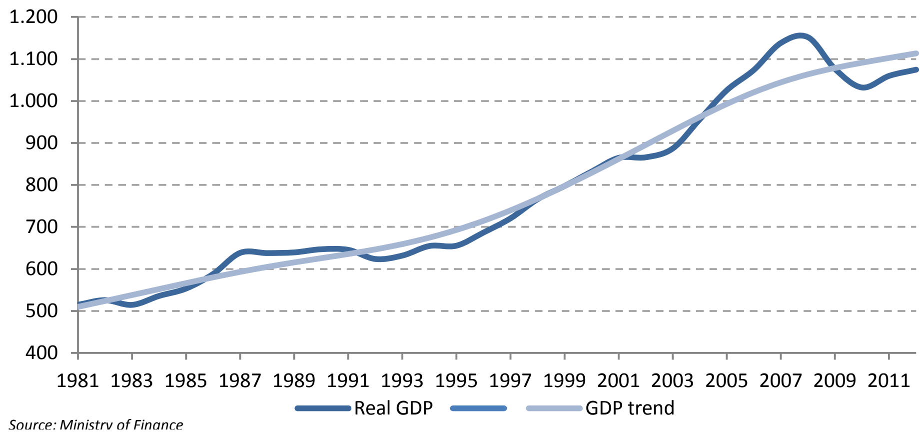
- State activities shall be coordinated, efficient and flexible and work jointly on the tasks at hand in each case.
- Services shall be dynamic, lead to innovation and be tailored to the actual needs of the population and community.
- The state's communications with the public and the market shall be founded on equality, transparency and a clear legal framework.
- State institutions shall continue to be interesting work places and cultivate the great human capital that underlies all state activities.
- Institutions shall be enlarged and strengthened in order to improve services and ensure interesting jobs.
- Policy making, funding decisions and the activities of institutions shall always be founded on performance, quality and an optimised utilisation of funds.
- Corporate governance shall be modern and professional and guided by the principle of ensuring quality procedures and the effective management of funds.
- Information technology and e-government shall facilitate the streamlining and integration of the administrative system and lead to better and simpler services.
- The business community shall be provided with good working conditions and the advantages of public-private partnerships shall be utilised.

4. Structural reform objectives

4.1 Obstacles to growth and structural reform agenda

Recovering the production capacity lost during the crisis needs to be central theme of economy policy as the recovery takes hold and the output gap closes. The depreciated real exchange rate allows for growth of new competitive or international sectors and renewed vigour within existing export sectors. Economic policy needs to reduce obstacles to growth in these sectors to allow them to fill the void left by the sharp contraction of the financial and construction sectors. Every effort has therefore to be made to ensure that the loss in output following the crisis does not become permanent and thus lead to reduced prosperity. Reversing the output loss and increasing the economy's growth potential are therefore the guiding lights of economic policy.

Figure 27: GDP and growth trend



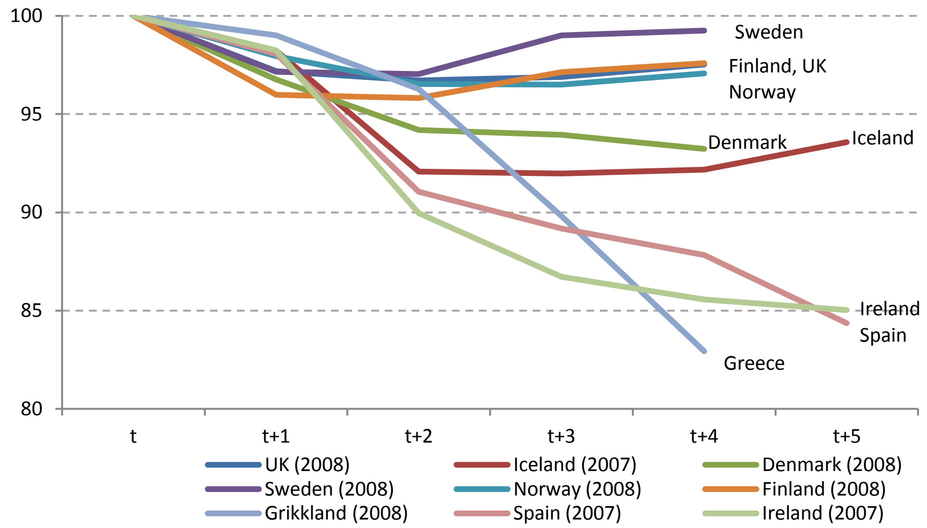
Source: Ministry of Finance

Importance of a flexible labour market

A dynamic and flexible labour market remains one of the greatest strengths of the Icelandic economy. The high activity rate, which has already started to rise again, and flexible workforce, with the participation of both Icelanders and workforce from other EEA countries, has facilitated the adjustment of the economy, both in the lead-up to and aftermath of the crises. As discussed in Chapter 2.2, the outflow of labour between 2009 and 2012 has now stopped and an increased demand in the labour market has resulted in a rise in imported labour again. Low productivity is, nevertheless, a concern that has been heightened by indications of brain drain from Iceland since the onset of the crisis, with an educated workforce emigrating to other Nordic countries, while an uneducated workforce moves to Iceland to work in the service sector.[17] The flexibility of the labour force can clearly be seen from the graph below, with a renewed rise in the activity rate.

[17] Statistics Norway, survey on the education of foreign immigrants, see http://www.ssb.no/utdanning/artikler-og-publikasjoner/_attachment/115532?_ts=13f0ed11d68.

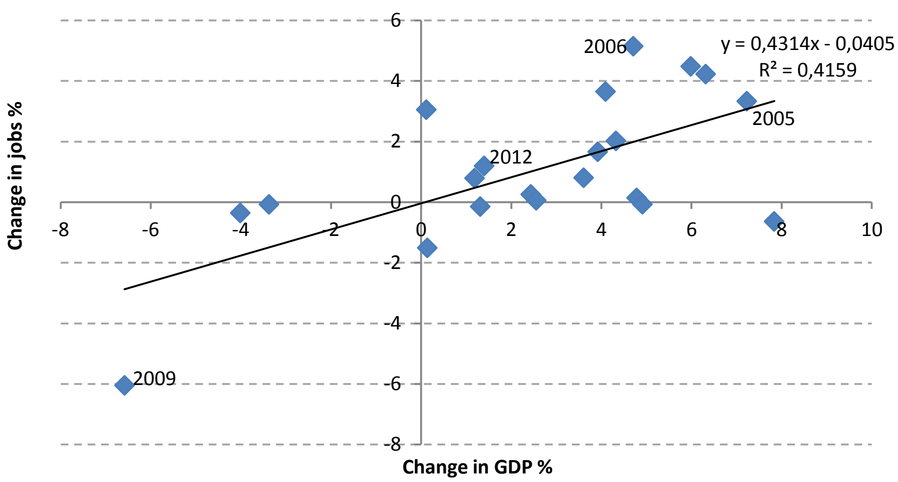
Figure 28: Labour participation during recession, indeces t=100



Source: OECD, Ministry of Finance and Economic Affairs

Over the past years, the rise in output has contracted according to the forecast of the Central Bank of Iceland in the second issue of its Monetary Bulletin in 2013.[18] From 1992 through 2012, the number of jobs increased by 0.42% for each percentage point in growth. From 2008 to 2012, this percentage showed an increase of 0.61% in the number of jobs for each percentage point of growth, compared to a 0.28% increase up to the crisis. This means that unit labour cost increased more than might have been expected on the basis of the long-term correlation between economic growth and the rise in the number of jobs.

Figure 29: Correlation between growth and employment 1992 - 2012



Productivity uneven between sectors

The high labour market participation rates and good labour productivity of fisheries and energy intensive sectors have allowed Iceland to have one of the world's highest GDP per capita according to purchasing power parity. However, as discussed in detail in the McKinsey report and the work of

[18] Source: Central Bank of Iceland, Monetary Bulletin 2013/3

the Iceland Growth Forum, productivity in the Icelandic economy as a whole is low, with productivity estimated to have been a fifth lower in 2010 than in Iceland's neighbouring countries. This is not least the case in the domestic service sector, which accounts for 34% of output, and the public sector.[19]

There are opportunities to increase the productivity of the services sector through reforms in their operating environment. This is clear from Iceland's position below the average of the member states of the Organisation for Economic Cooperation and Development (OECD) according to its PMR (Product Market Regulation) indicators.[20] There are also opportunities to increase efficiency and productivity in the public sector.[21]

Increased efficiency of the education system has been one of the central themes of recent reports on Iceland by both the OECD and the IMF. Improving the performance of the education system, as well as shortening the schooling period, could play a major role in enhancing the productivity of the economy as well as government expenditure efficiency. Among the most important changes to the system would be to reduce the long duration of studies, which is 7.0 years for both primary and secondary education compared with OECD averages of 5.9 and 6.5 years, respectively. The shortening of the number of years required to complete secondary education would hopefully reduce the high drop-out rate, with 45% of students successfully completing upper secondary education within four years compared with an OECD average of 68%.[22] The high drop-out rate is, however, is not only driven by the education system but also the structure of the economy, which has historically allowed for ample employment for a relatively low-skilled workforce, whether the jobs have been in the fisheries sector, energy intensive industries, construction or tourism. Alongside its recommendations of the reformation of the education system, the OECD's main recommendations to Iceland are:

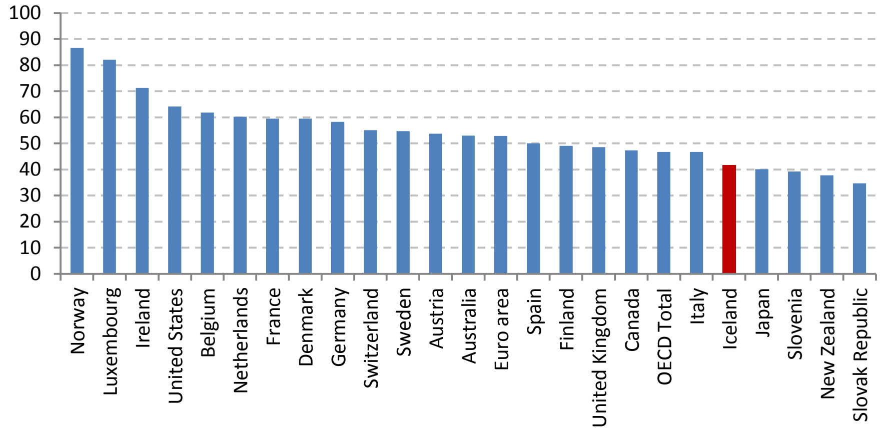
- Reduce the obstacles to normal competition in the commodities market, simplify the legal framework, increase the transparency of regulations etc.
- Reduce the obstacles to acquire holdings in companies facing both domestic and non-resident entities
- Reduce agricultural subsidies, diminish custom duties
- Increase the efficiency of public management
- Improve the educational system in consideration of the poor results attained in reading and mathematics, increase the responsibilities and requirements of the schooling system

Other international institutions, including the IMD in Switzerland, have pointed to other features that could be improved in the Icelandic economy. Iceland fell to the 29th position according to a multitude of indicators in the most recent annual report by IMD on the competitiveness of countries, whereas it had topped the list in 2006. According to the IMD, the main obstacles to Iceland's competitiveness

[19] McKinsey report and OECD report on Iceland, June 2013.
[20] The OECD measures the competitiveness of countries on the basis of how burdensome their regulatory frameworks are, according to a Product Market Regulation questionnaire that is submitted to OECD countries every 5 years.
[21] McKinsey & Company (June 2012)
[22] OECD 2013 Review of Iceland.

are the capital controls, high indebtedness, the limited efficiency of the public sector and low foreign investment.

GDP per hour worked, current prices, USD

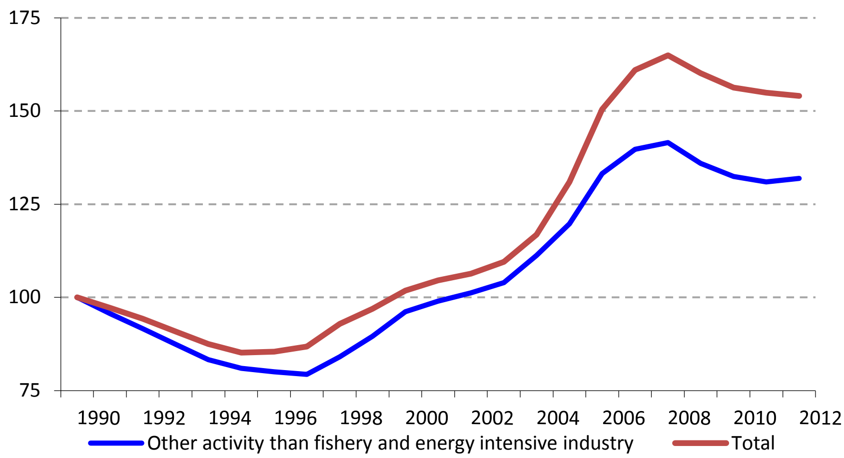


Source: OECD

Need to deepen the capital stock

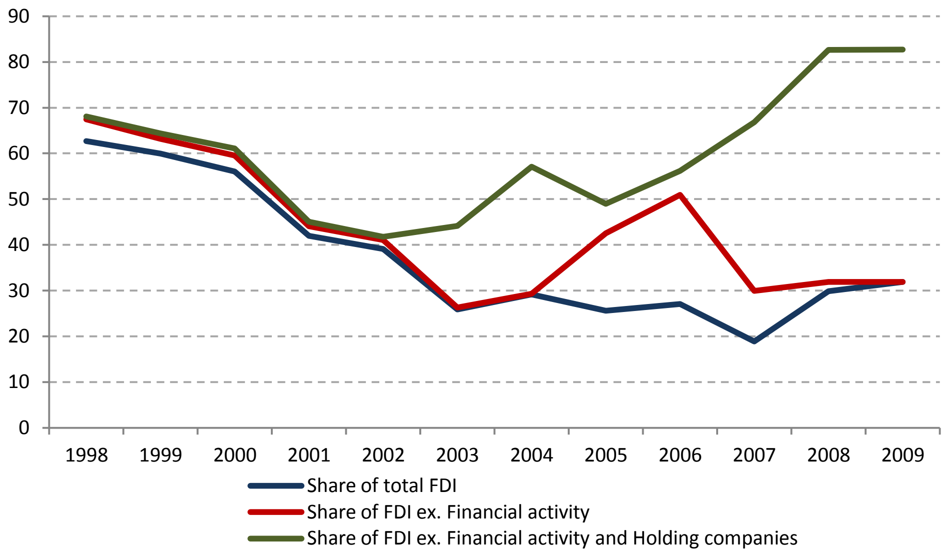
Increased profitable investment is important for improved productivity and growth. With very low investment levels following the crisis, the direct investment position of the business sector has gradually shrunk in real terms over the past years, after peaking in 2008. The direct investment position of sectors other than marine exports and heavy industry contracted by 7.5% between 2009 and 2011, before increasing slightly in 2012. The outlook is for the contraction period in industrial investments to neither as deep nor as protracted as the contraction period between 1990 and 1997 when the direct investment position shrank by 22.7%.

Figure 30: Investment index



Iceland has historically faced relatively low levels of foreign direct investment, with the exception of energy intensive industry, which has benefitted greatly from this inflow, and inflows directly related to the financial sector bubble, as can be seen from the graph below. As mentioned in Chapter 4.2., work is already under way to improve the framework of foreign investment. This work reflects in part Iceland's relatively poor position in OECD comparison of openness to FDI.

Figure 31: Share of Energy Intensive Industry in FDI stock (%)



Risk aversion and a lack of confidence are major factors behind the low level of investment in the aftermath of the crises, although the over-investment of the previous years, heavy debt position and difficult challenges that have faced the banking system also play a role in this regard. The lifting of capital controls has a key function in this regard, since they are one of the main causes of the deterioration in Iceland's competitiveness as discussed above. The negative impact of capital controls can manifest itself both in a shortage of investment and a suboptimal allocation of capital.

The high indebtedness and low profitability of many sectors, when high interest rates are taken into account, are also a determinant factor behind low investment levels. The indications are that companies are too indebted when they emerge from financial restructuring,[23] and this reduces investment and economic growth. During the boom years the level of business investments was very high and Icelandic companies were net borrowers, whereas today that trend has been reversed and companies use their operating capital to pay down their debt instead of investing.

4.2 Key areas of structural reform

4.2.1 Product and capital markets

One of the principal tasks of economic policy is to create an environment which encourages increased profitable business sector investment so that, among other things, companies in the international sectors can make full use of the competitive edge that a favourable real exchange rate can give them. Further progress in the restructuring of companies and their finances will also facilitate investment and therefore fuel growth. In this regard it is vital to have a stable operating environment, both with an improved regulatory framework and fiscal stability with a reduction in taxes and public fees. The first step towards lowering taxes and public fees was taken in the 2014 budget.

[23] Competition Authority: Does a lost decade lie ahead? Dynamic competition cures stagnation.

The government’s policy statement focuses on four elements of economic reform. Firstly, one of the most important tasks of the government is to work on lifting capital controls. Secondly, the government places an emphasis on simplifying the tax system and implementing positive incentives the make the management of businesses simpler and more efficient. Thirdly, the regulatory framework of economic activity needs to be reviewed with a view to reducing bureaucracy and simplifying communication with public entities while, at the same time, keeping costs down. Fourthly, the utilisation of funds allocated to research and development activities needs to be optimised by consolidating the management base and environment of the state institutions that conduct research and development.

Along these lines, the Prime Minister appointed in September 2013 an advisory committee on the supervision by government entities and the implementation of Administration Procedure Act, no. 27/1999. According the law, the committee is supposed to advise ministries and those being supervised, or are affected by government supervision, on regulations in this field. The committee is to advise on the implementation of the government’s policy of a simpler and more effective regulatory environment of the business sector.[24] The government‘s action plan includes a special review of legal acts presented by the government on their possible burdensome effects on business. This assessment should include a justification for acts that may cause economic burdens. An interim report on the implementation of the government’s action plan is to be submitted by mid-2015.

Endeavours are being made to simplify the legal and regulatory framework in to encourage foreign direct investment. A bill is being prepared to be presented in the spring session of Parliament to amend Act no. 34/1991 on Investment by Non-residents in Business Enterprises which will include first steps to increased transparency and simplification of the legal framework.

There is also a need to combat the instability that has characterised the Icelandic economy, with volatility of GDP measuring twice as high in Iceland as it does in other Nordic countries and among the countries in the European Union. Increased economic stability facilitates investment and boosts economic growth.[25] Work is therefore being done on strengthening the economic policy framework, not just to ease the process of stabilizing the economic cycle but also, to lay the foundations for greater growth in the future. With this objective in mind, two bills will be submitted to parliament in the spring of 2014 with the aim of strengthening the framework of economic policy, i.e. the Fiscal Policy bill and the Financial Stability Council bill.

Increased economic stability will allow for further growth of the export sectors, which have historically been the growth engines of the Icelandic economy with high investment and productivity levels. These sectors remain especially important as the composition of growth changes with the tight balance of payments position and the sharp contraction in previously important sectors, as is discussed in Chapter 2. It is crucial to maintain a strong competitive edge and to support the exports sector with a stable real exchange rate and an enhanced operating framework. Fiscal policy can also play a part in improving the competitiveness, with indications that increased public consumption can lead to a rise in the real exchange rate but that increased public investment can have a lowering effect.

[24] http://www.forsaetisraduneyti.is/media/frettir2/adgerdaaaetlun-einfaldara-regluverk.pdf

[25] Source: BIS Working Papers. no 434. Cyclical macroeconomic policy, financial regulation and economic growth, by Philippe Aghion and Enisse Kharroubi. December 2013. p. 3-4

This is particularly important for service exports, whether it is in the fields of tourism or various high technology services. The IMF pointed to the hi-tech industry in the field of scientific measuring and monitoring technology as an important avenue to strengthen and diversify the export sector, which needs in the first instance to be based on current comparative strengths. In its study, the IMF also pointed to the energy-intensive industry as a source of export led growth, with a special emphasis on increasing value creation in the production process.[26]

The resource and international sectors

The Icelandic economy has divided into four sectors in the work of the Iceland Growth Forum: domestic services, public services, the resources sector and international sector. The resources sector is the backbone of value creation in the economy because of its high contribution to exports, since over 80% of all exports stem from the fishing industry, tourism and energy production. The position of these sectors is discussed at length below.

The international sector, on the other hand, comprises companies that compete in international markets and are mostly not dependent on the country's local resources. The international sector accounts for about a fifth of exports, but also represents the greatest growth opportunity for the Icelandic economy. This sector needs to grow considerably faster than the economy as a whole, since it will play a key role in the growth of exports over the coming years, due to the growth constraints the resource sector will have to face.

The contribution of international sector to the GDP and exports has been low in comparison with that of other Nordic countries. A possible explanation for this may be, among other reasons, their unstable and unpredictable operating environment, which is small and far from global markets, with difficult access to domestic and foreign expertise and limited access to foreign funding. In order to ensure growth and the evolution of the international sector, there is a need to create an operating environment that meets international standards in terms of stability, connections with abroad, human resources, innovation and investments. The strengthening of the educational system and the removal of administrative hurdles are especially important for nascent industries in this sector. Moreover, the continued relatively low real exchange rate plays an important role to secure the sector's competitiveness. The removal of capital controls is one of the preconditions for the growth and evolution of the international entrepreneurial sector.

The fisheries sector

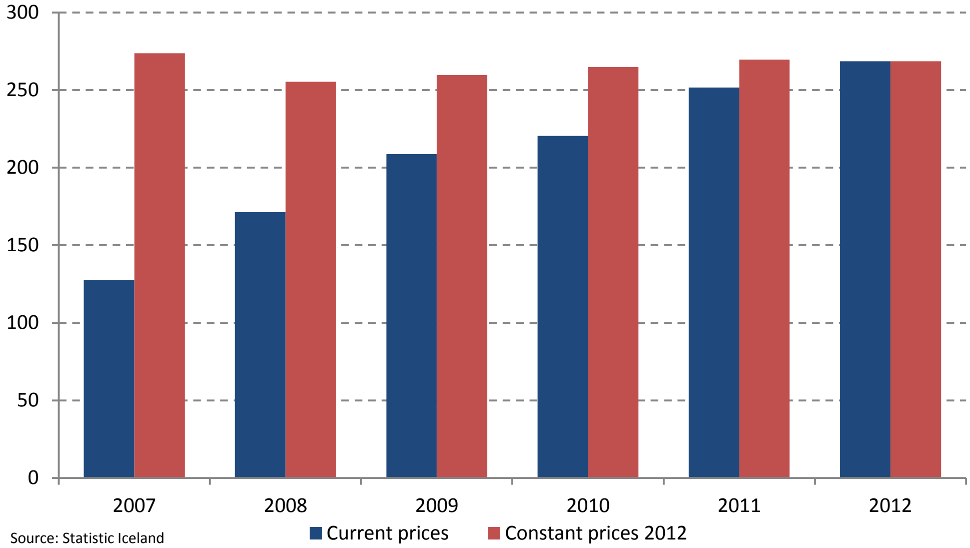
The fisheries sector has for decades been a driving force behind exports and economic growth. The productivity of its labour force and capital are high both in domestic and international comparison.[27] The government's fisheries policy will first and foremost be focused on ensuring a favourable and stable operating environment for the fisheries sector and related branches, with a focus on protecting the productivity of the sector and paving the way for further progress. A durable consensus on the fisheries management system and a redistribution of the dividends this sector generates by tapping this limited natural resource are the most important steps in this regard.

---

[26] http://www.imf.org/external/pubs/ft/scr/2010/cr10304.pdf
[27] See www.samradsvettvangur.is.

In 2012 the value of marine product exports amounted to about ISK 270 bn, which corresponds to about a 27% share of the total value of the exports of goods and services. According to these figures, marine products form the biggest individual item in the value of the country's total exports. Since 2008 the export value of marine products has increased by a nominal value of 57% and important fish stocks are strengthening.

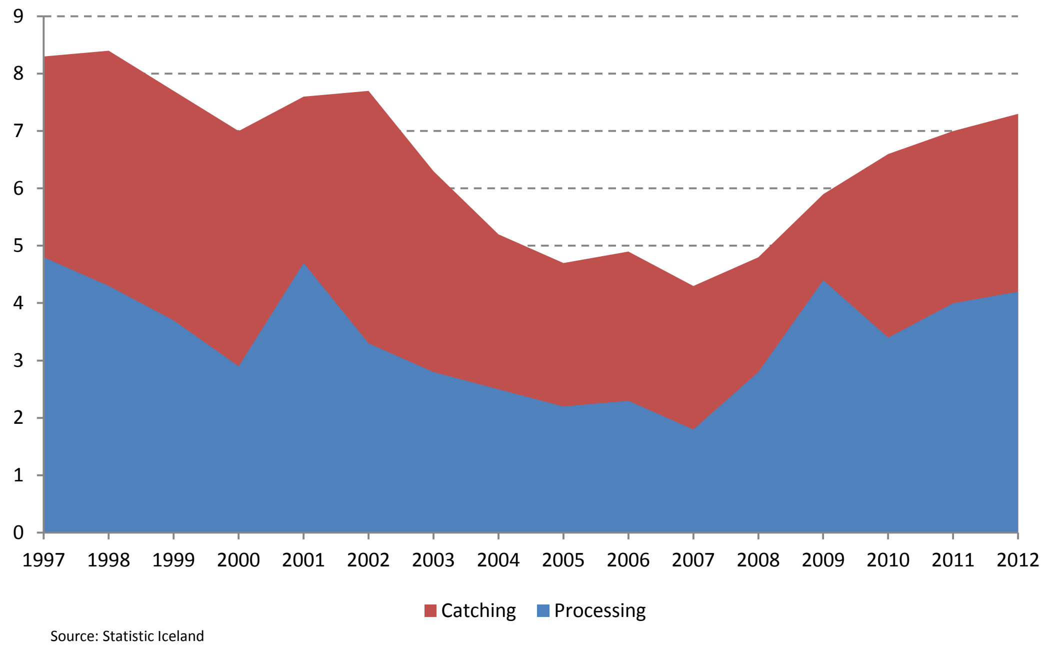
Figure 32: Export value of marine products (ISK bn)[28]



The fisheries sector's direct contribution to GDP amounted to 11.5% in 2012 and has risen substantially since the economic crisis struck at the end of 2008. This sector's contribution is now similar to what it was around 2001-2002, as can be seen in the graph below. Historically speaking, about two thirds of direct value creation in the fisheries industry can generally be attributed to fishing and one third to fish processing. However, official figures on this sector's activity and contribution probably underestimate the importance of the fisheries industry in the Icelandic economy, due to, among other things, the fact that the revenue of many businesses and service entities is founded on their trading and collaboration with fishery companies.

[28] Source: Statistics Iceland

Figure 33: Direct contribution of fisheries industry to GDP (%)[29]



A recent report by Íslandsbanki attempts to shed light on the total contribution of the fisheries industry to the GDP when indirect effects are taken into account, particularly in sectors that stem from the Icelandic fisheries industry.[30] Its conclusion is that the contribution of the ocean cluster to GDP is about two to three times more than its direct contribution, according to what the national accounts suggest, and the ocean cluster stands behind between 25-30 thousand jobs.[31]

The financial position of the sector has recently strengthened considerably. In 2011, the EBITDA of the fisheries industry amounted to ISK 80 bn, according to Statistics Iceland's calculations, and increased by 26% from the previous year.[32] The results were similar to those of 2012 and the EBITDA amounted to approximately ISK 80 bn. Naturally, results varied between individual companies, but as a whole the profits of the sector increased by 80% since 2008. Of this amount, fishing profits have increased by over 60%, whereas fish processing profits almost doubled. The EBITDA in fishing was 26% in 2011 and 19% in processing.

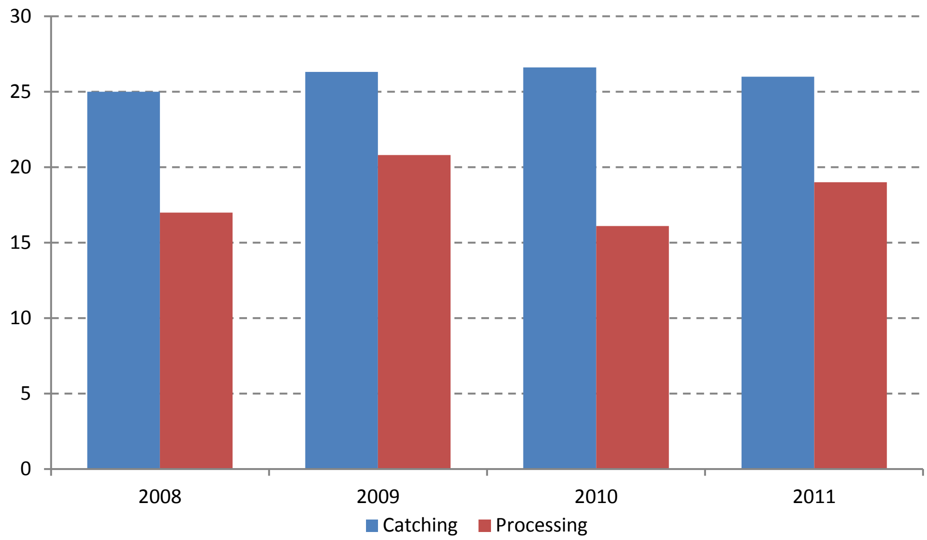
[29] Source: Statistics Iceland

[30] Significance of the ocean cluster in the Icelandic economy. Íslandsbanki 2012. The authors of the report are Thór Sigfússon and Ragnar Árnason.

[31] The total contribution to the GDP is estimated at 26% for 2010, compared to the direct contribution which amounts to 10.2%, according to Statistics Iceland's figures.

[32] The fisheries sector here is understood as the fishing and fish processing sectors combined.

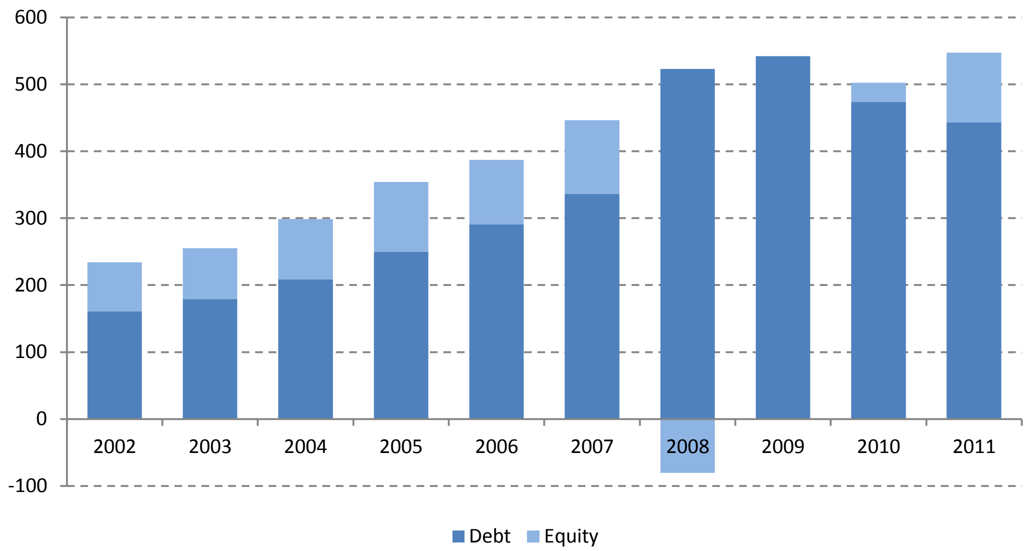
Figure 34: EBITDA as a percentage of revenue[33]



Source: Statistic Iceland

The balance sheets of fishery companies were badly hit by the financial crisis. The sector's debt rose dramatically with the fall of the króna and, as a consequence, the equity of the fisheries sector was negative by ISK 80 bn in 2008. Driven by its sound performance over the past quarters, however, the debt level has been lightened and amounted to ISK 443 bn at year-end 2011, compared to ISK 542 bn at the end of 2009. The EBITDA, which is a yardstick for measuring a company's capacity to pay off its debt, has declined in the sector as a whole from over 10% in 2008 to 4.2% in 2011. Everything seems to indicate that the sector has continued to pay down its debt in 2012 and 2013 and one can therefore expect to see a further strengthening of equity ratios.

Figure 35: Debt and equity of fisheries sector[34]

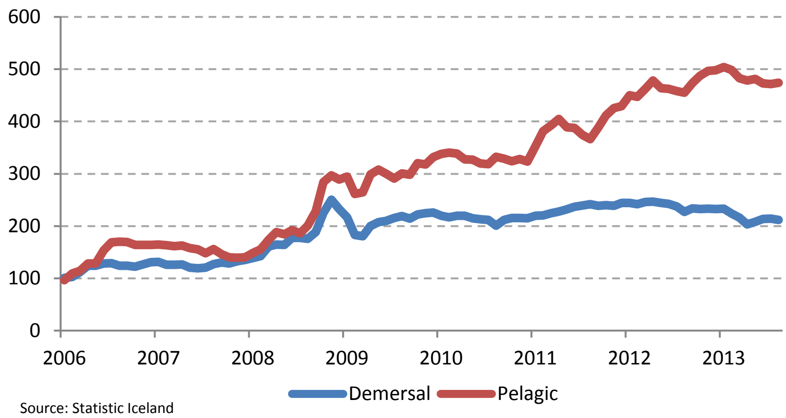


Source: Statistic Iceland

[33] Source: Statistics Iceland
[34] Source: Statistics Iceland

Despite a 8% drop in the marine product price index in 2013 the long-term outlook is generally positive for the sector as demand remains strong, and is forecast to grow substantially by the UN's Food and Agriculture Organisation (FAO),while supply is generally subject to natural limits.

Figure 36: Marine product price index, 2006=100



Source: Statistic Iceland

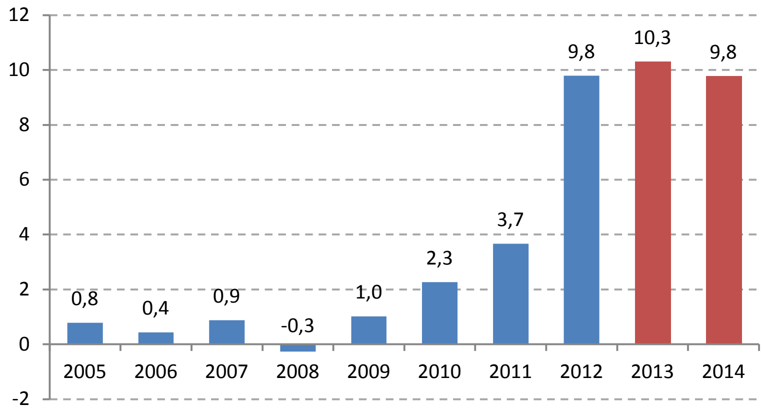
A consensus needs to be reached on fishing levies

In mid- 2012, new legislation on fishing levies was approved, proposing extensive changes in the organization and collection of fishing levies. Broadly speaking, the Act entailed adopting a special fishing levy in addition to the general fee that has been collected over the past years.

This Act was temporarily amended in the 2013 summer session of the Althingi, when it transpired that the fishing levy committee, which according to the Act was to determine the fishing levy, had not received the information required to make its calculations. In addition to this, insufficient consideration was given to the fact that the results of companies vary, according to the species of fish. The Act was therefore temporarily amended to meet the need for greater flexibility with regard to species and to ensure it would be possible to collect the levies. The change entailed a special krona-denominated fishing levy being applied to the 2013/2014 fishing year. A comprehensive review of taxing and levy collection in the fisheries sector is proposed. At the same time, this review has to create a consensus on the levies applied to sectors that tap comparable national resources and to guarantee companies in the fisheries industry and related branches a stable external environment. There are indications that the investment requirements of this sector are high, but companies are holding back while uncertainty still reigns with regard to their tax environment and fishing levies. The revision of the fishing levies also needs to ensure moderation is exercised, since high levies could undermine the competitiveness of the Icelandic fisheries sector in global markets. In this context it should be noted that fishery companies are now paying up to ISK 10 bn in fishing levies a year and the collection of levies has increased substantially 2013, as can be seen in the graph below. The government intends to create a framework that will safeguard the high productivity of the fisheries sector and encourage innovation and further progress.

One proposal is to impose an additional income tax on the earnings of fishery companies that exceed a certain threshold, instead of collecting a special levy that is based on estimated earnings and complicated to implement. There are precedents for arrangements of this kind in Iceland, since financial and insurance undertakings, for example, pay an additional income tax of 6% on earnings that exceed ISK 1 bn. Like other export industries, the fisheries sector has benefitted from the low real exchange rate in recent years. This gives the sector more leeway to increase wages than the domestic sector. The risk is that the wage drift in export sectors could push up the real exchange rate with consequent inflation. A work group has already been established to explore this possibility.

Figure 37: Treasury revenue from fishing levies (ISK bn)[35]



Tourism

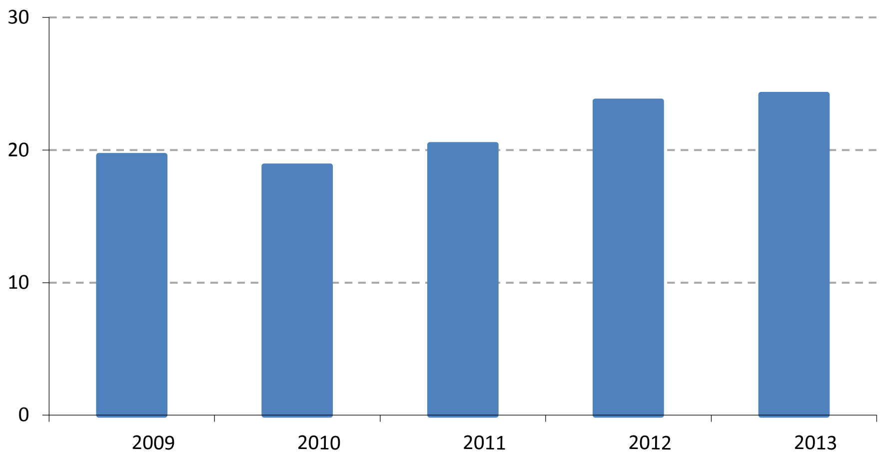
Tourism is a rapidly growing component of the Icelandic economy and is now one of the country's main export sectors. There is a need to create the scope for tourism to grow further over the coming years, although its evolution needs to be moderated to ensure that the development and supervision of tourist destinations is consistent with the number of visitors. As this sector grows, its business environment also needs to be brought into line with other sectors, since the tourist industry is in sharp competition with other sectors, both in terms of labour and capital. Revenue from foreign tourists is estimated at ISK 237.7 bn for 2012, corresponding to 23.5% of the value of exports of goods and services that year.[36] The revenue of tourism services in Iceland is estimated at ISK 107.9 bn and the revenue from the transport of passengers by air ISK 131.5 bn. In the first part of 2013, tourism is estimated to have generated 24.2% of total export revenue, compared the fisheries sector accounted for 26.6%, and aluminium and aluminium products amounted to 22.3%.

The growth in the tourism sector is likely to persist in the coming years, as stated in the report of the Boston Consulting Group of September 2013. The report estimates that tourists will pay ISK 17 bn in direct taxes in 2013 and ISK 10 bn more if indirect taxes are included. Over seven thousand people worked in the tourist sector so far this year, either in a full-time or part-time capacity. More than 810 thousand tourists visited Iceland in 2013, representing a 21% increase from 2012. The growth has been dramatic in recent years and the authors of the report estimate that figures could more than double over the next 10 years.

[35] Source: Ministry of Finance and Economic Affairs. Amounts on an accrual basis. The revenues for 2013 and 2014 are from the ministry's estimate which appeared in the budget proposal for 2014.

[36] Statistics Iceland: Tourism revenue, according to the definition of Statistics Iceland, is the combination of services category 2 (tourism services) and category 1.2.1 (air travel services). i.e. revenues from foreign tourists in Iceland and the revenue of Icelandic airlines from transporting foreign passengers whether it be to Iceland or other destinations.

Figure 38: Revenue from foreign tourists in relation to export value (%)



Many sub-branches of the tourist industry are in the lower Value Added Tax (VAT) bracket, including hotels and guest houses. A report compiled by the Institute of Economic Studies points out that the lower VAT rate applied to accommodation can be looked upon as a concession or subsidy to the sector. The report also contends that varying tax rates in this sector create discrimination between companies and result in the economy not utilising its factors of production in the most cost-effective manner. It also points out that there are many indications that the tourist industry can no longer be considered as a start-up sector and that these tax concessions are therefore perhaps no longer justified, since the sector no longer needs any special support.

These various considerations need to be taken into consideration now when the levy environment in the tourist industry is reviewed. Special concessions to big economic sectors in the form of tax discounts hinder other sectors in the form of undesirable crowding-out effects. As is discussed in greater detail in Chapter 3 on fiscal policy, the government intends to thoroughly review the VAT system.

In order to meet the need to generate more capital for the development of tourist destinations, the possibility of introducing the sale of so-called “nature passes”, which would give buyers access to the main tourist destinations, is being discussed. In addition to this, there have been discussions on the pros and cons of charging an admission fee to popular spots, such as the Gullfoss waterfall and Geysir. It is clear that mass tourism in delicate areas also entails costs in terms of nature conservation, in addition to which the tourist experience diminishes in proportion to the number of people visiting the area. Free access to tourist destinations does not therefore in any way reflect the economic cost of visiting the location.

Energy industry

The energy industry is one of the pillars of value creation in the Icelandic economy. There is potential to increase productivity and production in the sector, but the industry faces growth obstacles, due to limited resources, and overlaps with nature conservation concerns and the growth potential of the tourist industry. It is important to endeavour to reach a consensus and strike a balance between the use of nature to produce energy and its protection. In this regard it is crucial to focus on the dividends that the tapping of these natural resources can yield.

The increase in the production of energy over the past decades has mainly been used for energy-intensive industry, not least in the production of aluminium. The percentage of aluminium companies' usage of energy in relation to total energy consumption has rapidly increased in recent years, i.e. from 35% in 1990 to 73% in 2012. Other energy intensive companies accounted for 6% of the energy usage.[37] Aluminium exports have almost quadrupled over the past 20 years and aluminium as a percentage of good exports has risen from 15.6% in 1999 to 39% in 2008.

The price of electricity to the public is quite low in Iceland and lower than in neighbouring countries, with energy being most expensive in Denmark.[38] The low electricity prices to the public are partly due to major developments in heavy industry, which have generated greater economies of scale and therefore lower average costs, as well as a better and more secure supply.

In order for the energy industry to yield satisfactory value creation to the Icelandic community over the coming years, the dividends of this sector will have to be increased with higher electricity prices. As stated in the interim report of the Iceland Growth Forum, the average return of Landsvirkjun (the National Power Company of Iceland) in half a century since its foundation in 1965 has been 1.7%, although it has risen somewhat from the beginning of this decade. Taking into account the State guarantee, the Treasury's return on equity (ROE) in Landsvirkjun has been negative during this period. Looking at the past few years, the average ROE of Landsvirkjun between 2009 and 2012 has been 5%, compared to the average ROE of Statkraft in Norway, which was 13.5%.[39] Despite the rising average return of Landsvirkjun over the past few years, it must still be considered low in view of the fact that its operations are backed by the country's natural resources. The utilisation of natural resources needs to be reflected in higher returns for the sector and substantial dividends to their owners. But the fact that the returns are as low as they are indicates that the resource rent flows directly to the buyer of the energy, in the form of low energy prices.[40]

The Icelandic electricity market is very isolated, which increases the risk for both the producer and the buyer because of potential sudden contractions in the demand or supply of energy, in addition to which opportunities to increase cost effectiveness can be lost. The bargaining power of producers with energy buyers is weaker than it would be otherwise, which results in lower energy prices and therefore less cost-effective power plants.

Recently, a submarine power cable between Iceland and Europe (the UK) has been proposed to enhance the competitiveness of the sector and broaden its options. By laying a submarine cable, the power can flow in both directions and therefore increase the security of domestic delivery as well. A feasibility study is currently being conducted on this project in an endeavour to evaluate start-up costs as well as future operating costs. This should be completed by the end of 2015.[41] There are vast differences between the price of electricity in Iceland and Europe and it can be of great interest for

---

[37] See website of National Energy Authority (Orkustofnun). The difference is the agreed upon amount of energy that can be cut, in the event of difficulties that may arise, for example, in hydroelectric power stations or due to limitations in the transmission or distribution system.

[38] The price difference between Iceland and Denmark is substantial, since the cost of a KWh in Iceland was ISK 16 in 2012, compared to ISK 48 in Denmark. Orkustofnun: *Energy policy 2012 - Electricity*

[39] Iceland Growth Forum

[40] Resource rent is the difference between the sale price and the average cost. In normal competitive management the rent disappears in the competition between companies. If a company has access to resources at lower prices than the competitors, this creates the conditions to maintain the rent in the longer term.

[41] See website of Landsvirkjun.

the economy.[42] In order to embark on a project of this scale, it is important to bring other partners on board and, with this in mind, informal discussions have been held with the British Government, although the authorities there have yet to finalise their energy policy so it is not known what their priorities will be.[43] The extensive processing of natural gas in the US has created uncertainty in the energy market. Its processing is partly being considered in Europe and there could therefore be major changes in the energy market in the near future. It is therefore clear that, in order to minimize risk and ensure the long-term profitability of the project, that a long-term agreement on sale of electricity needs to be concluded.

Capital controls

The removal of capital controls is one of the largest challenges facing the Icelandic economic policy. Capital account liberalization is a prerequisite for sustainable long-term economic growth based on high added value sectors. The importance of this is reiterated in the policy statement of the government which says: “One of the most important tasks of the government will be to remove capital controls, since capital controls distort asset prices and undermine the nation’s competitiveness.” Although the capital controls were necessary when the financial crisis engulfed the economy in 2008, they have a persistent long-term negative effect on the economy. It is therefore necessary to make considerably more progress in the easing of capital controls in the near future than has been made over the past five years.

In order to minimize the negative impact the lifting of capital controls may have on the national balance of payments there broadly needs to be a focus on three elements: 1) the “old” overhang, 2) the impact of the settlement of the old banks and 3) the possible outflow of capital owned by domestic entities.

The capital account liberalisation strategy approved by the government in the spring of 2011 primarily focused on the offshore króna that form the “old” overhang, i.e. non-resident’s assets in deposits, Treasury bonds and Housing Financing Fund (HFF) bonds. This problem has in part been tackled through auctions by the Central Bank of Iceland, with the total amount of these offshore ISK falling from ISK 384 bn at year-end 2012 to ISK 327 bn at year-end 2013.

[42] GAMMA: Economical impact of Landsvirkjun’s operations and profitability to 2035.
[43] Power cable to Europe: Conclusions and proposals of the advisory group to the Minister of Industry and Commerce.

Table 6: Central Banks auction results for purchacing Euros for ISK, amounts in million Euros

			Total amount of bids		Accepted bids		
Dates	number of bids	Total amounts	Treasury bonds	Investment Programme	Treasury bonds	Investment Programme	ISK/EUR
28.6.2011		71,8	71,8		61,7		210
16.8.2011		3,4	3,4		3,4		210
15.2.2012	77	173,6	114,5	59,1	82,2	59,1	240
28.3.2012	79	92,9	70,9	22	1,8	20,7	239
9.5.2012	66	61,3	35,6	25,7	12,9	25,7	238,8
20.6.2012	49	43,8	26,7	17,1	6,6	17,1	245
29.8.2012	76	31,8	12,5	19,3	3,7	14,9	235
3.10.2012	59	22,8	11,7	11,1	10,1	10	235
7.11.2012	57	27	3,2	23,8	2,9	16,8	235
18.12.2012	86	43,9	4,8	39,1	4,5	26,4	233
5.2.2013	68	41,3	5,9	35,4	3	22,2	230
19.3.2013	100	41,3	6	35,3	3,2	34,1	225
30.4.2013	116	33,4	7,4	26	5	23,9	210
11.6.2013	95	47,1	18,7	28,4	17,6	26,5	210
3.9.2013	77	21,0	3,7	17,3	2,9	16,5	210
15.10.2013	81	24,9	4,2	20,7	21,4	3,5	210
3.12.2013	94	52,6	13,3	39,3	0,5	39,3	210
4.2.2014	93	49,3	22,8	26,5	22,3	24,5	209
Total	833	688,3	374,4	313,9	201	270,9	

Table 7: Central Banks auction results for purchacing ISK for Euros, amounts in million Euros

Date	Number of bids	Total amount	Accepted amount	ISK/EUR
28.3.2012	40	26,3	4,9	>=235
9.5.2012	39	25,3	9,1	239
20.6.2012	42	29	7,5	246
29.8.2012	26	7,3	3,8	236
3.10.2012	34	18,3	4,9	235
7.11.2012	18	10,3	4,7	236
18.12.2012	40	19,9	6,8	233
5.2.2013	30	9,3	5,7	231
19.3.2013	43	12,4	8,2	226
30.4.2013	39	9,3	6	210
11.6.2013	39	22,0	9,9	221
3.9.2013	43	14,5	4,4	224
15.10.2013	34	14,6	4,9	227
3.12.2013	29	11,0	8,7	216
4.2.2014	38	15,9	9,9	210
Samtals	351	167,4	61,6	

As time has passed, increased attention has been given to the winding-up of the estates of the fallen banks and the possible impact from the process on the balance of payments. The removal of this uncertainty is a prerequisite for the full removal of capital controls.

The government's task is to restore confidence in the economy and the nation's balance sheet in the long term so that equilibrium and stability can be achieved in the external balance of payments. It is in itself just as desirable that non-residents invest their assets in Iceland as domestic entities build up their asset positions abroad. The success of the implementation of capital account liberalization will not least depend on whether the government manages to foster such trust. This will facilitate the desirable flow of foreign capital into the financial system and a natural pace in the outflow of currency, without the application of any special restrictions.

Financial market

The Icelandic legislation governing financial services is largely based on the European regulatory framework, which enshrines the principle of the free movement of financial services as one of the Four Freedoms and cornerstones of the EEA agreement and internal market. It is on this basis that Iceland is a member of the internal market and enjoys the same status and rights as other member states of the EEA. The nature of the European Union has changed profoundly in recent years. At the beginning of 2011, new European supervisory bodies were established in the financial market. They continue to be founded on the principle of monitoring financial markets on a national basis, although these bodies now also possess supranational powers within the internal market, so to speak. Almost all of the EU's financial market legislation refers to these institutions or grants them increased powers. No way has yet been found of incorporating the regulations regarding supervisory authorities into the EEA agreement despite continued dialogue, since the new institutional system and the powers allocated to these institutions are not easily harmonized with the constitutions of Norway or Iceland nor the two pillars of the EEA agreement. Until these regulations have been incorporated into the EEA agreement, it is only possible to transpose a small part of the new financial market regulations into the agreement. If nothing is done there is a danger that the regulations of EFTA/EEA member states will lag behind and that a split will form between financial services in the internal market.

In light of these challenges, the government is now focusing on continuing to develop the financial regulatory framework with more of an eye on new European measures. In Iceland two regulations have been examined in particular in this task. On one hand work has begun on the drafting of a bill on alternative investment funds. Currently, there is no comprehensive legislation on these funds in Iceland. It is therefore logical to seek inspiration in European legislation that came into effect in 2013 and will eventually be incorporated into the EEA Agreement. A bill on this issue is expected to be submitted to parliament during the 2014-2015 session. On the other hand, work is being conducted on developing new rules for financial undertakings based in large parts on the CRD IV / CRR package as discussed below. Banking activities in Iceland are facing substantial reforms. On one hand, the framework for the comprehensive supervision of the financial system will be enhanced with the establishment of a new Financial Stability Council, which will ensure consultation between ministries, the Central Bank of Iceland and the Financial Supervisory Authority (FME). With this council the framework for financial stability will be better formed than before and the function and responsibilities of institutions shall be better defined. A financial stability bill is expected to be submitted to parliament in the first quarter of 2014.

On the other hand, substantial amendments will be made to the legal framework of financial undertakings, founded on international criteria and European legislation (CRD IV and CRR). These changes will ensure that the requirements being placed on financial undertakings are comparable to those being applied in our neighbouring countries. This legislation will substantially increase and strengthen capital adequacy of banks and establish a framework for the use of capital ratios for macro-prudential purposes through so-called “buffers”. The experience acquired from the financial crisis, as well as recent research, indicate that the minimum capital adequacy ratios that were set before 2008 were far too low.

In addition to this, reformed legislation governing deposit guarantees and the future framework of winding-up proceedings for financial undertakings will facilitate the abolition of declarations of liability for deposits, which were first issued towards the end of 2008. The abolition of these declarations is an important step in the endeavour to restore a normal environment for the financial markets and ensure healthy competition.

The aim is to reduce Treasury holdings in the financial market over the coming years (see table of state holdings in financial undertakings). It is important to use the capital that will be freed by the sale of state holdings in the banks to repay subordinated loans as much as possible, in order to pay down the many debts accumulated by the Treasury as a result of the financial crash. The Treasury’s recapitalisation of the financial system has been expensive, since the debts it accumulated as a result amounted to ISK 420 bn. Part of this is due to the recapitalisation of the Central Bank of Iceland, since the Treasury bonds issued by the Treasury to refinance the banking system amounted to ISK 209 bn. The capital contributions and expense costs of the Treasury for the restoration of the commercial banks amounted to a total of ISK 264 bn at the end of last year. Current legislation allows for the sale of up to 30% stake in Landsbankinn, but no decision has yet been taken when the stake could be sold.

Table 8: State holdings of the commercial banks and saving banks and capital ratios

	State holdings%	Capital ratio at year-end 2012
Arion banki	13%	24.3%
Landsbankinn	97.9%	25.1%
Íslandsbanki	5%	25.5%
Sparisjóður Bolungarvíkur	90.9%	15.1%
Sparisjóður Norðfjarðar	49.5	18.6%
Sparisjóður Norðurlands*	80.9%	16.5%
Sparisjóður Vestmannaeyja	55.3	17.4%
* by merge of two saving banks 4. July2013		

4.2.2 Labour market

The active labour market programmes introduced and strengthened during the crisis continue to run, with women making proportionally more of these schemes than men and opted for longer schemes, such as training agreements and longer studies. As the labour market improves the focus has increasingly been moving from active labour market programmes towards an improved structure for wage negotiations.[44] The aim is to focus increasingly on real wage improvements rather than nominal wage increases.

Wage agreements in the private market expired on 30 November. The social partners and government established a consultative committee on wage information and the prerequisites of collective wage agreements. This group has worked on making wage negotiations more targeted and has, among other things, visited other Nordic countries to familiarise themselves with the procedures followed in the making of collective agreements. The conclusions of that work were presented in a report published in October 2013, which lay the foundations for new working procedures.[45] The idea is that all negotiating parties should base their discussions on the same economic assumptions. The common objective of the social partners is to increase purchasing power, give precedence to raising lower wages, ensure low inflation and boost stability. This improved process was followed in the short-term agreements approved end-2014. These agreements were to pave the way for longer-term agreements this year, in part with government input to lower increase of certain government fees as discussed above.

4.2.3 Administrative reform

It is a priority for the government to increase efficiency and improve services. The government set up a Working Group during the summer of 2013 with members of parliament from both coalition parties. The Working Group's main task was to come up with proposals designed to increase productivity in the public sector and better utilize public funds. In November 2013 the working group submitted 111 proposals aimed at the whole public sector. The Working Group focuses primarily on diverse system problems. Preparation for extensive structural changes is already underway in many departments and will focus on basic services and administrative systems.

The government will work towards reforming the structure, operation and services of the state. As stated in the government's policy agreement this will include changes to organizational structure, further coordination and consolidation of support services agencies. Reform is intended to ensure efficient and transparent administration and good and efficient services. The objectives of the reform plan are as followed:

1. Activities of the state will be integrated, efficient and flexible.
2. Services will be effective, encourage innovation and consider the needs of residents and the community.

[44] According to Act no. 54/2006 on unemployment insurance and Act no. 55/2006 on labour market measures, and related regulations, job seekers shall be offered opportunities to participate in various schemes to strengthen their positions in the labour market. The Directorate of Labour contributes to the cost these schemes and has allocated funds to projects of this kind on an annual basis.

[45] The lead-up to collective agreements: Economic environment and development of wages. http://www.fjarmalaraduneyti.is/frettir/nr/17315

3. Communication with the public and the market will be equitable and transparent.
4. Public agencies will have a stimulating working environment and it is important to foster the human capital in those agencies.
5. Public agencies will be expanded and strengthened to improve the services and ensure an interesting working environment.
6. Public agencies will always look to performance, quality and effective use of funds when developing new policies.
7. Modern governance will incorporate quality assured procedures and effective management of funds.
8. ICT and e-government will contribute to the optimization and coordination of administrative systems and lead to better and simpler services.
9. The economy will be equipped with good working conditions and the benefits of public-private partnerships will be utilized.

4.2.4 Additional reform areas

Improving the financial position of households is one of the top priorities of the government, like the removal of capital controls. According to the most recent estimate conducted by the Central Bank of Iceland, household debt amounted to 108% of GDP at the end of June 2013, after peaking at 134% at the end of the first quarter of 2009. Household debt is still very high and many households are still grappling with debt and payment difficulties. One of the main objectives of the government is to take systematic measures to reduce household debt. For this purpose a special committee of experts was appointed on the basis of a parliamentary resolution regarding household debt, and this committee has submitted a report with recommended measures to the government. The government has now examined the measures recommended in the report, with a twofold outcome: Regarding the direct writing down of debt, on one hand, and the so-called private pension savings option, on the other. For a more detailed discussion please refer to the government's press release.[46]

In the government's estimation, the measures that will be taken will neither threaten economic stability nor exchange rate and price stability. On the contrary, the measures are expected to catalyse the economic recovery and strengthen growth, at least in the short term.[47] One of the reasons for this is that heavily indebted households generally have higher borderline consumption tendencies than those with less debt. This means that measures to increase the disposable income of heavily indebted families, e.g. through lower mortgage payments, will boost private consumption, which in turn strengthens general activity in the economy. A special private pension savings option was also offered to young people under which individuals buying their first home can make a withdrawal from their private pension savings to make their first instalment tax free.

In light of the Treasury's heavy debt position, it is important to ensure that the lowering of household debt does not come at the expense of responsible fiscal policy. In parallel with the recommendations for household debt relief, the funding that was announced did not, therefore, undermine the plan of achieving an even and later positive fiscal balance. The funding of these measures was ensured in this year's budget though special bank levies to be imposed on large financial undertakings and

---

[46] See government press release: http://www.forsaetisraduneyti.is/media/frettir2/kynning-leidrettingin.pdf
[47] See e.g. Coenen and others (2012).

financial undertakings undergoing winding-up proceedings. A bill is currently being drafted on the basis of the committee's recommendations. The write-downs are expected to be implemented in mid 2014 and to entail a total debt reduction of ISK 150 bn over a four year period, through the two options that have been presented. The impact of these measures on fiscal policy is discussed in Chapter 3 above.

In addition to the work being conducted on the reduction of debt, a committee of experts was also appointed to examine the abolition of indexation in new consumer loans and submitted its recommendations in January 2014. With the recommendations of the committee of experts, an important step has been taken towards abolishing indexation, as declared in the government's policy statement. The committee proposes that, as of 1 January 2015, it will be forbidden to offer consumers indexed annuity loans for periods longer than 25 years; the minimum period for indexed loans will be extended by up to 10 years; a ceiling will be placed on the collateralization of indexed housing loans and there will be increased incentives to issue and take out nominal loans. The objective of the proposals is to address the main faults of indexation that were highlighted in the parliamentary draft resolution on household debt relief measures, and these are: i) the risk that overcollateralization will create imbalances between nominal wages and indexed loans during periods of inflation, ii) the moral hazard of a surge in lending and iii) the negative impact on the effectiveness of monetary policy caused by the spread of indexed annuity loans.

Predictability is being increased for borrowers and their payment schedules are becoming more front-heavy while overall interest costs are being reduced. Special measures are being proposed through the transfer system for low income individuals buying their first home. The group has proposed that these steps be evaluated one year after their implementation and that the complete abolition of indexation be formulated for 2016.

A work group is also focusing on the future housing policy on behalf of the Minister of Social Affairs and Housing. The group is expected to submit its recommendations in February 2014.

Annex: Statistical Appendix

Annex Table 1: GDP

Percentages unless otherwise indicated	ESA Code	Year 2012	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
		Level (bn EUR)	Rate of change				
1. Real GDP at market prices	B1*g	5,470	1.4	2.0	2.5	2.8	2.6
2. Current GDP at market prices	B1*g	10,522	4.3	4.2	6.3	6.3	5.6
Components of real GDP							
3. Private consumption expenditure	P3	2,837	2.4	1.6	2.5	2.7	2.8
4. Government consumption expenditure	P3	1,242	-1.4	0.8	0.0	1.5	1.5
5. Gross fixed capital formation	P51	0,704	5.0	-3.1	10.6	17.5	3.4
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	0,064	-17.4	17.7	-20.1	-11.6	-5.1
7. Exports of goods and services	P6	2,618	3.8	2.3	2.8	2.0	3.6
8. Imports of goods and services	P7	1,995	4.7	0.0	3.3	5.7	3.7
Contribution to real GDP growth							
9. Final domestic demand		4,8	1.5	0.6	2.6	4.0	2.3
10. Change in inventories and net acquisition of valuables	P52+P53	0,1	-0.2	0.2	-0.3	-0.1	0.0
11. External balance of goods/services	B11	0,6	0.1	1.1	0.2	-1.1	0.3

Annex Table 2: Price developments

Percentage changes, annual averages	ESA Code	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
1. GDP deflator		2.8	2.1	3.7	3.4	3.0
2. Private consumption deflator		5.6	3.5	3.6	3.1	2.5
3. HICP		6.0	4.1			
4. National CPI change		5.2	3.9	3.6	3.0	2.5
5. Public consumption deflator		5.6	4.7	4.2	4.0	3.4
6. Investment deflator		2.5	2.2	3.9	2.0	2.8
7. Export price deflator (goods & services)		1.1	-3.3	3.7	4.1	3.2
8. Import price deflator (goods & services)		4.8	-1.5	3.9	3.7	3.0

Annex Table 3: Labour market developments

	ESA Code	Year 2012	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
		Level	Level/Rate of change				
1. Population (thousands)			320716.0	323111.0	325630.0	328412.0	331540.0
2. Population (growth rate in %)			0.53	0.75	0.78	0.85	0.95
3. Working-age population (persons)[1]			212970.0	213714.0	214491.0	215180.0	216277.0
4. Participation rate			0.1	0.1	0.1	0.1	0.1
5. Employment, persons [2]			148.6	152.0	153.4	155.4	156.7
6. Employment, hours worked[3]			n.a.	n.a.	n.a.	n.a.	n.a.
7. Employment (growth rate in %)			0.5	2.3	0.9	1.3	0.9
8. Public sector employment (persons)			0.0	0.0	0.0	0.0	0.0
9. Public sector employment (growth in %)							
10. Unemployment rate [4]			5.7	4.6	4.4	4.0	3.8
11. Labour productivity, persons[5]		5940,7	0.9	-0.3	1.5	1.5	1.7
12. Labour productivity, hours worked[6]			n.a.	n.a.	n.a.	n.a.	n.a.
13. Compensation of employees	D1	944,4	6.3	7.9	6.6	6.4	5.3

Annex Table 4: Sectoral balances

Percentages of GDP	ESA code	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-5.2	-1.7	-3.3	-4.7	-4.4
of which:						
- *Balance of goods and services*		6.1	6.0	5.7	4.1	4.2
- *Balance of primary incomes and transfers*		-7.1	-4.2	-6.2	-6.1	-5.8
- *Capital account*		-4.2	-3.6	-2.8	-2.7	-2.8
2. Net lending/borrowing of the private sector	B.9/ EDP B.9	-2.5	-1.9	-3.4	-4.3	-4.4
3. Net lending/borrowing of general government		-2.7	0.2	0.1	-0.4	0.0
4. Statistical discrepancy		0.0	0	0	0	0

Annex Table 5: GDP, investment and gross value added

	ESA Code	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
GDP and investment						
GDP *level* at *current* market prices (in domestic currency)	B1g	1698.5	1769.1	1880.0	1997.9	2110.7
Investment ratio (% of GDP)		14.5	13.8	15.0	16.9	17.0
Growth of Gross Value Added, percentage changes at constant prices						
1. Agriculture						
2. Industry (excluding construction)						
3. Construction						
4. Services						
Billion Euro unless otherwise indicated		Year	Year	Year	Year	Year
		2012	2013	2014	2015	2016
1. Current account balance (% of GDP)	% of GDP	-5.2	-1.7	-3.3	-4.7	-4.4
2. Export of goods	NCU or EUR	3.922	3.680	3.835	4.010	4.337
3. Import of goods	NCU or EUR	3.443	3.440	3.667	4.049	4.294
4. Trade balance	NCU or EUR	0.479	0.241	0.168	-0.040	0.043
5. Export of services	NCU or EUR	2.332	2.534	2.795	3.001	3.151
6. Import of services	NCU or EUR	2.167	2.109	2.293	2.458	2.646
7. Service balance	NCU or EUR	0.165	0.425	0.502	0.543	0.505
8. Net interest payments from abroad	NCU or EUR	-0.438	-0.394	-0.329	-0.335	-0.364
9. Other net factor income from abroad	NCU or EUR	-0.685	-0.458	-0.729	-0.751	-0.762
10. Current transfers	NCU or EUR	-0.063	0.000	0.000	0.000	0.000
11. Of which from EU	NCU or EUR	0.000	0.000	0.000	0.000	0.000
12. Current account balance	NCU or EUR	-0.542	-0.186	-0.389	-0.583	-0.578
13. Capital and financial account	NCU or EUR	0.471	0.000	0.000	0.000	0.000
14. Foreign direct investment (position at the end of the year)	NCU or EUR	9.833	9.377	0.000	0.000	0.000
15. Foreign reserves (position at the end of the year)	NCU or EUR	3.344	0.000	0.000	0.000	0.000
16. Foreign debt (position at the end of the year)	NCU or EUR	81.465	77.436	0.000	0.000	0.000
17. Of which: public	NCU or EUR	3.937	3.642	0.000	0.000	0.000
18. O/w: foreign currency denominated	NCU or EUR	0.000	0.000	0.000	0.000	0.000
19.O/w: repayments due	NCU or EUR	56.804	55.288	0.000	0.000	0.000
20. Exchange rate vis-à-vis EUR (end-year)	NCU/EUR	158.84	169.80	160.49	163.01	158.18

21. Exchange rate vis-à-vis EUR (annual average)	NCU/EUR	161.42	160.73	160.61	161.19	161.44
22. Net foreign saving	% of GDP	0.0	0.0	0.0	0.0	0.0
23. Domestic private saving	% of GDP	0.0	0.0	0.0	0.0	0.0
24. Domestic private investment	% of GDP	0.0	0.0	0.0	0.0	0.0
25. Domestic public saving	% of GDP	0.0	0.0	0.0	0.0	0.0
26. Domestic public investment	% of GDP	0.0	0.0	0.0	0.0	0.0

Annex Table 6: External sector developments

Billion Euro unless otherwise indicated		Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
1. Current account balance (% of GDP)	% of GDP	-5.2	-1.7	-3.3	-4.7	-4.4
2. Export of goods	NCU or EUR	3.922	3.680	3.835	4.010	4.337
3. Import of goods	NCU or EUR	3.443	3.440	3.667	4.049	4.294
4. Trade balance	NCU or EUR	0.479	0.241	0.168	-0.040	0.043
5. Export of services	NCU or EUR	2.332	2.534	2.795	3.001	3.151
6. Import of services	NCU or EUR	2.167	2.109	2.293	2.458	2.646
7. Service balance	NCU or EUR	0.165	0.425	0.502	0.543	0.505
8. Net interest payments from abroad	NCU or EUR	-0.438	-0.394	-0.329	-0.335	-0.364
9. Other net factor income from abroad	NCU or EUR	-0.685	-0.458	-0.729	-0.751	-0.762
10. Current transfers	NCU or EUR	-0.063	0.000	0.000	0.000	0.000
11. Of which from EU	NCU or EUR	0.000	0.000	0.000	0.000	0.000
12. Current account balance	NCU or EUR	-0.542	-0.186	-0.389	-0.583	-0.578
13. Capital and financial account	NCU or EUR	0.471	0.000	0.000	0.000	0.000
14. Foreign direct investment (position at the end of the year)	NCU or EUR	9.833	9.377	0.000	0.000	0.000
15. Foreign reserves (position at the end of the year)	NCU or EUR	3.344	0.000	0.000	0.000	0.000
16. Foreign debt (position at the end of the year)	NCU or EUR	81.465	77.436	0.000	0.000	0.000
17. Of which: public	NCU or EUR	3.937	3.642	0.000	0.000	0.000
18. O/w: foreign currency denominated	NCU or EUR	0.000	0.000	0.000	0.000	0.000
19.O/w: repayments due	NCU or EUR	56.804	55.288	0.000	0.000	0.000
20. Exchange rate vis-à-vis EUR (end-year)	NCU/EUR	158.84	169.80	160.49	163.01	158.18
21. Exchange rate vis-à-vis EUR (annual average)	NCU/EUR	161.42	160.73	160.61	161.19	161.44
22. Net foreign saving	% of GDP	0.0	0.0	0.0	0.0	0.0
23. Domestic private saving	% of GDP	0.0	0.0	0.0	0.0	0.0
24. Domestic private investment	% of GDP	0.0	0.0	0.0	0.0	0.0
25. Domestic public saving	% of GDP	0.0	0.0	0.0	0.0	0.0
26. Domestic public investment	% of GDP	0.0	0.0	0.0	0.0	0.0

Annex Table 7: Sustainability indicators

	Dimension	Year 2009	Year 2010	Year 2011	Year 2012	Year 2013
1. Current Account Balance	% of GDP	-11.5	-8.0	-6.3	-5.2	-1.7
2. Net International Investment Position	% of GDP	-707.8	-639.4	-569.0	-485.6	-432.2
3. Export market shares	%, yoy					
4. Real Effective Exchange Rate [1]	%, yoy	-18.1	6.3	1.1	0.8	4.0
5. Nominal Unit Labour Costs	%, yoy	-2.7	9.7	5.9	6.6	5.8
6. Private sector credit flow	% of GDP	0.0	0.0	0.0	0.0	0.0
7. Private sector debt	% of GDP	0.0	0.0	0.0	0.0	0.0
8. General Government Debt	% of GDP	145.5	160.1	169.0	156.9	148.3

Annex Table 8: General government budgetary prospects

	ESA code	Year 2012	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
		Level (bn NCU)	% of GDP				
Net lending (B9) by sub-sectors							
1. General government	S13	-65,293	-3.8	-2.7	0.2	0.1	-0.4
2. Central government	S1311	543,600	32.0	32.6	33.8	32.8	32.0
3. State government	S1312	0,000	0.0	0.0	0.0	0.0	0.0
4. Local government	S1313	225,700	13.3	13.7	13.6	13.4	13.4
5. Social security funds	S1314	157,900	9.3	0.0	0.0	0.0	0.0
General government (S13)							
6. Total revenue	TR	740,324	43.6	46.3	47.4	46.3	45.4
7. Total expenditure[1]	TE	805,617	47.4	49.0	47.2	46.2	45.8
8. Net borrowing/lending	EDP.B9	-65,293	-3.8	-2.7	0.2	0.1	-0.4
9. Interest expenditure	EDP.D41 incl. FISIM	95,812	5.6	5.3	4.6	4.5	4.5
10. Primary balance[2]		30,519	1.8	2.6	4.7	4.5	4.1
11. One-off and other temporary measures [3]		0,000	0.0	0.0	0.0	0.0	0.0
Components of revenues							
12. Total taxes (12 = 12a+12b+12c)		559,652	32.9	33.6	33.8	33.1	32.4
12a. Taxes on production and imports	D2	267,017	15.7	0.0	0.0	0.0	0.0

12b. Current taxes on income and wealth	D5	277,851	16.4	0.0	0.0	0.0	0.0
12c. Capital taxes	D91	14,784	0.9	0.0	0.0	0.0	0.0
13. Social contributions	D61	64,882	3.8	3.9	3.9	3.8	3.7
14. Property income	D4	46,986	2.8	0.0	0.0	0.0	0.0
15. Other (15 = 16-(12+13+14)) [4]		68,804	4.1	0.0	0.0	0.0	0.0
16 = 6. Total revenue	TR	740,324	43.6	46.3	47.4	46.3	45.4
p.m.: Tax burden (D2+D5+D61+D91-D995) [5]		624,534	36.8	37.5	37.7	36.9	36.2
Selected components of expenditures							
16. Collective consumption	P32	430,413	25.3	25.7	25.2	25.0	24.9
17. Total social transfers	D62 + D63	135,268	8.0	0.0	0.0	0.0	0.0
17a. Social transfers in kind	P31 = D63	0,000	0.0	0.0	0.0	0.0	0.0
17b. Social transfers other than in kind	D62	135,268	8.0	0.0	0.0	0.0	0.0
18 = 9. Interest expenditure (incl. FISIM)	EDP.D41 + FISIM	95,812	5.6	5.3	4.6	4.5	4.5
19. Subsidies	D3	30,478	1.8	0.0	0.0	0.0	0.0
20. Gross fixed capital formation	P51	34,622	2.0	2.2	2.3	2.2	2.2
21. Other (21 = 22-(16+17+18+19+20) [6]		79,024	4.7	0.0	0.0	0.0	0.0
22. Total expenditures	TE [1]	805,617	47.4	49.0	47.2	46.2	45.8
p.m. compensation of employees	D1	250,73	14.8	0.0	0.0	0.0	0.0

Annex Table 9: General government expenditure by function

% of GDP	COFOG Code	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
1. General public services	1	9.1	0.0	0.0	0.0	0.0
2. Defence	2	0.0	0.0	0.0	0.0	0.0
3. Public order and safety	3	1.5	0.0	0.0	0.0	0.0
4. Economic affairs	4	4.9	0.0	0.0	0.0	0.0
5. Environmental protection	5	0.6	0.0	0.0	0.0	0.0
6. Housing and community amenities	6	1.1	0.0	0.0	0.0	0.0
7. Health	7	7.7	0.0	0.0	0.0	0.0
8. Recreation, culture and religion	8	3.3	0.0	0.0	0.0	0.0
9. Education	9	8.0	0.0	0.0	0.0	0.0
10. Social protection	10	11.2	0.0	0.0	0.0	0.0
11. Total expenditure (item 7 = 23 in Table 2)	TE	47.4	49.0	47.2	46.2	45.8

Annex Table 10: General government debt developments

% of GDP	ESA code	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
1. Gross debt [1]		96.9	93.9	89.4	84.5	81.0
2. Change in gross debt ratio		-2.4	-3.0	-4.5	-4.9	-3.5
Contributions to change in gross debt						
3. Primary balance [2]		-1.8	-2.6	-4.7	-4.5	-4.1
4. Interest expenditure [3]	EDP D.41	5.6	5.3	4.6	4.5	4.5
5. Stock-flow adjustment		-6.3	-5.7	-4.4	-4.8	-3.9
of which:						
- Differences between cash and accruals [4]		0.0	0.0	0.0	0.0	0.0
- Net accumulation of financial assets [5]		0.0	0.0	0.0	0.0	0.0
of which:						
- Privatisation proceeds		0.0	0.0	0.0	0.0	0.0
- Valuation effects and other [6]		0.0	0.0	0.0	0.0	0.0
p.m. implicit interest rate on debt [7]		5.9	5.7	5.2	5.3	5.6
Other relevant variables						
6. Liquid financial assets [8]		0.0	0.0	0.0	0.0	0.0
7. Net financial debt (7 = 1 - 6)		96.9	93.9	89.4	84.5	81.0

Annex Table 11: Cyclical developments

		2012	2013	2014	2015	2016
1. Real GDP growth (%)	B1g	1.4	2.0	2.5	2.8	2.6
2. Net lending of general government	EDP.B.9	-3.8	-2.7	0.2	0.1	-0.4
3. Interest expenditure	EDP.D.41	5.6	5.3	4.6	4.5	4.5
4. One-off and other temporary measures [1]						
5. Potential GDP growth (%)						
Contributions:						
- labour						
- capital						
- total factor productivity						
6. Output gap						
7. Cyclical budgetary component						
8. Cyclically-adjusted balance (2-7)		-3.8	-2.7	0.2	0.1	-0.4
9. Cyclically-adjusted primary balance (8+3)		1.8	2.6	4.7	4.5	4.1
10. Structural balance (8-4)		-3.8	-2.7	0.2	0.1	-0.4

Annex Table 12: Divergence from previous programme

	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
1. GDP growth (%, yoy)					
Previous update					
Latest update	1.4	2.0	2.5	2.8	2.6
Difference (percentage points)	1.4	2.0	2.5	2.8	2.6
2. General government net lending (% of GDP)					
Previous update					
Latest update	-3.8	-2.7	0.2	0.1	-0.4
Difference	-3.8	-2.7	0.2	0.1	-0.4
3. General government gross debt (% of GDP)					
Previous update					
Latest update	96.9	93.9	89.4	84.5	81.0
Difference	96.9	93.9	89.4	84.5	81.0