Box 4 Balance on income

The current account balance measures the difference in value between exported and imported goods and services. When this value is negative, as has frequently been the case in recent years, the deficit is financed either with increased external debt or by depleting foreign assets. The main subcomponents of the current account are the balance on goods, which measures the difference in value between exported and imported merchandise; the balance on services, which measures the difference in value between exported and imported services; and the balance on income, which measures the difference between inward and outward compensation of employees, equity investment income and interest payments. Another subcomponent of the current account is current transfers, which mostly consist of contributions by central government to international agencies and development aid, but also include insurance compensation.

Table 1 shows the development of the balance on income since 1998. Employee compensation receipts are far higher than expenditures because wages paid to Icelandic workers at the NATO base in Keflavík are classified as being paid from abroad.

The table reveals that equity investment income has soared, from a negligible figure in 1998 to roughly 18 b.kr. per year in 2002 and 2003. Equity investment income consists of both dividends paid on equities owned by Icelandic residents and reinvested earnings from companies (including subsidiaries and branches) located abroad in which residents own a holding of 10% or more. The latter item has shown by far the most growth in recent years and is headed for a very high figure this year. It has made a substantial contribution to reducing the negative balance on income in 2002 and 2003 compared with preceding years. A similar effect is likely in 2004. However, this item is highly volatile, especially in the short term. Its quarterly values fluctuate very sharply (see Chart 36). In Q1/2004 reinvested earnings amounted to just over 1 b.kr., but in Q2 they measured 8.7 b.kr., equivalent to 4% of GDP for that quarter. If foreign companies owned by residents produce heavy losses, investment income can turn negative.

Outward equity investment income is much steadier. The lion's share is accounted for by profits of foreign-owned metals manufacturers in Iceland.

Balance on income, liabilities and assets 1998-2004[1]

In b.kr.	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2003/Q1-2*	*2004/Q1-2*
Balance on income	-12.6	-12.6	-19.4	-24.9	-8.1	-8.0	-6.8	-4.4
Receipts	8.5	9.3	11.6	16.9	27.9	28.8	12.5	17.5
Compensation of employees	4.7	4.9	5.5	5.8	5.4	6.2	3.0	2.8
Equity investment income	0.6	2.1	2.6	7.8	17.6	18.2	7.5	11.2
Of which reinvested earnings	0.5	1.4	1.0	5.1	14.7	15.9	6.3	9.7
Of which dividends	0.2	0.7	1.6	2.7	2.9	2.3	1.1	1.5
Interest payments	3.1	2.3	3.5	3.4	4.9	4.4	2.1	3.5
Expenditures	-21.2	-21.9	-31.0	-41.9	-36.0	-36.7	-19.3	-21.9
Compensation of employees	-0.3	-0.3	-0.8	-0.5	-0.7	-0.5	-0.3	-0.4
Equity investment income	-2.3	-0.8	-1.6	-0.3	-1.1	-4.6	-2.5	-4.2
Interest payments	-18.6	-20.8	-28.5	-41.1	-34.2	-31.7	-16.5	-17.2
Foreign liabilities less FDI	409	512	723	938	902	1,152	994	1,357
FDI	32	35	42	71	63	75	62	82
Total foreign assets	152	244	316	422	395	677	480	842
USD/kr. exchange rate	69.32	72.35	84.47	102.95	80.58	70.99	76.38	72.49

1. Data for assets and liabilities show the position at the end of the period. *Source:* Central Bank of Iceland.

Interest payment expenditures are the largest single component of the balance on income. As the table shows, this item is very volatile. It is determined by the volume of Iceland's foreign borrowing and the interest rates on those liabilities. Foreign liabilities have increased sharply in recent years, more than tripling from the end of 1998 to the end of 2003. Nonetheless, interest payments on foreign borrowing were only 70% higher in 2003 than in 1998, due to falling foreign interest rates over that period. This item will probably rise in the near future since foreign interest rates are likely to head upwards.

The hefty growth in external debt of the economy reflects not only the widening current account deficit, but also large-scale foreign investment by Icelandic residents. The table reveals a surge in foreign assets over the past few years – by 344% from the end of 1998 to the end of 2003. Foreign assets of Icelandic residents amounted to 842 b.kr. at end-June 2004, of which 147 b.kr. were direct investments and 695 b.kr. investments in foreign marketable securities, derivatives and other financial assets.