Box VII-1

Increased stocks of foreign assets and liabilities heighten volatility in net investment income

Only a few years ago merchandise trade was the dominating factor in Iceland's current account. In recent years the importance of the income account in the balance of payments has grown substantially. Income receipts and expenditure have grown exponentially as a result of extensive investment abroad by Icelandic residents. Both foreign and domestic investment has largely been financed by foreign borrowing. The income account comprises dividends and reinvested earnings from direct and portfolio investment, in addition to interest generated from other investment. Compensation to foreign employees is also counted among expenditures and compensation to Icelanders abroad as receipts in the income account.

The international investment position is not influenced only by the extent of foreign investment and borrowing. In addition to annual flows resulting from investment and loans, there are two other main factors. First, the revaluation of assets and liabilities to reflect changes in the exchange rate and market value. A large stock of foreign liabilities leaves the economy more exposed to changes in the exchange rate of the króna. Second, returns on different asset categories in the portfolio of foreign assets and liabilities vary, for example with regard to risk. If the composition of foreign assets and foreign liabilities differs, a mismatch can result between their respective returns. In theory, the net income account can be heavily imbalanced as a result, even though the net investment position is close to zero. The methodology for valuation and revaluation varies depending of the type of foreign investment involved. The stock of foreign direct investment, for instance, is entered at book value while the annual flow of direct investment is recorded at market value.[1] Portfolio investment is recorded at market value at the time the transaction occurs. Thus the combination of different types of investments can greatly impact how accurately the data reflect the market value of individual components of the asset stocks.

A large proportion of foreign investment by residents is in equity

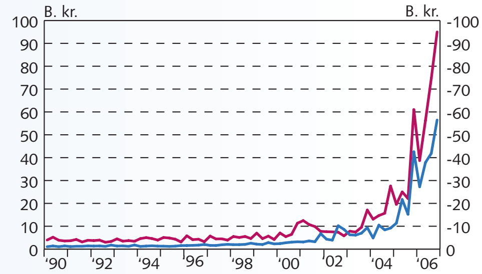
In 1995, the stock of foreign investment by Icelandic residents was equivalent to approximately 14½% of GDP. In 2006, only eleven years later, foreign assets had risen twenty-six-fold to 380% of GDP. The composition of foreign assets has also changed substantially over this period. In 1995, reserves and trade credit accounted for a significant portion of foreign assets but are now relatively unimportant. Instead, foreign lending now comprises 39% of foreign assets. The share of foreign equity (in portfolio investment) has also almost doubled to roughly a fifth of total foreign assets. Foreign direct investment was 928 b.kr. at the end of 2006, accounting for about 21%.

Table 1 Composition of foreign assets in 1995 and 2006

	Foreign direct investment	*Equity portfolio*	*Debt securities*	*Loans*	*Currency and deposits*	*Trade credit*	*Reserves*
1995	19%	11%	10%	0%	13%	12%	34%
2006	21%	20%	6%	39%	10%	0%	4%

1. In their methodologies, the OECD and IMF recommend recording foreign direct investment at market value, while at the same time they acknowledge the difficulties involving the evaluation of unlisted companies. Lack of reliable data has hitherto hindered most countries, including Iceland, from recording foreign direct investment at market value. For the sake of compatibility of data it is preferable that as many countries as possible agree on applying either market value or book value.

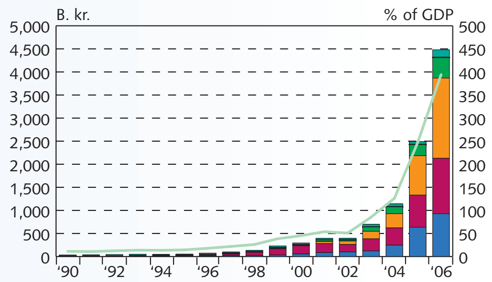
Chart 1
Income receipts and expenditures
Q1/1990-Q4/2006



Income receipts (left)
Income expenditures (right)

Source: Central Bank of Iceland.

Chart 2
Foreign assets
Annual data



Foreign direct investment (left)
Portfolio (left)
Loans (left)
Currency and deposits (left)
Other (left)
Reserves (left)
Foreign assets, % of GDP (right)

Source: Central Bank of Iceland.

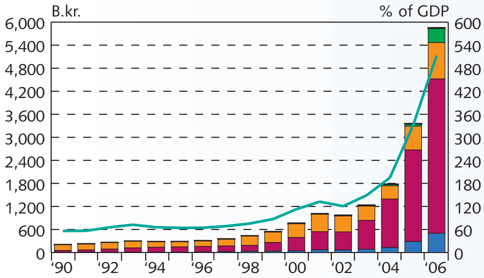
Table 2 Composition of foreign liabilities in 1995 and 2006

	Foreign direct investment	*Equity portfolio*	*Debt securities*	*Loans*	*Currency and deposits*	*Trade credit*	*Other*
1995	3%	0%	48%	46%	0%	2%	1%
2006	9%	6%	63%	16%	6%	0%	0%

The composition of foreign debt has also changed substantially in the past 11 years. However, unlike the portfolio of foreign assets, equity investment comprises only a relatively small proportion of foreign liabilities, at roughly 15%. The remaining 85% of the foreign liabilities are in interest-bearing categories.

The difference between the return on total foreign assets and liabilities in 2006 was -1.2%. However, the difference between individual categories was in some cases much greater. For instance, the return on inward foreign direct investment was 24.4%, but on outward foreign direct investment only 9.8%.

Chart 3
Foreign liabilities
Annual data 1990-2006



Source: Central Bank of Iceland.

Table 3 Average return on foreign assets and liabilities in 2006

	Yield on assets (%)	*Yield on liabilities (%)*	*Difference (%)*
Total	4.4	5.7	-1.2
Direct investment	9.8	24.4	-14.6
Equity capital	11.0	29.9	-18.9
Other capital	2.3	0.6	1.7
Portfolio investment	1.6	3.9	-2.3
Equity	1.2	1.2	0.0
Debt securities	3.5	4.2	-0.7
Other investment	3.7	3.9	-0.2

When comparing respective average returns on direct investment and portfolio investment, it is important to bear in mind that different methodologies are used to measure them. As a result, the average return on direct investment is generally higher than on portfolio equity investment. The most significant difference involves generally low dividend payments and the fact that no adjustment is made to capture changes in market value.[2]

A much smaller difference was seen between returns on inward and outward portfolio investment, at only about 2.3% in favour of inward investment. This difference is explained solely by higher interest rates on Icelandic securities, as the return on outward and inward portfolio equity was identical in 2006.

Over the past few years, re-invested earnings from inward foreign direct investment have increased enormously, while re-invested earnings from outward direct investment have shown much less growth.

2. Furthermore, re-invested earnings are not accounted for in equity portfolio investment.