

Box 4

Iceland's external position in historical and international context

Iceland's international investment position (IIP) as measured according to international standards changed radically after the composition agreements of the failed financial institutions' estates were approved on the basis of fulfilled stability conditions late in 2015. As a result, there is no longer any need to calculate separately the underlying IIP, which looked through the settlement of the estates in order to obtain a more realistic view of the external position of the economy going forward.¹ This Box discusses the IIP in historical and international context. Examination reveals that Iceland's net IIP (NIIP), which was negative by 14½% of GDP at the end of 2015, is at its most favourable in about fifty years and is better than in many other developed countries.² Foreign direct investment (FDI), which is generally considered more reliable financing than debt, is larger as a share of gross external liabilities than it has been in decades.

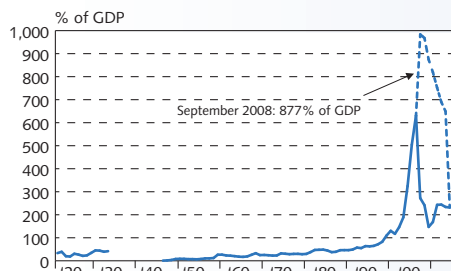
External liabilities rose steeply in the early 1930s ...

It is no coincidence that historical data on Iceland's external liabilities extend back to 1922.³ A year earlier, the Icelandic authorities had to take a loan from an English bank in the amount of 8% of GDP in order to resolve the severe banking and currency crisis that had persisted for some time. Afterwards, temporary restrictions on international trade were lifted, and the *de facto* depreciation of the króna against the Danish krone was acknowledged for the first time with a separate exchange rate listing (Einarsson *et al.*, 2015). Thereafter, Statistics Iceland was tasked with collecting information on Iceland's external liabilities, as it was clear to the authorities that, in view of experience, these matters must be monitored more closely (Gudmundsson, 1922). After the English loan was taken, Iceland's gross external liabilities amounted to about a third of GDP and then fell to about a fourth of GDP before the onset of the Great Depression (Chart 1). Then the authorities were faced once again with a severe banking and currency crisis (Einarsson *et al.*, 2015), and gross external liabilities rose to 45% of GDP in 1931.

... but was paid off during World War II before increasing again

Comprehensive information on developments in Iceland's external liabilities during the period from 1935-1946 is lacking, but it can be assumed that most of the liabilities was paid off during World War II, after strong GDP growth and lengthy restrictions on foreign exchange transactions and international trade led to the accumulation of a current account surplus (Chart 2). Substantial foreign liquidity was accumulated as well, but it was depleted in only two years after the close of the war. Gross external liabilities therefore rose again, to just over a fourth of GDP by 1960, following a period of brisk investment, an uninterrupted current account deficit dating back to the end of the war, and two large currency devaluations. Important steps towards more balanced trade and greater economic stability

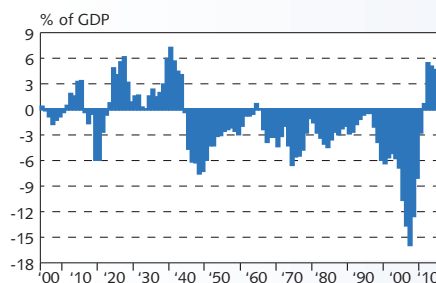
Chart 1
Iceland's gross external liabilities 1922-2015¹



1. Data for 1922-1994 are from the National Economic Institute; however, data for 1935-1946 are lacking. Data for 1995-2015 are from the Central Bank of Iceland and Statistics Iceland. The broken line shows gross external liabilities calculated according to international standards, including the liabilities of the failed financial institutions at full nominal value. The solid line indicates the Central Bank's estimate of Iceland's underlying gross external liabilities.

Sources: National Economic Institute, Statistics Iceland, Central Bank of Iceland.

Chart 2
Current account balance 1905-2015¹



1. Based on National Economic Institute figures for 1901-1944, Statistics Iceland figures for 1945-1994, and figures from the Central Bank and Statistics Iceland for 1995-2015, and based on the underlying current account balance in 2008-2015.

Sources: National Economic Institute, Statistics Iceland, Central Bank of Iceland.

1. Nevertheless, the failed banks' estates still affect the external position to some degree, and further changes can be expected as their settlement progresses. *Financial Stability 2016/1* also contains a discussion of Iceland's IIP following the settlement of the failed banks' estates.
2. This Box is based in part on historical data from the National Economic Institute on gross external liabilities during the period 1922-1994 and the NIIP (i.e., the difference between external assets and liabilities) for 1960-1994. There appears to be some discrepancy between the series, as in some instances the NIIP is negative by an amount greater than gross external liabilities. As a result, these older data must be interpreted with some caution.
3. Figures on the banking system's external liabilities are available back to 1886 (see Einarsson *et al.*, 2015) and external Treasury liabilities back to 1908, when the Icelandic Treasury took its first foreign loan in the amount of 500,000 kr. to finance the development of the telephone system (see Snævarr, 1993).

were taken in 1960, but the authorities took nearly full control over external obligations at the same time by requiring Government approval of all foreign loans with a maturity of more than one year. Gross external liabilities declined thereafter, and the NIIP (for which data only extend back to 1960) has never been more favourable than during the herring boom of the mid-1960s, when it was negative by about 8½% of GDP (Chart 3).

The NIIP deteriorated steadily in the following decades ...

The NIIP deteriorated steadily from the mid-1960s until the capital account was liberalised in the early 1990s. The Treasury and Central Bank played a leading role in the intermediation of foreign credit to Iceland over these three decades, which generally featured a current account deficit coupled with strong nominal GDP growth, as inflation crises and currency crises were frequent occurrences. The NIIP therefore deteriorated steadily relative to GDP and was negative by about half of GDP by the time nearly all restrictions on foreign borrowing were lifted at the beginning of 1993 (the Act on Foreign Exchange, no. 87/1992). The fact that gross external liabilities totalled about 57% of GDP at that time indicates how limited Iceland's external assets were.

... and Iceland's foreign-denominated balance sheet expanded unabated following the capital account liberalisation and the privatisation of the banking system

Iceland's international balance sheet expanded rapidly in the 1990s, after the capital account liberalisation. Gross external liabilities nearly doubled over the period until year-end 2000, gross external assets grew to nearly half of GDP, and the NIIP was negative by 62% of GDP. This development accelerated, however, following the privatisation of Landsbankinn and Búnaðarbanki Íslands in 2002-2003. From year-end 2002 until the collapse of the banking system in autumn 2008, gross external liabilities mushroomed from 117% to 877% of GDP and gross external assets from 50½% to 691% of GDP, and the NIIP ended by being negative in the amount of 186% of GDP.

External position of the economy uncertain during the post-crisis period and until the settlement of the failed banks' estates

In the wake of the financial crisis, there has been some uncertainty about how Iceland's international balance sheet would look following the settlement of the failed banks' estates and comprehensive restructuring of other domestic balance sheets. The Central Bank has published regular estimates of the underlying position, which deviated greatly from the IIP as calculated according to international standards, as the latter included all of the estates' debt at full nominal value even though it was clear that it would never be paid in full. Iceland's gross external liabilities totalled just over 231% of GDP at the end of 2015 and gross external assets were 217%, giving a negative NIIP of 14½% of GDP. The size of Iceland's international balance sheet is therefore about the same as in mid-2005, and the NIIP is at its most favourable in roughly fifty years. Furthermore, FDI accounts for about 40% of gross liabilities, whereas until now the vast majority of liabilities have been in the form of debt instruments and other investments (Chart 4) that are generally considered riskier and more volatile financing (Ahrend *et al.*, 2012).

NIIP now stronger than is generally seen among developed countries after having been weaker for decades

As Chart 5 shows, for most of the past five decades, Iceland's NIIP has been worse than has generally been seen in developed coun-

Chart 3

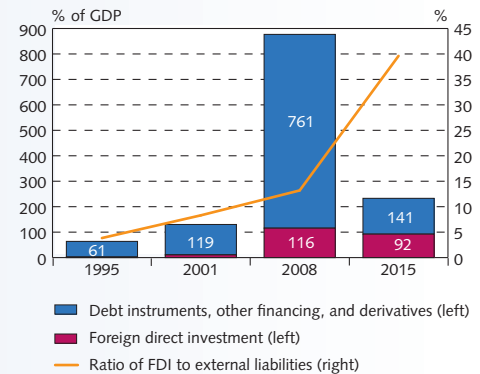
Iceland's net international investment position 1960-2015¹



1. The chart shows the net international investment position; i.e., the difference between external assets and liabilities. Data for 1960-1994 are from the National Economic Institute, while information from 1995 onwards is based on data from the Central Bank and Statistics Iceland, including the Central Bank's estimate of the underlying NIIP for the period 2008-2014. The broken line shows the NIIP calculated according to international standards, including the liabilities of the failed financial institutions at full nominal value. Sources: National Economic Institute, Statistics Iceland, Central Bank of Iceland.

Chart 4

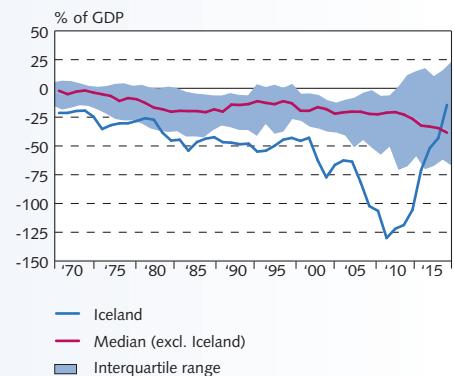
Gross external liabilities and foreign direct investment¹



1. Gross external liabilities fall into two categories: foreign direct investment, on the one hand, and debt instruments, other financing, and derivatives, on the other. Values for 2008 are as of end-Q3, just before the collapse of the banks. Sources: Statistics Iceland, Central Bank of Iceland.

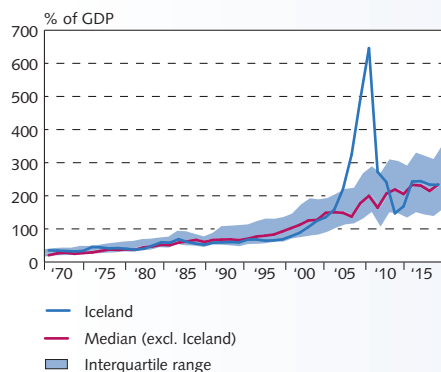
Chart 5

NIIP in 30 developed countries 1970-2015¹



1. Figures for Iceland are from the National Economic Institute (1970-1994) and the Central Bank and Statistics Iceland (1995-2015), based on the underlying position during the period 2008-2014. Figures from the other countries are from the Lane and Milesi-Ferretti database for 1970-2011. Their data are extended through 2015 based on developments according to the IMF's international financial statistics (IFS) database. Sources: International Monetary Fund, Lane and Milesi-Ferretti (2007), National Economic Institute, Statistics Iceland, Central Bank of Iceland.

Chart 6
Gross external liabilities in 30 developed countries 1970-2015¹



1. Figures for Iceland are from the National Economic Institute (1970-1994) and the Central Bank and Statistics Iceland (1995-2015), based on the underlying position during the period 2008-2014. Figures from the other countries are from the Lane and Milesi-Ferretti database for 1970-2011. Their data are extended through 2015 based on developments according to the IMF's international financial statistics (IFS) database.

Sources: International Monetary Fund, Lane and Milesi-Ferretti (2007), National Economic Institute, Statistics Iceland, Central Bank of Iceland.

tries. That has changed in recent years, however, and after the sharp decline in gross external liabilities at the end of 2015, Iceland's NIIP is more favourable than in many developed countries.⁴ It is interesting to note that the net position has long been worse than in other developed countries even though gross external liabilities have been similar for most of the period (Chart 6). This reflects, among other things, the fact that restrictions on foreign investment were in place longer in Iceland than in many other countries and that for a long time Iceland had a persistent current account deficit, with the associated accumulation of debt. This has changed radically, as is stated above, and if forecasts of a continued current account surplus materialise, Iceland's NIIP could turn positive in the near term.

References

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4. Among other things, this dramatic change has affected the equilibrium real exchange rate, as is discussed in Box 3.