

# Economic Programme

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## 1. Introduction

The Icelandic Economic Programme presented here is essentially harmonious to the National Economic Programme which was submitted to parliament on 4 October 2011. A short-term economic outlook has been added to it, as well as a more detailed account of elements that are discussed in the National Economic Programme. Annexed to this document, there is also an overview of specific measures connected to the Economic Programme, as well as specifications on which ministries are responsible for them and when the actions are scheduled to be completed.

This Economic Programme has been shaped by other plans and issues that have already been decided upon in this area. Thus the programme is a kind of common denominator for the government's most important actions in the field of economic affairs in each case. This is particularly true of this programme since it is based on new work procedures. In the future one can expect the emphases of this Economic Programme to shape policies in economic affairs and the economy in general and for the programmes to become clearer and more specific. Thus the Economic Programme will establish itself as a tool for developing and coordinating economic policy.

In order to ensure that the proposed Economic Programme is in complete harmony with the emphases of the tasks being conducted by other ministries and institutions, there has been broad-based consultation within the government in the shaping of economic policy. Moreover, representatives from the municipalities and social partners have been included in discussions to ensure transparency and exchanges of views. In the Ministry of Economic Affairs opinion, this consultation has strengthened the credibility of the programme and promoted a broader understanding of the importance of coordinating economic policy.

## 2. Main emphases of the Economic Programme

Economic policy in Iceland over the past decades has been aimed at maintaining economic growth through government intervention on the demand side of the economy. This was primarily achieved by increasing the Treasury's debt up until 1990 and from then onwards by paving the way for foreign investment in energy-intensive industrial plants up until 2007. This policy caused instability and the economy to overheat, a phenomenon which was further exacerbated by the lack of a coordinated economic policy. The consequences of this included the persistent homogeneity of the exports sector and the accumulation of foreign debt.

Over the past years, Iceland has been subject to a threefold crisis: A financial crisis, currency crisis, and economic crisis, as a result of the predictable adjustments of the economy, in the wake of the economic boom that spanned 2004-2007. The economic vision presented in this governmental Economic Programme is designed to lay the foundations for clearer and more coordinated economic policy-making in the wake of this economic shock. This strategy is founded on the tasks and programmes that have already been set in motion or been completed during the government's mandate. The Economic Programme interweaves elements that are to be found in the [Government Coalition Platform](#), the [Stand-by Arrangement with the IMF](#), the [Declaration of the government](#) regarding the wage agreements in the spring of 2011, policies that have been developed in various

ministries, budgets for each period, and finally the long-term objectives that were established under [Iceland 2020](#).

The formation of the policy takes into account the [economic forecast of Statistics Iceland](#), which expects annual growth to average at 2.9% up until 2015. It is clear that moderate growth of this kind is unlikely to be sufficient enough to reduce the slack that formed in the economy in the wake of the financial collapse. Greater economic growth than what has been forecast will be required to restore the production capacity that has been lost.

The Economic Programme focuses on sustainable growth, based on better utilisation of factors of production and increased investment over the coming years. The Programme will be founded on measures in six priority areas:

1. Investments will be incentivised through direct government measures and supporting the private sector.
2. A sustainable fiscal policy will be ensured for the future, as well as economic stability.
3. An increased emphasis on the integration of education with employment. Efforts will be made to tackle the negative effects of long-term unemployment.
4. The debt restructuring of households and businesses in the wake of the collapse of the banks will be completed.
5. Businesses and households shall have access to a competitive and strong financial system.
6. A future monetary policy will be formed and capital controls will be eased in stages.

All of these priorities are important for the objective of greater and sustainable economic growth to be reached, although the results are by no means a foregone conclusion. The public sector is still heavily indebted and the access of Icelandic entities to financial markets is still limited, despite the Treasury's successful issuance of bonds on foreign markets earlier this year. In order to ensure a sustainable fiscal policy, the balance of payments of the economy need to be positive to pave the way for reducing the foreign public debt that inevitably mounted in the wake of the financial crash.

Innovation is important in cultivating sustainable growth. Companies which compete on international markets are more likely than others to stand at the forefront of innovation. These conclusions should come as no surprise, since the companies that have excelled in this area in Iceland have generally been large companies with extensive international operations. Support needs to be provided to boost the competitiveness of companies in order to achieve the objective of greater diversification and economic growth. It is therefore vital to remove some of the hindrances that have been created by the current situation, particularly with regard to access to foreign credit markets and capital controls. An emphasis on education and research, as well as social infrastructure investments, can fuel the growth of companies of this kind.

It is important to remember that the emphasis on increased investment does not solely apply to traditional investments in, for example, machinery, tools and construction. As society evolves and the services sector's share of the economy grows, the nature of investment also changes. Intangible investments, such as research and development, software development and acquisitions, the building of databases and staff training expenditure are all ever increasingly important. In many places investment costs of this kind have exceeded the costs of purchasing new machinery, equipment and

constructions. The emphasis on exports and innovation-driven growth will therefore be reflected in increased expenditure in these areas.

When all is said and done, however, it is the efficient mediation of capital that matters the most in the short term. The impact of the financial crisis is still great on the Icelandic economy and it is therefore paramount to use every opportunity to stimulate investment. Debt adjustment, a favourable competitive environment, and low interest rates play a vital role in this regard. The participation of institutional investors, such as pension funds and long-term non-resident investors, is also important.

The Economic Programme presented here is based on an economic growth model that largely differs from the one that has been followed over the past decades. Instead of the volatility of demand-driven growth, the aim is to strengthen the supply side of the economy and to be guided by principles of sustainability and eco-friendly economic growth. Growth of this kind increases the stability of the economy and creates greater and more long-lasting prosperity.

There is therefore a need to ensure that the stability in the labour market, which current wage agreements provide, takes root and does not result in inflation increasing any more than it already has. This is particularly important now that the three year Stand-by Arrangement between the Icelandic government and the International Monetary Fund (IMF) has drawn to an end, since the economic framework of the past years has been largely shaped in collaboration with the IMF. The IMF is of the opinion that substantial results have been achieved in the reviving of the Icelandic economy in the wake of the banking crisis, since the government has been able to meet the targets set in the stand-by arrangement. These results now need to be built upon and advances need to be made in those areas that still require work.

### **3. Short-term economic outlook**

After the contraction of the past years, the economy seems to be picking up again, although this growth has so far been slow and fragile. In the second quarter, GDP growth on an annualised basis slowed from 3.6% in the first quarter to 1.4% in the second quarter. GDP growth has thus been positive for two quarters in a row, following a continuous contraction from the third quarter of 2008. There are positive signs on many fronts, such as in the slow increase in private consumption investment, for example, as well as a decline in unemployment, a rise in real wages and a turnaround in the property market. Nevertheless, it is a source for concern to see how slowly product exports have grown, despite the favourable operating environment created by the low real exchange rate. Production in the fishing industry and power-intensive industry is restricted, because of the quota system imposed on fish catches and limited production capacity, while other production sectors are still heavily shackled by the ramifications of the financial crisis. It is mainly the tourist industry that has flourished the most, with a 17.5% increase in the number of tourists travelling to Iceland in the first eight months of the year, compared to the same period last year. According to Statistics Iceland's forecast, economic growth will average at 3% per annum between 2013 and 2015.

With the swifter processing of household and corporate debt and renewed confidence in fiscal stability and consumers' growing faith in an economic recovery, one can expect to see a gradual return to normality in the Icelandic economy. The government's economic policies, as a result of,

among other things, its Stand-by Arrangement with the IMF, has yielded results and now, three years after the financial crash, the turnaround has become a reality. Fears of a substantial backlash mainly stem from the risks currently hovering over the global economy due to debt crisis in Europe and the stagnation of the American economy. Inevitably, in one way or another, the impact of the global crisis could make itself felt in Iceland, even though the country's economic links with the rest of the world are shielded in an unusual way, thanks to its capital controls.

Private consumption as a percentage of GDP is currently at an historical low, after a steep contraction in the wake of the economic and financial crisis. However, the contraction was not as great as had been originally forecast, due to a number of measures taken by the government and financial institutions, such as the freezing of payments on loans and the paying out of private pension savings. Private consumption was given a boost in the second quarter, as a result of trade-union negotiated wage agreements, in addition to the fact that ISK 14 billion were withdrawn from private pension savings accounts in the first half of the year. Statistics Iceland's forecast expects to see a real annual increase of up to 3% in private consumption this and next year.

Investment is at minimum levels, whether it be in industry, housing or public investment. Industrial investment is at an all-time low, but is expected to grow by a total of over 40% in real terms over the next two years. Energy-intensive projects stand out the most because of the enlargement of the Straumsvík aluminium smelter and the Búdarháls power plant. Production at the silicon factory in Helguvík is also expected to start in the latter part of this year and to carry on into the next. Industrial investments in general are only expected to increase slightly, depending on how the restructuring of corporate balance sheets progresses. Investments in housing are also at a minimum, although they are expected to increase somewhat this and next year, as financial undertakings are slowly but surely freeing themselves of the volume of residential property they have taken over. There have been few new construction projects so far, however, and this is likely to remain the case in the quarters ahead, since there is still an ample supply of uncompleted residential property. Total investments amount to 14% of the GDP this year and are set to amount to 16% in 2012, however, indicators point to it being a little lower than earlier expected.

There has been a veritable transformation in the trade balance in the wake of the depreciation of the real exchange rate of the Icelandic króna and the surplus currently amounts to 10% of GDP. This surplus is likely to remain unchanged over the next year. The ample surplus offsets the high income account deficit. Exported goods and services are expected to increase slightly this and next year and there is likely to be a minor increase in marine product exports and commission income. On the other hand, increased production at the Straumsvík plant is not expected to result in a rise in export revenue until 2013. The increase in product and service imports is expected to slightly exceed the increase in exports in the wake of the rise in real wages and disposable income, reduced unemployment and an increase in travel abroad. Official current account balance figures estimate a considerable increase in interest expenses, as a result of old banks undergoing winding-up proceedings, but expect a large proportion of these expenses to be written off in the final settlements. Apart from these items, the current account balance will be close to equilibrium.

Unemployment has dropped this year and the figures of the past months show continuous improvement. Statistics Iceland's forecast unemployment rate of 7.2% for this year is therefore likely to prove correct. The decrease in unemployment can be attributed to labour market measures,

which have, among other things, focused on helping people to find appropriate studies, while at the same time a number of people of a working age have emigrated. With positive growth, unemployment will gradually decrease and, according to Statistics Iceland's forecast, unemployment is likely to come down to 5% by 2015.

The development of inflation has been a cause for concern so far this year. At the beginning of 2011, the króna depreciated at the same time as global commodity and fuel prices were rising. This triggered off inflation which measured in October at 5.3%. The Central Bank of Iceland (CBI) felt there were insufficient grounds to respond with an interest rate hike, but in the middle of the year union-negotiated wage increases were agreed, which fuelled inflationary pressures and prompted the CBI to increase its policy rate in August and again on 2 November. According to the CBI's forecast, inflation will continue to rise in the short term, in the next two quarters, but will then decrease to a 4,1% and the bank does not therefore exclude the possibility of further interest rate increase, since it believes that moderate interest rate increases will not hamper the economic recovery. According to the CBI's forecast, its 2.5% inflation target should be reached by 2014. Statistics Iceland's forecast predicts an almost unchanged nominal exchange rate until year-end 2013, on condition that the capital controls will remain for this period.

The CBI's forecast on 2 November is more in line with Statistics Iceland's forecast than the bank's previous forecast. Some discrepancies remain for 2010, since the Statistic Iceland's newest forecast was made this summer, as earlier stated. The CBI has reduced the expected contraction in public consumption, since it increased on both the central government and municipalities level in the 2nd quarter on account of wage hikes and public procurement. The CBI has also reduced expectations of business investment, the weightiest factor being delays regarding the Helguvík silicon factory. Investment remains at a very low level and a single project can matter a great deal when looking at level changes between years. Next year, the major discrepancy is public investment, since the CBI expects further investments stemming from the projects introduced in relation to the wage agreements last spring. Furthermore, forecasts can differ on account of the classification of single projects as public or private undertakings. The CBI expects a more modest growth in exports as a result of investment this year. Over the whole, the CBI predicts slower growth in 2012 than Statistics Iceland does, 2.3%. The difference is smaller than in the previous forecast, when the CBI expected 1.6% growth in 2012.

## Main economic indicators – comparison of forecasts

	2011		2012		2013		2014		2015	2016
	Hagstofa júlí 2011	PM 2011/4	Hagstofa júlí 2011	PM 2011/4	Hagstofa júlí 2011	PM 2011/4	Hagstofa júlí 2011	PM 2011/4	Hagstofa júlí 2011	Hagstofa júlí 2011
Private consumption	3,1	2,9	3,3	3,1	3,1	3,2	3,0	2,8	3,0	3,0
Public consumption	-2,6	-0,2	-0,8	-1,2	-0,1	0,4	0,5	0,3	0,9	2,0
Gross fixed capital formation	15,0	6,7	14,5	16,5	14,3	4,4	8,3	11,1	-0,3	4,4
Business investment	25,2	13,2	17,6	16,5	15,9	4,4	5,1	13,5	-6,3	1,1
Housing investment	17,0	13,8	26,8	21,6	15,9	14,6	19,1	15,1	11,6	8,5
Public investment	-18,1	-19,8	-15,5	9,5	0,4	-8,8	10,6	-8,5	16,9	14,6
National expenditure	3,5	3,9	4,0	3,2	4,2	2,3	3,4	3,4	1,9	3,0
Exports of goods and services	2,1	2,5	3,3	1,3	2,8	1,6	2,1	2,1	3,6	3,0
Import of goods and services	3,8	4,0	4,9	2,8	5,5	1,6	3,0	3,5	2,2	3,1
Gross domestic product	2,5	3,1	3,1	2,3	2,8	2,3	2,8	2,6	2,7	3,0
Current account balance, % of GDP	-7,4	-8,2	-6,0	-1,5	-7,1	1,1	-5,9	-0,2	-6,0	-5,8
Inflation, CPI	3,9	4,1	3,7	4,1	2,6	3,0	2,5	2,5	2,5	2,5
Exchange rate index	1,1		0,9		0,0		0,0		-0,9	-1,0
Real exchange rate	0,0		0,4		0,4		0,3		1,0	0,9
Unemployment rate, % of workforce	7,2	7,4	6,0	6,2	5,4	5,8	5,2	4,9	4,8	4,3
Wage rate index	6,2		5,0		4,2		4,6		4,7	4,6
World GDP	2,2		2,4		2,5		2,4		2,4	2,4
World CPI	2,7		2,2		2,1		2,1		2,5	2,6

Source: Statistics Iceland Economic forecast July 2011 og CB Monetary bulletin 2011/4

## 4. Investments and competitiveness

The government's principal objective is to facilitate Iceland's economic recovery through increased investments by increasing the investment to GDP ratio from 13% to 20% by 2013. It also aims to create a sustainable business environment by reforming companies' corporate legal framework. The government's statement on wage settlements in the spring includes a detailed formulation of the legal reforms that revolve around working conditions in the economy, as well as direct actions that have been undertaken on behalf of the government. These measures are essential to break away from the stagnancy that currently reigns in many areas of the economy. Investment is at an historical low. According to the current forecast, the investment to GDP ratio will increase from around 13% in 2010 to 18% in 2015. Although this will be a veritable turnaround, the investment to GDP ratio will nevertheless still be below the long-term average, if this outlook proves to be correct. More needs to happen before investment increases any further and reaches satisfactory levels.

### Investment plan

With regard to long-term strategies and the [Iceland 2020](#) project, an investment plan is currently being developed by the Ministry of Finance in collaboration with other ministries, which take into account different integrated policies and programmes, such as, for example, transport and regional plans, to ensure success in these areas. The programme is expected to be formulated by the end of autumn 2012, along with the work on the budget, and it will remain in force during the 2013 – 2020 period.

## Competitiveness and the ISK exchange rate

It is important to ensure equal competition between companies, not least in the export sector. Their positions have become insecure as a result of the great volatility of the króna and there is therefore a need to guarantee their long-term stability. One of the main tasks of the Central Bank will be to maintain the stability that is needed to allow the export sectors to grow and thrive in as many areas as possible. The Ministry of Finance is working on a tax framework for businesses. Legislation will be amended, for example, to limit the scope of foreign parent companies to indebted their subsidiaries in Iceland. The Ministry of Economic Affairs is working on creating a framework for improving business practices by, among other things, preventing people who have repeatedly led companies into bankruptcy from founding or sitting on the boards of companies. The [“Everyone works”](#) campaign, which has now been extended throughout 2012, is an important element in preventing the black labour market from taking root.

A low exchange rate generally leads to greater competitiveness and fuels growth in the export sector. In 2008, the ISK exchange rate plummeted by a half and the real exchange rate swiftly dropped after that. The competitiveness of the export and competitive sectors has been very good in recent quarters, while at the same time, the low real exchange rate caused a contraction in imports, creating a positive trade balance.

It certainly seems likely that the real exchange rate will follow the traditional trend of increasing when the economy starts to rise from its current downturn, with all the associated negative effects on the working environment in the economy. At the same time, this will generate the risk of increasing debt and a trade deficit, which would hamper export-driven growth and the development of sustainable debt. It is vital that economic policy take this into account to prevent any negative effects of a development of this kind.

One of the most important factors in Iceland's economic policy is the fact that the largest export sectors, the fishing industry and heavy industry, are to a large extent, vulnerable to the impact of exchange rate volatility. The income and expenditure of these sectors are mostly, directly or indirectly, denominated in foreign currency and they can therefore withstand high exchange rates a lot differently than other export and competitive sectors. The vulnerability of these sectors to domestic cost pressures is therefore not as great as that of other sectors, which cannot protect themselves as easily from the negative impact of rising exchange rates. This means that the government has to be particularly attentive to the inequalities that high real exchange rates can create between the various sectors. If a satisfactory equilibrium cannot be struck between the sectors that are, to a greater or lesser degree, vulnerable to the effects of rising exchange rates and those that are hedged against developments of this kind, there is a danger that the competitive advantage Iceland gained with its low exchange rate will rapidly fade. If this were to happen, investment would be unlikely to increase to the level required. This would nullify the Economic Programme's objective of achieving sustainable growth and recreate a climate of instability and debt accumulation.

## Public procurement and gender responsive economic policy

The competitiveness of the private sector must be considered in relation to the fundamental shifts in employment for the last decades. To put it simply, the traditional male jobs in construction and manual labour have decreased, whereas the traditional female jobs in caregiving have increased in the

public sector. On account of the size of the Icelandic economy, the state plays a leading role in the purchase of goods and services and can influence the development of new businesses with its public procurement policies. This calls for supporting the foundations of a competitive and diverse private sector and that public policies are in line with the goals of gender responsive economic policy and equal opportunities for men and women in economic innovation.

### **Corporate tax environment**

Despite the good competitive position of the export sector, this has not resulted in an increase in investments, due to, among other things, the high level of corporate debt, capital controls and restricted access to foreign credit. It is vital that these obstacles be removed as swiftly as possible to enable the economy to make full use of the competitive advantage that currently exists. An improved corporate tax environment will play an important role in this respect. One of the elements of this will be to change the social security contributions and employment insurance, which will decrease as unemployment diminishes.

### **Financing terms and public sector projects**

Domestic entities' restricted access to foreign credit underpins the importance of ensuring the best results for pension funds and other institutional investors from investment projects. It is important that the government and Central Bank of Iceland's capital account liberalisation strategy should create an incentive to invest in the economy in the correct manner. There is also a need to open up the possibilities for the financing of energy company projects. This is currently being focused on. Funding of this kind will make it possible to limit public risk and ensure satisfactory financing terms for further investments in energy-intensive industry. The Ministry of Finance is working on improving financing terms through, among other things, a framework for the funding of large energy projects. This will, for example, make it easier for pension funds to finance profitable projects that are deemed to be of macroeconomic importance. The Act on Incentives for Initial Investments in Iceland, which came into effect in 2009, promotes investments from domestic and non-resident entities. The objective of the act is to promote research and development and improve the competitive conditions of innovative companies by granting them derogations from taxes and charges on innovative projects.

Many projects are already being prepared by public sector entities or being implemented with multiple sources of funding, including:

- The National Hospital – University Hospital which is in the designing phase
- Nursing homes
- Secondary schools
- Vaðlaheiðargöng tunnel
- New prison
- Suðurlandsvegur road project
- Avalanche defences
- Energy-related projects (*see chapter on energy and industry strategy*)
- Construction of 289 student apartments, spearheaded by the Icelandic Student Services

## Foreign direct investment

Foreign direct investment is important to stimulate the economy in the current environment and, in order for this to happen, Iceland may need to simplify the framework for foreign investors and send out a clearer signal of its desire to attract foreign investors. In this context an official proposal regarding foreign investors will be submitted to parliament and a revision of the legislation governing non-resident investors and how they are taxed is taking place. A bill is expected to be submitted by the Ministry of Economic Affairs at the spring parliamentary assembly. A key element will be to facilitate the flow of foreign capital into the country both in the short and long term, particularly into projects that fuel export-driven growth and have a positive impact on the labour market.

## Energy and industry strategy

A great deal of work has been conducted on the drafting of the [Master Plan for hydro and geothermal energy resources](#), which a working group submitted at the end of the summer. This issue is being discussed in parliament and this debate needs to be concluded as soon as possible so that important projects in the energy-intensive sector can be launched and uncertainty can be dispelled in the sectors concerned.

Many projects are already under way, some at a drawing board stage and others well advanced or already completed:

- The building of the Búdarháls power plant and enlargement of the Straumsvík aluminium smelter at the end of 2013
- The construction of the silicon plant in Helguvík is at design stage
- Energy projects in the north of Iceland, including among others Blöndulína 3 and the geothermal plants that are being planned in Theistareykir and Bjarnarflag
- The construction of the Verne Holding data centre in Reykjanesbær has been completed

## Green economy

A green economy is an economy, which enhances the quality of life by substantially reducing environmental risks and damage to the ecosystem. In a green economy the emphasis is placed on the investments of private and public entities, which reduce pollution and the emission of greenhouse gases, promote a better use of energy and resources, prevent the decline of biodiversity, and serve the ecosystem.

In the summer of 2010, the Althing approved a proposal to draft a parliamentary resolution on strengthening the green economy. A committee working on this issue submitted its conclusions in September 2011 and a draft resolution regarding 48 measures to strengthen the green economy are currently being discussed by parliament.

## Legislation on the management of fisheries

A bill regarding the management of fisheries has been submitted to parliament and is being processed. There is an imperative need to create a more stable environment for the fishing sector as soon as possible and for a consensus to be reached on how to organise the management of fishing and the use of resources in this important export sector for Iceland.

## Creative sector

A great deal of emphasis has been placed on the innovative sector and its importance in the economy. The Research Centre for Creative Industries at the University of Iceland conducted research with the aim of mapping the economic [effects](#) of creative industries, in collaboration with the ministries for Education and Culture, Foreign Affairs, Finance, Industry, Economic Affairs and the *Promote Iceland* campaign. The research reveals that creative industries generated a turnover of ISK 189 billion in 2009, over 9 thousand man-years and export revenues amounting to ISK 24 billion or 3% of the nation's total exports. The research also indicated that creative industries have remained relatively stable and increased the activities, despite the contraction in the economy.

It is important to create a database on the added value of creative industries, so that information on their development can be accessible to public authorities and interested parties. The Ministry of Economic Affairs and Statistics Iceland will examine the possibility of applying the ISAT2008 classification to these industries so that their share of value creation in the economy can be measured. The Ministry of Finance and the Ministry of Education will examine to possibility of increasing tax incentives to strengthen the creative industries as they have been defined here.

## Tourism

Over the past three years there has been a substantial increase in the number of tourists travelling to Iceland. 2011 is expected to be the biggest year ever for tourism, since at the end of September the number of tourists travelling from Keflavik airport had already equalled the number for the whole of last year. This can be attributed to multiple factors, including the low ISK exchange rate and strong promotion work, such as the *"Inspired by Iceland"* campaign. Further campaigns are being planned for the tourist industry, such as, for example, the *"Iceland all year round"* campaign, which is focused on boosting health tourism services.

## Improved statistics

Reliable and timely statistics are essential for the shaping of a more successful economic policy. The activities of Statistics Iceland need to be boosted to strengthen its compilation of data. A lot of work is currently being done at Statistics Iceland in response to the feedback and requirements of the European Union, the Federation of Icelandic Industries and, not least, the ministries, to strengthen available tools for statistical analysis. Statistics Iceland is working on conducting a register-based census. This will provide data on the number and types of households and strengthen the analysis of household finance elements, such as income, debt, consumption and other expenditure. Statistics Iceland is also working on creating a database for agriculture to provide statistics on that sector. Up until now, the Farmers Association of Iceland has largely provided statistics on this sector and this has been criticised by the European Union. Statistics Iceland aims to create a database on the financial position of households and businesses. The shortage of data of this kind has been a great hindrance in the work that has been conducted in recent quarters on the adoption, implementation, and monitoring of the restructuring of household debt in the country. Finally, mention should be made of the planned development of a register of enterprises within Statistics Iceland, with the aim of providing a permanent foundation for corporate statistics. These statistics will be used to, among other things, improve national accounts and labour market data and to monitor and evaluate the production and output of specific sectors, since statistics of this kind have been rather poor in Iceland up until now.

## **5. Fiscal policy priorities**

The impact of the banking crisis on public finances has been huge. The liabilities of the Treasury, excluding pension obligations and short-term business debt, increased from about 24% of GDP at the end of 2007 to 84% at the end of 2010, according to Statistics Iceland's preliminary figures. Its impact on the debt position of municipalities has also been great and total public debt amounted to 93% of GDP at the end of 2010. This vast increase in debt can be attributed to both various costs incurred with the collapse of the banks and also the steep drop in tax revenue, due to the contraction in corporate and household income during the current recession. The Treasury has drawn up a strategy of principal objectives until 2015. The main goal of this strategy is to ensure that the Treasury is run with a surplus from 2014 and to reduce governmental and municipal debt at a satisfactory pace and bring it down to below 60% by 2020. This will be achieved by focusing on reducing interest costs and increasing credit ratings. The Minister of Finance submitted a report on its Fiscal Plan for 2012-2015 on 1 October along with its draft budget. This provides a further analysis of the strategy and outlook for the coming budgetary year and long-term plan for the next four years.

### **Fiscal rules for public entities**

The fiscal framework of municipalities is currently under review, since over the past years their share of public finance has substantially increased. Their prudent management as a whole is therefore more vital than it was. A number of municipalities have struggled with persistent difficulties in their operations. Some of these are in growth areas and rapidly developing, while others are in areas with declining populations. There is an urgent need to strengthen the position of municipalities and prevent deficits in the operations of the projects they manage. At the last parliamentary assembly, a new Local Government Act was approved for this purpose and will come into effect at the beginning of 2012. Among other things, the Act stipulates that debt may not exceed 150% of revenue and that an equilibrium has to be reached between revenue and expenditure at three-year intervals. In order to be able to tackle the current situation, the Ministry of the Interior is working on the financial adjustment of each municipality individually.

Binding financial regulations for the Treasury are currently being formulated and should be ready by the end of 2011. Deficits have been widespread in a range of government enterprises. With the increasing demands the legislative is placing on local governments, there is also a need to set financial regulations for state institutions and enterprises.

### **General government debt**

On the basis of the current fiscal plan, one can expect debt, excluding pension obligations and short-term business debt, to decrease and meet the Maastricht criteria, which is 60% of GDP, during the period from 2016 to 2019. This would unlock the shackles which have been created by the unfavourable development of public finances. Instead of the negative crowding-out effect, a positive development in public finances would pave the way for an increase in investment from individuals and businesses, thus fuelling economic growth. Given the small size of the Icelandic economy, it is essential for the Treasury to have the required financial leeway when shocks occur. It is therefore sensible to aim to reduce debt even further at the end of the current fiscal programme. Improving the Treasury's financial position is also a prerequisite for protecting and strengthening the welfare society in line with the Nordic model.

## **Tax environment for individuals and self-employed individuals**

The Ministry of Finance is currently reviewing its tax brackets for individual income tax, as well as the individual tax-free income threshold, in accordance with the letter of intent attached to the wage settlements reached with the Icelandic Federation of Labour (ASÍ) and the Confederation of Icelandic Employers (SA). The Ministry of Finance is also reviewing the Income Tax Act for individuals who work in their own businesses by, among other things, limiting the dividends that are taxed as capital gains to 20% of the company's profits. A decision has been made to reduce the tax deduction on private pension savings from 4% to 2% from the beginning of 2012. Legislation was completed regarding the valuation of companies for the computation of wealth tax. Wealth tax will be extended to 2015 with individuals paying 1.5% wealth tax on net assets ranging between ISK 75 m and ISK 150 m and couples on net assets between ISK 100 to ISK 200 m, although the tax surcharge to be applied when individual net assets exceed ISK 150 m and couples' assets exceed ISK 200 m. will be set at 2%. The implementation of a carbon tax will be completed to bring rates fully in line with the carbon price equivalent on the European market instead of the current 75%. Excise duties on fuel will increase less than was originally anticipated to offset this change. Work is being done to broaden the carbon tax base to include solid mineral carbon emissions from solid fossil fuels.

## **Corporate tax environment**

The Ministry of Finance is reviewing the corporate tax environment. Legislation is being examined to find ways of stimulating investment and innovation and ensuring equal competition. A number of changes were introduced by parliament in the spring of 2011, including amendments to the legislation on tax deductions on dividends and the transferral of sale profits between companies. Amendments were also made to the legislation regarding tax deductions on the interest payments of non-residents, limiting them solely to the interest income on Icelandic securities but not foreign loan agreements. Legislation was passed to give undertakings greater flexibility in the manner in which they distribute value added tax and excise duties. The Ministry of Finance is working on regulations for the taxing of derivatives trading, which are due to be completed by the end of 2011.

## **New financial activities tax**

A new financial activities tax will be imposed on the total wage payments of financial undertakings, pension funds and insurance companies. This tax will initially be set at 10.5%. A special tax of 0.0875% will also be imposed on financial undertakings to go towards financing part of the commercial banks' interest rebates to indebted households.

## **Changes in social benefit amounts and personal tax allowances**

The Ministry of Finance and the Ministry of Welfare are working on changes to social benefit amounts and personal tax allowances, in accordance with the letter of intent issued by the government in connection with the wage settlement reached with the social partners on 5 May 2011. A decision was made to review social security benefits in general in light of the conclusions of the wage settlements with the social partners so that they can be adjusted to reflect general wage-increases. Income and asset-related interest rebates, as well as child benefits, will be reviewed at the end of 2011.

## **Review of public procurement**

The laws and regulations governing public procurement are being revised, not least to guarantee a healthy competitive environment and the rights of wage earners. Workers' rights are being examined both at a contractor and sub-contractor level, not least to ensure that workers enjoy solid terms of employment. In light of this, public procurement laws are being examined to ensure that they are also observed in municipalities and institutions that operate on the state's behalf.

## **Harmonised taxation of resources**

The Ministry of Finance is working on harmonising the taxation of resources. The legislation governing resource taxes on fishing quotas is being reviewed, and the possibility of imposing a tax on companies that enjoy subsidised energy is being examined. Fishing fees are expected to rise from 13.3% to 27%.

## **6. Labour market, education and welfare**

Unemployment has decreased somewhat this year, compared to 2009-2010. In the second quarter of this year, unemployment measured at 8.5% and the number of job seekers had dropped by 400 from the same quarter in 2010, according to the labour market research conducted by Statistics Iceland. The number of registered unemployed at the Directorate of Labour has also decreased. In 2009, the average number of registered unemployed for each month was 9,363, compared to 2010 when it was 9,281. So far this year, their number has averaged at 8,858. There are still cases of group redundancies, however, as a result of the restructuring of companies, and this continues to create some uncertainty with regard to the development of unemployment. As has already been mentioned, unemployment has hit the younger age groups the hardest, particularly those who have only had a basic education. The duration of the unemployment periods is also lengthening for these groups. The government's principal objective is to minimise the damage caused by long-term unemployment, facilitate the reintegration of the unemployed into the labour market and prepare the ground for the creation of new jobs. The objective is to reduce unemployment to 5% by 2015.

### **Measures to reduce the impact of long-term unemployment**

The government has taken comprehensive measures to make job seekers more active with the aim of reducing the impact of long-term unemployment. The range of labour market measures has been increased, social security benefit periods have been lengthened, benefits have been granted to those with reduced working hours and social benefit regulations have been eased for job seekers who were previously self-employed. The Icelandic Rehabilitation Fund was legally established in July 2011 and all employers contribute a percentage of the salaries they pay into the fund. The pension funds also make a counter-contribution into the fund. In the past employers negotiated contributions of this kind with their employees.

### **Strengthening education**

In accordance with the [Government's statement](#) on the occasion of the wage settlement reached with the social partners in May 2011, actions are currently being undertaken to promote labour market measures and boost education. In this context, secondary schools are expected to cater for all the young people seeking education opportunities and to facilitate job seekers and companies' access to job-related schemes. It is hoped that these measures will enable young job seekers to

adapt to the labour market and increase the country's education standards. Increased education, particularly in vocational training, will boost export companies' potential for growth. At the same time, growing companies need to be encouraged to take on individuals in on-the-job training to combat long-term unemployment.

The labour market and education system is flexible in Iceland. In this context it should be noted that, even though the drop-out rate of young people from secondary schools in Iceland is particularly high, it is offset by the fact that it has been easy for them to leave their jobs and restart their education later in their lives. When the number of graduates from secondary schools and universities, who are outside the traditional school age groups, is taken into account, the average is higher in Iceland by international standards.

A longer-term education strategy will be formed with regard to, among other things, the needs of the economy and investment policy priorities. The Ministry of Education, Science and Culture has started to review the Icelandic Student Loan Fund and will be working on this task in consultation with social partners. The goal is to establish a development fund for the purpose of strengthening job-related studies at various educational levels and develop shorter study programmes. The Workplace Study Fund will be set up with a contribution of ISK 150 m in 2012 to meet the costs of on-the-job training. Certified training and a quality control system is scheduled to be developed shortly to facilitate the evaluation of courses so that students' studies can be more easily evaluated in secondary schools. Collaboration will be sought with universities to achieve the same objective.

### **Legal status of workers**

The Ministry for Welfare and Ministry of Finance are working on guaranteeing the rights of workers in companies that are subjected to insolvency proceedings. The legislation covering the legal status of employees involved in the transfer of undertakings with regard to wage terms and working conditions, in addition to protection against dismissal, does not cover the employees of companies that go bankrupt and this must be changed during the autumn session of parliament.

### **More people working**

There are positive signs that the number of people working on the labour market is increasing. In the second quarter of 2011, the number of people working increased by 500 from the same period in 2010. The greatest increases have been in the fishing industry, hotel and restaurant management, the health and social services and "other industries". Ministries and institutions are currently working on making more detailed statistical analyses of the labour market, since there is a need to be able to analyse potential vacancies to evaluate possible mismatches between supply and demand with regard to education and specific sectors of the economy.

### **Migration**

Internal and external migration figures have been volatile. In 2010, the number of people who emigrated from Iceland exceeded those who immigrated by 2,134, although 431 of these people (i.e. 20%) were foreign citizens. The net migration figure was considerably better than the year before, however, when the number of people who emigrated exceeded the number who immigrated by 4,835. Some 2,368 of these were foreign citizens, i.e. 49% of the total number of emigrants. Figures for the first half of 2011 indicate that a turnaround may have taken place, since the number of

people moving out of the country exceeded those moving in by 545 during the first six months of the year. In the same period in 2010, there were twice as many emigrants, i.e. 1,090.

### **Long-term unemployment and its interplay with the social security system**

The government's priority task is to prevent long-term unemployment from taking root in Iceland. Experience shows that the longer unemployment lasts, the more difficult it becomes for job seekers to find appropriate work and to be fully integrated in the labour market. The unemployment benefit framework needs to be continuously revised in line with changing circumstances. If the situation is not handled correctly, the unemployment benefit scheme could de-motivate the unemployed from accepting the jobs that are on offer. The amounts granted in unemployment benefit are relevant, as is the extent to which these benefits compete with regular wages. The scope of the unemployment benefit right is also an important factor, as is its duration and how obligations are enforced.

According to labour market research conducted by Statistics Iceland, there was a slight increase in the number of people outside the labour market in 2010. The greatest increase was among those who are without a job and choose not to accept a job within a specific time. In 2006, the percentage of people outside the labour market was 3.3%, but by last year this percentage had risen to 8.8%.

Statistics Iceland's forecast expects unemployment to average at 7.2% this year, but to gradually decrease until it reaches 4.8% of the workforce in 2015. In the government's opinion, it would be desirable for unemployment to decrease more rapidly than Statistics Iceland predicts and be below 5% in 2013.

### **Harmonisation of pension rights**

A working group on the harmonisation of pension rights, featuring representatives of the social partners, will put forth proposals regarding a coordinated and sustainable pension system for the whole employment sector. Authorities have stated that the accrued benefits of public sector employees will be honoured and that any changes to the pension system will be decided in close cooperation with public sector representatives.

The harmonisation of the pension rights of public and private sector employees is a vast and vital project, related to the creation of a coordinated and sustainable pension system for the future. Cuts in pension benefits have been inevitable in pension funds related to the Icelandic Confederation of Labour as a result of the banking crisis. This must be addressed specifically. Solutions might entail i.a. state participation in contributions in order to support the private pension funds in meeting the accrued benefit level of the public funds where applicable, for a 10-15 year period. Authorities have commissioned a working group with representatives of the Icelandic Confederation of Labour, the Confederation of Icelandic Employers and the Ministry of Finance with putting forth proposals on how this can be accomplished and the conclusions will be submitted to parliament when the work has concluded.

### **Child insurance**

The Ministry for Welfare is working on a child insurance scheme, which will replace the child allowance and child pension scheme system, and will be legally established in 2012.

## **Distribution of income and gender equality**

One of the main objectives of the government is to balance standards of living and reduce inequality. Inequalities decreased between 2009 and 2010. The Gini coefficient was highest at 29.6 in 2009, but was 25.6 in 2010. Considerable progress has therefore been made in reducing inequality. An equal pay standard is being developed and should be ready to be applied by the end of the year. This is pioneering work since no standard of this kind has been applied anywhere else before.

Gender Responsive Budgeting is one of the tools that can be used to promote equal rights and a fairer strengthening and distribution of public funds. In 2009, gender responsive economic policy making and budgeting started in Iceland with experimental projects that were launched in the ministries and institutions. These test projects were the first step towards developing the tools and procedures for Iceland, as well as building up knowledge and promoting a greater awareness of the importance of gender responsive economic policies and budgeting. The projects differ both in terms of scope and content and their conclusions are presented in the draft budget for 2012. In the next phase of its implementation, the emphasis will be placed on, among other things, getting all the ministries working in one main category, to operate according the principles of gender responsive policy making and budgeting over the next three years. The aim is to have a working plan ready by the beginning of next year and to publish annual reports on the projects' progress. The government's Economic Programme is part of that task. Gender responsive budgeting has also been launched in municipalities, some of which are in the first stages of implementing it.

## **Housing policy**

In the wake of these measures it is important to ensure that the framework for households and businesses adapts to the changed circumstances. The principal goal is to guarantee everyone an appropriate home. The housing market therefore needs to work efficiently and meet changing needs at prices that individuals can finance with an appropriate percentage of their wages. The government's strategy has been to develop a housing policy that will broaden the variety of housing forms being offered. In this context the Ministry of Economic Affairs has been working on amending the law to facilitate the foundation of housing cooperatives and the Ministry of Welfare has been working on enabling the Housing Financing Fund (HFF) to offer housing for hire purchasing.

## **Housing benefit system**

The housing benefit system will be updated to supplant the interest rebate and rent subsidy system in 2013. There is a basic difference in the implementation of these two systems, since the interest rebate system is totally in the hands of the state, whereas rent subsidies are partly managed by municipalities. The objective is to ensure equal rights for individuals on the property market, on one hand, and the residential rental market, on the other.

## **7. Restructuring of household and corporate debt**

A twin crisis, i.e. a banking crisis coupled with a currency crisis, generally creates great difficulties for households and businesses. More often than not they are accompanied by a sharp drop in the real exchange rate and a reduction in domestic demand. Corporate balance sheets are badly hit and access to foreign credit tightens, at the same time as domestic banks are placed in a critical position and face uncertainty with regard to their loan portfolios. In light of this, there is a vital need for

household and corporate debt to be written down to its real value in a swift and efficient manner. In Iceland the indebtedness of the private sector was a particularly big problem, since the banks' loans to businesses were largely denominated in foreign currency. When the price of foreign currency doubled in 2008, thousands of companies were caught without currency hedges and with liabilities that far exceeded the value of their assets. The majority of Icelandic households have inflation-linked mortgages, which rose in the surge of inflation, as purchasing power dropped and unemployment increased. The restructuring of household debt and the economy has therefore been one of the government's most important tasks to restart investment and private consumption in the wake of the collapse of the banks.

The restructuring of household and corporate debt is at an advanced stage, although these measures are often complex and time-consuming, as the experience of other states has demonstrated. Current figures indicate that certain results have been achieved in the restructuring of debt. The write-downs stemming from the recalculation of loans by the Supreme Court of Iceland, because of the illegality of linking loans denominated in Icelandic króna to the exchange rates of foreign currencies, have now almost been completed, as far as households are concerned, with some exceptions. The main objective of the government is to complete the processing of the debt of households and small and medium enterprises by the end of 2011. All offers regarding corporate debt restructuring will be closed by the end of 2011. In the wake of these measures it is important to ensure that the framework for households and businesses can adapt to evolving circumstances. This will be based on the guiding principle of ensuring equal assistance to people on the residential property and rental market.

### **Debt restructuring of households**

Without any doubt, significant progress has been made in the adjustment of household debt, although challenging tasks still lie ahead, particularly with regard to ensuring that the households that face higher risks than others are not overburdened by serious liquidity problems and do not become entrenched in poverty in the long-term. The Ministry of Economic Affairs considers there to be a vital need to ensure access to data so that work can be done on defining this group according to, among other things, gender, income, assets and family composition. This task has been underway for some time, including in relation to the bill on the investigation into the debt position of households, which has been submitted to parliament on two occasions, but not been passed yet. This task is currently being carried out by the ministry in collaboration with Statistics Iceland, the Central Bank of Iceland and the Ministry of Finance.

The results of the debt adjustment of households can be gleaned from private consumption figures, which rose this year and considerable further growth is expected in the coming year. Important factors are the writing down of debt, temporary freezing of loans and the further advance payments of private pension savings, which have been authorised from 1 October 2011 to 30 June 2012. Moreover, the interest rebates for households with heavy debt burdens and low average incomes, which came into effect last year, improved their positions. A special interest subsidy was applied this year and will also be applied in 2012. The cost of this deduction was ISK 12 bn. The wage settlements that were signed in the spring are expected to result in a 6% increase in wages in 2011, after which wages are expected to increase by an annual average of between 4.2% and 5% until 2015. According

to Statistics Iceland's forecast, purchasing power and disposable income will increase by 3.3% this year and by 2.5% - 3.2% a year until 2015.

### **Write-downs of household loans**

By the end of August 2011, household loans had been written down by ISK 164 bn, as is explained in greater detail below. ISK 131 bn of this amount was due to the recalculation of foreign currency-linked loans, which were divided between house loans amounting to ISK 92 bn and car loans amounting to ISK 38 bn.

In December of last year, the government, credit institutions and pension funds signed a declaration on measures for households with debt problems. These covered the so-called 110% solution, on the one hand, and changes to special debt adjustments, on the other. It is estimated that the total write-down of household loans will amount to ISK 200 bn.

### **The 110% solution**

The 110% solution was based on an offer, which remained valid until 1 July of this year, which allowed borrowers with over-mortgaged homes to have the principal of their debt lowered to 110% of the current value of their property, provided the mortgage on their property had been taken out before 2009 and was secured on property that was intended to be used as a home. In the first few months that followed this announcement, the banks and Housing Financing Fund received considerably fewer applications for the 110% solution than they had originally anticipated. It should be noted, however, that the Housing Financing Fund was not authorised to process the applications until two months after the statement had been signed. Just before the deadline ran out, considerably more applications were submitted. By March 2011, the financial undertakings and Housing Financing Fund had received 4,024 applications, but by the end of August 2011, this number has shot up to 15,594, and 468 of these applications had been sent to the pension funds before the end of July. Some 8,551 of those requests were approved at the end of August 2011 and total write-downs on the loans amounted to ISK 27,189 m, some ISK 24 bn of which were from financial undertakings. Prior to this, banks and savings banks had processed 1,510 requests, under the terms of the old 110% solution, and those write-downs amounted to about ISK 9,864 m.

### **Amendments to specific debt adjustments**

The objective behind changes to specific debt adjustments was to ensure that more households could avail of the solution. With the amendments, mortgage holders with serious debt burdens were offered the option of lowering their loans all the way down to as much as 70% of the value of their property, in accordance with their capacity to pay. Up to 30% of the value of the property was then placed on an interest and payment-free subordinated loan for three years and debt in excess of 100% of the value was cancelled. At the end of March 2011, 722 applications had been received by financial undertakings, and some 543 were approved. By the end of August, received applications amounted to 1,372, some 894 of which were approved. It should be noted that there may be some overlap in these figures, since some applications may have been counted twice. Under this solution, total write-downs amounted to ISK 6,201 m at the end of August 2011.

The most recent report of the [Monitory Committee for special debt adjustments](#) concluded that in the cases which the committee examined all comparable cases were processed in a comparable

manner. However, the committee proposed that the financial institutions themselves should be offering this solution to households and that detailed credit assessments should then be conducted.

### **Freezing of loans**

At the end of August of this year, a total of 2,461 homes (3,899 loans) had loans that were frozen in financial institutions and the Housing Financing Fund. By comparison, at the end of 2010, some 4,412 homes (6,867 loans) held frozen loans. The freezing of loans therefore decreased by 43% during this period. The balance of frozen loans at the end of July 2011 amounted to 43,066 m.

### **Debt mitigation**

The number of applications for debt mitigation received by the Debtors' Ombudsman office amounted to a total of 3,737 on 1 October. Decisions had been made on 1,874 of these applications. Following these decisions, representatives have already been appointed for 1,427 applicants and in 111 cases of these agreements have been reached, 167 applications have been rejected and 157 have been withdrawn at the applicant's request, meaning that there are still many applications that need to be processed.

Before the Debtor's Ombudsman Office was set up, the courts had, between May 2009 and August 2010, approved 130 applications for debt adjustments on house mortgages and 555 applications for composition agreements containing debt mitigation. After that, or from September 2010 to September 2011, the courts approved an additional 40 applications for debt adjustments to house mortgages and 124 applications for composition agreements containing debt mitigation.

The processing of applications submitted to the Debtor's Ombudsman Office has gained considerable momentum, since the office now processes an average of 200-250 applications per month. Moreover, the number of applications has been decreasing, which can be attributed to the fact that the temporary provision on the deferral of payments from the receipt of applications expired on 1 July of this year. On the other hand, there has been an increase in the number of requests for advice on seeking other alternatives. In the opinion of the Debtor's Ombudsman Office, the reason for the delays in the processing of cases is to be found in the negotiating process itself, once a decision has been made to authorise debt mitigation. Various issues crop up and disagreements between claimants, representatives and debtors can delay solutions.

### **Debt adjustment of businesses**

The Financial Supervisory Authority (FSA) and Competition Authority strive to ensure that corporate debt problems are solved efficiently. The FSA has defined capital adequacy ratios and improved its collection of data on defaults on loans in order to be able to better analyse the results of debt solutions and risk factors. The Competition Authority will continue to ensure that financial undertakings do not overburden companies with debt in the debt solutions they offer and they set strict terms for the selling of companies they have acquired. Banks that overload companies with debt could face fines and penalties in accordance with the Competition Act.

### **Writing down of debt**

At the same time as an agreement was signed for the writing down of household debt, an agreement for the debt restructuring of small and medium enterprises called referred to in Iceland as "*Beina Brautin*" or direct track was signed. After a slow start, the restructuring has now gained considerable

momentum. At the end of May of this year, debt restructuring proposals were sent out to practically all of the companies concerned. The Ministry of Finance has also offered large and smaller enterprises special debt solutions. These apply to all kinds of economic activities, such as real estate, investment and holding companies. At the end of August, corporate debt had been written down by ISK 921 bn, some ISK 102.2 bn thereof as a result of recalculated foreign-currency linked loans; ISK 124.2 bn of this amount was in smaller companies and ISK 65.3 bn in large companies, according to *Beina brautin*. A total of 2,177 loans came under the *Beina Brautin* scheme and special debt solutions, whereas 4,190 were the result of recalculated foreign-currency linked loans.

According to Statistics Iceland's macroeconomic forecast, there are signs of an increase in investment and a growth in exports. What is particularly noteworthy is that the forecast expects to see increased investment in industries other than heavy industry. It is important to process the debt adjustment of businesses as swiftly as possible to enable them to build up economic sectors and employment opportunities after the difficulties of the past years. The Ministry of Economic Affairs will continue to monitor corporate debt solutions and exert pressure on financial institutions to accelerate the solving of debt issues.

## **8. The restoration of the financial system**

Significant progress has been made in the restoration of the financial system and improving its framework and supervision. Laws and regulations have been strengthened, collaboration between supervisory bodies has been tightened, the manpower of the Financial Supervisory Authority has been increased and the banks have been recapitalised and now have the financial capacity to deal with the necessary financial restructuring of household and corporate debt. Further measures are needed, however, to enable the financial system to fulfil its function in the mediation of capital at full capacity. The principal objective is the ongoing streamlining of the banking system, a more efficient mediation of savings to profitable projects, and the strengthening of the financial market.

### **Speeding up financial restructuring**

The financial restructuring of businesses has been proceeding too slowly and innovation in the economy has been restricted. For example, no new company has been listed on the Icelandic stock exchange since the financial crash. It is also clear that the Icelandic banking sector is still very large by international standards, whether it be in terms of the number of its employees, the size of its balance sheets or the domestic demand for financial services. Considerable streamlining was achieved with the merging of SpKef and Landsbanki and the merging of Byr and Íslandsbanki. Despite these mergers, however, a further rationalisation of the financial system is required – particularly once the restructuring of household and corporate debt has drawn to an end. ISFI (Icelandic State Financial Investments) is currently working on an evaluation of the future position of the savings banks system.

The Ministry of Economic Affairs is currently working on defining what the nation needs from its financial system and how the future of the financial market should be organised on the basis of this analysis. The Ministry of Economic Affairs will be submitting a report to parliament on this issue in the autumn session of 2011. On the basis of this report there will be an open debate on various aspects of the structure of the financial system, such as the separation between commercial and investment banking activities.

## **New ownership policy of the government**

A new government ownership policy is being formulated in collaboration with the Prime Minister's Office and the Ministry of Economic Affairs, particularly with regard to small government-owned financial undertakings.

## **Strengthening of risk management**

Amendments have been made to the Act on Financial Undertakings since the collapse of the banking system, in light of, among other things, the Kaarlo Jännäri proposals and amendments to EU regulations. Through these amendments risk management was given a formal status in financial undertakings, a ban was imposed on pledging own shares or guarantee capital certificates as collateral, rules regarding loans to connected parties were tightened, the requirements of financial undertakings with regard to the provision of information to supervisory bodies were increased, collaboration between supervisory bodies was strengthened with regard to, among other things: the channelling of information on the position of big borrowers, the suitability and eligibility criteria for board of director members and CEOs, and a clearer definition of the personal liability of these individuals.

## **Tighter provisions for internal and external auditing**

Provisions for internal and external auditing have been tightened and the role of auditors has been more sharply defined. In addition to this, rules have been set with regard to pay increases and retirement agreements, and the demands for transparency in holding companies have also been increased. The amended legislation provide the basis for the changes the Financial Supervisory Authority is making to its rules regarding connected parties, large risk exposures, foreign currency loans and liquidity management, and which are now nearing completion. Further changes to the legal framework of financial undertakings are being worked upon, including i.a. clearer rules on equity and the calculation of financial strength and the operating licences of specific types of financial undertakings. Work on the harmonised reporting of financial undertakings to the Financial Supervisory Authority has been completed and was submitted for the first time in September 2011. This reporting will facilitate the Financial Supervisory Authority's in its monitoring of the positions of financial undertakings.

## **Capital adequacy ratio has been lowered**

The capital adequacy ratio of the banks is high from an historical perspective and somewhat higher than the norm in the banking systems of other European states that have been worst hit by the global banking crisis. The percentage of defaults on loans is particularly high in Iceland, however, and it is therefore important to ensure that the banks' capital adequacy ratios are ample enough to tackle the uncertainty of defaults. It is important that capitalisation requirements reflect the risk of default on loans as accurately as possible. Moreover, equity rules need to fully take into account the fact that loans have been restructured with high levels of indebtedness and the likelihood of further write-downs. It is possible that a more detailed evaluation of the risk attached to specific asset items may give grounds to some lowering of the total capital adequacy ratio. This could pave the way for the issuance of new loans since their costs would be lowered.

## **New depositor guarantee scheme implemented**

The Ministry of Economic Affairs will be proposing amendments to the Act on Deposit Guarantees and they will be brought in line with international best practice. The aim is to legally establish a new depositor guarantee system by the end of this year.

## **Restructured framework for the supervision of the financial market**

The Ministry of Economic Affairs is working on defining the institutional framework of the financial system, as well as its options for the future. The report on the future organisation of the financial system and its supervision will cover, among other things, how best to articulate the collaboration and division of tasks between the Financial Supervisory Authority and the Central Bank of Iceland. The report is expected to be debated in parliament and to be referred to a committee. Following this, a group of both Icelandic and international experts will work on drafting a bill to be submitted to parliament in autumn 2012.

## **Restructuring of Housing Financing Fund**

The severe losses incurred by the Housing Financing Fund during the banking crisis have demonstrated the important need to review the framework of the fund to reduce its operational risk. The Treasury has injected ISK 33 bn into the fund. Despite this, the capital ratio of the fund is just over 2%, which is substantially below the fund's regulatory minimum target of 5%. The first step in this regard is to ensure the Financial Supervisory Authority fully monitors the financial position and risk management of the fund. The activities of the Housing Financing Fund have to be revised with a view to ensuring that they comply with state aid regulations in the European Economic Area. It is therefore vital to reduce the fund's operational risk in connection with repayments and loan periods. There is also a need to ensure that when decisions on the supply of loans and the fund's interest rates are made, the conditions of the economy are taken into account and the decisions are in harmony with the government's Economic Programme.

## **A stronger legal framework for the mortgage market based on the Danish model**

There is a need to ensure that the legal framework of the housing mortgage market in Iceland, both in the case of public institutions and private entities, is of the highest order. In this context there is a need to create the conditions for the natural financing of loans for all housing and to ensure that the loans are issued in a financially responsible manner. To facilitate this, the Ministry of Economic Affairs is preparing special legislation for the mortgage market, based on the Danish model.

## **Less indexation and a greater choice of mortgage options**

One of the elements that has characterised the Icelandic financial environment is the widespread application of indexation, which was implemented with the Economic Management Act of 1979 in the wake of a manual management of interest rates and runaway inflation which had a detrimental effect on monetary savings and the principal amounts of loans, as a result of the negative impact of real interest rates. From the lenders' point of view, the advantage of an indexation system is that it guarantees that loans are repaid at their real value. The lender can therefore offer lower interest rates and longer repayment periods than if the loan were non-indexed and the borrower enjoys lower financing costs. But indexation is not without its weaknesses and at times when there are imbalances between loans, wages and asset prices these weaknesses clearly manifest themselves. A

[Committee appointed by the Ministry of Economic Affairs](#) discussed the conditions for indexation and possible ways of reducing its weight in line with the government's policy statement. The committee felt it was important to broaden the range of non-indexed loan options and, in particular, suggested that the Housing Financing Fund should offer non-indexed housing loans, for which preparations are currently being made. The committee also highlighted the need to increase the public's financial literacy, the dissemination of information on savings and borrowing, and consumer protection against the risk of becoming over-indebted. The Ministry of Economic Affairs has been working on these ideas as well as other elements that require attention. These include, for example, elements to reduce the automatic effects of indexation on price setting, which are covered in the Central Bank of Iceland's [recent report](#).

## **9. Monetary policy framework and lifting of capital controls**

Monetary policy ran aground in 2008 with the crash of the Icelandic króna and the implementation of capital controls. Clearly, the lifting of capital controls and restoration of Iceland's financial links with the international economic system is one of the most important tasks facing the Icelandic government right now. In order for this to happen, a credible exchange rate and monetary policy framework needs to be in place. This work needs to take into account the complications, which the global financial crisis brought to light, with regard to the implementation of independent monetary policies in small open economies like Iceland's, with regard to the conditions for the free movement of capital. A satisfactory solution needs to be found to ensure stable prices and financial stability. The common objective of the government and Central Bank of Iceland is to lift capital controls, in accordance with the plan of 25 March 2011, and also to strengthen the monetary policy framework, both through amendments to the legislation governing the Central Bank and the formulation of a new monetary policy.

### **Framework of the Central Bank of Iceland**

Macro-prudential ideas need to be closely linked to a revision of the legislation governing the Central Bank of Iceland and future monetary policy. An important step in this work was taken with the change that occurred in October 2009, when the framework for all financial market and economic issues, including legislation governing the Central Bank of Iceland and the Financial Supervisory Authority, was transferred under the roof of a single ministry with the establishment of the Ministry of Economic Affairs. The [CBI report](#) published by the Central Bank at the end of 2010 provides an important input into this discussion. It clearly indicates that new monetary policy needs to be accompanied by better control tools to ensure macro-prudential stability, in addition to which there needs to be more effective intervention in the foreign exchange market. It is vital to ensure, however, that the tools at hand are consistent with Iceland's international obligations with regard to the EEA Agreement. This is regardless of whether the monetary policy is based on a fixed exchange rate arrangement or some other criteria. The Ministry of Economic Affairs shall submit a special macroprudential report by the end of February 2012.

As a follow-up to the Central Bank of Iceland's report, the Ministry of Economic Affairs appointed three monetary policy experts to submit an opinion on the CBI's report and the policies it proposes, and this report may be viewed on the [Ministry's website](#). The ministry has also sought the views of the social partners with regard to future monetary policy. The ministry has also decided to set up a

committee comprising representatives from all political parties to discuss the formation of exchange rate and monetary policy. The committee awaits the appointment of members.

### **Future monetary policy**

The management of monetary policy in Iceland and the monetary strategy of the Central Bank of Iceland need to be revised. A new understanding of external risk, such as the carry trade risk, a shift in circumstances for the national economy as a whole, and the firm resolve to lift capital controls call for a fundamental revision. The assumptions of the Central Bank of Iceland's monetary policy from 2001 must be critically revised in the light of experience. The framework of monetary policy from 2009 also needs to be improved in the light of experience. Fundamental questions regarding the currency itself are on the table in parliament, as a result of Iceland's application for membership of the European Union and because the Icelandic króna, as an independent currency, will be shackled by restrictions in one form or another for some time to come. The timeframe for the lifting of capital controls, on one hand, and the strategic goals of the economy, on the other, regarding price and interest rate stability, must go hand in hand to guarantee economic security in these uncertain times. At the same time, it is clear that delays in the establishment of future strategies will result in heavy losses.

### **Capital account liberalisation strategy**

Work is being done on lifting capital controls in accordance with the [Capital account liberalisation strategy](#) which was adopted by the government on 25 March 2011. Some amendments were introduced, however, when the strategy was submitted to parliament in the autumn session when the timeframe for the lifting of capital controls was shortened to the end of 2013, with the proviso, though, that capital controls can be maintained for longer if there is a compelling reason to do so. In connection with this task, it was agreed that the Ministry of Economic Affairs would appoint a cross-party committee of experts to evaluate the scope for accelerating the capital account liberalisation process and exercising restraint on the authorities and the Central Bank. The legal provisions regarding capital controls will be examined with a view to investigating the possibility of simplifying the legislation and doing away with unnecessarily burdensome features.

## 10. Measures linked to the Economic Programme

	Individual measures linked to the Economic Programme	Responsibility	To be completed
<b>Investments and competitiveness</b>	1 Changes to employment taxes	MOF	12.2011
	2 Energy policy formulated	MIET	12.2011
	3 Framework plan for the use of natural resources	MIET	12.2011
	4 Financing terms of pension funds improved with changes to their legal framework	MOF	12.2011
	5 New legislation governing the management of fishing	MFA	12.2011
	6 Policy set for foreign direct investment	MEA	12.2011
	7 Review of legal framework for foreign investment	MEA	06.2012
	8 Ensure strong competitiveness	MEA	03.2012
	9 Review of legislation governing taxation of businesses to promote equal competition	MOF	06.2012
	10 Encourage innovation and investment in the culture and arts sectors through tax incentives	MRN	Unscheduled
	11 Create framework for improved business practices to i.a. prevent the constant changing of social security numbers behind companies	MEA	02.2012
	12 Revision of economic sector classifications to include the creative industries	MEA,MRN,MIET	Started
	13 Extension of "Everyone works" campaign	MOF	12.2012
	14 Minimise tax evasion and prevent activities of this kind from taking root	MOF	Started
	15 Employment policy formulated	MIET,MFA	07.2012
<b>Fiscal priorities</b>	16 Changes in legislation regarding the taxing of individuals working in their own companies	MOF	Completed
	17 Changes in legislation regarding tax deductions on dividends and sale profits between companies	MOF	Completed
	18 Revision of legislation on tax deductions to non-residents	MOF	Completed
	19 Legislation on distribution of value added tax and excise duties	MOF	Completed
	20 Legislation regarding the valuation of companies for the computation of wealth tax	MOF	Completed
	21 Establishment of Icelandic Rehabilitation Fund, which pension funds and employers contribute to	MOW	Completed
	22 Financial Supervisory Authority and Central Bank of Iceland responsible for asset	CBI,FSA	Started
	23 FSA sets new regulations regarding hedges against defaults on NPLs	FSA	Completed
	24 Database on business entities whose debt levels exceed certain amounts	FSA	Started
	25 Harmonisation of reporting of financial undertakings	FSA	Started
	26 Fiscal rules for the Treasury before end of 2011	MOF	12.2011
	27 Fiscal rules for municipalities before end of 2011	MOF,MEA,MOI	12.2011
	28 Adjustment of municipalities facing serious financial difficulties	MOF,MOI,MEA	12.2011
	29 Review of individual income tax	MOF	12.2011
	30 Regulations regarding temporary employment abroad	MOF	12.2011
	31 Review of corporate tax framework	MOF	12.2012
	32 Regulations regarding thin financing	MOF	12.2011
	33 Regulations regarding taxing of derivatives trading	MOF	12.2011
	34 Review of income and asset-related interest rebates and child benefits	MOF,MOW	12.2011
	35 Changes in social benefits	MOF,MOW	12.2011
	36 Review of legislation and regulations governing public procurement	MOF	12.2011
	37 Fishing fees will be increased	MOF,MFA	12.2011
	38 Final steps in implementation of carbon tax	MOF,MFE	12.2011
	39 Harmonised taxation of resources	MOF	12.2011
	40 Financing of special interest subsidy	MOF	12.2011

	Individual measures linked to the Economic Programme	Responsibility	To be completed
<b>Labour market, education and welfare</b>	41 Legal status of employees of companies that are subjected to insolvency proceedings will be guaranteed	MOW,MOF	12.2011
	42 Persistent revaluation of social benefit amounts by taking wage developments into account	MOW,MEA	Started
	43 Review of social security system	MOW	07.2012
	44 Policy-making in education with regard to the needs of the economy and investment policy priorities	MRN	Started
	45 Facilitate the reintegration of people who have dropped out of their studies into education again	MRN,MOW	Started
	46 Boost education options for job seekers	MRN,MOW	Started
	47 Harmonisation of pension rights	MOF,MEA	Started
	48 Establishment of child insurance scheme, which will replace the child allowance and the child pension scheme	MOW,MOF	12.2012
	49 Endeavour to replace interest and rent subsidy scheme with a housing benefit	MOW,MOF	12.2012
	50 Framework for housing cooperatives formulated	MOW	06.2012
<b>Restructuring of household and corporate dept</b>	51 Special campaign to accelerate processing of debt adjustment applications	MOW	04.2012
	52 Housing Financing Fund to complete processing of applications for writing debt down to 110% LTV	MOW	04.2012
	53 Review of Housing Financing Fund framework to i.a. broaden the diversity of forms of housing	MOW	Unscheduled
	54 Monitoring committees for special debt adjustments have been strengthened	MEA	12.2011
	55 Monthly report on debt restructuring status of companies submitted to authorities	MEA	Started
	56 Monitoring of recalculations of financial undertakings	FSA	Started
	57 Monitoring of companies that financial institutions take over	FSA	Started
	58 Ensure that financial undertakings do not place too heavy a debt burden on companies in their debt management solutions	CA	Started
<b>The restoration of financial system</b>	59 Review of capital adequacy ratios of commercial banks	FSA	06.2012
	60 Review of legal restructuring of financial market	MEA	12.2011
	61 Complete the recapitalisation of banks	MOF,MEA	Completed
	62 Further boosting of prudential rules and supervision of financial undertakings' balance sheets	FSA	06.2012
	63 Act on Depositors' Guarantee Fund	MEA	12.2011
	64 Endeavour to review supervisory framework of the financial market	MEA,FSA,CBI	06.2012
	65 New government ownership policy, particularly with regard to the future of the savings banks	MOF,PMO,MEA	Started
	66 Reduce the weight of indexation and create framework for non-indexed loans	MEA	Started
	67 Form a framework for the future activities of the Housing Financing Fund	MEA,MOW	06.2012
68 Restructuring of Housing Financing Fund	MOW,MEA	06.2012	
<b>Monetary policy framwork and lifting of capital controls</b>	69 Review of legislation governing the Central Bank of Iceland	MEA	03.2012
	70 Monetary policy framework on the basis of the capital liberalisation strategy	MEA,CBI	06.2012
	71 Development of macroprudential tools and presentation of the framework for these tools	MEA,CBI	02.2012
	72 Work on the lifting of capital controls in accordance with the strategy	MEA,CBI	12.2013