ICELAND

PRE-ACCESSION ECONOMIC PROGRAMME 2013

Ministry of Finance and Economic Affairs

January 2013

Table of contents

Figures

Tables

Annex Tables

1. Overall policy framework and objectives

Now that the Icelandic economy has pulled through the worst of the crisis, it is vital to shape a comprehensive economic policy framework for the future. This framework should be founded on an integration of the economic instruments tools that need to be applied, with a clear division of tasks in which each unit is sturdy enough to deal with the many complex issues, which a small, open and volatile economy like Iceland's is confronted with. It is in this spirit that the economic policy-making tasks of the former Ministry of Economic Affairs were transferred to the new Ministry of Finance and Economic Affairs on 1 September 2012. This reorganisation will facilitate the work that is currently being conducted in the formulation of a new comprehensive Organic Budget Law, which will provide a framework for even better fiscal management. Moreover, it provides an opportunity to strengthen the application of fiscal policy as an economic instrument, since the global financial crisis has demonstrated beyond any doubt that fiscal management has a vital role to play both in the lead-up to and aftermath of economic shocks. The Ministry of Finance and Economic Affairs will also prepare the meetings of the Ministerial Committee on Economic Affairs, since this committee has played a key role in the harmonisation of economic policy over the past years. In addition to this, the Ministry of Finance and Economic Affairs acts as a guiding force in government measures concerning the comprehensive management of the financial system, since in many places, macroprudential supervision of this kind is forging its way as the third pillar of economic management, along with monetary and fiscal management.

From the second half of 2010, economic activity in Iceland has slowly started to pick up after the banking and currency crisis. GDP has steadily grown, driven by domestic demand, i.e. private consumption and investment, while exports have increased at the same time. By 2013, the GDP per capita, at fixed prices, is set to be similar to what it was in 2005 and the same applies to disposable income. The country is still some distance away from recovering from the drop in income the national economy suffered with the collapse of the banks and the adjustment of the economy in the wake of the boom years. Despite some dynamic growth and declining unemployment, the economy still faces challenges in the aftermath of the crisis. The high levels of debt of the Treasury, households and businesses call for special caution to be exercised in the formation of economic policy. The debt problem is closely linked to the lifting of capital controls, because the economy is vulnerable to shocks in the financial markets, while the indebtedness of all the major sectors remains as high as it is. On the other hand, the removal of capital controls is important for the long-term growth of the economy. Iceland's long-term growth capacity will also be determined by the government's ability to curb long-term unemployment and to prevent the unemployed from abandoning the labour market.

This Pre-Accession Economic Programme was prepared by the Ministry of Finance and Economic Affairs with the participation of relevant ministries and agencies.

2. Economic Outlook

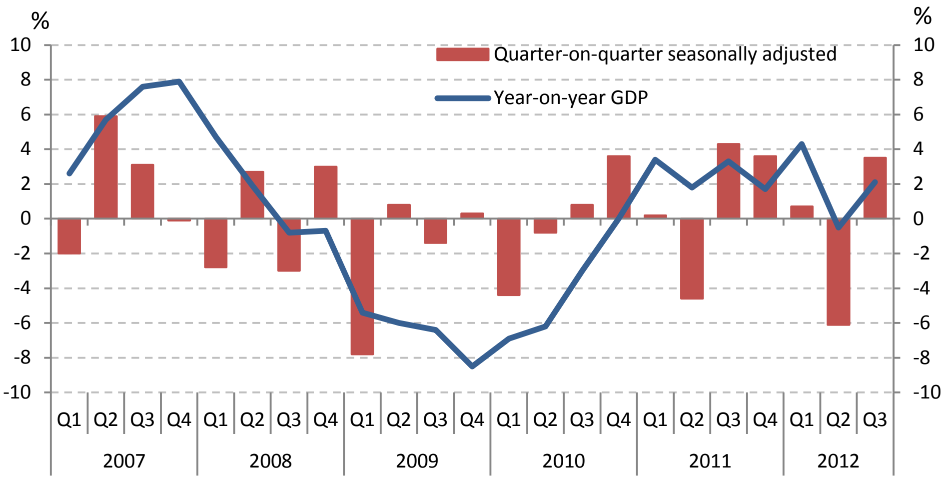
The macroeconomic assumptions underpinning the medium-term economic forecast and 2013 fiscal budget are developed by an independent department within Statistics Iceland. The most recent forecast was made in November 2012.

External assumptions underlying the forecast are based on the most recent IMF and OECD global forecasts. It assumes stagnation in economic growth in 2012 and moderate growth from 2013 among Iceland's main trading partners as GDP world growth has weakened and uncertainty has increased as a result of unrest in financial markets due to the debt burden of banks and high sovereign debt, especially in Europe. A large share of Iceland´s merchandise exports is marine products and aluminium. In the first months of 2012 the export prices on aluminium decreased in USD, but have been picking up again last months. They are expected to be stable in 2013. Prices for marine products in foreign currency increased by 1.9 percent in 2012, which was less than expected at the beginning of the year, in the wake of an almost 10 percent annual increase both in 2010 and 2011. Prices are expected to increase by about 1.5 percent in 2013.

2.1 Recent economic developments

The Icelandic economy returned to 2.6 percent growth in 2011 following a 4 percent decline in 2010. This development continued into 2012 with constant moderate growth, and most indications point to continued growth over the coming years. Real GDP has been driven by domestic demand, i.e. private consumption and investment, as well as by growth in exports, especially of marine product exports in 2012. In 2012 the real GDP will be similar to what it was in 2006 and real disposable income will be at a similar level to 2005. The November forecast expected to see 2.7 percent growth in 2012 but the latest estimate points to economic growth in the region of 2 to 2.5 percent that year.

Figure 1: Gross domestic product growth

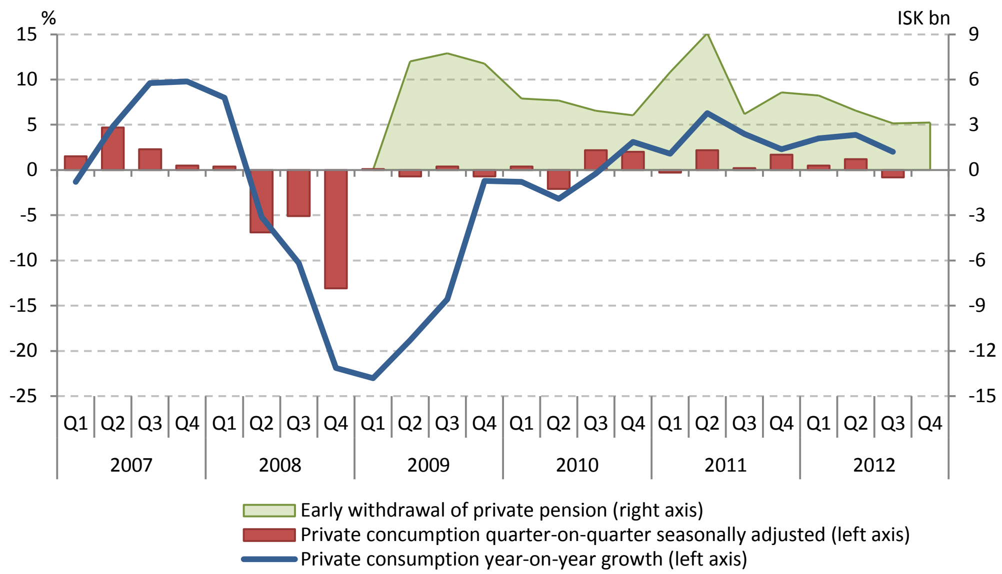


Source: Statistics Iceland

The rise in private consumption over the last years was supported by higher wages, social benefits, temporary interest rate subsidies and a number of policy initiatives, such as the freezing of payments on loans and the reimbursement of private pension savings. Furthermore, growth in certain exports sectors, mainly fisheries and tourism, and a pickup in investments, albeit from very low levels, have supported growth. In 2011, private consumption increased by 2.7 percent and investment by 12.8 percent, of which industrial investment increased by 25.1 percent. In 2012, the outlook is for close to 3 percent growth in private consumption which is somewhat less than expected in the November forecast since growth has declined in the latter half of the year. It is more difficult to estimate last year's growth in investment, as single projects can move growth rates by large margins. In the first three quarters of 2012, investment is expected to have increased by up to 16 percent.

Low exchange rates and higher prices in foreign currency for Iceland's main export products have increased the export value substantially since the economic crisis and turned the trade balance into a surplus of approximately 9 percent of GDP from 2009 to 2011. The outlook is for a smaller surplus in 2012, as import growth was strong in the first half of the year. Increased national expenditure fuels a rise in imports, which grew by 6.8 percent in 2011, and the outlook is for strong growth again in 2012, substantially exceeding export growth. External trade therefore made a negative contribution to economic growth in 2011 and 2012. In spite of that, the current account balance was negative by 7.0 percent of GDP in 2011 and, in the November forecast, is expected to be negative by 7.5 percent in 2012, as high net interest costs cause the balance of factor income to offset the substantial surplus in the trade balance. A large share of that interest cost is accrued net interest cost from the old banks in bankruptcy proceedings and will be written off when the winding-up proceedings are finished. The Central Bank of Iceland (CBI) estimates the underlying current account (without the old banks) to show a minor deficit for 2011 and 2012.

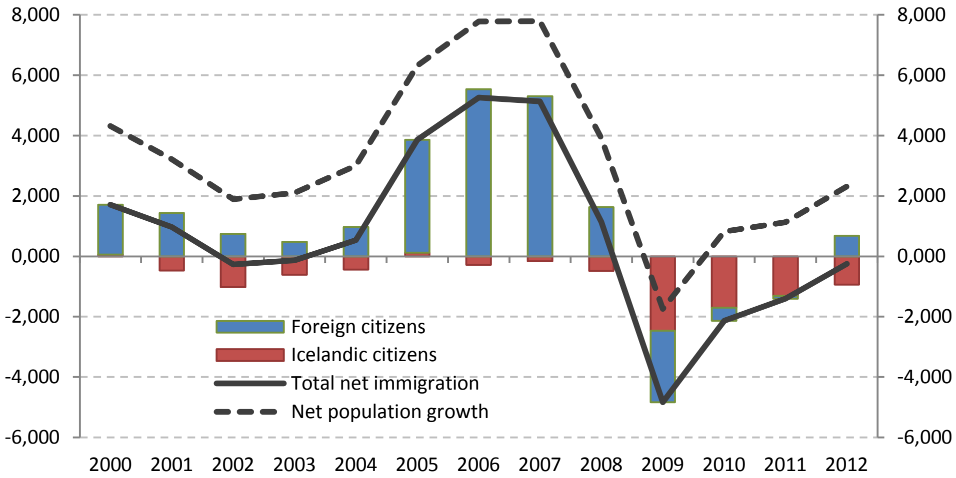
Figure 2: Private consumption growth and withdrawal of private pension savings



Source: Statistics Iceland, Directorate of internal revenue

The Icelandic population was 319,575 on 1 January 2012. In 2011, the number of people who migrated from Iceland exceeded those who immigrated by 1,465, of which 1.335 were Icelandic citizens. In the first three quarters of last year, emigrants exceeded immigrants by 880 people, of which 940 were Icelandic citizens. The proportion of men was much higher than women, i.e. 61 percent, whereas in 2011 the ratio was about 70 percent.

Figure 3: Net immigration and population growth



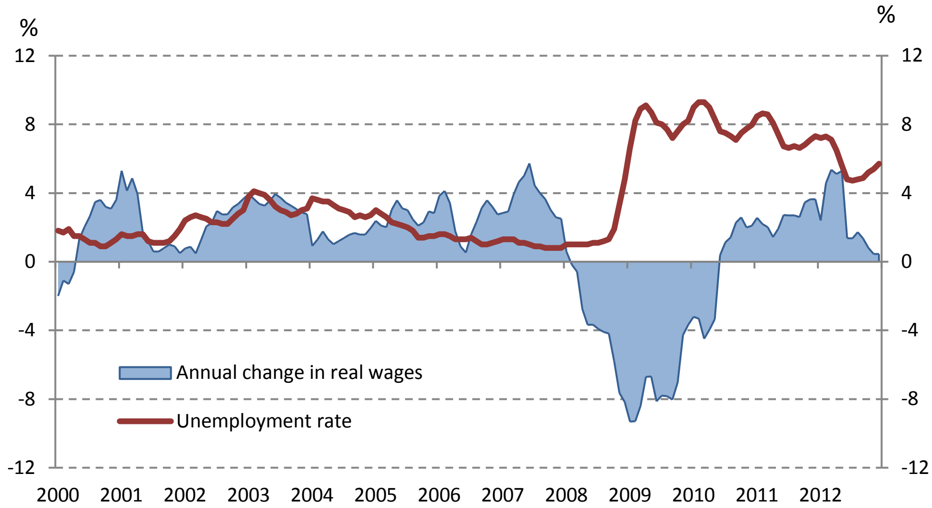
Source: Statistics Iceland

The activity rate in Iceland is high by international standards, i.e. 81.1 percent in 2010, 80.4 percent in 2011 and 80.5 in 2012. The rate is higher among men than women, i.e. 83.8 percent among men in 2011 and 77.0 percent among women. The activity rate has been stable in recent years and is expected to remain stable in the medium term. Average working hours have been stable between year 2011 and 2012, averaging at 44.1 hours per week.

The labour market situation has improved gradually since 2009. Average measured unemployment in 2011 was according to Statistics Iceland's labour market survey 7.1 percent compared to 7.6 percent in 2010. The registered unemployment rate, from the Directorate of Labour, has dropped further, from 8.1 percent in 2010 to 7.4 percent in 2011. The registered unemployment rate in December was 5.7 percent, compared to the same period in 2011 when the rate was 7.3 percent. The average rate in 2012 was 5.8 percent compared to 7.4 percent in 2011. The rate dropped to 4.7 percent in mid-summer 2012, but has since increased slightly because of the seasonal fluctuations which tend to peak in mid-winter.

Since the turnaround in the economy commenced in late 2010, real wages have risen. In 2012, there was slowdown in this trend, however, and the assumptions on which the 2011 collective wage agreements were based have not held, in terms of the exchange rate or inflation.

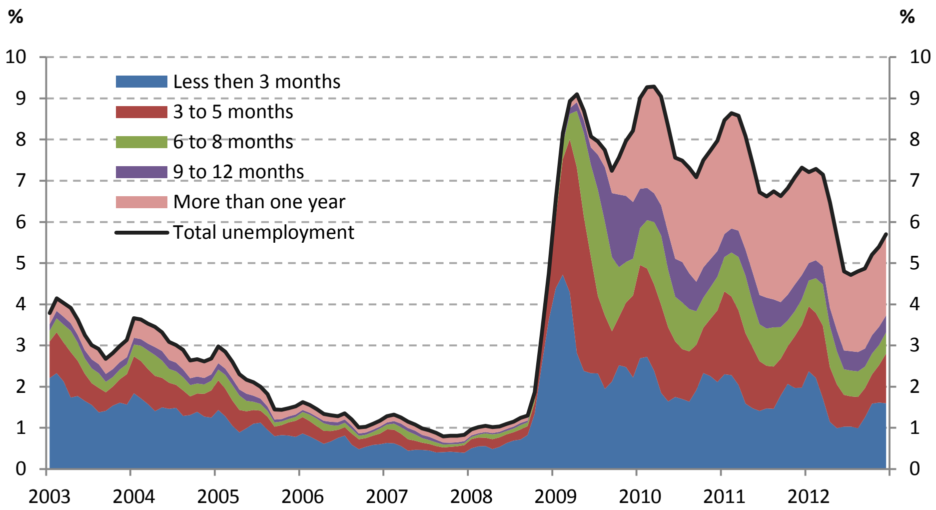
Figure 4: Real wages and registered unemployment



Source: Statistics Iceland, Directorate of Labour

Long-term unemployment has been a concern for the last few years. In the last quarter of 2011 long-term unemployment decreased, but registered long-term unemployment remains over 50% and has been persistent. Expectations for continued reduction have not been met, even though a great effort has been made to combat this trend.

Figure 5: Long-term registered unemployment



Source: Directorate of Labour

2.2 Medium-term macroeconomic scenario

2.2.1 Real sector

Since 2010, the economy has been showing positive economic growth with lower unemployment and higher purchasing power, driven by an increase in domestic demand and exports of goods and services. The economic policy goal for the next years is therefore to build on that success, increase the stability of the economy and promote long-lasting prosperity. Medium-term projections expect growth to be fuelled by an increase in domestic demand, as economic growth will average at 2.7 percent in 2013 to 2015.

Unemployment has dropped substantially since the crisis and is expected to average at 5.3 percent in this year and decline to 4.9 percent in 2014 and 4.4 percent in 2015, as the economic recovery continues. Jobs are increasing and the number of hours worked is also on the rise again, especially among women. Nominal wages are expected to increase faster than CPI inflation and thus generate positive growth for real disposable income, which is projected to fuel growth in private consumption. Real wages were forecasted in November to increase by 1.5 percent this year. The November forecast from Statistics Iceland expects real wages to average 2.5 percent growth in 2014 and 2015.

Private consumption is forecast to rise by 2.5 percent this year, but with some major upside risk. It may be expected to increase further in light of the debt resolution measures already taken and following the Supreme Court verdict of February 2012 on the settlement of exchange-rate tied loans. The government has also decided to extend options for the withdrawal of supplementary pension savings in 2013, which was not factored into the forecast. Public consumption is expected to start increasing again this year, following a substantial decline in the wake of the crisis. On the other hand, it will not follow the general growth in the economy and, as a share of GDP, public consumption is expected to reach its 30 year average in 2017, which is close to 22 percent of GDP.

Total investment is not expected to increase much this year, as some large-scale projects have been delayed or postponed, due to either uncertainty regarding energy supply and/or an expected drop in demand on international markets this year. Total investment growth is therefore only expected to reach 4.3 percent in 2013, but approximately 20 percent in 2014, as large-scale corporate investment is expected to pick-up.

For the first time since 2006, the corporate investment sector, as a percentage of GDP, increased in 2011. For the last 30 years, corporate investment has averaged at around 12.3 percent of GDP. Corporate investment growth is not expected to increase this year, but in 2014 is projected to rise by 24 percent, primarily as the result of huge growth in large-scale investment projects and reaching the long-term average, as a share of GDP.

There is a considerable uncertainty in macroeconomic projections regarding large scale industrial investments. The scale of these investments is expected to be less in 2013 than was originally anticipated, as there have been delays in the implementation of projects, such as the enlargement of the Straumsvík aluminium smelter. Currently, it is assumed that these projects will materialize in the years 2014 and 2015. Construction at the Búðarháls power plant is on schedule in 2013, but construction at the silicon factory in Helguvík has been postponed, due to uncertainty regarding energy supply, although official forecasts expect construction to possibly start at the end of the year.

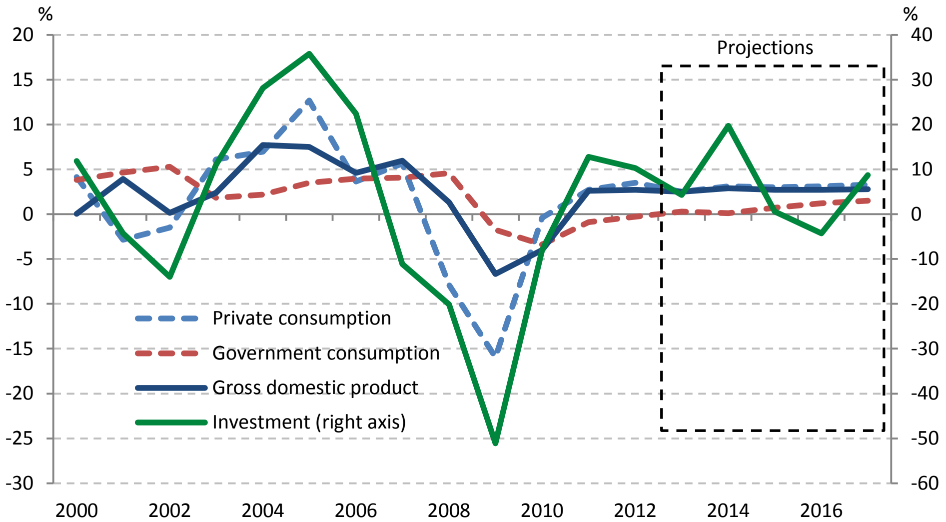
There is also still uncertainty regarding the aluminium smelter in Helguvík, although the first phase of that project is expected to start in 2014.

Housing investment is predicted to lead the growth in total investment in the medium term, as the housing market regains strength again, after a substantial downturn in the wake of the crisis. Growth is expected to average at about 15 percent a year until 2017 and reach the 30 year average as a share of GDP (5 percent) in 2017. Growth is expected to be slow in public investment this year and in 2014, after public investment reached an historically low level, as a share of GDP, in 2012 (1.8 percent).

Growth in exports of goods and services is expected to continue this year, albeit not as strongly as in 2012. Strong growth in export services is expected to continue, as exports from large-scale industries will increase somewhat, due to more valuable production. Substantial growth is also expected to continue in the exports of products other than those from large-scale industries and fisheries. Growth in imports of goods and services is less this year, due to large imports of ships and aircrafts in 2012. No imports of that kind have been forecasted for this year, which scales down the growth rates. No strong growth is expected in domestic demand either in 2013, as investment in large-scale projects has stalled. Growth in imports will increase again in the wake of large-scale investment projects.

The balance in goods and services is expected to be 7 percent of GDP this year, as external trade will make a positive contribution to economic growth. In 2014, it will turn around, due to a steep growth in imports that year, and external trade is expected to have a negative impact on GDP growth by up to 4 percent.

Figure 6: Annual real growth



Source: Statistics Iceland

2.2.2 Inflation

The twelve-month inflation increased in 2011, from 1.8 percent in January to 5.3 percent in December, averaging at 4.0 percent over the course of the year. It continued to rise in 2012, peaking at 6.5 percent in January, but was down to 4.2 percent by December. The Central Bank of Iceland

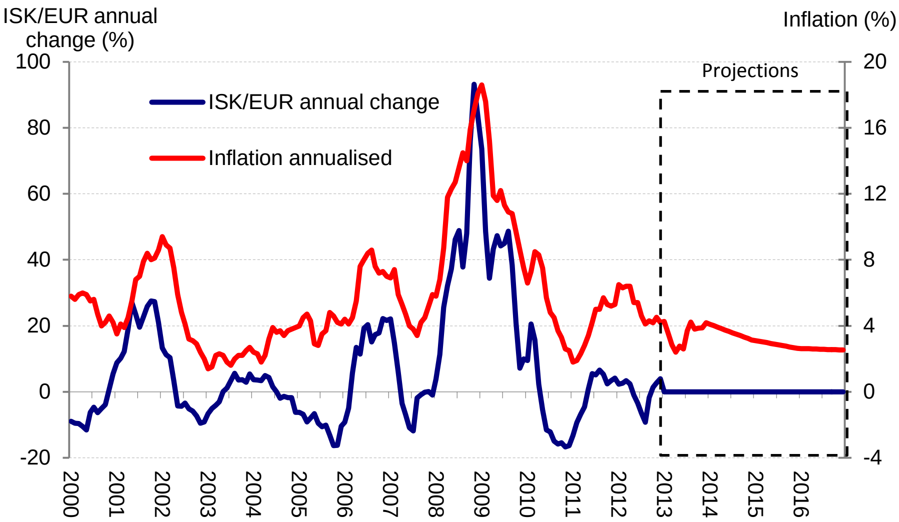
(CBI) projects that inflation will continue to taper off to around 3.6 percent in 2013 and move close to the inflation target, or 2.7 percent, in 2014.

Fuel prices and prices of domestically produced food have increased in excess of general prices, and prices of imported foodstuffs have increased as well but less than domestic production. Housing prices increased in excess of general prices in 2012 following a sharp downturn in the wake of the crisis. Average housing prices increased by 6.9 percent last year, but substantially higher than in the capital area than in rural areas. The prices of multi-family dwellings also increased more than those of single-family dwellings.

In line with rising inflation and inflation expectations, the CBI began to tighten its monetary stance in the latter half of 2011 and incrementally raised its policy rate by 1.5 percentage points between August 2011 and November 2012. Since the last 0.25-point increase (in November), however, the Monetary Policy Committee (MPC) has kept rates unchanged, with the main lending rate at 6 percent but the effective rate somewhat lower, at 5.4 percent. Despite these rate hikes, the real policy rate remains low, at just below 1 percent.

Exchange rate pass-through remains high in Iceland. The exchange rate rose during the summer of 2012, boosted by record tourist arrivals, but then began to drop in August 2012, and most of the gains had reversed by late autumn. The depreciation probably reflected foreign exchange outflows related to ongoing domestic entities' foreign debt deleveraging and deteriorating terms of trade. Uncertainty about capital account liberalisation may also have contributed to the weakening of the ISK.

Figure 7: Inflation and currency rate

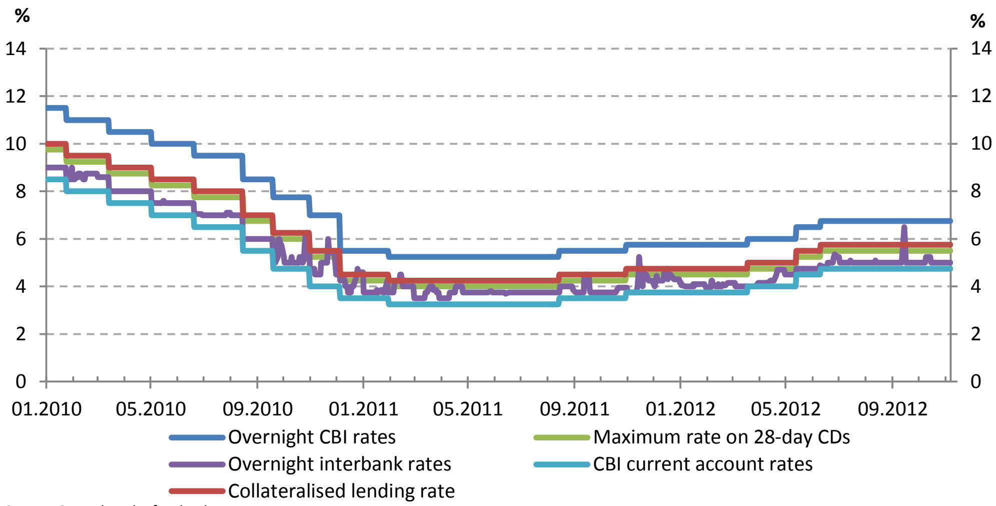


Source: Central Bank of Iceland, Statistics Iceland

2.2.3 Monetary and exchange rate policy

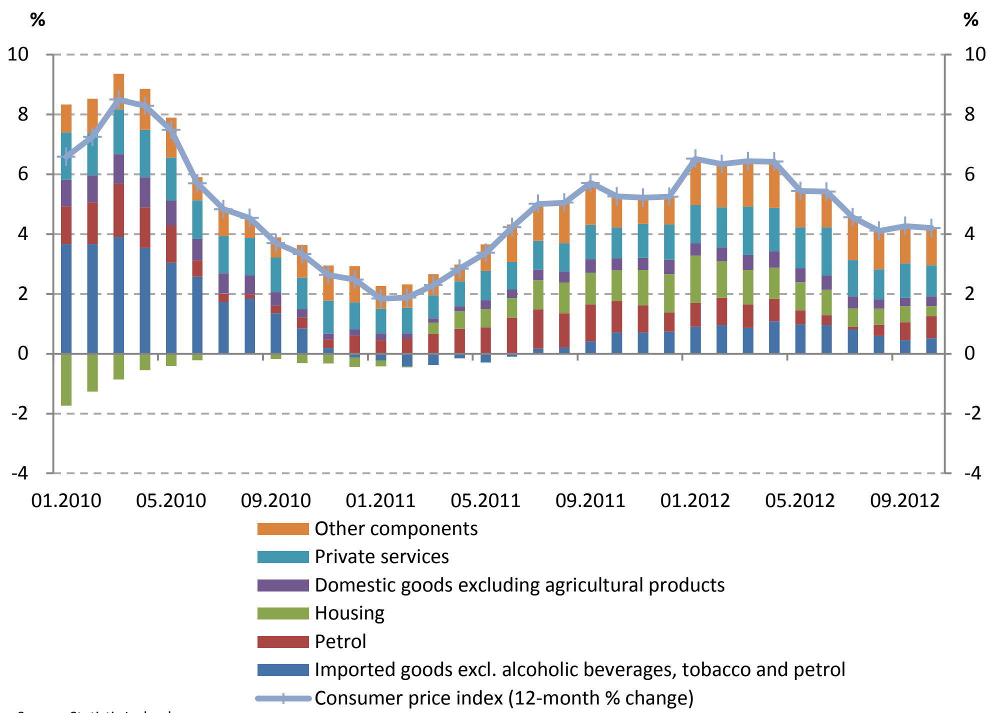
The CBI published an extensive report on future exchange rate and monetary policy options in September 2012[1]. It has also issued proposals for macroprudential rules that, together with a strengthened exchange rate framework, could strengthen economic policy.

Figure 8: Central Bank of Iceland interest rates and short-term market interest rates



Source: Central Bank of Iceland

Figure 9: Components of CPI Inflation



Source: Statistic Iceland

[1] An executive summary can be found at the CBI's website: http://www.cb.is/publications-and-speeches/publications/special-publications/special-publication-7/

The current capital controls regime

Capital controls were imposed on 28 November 2008. Parliament extended a provision in the Foreign Exchange Act (the Act) authorising the CBI to set rules limiting international capital transactions, the Rules on Foreign Exchange. In spring 2011, Parliament revoked the Bank's authorisation to specify the details of the capital controls in a regulation and incorporated the Rules on Foreign Exchange into the Act. In September 2011, a sunset clause was added, extending the capital controls until the end of 2013.

The regime is not a full-fledged currency control regime, but a capital control regime that only limits transactions classified as capital transactions. This includes investment in any type of foreign asset, such as transferable financial instruments issued in foreign currency and real estate or other assets in foreign currency, irrespective of whether these assets are sold by residents or non-residents. Transactions classified as current transactions, as well as cross-border movement of capital and foreign exchange transactions related to contractual instalment payments and dividend and interest payments, are exempted from the controls, with a few exceptions to limit circumvention.

Lifting the capital controls

In late October 2009, the CBI took the first step in the sequenced removal of the capital controls by permitting potential outflows of capital that may derive from the sale of new investments. The primary objective of the subsequent steps in the capital account liberalisation strategy has been to unwind non-residents' offshore ISK holdings, currently held in local banks' deposit accounts and short-term Treasury or HFF bonds. The strategy focuses on facilitating the sale of short-term Icelandic assets by those seeking to exit their investment, to those seeking to invest long-term. This increases investments in long-term assets and reduces the overhang of volatile capital that may seek to exit quickly when the aforementioned capital controls are lifted.

In November 2011, the CBI announced its intention to hold foreign exchange auctions in which it will purchase foreign currency in exchange for Icelandic ISK to be used for domestic investment, provided that the investment remains in Iceland for a long-term commitment period of five years. The Bank's aim with the transactions is to facilitate the removal of the capital controls without causing major exchange rate or monetary instability or jeopardising financial stability. Increased investment is an important factor in preparing the ground for removal of the capital controls, as is described in the Bank's capital account liberalisation strategy, published on 25 March 2011.[2] Investors planning to invest in Iceland and sell foreign currency in a domestic financial institution may participate in such auctions, in which the investor invites the Bank to purchase foreign currency in an amount equivalent to the amount the investor sold to the domestic institution.[3] Investors participating in CBI auctions are also offered the option of purchasing Icelandic Treasury bonds in exchange for Euros. Under this option, investors can sell foreign currency to the Central Bank in exchange for the bonds, which they pledge to hold for five years. Concurrent with these auctions under the Central Bank Investment Programme, parties wishing to scale down or close out their ISK positions are invited to participate in

---

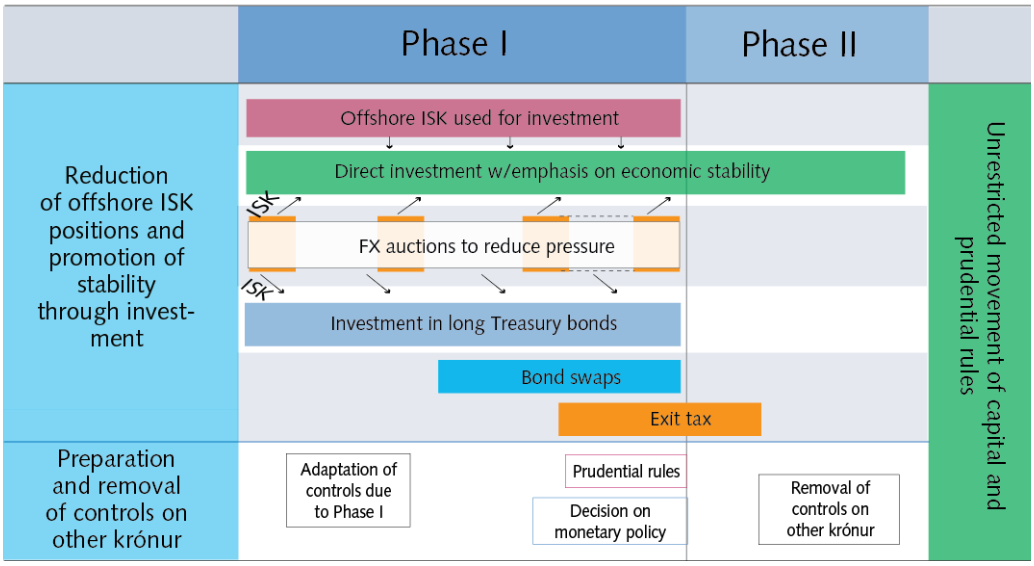
[2] http://www.cb.is/lisalib/getfile.aspx?itemid=8673

[3] The EURISK exchange rate at which these single-rate auctions have been completed has ranged from 210 to 246.

auctions in which they offer to sell ISK in exchange for foreign currency. This foreign currency is not bound by the provisions of the Foreign Exchange Act. In this process, the CBI role is to pair parties interested in long-term investment in Iceland together with investors wishing to unwind their ISK positions, but without affecting exchange rate stability.

Iceland has seen a significant amount of flows through these programmes. From their launch in June 2011 through the December 2012 auction, the Investment Programme and the Treasury bond programme have generated investment totalling ISK 104 bn., which amounts to 6.4 percent of GDP in the span of 18 months.

Figure 10: Capital account liberalization - Phases and steps



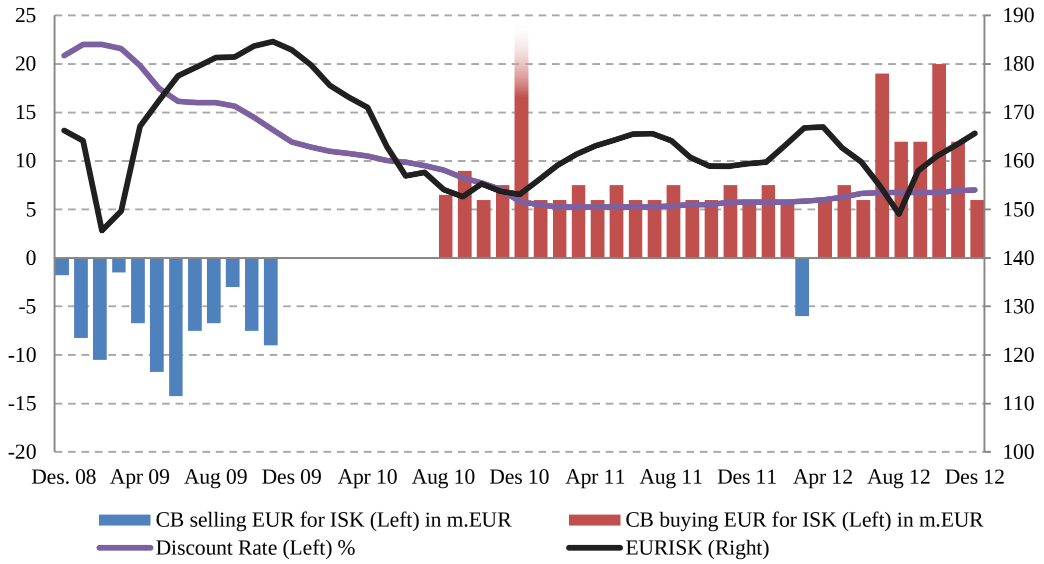
The current capital account liberalisation strategy also outlines plans for bond swaps in which the Icelandic State will issue long-term liabilities in foreign currencies for Icelandic assets. Furthermore, the strategy also outlines plans for an exit tax. Specifics concerning size, rates, and duration for these two aforementioned plans have yet to be published.

As a part of the capital account liberalisation strategy, the CBI has proposed a set of prudential rules designed to protect the financial system against the risk that could accompany unrestricted capital flows. The pertinent ministries, the CBI, and the Financial Supervisory Authority (FME) have begun preparing the appropriate bills of legislation.

Central Bank exchange rate intervention activities

Since capital controls were imposed, the CBI has both sold and bought foreign currency in local currency markets. Foreign currency is sold to stabilise the local currency during periods of imbalance and is then bought back when markets stabilise.

Figure 11: Central Bank FX interventions



Source: Central Bank of Iceland

Note: In December 2010 the CBI bought EUR 160m from local banks

2.2.4 External sector and its medium-term sustainability

The balance of trade account was 8.5 percent of GDP in 2011 but is estimated to have declined to 6.5 percent in 2012, according to the latest CBI forecast. The forecast assumes that the trade surplus will remain in the 6-7 percent region over the next 3 years.

Evaluation of Iceland's external position and the current account outlook is complicated by the impact of deposit money banks (DMBs) undergoing winding-up proceedings. The impact of a multinational company, Actavis, on the income account must also be set aside. This company has sizeable debt, and accrued but unpaid interest weighs heavily in the income balance. However, its operations are almost entirely foreign and have limited effect on actual financial flows. The headline current account was negative by 7 percent of GDP in 2011 but measured only -0.9 percent of GDP excluding the DMBs, and excluding Actavis it was positive by just under 3 percent of GDP. The latest estimates for 2012 suggest a broadly unchanged current account: the headline number is estimated at -8.1 percent, while excluding the DMBs gives -1 percent. Excluding Actavis, there is a current account surplus of 2.4 percent of GDP. The outlook according to the latest CBI forecast suggests that the headline deficit will decline to roughly 4 percent over the next 3 years, while the underlying surplus (i.e., excluding the DMBs and Actavis) will rise to 3.5 percent in 2013 before declining again to 2-2.5 percent in 2014-2015.

Iceland's international investment position (IIP) was recorded as ISK -9,227 bn. at end-2011, and excluding the DMBs, it amounted to ISK -856 m., or around -52 percent of GDP.

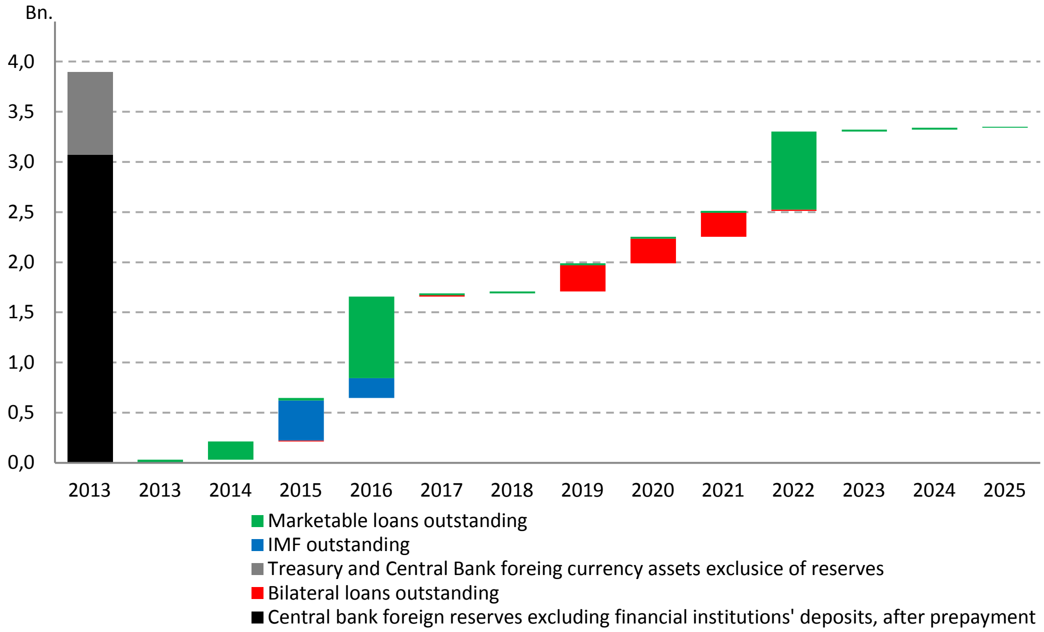
Overall, the Icelandic economy has delivered large trade surpluses since the financial crisis in 2008. While headline current account numbers continue to report relatively large deficits, these numbers are misleading. Estimates of the underlying balance suggest a significant, albeit declining, underlying surplus on the current account, suggesting that the external debt of the economy is on a sustainable path. The main risks include continued slow or negative growth in main trading partner countries, which would affect export revenues. The massive depreciation of the ISK in 2008 (admittedly from an unsustainably high level) has increased profits in export industries and helped to attract tourists in record numbers. The benefits of the low real exchange rate are somewhat limited, however, as expenditure switching towards domestic goods is restricted by the limited availability of domestically produced alternatives. Also, there are technical and capacity constraints in the main export industries; i.e., fisheries (fishing quotas) and the energy sector (long lead times for capacity expansion). Therefore, the lower real exchange rate has mainly been reflected in higher profits in these industries. However, advances in marketing and final processing have also contributed to increased profitability, and the prospects are generally favourable. Tourism has increased sharply in recent years, and a record number of tourists visited Iceland in 2012. The outlook is also positive in this sector.

Foreign reserves

The foreign reserves of the Central Bank of Iceland (excluding financial institutions' foreign currency deposits) at the end of 2012 amounted to EUR 3.1 bn. The Treasury and the Central Bank's non-reserve assets in foreign currency amounted to EUR 0.8 bn. The reserves declined in 2012, owing to prepayments of liabilities and the withdrawal of financial institutions' foreign currency deposits due to recoveries from the failed banks. The reserves are still large in an international perspective. They amount to around 32 percent of GDP, 35 percent of the M3 money supply, and 112 percent of the country's short-term debt. The reserves will most likely be kept large in the near future in light of the liberalisation of capital controls. There are many variables that can affect the size of the reserves in the coming years. The two most important ones are the foreign debt of the Treasury and the Central Bank and the removal of capital controls.

Projections of future annual payments of principal on Treasury and Central Bank loans are set forth in the graph below, plotted against the size of the reserves and other foreign currency assets today.

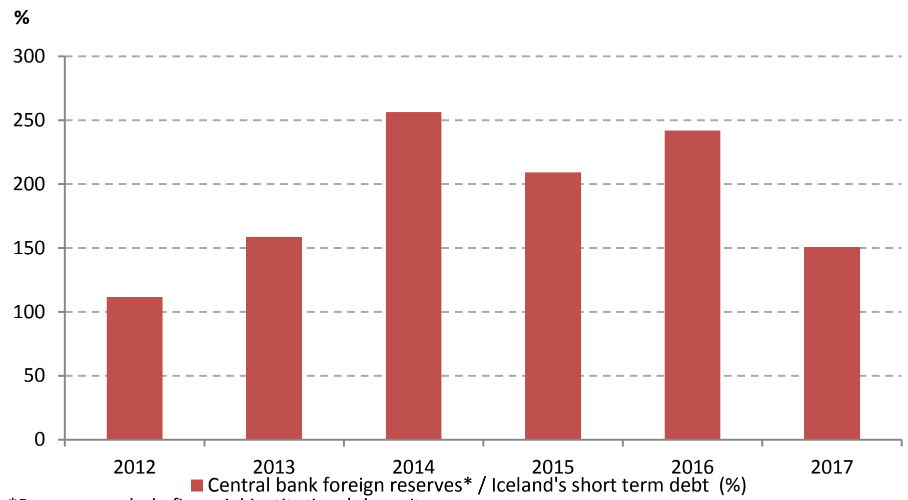
Figure 12: Projections of principal payments of loans of the Treasury and Central Bank



Source: Central Bank of Iceland

Projected reserve adequacy based on the assumptions that capital controls will not be lifted in the medium term can be seen in the figure below as a percentage of estimated short-term national debt.

Figure 13: Foreign reserves ratio (%)



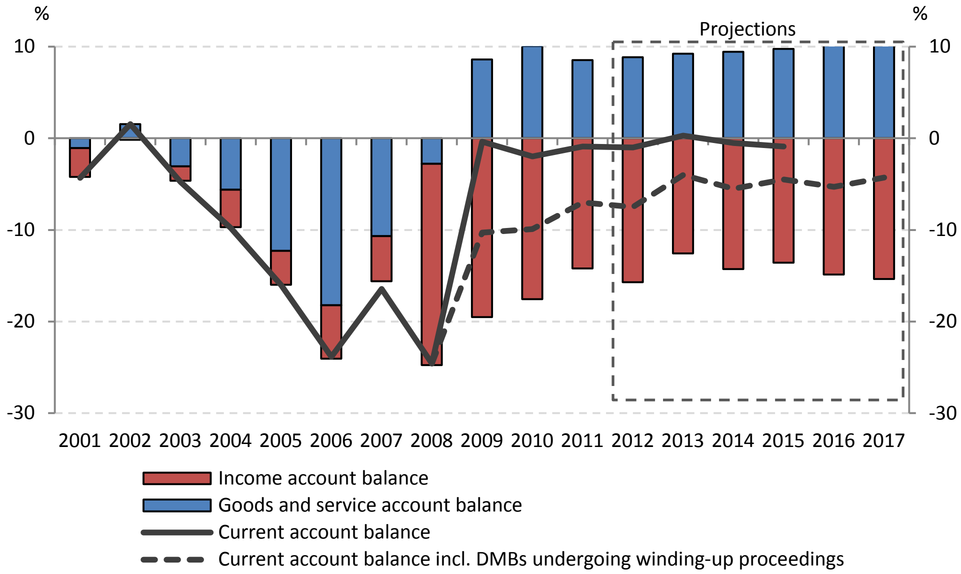
*Reserves exclude financial institutions' deposits

Source: Internation Monetary Fund

Real exchange rate of the ISK

The real exchange rate in terms of relative consumer prices fell by 0.8 percent between November and December 2012 and by 2.4 percent from December 2011. The average rate rose by 0.8 percent from 2011 to 2012. The real exchange rate of the Icelandic ISK is shown as an index with a base year of 2000 (January 2000 = 100). Relative consumer prices are defined as consumer prices in Iceland from a base year compared to those in other trading partner countries, calculated in the same currency. Relative unit labour costs (ULC) are defined as unit labour costs from a base year in Iceland compared to those in other trading partner countries, calculated in the same currency.

Figure 14: Current account balance components, % of GDP



Source: Statistics Iceland, CBI

2.2.5 Financial sector

The financial system and deposit money banks (DMBs)

The total assets of the financial system at the end of June 2012 amounted to ISK 8,373 bn., down by 108 bn. since the beginning of the year (Table 1). This is due primarily to the national Treasury and the Central Bank of Iceland's early paybacks of foreign loans in the amount of ISK 171 bn. The decision on repayment was taken following the Treasury's USD 1,000 m. (ISK 125 bn.) bond issue on international markets last May, and in view of the relatively high FX liquidity position of the Treasury and Central Bank in subsequent quarters. The decrease also reflects prepayment by Landsbankinn hf. on its bond to the old Landsbanki, in the amount of just over ISK 73 bn.

Total assets of DMBs[4] have shrunk since the beginning of 2012 and, at the end of June, amounted to ISK 2,835 bn., compared to 2,912 bn. at year-end 2011. Assets of DMBs were equivalent to 174 percent of GDP as of end-June 2012, which was similar to the previous two years. Total assets of DMBs were equivalent to 71 percent of total assets of credit institutions as of the end of June 2012; the HFF's assets were 22 percent and those of other credit institutions around 5 percent.

[4] Deposit money banks (DMBs) are commercial banks and savings banks.

Table 1: Credit system assets

Assets, ISK bn.	*30.9.2008*	*31.12.2008*	*31.12.2009*	*31.12.2010*	*31.12.2011*	*30.6.2012*	*Change from 31.12.2011*
Banking system[1]	15.087	4.632	3.967	3.878	4.378	4.107	-271
portion due to Central Bank of Iceland	192	447	1.011	1.114	1.466	1.272	-194
portion due to commercial banks	14.153	3.417	2.573	2.627	2.852	2.774	-78
portion due to savings banks	742	768	383	137	60	61	1
Other credit institutions	1.321	1.284	1.194	1.129	1.097	1.072	-25
portion due to Housing Financing Fund	699	733	795	836	864	878	14
Pension funds	1.871	1.665	1.849	1.989	2.169	2.306	137
Insurance companies	161	122	131	138	145	157	12
Mutual, investment and institutional funds	667	212	195	284	521	549	28
Government credit funds	103	125	146	161	171	182	11
Total assets	**19.209**	**8.040**	**7.483**	**7.579**	**8.481**	**8.373**	**-108**

1. The banking system consists of commercial banks, saving banks and the Central Bank of Iceland. Internal trades between the Central Bank of Iceland and other parties are excluded.

Source: Central Bank of Iceland.

The book value of loans by DMBs was ISK 1,895 bn. as of end-June 2012, after increasing slightly in nominal terms since the beginning of the year.

Commercial banks: assets restructuring and defaults

Household and corporate debt restructuring continued in 2012 and is proceeding apace, especially at the large commercial banks. The default ratios of the three largest commercial banks have dropped from 23 percent at year-end 2011 to 19 percent at the end of June 2012. These figures are based on book value and assume that all of a customer's loans are in default if one is in default or if payment is considered unlikely (cross-default). According to another measure of default, however, even though a customer has one loan in arrears by 90 days or more, that customer's other loans are not considered to be non-performing. If this measure is applied, just under 10 percent of loans of the large commercial banks were in default as of the end of June 2012, a decrease of over 2 percent points since the beginning of the year. Rulings handed down by the Supreme Court of Iceland in 2012 concerning the validity of receipts for full payment necessitated a recalculation yet again of all exchange rate-linked loan contracts involving illegal exchange rate linkage. It should be stated that there is still some uncertainty over the outcome of future legal decisions and new or amended legislation that may require the recalculation of other categories of foreign currency loans which the banks have not previously considered vulnerable.

The recognised foreign currency imbalances of the commercial bank groups continue to decrease. At the end of June 2012, the foreign currency imbalance recognised by the three largest commercial banks amounted to 20 percent of their capital base, after declining steadily in previous quarters. Since then, the imbalances have declined further, mainly because of Landsbanki's conversion of a contingent bond from ISK liability to FX.

Commercial banks: funding

In June 2012, deposits comprised around 58 percent of the commercial banks' funding. At the end of Q2, subordinated loans represented 2 percent of the commercial banks' funding, equity was 17 percent, and other borrowing was still a relatively small proportion of their funding, at around 23 percent.

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

At the end of June 2012, non-residents held around 8 percent of deposits with the commercial banks, compared with around 9 percent at year-end 2011; the decrease amounted to just over ISK 17 bn. About 86 percent of non-residents' deposits are in ISK. The decrease in non-residents' deposits is attributable mainly to liberalisation-related measures by the Central Bank and a transfer of deposits to other investment options. Other depositors' holdings have changed insignificantly since the beginning of the year.

Commercial banks: operations and equity position

The commercial banks seem to perform well within the temporary capital control regime. Their operating performance has been good, and their equity position is strong.

The aggregate profit of the commercial banks in H1/2012 amounted to ISK 34.8 bn., down by almost 8 bn. from the same period in 2011. Return on total assets (ROA) was 2.5 percent and ROE almost 16 percent, which is lower than in the same period of the previous year.

The equity of the large commercial banks totalled ISK 473 bn. as of end-June 2012, increasing by the amount of their profit since last year-end. Over the same period, their leverage ratio (ratio of net debt to equity) decreased somewhat, to 475 percent at the end of June. The banks' capital base as a proportion of their risk-weighted asset base was 23.1 percent at the end of June 2012, well above the 16 percent minimum set by the FME for the banks, and their Tier 1 ratio was 20.8 percent. The savings banks' position remains difficult. In H1/2012, the majority of savings banks reported losses or minimal profit. Some of the savings banks still fail to meet the FME's capital requirement.

Uncertainty persists, however, as to the actual value of the banks' loans, owing to high default levels, continuing the uncertainty about the legality of loan contracts and other factors. The relaxation of capital controls could also destabilise the ISK and put pressure on their capital position. A temporary drop in the exchange rate could affect repayments of FX loans still held by borrowers with income in ISK, and the payment capacity of borrowers with indexed obligations could also be jeopardized if inflation outpaces wage increases. A substantial risk of impairment therefore remains, which could have a major impact on the banks' capital ratios. This makes a strong capital position necessary until debt restructuring is concluded and the above uncertainty reduced. Furthermore, a strong capital position is a prerequisite for facilitating market refinancing.

Housing Financing Fund (HFF)

HFF loans in default or frozen were 15.1 percent of total loans as of the end of June 2012 and have increased since the beginning of the year, in contrast with the commercial banks, whose defaults have been decreasing. The Fund's real estate assets continue to increase. At the end of June 2012, it owned a total of 2,049 real estate units, an increase of 443 year-to-date. The findings of a working group appointed by the Minister of Welfare in September 2011 to examine the HFF's future role are still awaited, as is the report of an investigation commission on the Fund's activities, to be delivered in the coming months.[5]

By far the greatest share of funding for the HFF comes from issuing inflation-indexed HFF bonds in four series (HFF14, HFF24, HFF34, and HFF44). As of end-June 2012, the outstanding stock of bonds issued by the HFF amounted to almost ISK 865 bn. As large-scale debt retirement could disturb the balance in the average duration of the Fund's assets and liabilities, it is important that the HFF keep such mismatches under control despite increased paybacks.

The equity of the HFF amounted to almost ISK 6.5 bn. at the end of June 2012, decreasing by one-third since the beginning of the year. The HFF's capital ratio was only 1.4 percent, whereas its long-term goal is to maintain a capital ratio of over 5.0 percent. In H1/2012, impairment of the HFF's loans and real estate held for sale amounted to over ISK 3 bn., explaining the Fund's half-year losses and equity impairment. In November 2012, the government decided to obtain authorisation in the 2013 fiscal budget to increase the HFF's guarantee capital up to ISK 13 bn. in order to ensure an equity ratio of at least 3 percent at the beginning of 2013. However, the authorities' firm policy is that the Fund's equity should stand at 5 percent, as is stipulated in the pertinent regulation.

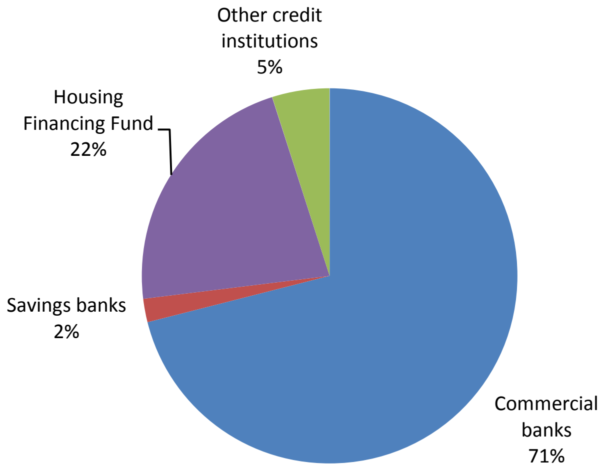
Financial system risk outlook

In recent years, financial system risk has declined in tandem with overall improvement in the economy, the progress of household and corporate debt restructuring, stronger capital position of financial undertakings, and reduced balance sheet mismatches. At present, the main risk factors are linked to the uncertain global economic situation; the potential impact of capital account liberalisation on the ISK exchange rate, the banks' liquidity and Treasury funding; the resolution of the banks currently in winding-up proceedings and its interaction with capital controls and effects on the new banks; heavy debt service on foreign debt after 2014 of parties still lacking access to foreign capital markets, legal uncertainty, and the quality of their loan portfolios. Some other risks posed to the financial system by feedback loops from the real economy are estimated to be modest. However, non-performing loan ratios still remain high, in both historical and international contexts, and credit growth remains subdued.

---

[5] A) Working Group on the Future Role of the Housing Financing Fund. The group's task includes examining the HFF's participation in the housing mortgage market, finding ways to maintain and ensure a public service mortgage institution, and discussing the Fund's impact on financial stability and its importance for the overall Icelandic economy. B) Investigation Commission on the Housing Financing Fund. The commission is intended to investigate the Fund's activities from the period leading up to changes in its funding and lending rules implemented in 2004 until year-end 2010. Furthermore, the commission is to assess the impact of these changes, the Fund's strategy, and specific decisions during this period on the Fund's financial situation and the overall housing market. It is also to assess the impact of the HFF's activities on economic management in Iceland and, finally, to assess how well the Fund has performed its statutory role during the period.

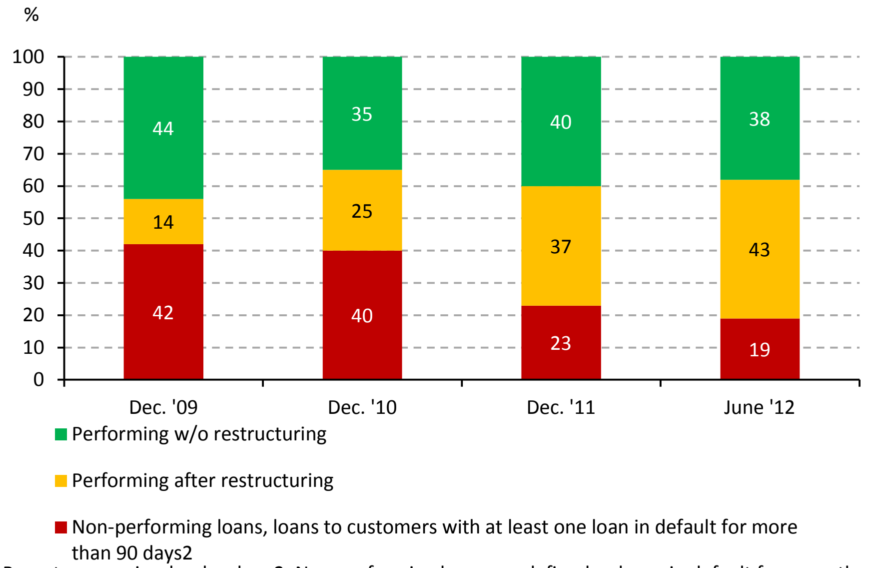
Figure 15: Credit institutions' total assets[1]



1. Parent companies.
Source: Central Bank of Iceland.

Efforts are underway on various fronts to prepare for the removal of capital controls on residents. These efforts are aimed at minimising the effect of the liberalisation on foreign capital outflows and hence foreign exchange markets. The primary objective of these efforts has been to unwind non-residents' offshore ISK holdings, currently held in local banks' deposit accounts and short-term Treasury or HFF bonds. The Central Bank has also begun to prepare for unrestricted capital flows by proposing a number of prudential rules designed to protect the financial system against the risk that could accompany the procyclical effects of capital flows.

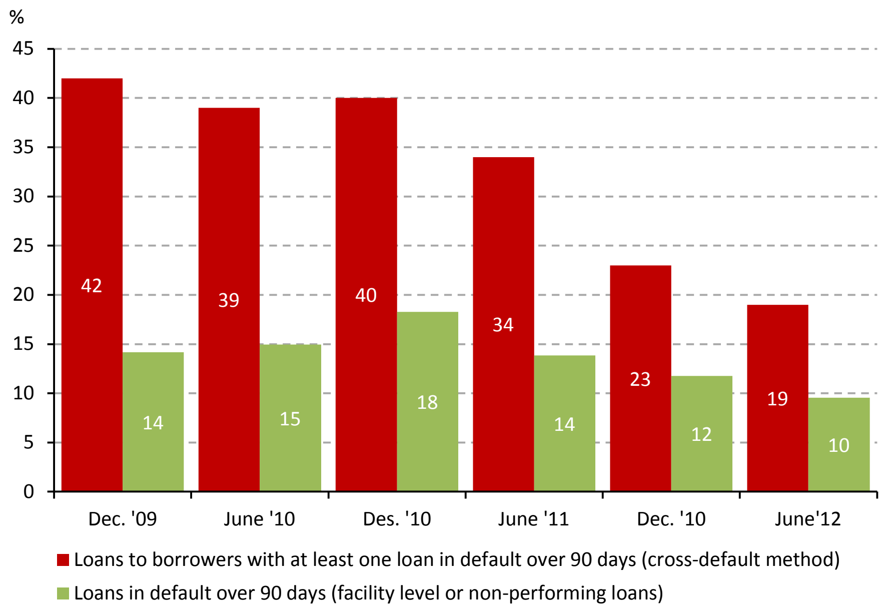
Figure 16: Status of loans from three largest banks1, book value (cross-default method)



1. Parent companies, book value. 2. Non-performing loans are defined as loans in default for more than 90 days or deemed unlikely to be paid. The cross-default method is used; that is, if one loan taken by a customer is non-performing, all of that customer's loans are considered non-performing.

Source: Financial Supervisory Authority.

Figure 17: Default ratios of the three largest commercial banks[1]



1. Parent companies, book value.

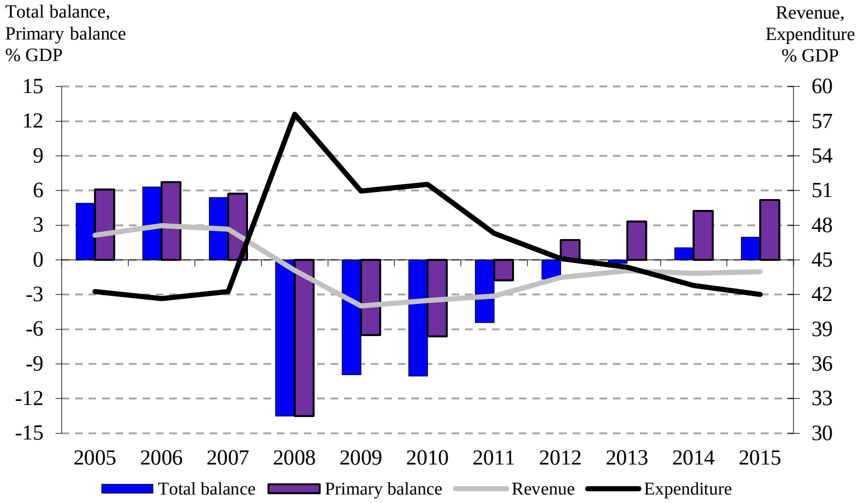
Sources: Financial Supervisory Authority, Cetnral Bank of Iceland.

3. General government balance and debt

3.1 Policy strategy and medium-term objectives

In the area of fiscal policy, the current government's priority task has been to reach a balance in government finances, with the objective of paying down government debt and achieving long-term public finance sustainability. In the medium term, the government's fiscal policy is founded on two primary objectives: Firstly, to attain a surplus in the primary balance, i.e. the operating results excluding capital gains and financing fees, in public finances in 2012. Secondly, to attain a surplus in the overall balance, where the interest balance is included, in 2014.

Figure 18: General government finances, % of GDP



According to the 2012 budget, an ample surplus is expected in the primary balance in 2012 on an accrual basis, provided there are no unforeseen charge entries. This phase is an important element in lowering the Treasury's debt and reining in interest costs. To emphasise the importance of reducing the Treasury's interest costs, it should be noted that in the 2013 budget interest costs constitute the biggest expenditure item. The principal long-term objective of fiscal policy is to reduce the Treasury's total debt to 45–50 percent of GDP and total public debt to 60 percent of GDP. In order to reach that objective, there needs to be a satisfactory surplus in the Treasury's balance in the coming years and this capital must be allocated to paying down debt. This fiscal policy will reinforce the pillars of the welfare system, create the foundations for sustainable public finances and ensure the Treasury's continuous access to global credit markets.

Although the government's objective of achieving fiscal equilibrium and reducing government debt remains unchanged, the long-term plan has undergone considerable changes in recent years. In 2009, the initial Stand-by Arrangement with the International Monetary Fund (IMF) was formulated with the aim of improving fiscal management and reaching equilibrium in the economy. The plan was then revised, in light of developments and changed circumstances, for the 2012 draft budget and a somewhat shorter adjustment period than had been originally envisaged was estimated, as well as a slowdown in cost-saving measures, which would delay the fiscal balance by one year. The revised fiscal policy took into account the need to address the slack in the economy and boost economic growth. Nevertheless, the government's basic premise in its revision of fiscal policy was to ensure that the measures to stimulate the economy and economic activity fitted in with the objective to attain a positive fiscal balance. Since the Stand-by Arrangement with the IMF formally drew to a close in the autumn of 2011, the government has continued to work according to the fiscal policy that was formulated in collaboration with the Fund, and also continued to adjust fiscal policy to economic circumstances. According to the 2013 budget, the general government primary balance will be positive by 3.3 percent of GDP. There is good reason to expect a slight deficit in the total balance of -0.3 percent of GDP. The capital and financial account will also be negative by -3.6 percent of GDP. Both the total balance and primary balance in the 2013 budget are in line with the government's fiscal plan, which was submitted with the 2012 draft budget.

3.2 Budget implementation in 2012

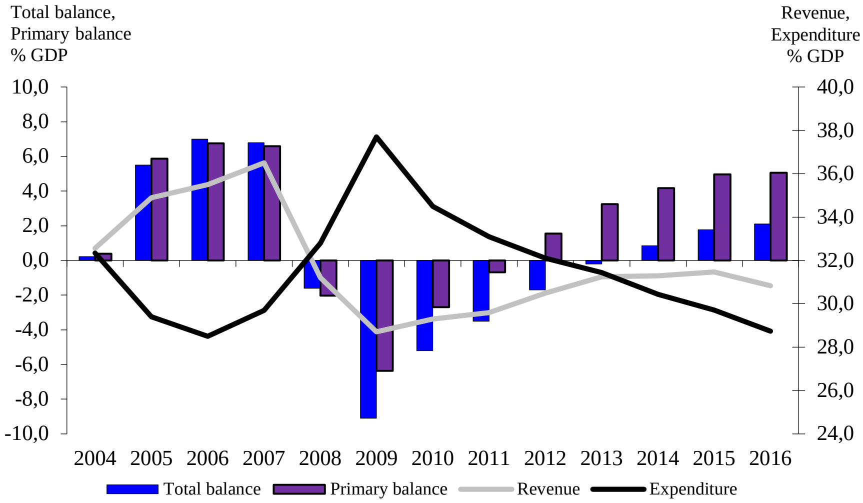
The 2012 budget estimated a deficit of ISK 20.7 bn. in the Treasury's balance that year. This estimate was revised during the drafting of the budget in the autumn of 2012, in light of new data on the development of the revenue base and expenditure categories and taking into account the macroeconomic forecast published by Statistics Iceland on 5 July. It estimated primary revenue would rise by ISK 6.8 bn. and primary expenditure by ISK 15.8 bn. According to the revised estimates for 2012, the primary balance is therefore ISK 9.1 bn. lower than the budget anticipated. Moreover, interest expenses are expected to rise by ISK 0.8 bn. more than the increase in interest income, which leads to a correspondingly lower interest balance. According to the revised estimates, the total balance for 2012 is therefore ISK 8.3 bn. less favourable than the budget projected.

Changes on the revenue side of the balance sheet show both rises and drops in income. The most significant rises stemmed from higher revenue from individual income tax, higher dividends paid by Landsvirkjun and other public entities, and higher revenue from fishing fees, since these three revenue items combined rose by ISK 12.2 bn. These are offset, on the other hand, by reductions in other revenue items, particularly lower revenue from the selling of assets and less revenue from individual capital gains tax, since these two items dropped by a combined value of ISK 10.9 bn. Total revenue rises by ISK 6.3 bn. in 2012, according to this estimate. On the expenditure side, the same applied. The main rises in expenditure in the budget are to be found in increases in social security benefits, health insurance and unemployment benefit, which together amounted to ISK 4.1 bn., and expenditure due the settlement with Arion Bank for the overtaking and transfer of government guarantees on Kaupthing's bonds, which amounted to ISK 3.1 bn. Moreover, expenditure due to tax refunds to innovative and development projects amounted to ISK 1.1 bn. and pension obligations to ISK 1 bn., as a result of the impact of collective wage agreements on the pension rights of pensioners. The biggest decreases in expenditure were in interest rebates, which amounted to ISK 1.5 and the Treasury's interest payments, which dropped by ISK 1.3 bn. The Treasury's total expenditure rose by ISK 14.6 bn., according to the 2012 budget.

3.3 Medium-term budgetary outlook

Government Financial Reporting Act no.88/1997 stipulates that the draft budget for each year shall be accompanied by a fiscal plan for the three years following the fiscal year, which the draft budget refers to. This year a fiscal plan that extends to 2016 was submitted with the draft Treasury budget for 2013. During its processing in parliament, the draft budget was upwardly revised for 2013, both on the revenue and expenditure side of the balance sheet. Once more, these changes were made with the objective of achieving a fiscal balance and they do not have any significant impact of the Treasury's balance for 2013. The fiscal plan has not, at this point, been reassessed for the entire period since the publication of the draft budget for 2013 to take into account parliamentary amendments and evaluate to what extent it can be considered viable after 2013, with regard to, among other things, increased revenue. The fiscal plan is expected to be reviewed in light of changed assumptions in the spring, as is the custom with the drafting of budgets in Iceland. The preliminary long-term plan for 2014-2016 has been updated here, however, in line with the budget for 2013. The revised long-term plan expects the increases that occurred in the revenue and expenditure sides of the 2013 budget processed by parliament to endure throughout the duration of the plan. The graph below shows Treasury finances in the 2004–2011 period, according to state accounts and the updated fiscal plan for 2012–2016. The graph shows the development of revenue, expenditure and the balance during the upswing and boom years between 2004 and the first half of 2008, and then the year that followed the economic crash up until a balance is reached again, according to the objectives of the fiscal plan. The graph presents the Treasury's revenue and expenditure as a percentage of GDP on the right axis and its balance as a percentage of GDP on the left axis. To better chart the underlying development of fiscal policy, irregular revenue and expenditure items have been excluded.

Figure 19: Central government finances, % of GDP



On one hand, the graph shows the blow that was dealt to the Treasury in the wake of the economic crash, both on the revenue and expenditures sides of the balance sheet and, on the other hand, the turnaround that has occurred since then and is expected to continue throughout the forecast horizon. The positive total fiscal balance in 2014 will amount to a lower percentage of GDP than before, primarily as a result of a reduction in the revenue side. The turnaround in fiscal management is therefore founded on the decline in expenditure as a percentage of GDP rather than a rise in revenue levels. General government total expenditure is expected to amount to 44.4 percent of GDP in 2013, compared to 57.6 percent of GDP when it was at its peak in 2008, and 42,2 percent of GDP in 2005, at the beginning of the upswing, following a short-lived economic downturn between 2002 and 2003. Total expenditure will therefore reach a level comparable to what it was in the pre-crash years. On the other hand, primary expenditure in 2013 will be equivalent to 39.3 percent of GDP, which is considerably lower than it was before the collapse of the banks and can be attributable to the fact that interest payments have become such a huge item in Treasury expenditure. The key element in fiscal management in the coming years is to channel the general government surplus into paying down debt and reducing it to more moderate levels.

The table below shows the Treasury's balance, according to the aforementioned preliminary revised fiscal plan. The balance figures are based on the prices that are current for each year and, between 2014-2016, the increases on the revenue and expenditures sides of the draft budget for 2013 processed by parliament are expected to endure throughout the forecast horizon. The table shows figures on an accrual basis, which is the accounting basis applied to budgets and state accounts, whereas the medium-term objectives for the Treasury's performance and year-on-year improvements, on the other hand, are based on payments and expenditure on a cash basis. In their presentation the emphasis is on the Treasury's cash flow, particularly its borrowing requirements, and therefore focuses more on the immediate effects of fiscal policy than long-term obligations. Excluding irregular items, the Treasury's balance is generally slightly lower on a cash basis, mainly due to differences in adjustments and the collection of tax. On the other hand, the balance can look considerably worse on an accrual basis, excluding irregular items.

Table 2: Estimated Treasury finances

bn ISK	Budget 2013	Estimate* 2014	Estimate* 2015	Estimate* 2016
Total revenue	**579,4**	**620,8**	**659,5**	**681,7**
thereof tax revenue	512,4	550,2	584,9	613,1
Total expenditure	**583**	**603,9**	**622,5**	**635,2**
Current expenditure	231	238,1	245,2	253,4
Interest	84,7	88,5	92,1	90,4
Transfer payments	244,1	251,7	259,5	265,2
Maintenance	8,8	9,2	9,6	9,8
Capital expenditure	14,5	16,4	16,1	16,3
Total balance	**-3,7**	**16,9**	**37**	**46,6**
percentage of GDP	-0,2	0,9	1,8	2,1
change from previous year	1,5	1,1	0,9	0,3
Primary revenue	558,6	598,1	634,7	656,7
Primary expenditure	498,4	515,4	530,4	544,8
Primary balance	**60,2**	**82,8**	**104,3**	**111,9**
percentage of GDP	3,2	4,2	5	5,1
change from previous year	1,5	0,9	0,8	0,1
Interest income	20,8	22,6	24,8	25
Interest expenditure	84,7	88,5	92,1	90,4
Interest balance	**-63,9**	**-65,8**	**-67,3**	**-65,4**
percentage of GDP	-3,4	-3,3	-3,2	-3

* Revised long-term projections for 2014-2016, on the basis of amendments to the budget approved by parliament in the second and third debates. The increase in the revenue and expenditure sides of the 2013 budget are expected to persist throughout the forecast horizon.

On the whole, one can see that the adjustment process, i.e. the primary and total balances as a percentage of GDP in the coming years, is similar in the revised fiscal plan to what it was in the previous long-term plan, which was submitted with the draft budget for 2012. As was the case before, the adjustment process is expected to improve the primary balance in the period between 2009 and 2015, bringing it up to 11 percent of GDP. Comparisons between the revised fiscal plan and the previous plan are discussed in greater detail in chapter 3.6.

It is clear that a veritable turnaround was achieved in government finances in relation to the ISK 100 bn. deficit in the primary balance in 2009, which was the first year after the financial crash. In light of the global economic outlook and the development of fiscal management in many western states, it is to be considered a good result to have improved the primary balance by about 10 percent over a period of four years, i.e. from -6.5 percent of GDP in 2009 to 3.2 percent in 2013. In order to achieve this adjustment, a mixture of options had to be followed, both to boost revenue, on one hand, and rein in expenditure, on the other, since a fiscal balance was not considered possible, by only following a single option. On one hand, an excessive drop in expenditure would have had a negative on demand in the economy and the government’s ability to support an effective social welfare system, while on the other hand, the adjustment could not have been achieved on the revenue side alone. The graph below shows how the fiscal objectives for 2009–2013 were achieved by mixing revenue-generating and cost-saving measures. This is the Ministry of Finance and Economic Affairs evaluation of the accrued impact of revenue measures, which amounted to a total 6.5 percent of GDP during the period, and spending cuts that were implemented in budgets, which amounted to a total of 7.4 percent of GDP. These measures alone, excluding the general development of revenue and expenditure, improved the primary balance by what amounts to 13.8 percent of GDP. With regard to the expenditure side, it should be pointed out that these are only direct measures to reduce government expenditure, based on proposals that were approved in the preparation and passing of budgets. On the other hand, there were increases in expenditure items that are not taken into account in this discussion, e.g. due to systemic developments and government decisions, as well as wage and price increases. In other words, this is the ministry’s evaluation of the cost-saving measures that were introduced in the budgets between 2009–2012 and the draft budget for 2013. In this evaluation, a number of cost-saving measures that were planned for in the budgets have been excluded, either because they were abandoned or for some reason failed to get off the ground.

Looking forward, one needs to bear in mind the uncertain factors that can have an impact on the public finances in the coming years, such as economic developments in Iceland's main trading partner countries. One needs to take into account the effect which the contraction in trading partner countries can have on economic activity in Iceland and therefore its fiscal management. Nevertheless, most indicators suggest that the government's medium-term fiscal objective of achieving a positive total fiscal balance will be realised in 2014. There are a number of signs that the slack in the economy will be reduced in the quarters ahead, and there is therefore a need to maintain firmness and equilibrium in the economy and to hinder any immoderate growth in expenditure. The general government total debt (Maastricht criteria) is expected to amount to ISK 1,670 bn. at the end of 2013, which is equivalent to 91.4 percent of expected GDP of that year. The principal long-term objective of fiscal policy is to reduce the Treasury’s total debt to 45–50 percent of GDP and total public debt to 60 percent of GDP. In order to reach that objective, Treasury finances need to yield ample annual surpluses over a long period of time or the proceeds from the government’s asset sales must be allocated to paying down debt. One also has to take into account the financial risks which the Treasury’s direct or indirect obligations entail.

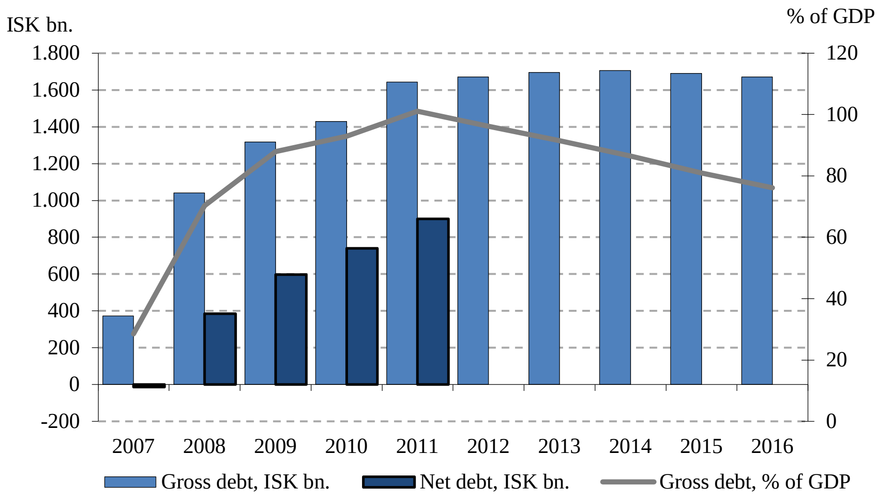
3.4 Structural balance (cyclical component of the deficit, one-off and temporary measures, fiscal stance)

A systematic analysis of the structural balance has not been presented by Icelandic authorities. The Pre-Accession Economic Programme of 2011 features a discussion regarding this issue.

3.5 Debt levels and developments, analysis of below-the-line operations and stock-flow adjustments

In 2012 the Ministry of Finance and Economic Affairs published *Medium-Term Debt Management Strategy 2012-2015* in which it sets forth its plans for debt financing and debt management for the period. The plan is to update and revise the strategy annually. The principal objective of the strategy is to ensure that the Treasury's financing needs and financial obligations are met at the lowest possible cost that is consistent with a prudent degree of risk. A sustainable debt service profile consistent with the government's medium-term payment capacity needs to be ensured. The aim of the strategy is also to promote the further development of efficient primary and secondary markets for domestic government securities. The objective is to broaden the government's investor base and diversify funding sources.

Figure 20: General government debt, % GDP



Looking at the composition of the debt portfolio, excluding loans that are taken for the specific purpose of boosting currency reserves, the greatest emphasis is placed on the issuance of nominal Treasury bonds, since these issues form the basis of an efficient bond market. The aim is for 60–80 percent of the debt portfolio to be in nominal bonds. The Treasury also issues inflation-linked bonds, which appeal to long-term investors. The aim is for 10-40 percent of the debt portfolio to be in inflation-linked bonds. Although, according to the guidelines for the composition of the Treasury's debt portfolio, foreign loans should make up 20 percent of the debt portfolio, this scope is not expected to be used and the Treasury will issue one foreign currency bond to boost its foreign exchange reserves.

The financing needs of the Treasury will be met through the issuance of government securities in the domestic market and by drawing on the Treasury's deposits at the Central Bank of Iceland (CBI). At any given time, the Treasury aims to hold deposits amounting to at least ISK 80 bn. This is done, among other reasons, to cater for the uncertainty that surrounds the lifting of capital controls.

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

The structure of the benchmark series will be designed so that each series is large enough to ensure effective price formation in the secondary market. The Treasury's debt shall be taken into account when determining the number of issues and their size. The aim is to issue a relatively stable amount of Treasury bonds through the year with varying maturities. To fulfil these aims, the benchmark Treasury bond series will be issued each year with maturities of 2, 5 and 10 years. The issuance of inflation-linked and longer nominal Treasury bonds will be irregular and take into account the borrowing requirements of the Treasury and market conditions. The objective is for the final size of each series to be in the range of ISK 40-100 bn. In addition to this, Treasury bills will be issued on a monthly basis, for an amount that will be determined by the Treasury's financing requirements at any given time.

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

According to the Treasury's annual debt management strategy for 2013, the aim is to issue Treasury bonds for a sale value of ISK 90 bn. The Treasury bill position will remain unchanged amounting to approximately ISK 40 bn. at the end of 2012. In addition to this, there will be a draw on the Treasury's deposits at the Central Bank of Iceland (CBI). In 2012, the issuance of Treasury bonds amounted to a nominal value of ISK 81 bn., some ISK 54 bn. of which were issued in public auctions and ISK 27 bn. in the foreign currency auctions of the CBI.

In May, the Treasury issued a 10-year Treasury bond for a value of USD 1 bn. (equivalent to ISK 124 bn.) on global bond markets. The high demand for bonds from foreign institutional investors, which was also witnessed in comparable issues last year, confirms that the Treasury has regained access to the global capital markets. This issue and a similar issue in 2011 were used for the early repayment, in March and June 2012, of loans for the equivalent value of ISK 287 bn., which the Treasury and Central Bank had received from the International Monetary Fund (IMF) and the Nordic countries, in connection with the Stand-by Arrangement between the government and the IMF. Of the initial loan amount, the Treasury and Central Bank have repaid 59 percent of their loans from the Nordic countries and 53 percent of their loans from the IMF. At the end of December 2012, the government repaid DKK 300 m. of its loan from the Faroe Islands.

The estimated currency composition of debt at the end of 2012 is shown in the next graph. The largest part of the debt is in ISK, i.e. 71 percent. Nominal loans are expected to make up 45 percent of total debt, indexed loans 26 percent, and foreign currency loans 29 percent.

3.5.1 Contingent liabilities

Contingent liabilities are financial obligations that could fall on the Treasury; for example, due to state guarantees or administrative decisions that entail involvement in the financing of municipalities or undertakings that play a key role in Icelandic society. The Treasury's main obligations are in State guarantees. Treasury guarantees are governed by Act no. 121/1997. Icelandic Parliament issues State guarantees upon receiving requests from the Ministry of Finance and Economic Affairs. The position of State guarantees end- 2012 is stated in the table below.

Table 3: State guarantees

Staða 30.11.2012	Fjárhæð í m. kr.	Hlutfall
Íbúðalánasjóður	951.821	72%
Landsvirkjun	332.798	25%
Aðrar stofnanir	36.393	3%
Samtals	1.321.012	

Housing Financing Fund

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

At the end of 2012, Althingi agreed to grant the fund an additional capital contribution of up to ISK 13 bn. In 2010, the fund had received an extra capital contribution of ISK 33 bn. The Housing Financing Fund has therefore received a total of ISK 46 bn. in capital contributions over the past years.

Prepayment and credit risks are the two greatest risk factors, which are reflected in the fact that the Fund's operational losses in recent years stem primarily from loan impairment and an increase in prepayments. The HFF is further discussed in chapter 2.2.5.

Landsvirkjun

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

Landsvirkjun's liquidity position is sound because of its strong cash position and undrawn revolving credit facilities, and is well prepared to service its debt in coming years The company's debt has decreased over the past years and it is working on paying down its obligations.

Landsvirkjun's financial risk consists of market risk, liquidity risk, and counterparty risk. Landsvirkjun has systematically reduced its market risk. With a new agreement negotiated between Landsvirkjun and Alcan Iceland in 2010, the aluminium price linkage in the previous contract was revoked and all sale of electricity to Alcan linked to the US consumer price index. The proportion of Landsvirkjun's electricity sales linked to the price of aluminium has therefore declined sharply, from 76 percent to 50 percent in 2011.

The company's operations will continue to be vulnerable to changes in the price of aluminium, but hedging and a broader revenue base will ensure strong cash flow in the years to come. It is therefore considered unlikely that the State guarantee will be activated in the near future.

Icesave

The EFTA Court ruling of 28 January on Icesave rejected all claims by the EFTA Surveillance Authority that Iceland should be declared in breach of the EEA Agreement. The Court rejected the claim that Iceland has breached the Deposit Guarantee Directive or has discriminated against depositors contrary to EEA law.

Payments from the estate of the failed Landsbanki will continue regardless of the ruling of the EFTA Court. The assets of the estate are now estimated to be ISK 1,517 bn. which is approximately 200 bn. more than the priority claims which amount to ISK 1,318 bn. Of these priority claims ISK 1,166 bn. result from the Icesave deposits while just under ISK 150 bn. result from wholesale deposits, including those from municipalities, charities etc. The sum of ISK 660 bn. has already been paid out of the estate against priority claims, i.e. around 50 percent of their total value. Of this ISK 585 bn. have gone to claims resulting from the Icesave accounts. This sum amounts to over 90 percent of the total which the UK and Dutch authorities advanced to cover the minimum deposit guarantee.

It is expected that the Icesave claims will be paid out in full by the actual debtor, the estate of the failed Landsbanki. This outcome results from the implementation of emergency legislation in 2008, according to which deposits were given priority against unsecured claims.

3.6 Sensitivity analysis and comparison with previous programme

Comparison with the previous programme

The fiscal plan is revised annually with the preparation of the budget by reviewing the government's revenue estimates and analysing the development of its various expenditure categories. The government's decisions and new policy objectives are taken into account and Statistics Iceland's macroeconomic forecasts [6] are used to provide the underlying assumptions for economic development. The revision of the plan is based on the assumption that increased expenditure will be offset by cost-saving measures and increased state revenue. According to the revenue estimate for the 2013 budget, the Treasury's primary revenue is set to increase by ISK 36.4 bn. in relation to the previous fiscal plan, which was published autumn 2011 with the draft budget for 2012. The increase in primary revenue is broken down as follows:

1. The new revenue-generating measures, which were not included in the previous plan, will increase the Treasury's primary revenue by ISK 22.5 bn. ISK 9.5 bn. of this amount is to come from increased revenue, due to changes in payment plans for dividends and the sale of assets. This change consists in dividends increasing by a total of ISK 13.5 bn. in relation to the previous plan, while on the other hand, the capital gain from the estimated sale of assets is set to drop by ISK 4 bn. There will also be a considerable increase in revenue from the special fishing fee on catch quotas in the fishing sector, which Althingi adopted into legislation last June and this increase amounts to ISK 4.4 bn. Other revenue-generating measures raise the Treasury's revenue by ISK 8.6 bn. from the previous plan and include, among other things, changes in the financial activities tax on banking institutions, value added tax (VAT) on hotel accommodation and social security tax.
2. General increases in the Treasury's primary revenue amount to ISK 9.2 bn., due to altered assumptions and a higher baseline forecast regarding the revenue base of the Treasury. This can be attributed to the positive effects of the economic recovery and a better than expected collection this year.
3. Other changes in primary revenue, such as increases in the Treasury's capital gains tax, due to changes in the presentation of accounts, amount to ISK 4.7 bn.

The Treasury's interest income drops by ISK 2.3 bn. in relation to the previous plan and total revenue therefore increases by ISK 34.1 bn. In the 2013 budget, the Treasury's primary expenditure increases by a total of ISK 33.6 bn. in relation to the previous fiscal plan and can be broken down as follows:

1. Increases in primary expenditure due to special government priority actions amount to ISK 15 bn. This increase is twofold. Firstly, emphasis was placed on measures to stimulate investment and innovation in the economy and, in this context, the government presented its 2013-2015 Investment Plan. The contribution to the Investment Plan in the 2013 budget amounts to a total of ISK 9.3 bn., but is fully funded by revenue generated by the special

[6] Statistics Iceland's previous macroeconomic forecast was published on 5 July 2012 and was used as the basic premise for the development of the Icelandic economy in the drafting of the 2013 budget. Statistics Iceland's second macroeconomic forecast was published on 2 November 2012 and was taken into account in the making of the budget for 2013.

fishing fee, dividends from state undertakings, particularly financial undertakings, and capital gains from the selling of assets. The funding for the Investment Plan was divided so that ISK 3.3 bn. were allocated to investment projects, ISK 2.5 bn. to transport infrastructure, ISK 1.3 bn. to research and technological development funds, and ISK 2.2 bn. were allocated to other projects. The 2013-2015 Investment Plan for Iceland is discussed in greater detail in chapter 3.7. Secondly, one of the special priorities in the revision of the fiscal plan was to address the financial difficulties of indebted households and contributions to that end amounted to a total of ISK 4.7 bn. and included, among other things, increases in child allowances, rent subsidies and contributions to the Childbirth Leave Fund. A decision was also made to contribute ISK 1 bn. to international development projects.

2. Increases in primary expenditure, due to increased expenditure obligations, changes in wages, prices and exchange rates, and altered assumptions in relation to the previous fiscal plan amount to a total of ISK 18.6 bn. They include, among other things, increases in the state's pension obligations, expenditure increases due to hospital-category drugs and increases in social insurance and social care benefits. To offset these increases in primary expenditure, cost-saving measures in 2013 exceeded what had been envisaged in the previous fiscal plan by ISK 1.3 bn., and consisted in turnover-related cost-saving measures in the ministries, on one hand, and special cost-saving measures, on the other.

The Treasury's interest payments rose by ISK 2.8 bn. in relation to the previous plan and, therefore, total expenditure by ISK 36.4 bn. The main changes in the fiscal management outlook in comparison with the previous plan is that both total revenue and total expenditure as percentages of GDP have increased by what amounts to 2 percent of GDP during the forecast horizon. On the other hand, the total balance as a percentage of GDP is almost in line with what was expected. The primary balance as a percentage of GDP is also similar to what was projected in 2013, albeit slightly higher in the latter part of the forecast horizon. The capital and financial account balance is somewhat lower in 2013 than the previous plan projected and is negative by 3.4 percent of GDP instead of 3.2 percent, but otherwise remains similar throughout the forecast horizon.

Sensitivity of the budgetary projections to alternative scenarios and risks

In the preparation of budgets it has not been customary to make sensitivity analyses of deviations from the main economic assumptions the budgets are based on and the impact they might have on fiscal management. The main analyses of the risk factors in fiscal management have consisted in mapping the direct and indirect exposures of the Treasury, but there is no numerical evaluation of the impact they could have on the fiscal balance. The Treasury's risk exposure is discussed in greater detail in chapter 3.5, but the main risk factor that is relevant to the 2013 budget is primarily the likelihood that the management of the Housing Financing Fund (HFF) will be more difficult in the coming years than was previously expected. This situation manifests itself in, among other things, the Fund's unsatisfactory interest rate differential, which could, all things being equal, lead to a long-lasting operating deficit, but the fund is also exposed to risk due to a continuous rise in defaults and mounting write-off requirements, in addition to the risk attached to the repayment of the loans it has issued. Moreover, the taking over of appropriated assets is starting to prove quite costly for the Fund. These factors mean that the management of the Fund cannot be considered sustainable in its current state.

Secondly, another risk worth mentioning is that the yields on Treasury bonds might increase more than is anticipated in the current plan, which would lead to higher interest costs on new borrowing and have a negative impact on the Treasury's operating results.

Thirdly, it should be mentioned that the pension liabilities of the Treasury for state employees amounted to ISK 373 bn. at the end of 2011, according to the annual accounts, which corresponded to 21.5 percent of GDP, and these obligations are to Division B of the Pension Fund for State Employees (LSR) and the Pension Fund for Nurses. It should be noted that the Treasury has no pension obligations towards Division A of the LSR. According to the results of the actuarial assessment of the A Division's position at the end of 2011, the total balance was negative by 13.1 percent, which was within the temporary 15 percent maximum limit. Nevertheless, it is clear that, if the actuarial position of the division deteriorates over the coming years, appropriate measures will need to be taken, e.g. by raising contributions, which would have a negative impact of the Treasury's operating results.

3.7 Quality of public finances

Central government investments

The following is a more detailed account of the 2013-2015 Investment Plan for Iceland, which the government presented last year with the aim of better supporting the economic recovery and growth.

By investing in the social infrastructure in a systematic manner, the foundations of economic growth and the Treasury's revenue base for the future can be strengthened. A basic premise of the Investment Plan is to prioritise the objectives of the long-term fiscal plan and it will therefore not alter the goal to achieve overall fiscal balance by 2014. On the other hand, an increase in investments and a more vigorous economic recovery could accelerate the turnaround in fiscal balance, since investment, as a percentage of GDP, is still low.

3.8 Sustainability of public finances

The Icelandic authorities are presently not conducting quantitative analysis of the long-term sustainability of public finance. Preparation for such a programme is ongoing between relevant ministries and institutions, as stated in chapter 3.4 of the 2012 Pre-Accession Economic Programme.

3.9 Institutional features of public finances

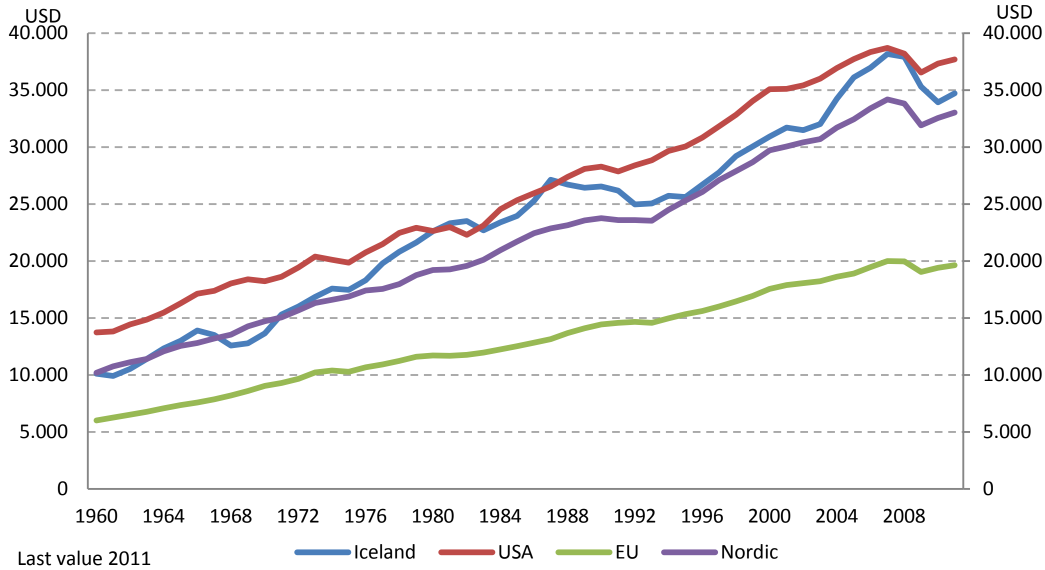
A new bill on organic budget laws is expected to be completed in February or March 2013 and subsequently submitted to Althingi. Its contents remain broadly the same as discussed in chapter 3.5.2 of Iceland's Pre-Accession Economic Programme of 2012.

4. Structural reform objectives

4.1 Obstacles to growth and structural reform agenda

Iceland has, during the last 50 years, experienced higher GDP growth than most other advanced economies but at the same time growth has been more volatile. Measured in constant USD terms per capita, annual growth in Iceland from 1960 to 2011 was 2.5 percent, compared with 2.4 percent in the EU and the Nordic Countries.[7] Volatility, measured by the standard deviation of GPD growth, is, however, twice as high in Iceland compared with the EU and the Nordic Countries. In terms of levels, GDP per capita in Iceland was around 70 percent higher than the EU average in 1960 and almost 80 per cent higher than the EU average in 2011. Consequently, living standards measured in constant USD terms per capita in Iceland and the EU have not converged during the last 50 years. On the contrary, a slight widening has taken place.[8] In this sense, Iceland's growth problems have mostly been related to excessive volatility, rather than the rate of growth in recent decades.

Figure 21: GDP growth per capita in Iceland, USA, the EU and Nordic countries



Last value 2011
Source: Internation Monetary Fund

Several studies have pointed out that despite high growth performance important structural weaknesses continue to exist. Iceland's export structure is still relatively narrow, based primarily on marine and aluminium products with weak links to the global supply chain.[9] Another study by McKinsey & Company points to low labour productivity in the domestic service sector and low capital productivity in the energy sector as the main challenges to growth.[10] Other obstacles to growth could be; resource constraints in existing key export industries, geographical location, size, level of education and finally legacy issues form the ongoing financial crisis such as the capital account restrictions that were put in place in late 2008.

---

[7] The Nordic Countries in this comparison are Denmark, Finland, Norway and Sweden.

[8] It should be noted that measuring living standards and making cross country comparison based on National Account data is notoriously difficult. Here, constant USD per capita outcomes are used. Another option could be to correct for price level differences and using PPP corrected data. Also, it should be noted that in 1960 the number of countries within the EU was 6, whereas in 2011, the number of EU countries had risen to 27.

[9] Iceland: Selected Issues Paper, IMF, 2010

[10] Charting a Growth Path for Iceland, McKinsey & Company, 2012

As a resource based economy, Iceland shares many of the characteristic of other resource based economies such as Australia, Canada, Finland, New Zealand and Norway. These include among other things a bias towards agriculture, small manufacturing and large service sector.[11] However, these countries are among the most successful economies in terms of per capita income and score high as democratic welfare states. From that point of view these economies have hardly been "cursed" by their high resource dependence.

There are, however, good reasons for the authorities to remain vigilant *vis-a-vis* diversification issues and productivity enhancement. Key industries such as the marine sector still remain mostly upstream in character, and the same can be said about the aluminium sector. Promoting strategies that facilitate more downstream characteristics is therefore an obvious policy priority.

The fishing sector faces obvious supply constraints pertaining to sustainable exploitation of the marine resource, which is subject to strict scientific oversight. Iceland has managed to maintain environmental sustainability along with increased output which partly reflects changed conditions in the ocean due to climatic conditions. Furthermore, prices of fish products have increased faster than manufacturing prices, giving rise to terms-of-trade gains. Achieving diversification through promoting fisheries related downstream has been an important policy priority of successive governments in Iceland and currently renewed interest in this area is demonstrated, among other things, by ongoing efforts to develop the fisheries cluster in Iceland.[12] As for the aluminium sector, a similar story could be told on leveraging the energy resource base into downstream industries.

Perhaps the most important obstacles to growth are more related to lack of macroeconomic stability rather than lack of coherent industrial policies or structural reforms. Measured by the World Economic Forum scoreboard, Iceland's poor performance is mostly related to the macroeconomic environment in addition to financial sector conditions and market size.[13] Obviously, the situation in the financial sector, such as the current capital controls, is a direct consequence of the recent financial turmoil and is being actively resolved.[14] As for market size, it is unlikely that much can be done about that any time soon. The macroeconomic environment on the other hand is an area where there is considerable scope to improvement which, if successful, would give rise to a double dividend in terms of less volatility at the macro level and improve substantially the potential for micro economic performance.

Apart from issues pertaining to fiscal matters, exchange rate stability and the level of the real exchange rate are of crucial importance. The sharp fall in the ISK exchange rate following the financial crisis in late 2008 has led to a fundamental shift in relative prices in the economy. A similar shift occurred in Sweden and Finland and in the early 90's following the Nordic financial crises at that time and the collapse of the Soviet Union which had dire consequences for the Finnish economy. It is interesting to note that prior to the crisis in Sweden Finland and both countries experienced a similar zic-zac pattern of the exchange rate with a clear tendency towards appreciation, which was characteristic of the development in Iceland prior to the crisis. However, following the collapse of the

[11] Smith, K., Innovation and Growth in Resource-Based Economics, CEDA, 2007

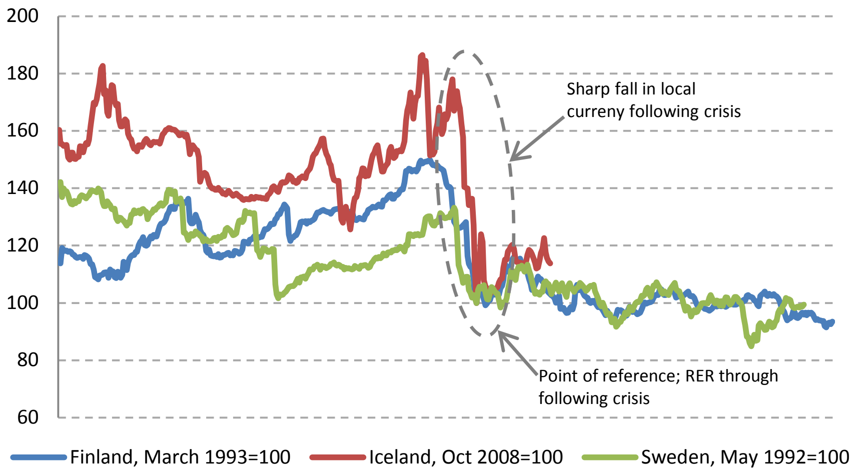
[12] Icelandic ocean cluster was formally introduced in May 2011. It is defined as economic activity directly related to the ocean around Iceland and is its mission is to reflect the diversity in the industry, see: http://www.sjavarklasinn.is/

[13] The Global Competitiveness Report 2011-2012, World Economic Forum.

[14] See chapter 2.2.5.

Swedish Krona and the Finnish Mark, both countries have maintained their respective real exchange rates more or less aligned with the level to which the currencies fell. In the case of Sweden, the point of reference is May 1992 and in the case of Finland the point of reference is March 1993. It should be noted that the two countries chose two different exchange rate regimes following the crisis the experienced in the early 90's, although both countries joined the EU shortly afterwards[15] Sweden opted to maintain an independent monetary policy with a floating exchange rate, whereas Finland joined the Euro area on 1 January 1999. There is little doubt that both in the Swedish and Finnish case the shift in relative prices in the early 90's was supportive of subsequent growth and improved macroeconomic performance.

Figure 22: Real Exchange Rates in Iceland, Sweden and Finland, following crises



Source: Central Bank of Iceland, Ministry of Finance and Economic affairs

In Iceland, the real exchange rate has also remained close to the level to which it fell right after the initial collapse in late 2008 even though there has been a slight appreciating trend over the last years. There can be little doubt that the economic conditions that followed the crisis with a significant depreciation of the exchange rate, both in real and nominal terms, has had a fundamental impact on conditions in the export and import competing sectors. In that sense a favourable competitive position has unleashed a new growth potential which could otherwise have gone unexploited. To what extend this situation is temporary, or if Iceland will follow the examples of Sweden and Finland in this respect, remains to be seen.

The issue of capital controls which were imposed in late 2008 following the financial crisis have a direct bearing on the growth and structural reform agenda. Obviously, as long as the capital controls remain in place the options available to Icelandic firms and households remain limited. In the long run this will hamper growth as access to international financial markets is not secured and less exposure to international competition will negatively impact corporate performance. Abolishing the capital controls as soon as possible is therefore a fundamental priority in order to remove obstacles to growth.

---

[15] Sweden and Finland joined the EU in 1995 and Finland was one of the first eleven countries to adopt the Euro in 1999 .

4.2 Key areas of structural reform

The government places its emphasis on increasing investment in the country, ensuring stability in the financial market, and boosting employment, as well as added value for the future through the diversification of economic activity. This section of the chapter discusses measures to boost investment, progress in the restructuring of corporate debt, and priorities to strengthen the pillars of the financial market. Although Iceland continues to be subject to capital controls, pursuant to Act no.127/2011, it is important to ensure that companies that bring in fresh capital for new investments in economic activities are granted exemptions from the capital controls.

4.2.1 Product and capital markets

Exploration of hydrocarbon production

At the beginning of January 2013, Orkustofnun (the National Energy Authority) issued two licences to explore and produce hydrocarbons. The holders of both licences own a 25% share, which is accordance with the agreement between Iceland and Norway, which has been in force since 1981. The licences were granted, pursuant to Act no. 13/2001 on the Prospecting, Exploration and Production of Hydrocarbons, with subsequent amendments and regulations no. 884/2011, as well as on the basis of the information in the licence applications and other information provided by the applicants. Before the licences were issued, Orkustofnun sought the opinions of the Ministry for the Environment and the Ministry of Fisheries and Agriculture, in accordance with the provisions of the act, and examined the work programmes involved. Orkustofnun made a careful evaluation of the technical and geological capacity of the applicants to handle the extensive activities associated with the licence. Orkustofnun also evaluated the financial capacity of the parent companies of the applicants, in order to ensure that the applicants have sufficient financial resources to conduct the activities in the long term and can handle the corresponding environmental and safety elements.

The government has evaluated environmental, occupational protection, safety and hygiene issues, in addition to which it has made a resource assessment on the basis of current knowledge. Prospecting and drilling are activities, which require environmental impact assessments to be made, in accordance with Environmental Impact Assessment Act no. 106/2000. Evaluations of the geology, biota and climate of the Dreki area have also been conducted.

In addition to taxes and other fees that are charged for economic activities in Iceland, a special hydrocarbon tax will be levied on these activities:

1. An area fee shall be paid for a licence to engage in hydrocarbon prospecting or production and the fee shall be calculated on the basis of the rights the licence grants. The fee is determined by Article 30a of Act no. 13/2001 on the Prospecting, Exploration and Production of Hydrocarbons.
2. The excise duty is based on the value of the hydrocarbons, which are used from the resource. The start-up fee is based on the selling price of the hydrocarbons that are exploited from the resource and the charge is therefore independent of the performance of hydrocarbon production. The state's revenue from these fees is therefore relatively secure, once production starts, and it should guarantee the state a minimum return for the exploitation of the resources, if the activity does not yield a profit.

3. A special hydrocarbon tax is imposed on profits deriving from the exploitation of hydrocarbon resources. If, all going well, oil or gas are found in workable quantities, the profits from this kind of production could be extremely high. In Norway a special 50% hydrocarbon tax is applied on top of the regular corporate tax imposed on these companies. If successful, it can be assumed that the Icelandic state's revenue will primarily come in the form of income tax and the special hydrocarbon tax.

There is no guarantee that gas or oil will be found in the area. The issuance of licences is articulated in four phases and each phase can last for up to three years. The outcome of each phase is a determinant factor in the extension of the licence. If explorations yield positive results and developments follow the general pattern, one can expect production to begin in about 12 years time.

Feasibility study on laying a submarine cable to Europe

Over the past years, Landsvirkjun has been exploring the possibility of connecting Iceland's electrical network to mainland Europe via a submarine cable. A project of this kind is now considered to be technically possible and the first indicators are that it would be financially viable for Iceland. For this reason, the government has set up an advisory group to examine all of the prerequisites for the laying of a submarine cable to Europe. The tasks, which the group has been entrusted with, include analysing the social and macroeconomic impact of laying a submarine cable, as well as the technical aspects of transporting energy from Iceland to Europe, and examining the legal framework and intrastate agreements. It is believed that a project of this kind could lead to gaining access to higher energy prices and result in a rise in the energy output of energy companies, but there is also a need to investigate what impact this project would have on energy prices to households. Furthermore, the community's attitude to a major project of this kind also needs to be researched, since there has to be broad social consensus before any final decisions on this issue are made. The committee is expected to submit its conclusions in May 2013. If the project goes ahead, the construction phase is expected to last until 2020.

Green project investments

In 2011, the government decided to support campaigns in 2012 aimed at stimulating eco-friendly investments. This funding was aimed at identifying promising areas to invest in for the promotion of eco-friendly activities in Iceland. In 2012, this amount was used for mapping, conducting feasibility studies and mounting potential marketing activities in the fields of tourism, biotechnology, carbon fibre processing and data centres. Since then the government has approved further funding for projects in 2013. Green project investments form part of the plan of action for the strengthening of the green economy, which was approved by Althingi in 2011, pursuant to Parliamentary Resolution no. 18/138. Following this approval, a cross-party parliamentary committee was appointed to work on a report to be submitted to Althingi. The report proposed 48 measures, for which the ministries are responsible, and a working group, which was set up to follow up on these measures, is currently at work. The measures include the implementation of eco-friendly public procurement, tax incentives and the development of green funds.

Financial market

In March 2012, the government presented a report on the future structure of the Icelandic financial system and its official supervision.[16] The report did not contain any tightly modelled proposals but

[16] http://www.ministryoffinance.is/media/skjal/Framework_for_Financial_Stability_in_Iceland.pdf

rather discussed the fundamental issues and opinions in this field, also in relation to global developments. As a follow-up to the publication of the report, a working group of experts was appointed, with the participation of foreign specialists, in order to draft recommendations for a harmonised and comprehensive legal and regulatory framework for all activities in the Icelandic financial market. In October 2012, the group experts delivered its recommendations to the government, which can be found in the *Framework for Financial Stability in Iceland* report. The recommendations of the working group include, among other things, a wide range of ways of addressing structural problems of concentration, complexity, lax competition and distorted incentives in the Icelandic financial system. Among other things, it recommends making all financial undertakings subject to a common core set of rules for comparable activities. It also recommends that it should be possible to distinguish the most critical operational functions, such as investment banking and commercial banking separable in resolution, and consider requiring legal separation of certain particularly risky financial activities from deposit-taking operations of banks, if such activities amount to a significant share of a bank's business. It recommends using regulatory powers and control rights that arise from public ownership to, for example, require variable compensation (bonuses) of key staff and management to be paid in the form of non-voting equity or non-negotiable junior subordinated instruments. The government has already appointed two committees to work on the implementation of the recommendations of the group of experts and the aim is to submit two bills to the current parliament; one regarding the separation of investment and commercial banking activities from resolution procedures, and the other concerning the establishment of a special Financial Stability Council.

4.2.2 Labour market

Unemployment

The number of people of a working age is expected to increase over the coming years, according to Statistics Iceland's population forecast, i.e. by 0.8 percent a year. To keep up with this demographic trend, the number of jobs will therefore have to increase by around 1,400 per annum over the next years, and by more than this number, if unemployment is to be reduced, assuming the activity rate remains at a similar level to what it has been. Surveys conducted among businesses to gauge labour force demand indicate that the number of jobs will increase in 2013, albeit slightly.

In 2012, over 8,000 people participated in various schemes in addition to receiving unemployment benefit. A special emphasis was placed on on-the-job training for the unemployed through the special *Vinnandi vegur (Path to Work)* campaign. The campaign focused on facilitating the return of the long-term unemployed into the labour market, and close to 1,500 people were given on-the-job training in various municipalities, companies and institutions in the spring of 2012. A third of the training offered was for a period of six months, while the other two thirds of the training lasted for up to 12 months.

A thousand individuals, who had been unemployed for long periods, were invited to participate in a special education campaign in the winter of 2011-2012. They were given the opportunity to complete a full course, in addition to receiving unemployment benefit in the autumn of 2011, but were then removed from the unemployed registry in the spring of 2012 and then received support from the Icelandic Student Loan Fund or some other special grant funds. Over 700 people completed their course and continued their studies or eventually re-entered the labour market. The project was extended in the autumn of 2012, when 300 people took a course under the same conditions that had applied in the previous year, with the objective of reaching the target figure of a total of 1,000 participants in the project.

At the end of 2012 and beginning of 2013, the Unemployment Insurance Act was amended to abolish the exemption clause regarding the 4-year benefit period, which means that job seekers are now only entitled to unemployment benefit for a period of up to three years. This meant that 1,400 people, who had exceeded the three year limit for unemployment benefit, were immediately removed from the unemployment registry, and an average of 130 people per month are expected to have exceeded their benefit right periods in 2013. Special measures were taken to assist these individuals through an on-the-job training scheme similar to the one that had been launched in the spring of 2012, in collaboration with municipalities, companies and state institutions. Individuals with no unemployment benefit are therefore offered on-the-job training contracts, which are paid out of the Unemployment Insurance Fund, under the same rules that apply to those who receive unemployment benefit. Furthermore, part of this group are paid grants, equivalent to several month's of unemployment benefit, for the period in which they are searching for the on-the-job training that is suited to their abilities. The purpose of these measures is to systematically assist individuals in their search for jobs and curb long-term unemployment, as well as to reduce the likelihood of individuals, who are no longer entitled to unemployment benefit, having to turn to municipalities for financial support.

Social security reform

The social security system in Iceland is currently undergoing extensive reform. A description of the current structure of the social security system may be found in Iceland's answers to the 'Questionnaire Information' requested for the preparation of the Opinion on the application of Iceland for membership of the European Union, especially in chapters 2 and 19 and in the screening reports pertaining to the same chapters. The reform of the social security system is intended to bring Iceland closer to achieving its goals of decreasing the number of individuals in or at risk of poverty or social exclusion. It is also intended to bring Iceland closer to achieving its goals of reducing the percentage of individuals classified as being disabled, aged between 18-66, from 6.9 percent of the population to 5.7 percent by 2020 as well as to achieve greater equality by lowering the *Gini* coefficient for disposable income to around 23 by 2020, in conformity with the objectives presented in *Iceland 2020*.

To reach the aforementioned objectives, *Iceland 2020* states that a plan to increase equality and active citizen participation must be drafted. Furthermore, it provides that children must be ensured a good and secure environment in which to grow up in, that the entire social compensation and disability pension system needs to be revised and refocused on individual ability and that the growing trend in the number of individuals on disability pensions needs to be reversed. Moreover, it states that the earnings of the lowest income groups in the community must be systematically guaranteed, that equality must increase, that long-term poverty must be eradicated and that those who are unable to play an active role in society due to illness, disability, age or social circumstances must be provided with the appropriate services and assistance that will enable these individuals to help themselves. The following measures have been taken to reach the aforementioned objectives.

In February 2010, the Minister of Finance established a committee comprising representatives from the Ministry of Finance, Ministry of Welfare, trade unions and other stakeholders to discuss and submit proposals for a long-term policy on the Icelandic pension scheme, the interplay between the two pillars on which the Icelandic social security system is based, i. e. the universal scheme and the employment-related scheme, as well as the equalization of the pension rights of individuals on the labour market. Emphasis shall be placed on ensuring the future sustainability of the pension schemes. The committee's work is ongoing.

In 2007, the Minister of Welfare established a working group of experts to examine and report on the Icelandic social security system as a whole. Subsequent to the release of the working group's report in October 2009, the Minister of Welfare appointed a committee in April 2011 comprising representatives of political parties, trade unions, employers and organizations of elderly and of disabled persons to make proposals for social security reform. The submission of the committee's proposals on the comprehensive simplification of the Icelandic social security system marked the completion of the first stage of this project in June of 2012. Next, the committee will turn its attention to the social security system's invalidity benefits. In the assessment of the disability and incapacity level of the applicants for benefits, emphasis will be placed on the ability, rather than the disability, with the aim of promoting general and vocational rehabilitation and encouraging the individuals to participate in the labour market in accordance with their vocational abilities.

A legislative proposal based on the aforementioned committee's proposals has been drafted and is expected to be presented to Parliament in 2013. It entails a comprehensive review of the Social Security Act, no. 100/2007, and Social Assistance Act no. 99/2007, and is intended, inter alia, to make the social security benefits scheme more transparent and accessible to the public, to simplify and to reduce income testing of social security benefits against income from other sources in order to increase the overall income of the benefit recipients and stimulate participation of the benefit recipients in the labour market while strengthening the foundations of the mandatory pension funds.

With regard to the elderly, the bill provides for the simplification of the old-age pension benefits scheme through the consolidation of pension categories, the abolition of income thresholds and by ensuring that the same rules apply when calculating the amount of the benefits without regard to the type of income from other sources. In general, these changes are expected to provide old-age pensioners with increased pension rights. With regard to the disabled, the bill proposes, among other things, that changes be made in respect of the rehabilitation allowance.

Finally, it should be noted that in June 2012, Icelandic Parliament passed Act no. 60/2012, on Vocational Rehabilitation and the Operation of Vocational Rehabilitation Funds. The Act provides that special vocational rehabilitation funds are made responsible for the vocational rehabilitation of individuals who have been forced to leave the labour market due to loss of health but wish to return as soon as possible. According to the Act, the vocational ability of such individuals is to be assessed and solutions subsequently chosen in light of that ability.

4.2.3 Administrative reform

In September 2012 the final step in the reduction of ministries from twelve to eight took place. The Ministry of Fisheries and Agriculture merged with the Ministry of Industry along with part of the

Ministry of Economic Affairs into a new Ministry of Industries and Innovation. The Ministry of Environment was changed into the Ministry for the Environment and Natural Resources as some tasks of the Ministry of Fisheries and Agriculture and the Ministry of Industry were transferred to it. Finally the Ministry of Economic Affairs was abolished and the remaining tasks were merged with the Ministry of Finance in the new Ministry of Finance and Economic Affairs. These changes were according to the current government's coalition platform. The main objective is to enhance administrative capacity in the centre of government and build strong and well functioning administrative units that work well together.

To further facilitate these changes, a new law on central administration (the Ministries) was passed in 2011, which aims to make the administration more flexible, transparent and accountable, while facilitating cooperation.

4.2.4 Additional reform areas

Restructuring of companies in the aftermath of the banking and currency crisis

In the wake of the crash, the financial restructuring of companies was primarily conducted through agreements between creditors and debtors, without the intervention of the government. The government ensured there was a certain harmonisation and supervision in the restructuring process, according to specific objectives, pursuant to Act no. 107/2009. In this context, it is worth mentioning the supervisory committee that was appointed for this purpose and started work in 2009. As stated in its 2012 report, the Icelandic Competition Authority believes this is a more desirable option for competition than any government intervention in the form of takeovers of assets and liabilities. In its conclusions, the supervisory committee states that the legal provisions and rules were observed in the financial restructuring of small and medium enterprises (SMEs) in the financial sector between October 2009 and June 2012.

Number of companies and their future

In September 2009, the total loan portfolio showed that 57 percent of the companies that were in borrowing agreements with financial undertakings were not considered to require any debt adjustment assistance, i.e. their positions was acceptable, whereas 43 percent of the companies needed some form of remediation. The remediation could be in the form of financial restructuring, including a reduction of the principal of their loans, loan extensions, debt settlements etc. Looking at companies with total loan facilities of over ISK 10 m. from specific banks, only 39 percent of the companies did not need restructuring, as can be seen in the following table.

Table 4: Companies in borrowing agreements with financial undertakings

Processing of corporate debt, June 2012	Total loans	%	Over 10m.	%
Number of companies	26,035	100.0	9,922	100.0
No need for restructuring	14,98	57.5	3,896	39.3
Cases requiring remedies	11,055	42.5	6,026	60.7
• Milder remedies	4,492	40.6	2,285	37.9
• Bankruptcy request from financial undertaking	361	3.3	327	5.4
• Failed seizure of property	3,059		1,387	23.0
• Bankruptcy request from third party		27.7		
• Financial restructuring	648		517	
• Approved		5.9		8.6
• In collection/processing	2,495	22.6	1,51	25.1
Cases of more than ISK 1 bn.	318		318	

At the end of the second quarter of 2012, financial undertakings had approved the financial restructuring of 648 SMEs. The write-offs linked to their cases therefore form a small part of total corporate write-offs. Most of the write-offs the financial undertakings granted to companies are due to the recalculation of exchange rate-linked loans, insolvencies, legal composition agreements and cases of more than ISK 1 bn. The court rulings on exchange rate-linked loans, which have been issued over the past few years, have gradually settled the disputes on the recalculation of loans, but there has been no ruling, on the other hand, on how the recalculation of loans in default is to be made. There is also some dispute on the issue of agreements that were paid off before the court issued its ruling on their illegality and the recalculation of loans. However, a certain percentage of the companies, which are considered to require restructuring, have decided not to negotiate with the financial undertakings until the legal status of exchange rate-linked loans and recalculations has been established. On the other hand, all of the financial undertakings have declared that companies will enjoy better rights, in accordance with the court rulings and/or legislation, and that no-one forfeits their rights by working with their commercial banks to re-organize their finances into a more viable state. The supervisory committee therefore sees nothing to prevent companies from making agreements with financial undertakings and it is hoped that this will be done in the coming months.

In addition to the supervision ensured by the aforementioned committee, the Competition Authority has the task of supervising mergers and takeovers, such as in cases where banks take over companies because of their difficult debt positions in the aftermath of the crash. The Competition Authority has endeavoured to ensure that the banks' actual control of the companies is above board and it has set conditions to ensure that natural rates of return are expected from the companies on the basis of theoretical financial models. This is done to reduce the risk of banks financing costly marketing campaigns, which would enable the overtaken companies to conquer a bigger share of the relevant market and even wipe out the competition. In other words, these terms are an endeavour to prevent the banks from being tempted to maximise the value of companies through the oligopolistic position and profits they would expect to achieve, by setting temporary profitability considerations aside and being guided by the long-term objectives of oligopoly.

The Competition Authority has pointed out to the government the need to set up an efficient and robust enterprise register to bring greater discipline into economic activities, such as in the case of takeovers. The government has taken measures in this regard and Statistics Iceland is currently working on reforming its corporate statistics. Once this is completed, it will be possible to, among other things, follow the development of companies, as well as their lifespan and holdings. Furthermore, the Minister of Industry and Innovation has appointed a committee, which has been entrusted with the task of reviewing the legal framework for the registration of enterprises and ensuring that the remedies for their dissolution facilitate the dissolution of inactive companies and sanctions against companies, which do not respect their legal obligations regarding the submission of annual accounts and the implementation of the Act on Public Limited Companies. Moreover, the minister has established a working group to discuss the ministry's need for economic reports on the Icelandic economy and the statistical standards that need to be met in light of Iceland's international obligations with regard to the compilation of economic reports.

Fishing fees

The new Fishing Fee Act no. 74/2012 was passed by parliament in 2012 and provides for a *special* fishing fee on top of the *general* fishing fee. Moreover, the act provides for an increase in the *general* fishing fee. The purpose of the fishing fee is to meet the government's costs in the research, management, monitoring and supervision of fishing and fish processing in order to guarantee the nation as a whole some share in the returns which the exploitation of marine resources generates. The Minister of Industry and Innovation has appointed a three-member committee, which is entrusted with the task of determining the *special* fishing fee. The committee is independent in its work and its duties are specified in the act. The committee shall foster broad collaboration with, among others, specialists and professionals in the areas of fishing and fish processing, as well as ensure its statutory consultation with the parliamentary committee. In accordance with the new act, the fishing fees were applied for the first time in September 2012 for the fishing year 2012/2013. The increase in fishing fees is expected to yield the Treasury up to ISK 13 bn. over the coming year. Fishing fees provide some of the stock revenue for the government's investment strategy.

The fishing fees will lead to lower net profits for the fishing companies, although the value added, including fishing fees revenue, of the fishing sector should not necessarily be affected. The long-term effects on investment in the fishing industry are complex. The fishing fees, in particular the *general* fee, will probably lead to the elimination of the least profitable fishing firms, thus reducing the fleet and the total need for capital. The *special* fishing fee is dependent on the creation of substantial resource rent in the fishing industry and leaves high returns on capital in the companies. As long as this return is higher than the return in other industries, this should not reduce investment in fishing below what is economically reasonable. On the other hand, the fishing fees could hamper over-investment caused by very high profitability and rent-seeking behaviour. A substantial part of the investment in the fishing sector has been the acquisition of fishing rights (quotas). The introduction of the fishing fees should lead to a reduction in the prices of quotas. This should reduce the need for financing capital to that end and enhance investment in operating capital.

Annex: Statistical Appendix

Annex Table 1: Macroeconomic prospects

Percentages unless otherwise indicated	ESA Code	Year 2011	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
		Level (bn EUR)	Rate of change				
1. Real GDP at market prices	B1*g	5.392	2.6	2.7	2.5	2.9	2.7
2. GDP at market prices	B1*g	10.075	5.8	6.8	6.8	6.4	5.8
Components of real GDP							
3. Private consumption expenditure	P3	2.772	2.7	3.5	2.5	3.1	3.0
4. Government consumption expenditure	P3	1.253	-0.9	-0.3	0.3	0.1	0.7
5. Gross fixed capital formation	P51	0.668	12.8	10.3	4.3	19.7	0.6
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+ P53	0.078	31.3	-20.3	-6.5	-27.4	10.9
7. Exports of goods and services	P6	2.528	4.1	5.0	3.0	2.8	4.2
8. Imports of goods and services	P7	1.906	6.8	6.7	2.2	6.7	3.1
Contribution to real GDP growth							
9. Final domestic demand		4.7	2.6	3.0	1.9	4.3	1.8
10. Change in inventories and net acquisition of valuables	P52+P53	0.1	0.4	-0.3	-0.1	-0.3	0.1
11. External balance of goods/services	B11	0.6	-0.4	0.0	0.6	-1.1	0.8

Real GDP is calculated at year 2000 constant prices

Annex Table 2: Price developments

Percentage changes. annual averages	ESA Code	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
1. GDP deflator		3.2	4.0	4.2	3.4	3.0
2. Private consumption deflator		4.1	5.8	4.0	2.9	2.6
3. HICP		4.2	6.1	-	-	-
4. National CPI change		4.0	5.3	4.1	3.1	2.6
5. Public consumption deflator		4.0	5.4	3.9	3.1	2.7
6. Investment deflator		2.6	3.9	6.1	3.7	3.0
7. Export price deflator (goods & services)		7.1	1.4	3.0	4.3	3.4
8. Import price deflator (goods & services)		8.9	3.5	3.1	3.9	2.9

Annex Table 3: Labour market developments

	ESA Code	Year 2011	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
		Level	Level/Rate of change				
1. Population (thousands)		-	319.0	320.8	323.5	326.5	329.7
2. Population (growth rate in %)		-	0.32	0.57	0.84	0.92	0.98
3. Working-age population (persons) [1]		-	223.7	223.7	225.9	227.6	229.4
4. Activity rate		-	80.5	80.5	80.7	80.9	81.1
5. Employment, persons [2]		-	167.4	169.3	172.6	175.0	177.8
6. Employment, hours worked [3]		-	39.5	40.0	-	-	-
7. Employment (growth rate in %)		-	0.0	1.1	2.0	1.4	1.6
8. Public sector employment (persons)		-	36.5	-	-	-	-
9. Public sector employment (growth in %)		-	-1.4	-	-	-	-
10. Unemployment rate [5]		-	7.1	6.0	5.3	4.9	4.4
11. Labour productivity, persons [6]		5,840.4	-2.9	0.7	0.5	1.2	1.9
12. Labour productivity, hours worked [7]		-	-	-	-	-	-
13. Compensation of employees	D1	827.9	3.5	8.6	8.5	6.2	6.1

[1] Age group of 16-74 years
[2] Occupied population, domestic concept national accounts definition

[3] Average hours per week.

[4] Harmonised definition, Eurostat; levels

[5] Real GDP per person employed

[6] Real GDP per hour worked

Annex Table 4: Sectoral balances

Percentages of GDP	ESA code	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-6.2	-7.5	-3.4	-5.0	-8.4
of which:						
- Balance of goods and services		8.5	6.6	7.0	5.2	6.2
- Balance of primary incomes and transfers		-1.0	-	-	-	-
- Capital account		-13.7	-	-	-	-
2. Net lending/borrowing of the private sector	B.9/ EDP B.9	-4.5	-7.2	-4.4	-7.0	-8.4
3. Net lending/borrowing of general government		-1.7	-0.3	1.1	2.0	0.0
4. Statistical discrepancy		0.0	0.0	0.0	0.0	0.0

Annex Table 5: GDP, investment and gross value added

	ESA Code	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
GDP and investment						
GDP *level* at *current* market prices (in domestic currency)	B1g	1,626.3	1,736.6	1,854.3	1,973.7	2,088.2
Investment ratio (% of GDP)		14.0	15.0	15.5	18.1	17.8
Growth of Gross Value Added. percentage changes at constant prices						
1. Agriculture		-	-	-	-	-
2. Industry (excluding construction)		-	-	-	-	-
3. Construction		-	-	-	-	-
4. Services		-	-	-	-	-

Annex Table 6: External sector developments

Billion EUR unless otherwise indicated		Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
1. Current account balance (% of GDP)	% of GDP	-6.2	-7.5	-3.4	-5þ0	-8.4
2. Export of goods		3.842	4.081	4.263	4.516	4.863
3. Import of goods		3.240	3.604	3.765	4.143	4.422
4. Trade balance		0.602	0.477	0.498	0.373	0.441
5. Export of services		2.135	2.312	2.526	2.738	2.940
6. Import of services		1.876	2.072	2.220	2.469	2.585
7. Service balance		0.258	0.240	0.306	0.269	0.355
8. Net interest payments from abroad		-1.379	-	-	-	-
9. Other net factor income from abroad		-0.052	-	-	-	-
10. Current transfers		-0.053	-	-	-	-
***11. Of which* from EU**		-	-	-	-	-
12. Current account balance		-0.623	-0.806	-0.389	-0.612	-1.085
13. Capital and financial account		0.485	-	-	-	-
14. Foreign direct investment		9.621	10.243	-	-	-
15. Foreign reserves		6.488	3.313	-	-	-
16. Foreign debt		84.265	81.783	-	-	-
***17. Of which*: public**		4.099	3.929	-	-	-
***18. O/w:* foreign currency denominated**		0.000	0.000	-	-	-
***19.O/w:* repayments due**		50.290	53.076	-	-	-
20. Exchange rate vis-à-vis EUR (end-year)	NCU/EUR	158.84	169.80	160.49	163.01	158.18
21. Exchange rate vis-à-vis EUR (annual average)	NCU/EUR	161.42	160.73	160.61	161.19	161.44
22. Net foreign saving	% of GDP	-	-	-	-	-
23. Domestic private saving	% of GDP	-	-	-	-	-
24. Domestic private investment	% of GDP	-	-	-	-	-
25. Domestic public saving	% of GDP	-	-	-	-	-
26. Domestic public investment	% of GDP	2.1	1.8	1.9	1.9	2.0

Annex Table 7: General government budgetary prospects

	ESA code	Year 2011	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
		Level	% of GDP				
Net lending (B9) by sub-sectors							
1. General government	S13	-88.478	-5.4	-1.7	-0.3	1.1	2.0
2. Central government	S1311	-92.557	-5.7	-1.7	-0.2	0.9	1.8
3. State government	S1312	-	-	-	-	-	-
4. Local government	S1313	-2.149	-0.1	0.0	-0.1	0.2	0.2

5. Social security funds	S1314	6.229	0.4	-	-	-	-
		General government (S13)					
6. Total revenue	TR	680.865	41.9	43.5	44.1	43.8	44.0
7. Total expenditure	TE	769.343	47.3	45.1	44.4	42.8	42.0
8. Net borrowing/lending	EDP.B9	-88.478	-5.4	-1.7	-0.3	1.1	2.0
9. Interest expenditure	EDP.D41 incl. FISIM	83.508	5.1	4.9	5.0	4.8	4.9
10. Primary balance		-28.737	-1.8	1.7	3.3	4.2	5.2
11. One-off and other temporary measures		-	-	-	-	-	-
		Components of revenues					
12. Total taxes (12 = 12a+12b+12c)		517.687	31.8	-	-	-	-
12a. Taxes on production and imports	D2	245.143	15.1	-	-	-	-
12b. Current taxes on income and wealth	D5	255.772	15.7	-	-	-	-
12c. Capital taxes	D91	16.772	1.0	-	-	-	-
13. Social contributions	D61	66.820	4.1	-	-	-	-
14. Property income	D4	33.143	2.0	-	-	-	-
15. Other (15 = 16-(12+13+14))		63.215	3.9	-	-	-	-
16 = 6. Total revenue	TR	680.865	41.9	43.5	44.1	43.8	44.0
p.m.: Tax burden (D2+D5+D61+D91-D995)		584.507	35,9	-	-	-	-

	ESA code	Year 2010	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
		Level	**% of GDP**				
		Selected components of expenditures					
16. Collective consumption	P32	411.231	25.3	24.9	24.3	23.6	23.0
17. Total social transfers	D62 + D63	138.759	8.5	-	-	-	-
17a. Social transfers in kind	P31 = D63	0.000	0.0	-	-	-	-
17b. Social transfers other than in kind	D62	0.000	0.0	-	-	-	-
18 = 9. Interest expenditure (incl. FISIM)	EDP.D41 + FISIM	83.508	5.1	4.9	5.0	4.8	4.9
19. Subsidies	D3	28.179	1.7	-	-	-	-
20. Gross fixed capital formation	P51	29.520	1.8	1.8	1.8	1.8	1.9
21. Other (21 = 22-(16+17+18+19+20)		78.147	4.8	13.5	13.2	12.6	12.3
22. Total expenditures	TE	769.343	47.3	45.1	44.4	42.8	42.0
p.m. compensation of employees	D1	236.106	14.5	-	-	-	-

Annex Table 8: General government expenditure by function

Percentages of GDP	COFOG Code	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
1. General public services	1	8.4	-	-	-	-
2. Defence	2	0.0	-	-	-	-
3. Public order and safety	3	1.4	-	-	-	-
4. Economic affairs	4	5.7	-	-	-	-
5. Environmental protection	5	0.6	-	-	-	-
6. Housing and community amenities	6	0.3	-	-	-	-
7. Health	7	7.6	-	-	-	-
8. Recreation. culture and religion	8	3.5	-	-	-	-
9. Education	9	7.9	-	-	-	-
10. Social protection	10	11.7	-	-	-	-
11. Total expenditure (item 7 = 22 in Table 2)	TE	47.3	45.1	44.4	42.8	42.0

Annex Table 9: General government debt developments

Percentages of GDP	ESA code	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
1. Gross debt		101.0	96.2	91.4	86.4	80.9
2. Change in gross debt ratio		8.1	-4.9	-4.7	-5.0	-5.5
Contributions to change in gross debt						
3. Primary balance		1.8	-1.7	-3.3	-4.2	-5.2
4. Interest expenditure (incl. FISIM		5.1	4.9	5.0	4.8	4.9
5. Stock-flow adjustment		1.2	-8.0	-6.4	-5.6	-5.2
of which:						
- Differences between cash and accruals		-	-	-	-	-
- Net accumulation of financial assets		-	-	-	-	-
of which:						
- Privatisation proceeds		-	-	-	-	-
- Valuation effects and other		-	-	-	-	-
p.m. implicit interest rate on debt		5.8	5.2	5.6	5.6	5.9
Other relevant variables						
6. Liquid financial assets		-	-	-	-	-
7. Net financial debt (7 = 1 - 6)		-	-	-	-	-

Annex Table 10: Cyclical developments

Percentages of GDP	ESA Code	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
1. Real GDP growth (%)	B1g	2.6	2.7	2.5	2.9	2.7
2. Net lending of general government	EDP.B.9	-5.4	-1.7	-0.3	1.1	2.0
3. Interest expenditure	EDP.D.41	5.1	4.9	5.0	4.8	4.9
4. One-off and other temporary measures		-	-	-	-	-
5. Potential GDP growth (%)		-	-	-	-	-
Contributions:						
- labour		-	-	-	-	-
- capital		-	-	-	-	-
- total factor productivity		-	-	-	-	-
6. Output gap (in % of potential output)		-	-	-	-	-
7. Cyclical budgetary component		-	-	-	-	-
8. Cyclically-adjusted balance (2-7)		-5.4	-1.7	-0.3	1.1	2.0
9. Cyclically-adjusted primary balance (8+3)		-0.3	3.2	4.7	5.9	6.8
10. Structural balance (8-4)		-5.4	-1.7	-0.3	1.1	2.0

Annex Table 11: Divergence from previous programme

	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
1. GDP growth (% points)					
Previous update	2.6	2.4	2.5	2.8	-
Latest update	2.6	2.7	2.5	2.9	2.7
Difference	0.0	0.3	0.0	0.1	-
2. General government net lending (% of GDP)					
Previous update	-3.4	-1.4	0.0	1.2	-
Latest update	-5.4	-1.7	-0.3	1.1	2.0
Difference	-2.0	-0.3	-0.3	-0.1	-
3. General government gross debt (% of GDP)					
Previous update	98.4	93.2	89.4	84.8	-
Latest update	101.0	96.2	91.4	86.4	80.9
Difference	2.6	3.0	2.0	1.6	-