Iceland was the object lesson of the economic crisis, brought to ruin through regulatory mismanagement, wilful ignorance, aggressive lending and a huge currency bet. It had already begun to unravel before U.S. investment bank Lehman Brothers crashed in September 2008, causing turmoil through global markets and bring Iceland's financial system down.

Its three main banks, Glitnir, Landsbanki and Kaupthing, all collapsed. Landsbanki had big retail operations abroad, accepting deposits particularly in Britain and the Netherlands under the brand name "Icesave". When it failed, Iceland's banking insurance scheme was unable to cover those deposits, setting the stage for years of international litigation.

Back home, residents still have trouble understanding how a tiny island country of glacier-topped volcanoes, which survived for centuries mainly on fishing, came to grow a gargantuan financial industry whose collapse its taxpayers could never have afforded to bear.

"It was not growth, it was cancer. It was ridiculous and it was using the naivety of the Icelandic public," 52-year-old Thorhallur Vilhjalmsson, now a cafe owner in Reykjavik, said of the boom before the crisis.

Iceland turned to banking at the start of the 21st century, modeling itself on "Celtic Tiger" Ireland as a low-tax island economy that could serve as a base for offshore investment and finance.

In 2008, Vilhjalmsson was working in marketing for the Harpa concert hall - a mammoth project owned by Landsbanki that became a half-finished symbol of what he called "hocus pocus" money when the bank and its project collapsed.

The giant hall, billed as Europe's biggest glass structure, now towers over Reykjavik's harbor, a symbol of the excesses of its era at odds with the low rise capital, where even the prime minister's residence is a modest two-storey Nordic villa. The state finally completed the gleaming concert hall in 2011, but a surrounding hotel, luxury apartment complex, restaurants and new Landsbanki headquarters were never built.

Since the crash, Iceland has been on a slow path to recovery. Unlike in countries in the euro zone that hit trouble and could not devalue their currencies, a fall in the crown helped restore Iceland's competitiveness. Despite the capital controls, foreign businesses were allowed to repatriate profits, tempting them to stay.

Iceland's GDP exceeded pre-crisis levels for the first time last year - in crowns if not dollars. Unemployment is less than 5 percent, inflation is below a 2.5 percent target and state finances reached a surplus last year - signs that the time to relax capital controls has arrived.

That means allowing investors with assets in crowns to sell them for hard currency and take their money abroad. But to avoid a new run on the crown, the central bank needs to act carefully.

Officials say they will deal separately with three categories of investors: creditors of the estates of the three failed banks, other foreign investors with assets trapped in Iceland and domestic savers looking to invest abroad.

First up will be the creditors of the failed banks, mostly hedge funds that bought obligations on the secondary market. Iceland wants to avoid a long legal fight, but officials say ultimately rules will be imposed and not negotiated, noting it is private debt, not sovereign.

To keep all the funds released in the settlement from leaving the country at once, Iceland is considering an exit tax, or "stabilization tax", officials said.

They hope to make an announcement on the estates of the banks within weeks, or at least before the end of May when the world's oldest parliament, which would have to approve the deal, breaks for recess.

A separate deal will be offered to foreign investors whose capital has been stuck in Iceland since controls were imposed in 2008. Foreign capital has leaked out over the years via currency auctions, partly in exchange for long-term investment into Iceland, and now amounts to 15 percent of GDP, or around $2.2 billion, from 40 percent five years ago.

Investors may be offered various schemes to keep their capital in Iceland, with "an option for currency, an option for different bonds in different currencies with different maturity dates", Finance Minister Bjarni Benediktsson told Reuters.

Officials said it was too early to say if they would also be offered physical assets, such as Iceland's giant geothermal industry. The government says privatization is not on the table.

Those who want to withdraw immediately would have to sell their crowns at a discount through the central bank's foreign currency auctions. The bank said it had not yet ascertained which proportion of the $2.2 billion would exit early.

Finally, domestic institutions will be permitted to invest abroad. While this comes last on the list, officials say it is important to allow institutions and the state's own big pension fund to diversify away from Icelandic assets.

With a series of announcements due by the end of the year, officials have painted a picture of the kind of outcome they would like, but are wary of committing themselves to details.

"We're going to have a flexible exchange rate but it doesn't mean it will be a free-floating exchange rate," said Gudmundsson, the central banker. Tools such as intervention on the foreign exchange market and limits on foreign currency borrowing would be used to control capital flows.

"We're basically going to restrict our banks to being domestically-orientated crown-based banks with limited international activities," he added.

Ratings agencies could upgrade Iceland's sovereign rating if capital controls are removed in an orderly way. A rise of two or three notches would give it a similar rating to Ireland and lower borrowing costs for banks and companies.

Arion Bank, the new bank to emerge from Kaupthing, issued a 10-year 300 million eurobond recently with 3.25 percent interest, compared to a Bank of Ireland (BKIR.I) bond paying a third of that interest.

Away from banks' boardrooms and ministers' meeting rooms, distrust of the government remains and a culture of protest has grown. The collapse was so sudden, so shocking and its impact felt so widely that many still feel betrayed.

The suspicion is reflected in the sudden rise of the Pirate Party, now the most popular political force in Iceland espousing roots-level democracy and transparency.

Cafe owner Vilhjalmsson said he had no faith that the authorities would manage Iceland's financial rehabilitation any better than they managed its catastrophic boom.

"I have no trust in those people or the forces behind them. They are demagogues and are, in my opinion, the corrupted."