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Iceland: Letter of Intent and Technical Memorandum of Understanding

November 15, 2008

The following item is a Letter of Intent of the government of Iceland, which describes the policies that Iceland intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Iceland, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

Reykjavík, November 15, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. Strauss-Kahn:

1. **In the wake of the recent international financial turmoil, Iceland's economy is facing a banking crisis of extraordinary proportions.** Triggered by a loss of confidence and fuelled by the financial sector's high leverage and dependence on foreign financing, the crisis led to the collapse of Iceland's three main banks, accounting for around 85 percent of the banking system. This precipitated an abrupt adjustment in key asset prices, while the onshore foreign exchange market dried up, and external payment systems have been severely disrupted. The economy is heading for a deep recession, a sharp rise in the fiscal deficit, and a dramatic surge in public sector debt—by about 80 percent of GDP—reflecting an unprecedented high fiscal cost of restructuring the banking system.

2. **While the economy is flexible, adjustment to this significant shock could be sharp and costly.** The Icelandic economy has a history of quickly adjusting to shocks, mainly through large and swift import compression and strong improvements in the current account. Still, given that confidence has been severely shaken, potentially substantial capital outflows could lead to a further large loss in the value of the króna. In the context of the high leverage in the economy, this would produce massive balance sheet effects and a substantial contraction in domestic activity. The immediate challenges facing us are, therefore, to restore a functioning and viable banking system, and to stabilize the króna. Looking further ahead, the challenge will be to reduce a very high level of public debt, by embarking on a process of sustained fiscal consolidation.

Banking sector restructuring and insolvency framework reform

3. **We have embarked on a comprehensive strategy to address the crisis in the banking sector that has been escalated by the global credit crunch.** As an emergency measure the Parliament of Iceland on October 6, 2008 passed a law that gave the Iceland Financial Supervisory Authority (FME) far-reaching powers, which it used to intervene in three of the larger banks. These banks also had a number of branches and subsidiaries, mainly in several European countries.

4. **The strategy for intervening the banks was driven by the need to secure continued domestic operations and downsize the banking sector to a level consistent**

with the size of the economy. To achieve this objective each of the three banks was split into a new bank and an old bank. The new banks included the domestic operations funded by local depositors. The old banks included activities in foreign branches and subsidiaries, mainly funded through the issuance of bonds and foreign deposits. Derivatives were left in the old banks. In each of the three banks, the FME replaced the board with a resolution committee and named a team of professional auditors from three of the major international auditing firms to be in charge of a preliminary assessment about asset quality. In this regard, appropriate loan provisions were made in the new banks, bringing loan values in line with expected market values.

5. **We have decided on the organizational structure to resolve intervened banks and to transparently maximize asset recovery.** Our strategy has developed in recent days. A well-reputed expert in banking was appointed to be in charge of managing the bank restructuring process. The expert reports to the Prime Minister and has the overall responsibility of developing, implementing and communicating a comprehensive strategy for bank restructuring. A committee comprising representatives from the Prime Minister's Office, the Financial Supervisory Authority, the Central Bank of Iceland, the Ministry of Finance, and the Ministry of Commerce has been established to coordinate policy input and will be chaired by the expert.

6. **The next step in the restructuring process will be a second valuation of both the new and the old banks to ensure that creditor recovery is not affected by the split.** A well-reputed international auditing firm will be hired to oversee the process and to assist the FME in developing a methodology in accordance with international best practice on which the valuations will be based. The methodology will be finalized by November 15, 2008 after which separately hired international auditing firms will conduct the valuations, to be completed by end-January, 2009. The auditing firm overseeing the process will confirm by February 15, 2009 that the valuations have been conducted according to the prescribed methodology and make a final decision on the valuation. The valuation process will also include an assessment of whether or not managers and major shareholders have mismanaged or abused the banks.

7. **After the completion of the second valuation we will recapitalize the three new banks up to a capital adequacy ratio of at least 10 percent.** The total amount of capital to be injected has been estimated at 385 billion ISK. The injection, which will be made using tradable government bonds issued on market terms, will be completed by end-February 2009. Consistent with standard procedures in licensing new banks and to monitor their operational soundness, the FME will review the business plans of each new bank. These five-year business plans will describe banking services, capitalization, staffing, profitability, and branch network. We plan to sell the government's holdings of bank equity—as and when the situation stabilizes and market conditions permit.

8. **The government is determined to ensure that asset recovery is maximized.** To that end, the plan is to put the old banks into Moratorium under the Insolvency Act and the Act on Financial Undertakings, under which the resolution committees will continue to work on maximizing the value of the assets under the supervision of a court-appointed administrator. To ensure asset recoveries are maximized, we will hire an advisor, who will assist us in developing by end-November 2008 a strategy for asset recoveries.

9. **We are committed to progressing a sound and transparent process as regards depositors and creditors in the intervened banks.** We will be working constructively towards comparable agreements with all international counterparts for the Iceland deposit insurance scheme in line with the EEA legal framework. Under its deposit insurance system Iceland is committed to recognize the obligations to all insured depositors. We do so under the understanding that prefinancing for these claims is available by respective foreign governments and that we as well as these governments are committed to discussions within the coming days with a view to reaching agreement on the precise terms for this prefinancing. Furthermore, we recognize that the payment by the new banks of the fair value for the assets transferred from the old banks is a key factor in the fair treatment of depositors and creditors in the intervened banks. Accordingly, we have instituted a transparent process involving two sets of independent auditors to establish the fair value of the assets. More generally, we will ensure the fair, equitable and non-discriminatory treatment of depositors and creditors in line with applicable law.

10. **Going forward, we will review the bank regulatory framework and supervisory practice to strengthen the safeguards against potential new crises.** We will invite an experienced bank supervisor to assess the regulatory framework and supervisory practices and to propose needed changes. In particular, the expert will assess the framework of rules on liquidity management, connected lending, large exposures, cross-ownership, and the “fit and proper” status of owners and managers. Previous senior managers and major shareholders in intervened banks who are found to have mismanaged the banks should not assume similar roles for at least three years. The assessment, which will be made public, should be completed by end-March 2009. We will discuss in advance with IMF staff any changes to the adopted strategy.

11. **We need to address the insolvency framework to manage deleveraging and recovery in the banking, corporate and household sectors.** A special bank insolvency law (distinct from the general insolvency law) is needed to resolve the uncertainty over the legal status of intervened banks and to provide a coherent framework for the supervisory and debt-resolution aspects of bank insolvencies. The corporate insolvency regime, which has been relatively effective in normal times, should be refined to facilitate out-of-court workouts between creditors and viable firms. In particular, provisions to include secured creditors in agreed restructuring plans and to facilitate new financing during a firm’s rehabilitation are critical.

Fiscal policy

12. **The resolution of the banking crisis will result in a huge burden being placed on the public sector.** Preliminary estimates suggest that the *gross* cost to the budget of honoring deposit insurance obligations and of recapitalizing both commercial banks and the Central Bank of Iceland could amount to around 80 percent of GDP. The *net* cost will be somewhat lower on the assumption that money can be recovered by selling assets from the old banks. To this cost should be added the surge in the overall deficit of the general government to 13.5 percent of GDP that is expected in 2009 because of the recession that is likely to follow in the wake of the banking crisis. Overall, gross government debt could rise from 29 percent of GDP at end-2007 to 109 percent of GDP by end-2009. Thus, the banking crisis will significantly constrain the public sector and burden the public for years to come.

13. **We plan to let the automatic fiscal stabilizers operate in full in 2009.** In order not to exacerbate the recession, our intention is to allow the fiscal deficit to widen to the extent that this is driven by higher expenditures and lower revenues due to the effects of the economic cycle. But given the high financing need and the dramatic increase in public sector debt, we plan to significantly scale back a planned discretionary fiscal relaxation in 2009, keeping it to a minimum. Should revenues exceed expectations, we intend to save any windfall and lower the deficit accordingly. Pressures on financial markets resulting from the sharp rise in the government's financing need are expected to be limited by increased purchases of government securities by the pension funds. The operations of the central government will be subject to a quarterly ceiling on net borrowing, and agreement on the 2009 budget will be a key condition for the completion of the first review of the Stand-By Arrangement.

14. **We plan to embark on an ambitious medium-term fiscal consolidation program.** Such a plan will start to be implemented with the 2010 budget. Our intention is to take measures that will reduce the structural primary deficit by 2–3 percent annually over the medium-term, with the aim of achieving a small structural primary surplus by 2011 and a structural primary surplus of 3½–4 percent of GDP by 2012. We will begin soon the development and consensus-building process around this plan, with the aim of identifying the broad areas of focus before the end of 2008 and having a fully calibrated plan ready by mid-2009. Progress in this regard will be a key condition for completion of each of the quarterly reviews under the Stand-By Arrangement during this period. Icelandic society has a strong track record in responsible fiscal management as evidenced by the very low level of public debt at the outset of this crisis. This policy has been supported by broad social consensus. A significant reduction in government debt through the sale of the government's stake in the new banks could help reduce the needed fiscal adjustment over the medium term.

15. **To underpin confidence in debt sustainability, we will also strengthen our fiscal framework.** For the first time this year, a four-year medium term framework was sent to parliament at the same time as the budget. Moreover, we will undertake a debt sustainability

analysis and develop a debt strategy. Nonetheless, we realize that more needs to be done to improve the current framework. Therefore, we will conduct a thorough analysis of our fiscal framework and make recommendations, including on how local government finances can be better aligned with the governments' overall fiscal plans. The findings of this analysis will be discussed during the first program review, and progress in improving the fiscal and expenditure frameworks will be a condition for completion of each of the quarterly reviews under the program.

16. **The public sector will not take on additional obligations with regard to the banking crisis.** Unfortunately, the pension funds, domestic money market funds, and various foreign creditors, among others, are set to incur significant losses as a result of the collapse of the private commercial banks. Given the already high debt level, it will be critical not to burden the public sector balance sheet by further socializing such losses.

Monetary and exchange rate policy

17. **The immediate challenge facing the Central Bank of Iceland at this time is to stabilize the króna and set the stage for a gradual appreciation.** During the run-up to the banking crisis, the króna depreciated precipitously, culminating, when the banks collapsed, in the shut-down of the on-shore foreign exchange market and a further sharp depreciation in the off-shore market. The depreciation and the attendant surge in inflation have severely strained household and corporate balance sheets because of the high share of foreign-currency denominated and inflation-indexed debt. To prevent a wave of defaults from exacerbating what already is set to be a severe recession, we believe that it is a matter of urgency for the Central Bank of Iceland to stabilize the króna.

18. **We are particularly concerned about the near-term risk of pressure on the króna when the normal functioning of the foreign exchange market is restored.** While we believe the króna to be significantly undervalued, the collapse of the three banks has shaken confidence in the currency and the risk of substantial capital outflows in the short term is considerable. Concerns in this regard are heightened by uncertainty about the liquidity of the newly restructured banking system. This suggests that we need extraordinary measures to deal with short-term risks. The next paragraph describes these measures; the subsequent paragraph is devoted to monetary policy once a return of confidence will allow us again to use traditional monetary policy instruments.

19. **In the very short-run, we intend to adopt the following pragmatic mix of conventional and unconventional measures to stem capital outflow:**

- **To raise the policy interest rate to 18 percent.** We stand ready to increase it further, but we are aware that higher interest rates alone may not suffice to stem capital outflow in the current exceptional circumstances.

- **To maintain tight control over banks' access to Central Bank credits.** We are tightening liquidity management, in particular, by adjusting the structure of our liquidity facilities, so that the Central Bank can manage more proactively the volume of reserve money; and we have raised the spread of the standing facility rate to avoid excessive liquidity being drawn down through this route. We have narrowed the range of instruments accepted by the Central Bank as collateral—newly-issued uncovered bank bonds will no longer be acceptable. If necessary, we are ready to adjust the operational framework for reserve money management further, such as by changing parameters for reserve averaging and collateral requirements. Initially, we will allow little if any increase in the volume of central bank credit.
- **To stand ready to use foreign reserves to prevent excessive króna volatility.** While we do not have an exchange rate target and are prepared to let the rate move to equilibrate supply and demand, we are conscious that excessive short-run volatility would be undesirable and so are ready to draw on our reserves, to support the market if needed. Our ability to do so has been helped by the augmentation of our reserves, as discussed below.
- **To temporarily maintain restrictions on capital account transactions.** We realize that such restrictions have considerable adverse implications and intend to remove them as soon as possible. But their interim use is necessary until we have ensured that our monetary policy instruments are correctly calibrated to deal with the extreme uncertainty and lack of confidence that followed the banking sector collapse.

20. **We expect confidence to return soon, paving the way for a reduction in interest rates.** This process of normalization can start as soon as the króna stabilizes in the foreign exchange market, all demand for foreign exchange in respect of current account transactions is having unrestricted access to the foreign exchange market, and we no longer need to support the market by drawing on our reserves. With the current account rapidly swinging into a surplus, the króna significantly undervalued, the bank resolution scheme not giving rise to net outflow of foreign exchange in the coming year, and—above all—the policy undertakings and the support from the international community described in this letter, we expect to reach this point soon. This will allow us to begin to ease control over Central Bank's credit volume and increasingly rely on the policy interest rate as the primary monetary policy instrument, in the context of a flexible exchange rate policy. In this regard, we expect to see an early strengthening of the króna and a fast reduction in inflation year-on-year of 4½ percent at end-2009, with additional strengthening of the króna and further disinflation in 2010.

21. **The calibration of monetary policy is hampered by unusual uncertainty about monetary conditions.** Considering the uncertainties about the restructuring of the banking system, overall liquidity conditions, and the stability of monetary parameters, we intend to review comprehensive end-October monetary data with Fund staff as soon as data become

available, and will present a modification of the monetary program to the Executive Board if required. Our program contains a quarterly ceiling for net domestic assets and a quarterly floor for net international reserves of the Central Bank of Iceland.

22. **The exchange controls, temporarily imposed on October 10 in response to the sharp deterioration in the króna and pressures on reserves, will be removed during the program period.** These controls include exchange restrictions on certain current international transactions, which have contributed to private external payment arrears. Implementation of the key program objective of strengthening the current account position to allow bolstering reserves and reestablishing free international payments through the banking system would support removal of the exchange restrictions and clearance of these private external payment arrears. In the meantime, we request temporary Fund approval of the exchange restrictions in line with Fund policy, on the basis that they have been imposed for balance of payments reasons and are non-discriminatory. Furthermore, we commit not to impose or intensify restrictions on the making of payments and transfers for current international transactions nor to introduce multiple currency practices. This is a continuous performance criteria under the program.

Incomes policy

23. **It will be important to have a national consensus consistent with the objectives of the macroeconomic program.** Historically, income policy in Iceland has been very effective, with past agreements supporting the economic adjustment when difficult circumstances demanded it. Social partners recognize the need to enter an agreement that is commensurate with the severity of the situation.

External financing

24. **The collapse of the banking system has left us with considerable external financing needs.** We estimate this need to be about \$24 billion during the period from now and until the end of 2010. Of this, about \$19 billion are composed by arrears on obligations of the three intervened private banks as well as financing earmarked for payments in relation to foreign deposits, leaving a cash financing need of \$5 billion. We expect purchases from the IMF to amount to about \$2 billion, leaving a residual need of \$3 billion. We expect to cover this through assistance from bilateral creditors, and to obtain concrete commitments in this regard before IMF Board consideration of our program. Progress in covering our financing need will be assessed during the quarterly program reviews.

Fund arrangement

25. **Given our extraordinary financing needs, we request a Stand-By Arrangement for the period of November 2008 to November 2010** in the amount of SDR 1.4 billion, equivalent to 1190 percent of our quota. The program will be supported on the basis of policies and specific targets described in this letter. We believe that the policies set forth in

this Letter are adequate to achieve the objectives of its program, in particular underpinning renewed confidence in the Iceland economy. However, we will take any further measures that may become appropriate for this purpose. Iceland will consult with the IMF on the adoption of these measures, and in advance of revisions to the policies contained in this Letter, in accordance with the IMF's policies on such consultation. We will maintain a close and proactive dialogue with the Fund, in accordance with Fund policies on such matters.

26. **We recognize the importance of completing a first-time safeguards assessment of the CBI by the first review of the SBA.** In this regard, the Central Bank will receive a safeguards mission from the Fund and provide the information required to complete the assessment by the first review.

27. **We authorize the IMF to publish the Letter of Intent and its attachments, and the related staff report.**

Sincerely yours,

David Oddsson /s/
Chairman of the Central Bank

Árni M. Mathiesen /s/
Minister of Finance

Table 1. Iceland Quantitative Performance Criteria Under the 2008 Economic Program

	Performance Criteria	Indicative Targets	
	December-2008 Ceiling/ Floor 1/	March-2009 Ceiling/Floor 2/	June 2009 Ceiling/Floor 3/
(In billions of króna)			
1. Floor on the change in the central government net financial balance.4/	-12	-55	-55
2. Ceiling on the change in net credit of the Central Bank of Iceland to the private sector. 5/	25	50	50
3. Ceiling on the change in the domestic claims of the Central Bank of Iceland to the central government	25	25	25
(In millions of US dollars)			
4. Floor on the change in net international reserves of the Central Bank of Iceland 6/
5. Ceiling on the level of contracting or guaranteeing of new medium and long term external debt by central government 7/	4000	4075	4150
6. Ceiling on the stock of central government short-term external debt 7/ 8/	650	650	650
7. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors.8/ 9/	0	0	0

1/ Quantitative performance criteria from October 22, 2008 to December 31, 2008 (unless otherwise indicated).

2/ Indicative targets from January 1, 2009 to March 31, 2009.

3/ Indicative targets from April 1, 2009 to June 30, 2009.

4/ From October 1 to December 31. At end-September, the central government net financial balance was króna 4.28 billion. After contributions to the government employees pension fund. The net financial balance excludes the capital injection cost of bank and central bank recapitalization and excludes the increase in debt from guaranteeing the repayment of depositors in foreign branches of Icelandic banks.

5/ On October 21, net credit of the central bank to the private sector was króna 438 billion.

6/ (-) indicates decrease. On October 21 net international reserves stood at - \$ 0.425 billion. NIR is the difference of gross foreign assets and foreign liabilities (including all foreign currency deposits and other liabilities of financial institutions and the general government at the CBI).

7/ Cumulative from October 1 contracting medium and long-term external borrowing. Excludes IMF and excludes official bilateral loans for deposit insurance. On September 30, medium and long term external debt of the central government was \$ 2,678 million and short term external debt was \$ 619.8 million. Short term external debt has an original maturity of up to and including one year. Medium and long-term external debt has an original maturity of more than one year.

8/ Applies on a continuous basis.

9/ On October 20 the central government had no arrears to multilateral and official bilateral creditors.

Table 2. Iceland Structural Conditionality Under the 2008 Economic Program***Prior Actions***

- Raise the policy interest rate to 18 percent.
- Establish a committee comprising representatives from the Prime Minister's Office, the Financial Supervisory Authority, the Central Bank of Iceland, the Ministry of Finance and the Ministry of commerce to coordinate policy input and will be chaired by the expert in charge of the bank restructuring process.

Structural Performance Criteria

- A capital injection into the three new banks, made using tradable government bonds issued on market terms, to raise the capital adequacy ratio to at least 10 percent. *By end-February 2009.*
- An experienced banking supervisor to provide an assessment (to be published) of the regulatory framework and supervisory practice, including the framework of rules on liquidity management, connected lending, large exposures, cross-ownership, and the "fit and proper" status of owners and managers, and propose needed changes. *By end-March 2009.*

Structural Benchmarks

- Develop a strategy for asset recoveries. *By end-November 2008.*
- FME to review the business plans of each of the new banks. *By January 15, 2009.*
- International Auditing Firm to conduct valuations of the old and new banks using a methodology in accordance with international best practice. *Complete by end-January 2009.*
- Prepare plans to embark on medium-term fiscal consolidation. *By end-2008.* Improve the medium-term fiscal framework. *By end-June 2009.*

TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

November 15, 2008

1. This memorandum sets out the understandings between the Icelandic authorities and the IMF staff regarding the definitions of quantitative and structural performance criteria, as well as respective reporting requirements for the Stand-By Arrangement (SBA). These performance criteria and indicative targets are reported in Tables 1 and 2.
2. The exchange rate for the purposes of the program dollar is set at 113.9 Icelandic króna per U.S. dollar. The corresponding cross exchange rates are provided in Table 3.

Central Government

3. **Definition:** For the purposes of the program the government includes the central government, which includes government entities of group “A” as defined in the Government Financial Reporting Act No.88/1997.
4. **Supporting material:** The Ministry of Finance (MOF) will provide to the IMF detailed information on monthly revenues and expenditures both on a cash and accrual basis, domestic and foreign debt redemptions, new domestic and foreign debt issuance, change in the domestic and foreign cash balances of the central government at the central bank of Iceland, all other sources of financing including capital transactions, and arrears of the central government.

Quantitative Performance Criteria, Indicative Targets, and Continuous Performance

Criteria: Definitions and Reporting Standards

A. Floor on the Net Financial Balance of the Central Government

5. The net financial balance of the central government will be measured from the financing side at current exchange rates, and will be defined after contributions to the government employees pension fund. The net financial balance will be defined as the negative of the sum of (i) net domestic financing, and (ii) net external financing.

Net domestic financing (NDF) consists of financing by the banking system (the central bank of Iceland and commercial banks) and non-bank financial institutions to the central government. NDF consists of treasury bills, government bonds, promissory notes and other domestic debt instruments issued by the government, and loans and advances net of government deposits with the central bank of Iceland and commercial banks. NDF is calculated as the sum of (i) financing to the government by the central bank of Iceland, including any interest arrears, minus the change in all central government deposits with the central bank of Iceland, from the balance sheet of the central bank of Iceland; (ii) loans and advances to the central government by the commercial banks, including any interest arrears,

minus the change in all government deposits held with the banks, from the balance sheet of the commercial banks; (iii) the changes in the outstanding stock of treasury bills, government bonds, promissory notes and other domestic debt instruments issued by the government, including any interest arrears.

Net external financing is defined as the total of financing disbursed to the central government, net change in external arrears, minus amortization. Amortization includes all external debt-related payments of principal by the central government.

For the purposes of the program, the net financial balance will exclude any debt issuance for the purposes of bank restructuring, central bank recapitalization, and exclude debt accumulation for honoring obligations to depositors in foreign branches of Icelandic banks.

Supporting material:

- Data on domestic bank and nonbank financing will be provided to the IMF by the Central Bank of Iceland and the Financial Management Department of the MOF within three weeks after the end of the month. This will include data on redemptions of domestic central government liabilities and data on the cash balances in domestic currency of the MOF at the Central Bank of Iceland and in commercial banks.
- Data on net external financing as well as other external borrowing will be provided to the IMF monthly by the Financial Management Unit at the MOF within three weeks of the end of each month. This will include data on redemptions of foreign central government liabilities and data on the foreign exchange cash balances of the MOF at the Central Bank of Iceland and in commercial banks.
- Data will be provided at the actual exchange rates.

B. Floor on the Net International Reserves of the Central Bank of Iceland

6. **Definition:** Net international reserves (NIR) of the Central Bank of Iceland (CBI) are defined as the U.S. dollar value of gross foreign assets minus foreign liabilities of the CBI.

- **Gross foreign assets** are defined consistently with SDDS as readily available claims on nonresidents denominated in foreign convertible currencies. They include the CBI's holdings of monetary gold, SDRs, foreign currency cash, foreign currency securities, deposits abroad, and the country's reserve position at the Fund. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered, claims on residents, precious metals other than gold, assets in nonconvertible currencies, and illiquid assets.

- **Gross foreign liabilities** are defined consistently with SDDS as all foreign exchange liabilities to residents and nonresidents, including commitments to sell foreign exchange arising from derivatives, and all credit outstanding from the Fund. Foreign currency deposits and other liabilities of financial institutions and the general government at the CBI will be included in gross foreign liabilities.
- **For program monitoring purposes**, the stock of foreign assets and foreign liabilities of the Central Bank of Iceland shall be valued at program exchange rates as described on paragraph 2 above. The stock of NIR amounted to - \$ 425 million as of October 21, 2008 (at the program exchange rate).

7. **Supporting material:** Data on net international reserves (both at actual and program exchange rates) and on net foreign financing (balance of payments support loans; cash grants to the consolidated government; amortization (excluding repayments to the IMF); interest payments on external debt by the MOF and the CBI) will be provided to the IMF in a table on the Central Bank of Iceland's foreign exchange flows (which include details of inflows, outflows, and net international reserves) on a monthly basis within two weeks following the end of the month. Flows of net international reserves will be provided on a daily basis.

C. Ceiling on Net Credit of the Central Bank of Iceland to the Private Sector

8. **Definition:** Net credit of the central bank to the private sector is defined as the difference between CBI lending to private banks through its overnight and weekly collateral facilities and any other instruments to which the CBI would extend credit to the private sector, and current account balances of the banks at the CBI and central bank CDs in issuance. Performance against the net credit will be measured at program exchange rates.

9. **Supporting material:** The CBI will provide to the IMF with data on central bank lending to private banks through its overnight and weekly collateral facilities, any other instruments to which the CBI would extend credit to the private sector, current account balances of the banks at the CBI, and central bank CDs in issuance, on a daily basis.

D. Ceiling on Net Credit of the Central Bank of Iceland to the Central Government

10. **Definition.** Net credit of the Central Bank of Iceland to the public sector is defined as the difference between CBI lending to the central government and central government deposits at the CBI in domestic currency.

11. **Supporting material:** The CBI will provide the IMF with data on central bank lending to the central government and central government deposits at the central bank, on a daily basis.

E. Ceiling on Contracting or Guaranteeing of New Medium and Long Term External Debt by Central Government

12. **Definition:** This performance criterion applies not only to debt as defined in point No. 9 of the IMF's Guidelines on Performance Criteria with Respect to External Debt (Decision No. 12274-(00/85) August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received.¹ Previously contracted debt that has been rescheduled will be excluded from the definition of “new debt” for the purposes of this performance criterion. The performance criterion covers public and publicly guaranteed external debt with an original maturity of more than one year. Excluded from the limits are purchases from the IMF Stand-By Arrangement and bilateral official loans extended and earmarked for payments on foreign deposit guarantees. Debt falling within the limit shall be valued in US dollars at the time the contract or guarantee becomes effective.

13. **Supporting material:** Details of all new commitments and government guarantees for external borrowing, with detailed explanations, will be provided by the MOF to the IMF on a monthly basis within two weeks of the end of each month. Data will be provided using actual exchange rates.

F. Ceiling on the Stock of Central Government Short-Term External Debt

14. **Definition:** The limit on short-term external debt applies on a continuous basis to the stock of short-term external debt owed or guaranteed by the central government of Iceland,

¹ Point No. 9 of the IMF's guidelines reads as follows: “(a) For the purpose of this guideline, the term “debt” will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the leaser retains the title to the property. For the purpose of the Guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property. (b) Under the definition of debt set out in point 9a above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.”

with an original maturity of up to and including one year. It applies to debt as defined in paragraph 10 above. Excluded from the limit are any rescheduling operations (including the deferral of interest on commercial debt). Debt falling within the limit shall be valued in US dollars at the time the contract or guarantee becomes effective.

15. **Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors.** This performance criterion applies on a continuous basis. External payment arrears consist of external debt service obligations (principal and interest) falling due after October 20, 2008 and that have not been paid at the time due, taking into account the grace periods specified in contractual agreements.

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(In billions of Krona)			
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3. Ceiling on the change in the domestic claims of the Central Bank of Iceland to the central government	25	25	25
(In millions of US dollars)			
4. Floor on the change in net international reserves of the Central Bank of Iceland 6/
5. Ceiling on the level of contracting or guaranteeing of new medium and long term external debt by central government 7/	4000	4075	4150
6. Ceiling on the stock of central government short-term external debt 7/ 8/	650	650	650
7. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors.8/ 9/	0	0	0

1/ Quantitative performance criteria from October 22, 2008 to December 31, 2008 (unless otherwise indicated).

2/ Indicative targets from January 1, 2009 to March 31, 2009.

3/ Indicative targets from April 1, 2009 to June 30, 2009.

4/ From October 1 to December 31. At end-September, the central government net financial balance was króna 4.28 billion. After contributions to the government employees pension fund. The net financial balance excludes the capital injection cost of bank and central bank recapitalization and excludes the increase in debt from guaranteeing the repayment of depositors in foreign branches of Icelandic banks.

5/ On October 21, net credit of the central bank to the private sector was króna 438 billion.

6/ (-) indicates decrease. On October 21 net international reserves stood at - \$ 0.425 billion. NIR is the difference of gross foreign assets and foreign liabilities (including all foreign currency deposits and other liabilities of financial institutions and the general government at the CBI).

7/ Cumulative from October 1 contracting of medium and long-term external borrowing. Excludes IMF and excludes official bilateral loans for deposit insurance. On September 30, medium and long term external debt of the central government was \$ 2,678 million and short term external debt was \$ 619.8 million. Short term external debt has an original maturity of up to and including one year. Medium and long-term external debt has an original maturity of more than one year.

8/ Applies on a continuous basis.

9/ On October 20 the central government had no arrears to multilateral and official bilateral creditors.

Table 2. Iceland Structural Conditionality Under the 2008 Economic Program

<p>Prior Actions</p> <ul style="list-style-type: none"> • Raise the policy interest rate to 18 percent. • Establish a committee comprising representatives from the Prime Minister’s Office, the Financial Supervisory Authority, the Central Bank of Iceland, the Ministry of Finance and the Ministry of commerce to coordinate policy input and will be chaired by the expert in charge of the bank restructuring process. <p>Structural Performance Criteria</p> <ul style="list-style-type: none"> • A capital injection into the three new banks, made using tradable government bonds issued on market terms, to raise the capital adequacy ratio to at least 10 percent. <i>By end-February 2009.</i> • An experienced banking supervisor to provide an assessment (to be published) of the regulatory framework and supervisory practice, including the framework of rules on liquidity management, connected lending, large exposures, cross-ownership, and the “fit and proper” status of owners and managers, and propose needed changes. <i>By end March 2009.</i> <p>Structural Benchmarks</p> <ul style="list-style-type: none"> • Develop a strategy for asset recoveries. <i>By end November 2008.</i> • FME to review the business plans of each of the new banks. <i>By January 15, 2009.</i> • International Auditing Firm to conduct valuations of the old and new banks using a methodology in accordance with international best practice. <i>Complete by end-January 2009.</i> • Prepare plans to embark on medium-term fiscal consolidation. <i>By end-2008.</i> Improve the medium-term fiscal framework. <i>By end-June 2009.</i>

Table 3. Program Exchange Rates

Icelandic króna per U.S. dollar 113.9	Icelandic króna per pound 193.6	Icelandic króna per euro 150.5
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