

## 6 External position

*This chapter presents Iceland's international investment position, both gross (IIP) and net (NIIP). It discusses pre-crisis debt accumulation and post-crisis developments, describes changes in foreign direct investment, and provides figures on net foreign debt levels following the composition agreements between the failed banks and their creditors in December 2015.*

### Net international investment position

Iceland's net international investment position (NIIP) has improved radically in the post-crisis period, through debt repayment facilitated by the current account surplus, debt write-offs due to bankruptcies of private sector entities and other means, and the composition agreements of the failed financial institutions' estates in late 2015 (see Chapter 8).

Iceland's international balance sheet had expanded rapidly after the capital account liberalisation of the 1990s, and the expansion accelerated further following the privatisation of the banks in 2002-2003. Although the foreign assets of the Icelandic economy grew swiftly during that period, foreign debt grew even more rapidly. From year-end 2002 until the banking crisis in autumn 2008, gross external liabilities expanded from 117% to 877% of GDP and gross external assets from 50½% to 691% of GDP, resulting in a negative NIIP in the amount of 186% of GDP in Q3/2008. The NIIP continued to worsen as a result of the collapse of the banks and the depreciation of the króna, reaching a trough of -715% of GDP in Q3/2009 according to official NIIP calculations.

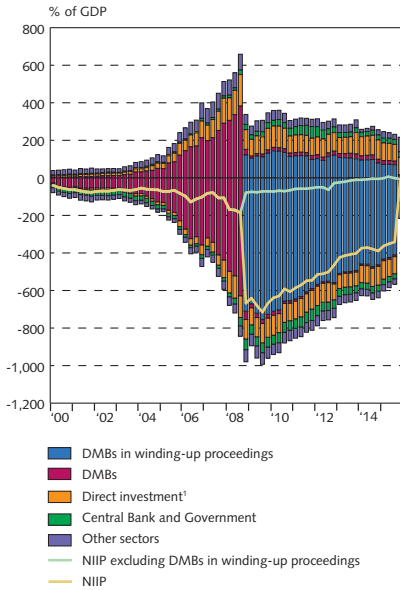
However, during the period from the banks' collapse until end-2015, the official calculation of Iceland's NIIP gave a misleading impression of the actual position. In autumn 2008, the estates of Iceland's largest banks were placed in winding-up proceedings and resolution committees

Table 6.1 Iceland's net international investment position

<i>EUR billions (b.kr.)</i>	2000	Q3/2008	Q3/2009	2014	2015
Total assets	4.2 (330)	73.2 (10,657)	25.0 (4,542)	33.8 (5,211)	34.4 (4,865)
- excl. DMBs in winding-up proceedings	-	-	15.3 (2,774)	23.5 (3,626)	34.4 (4,865)
Total liabilities	9.7 (767)	92.9 (13,520)	87.6 (15,909)	84.3 (13,008)	35.3 (4,991)
- excl. DMBs in winding-up proceedings	-	-	21.6 (3,918)	24.2 (3,728)	35.3 (4,991)
Net international investment position	-5.5 (-437)	-19.7 (-2,863)	-62.6 (-11,367)	-50.5 (-7,797)	-0.9 (-126)
- excl. DMBs in winding-up proceedings	-	-	-6.3 (-1,144)	-0.7 (-102)	-0.9 (-126)

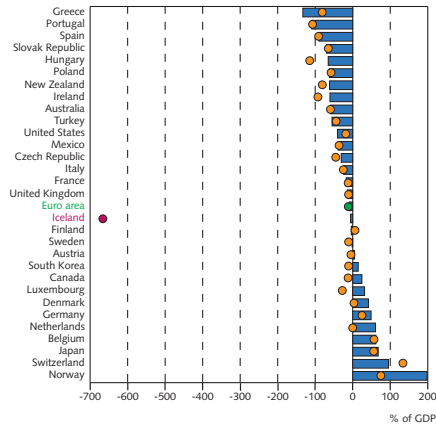
Source: Central Bank of Iceland.

Chart 6.1  
Net international investment position (NIIP)  
Q1/2000 - Q4/2015



1. Excluding special purpose entities from 2013.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 6.2  
Net international investment position  
of OECD countries 2015<sup>1</sup>



1. The dots show the NIIP for Q4/2009.  
Sources: Macrobond, Central Bank of Iceland.

were entrusted with their administration. The old banks' assets were transferred to the estates and revalued, whereas the liabilities were entered at nominal value plus accrued interest in official accounts. As it was clear from the outset that payments to creditors would be limited by the estates' assets and recoveries, the Central Bank of Iceland calculated the so-called underlying NIIP, which was based on the estimated settlement of the estates, alongside the official quarterly figures. The underlying NIIP was -131% of GDP in 2008 but had improved to -31.5% of GDP in Q3/2015. Nearly 40% of the reduction is due to the current account surplus and GDP growth during the period, and the rest is due to asset revaluation, debt restructuring, and other factors. With the composition agreements in 2015, the estates' liabilities were written off with reference to their assets, and the officially calculated NIIP thereby became the same as the underlying NIIP.

In December 2015, composition agreements sought by the failed banks' estates and approved by their creditors were confirmed by the District Court of Reykjavik, providing for cash distributions to creditors and establishment of asset management companies for the remainder of the assets. According to the settlements, payments to creditors totalled 13.5 billion euros (1,904 b.kr.)<sup>1</sup> and debt write-offs were 50.5 billion euros (7,134 b.kr.). Only a portion of the as-

1. Including distributions to priority creditors from the LBI estate. According to the Act on Bankruptcy, Etc., the confirmation of an estate's composition agreement is subject to the requirement that the estate be engaged in settling its debt to priority creditors. Full settlement of outstanding approved priority claims against the LBI estate took place in January 2016, with a distribution of 1.5 billion euros (210 b.kr.) to priority creditors.

sets, 3.3 billion euros (462 b.kr.), were distributed in Q4/2015.<sup>2</sup> With the settlements, the NIIP improved to -5.7% of GDP, the country's most favourable position in about half a century. Iceland's NIIP is low in comparison with other OECD countries and is now similar to that of Sweden, Finland, and the euro area as a whole.

### Foreign assets and liabilities

Iceland's total foreign debt soared prior to the collapse of the banks, rising to 877% of GDP in Q3/2008. It tapered off in 2010 and 2011, owing to the appreciation of the króna and the repayment of priority claims against the old Landsbanki Íslands estate, after having peaked at just over 1,000% in Q3/2009.<sup>3</sup> Foreign debt continued to decline over the next six years, due to the winding-up of the failed banks and the refinancing of foreign loans in the domestic credit market. Iceland's external assets deteriorated more abruptly than its foreign debt after the collapse of the banks and the króna. They stood at just over 691%

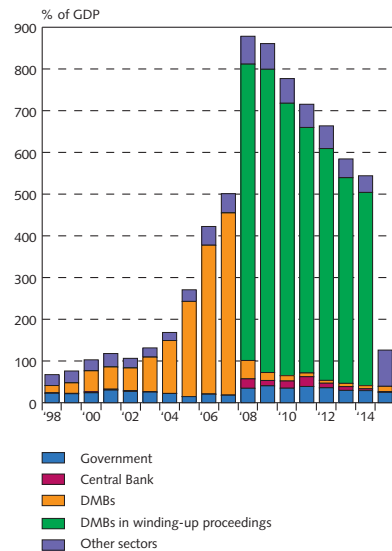
of GDP in Q3/2008 but fell to 260% of GDP in Q1/2009. Because the book value of many companies acquired by the banks prior to the crisis was revalued upwards by the banks' estates, the foreign asset position had improved to 308% of GDP by mid-year 2010. Several companies were then sold, mainly to repay priority claims, while others were declared insolvent, returning the foreign asset position to 260% of GDP at year-end 2014. A year later, following the composition agreements, Iceland's gross external assets were almost 221%, while external liabilities totalled just over 226% of GDP.

### Public sector foreign assets and liabilities

In the years before the crisis, the deterioration of the NIIP was due mainly to a surge in private sector debt intermediated by the domestic banking sector. Over the same period the public sector retired a substantial amount of its debt. The depreciation of the króna in 2008 and the need to strengthen the Central Bank's foreign exchange reserves increased the external liabilities of the general government and the Central Bank from 18% of GDP at year-end 2007 to the post-crisis peak of 61% of GDP at year-end 2011 (see Chapters 4, 5, and 7). Only a portion of the increase in public sector foreign debt had a direct effect on the NIIP, however, as loans taken to expand the reserves were mostly offset by assets. By year-end 2015, public sector external liabilities had fallen to 26% of GDP, due primarily to repayments of the long-term loans from the Nordic countries and the IMF to the Treasury and the Central Bank (see Chapters 4 and 7).

Chart 6.3

Estimated foreign debt by sector<sup>1</sup>



1. External debt position, excluding FDI and portfolio equities.  
Sources: Statistics Iceland, Central Bank of Iceland.

2. As of this writing, 3.3 billion euros (468 b.kr.) of the remaining 10.2 billion euros (1,443 b.kr.) have been paid out as cash distributions to creditors, while the remainder of the debt will be paid later, as asset sales are executed.

3. See Box 4.2 in *Economy of Iceland 2012*.

Table 6.2 Foreign assets and liabilities

<i>EUR billions (b.kr.)</i>	2007	2008	2009	2014	2015	'04-'07 (average change per year in ISK)	2008 (year- on-year change in ISK)	2009 (year- on-year change in ISK)	2014 (change from 2009 in ISK)	2015 (year- on-year change in ISK)
Outward FDI	20.0 (1,826)	9.5 (1,620)	10.2 (1,834)	13.4 (2,073)	14.7 (2,076)	91%	-11%	13%	13%	0%
Foreign equities	14.0 (1,276)	4.8 (809)	4.1 (736)	5.0 (765)	5.8 (816)	55%	-37%	-9%	4%	7%
Foreign debt securities	7.2 (652)	1.3 (216)	0.8 (149)	3.6 (560)	0.8 (112)	170%	-67%	-31%	275%	-80%
Foreign lending	23.1 (2,104)	8.2 (1,385)	6.2 (1,112)	2.2 (336)	2.1 (290)	98%	-34%	-20%	-70%	-14%
Total assets	78.5 (7,159)	30.1 (5,112)	26.6 (4,779)	33.8 (5,211)	34.4 (4,865)	79%	-29%	-7%	9%	-7%
Total assets (% of GDP)	525	316	301	260	221					
Inward FDI	14.1 (1,288)	9.4 (1,596)	9.1 (1,639)	13.0 (2,011)	14.8 (2,094)	89%	24%	3%	23%	4%
Total liabilities	94.4 (8,610)	89.2 (15,165)	85.5 (15,384)	84.3 (13,008)	35.3 (4,991)	63%	76%	1%	-15%	-62%
Total liabilities (% of GDP)	631	984	968	649	226					

Sources: Statistics Iceland, Central Bank of Iceland.

### Private sector foreign assets and liabilities

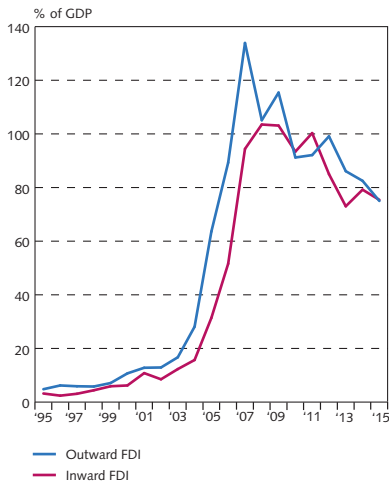
The private sector NIIP has seen some major changes in the last decade or so, first as a result of the financial crisis and, more recently, due to deleveraging and the failed banks' estates composition agreements. It deteriorated from -157% in Q3/2008 to a low of -685% of GDP in Q3/2009, owing to the collapse of the old banks. Since then, the private sector has deleveraged rapidly, primarily because of the winding-up of the failed banks, asset sales and deleveraging by several large companies, and the restructuring of the pharmaceuticals company Actavis and its acquisition by Watson Pharmaceuticals in 2012.<sup>4</sup> At year-end 2015, after the settlement of the failed banks' estates, the private sector's total foreign assets amounted to 171% of GDP and its liabilities totalled 176% of GDP.<sup>5</sup> The private sector NIIP had therefore improved to its most favourable position in decades, -4.4% of GDP.

The largest subgroup in this category is the pension funds, which own substantial assets abroad but whose foreign liabilities are negligible. The pension funds' foreign portfolios stood at 34% of GDP at year-end 2007. In 2010 and 2011, however, the value of their portfolios declined in krónur terms because of foreign asset sales and the appreciation of the króna, to 28% of GDP by year-end 2011. Since then, the value of the funds' portfolios has risen, to one-third of GDP

4. Actavis' impact on Iceland's external balance changed radically as a result of the Watson acquisition, from -44% of GDP in Q4/2011 to -9% of GDP a year later.

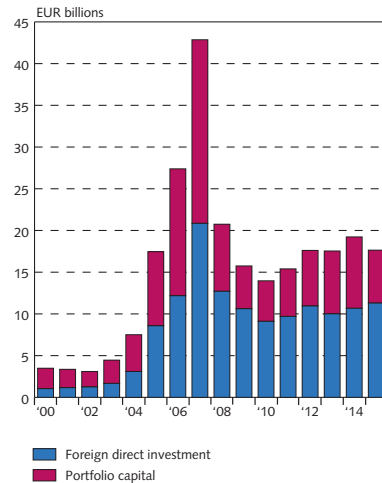
5. Special purpose entities are subtracted from outward and inward FDI according to the OECD's benchmark definition of FDI, as they are entities that have little or no employment, physical presence, or operations in the country but do provide important services to multinational enterprises (MNEs), such as holding assets and liabilities or raising capital. See <https://www.oecd.org/daf/inv/FDI-statistics-explanatory-notes.pdf>.

Chart 6.4  
Outward and inward FDI<sup>1</sup>



1. Excluding special purpose entities (SPEs) from 2013.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 6.5  
Foreign direct investment and portfolio capital owned abroad by residents  
At year-end



Source: Central Bank of Iceland.

or 5.2 billion euros (735 b.kr.) as of year-end 2015. In 2015, the pension funds owned 15% of Icelandic residents' total foreign assets and 79% of foreign portfolio holdings.

Following the settlement of the failed banks' estates, the rest of the private sector (excluding the pension funds) had an NIIP of -38% of GDP, a significantly more favourable position than the post-crisis trough of -86% of GDP at the beginning of 2010.

### Lending by domestic credit institutions to foreign borrowers

Lending by domestic credit institutions to foreign borrowers has been very limited during the post-crisis period; however, it was one of the largest single contributors to the rise in foreign assets from 2003 to 2007, when the stock of foreign lending increased from 19% of GDP to 154%. Due in part to valuation effects from the depreciation of the króna, the stock of foreign lending soared in the months leading up to the crash, rising by 66% between Q4/2007 and Q3/2008 and measuring 225% of GDP by end-September 2008. Foreign lending has decreased substantially during the post-crisis period, measuring 5.8% of GDP in 2015.

By the end of 2008, the failed banks owned 77% of total foreign loans. This share increased to 90% at year-end 2009 but had fallen to 64% by the end of 2014. Between 2009 and 2014, the stock of foreign lending by the DMBs in winding-up proceedings dropped from 63% of GDP to 11%. The main reason for this decline is that some of the loans were reclassified as foreign direct investment (FDI) at the end of 2009 because of financial difficulties among the banks' debtors, prompting a takeover of the companies concerned. At the end of 2015, foreign lending by the holding companies of the failed banks amounted to 6.8% of GDP.

Table 6.3 Foreign assets

% of total foreign assets	1999	2003	2007	2009	2013	2015
Outward FDI	18	20	26	38	30	34
Foreign equities	49	31	18	15	13	17
Foreign debt securities	5	2	9	3	10	2
Foreign derivatives	0	0	2	0	0	0
Foreign lending	4	22	29	23	9	6
Currency and deposits	5	13	14	8	18	16

Source: Central Bank of Iceland.

Table 6.4 Foreign liabilities

% of total foreign liabilities	1999	2003	2007	2009	2013	2015
Inward FDI	7	8	15	11	11	33
Icelandic equities	0	2	4	0	1	2
Icelandic debt securities	39	58	39	43	43	18
Icelandic derivatives	0	0	2	0	0	0
Icelandic lending	51	29	25	32	33	7
Currency and deposits	0	1	15	13	8	2

Source: Central Bank of Iceland.

### Investment in equities and debt securities

Investment in foreign equities and debt securities also grew substantially between 2003 and 2007 but has played a limited role during the post-crisis period. The total stock of foreign equities and debt securities held by residents rose sharply until Q3/2008, when foreign equities peaked at 99% of GDP and debt securities peaked at 50% of GDP, up from 26% and 2%, respectively, in 2003. They plunged during the financial crisis, and by year-end 2015, residents' foreign equities amounted to 37% of GDP and debt securities totalled 5% of GDP.

### Outward foreign direct investment

During the pre-crisis period, the Icelandic banks played a major role in brokering foreign capital for domestic investors, as well as investing extensively abroad on their own account. In addition, a sizeable share of foreign debt was used to fund domestic lending, some of which was then used to invest abroad. Outward FDI grew by an average of 80% per year in 2003-2007. The stock of outward FDI amounted to 168% of GDP at the end of Q3/2008, up from 17% of GDP in 2003. It fell dramatically as a result of the financial crisis, plunging to a new low of 89% of GDP in Q1/2009. Since then, its value has fluctuated due to the banks' restructuring and the revaluation of many companies' book value; it peaked at 116% of GDP in mid-2010 but had fallen back to 75% of GDP by year-end 2015.<sup>6</sup> Furthermore, the composition of the capital has changed during the post-crisis period: lending to subsidiaries has increased, while the share of foreign equity has declined. In 2015, lending to subsidiaries accounted for about 51% of outward FDI, and lending to Actavis subsidiaries accounted for the other 49%.

6. See Footnote 5 in this chapter.

**Inward foreign direct investment**

The stock of inward FDI also grew during the years prior to the crisis, peaking at 119% of GDP in mid-2008. It then declined steadily, to a low of 93% of GDP at year-end 2010. After an increase in the following year, inward FDI peaked at 104% in the beginning of 2012 but had fallen back to 75% of GDP by year-end 2015 because of the restructuring of Actavis, in 2012 and again in 2015. The 2012 restructuring also explains the turnaround in the net FDI position, which was negative in 2010 and 2011 but had turned positive by year-end 2012. Furthermore, non-residents' equity as a share of inward FDI had been roughly 12% in 2011 but fell to 0 at the end of 2013 because of the Actavis restructuring. At year-end 2015, the ratio had risen up to 32%, due to a further restructuring of Actavis in Q1/2015.