Box 1

Definitions of key concepts

Foreign assets and liabilities are classified according to the nature and scale of the investment in accordance with International Monetary Fund standards (IMF 1993). This Box explains the main concepts and their context in calculations of IIP.

Marketable securities. Investment by residents[1] in foreign equities and by non-residents in Icelandic equities is classified as portfolio investment provided that it does not exceed 10%. Units in mutual funds and debt instruments (bonds and notes) are also classified as portfolio investment.

Direct investment. If an investor acquires an active holding (defined as 10% or more of the equity capital), this is classified as direct investment. Once a direct investment relationship is established between a resident and non-resident company, all capital transactions between them are classified as direct investment, including loan transactions between a parent company and its affiliates.

Financial derivatives are swaps, forwards and futures, and options. Financial derivatives are inherently balanced on the asset and liability side when contracted, but a spread might occur due to price changes on settlement.

Other investments include trade credits and loans, currency and deposits.

Reserve assets are defined as foreign assets of the Central Bank which are accessible for intervention in the FX market.

The stock of foreign direct investment (FDI) is entered at book value

1. Based on the domicile/residence of the investor.

while the annual FDI flow is recorded at transaction value.[2] A considerable discrepancy can occur between these two values when large shareholdings are acquired at a premium which the buyer decides to amortise on purchase. The investment is then entered in the balance sheet at the investor's book value rather than transaction value. Portfolio investments are entered at market value at the time of the transaction and the portfolio stock is stated at current market value.

Balance of payments
The balance of payments is divided into the capital and financial balance and the current balance.

Capital and financial account = direct investment + portfolio investment + other capital + foreign reserves
The capital and financial balance shows flows of foreign assets and liabilities classified into direct investment, portfolio investment, other investment and the Central Bank's foreign reserves.

Current account balance = merchandise account + services account + balance on income + transfers
The current account balance shows exports and imports of goods and services, together with income and transfers.

Balance on income = dividends on equity investment + reinvested earnings + accrued interest + compensation of employees
The balance on income comprises dividends and reinvested earnings from direct and portfolio investment, accrued interest on other investments and compensation paid to employees by employers in other countries. *Reinvested earnings* are total consolidated profit after dividends have been paid to shareholders and are defined as an additional investment in the case of companies in which the shareholding is classified as direct investment (i.e. more than 10%). Such an investment increases the company's equity capital. Likewise, an operating loss produces a negative return and depletes the equity capital. Dividend payments can also be so high that reinvested earnings are negative. A profit on a resident business owned by non-residents is entered as an expenditure in the balance on income. The sole purpose of the aggregation into dividends and reinvested earnings is to specify these expenditures. Current income and expenditures are therefore entered in the account irrespective of whether they take the form of a dividend payment or a reinvestment in the same company.

In the capital and financial account, securities investments are divided into equities and debt instruments. Investments in foreign equities for a shareholding of less than 10% are classified as portfolio investments. The return on such investments is captured in the balance of payments as dividend payments. Under the IMF methodology, an increase in the market value of such investments is not included, even if investors post such a rise in market value as income.

Income on debt instruments is accrued interest. For other investments, interest earned on loans to non-residents is also included in the balance on income. The only investment on which interest is not calculated is claims.

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