

CENTRAL BANK OF ICELAND



2021 | 14

# SPECIAL PUBLICATION

ICELAND'S BALANCE OF PAYMENTS AND EXTERNAL POSITION

Published by:

The Central Bank of Iceland, Kalkofnsvegur 1, 101 Reykjavík, Iceland  
(+354) 569 9600, [sedlabanki@sedlabanki.is](mailto:sedlabanki@sedlabanki.is), [www.sedlabanki.is](http://www.sedlabanki.is)

ISSN 1670-8830, online

This is a translation of a document originally written in Icelandic. In case of discrepancy or difference in interpretation, the Icelandic original prevails. Both versions are available at [www.cb.is](http://www.cb.is).

Material may be reproduced, but an acknowledgement of source is kindly requested.



# ICELAND'S BALANCE OF PAYMENTS, EXTERNAL POSITION AND VULNERABILITIES

3. May 2021

**Symbols:**

- \* Preliminary or estimated data.
- 0 Less than half of the unit used.
- Nil.
- ... Not available.
- . Not applicable.

**Icelandic letters:**

ð/Ð (pronounced like th in English this)

þ/Þ (pronounced like th in English think)

In this report, ð is transliterated as d and þ as th in personal names, for consistency with international references, but otherwise the Icelandic letters are retained.

# Table of content

	Balance of payments and external position in a nutshell	6
I	Global conditions	7
II	Foreign exchange market	10
III	Balance of payments and external position	12
	Current account balance and financial transactions	12
	International investment position	16
	Central Bank international reserves	21
IV	Balance of payments scenario 2021	23
	Balance of payments scenario – assumptions	23
	Results of the balance of payments model	25
<b>Boxes</b>		
	1 The currency composition of Iceland's external position at year-end 2020	17
	2 Capital account liberalisation 2009-2019	28

# Balance of payments and external position in a nutshell<sup>1</sup>

The global recession in the wake of the COVID-19 pandemic is the largest peacetime contraction since the Great Depression in the 1930s. It brought with it an abrupt decline in world trade and a steep drop in commodity prices. Severe unrest in the global financial markets early in the pandemic pushed credit spreads higher and prompted investors to flee to safe currencies and highly liquid assets. Many economies saw their current account balances and currency exchange rates fluctuate widely. Icelandic firms experienced a sudden but short-lived deterioration in financing conditions, as well as uncertainty about how severely – and for how long – the export sector would be affected.

Iceland's balance of payments was robust before the pandemic. The current account had been in surplus since 2009, and this, together with successful liberalisation of the capital controls, had improved the debt position and enabled the country to build up sizeable international reserves. At the beginning of the pandemic, Iceland's foreign liabilities were at a twenty-year low, its international reserves ample, and its net international investment position (NIIP) at its most favourable since World War II. The domestic economy was therefore well prepared to face deteriorating external conditions and a reversal of non-residents' investment flows into domestic financial assets. Iceland's current account surplus shrank by 5.4 percentage points of GDP in 2020, to 1% of GDP, one of the largest changes recorded among OECD countries. Furthermore, non-residents' portfolio inflows flipped from being positive by 1% of GDP in 2019 to being negative by 2% in 2020. Even so, given the magnitude of the economic shock and developments in global capital flows – in emerging market economies, for instance – outflows from Iceland were rather modest in the wake of the pandemic but gained pace as the year progressed. A contributing factor was the relatively small stock of highly liquid króna-denominated assets at the beginning of the pandemic, at around 7% of GDP, in part because non-residents' capital inflows into highly

liquid domestic assets have been moderate in recent years. A development which has been influenced by the capital controls, that were lifted in 2017, and the Central Bank's capital flow management tool which had a dampening impact on foreign investors inflows into highly liquid domestic-denominated assets.

By the end of 2020, the Icelandic króna had depreciated by roughly 8% since the onset of the pandemic. This is the main reason foreign liabilities increased to 116% of GDP during the year. Nevertheless, in historical and international context, Iceland's foreign debt and short-term liabilities are low, and its NIIP is good. A balance of payments scenario analysis suggests that the pandemic will strongly affect Iceland's balance of payments throughout this year; however, the economy is well prepared to withstand external shock. Favourable external position at the start of the pandemic have made a major difference in Iceland's resilience. In addition, external conditions have developed more favourably in many respects than was feared early in the pandemic. Improving external financing conditions in global financial markets since mid-2020 and the rise in Iceland's non-tourism export revenues between 2019 and 2020 are contributing factors. This year, the trade balance is expected to show a somewhat larger deficit and the current account surplus is expected to shrink still further. Residents' and non-residents' investment-related foreign currency outflows are projected to continue, but at a greatly reduced pace. External financing inflows are set to increase this year, bolstering the international reserves. The outlook is for the reserves to remain sizeable, and close to the upper threshold of the International Monetary Fund's reserve adequacy metric.

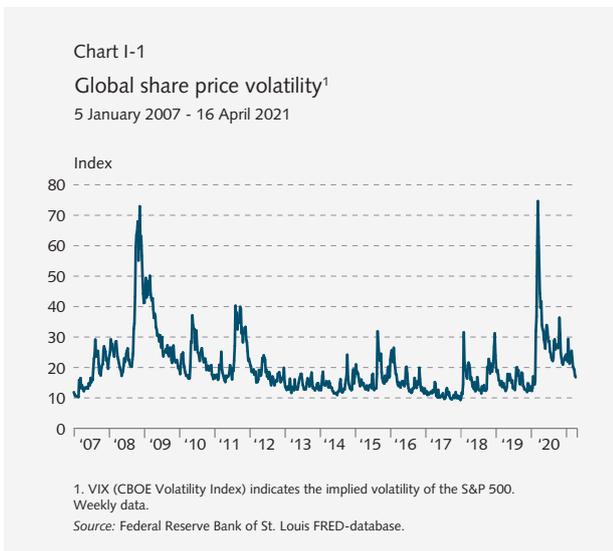
<sup>1</sup> The publication was written by Rósa Björk Sveinsdóttir, Kristófer Gunnlaugsson, Ríkarður Bergstað Ríkarðsson, Róbert Heimir Helgason and Steinn Friðriksson, of the Central Bank of Iceland. The opinions expressed in this report are those of the authors and do not necessarily represent the views of the Central Bank of Iceland.

# Global conditions



## The COVID-19 pandemic has severely disrupted the global economy ...

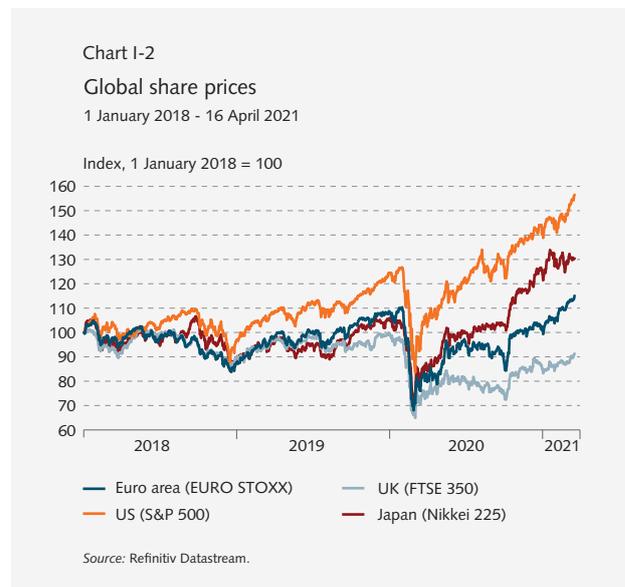
The COVID-19 pandemic that began spreading worldwide in early 2020 has left economic and health-related turmoil in its wake. Global GDP growth is estimated to have shrunk by a post-World War II record of 3.3% in 2020. The contraction in Q2, during the first wave of the pandemic, was the largest single-quarter contraction in the history of quarterly national accounts data.



## ... causing a steep contraction in world trade in 2020

World trade contracted markedly as well, owing to declining demand, border closures, and other restrictions imposed by governments worldwide in a bid to curb the spread of the disease. Global supply chains were disrupted when the pandemic struck. Goods trade declined by 8.6% year-on-year in the first five months of 2020, about the same as at the onset of the global financial crisis just over a decade ago, and by 5.3% in 2020 as

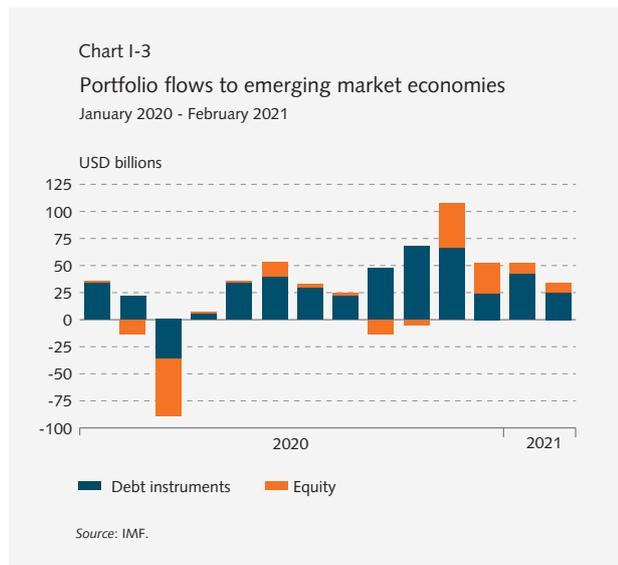
a whole. Cross-border services trade shrank even more during the year, as companies in tourism and other contact-intensive sectors were hit very hard. As a result, global trade in goods and services combined contracted by 8.5% year-on-year in 2020.



## Global financial markets in turmoil early in 2020 ...

The abrupt deterioration in the economic outlook and increased uncertainty at the onset of the pandemic early in 2020 sent global financial markets into a tailspin. Investors flocked to safe currencies and highly liquid assets – gold and US Treasury bonds in particular – and sold equities in droves when the pandemic hit. Global equity prices plunged as a result, and share price volatility soared back to the peak seen during the financial crisis (Charts I-1 and I-2). Many firms and sovereigns found that their funding terms deteriorated substantially because of rising credit spreads on riskier financial assets.

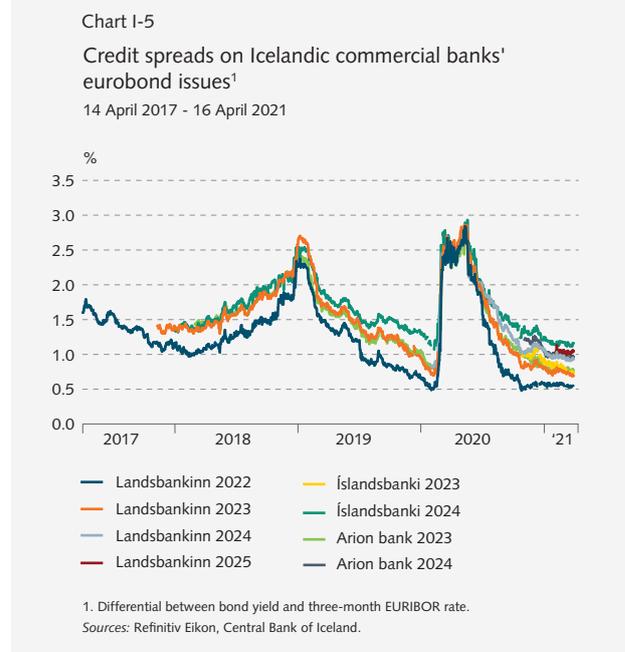
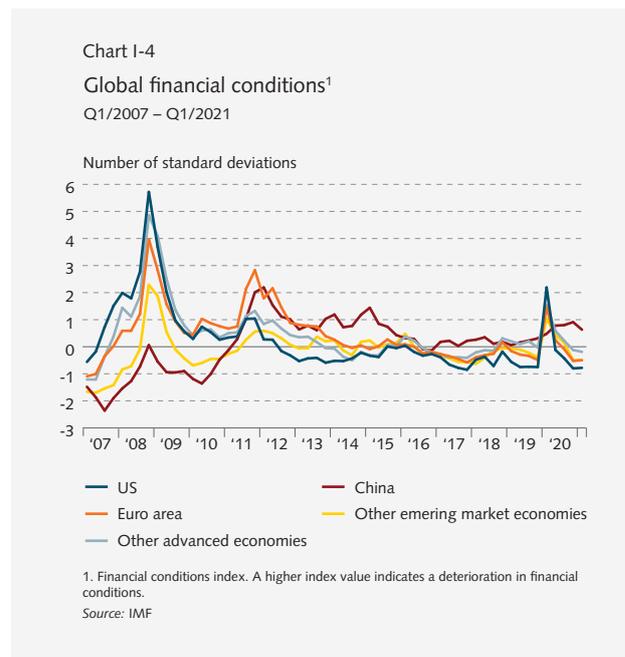
Increased investor demand for safe financial assets also led to large-scale capital flight, particularly from emerging and developing economies, many of which also suffered a marked erosion in terms of trade due to the pandemic-related decline in global commodity prices (Chart I-3). As a result, these countries and many advanced economies – particularly commodity exporters – saw their currencies depreciate, while global reserve currencies, always in demand during periods of global uncertainty, appreciated.



**... but global financial conditions have improved again ...**

Global financial markets began to recover in Q2/2020, concurrent with a decline in infection rates, relaxation of public health measures, and indications that economic activity was picking up. Mitigating measures taken by central banks and governmental authorities played a key role in supporting markets, facilitating government and corporate bond issues, boosting confidence in the economic outlook, and preventing the shock from having an even more profound impact on the global financial system. The arrival of vaccines in late 2020 and increased fiscal stimulus measures put in place in recent months by a few large economies – particularly the US – have supported markets still further and fostered greater optimism about the economic outlook. Despite a steep rise in infection rates in autumn 2020 and the following winter and the subsequent tightening of public health measures, global share prices have widely been recovering and volatility has eased. This is particularly the case for share price indices in the US and Japan, which are now well above pre-pandemic levels. The rise in risk premia and interest premia on high-risk assets has largely reversed, and capital has begun flowing into emerging

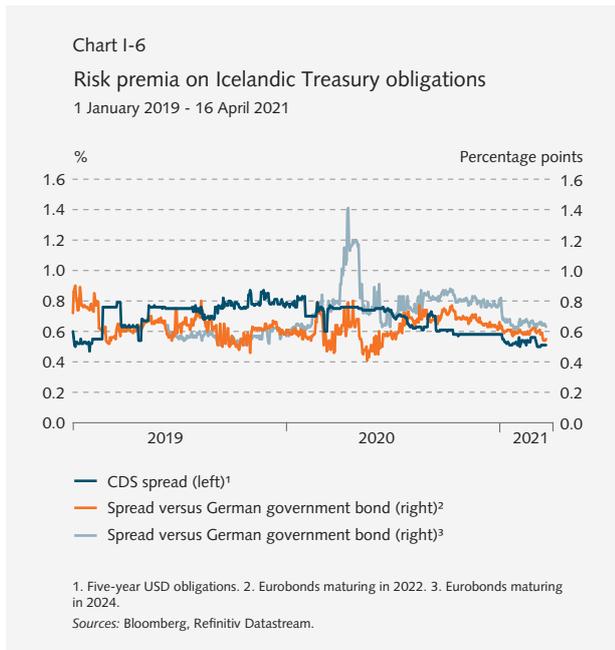
market economies once again. Furthermore, long-term interest rates in leading industrialised countries have been rising, and are in many cases back to the level seen before the pandemic. Nevertheless, long-term rates remain low in historical context. Financial conditions have therefore improved on the whole (Chart I-4), but there are still significant uncertainties, including about vaccine roll-outs and about how successful efforts to control the pandemic will be.



**... as have domestic banks' foreign funding conditions**

Credit spreads on the Icelandic commercial banks' foreign obligations also rose steeply in H1/2020 (Chart I-5). Interest premia on their market bond issues increased

by as much as a factor of three in the first few months of the year but then started to fall around mid-year, in tandem with improvements in global financial market conditions. The interest rates on the commercial banks' issues are now similar to those offered to them before the onset of the pandemic. Credit spreads on Treasury foreign obligations rose to a lesser degree last year and are now roughly where they were at the beginning of 2020 (Chart I-6).

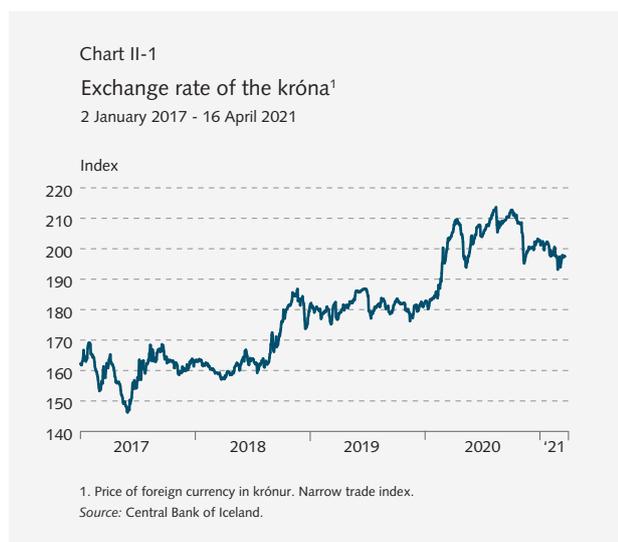


# Foreign exchange market

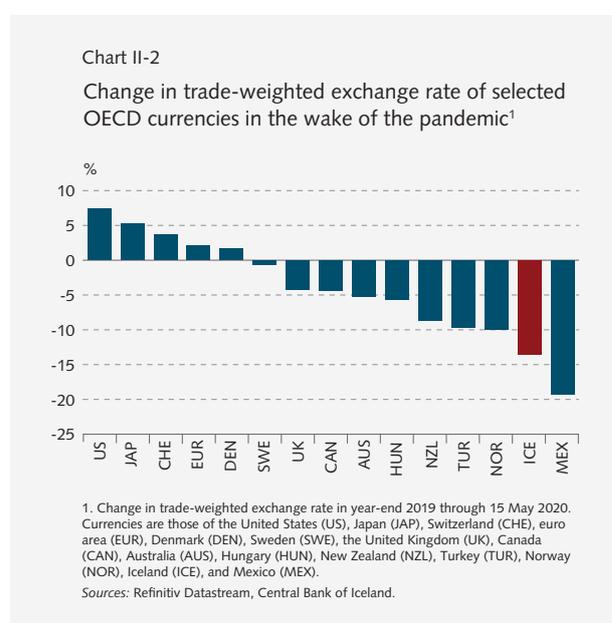


## The króna depreciated markedly after the pandemic struck ...

The króna began to weaken in late February after the pandemic arrived in Iceland, and by mid-May, it had fallen around 12% (Chart II-1). Many other developed countries, commodity exporters in particular, saw their currencies depreciate as the economic outlook changed and demand for safe financial assets and global reserve currencies soared (Chart II-2). The sharper depreciation in Iceland probably stems from the importance of tourism and other export sectors in the domestic economy, as it quickly became clear that the pandemic would hit tourism particularly hard. Outflows of foreign-owned capital were nevertheless limited at the beginning of the pandemic.



... and slid further during the summer and autumn ...  
The króna strengthened again in May, concurrent with declining uncertainty and increased optimism that



tourism would recover more swiftly than previously expected, as COVID-19 case numbers in Iceland had fallen sharply and governmental authorities in Iceland and abroad announced the relaxation of public health-related border restrictions. The appreciation reversed again over the summer, however, partly in response to a spike in domestic infections and a re-tightening of border restrictions in early August. From June onwards, increased outflows of foreign-owned capital affected the exchange rate and contributed to nearly constant downward pressure until winter set in. The pension funds began buying more foreign currency in the autumn, adding to the downward pressure at a time when foreign currency inflows were limited despite a current account surplus. Expectations may have developed of even more currency purchases by the pension funds after they

decided not to extend the six-month hiatus that expired on 17 September.

After depreciating by over 9% since the beginning of summer, the króna firmed up temporarily when, in early September, the Central Bank announced a regular currency sales programme aimed at deepening the market and improving price formation. With that announcement, the Bank declared itself ready to sell up to 40 b.kr. in regular transactions through the year-end. In addition, the Bank continued intervening in the foreign exchange market in order to mitigate volatility when it considered such intervention warranted (Chart II-3). In October, intervention in the market peaked when the Bank sold currency for 38 b.kr., owing to particularly large-scale outflows from pension funds and non-residents during the month. In 2020 as a whole, the Central Bank net foreign currency sales totalled 133 b.kr.

### ... but the króna has appreciated since November

At that point, the króna held relatively steady for a while but then started to appreciate in November, spurred by reduced outflows and positive news about the development of COVID-19 vaccines. In addition, the pension funds scaled down their net foreign currency purchases, and some of them even sold currency. Even though non-residents' and pension funds' capital outflows increased again in Q1/2021 and the deficit on goods trade has grown, the króna continued to appreciate. This may be due in part to expectations about the appreciation of the króna following an improved economic outlook, as is indicated by the increase in forward foreign currency sales in Q1/2021 (Chart II-4). The Central Bank's regular currency sales programme has supported the exchange rate as well. The króna appreciated by nearly 7% from the beginning of November through mid-April but was still a full 7% weaker than at the end of February 2020. The real exchange rate has developed comparably. In March 2021, it was about 4% lower, on average, than in February 2020, owing mainly to the nominal depreciation of the króna, although inflation in Iceland was about 3 percentage points above the trading partner average.

Chart II-3

#### Net Central Bank foreign currency purchases<sup>1</sup>

January 2019 - March 2021

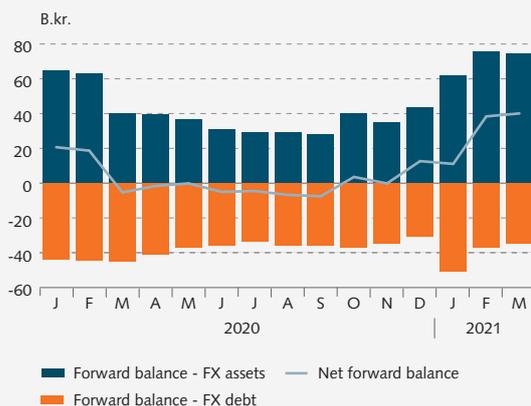


1. Without Central Bank's regular currency sales programme and one-off transactions.  
Source: Central Bank of Iceland.

Chart II-4

#### Commercial banks' forward position in foreign exchange transactions involving the króna<sup>1</sup>

January 2020 - March 2021



1. FX assets (FX debt) refers to commercial banks' foreign currency assets (debt).  
Source: Central Bank of Iceland.

# Balance of payments and external position



## Current account balance and financial transactions

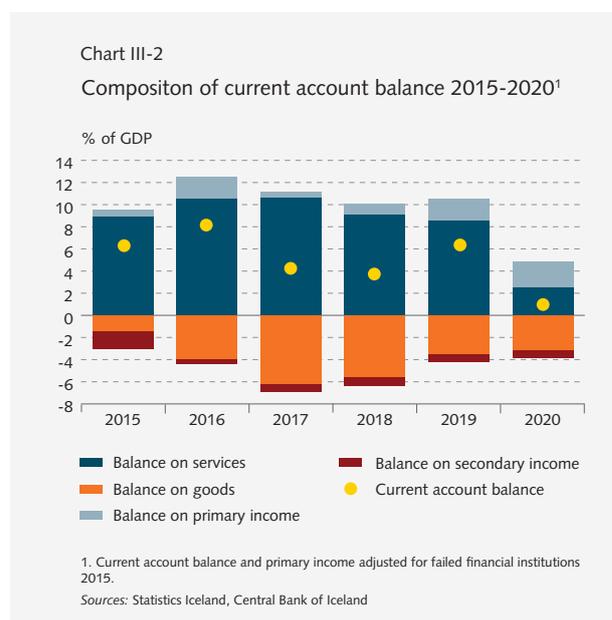
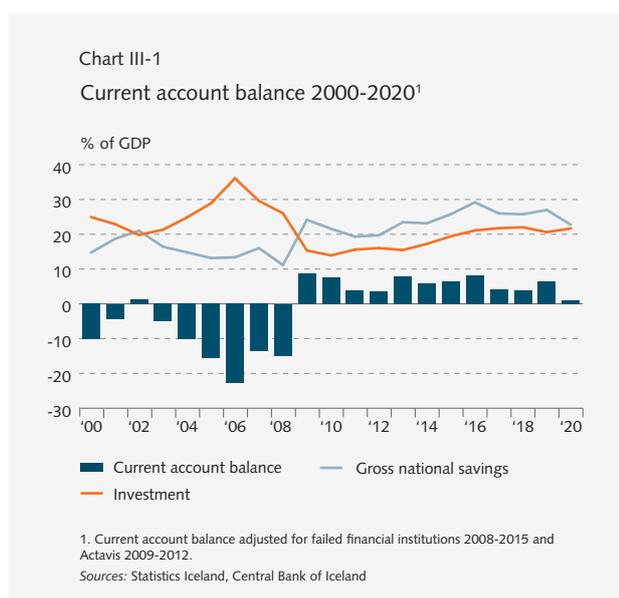
### National saving declined after the pandemic struck, but the current account remained in surplus

Iceland's current account balance changed radically after the 2008 financial crisis. The weight of services in total exports grew apace, contributing to a sustained current account surplus from 2009 onwards, whereas Iceland had run a current account deficit until that time. The increased weight of services exports can be traced mainly to the tourism boom, and the pandemic-induced collapse of tourism caused export revenues to plunge by over 25% year-on-year. The current account surplus shrank from 6.4% of GDP in 2019 to 1% of GDP in 2020. Even so, last year's surplus was 2.4 percentage points of GDP above the twenty-year average.

A surplus on the current account indicates that the country saves more than it invests. National saving shrank significantly in 2020, in tandem with the contraction in export revenues. It measured 22.7% of GDP, or 4.3 percentage points less than in 2019. On the other hand, the pandemic made little impact on the investment ratio, which was supported by historically low interest rates, ready access to credit, and favourable developments in asset prices.

### Major change in composition of 2020 current account balance

Iceland recorded a trade deficit measuring 0.6% of GDP in 2020. It was the first deficit on combined goods and services trade since 2008 and a deterioration of nearly 5.5 percentage points relative to 2019. Goods and



services exports contracted by 30.5% year-on-year, the largest single-year contraction since 1917. The downturn was due mostly to a 51% contraction in services exports, which in turn stemmed from the collapse in tourist visits by 1.5 million, or 76%, between years, bringing tourist arrival totals back to the level seen in 2010. The services account surplus therefore shrank markedly, but the goods account deficit shrank as well, owing to weaker economic activity and lower real exchange rate. The pandemic had a much greater impact on services sectors than on exported goods values, however. The depreciation of the króna supported value creation, and the value of exported goods (excluding ships and aircraft) rose by just over 0.2% between years, mainly because of an increase in aluminium and marine product export values. Actually, services sectors other than tourism also saw a rise in export revenues in 2020 as a whole. Terms of trade for goods and services deteriorated by 2.3% in 2020, as exported goods prices declined overall, while import prices fluctuated somewhat. For example, the foreign currency price of consumer goods and transport equipment rose markedly, while oil and commodity prices fell. Therefore, terms of trade have deteriorated for three years in a row, by a total of 6% since end-2017.

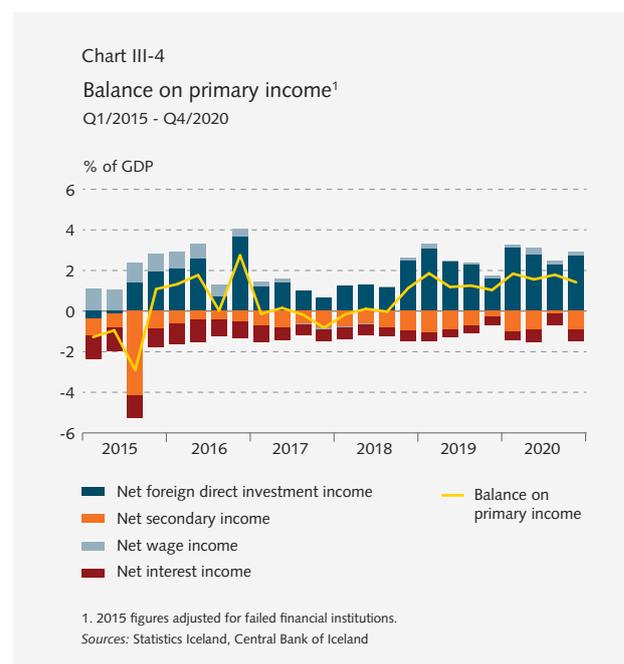
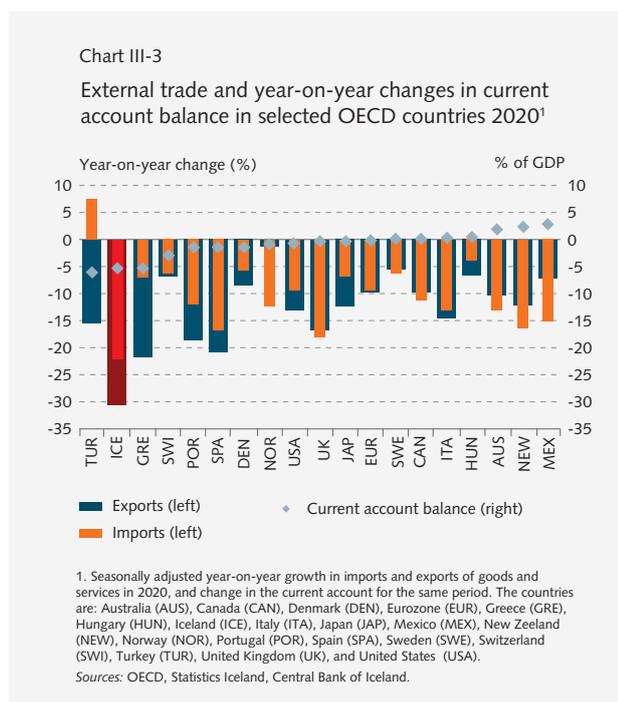
### Change in Iceland's current account balance among the largest in the OECD

The change in Iceland's current account balance was one of the largest in the OECD countries. It was on a par with that in Turkey and Greece, both of which

saw a deterioration of 5-6 percentage points of GDP between 2019 and 2020. Like Iceland, Turkey and Greece generally rely heavily on services exports, which account for over 20% of their GDP. As a result, they did not escape the repercussions of the pandemic-driven plunge in exports. Other tourism-dependent countries (Chart III-3) such as Spain and Italy suffered a less sharp deterioration in their current account balance because their imports contracted proportionally more than their exports. Few countries saw an improvement in the current account balance as imports contracted more than exports. This was particularly the case for countries that were forced to introduce stringent public health restrictions or whose real exchange rate fell steeply.

### The largest primary income surplus since measurements started

Iceland has recorded a surplus on the balance of primary and secondary income for the past three years. In 2020, it was positive by 1.6% of GDP, the largest surplus since measurements started. This trend is due in part to declining debt service on foreign liabilities, although positive returns on foreign direct investment played an important role as well. Increased returns stem mainly from operating losses at domestic companies owned by non-residents, including companies engaged in large-scale research activities whose production has not yet started and revenue generation is, therefore, limited at present. In addition, Icelandic-owned companies located abroad recorded sizeable profits, particularly companies in the food industry, which were not significantly



affected by the pandemic. The depreciation of the króna played a role as well.

In 2020, and especially in H2, foreign interest income declined somewhat more in krónur terms than interest expense did. The ratio of net foreign interest income to GDP, therefore, declined slightly during the year. A large share of the pension funds' foreign assets, which have grown rapidly in recent years, are in UCITS funds. According to balance of payments standards, dividend income on those investments is recognised not as primary income but as a change in the net international investment position. As a result, the positive impact of the past few years' improvements in the external asset position is not fully reflected in primary income.

### Non-residents' capital inflows positive since 2015, but turned negative last year ...

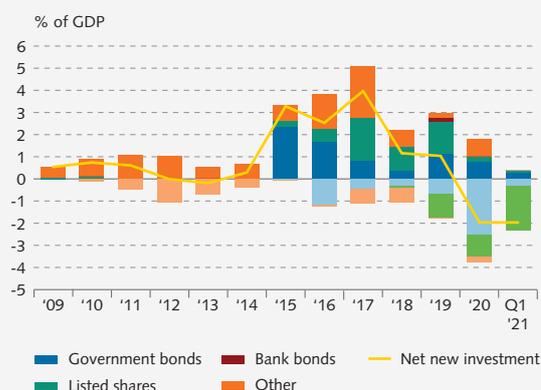
Capital flows for new investment were limited for the first few years after the financial crisis but began to increase after the authorities introduced their capital account liberalisation strategy in mid-2015 (Chart III-5).<sup>2</sup> Foreign bond funds invested over 70 b.kr. in Treasury bonds in H2/2015 and H1/2016, when the interest rate differential with abroad was wide, at slightly more than 5%. After the Central Bank activated a new policy instrument, the capital flow management tool, in June 2016, the composition changed and capital was invested to a greater degree in listed and unlisted equities (particularly in Arion Bank before it was listed on the stock exchange).<sup>3</sup> In 2015-2019, net new investment was positive by 12% of GDP, or over 300 b.kr., with 70% of that amount invested in listed and unlisted equities.

Foreign investors' capital flows reversed in 2020. At first the COVID-19 pandemic appeared to have little impact on foreign investors' net investment flows, unlike in many other countries faced with a sudden deterioration in financing conditions and a dramatically

2 New investments are investments made in Iceland by residents and non-residents, using foreign currency, in 2009 or later. The capital that entered the country through the New Investment Programme was not subject to the capital controls, and inflows were almost entirely from non-residents. While the capital controls remained in effect, capital inflows entered the country also via the Central Bank's offshore króna auctions. See also the Box entitled *Capital account liberalisation 2009-2019*.

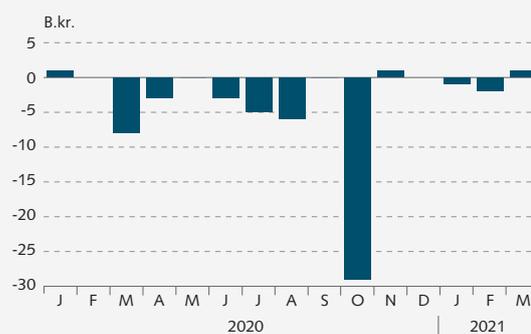
3 The capital flow management tool was a special reserve requirement applying to a portion of new inflows of foreign capital for investment in high-yielding deposits and in electronically registered bonds and bills denominated in krónur. The portion of inflows subject to the special reserve requirement was held in a non-remunerated account for one year. At first, the special reserve ratio (the portion subject to the special reserve requirement) was set at 40% of the inflow amount. It was lowered to 20% in December 2018 and then set at 0% in March 2019. The objectives were to mitigate the risk that can be associated with excessive capital inflows by tempering foreign inflows, particularly short-term inflows, and to strengthen the monetary policy transmission mechanism. For further discussion, see Box 1 of *Monetary Bulletin* 2016/4, Box 2 of *Monetary Bulletin* 2017/4, and Box 1 of *Monetary Bulletin* 2018/2.

Chart III-5  
Registered new investment<sup>1</sup>



1. Data on new investments represent inflows of foreign currency converted to Icelandic krónur for investment in Iceland. Total investment, new investment, and reinvestment. Inflows in dark colours; outflows in light colours.  
Sources: Statistics Iceland, Central Bank of Iceland

Chart III-6  
Net foreign flows into Treasury bonds



Source: Central Bank of Iceland.

worse outlook for exports. But outflows increased as the year progressed, peaking in Q4/2020 as a result of Treasury bond sales by non-residents (Chart III-6). The lion's share of the sales in question came from a single large bond fund, which held half of the foreign-owned Treasury bond stock at the beginning of 2020. As a result, net new investment was negative by 2% of GDP during the year. In 2021 to date, non-residents' outflows have been about equal to total outflows for 2020 as a whole, stemming almost entirely from two foreign fund management companies' divestment of shares in Arion Bank. Prior to the sale, the two companies combined held about a third of outstanding shares in the bank but began selling them in December 2020.

### ... albeit offset by a decline in residents' portfolio investment outflows

Residents' foreign portfolio investments amounted to just over 70 b.kr. in 2020, about half of the total for

2019.<sup>4</sup> The pension funds accounted for the bulk of residents' foreign portfolio investments (Chart III-7). They bought foreign currency for 56 b.kr. in 2020, about half the amount they bought in 2019.<sup>5</sup> The main reason for the year-on-year decline in the pension funds' currency purchases was the six-month hiatus they took between mid-March and mid-September, in response to the uncertainty associated with the COVID-19 pandemic. The pension funds' net currency purchases were limited in Q4/2020 as well, and in Q1/2021, they bought foreign currency for only 13 b.kr.

In general, outflows from residents other than the pension funds do not change markedly. Deposit institutions' portfolio investments are generally undertaken in connection with their liquidity management. In 2020, deposit institutions sold foreign debt securities and paid down marketable bonds. Outflows from residents other than pension funds and deposit institutions were slightly less in 2020 than in 2019.



### Marketable bond issuance declined in the wake of the pandemic

Because of uncertainty about the economic outlook after the pandemic struck, an ample foreign liquidity position, and poorer global financing conditions, Icelandic companies temporarily refrained from issuing marketable foreign-currency bonds, and foreign borrowing declined.

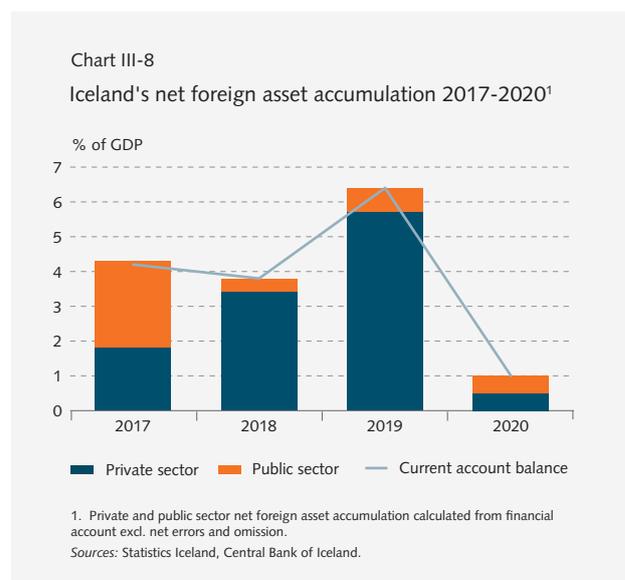
<sup>4</sup> New investment and reinvestment.

<sup>5</sup> In order to capture the pension funds' new capital outflows for foreign investment, their purchases of foreign currency are used, as it is not possible to distinguish between new investment and reinvestment in the financial account. Because of the large size of the pension funds' foreign asset portfolio, there is significant reinvestment. It is assumed that the funds' foreign currency deposits will ultimately be used for foreign investment.

Many companies had recently obtained financing or were well financed when the pandemic struck. Furthermore, most of them either have stable foreign-denominated revenues despite the economic shock, or the currency composition of their assets and liabilities was well balanced. Although external financing declined in the wake of the pandemic, overall it slightly exceeded debt service last year. This applies particularly to the Treasury, which issued a new bond in May, and to State-owned companies. However, deposit institutions, municipality-owned companies, and fisheries paid down debt.

### Capital outflows declined year-on-year, especially those from private entities

In previous years, the current account surplus was used to bolster private entities' net external assets, which grew at an increasing pace each year until 2020, when their asset formation declined year-on-year by 5 percentage points of GDP, to ½% of GDP (Chart III-8). The most pronounced change was on the assets side, particularly because of reduced portfolio investment, while liabilities decreased because of net financial transactions.<sup>6</sup> Public asset formation (by the Treasury and the Central Bank) was broadly unchanged, however, even though net financial transactions reduced the Bank's international reserves by 1% of GDP and the Treasury added on a small amount of foreign debt. This was offset by a reduction in the Treasury and Central Bank's króna-denominated debt, primarily because of non-resident investors' sales of Treasury bonds and Central Bank certificates of deposit.

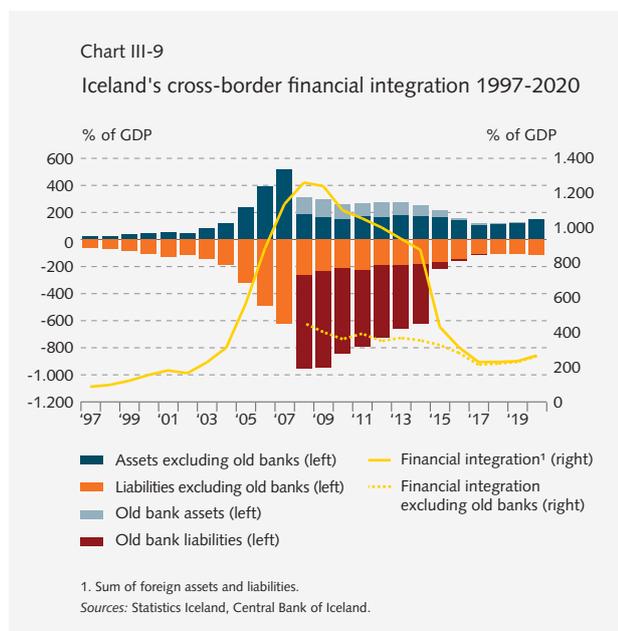


<sup>6</sup> Based on preliminary financial account figures. Net errors and omissions accounted for 12.3% of current account entries in 2020, up from 1.2% in 2019. A large net errors and omissions item generally stems from a lack of information on financial transactions by non-financial companies. More complete data will be available after approximately a year, when the companies' annual accounts have been prepared.

## International investment position

### Iceland has grown more financially integrated since the capital controls were lifted

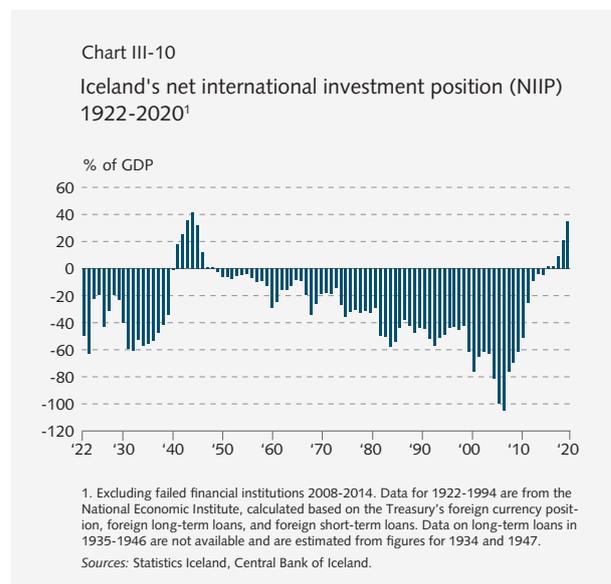
Financial integration has increased worldwide in the past two decades, and the global balance of foreign assets and liabilities had risen to a historical high by the time the pandemic struck.<sup>7</sup> In Iceland, financial integration has grown, as is natural for an open economy that relies on cross-border trade. Free movement of capital increased markedly in the latter half of the 1990s, after the EEA Agreement was ratified. This created the scope for greater financial integration, which soared with the expansion of Iceland's commercial banks during the run-up to the 2008 financial crisis. On the other hand, Iceland's balance of payments problem in the wake of the financial and economic crisis called for deleveraging, and foreign investment declined as well. Even so, the shift is less pronounced if the effects of the failed financial institutions on the external position are excluded (Chart III-9). Iceland has once again become more financially integrated since 2017, partly because of an increase in the pension funds' foreign investment and the commercial banks' foreign bond issuance. Actually, this trend began somewhat earlier, if factors relating to the settlement of the financial crisis and FDI-related accounting entries are ignored.



7 See, for example, *External Sector Report 2020*, issued by the IMF. Financial integration is the sum of external assets and liabilities expressed as a share of GDP.

### The NIIP has improved by 140% of GDP since 2007 and has seldom been better ...

Iceland's net external position has improved by leaps and bounds since 2007. It has been positive since 2016, after having been negative almost without exception since the end of World War II (Chart III-10). At the 2007



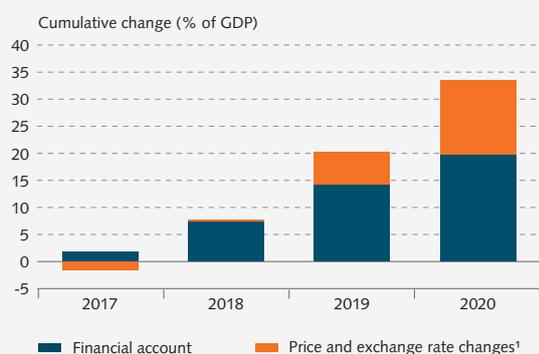
trough, it was negative by nearly 105% of GDP.<sup>8</sup> The improvement in the past decade is due to debt write-offs in connection with private sector insolvencies following the financial crisis, financial restructuring of companies, and a large current account surplus, which at first was used primarily to pay down foreign debt and then was used to enlarge the international reserves and build up the pension funds' foreign asset portfolios. Iceland's NIIP, for example, improved markedly with the settlement of the failed banks' estates.<sup>9</sup> Price and exchange rate movements also have a strong impact on the NIIP. The NIIP improved after the capital controls were lifted in 2017, primarily because of financial transactions, although price and exchange rate movements gave it a further boost – particularly to include the depreciation of the króna starting in late 2018, during the prelude to airline WOW Air's insolvency (Chart III-11).

At the end of 2020, Iceland's net international investment position (NIIP) was positive by 35% of GDP

8 Based on the underlying NIIP in 2008-2015. After the banks failed, it quickly became clear that the book value of their estates' assets comprised only a small share of the claims against the estates. As a result, the underlying NIIP was calculated. The underlying NIIP ignored the failed financial institutions' external assets and liabilities but included the estimated impact of their winding-up.

9 In all, about 17% of GDP, if only the stability contributions from the failed banks' estates are included. See the discussion of the failed financial institutions' composition agreements in the Box entitled *Capital account liberalisation 2009-2019*.

Chart III-11  
Improvement in NIIP following capital account liberalisation



1. Other changes included; i.e., transfers and depreciation.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-12  
Net international investment position



Sources: Statistics Iceland, Central Bank of Iceland.

and had improved by 14 percentage points between years. Net securities holdings rose, owing to price increases on the foreign portfolio assets held by the pension funds (Chart III-12). The funds' foreign assets grew

by 29% year-on-year in 2020, to 65% of GDP by the year-end. If the NIIP is itemised by party, it can be seen that the pension funds' net assets are positive by 57% of GDP, due mostly to foreign unit shares net of pension obligations to individuals domiciled abroad (Table III-1). The central government and Central Bank's net assets were also positive, by 16% of GDP, mainly because the Central Bank's international reserves exceeded the Treasury's foreign bonds and non-residents' Treasury bond holdings. The net position of State-owned companies was negative, however, by 10% of GDP, mainly because of domestic energy companies' foreign financing. Furthermore, foreign direct investment (FDI) was negative by just under 9% of GDP, although it has improved significantly in recent years. The net position of deposit institutions – primarily the three systemically important banks – was negative as well, by 11% of GDP, owing mainly to the foreign market funding the banks have obtained in order to finance foreign-denominated lending to domestic borrowers.

Table III-1 Breakdown of the international investment position at year-end 2020

% of GDP	Foreign assets	Foreign liabilities	NIIP
Government and Central bank of Iceland	28	12	16
Government guaranteed firms	0	8	-8
Municipal-guaranteed firms	0	2	-2
DMBs	14	25	-11
Pension funds	66	8	57
FDI - pharmaceuticals	5	8	-3
FDI - heavy industry	0	8	-8
FDI - SPEs	2	2	0
FDI - other <sup>1</sup>	19	18	1
Old banks	3	1	2
Other	15	24	-9
Total	151	116	35

1. Excluding old banks and pension funds.

Source: Central bank of Iceland.

## BOX 1

### The currency composition of Iceland's external position at year-end 2020

The Central Bank of Iceland recently began publishing the currency composition of its international investment position. The currency composition of Iceland's external assets differs from that of its external liabilities. The currency composition of liabilities can be a source of external vulnerability. Around

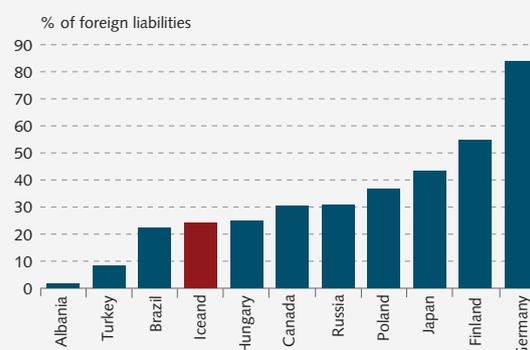
99% of Iceland's external assets are denominated in foreign currencies, as compared with only 76% of its external liabilities; in other words, 24% of external liabilities are denominated in Icelandic krónur. Iceland's share of external liabilities denominated in local currency is similar to that in Canada,

Hungary, and Brazil, but much lower than, for instance, in Germany and Finland (Chart 1).<sup>1</sup>

The vast majority of Iceland's external assets (92%) are in global reserve currencies such as US dollars, euros, pounds sterling, and Japanese yen (Chart 2). External liabilities are primarily in euros, although a large share are in krónur and US dollars as well. Just over one-third of króna-denominated liabilities stem from inward foreign direct investment. Such investments tend to be long-term, and they are less susceptible to short-term economic volatility than others are. About 29% of the pension funds' debt to non-resident beneficiaries are in krónur. Other króna-denominated external liabilities include non-residents' Treasury bond holdings and deposits with domestic banks, which account for around 13%.

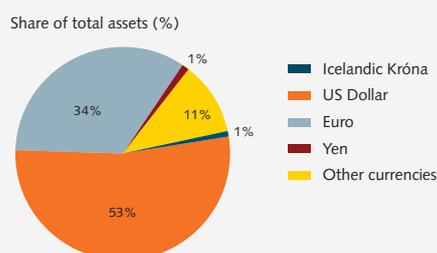
The impact of exchange rate movements on the external position depends on the size of the mismatch between foreign-denominated assets and liabilities. Overall, the foreign currency imbalance in the external position at the end of 2020 was 22.9%, which is close to the median for advanced economies.<sup>2</sup> A positive imbalance means that foreign-denominated assets exceed foreign-denominated liabilities; therefore, a depreciation of the króna improves Iceland's net external position. Exchange rate risk is primarily in US dollars, where the imbalance is positive by 20% because of the large proportion of dollars in the Central Bank's international reserves. The risk ratio for other currencies is much lower. Exchange rate risk is distributed unevenly across economic sectors. It is greatest for financial institutions, at 22.6%, largely because of the pension funds' foreign investments. For the Central Bank and central government combined, it is positive by 6.2%, whereas it is -8.3% for non-financial companies, -3.3% for companies in foreign direct investment, and -3.9% for deposit institutions. The deposit institutions' low exchange rate risk ratio is due in part to limits on how much risk they are allowed to take. According to current rules, mismatches between the systemically important banks' foreign assets and liabilities may not exceed 10% of risk-weighted assets, subject to a maximum of 25 b.kr.<sup>3</sup> At the end of 2020, deposit institutions' foreign-denominated external assets equalled 60% of their foreign-denominated liabilities.<sup>4</sup>

Chart 1  
Share of domestic currency in foreign liabilities 2020<sup>1</sup>



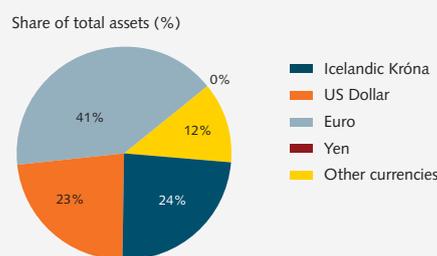
1. Data for Iceland is end of 2020. Finland end of 2018. Other countries end of 2019.  
Source: IMF, Central Bank of Iceland.

Chart 2  
Foreign assets - Currency composition at end of 2020



Source: Central Bank of Iceland.

Chart 3  
Foreign liabilities - Currency composition at end of 2020



Source: Central Bank of Iceland.

1 Few countries have published currency breakdowns of their external position, however. Data can be found on the IMF website: <https://data.imf.org/regular.aspx?key=62813992>.

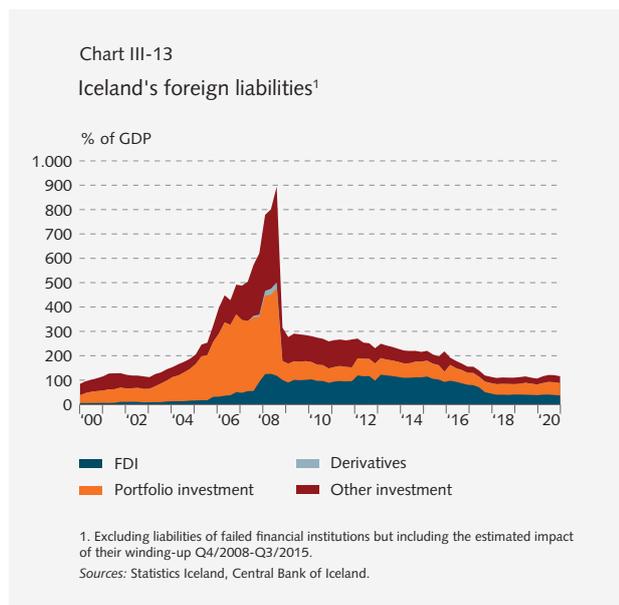
2 The mismatch between foreign-denominated external assets and liabilities expressed as a percentage of total external assets and liabilities.

3 See the Rules on Foreign Exchange Balance, no. 784/2018.

4 No adjustments are made for exchange rate hedging.

## Foreign liabilities at a twenty-year low before the pandemic struck

At the end of 2019, Iceland's foreign liabilities were at their lowest in two decades. Since the capital controls were lifted in 2017, the most pronounced change has been in FDI-related liabilities (Chart III-13), which declined in 2017, when domestic pharmaceutical companies transferred foreign assets and liabilities to foreign companies within the same group, and special-purpose vehicles with substantial assets and liabilities were delisted that same year.<sup>10</sup> Foreign liabilities declined by 42% of GDP in 2017.



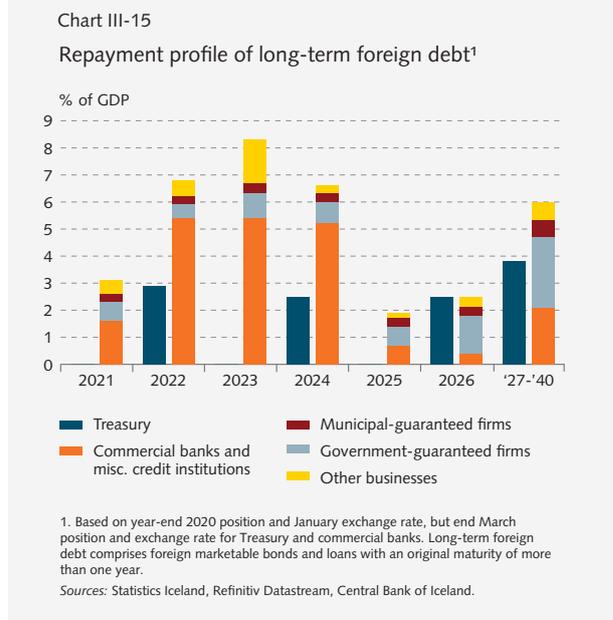
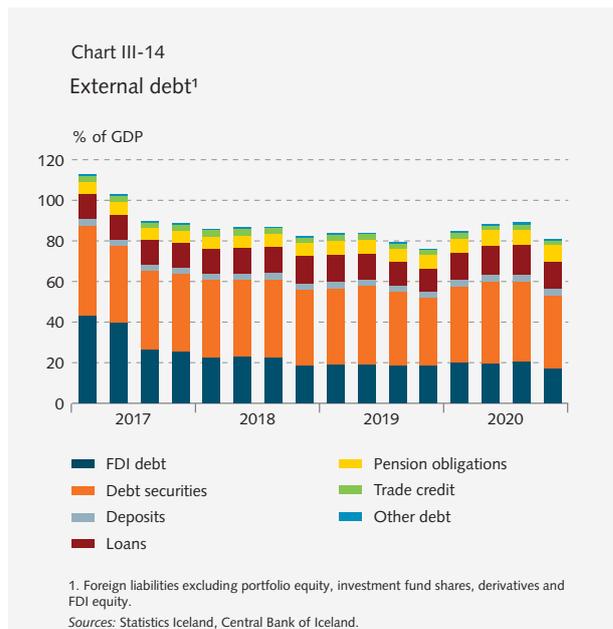
In 2020, foreign liabilities totalled 116% of GDP, up from 106% in 2019. Financial transactions reduced foreign liabilities by 5.5% of GDP during the year, but this was fully offset by the roughly 10% depreciation of the króna and the rise in domestic asset prices. Because of this and the contraction in GDP, the debt-to-GDP ratio rose in 2020.

## External debt grew in 2020, but next year's instalments on foreign long-term debt are low

External debt totalled 81% of GDP at the end of 2020, a year-on-year increase of nearly 5% of GDP, driven mainly by exchange rate movements and foreign financing obtained by the Treasury and energy companies during the year (Chart III-14).<sup>11</sup> Just under 60% of external debt is long-term funding, particularly to include the domestic commercial banks' and the central government's mar-

<sup>10</sup> Special-purpose vehicles are often established for tax purposes as holding companies for foreign assets and liabilities. They conduct no actual commercial activities.

<sup>11</sup> Excluding non-residents' holdings in equity securities, unit shares, derivatives, and equity in FDI.



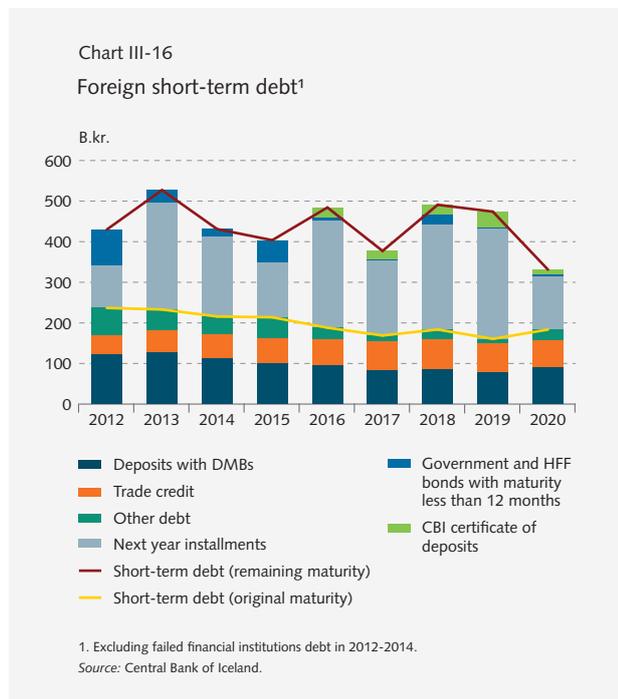
ket funding. Commercial companies' foreign financing consists almost solely of long-term loans. At the end of 2020, the commercial banks' debt accounted for 46% of long-term foreign funding, while the Treasury accounted for 19% and State- and municipality-owned companies 22%.

Because the commercial banks generally obtain funding for three years at a time, their payment profile is relatively front-loaded, and 85% of their debt is scheduled to mature by year-end 2024 (Chart III-15). Year-2021 instalments are relatively low, however, but the banks issued foreign market bonds amounting to 2.8% of GDP in Q1/2021. The Treasury also issued foreign marketable bonds during the quarter, with a seven-year maturity. The issue totalled just under 4% of GDP. The

Treasury repayment profile has therefore lengthened, and about a third of foreign financing matures in 2027 or later. This year's instalments are relatively low, at around 3% of GDP, whereas at this time last year, 2020 instalments totalled 5.2% of GDP.

### Short-term debt is low in historical context

Iceland's short-term foreign debt is low in historical context, both in absolute terms and as a share of total debt. At the end of 2020, it totalled 184 b.kr., or 6% of GDP, and consisted mainly of trade credit and non-residents' deposits with deposit institutions. Short-term debt is calculated based on the original maturity, but it is also possible to calculate it based on residual maturity (Chart III-16). Also included are the next year's instalments on long-term debt, highly liquid bonds maturing within twelve months, and certificates of deposit issued by the Central Bank of Iceland. When measured in this manner, Iceland's short-term debt amounts to roughly 330 b.kr., or 11% of GDP, but it has declined in the recent term. This is partly because of non-residents' securities sales, although the next year's long-term debt instalments were unusually low at the end of 2020.



### Foreign liabilities denominated in ISK declined by nearly 5% of GDP in 2020

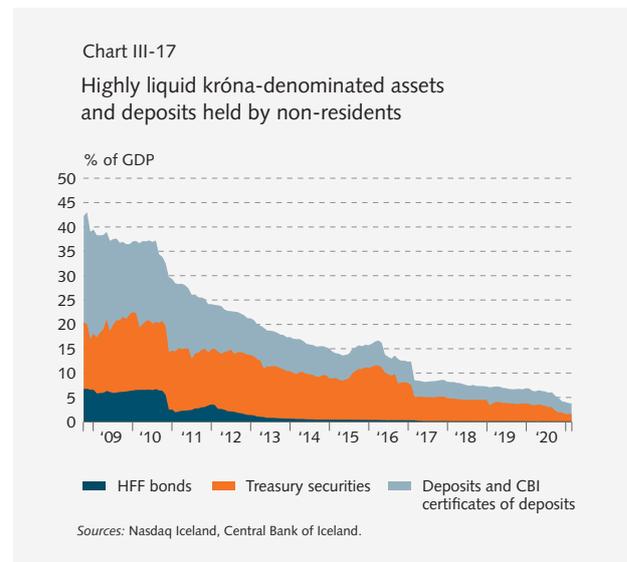
At the end of 2020, about a third of Iceland's debt, or just over 800 b.kr. (28% of GDP) was denominated in krónur (Table III-2). It declined by 129 b.kr. in 2020, mainly because of non-residents' sales of domestic securities and a reduction in FDI due to negative reinvested

earnings. After this change, about 2/3 of non-residents' króna-denominated holdings were due to FDI and pension entitlements, and about 15% were in highly liquid króna assets and deposits, which could flow out of Iceland at short notice and have a strong impact on domestic markets.<sup>12</sup>

Table III-2 Breakdown of foreign liabilities at year-end 2020

B.kr.	ISK	FX	Total
FDI - equity	172	423	595
FDI - loans	142	350	492
Portfolio investment - equities	81	334	415
Portfolio investment - unit shares	9	0	9
Portfolio investment - Treasury securities	54	246	300
Portfolio investment - bank bonds	8	583	591
Portfolio investment - other corporate bonds	8	145	154
Portfolio investment - CBI2016 certificates of deposit	12	0	12
Derivatives	0	3	4
Bank deposits	53	38	91
Deposits with the Central Bank	2	10	12
Corporate borrowings	36	337	373
Bank borrowings	0	19	19
Borrowings, other	0	4	4
Pension obligations	239	0	239
Trade credit	0	66	66
Counterpart, SDR	0	21	21
Other liabilities	1	6	7
	818	2,584	3,402

Source: Central Bank of Iceland.



This is a major change from the situation prevailing after the financial crisis, when the stock of highly liquid króna-denominated assets and deposits peaked at 40%

<sup>12</sup> Highly liquid króna-denominated assets are Treasury securities, Housing Financing Fund bonds, and Central Bank certificates of deposit held by non-residents.

of GDP (Chart III-17).<sup>13</sup> Until the general liberalisation of capital controls in spring 2017, the stock of highly liquid króna assets declined more or less unabated, mainly in connection with Central Bank foreign currency auctions.<sup>14</sup> It increased temporarily in 2015-2016, when foreign fund management companies invested heavily in Treasury bonds.

The stock of highly liquid króna-denominated assets and deposits totalled 111 b.kr. (about 4% of GDP) at the end of March 2021. Of that amount, non-residents' Treasury bond holdings came to 45 b.kr. (about 5% of total Treasury issuance), which is low in historical context (based on available data from 2005 to the present) and in international context. Furthermore, non-residents' króna-denominated shareholdings had declined from about 80 b.kr. at the end of 2019 to 70 b.kr. as of year-end 2020. Most foreign-owned shareholdings in Icelandic companies are listed on foreign stock exchanges (Table III-2). Moreover, non-residents own large holdings in domestic companies that are classified as FDI.

## Central Bank international reserves

The role of the Central Bank's international reserves is among other things to mitigate the influence of volatility in Iceland's balance of payments on the economy with a view to the Bank's monetary and exchange rate policy, and to reduce the likelihood that movement of capital to and from Iceland will compromise financial stability. For a small open economy with an independent currency, it is important that the international reserves be sufficiently large. This boosts investors' confidence in the stability of the króna and the Bank's ability to respond to unforeseen events that could jeopardise financial and economic stability. Ample reserves also give the Central Bank scope to trade in the interbank market in order to mitigate exchange rate volatility, deepen the market, and improve price formation when necessary, either through regular transactions or through intervention.

Historically, Iceland has used a variety of metrics of reserve adequacy, which have changed with shifts in prevailing global views and the Bank's objectives at any given time. The Bank keeps close watch on developments in the reserves and various reserve adequacy criteria,

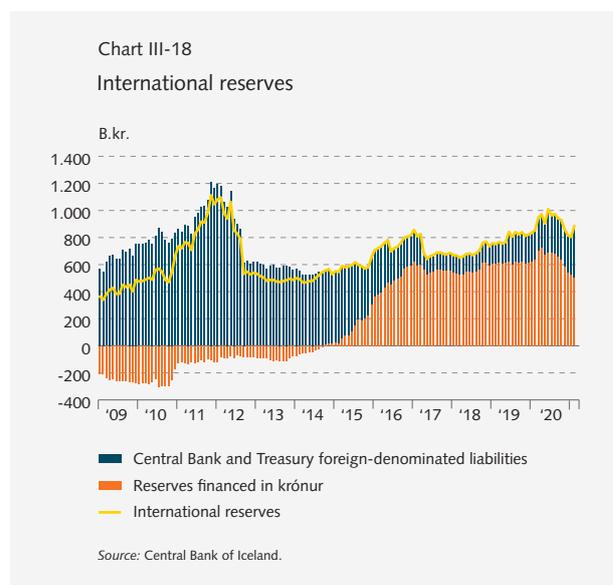
13 Non-residents acquired large positions in Treasury bonds and deposits with the commercial banks and the Central Bank in the wake of the financial crisis, mainly in connection with the settlement of the so-called glacier bonds, which peaked at 450 b.kr., or a third of year-2007 GDP. See, for example, the discussion of glacier bonds in Chapter 21 of the Parliamentary Special Investigation Commission (SIC) report on the background and causes of the collapse of the Icelandic banks in 2008.

14 See the Box entitled *Capital account liberalisation 2009-2019*.

but in recent years it has mainly used the International Monetary Fund's (IMF) reserve adequacy metric (RAM).

## Accumulation of the international reserves after the financial crisis

During the recent phase of growth in tourism, the Central Bank built up large international reserves that were financed with foreign debt only to a small degree (Chart III-18). The tourism boom brought strong inflows of foreign currency into the country, and the Bank bought large amounts from market makers in the interbank foreign exchange market, particularly in 2015 and 2016, as the accumulation of adequate reserves was a prerequisite to successful liberalisation of the capital controls. More recently, the reserves have mainly changed in line with exchange rate movements, Treasuries' foreign funding, and as a result of market intervention by the Bank. These abundant reserves provided a welcome buffer at the onset of the COVID-19 pandemic, which caused tourism revenues to collapse and narrowed Iceland's current account surplus significantly.



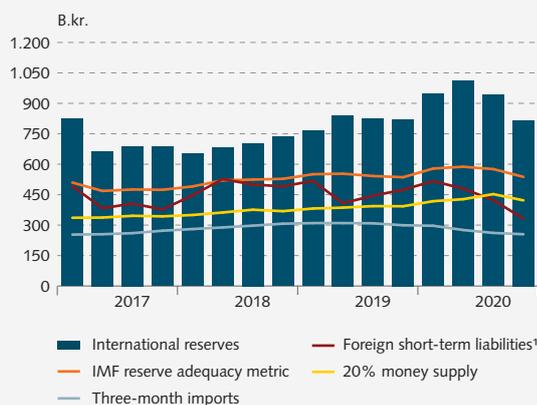
Foreign currency inflows into the interbank foreign exchange market were negligible, and as a result, price formation in the market was ineffective from mid-2020 onwards. In mid-September, the Central Bank launched its regular programme of selling currency in the amount of 3 million euros per day in order to deepen the market and improve price formation. The Bank has tapped the reserves both for these sales and in response to capital outflows resulting from non-residents' domestic securities sales. Since the pandemic reached Iceland, the international reserves have increased twice through Treasury foreign bond issuance.

### International reserves adequate by all measures

The Central Bank's international reserves totalled 817 b.kr. at the end of 2020. All reserve adequacy metrics indicate that the reserves are ample (Chart III-19). For instance, they are more than twice as large as foreign short-term liabilities and cover nearly 10 months of imports, whereas the usual criteria require only that they exceed short-term liabilities and cover three months of imports. In terms of the IMF's RAM, they are also well above the benchmark. At the end of 2020, the ratio of the reserves to the RAM was 152%. The Fund generally recommends reserves ranging between 100% and 150% in order to meet unforeseen changes in economic conditions, but this is always subject to conditions in the country concerned (Chart III-20). In this context, the IMF

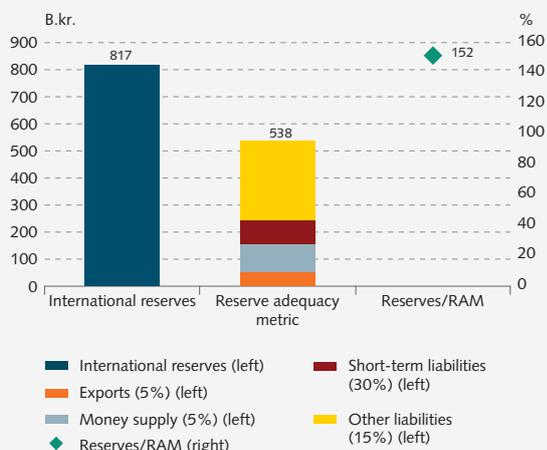
has recommended that countries highly dependent on cross-border commodity trade and those with a pegged exchange rate regime should hold larger reserves than they would otherwise. At the end of 2020, the Central Bank's international reserves exceeded the Fund's lower threshold of 100% of RAM by 280 b.kr. On average, they have been about 260 b.kr. above that threshold ever since the capital controls were lifted in early 2017. The Treasury's recent eurobond issue expanded the reserves and increased the ratio to 168% of RAM. The reserves totalled 857 b.kr. at the end of March 2021.

Chart III-19  
International reserves and reserve adequacy metrics



1. Based on residual maturity.  
Source: Central Bank of Iceland.

Chart III-20  
International reserves as of end-2020 and IMF reserve adequacy metric<sup>1</sup>



1. Weight of each reserve adequacy metric (RAM) component in parentheses.  
Source: Central Bank of Iceland.

# Balance of payments scenario 2021

## IV

The Central Bank developed its balance of payments model during the run-up to capital account liberalisation. The purpose of the model is to extrapolate the balance of payments and external position over an extended period, estimate currency flows, and forecast developments in the current account and the financial account. The model requires certain assumptions about developments in important macroeconomic variables such as the trade balance and the exchange rate of the króna, which are obtained using the Bank's macroeconomic model (QMM), as well as a number of additional assumptions about factors such as capital flows, returns, and interest rates on Iceland's assets and liabilities. This chapter examines further the assumptions underlying the balance of payments scenario recently prepared by the Bank.

## Balance of payments scenario – assumptions

### Economic outlook

The balance of payments scenario discussed in this chapter is based on the Bank's macroeconomic forecast, published in *Monetary Bulletin* 2021/1 on 3 February. According to that forecast, trading partner GDP growth is expected to flip from being negative by 5.7% in 2020 to being positive by 4.3% this year. The forecast assumes that just over 700,000 tourists will visit Iceland in 2021 and that year-on-year export growth will measure around 10%. This estimate assumes that the impact of the pandemic will taper off starting this summer. On the other hand, import growth is expected to be strong this year, at just over 11%, owing mainly to a jump in overseas travel by Icelanders and an increase in econom-

ic activity. Iceland's GDP is projected at 2.5% in 2021, after a contraction of 6.6% in 2020, the largest contraction in GDP since the financial crisis. Terms of trade are estimated to have deteriorated by 2.3% in 2020 and are projected to deteriorate further this year, owing to declining marine product prices in key markets and to higher oil and commodity prices.<sup>15</sup> In addition, the trade deficit is expected to widen from 0.6% of GDP in 2020 to 0.8% in 2021. These estimates are highly uncertain, and the economic outlook depends in large part on the path taken by the pandemic. The forecast also assumes that the króna will depreciate by an average of 1.9% in 2021. Furthermore, external financing conditions are expected to remain favourable.

Table IV-1 Balance of payments scenario – key assumptions

	2019	2020	2021
Foreign short-term interest rates (50/50 LIBOR EURIBOR) %	0.2	-0.1	-0.2
Central Bank key interest rate <sup>1</sup> (%)	3.9	1.5	0.75
Spread on Treasury-issued eurobonds (%)	0.4	0.7	0.5
Spread on commercial banks' foreign funding (%)	1.6	1.6	0.9
Exchange rate of the króna <sup>2</sup> (% change; an increase represents a depreciation of the króna)	8.6	11.1	1.9
GDP growth <sup>3</sup> (%)	1.9	-6.6	2.5
Trading partner GDP growth <sup>3</sup> (%)	1.9	-5.7	4.3
Terms of trade for goods and services <sup>3</sup> (% change)	-0.7	-2.3	-0.4
Trade balance <sup>3</sup> (% of GDP)	5.1	-0.6	-0.8

1. The key rate for 2021 is the average over the first four months of the year.

2. Trade-weighted exchange rate index (narrow trade basket). Figure for 2021 from the forecast in *Monetary Bulletin* 2021/1.

3. Figures for 2021 are obtained from the forecast in *Monetary Bulletin* 2021/1.

Sources: Bloomberg, Statistics Iceland, Central Bank of Iceland.

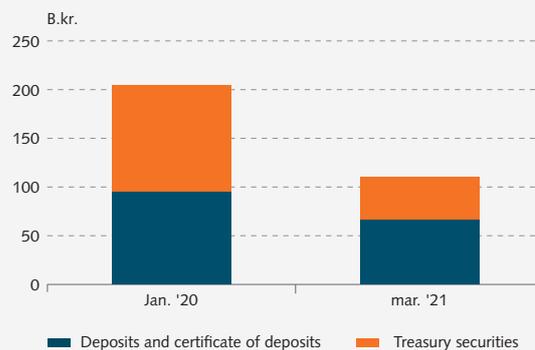
<sup>15</sup> On average, a 1% deterioration in terms of trade results in a permanent deterioration of the trade balance by 0.4% of GDP.

## Investment-related capital outflows

Preparing a realistic estimate of developments in the 2021 balance of payments requires estimates of capital flows for investment by residents and non-residents. The Treasury's robust position in international context, Iceland's positive nominal interest rate differential with abroad, and the prospect of a turnaround in exports are all considered likely to boost foreign investors' appetite for Icelandic assets. Inflows are expected to resume this year, after last year's substantial outflows from non-residents' króna-denominated investments. The stock of non-residents' highly liquid króna-denominated assets and deposits has declined steeply since the onset of the pandemic, to 111 b.kr. by the end of March 2021 (Chart IV-1). Presumably, most investors interested in closing out their positions did so while the economic impact of the pandemic was at its peak. For this year, non-residents' investments can be expected to focus both on equities, owing to the inclusion of two Icelandic companies in the MSCI Frontier Market Index as of May, and on Treasury bonds. In both historical and international contexts, foreign investors hold a small share of the outstanding stock of Treasury securities. In March, they owned Treasury bonds worth 45 b.kr., or 5% of the outstanding stock. That share is expected to rise this year to about 10%, which is still well below the 2010-2019 average of 19%. There is considerable uncertainty about how long-term these Treasury bond investments might prove to be, but developments in recent months underscore the importance of holding large enough international reserves to withstand outflows from highly liquid assets. Furthermore, foreign owners of offshore krónur have closed out about half of their position recently, leaving an offshore balance of just under 30 b.kr., which is expected to decline by half this year.

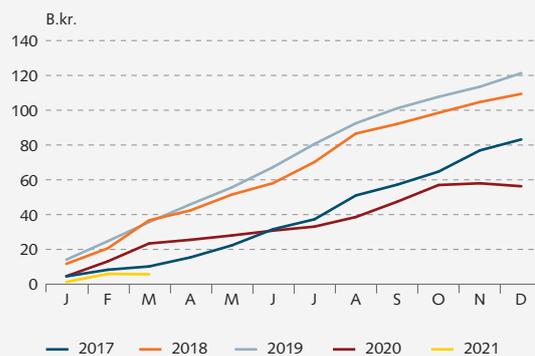
Positive currency flows from non-residents will be offset by outflows due to the pension funds, which aim to increase the share of foreign-denominated assets in their portfolios in the next few years. The pension funds bought little foreign currency in 2020; in fact, their total purchases were the smallest in a single year since the capital controls on their investments were lifted in 2017 (Chart IV-2).<sup>16</sup> Nevertheless, foreign-denominated assets increased as a share of their total assets by 2.9 percentage points, to 35% as of end-2020. The increase was due to a steep rise in foreign share prices, compounded by the depreciation of the króna. The pension funds' foreign exchange transactions at the end of 2020 and

Chart IV-1  
Non-residents' highly liquid króna-denominated assets



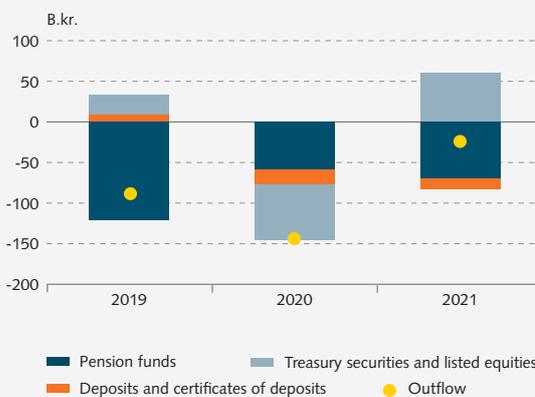
Source: Central Bank of Iceland.

Chart IV-2  
Pension funds' cumulative net foreign currency purchases



Source: Central Bank of Iceland.

Chart IV-3  
Currency flow due to portfolio investment, deposits and certificate of deposits 2019-2021<sup>1</sup>



1. Figures for 2021 are estimated. 2. Adjusted for exchange rate hedging. Excluding securities investments classified as foreign direct investment. 3. Change in non-residents' ISK deposits.

Source: Central Bank of Iceland.

<sup>16</sup> Further discussion of the liberalisation of the capital controls can be found in the Box entitled *Capital account liberalisation 2009-2019*.

in Q1/2021 indicate less appetite for foreign investment than in 2018-2019. In all likelihood, the pension funds' year-2021 outflows will be at least equal to their foreign obligations due to specialised investments, which come to 40-50 b.kr. annually over the next few years. This amount is therefore considered the minimum of their annual outflows. The balance of payments scenario assumes that the pension funds' outflows will be slightly larger in 2021 than in 2020.

The balance of payments scenario is therefore based on the assumption that foreign currency outflows related to portfolio investments, offshore króna assets, and deposits will total just over 20 b.kr. in 2021, or 0.7% of GDP (Chart IV-3). This is a major change from 2020, when outflows totalled 145 b.kr. Estimates of this kind are always subject to considerable uncertainty, however. Depending on assumptions about the economic recovery in 2022, residents' and non-residents' expected capital flows could lie in a relatively broad range. The interest rate differential with abroad and conditions in global capital markets are factors that could change and thereby affect the outcome. The balance of payments scenario is also based on assumptions concerning developments in inward and outward foreign direct investment (FDI), both of which are presumed to move broadly in line with investment and GDP growth in Iceland and abroad.

#### **Assumptions about debt rollover and reinvestment**

The above-described assumptions about capital flows affect the financial account, which includes foreign loan instalments, refinancing, and reinvestment of interest and dividends. It is assumed that residents will reinvest all of their interest income abroad. It is assumed that credit spreads on residents' foreign borrowings will remain favourable and that the commercial banks, the Treasury, and other borrowers (apart from fisheries and a few other companies) will refinance all of their debt. In 2020, borrowing and foreign issuance of marketable bonds slightly exceeded debt service, but foreign market issuance is expected to rise somewhat this year, mainly because of an increase in the Treasury's foreign debt. At the beginning of 2021, the Treasury issued a bond for the equivalent of 117 b.kr. (4% of GDP), but no instalments on that bond are scheduled for this year.

#### **Developments in the international reserves in the balance of payments model**

Because the exchange rate path in the balance of payments scenario is an external variable obtained from QMM, it must be assumed that the international

reserves will change if capital inflows and outflows are not equal to one another. As a result, the balance of payments model assumes that the current account surplus over and above estimated debt service, after adjusting for refinancing and other capital flows, will show as an increase in the international reserves.<sup>17</sup>

*Current account balance = Financial account balance excluding reserve activity +  $\Delta$ reserves*

By the same token, the reserves decrease if financial outflows exceed the current account surplus. This is naturally a simplified view of the economy's adjustment to financial flows. The adjustment would more likely involve interactions between exchange rate movements and reserve activity.

## **Results of the balance of payments model**

### **Balance of payments scenario for 2021**

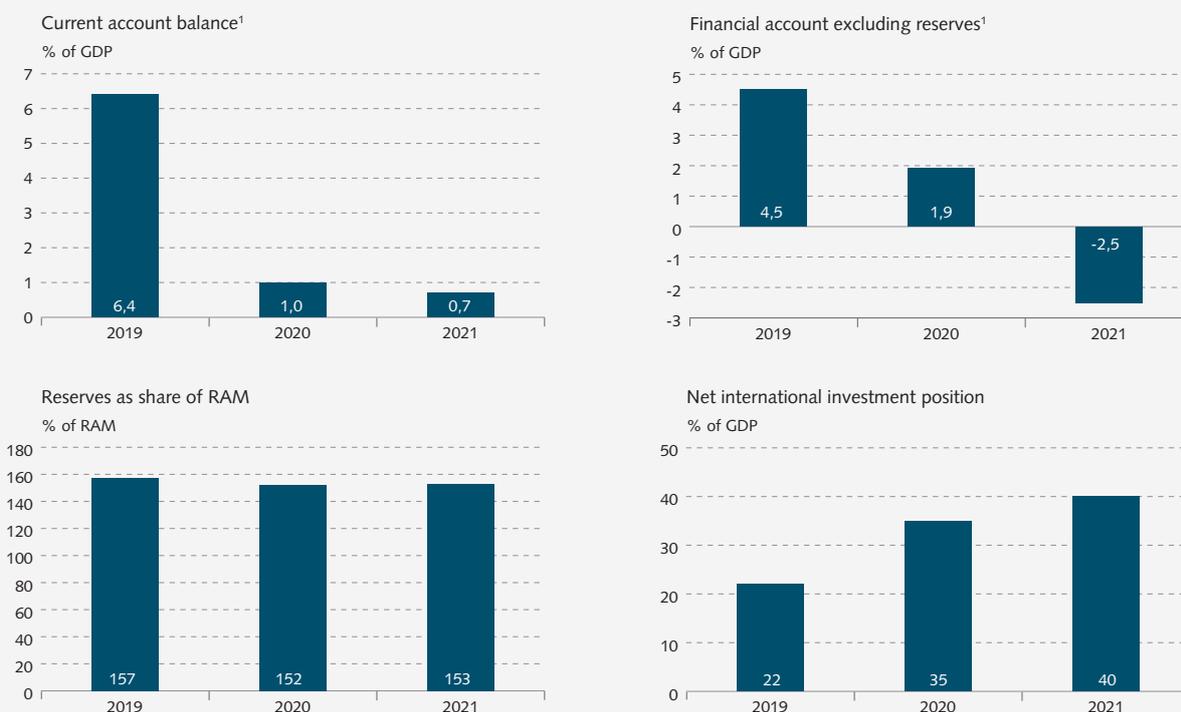
The charts below show developments in Iceland's NIIP, reserve ratio, financial account excluding reserve activity, and current account balance in the wake of the COVID-19 pandemic, together with a forecast for 2021 (Chart IV-4). The estimates are subject to some uncertainty, particularly as regards the trade surplus and residents' and non-residents' investment flows in 2021. Investment flows could turn out weaker or stronger, depending on how strongly domestic demand picks up and tourism recovers.

The results of the balance of payments scenario show that the current account balance will remain positive despite the export shock; however, the surplus will narrow from 1.0% in 2020 to 0.7% in 2021 (Chart IV-4). Deteriorating terms of trade and increased domestic demand are the main drivers of the change. A narrower current account surplus and increased capital inflows in 2021 will cause the financial account balance excluding reserve activity to fall into negative territory, measuring -2.5% of GDP for the year (a negative financial account balance indicates net capital inflows). This is due mainly to an increase in Treasury borrowing and in non-residents' portfolio investment in Iceland, but by the same token, foreign debt increases as well. Offsetting this are pension fund-related outflows. Capital inflows and a depreciation of the króna lead to an increase in the Central Bank's international reserves in 2021. As a share of the International Monetary Fund's reserve adequacy metric (RAM), the reserves increase to 153% in

<sup>17</sup> The capital account is close to 0 and stable. For simplification, it is omitted.

Chart IV-4

Developments in the balance of payments in the wake of the COVID-19 pandemic



1. Balance of payments outlook for 2021 according to the balance of payments model. Financial account balance excluding reserve activity and net errors and omissions. Source: Central Bank of Iceland.

2021, slightly above the Fund's upper reserve adequacy threshold.<sup>18</sup> Therefore, at the end of 2021, the reserves are estimated to exceed 100% of RAM by 285 b.kr., or 9.5% of GDP.

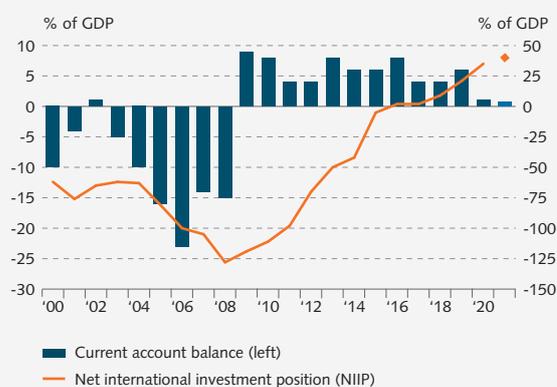
Iceland's NIIP is projected to improve from 35% of GDP at the end of 2020 to 40%, owing in particular to favourable developments in asset prices in foreign financial markets and to the depreciation of the króna. This is offset by rising asset prices in Iceland, which results in an increase in foreign liabilities. However, the outlook for the NIIP is subject to considerable uncertainty and depends on how factors such as developments in the current account balance and capital flows interact with the exchange rate of the króna.

The COVID-19 pandemic will continue to have a marked effect on the current account balance and capital flows this year; however, the economy is well positioned to withstand shocks. Ample Central Bank reserves, moderate foreign-denominated debt at the beginning of the pandemic, and a positive NIIP have made a major

difference. Furthermore, the stock of highly liquid króna-denominated assets was relatively small at the beginning of the pandemic, at around 200 b.kr., or 7% of GDP, in part because non-residents' capital inflows into highly liquid domestic assets have been moderate in recent years. The effects of the capital controls that were lifted in 2017 and the Central Bank's capital flow management

Chart IV-5

Current account balance and Iceland's net international investment position 2000-2021<sup>1</sup>

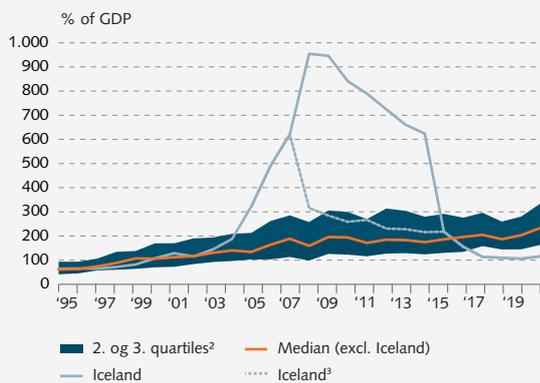


1. Forecast for 2021 obtained using the BOP model. Underlying current account balance 2008-2015 and underlying NIIP for 2008-2014. Sources: Statistics Iceland, Central Bank of Iceland.

18 The RAM is a measure of reserve adequacy that takes account of the exchange rate regime of the country concerned, as well as a variety of factors that could affect the balance of payments; i.e., exports, money supply, foreign liabilities, and short-term liabilities. See also Chapter III in this report and Box II-3 in *Financial Stability 2017/1*.

tool, which was applied between June 2016 and March 2019, had a dampening impact on foreign inflows into highly liquid assets such as Treasury bonds. The results suggest that in spite of the pandemic-induced shock, Iceland's NIIP will continue to be at or close to its most favourable since World War II, and much better than it was before the financial crisis (Chart IV-5). Foreign debt will also remain low in international context, at around 120% of GDP by the end of 2021 (Chart IV-6). A similar tale can be told of the reserves, which would remain large in terms of international reserve adequacy criteria and in historical and international context. It is worth noting that if all highly liquid assets held by non-residents were to flow out of the country, the reserves would still remain generous, at more than 130% of RAM. Currently available information indicates that the outlook for the balance of payments is positive and the scope to withstand further external shocks is ample.

Chart IV-6  
Foreign liabilities in comparison with OECD countries  
1995-2020<sup>1</sup>



1. Preliminary figures for OECD countries at year-end 2020, based on Q3'20 figures if a later value is not known. 2. Dividing the sample into four quarters, the blue shaded area shows the second and third quartiles. 3. Iceland excluding liabilities for failed financial institutions but taking into account estimated effect of their winding up 2008-2014.

Source: International monetary fund, Central Bank of Iceland.

## Capital account liberalisation 2009-2019

In 2009, the year after the onset of the banking and financial crisis, Iceland's external liabilities soared to a record 970% of GDP, owing mainly to an extremely leveraged banking system. At that time, Iceland had been among the most heavily indebted countries in the world for some time. The large stock of domestic assets held by foreign investors meant that Iceland was faced with a balance of payments problem. As a result, it proved necessary to impose restrictions on movement of capital to and from Iceland in November 2008. The fundamental principle was that movement of capital was prohibited while capital controls were in place unless explicitly authorised, whereas trade in goods and services was exempt from the controls unless explicitly prohibited. Since then, the Icelandic authorities have aimed to lift the capital controls as soon as possible. This has taken quite some time, however, and several times it proved necessary to tighten the restrictions. The capital controls were finally lifted in stages between 2015 and 2017. A large step was taken in October 2016, followed by a general liberalisation in March 2017, more than eight years after the controls were introduced. However, so-called offshore krónur, which mainly consisted of highly liquid króna-denominated assets owned or held in custody by non-residents at the time the capital controls were imposed, were subject to the restrictions until May

2019, whereupon their owners were authorised to convert them to foreign currency.<sup>1</sup>

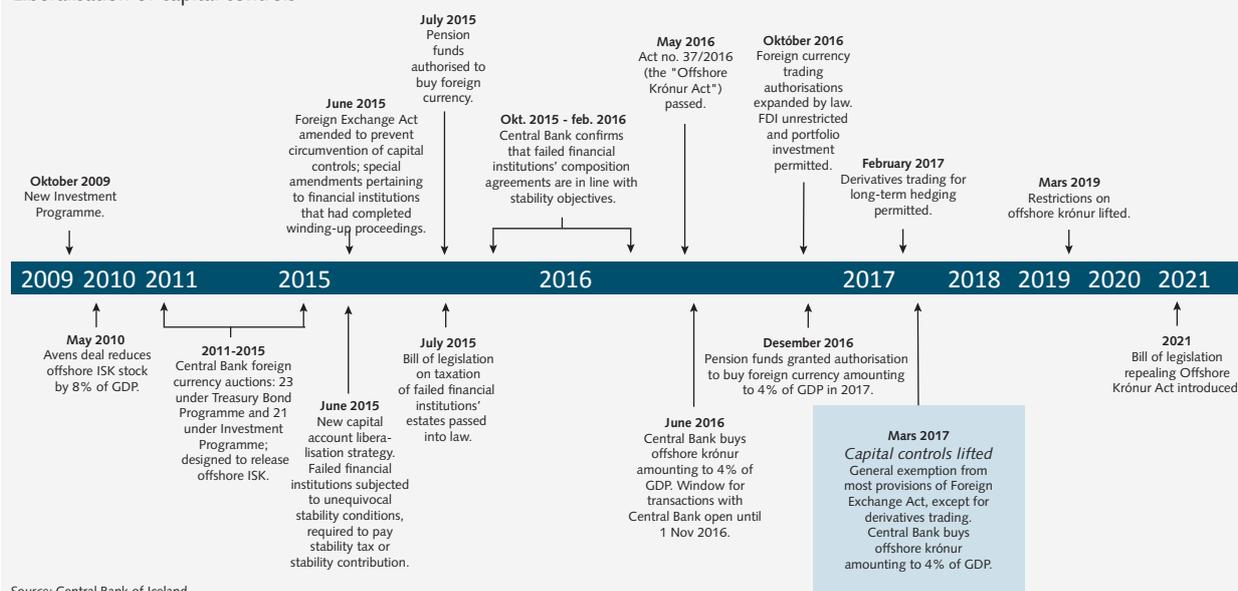
### Plans to lift the capital controls focused on resolving Iceland's balance of payments problem

The first capital account liberalisation strategy was introduced in August 2009, and the second one followed in March 2011. Both strategies aimed at resolving Iceland's balance of payments problem, which in the main was threefold. First of all, it entailed potential capital outflows due to offshore krónur, which equalled 35% of GDP at the end of 2009. Second, it involved potential outflows upon the settlement of the failed financial institutions' estates, as 40% of their assets were domestic, whereas 95% of claims against them were held by non-residents. The third part of the problem lay in resident entities' pent-up need to invest in foreign assets. The last capital account liberalisation strategy was presented in June 2015. It was based on the general approach taken by the International Monetary Fund (IMF) to capital account liberalisation and the fundamental objectives of maintaining sufficient foreign exchange reserves and minimising the risk of large capital outflows.

1 A more detailed definition of offshore krónur can be found in Act no. 37/2016.

Chart 1

### Liberalisation of capital controls



Source: Central Bank of Iceland.

### Offshore krónur reduced to 14% of GDP in 2015 with auctions and targeted measures

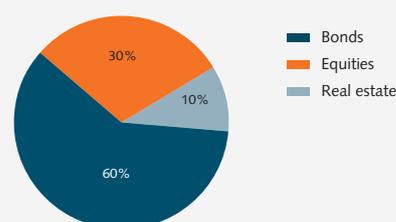
The first step towards liberalisation was taken in October 2009 with the New Investment Programme. Under the Programme, investments undertaken on or after 1 November 2009 using new inflows of foreign capital converted to Icelandic krónur were exempted from the capital controls. In May 2010, the Central Bank finalised the so-called Avens deal, under which the Bank, acting on behalf of the Treasury, bought bonds from the Banque centrale du Luxembourg and then sold them on to domestic pension funds at a profit. This reduced the stock of offshore krónur by 8% of GDP. The Bank began holding foreign currency auctions in May 2011. By that time, the króna effectively had two exchange rates: the onshore rate, which applied in the domestic interbank market, and the offshore rate, which was used to some extent in other transactions. The Bank solicited bids for foreign currency and sold it directly to holders of offshore krónur and simultaneously solicited bids from investors interested in buying króna-denominated Icelandic Treasury bonds in exchange for euros. This was called the Treasury Bond Programme. In February 2012, the first auction of offshore krónur was held under the Investment Programme. Bids were solicited simultaneously from parties interested in buying krónur for various investments and those interested in selling them. The EURISK exchange rate for these transactions was just over 30% below the onshore exchange rate. Capital inflows from auction participants had to satisfy certain requirements, mainly pertaining to the duration of the investment. The investment was subject to a commitment period of five years, and the investor was required to purchase a matching amount in krónur, but in the onshore market. The aim of the auctions was to thin out the stock of offshore krónur and attract long-term investment capital to Iceland. The majority of the capital that entered through the offshore auctions was invested in bonds, and

about 30% was invested in equities (Chart 2). Most of the funds were imported or exported via direct transactions with the Central Bank, so that currency flows in the interbank market for krónur do not reflect total currency flows over the period in question.<sup>2</sup> As the onshore exchange rate and the auction exchange rate drew closer together, the incentive to register investments as new investments increased, as it could be costly to tie an investment up for a period of five years. With the auctions and other measures, the stock of offshore krónur was reduced to 14% of GDP by the end of 2015.<sup>3</sup> The last auction under the Bank's Treasury Bond and Investment Programme was held in February 2015. By that time, capital inflows through the auctions totalled 262 b.kr., or 12% of year-2015 GDP, and the Central Bank bought 158 b.kr. With the passage of the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions in May 2016, owners of offshore krónur were separated out so as to facilitate the next steps in the liberalisation strategy. Owners of offshore krónur were authorised to invest in special Central Bank certificates of deposit (CBI2016) at 0.5% interest, or in Treasury bills. In June 2016, the Central Bank bought offshore krónur for the equivalent of 4% of GDP at an exchange rate 25% below the onshore rate, and from then until 1 November 2016, owners of offshore krónur were invited to conduct trades with the Bank at an even higher exchange rate.

### Failed financial institutions' composition agreements confirmed at the end of 2015

The June 2015 capital account liberalisation strategy entailed that the failed financial institutions would be subjected to unequivocal stability conditions, on the basis of which they could choose from two options – a stability tax or a stability contribution – which would mitigate the adverse impact that distributions from the estates would have on Iceland's balance of payments. Special amendments were made to the Foreign Exchange Act in connection with the financial institutions that had concluded winding-up proceedings, and a bill of legislation on a stability tax was passed in July 2015. Thereafter, seven failed financial institutions applied for exemptions from the Foreign Exchange Act in connection

Chart 2  
Distribution of investments through auction according to Investment Programme 2015



Source: Central Bank of Iceland.

2 The capital that entered via the Treasury Bond Programme was not routed through the interbank market for krónur, but half of the amount that entered via the Investment Programme was converted to krónur in the interbank market.

3 See, for example, the table summarising the main measures undertaken to resolve the balance of payments problem in the publication "Central Bank foreign currency auctions – Investment Programme and Treasury Bond Programme: The role of auctions in resolving Iceland's balance of payments problem" (in Icelandic), published on the Central Bank website in August 2019.

with planned composition agreements with their creditors and the winding-up of their estates. The Central Bank determined that the composition proposals were in compliance with the Foreign Exchange Act, as well as satisfying the stability conditions. The composition agreements were approved by the District Court in December 2015, and the Central Bank granted exemptions from the Foreign Exchange Act shortly thereafter. With the composition agreements, the companies were declared insolvent and new holding companies were established on the basis of the old ones. The holding companies' role was to administer the assets to be liquidated. At the end of 2015 and early in 2016, an enormous amount of the failed financial institutions debts were cancelled, stability contributions were paid, and foreign liquid assets had been applied towards debts owed to their creditors. Iceland's external liabilities therefore declined from 560% of GDP in Q3/2015 to just over 190% of GDP in Q1/2016. The net international investment position improved markedly as well, from being negative by 330% of GDP to being negative by 3.9% of GDP at the end of Q1/2016. This concluded one of the biggest chapters in the settlement of Iceland's 2008 financial crisis.

### **Major steps towards full liberalisation of capital controls on households and businesses taken in October 2016, and nearly all remaining controls lifted in March 2017**

Because of the importance of the pension funds to the Icelandic economy and in order to meet some of their pent-up demand prior to liberalisation, the funds were granted a special exemption from the Foreign Exchange Act in order to invest abroad, ahead of other domestic investors. From mid-2015 until the controls were lifted in March 2017, the pension funds bought foreign currency for 90 b.kr., or about 80% of the authorisation granted them.<sup>4</sup> In October 2016, the Foreign Exchange Act was amended so as to facilitate the liberalisation of controls on households and businesses. With the passage of those amendments, foreign direct investment was unrestricted and investments in foreign-denominated financial instruments authorised. Prepayment and retirement of loans was also permitted for the equivalent of 30

b.kr., purchases of up to one piece of foreign real estate per year were authorised, and various other restrictions were either lifted or eased. Furthermore, the 30 m.kr. maximum was raised to 100 m.kr. as of the beginning of 2017 and transfers of deposits were authorised up to that limit. When the Rules on Foreign Exchange took effect in March 2017, households, businesses, and pension funds were essentially unaffected by restrictions on movement of capital. From that time on, capital transfers for foreign exchange transactions, foreign investment, hedging, and lending transactions were permitted. In the main, the transactions that are still subject to restrictions are derivatives contracts for non-hedging purposes in which the króna is in a contract against foreign currencies, and foreign exchange transactions undertaken between residents and non-residents without the intermediation of a financial institution.

### **After liberalisation in March 2017, restrictions remained on offshore krónur, which were lifted in March 2019**

In March 2017, the Bank bought 112.4 b.kr. in offshore krónur at an exchange rate 15% below the onshore rate. At this point, the offshore stock had been reduced to 88 b.kr., or 3.5% of GDP. The restrictions on converting offshore krónur to foreign currency were lifted in March 2019. The stock of offshore krónur totalled 80 b.kr., or just under 3% of GDP, at that time. If the bill of legislation for a new Foreign Exchange Act, currently before Parliament, is passed unamended later this year, the Offshore Króna Act will be repealed, and the stock of offshore krónur, which totalled 26 b.kr. as of end-March 2021, or just under 1% of GDP, will merge with the onshore króna stock.

<sup>4</sup> At first, the authorisation for foreign currency purchases was granted for a few months at a time. By late 2016, Iceland's foreign currency position had improved markedly, and the likelihood of large-scale outflows following further liberalisation had diminished. The authorisation totalled 95 b.kr. for the period from mid-2015 through December 2016. The funds were granted increased scope for foreign investment with a 100 b.kr. authorisation for 2017. The funds' utilisation of the authorisation in 2017 is based on the first two months of the year, as the controls were lifted in March and the utilisation ratio assumes that the authorisation is spread equally over the entire year.



SPECIAL PUBLICATION  
2021 | 14