7 Government, corporate, and household balance sheets

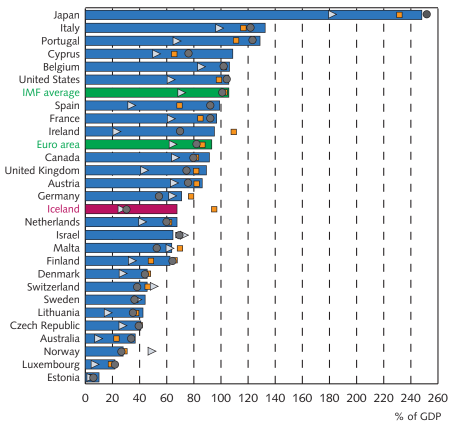
This chapter describes Government, corporate, and household balance sheets in Iceland; the position of the Government, households and businesses; and post crisis debt restructuring.

Government balance sheets

Iceland's general government gross debt was among the lowest in advanced IMF countries in 2007 (Chart 7.1). The general government's balance sheet and budgets then suffered a severe shock with the financial crisis and the sharp depreciation of the króna in 2008, as both general government and public enterprises had significant foreign-denominated debt. Furthermore, a substantial amount of debt was shifted from the private to the public sector when private enterprises, mostly banks, became insolvent. Gross debt therefore rose substantially in the wake of the crisis, peaking in 2011, but has tapered off and was well below the average for IMF member countries in 2015. Furthermore, the stability contributions from the failed banks' estates (see Chapter 8), in the amount of 17.2% of year-2015 GDP, are scheduled to be allocated to prepay-

Chart 7.1

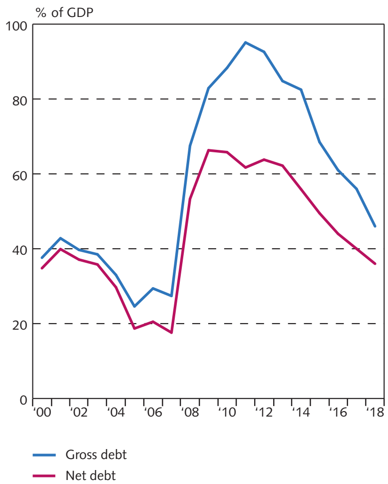
Gross general government debt in selected IMF countries



Sources: IMF Fiscal Monitor April 2016.

Chart 7.2

General government debt[1]



1. Central Bank baseline forecast 2016-2018 from *Monetary Bulletin* 2016/2. Gross debt according to Maastricht criteria and net debt according to the definition in the Act on Public Sector Finances.

Sources: Statistics Iceland, Central Bank of Iceland.

Table 7.1 General government financial assets and liabilities 2007-2015

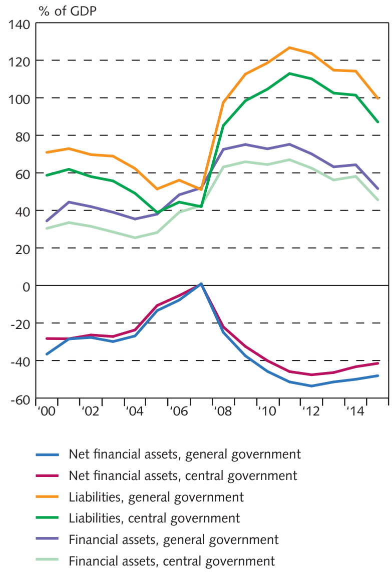
% GDP	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*
Financial assets	52.0	72.5	75.1	72.8	75.2	70.1	63.2	64.3	51.6
Currency and deposits	9.8	14.1	16.6	22.5	33.4	28.7	22.5	26.6	18.9
Loans	14.4	32.1	24.9	16.8	10.4	10.8	10.4	9.8	6.7
Shares and other equity	16.6	14.9	23.2	23.4	21.6	20.3	21.2	19.2	17.7
Other accounts receivable	11.2	11.5	10.4	10.1	9.8	10.2	9.1	8.6	8.2
Liabilities	51.1	97.5	112.6	118.6	126.7	123.6	114.7	114.2	99.7
Securities other than shares	9.2	19.9	39.2	44.6	46.4	47.2	44.6	43.8	40.2
Loans	18.2	47.2	43.5	43.6	48.7	45.3	40.2	38.7	27.9
Domestic loans	5.4	23.7	18.1	20.1	20.6	19.7	18.9	17.8	13.9
Foreign loans	12.8	23.5	25.4	23.5	28.1	25.7	21.3	20.9	13.9
Insurance technical reserves	19.7	24.6	23.7	23.6	24.5	24.7	24.2	24.4	26.0
Other accounts payable	4.1	5.7	6.2	6.8	7.1	6.4	5.8	7.4	5.6
Net financial assets	0.9	-25.0	-37.5	-45.8	-51.4	-53.6	-51.4	-50.0	-48.1

Source: Statistics Iceland.

ment of debt. Furthermore, if projections of nominal GDP growth and a continued general government surplus materialise, general government debt will be further reduced. According to a recent IMF forecast, by 2021 Iceland will again be among the advanced IMF countries with the lowest general government debt.[1]

The central government has by far the largest balance sheet, with assets and liabilities constituting almost 89% of the general government balance sheet, while the local government share is about 11%. Social security accounts constitute only a marginal share of general government accounts in comparison with central and local government. As a result, general government financial assets and liabilities are largely those of the central and local governments.

Chart 7.3
Financial assets and liabilities



Source: Statistics Iceland.

Central government

The fiscal position of the central government was strong when the financial crisis struck. Record surpluses in 2004-2007 had enabled the central government to retire a large portion of its debt while simultaneously accumulating cash deposits in the Central Bank of around 10% of GDP. The central government's net financial assets even became marginally positive in 2007. As a result of the financial crisis, net financial assets turned negative

1. International Monetary Fund (2016). *Fiscal Monitor*, April 2016.

Table 7.2 Central government financial assets and liabilities 2007-2015

% GDP	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*
Financial assets	42.6	63.1	65.9	64.4	67.0	62.5	56.2	58.1	45.6
Currency and deposits	7.7	11.9	14.2	19.6	31.4	27.2	21.4	25.6	18.0
Loans	12.8	30.4	22.7	15.3	8.7	9.1	8.6	8.4	5.6
Shares and other equity	14.1	12.8	21.0	21.2	19.5	18.4	19.3	17.5	15.9
Other accounts receivable	8.1	8.1	8.0	8.4	7.4	7.9	6.9	6.7	6.2
Liabilities	42.0	85.2	98.4	104.6	112.9	110.1	102.5	101.4	87.1
Securities other than shares	9.2	19.9	39.2	44.6	46.4	47.2	44.6	43.8	40.2
Loans	13.6	40.1	34.6	35.0	40.2	37.4	32.8	30.9	20.5
Domestic loans	2.3	19.6	12.3	13.8	13.8	13.0	12.3	10.2	6.7
Foreign loans	11.3	20.5	22.4	21.3	26.4	24.4	20.6	20.7	13.8
Insurance technical reserves	16.9	22.1	21.3	21.3	21.9	21.8	21.6	21.7	23.0
Other accounts payable	2.3	3.1	3.2	3.7	4.4	3.6	3.6	5.0	3.5
Net financial assets	0.6	-22.1	-32.5	-40.1	-45.9	-47.6	-46.4	-43.3	-41.5

Source: Statistics Iceland.

by 32.5% of GDP in 2009 and deteriorated further, bottoming out at -47.6% of GDP in 2012. Since then the position has been improving, and in 2015 net financial assets stood at -41.5% of GDP.

After the financial crisis, currency and deposits emerged as the central government's largest asset group, as foreign debt was used to build up the Central Bank's foreign exchange reserves. Furthermore, following the Treasury's international bond issuance in 2011-2014, the Treasury and the Central Bank have had a relatively strong near-term foreign liquidity position. The second-largest asset group is shares and other equity holdings, which also increased after the financial crisis, as the central government took equity stakes in the new banks (see Chapter 3). Shares and equity held by the central government declined by almost 6 percentage points as a share of GDP between 2010 and 2015. This is due mainly to nominal GDP growth, as the nominal value of shares and other equity has not declined. The increase in the two largest asset groups, plus the fact that the Treasury needed to hold more deposits to finance the deficit, explains why financial assets rose from 43% of GDP in 2007 to as high as 67% in 2011. They have since declined and stood at 46% of GDP in 2015 (see Table 7.2).

After bottoming out at 39% of GDP in 2005, financial liabilities soared in the wake of the financial crisis, reaching a high of 113% of GDP in 2011; however, they had fallen to 87% by 2015 and are estimated to fall further still in 2016, as the stability contributions from the failed banks' estates are scheduled to be allocated towards prepayment of debt.

The depreciation of the króna in 2008 led to a rapid weakening of the gross debt position, as 33% of central government debt was denominated in foreign currency. The need to strengthen the Central Bank's foreign exchange reserves led to a further increase in the gross debt position. Consequently, central government gross foreign debt rose from 11.3% of GDP in 2007 to 26.4% of GDP in 2011. Gross debt has since declined, mainly because the loans from the IMF and the bilateral loans taken to strengthen the Central Bank's reserves have been paid in full. By 2015, it had fallen to 13.8% of GDP.

As borroed funds were used to acquire assets, net debt[2] increased less. While central government gross debt increased by 68% of GDP between 2007 and the 2011 peak, net debt increased by only 44% of GDP to 66% of GDP. Net debt stood at just under 43% of GDP at year-end 2015.

In the wake of the financial crisis, fiscal deficits were financed primarily in domestic financial markets. Króna-denominated debt increased from 11.5% of GDP in 2007 to around 47% in 2015, after peaking in 2011 at 60%. Domestic government bonds issued in connection with the recapitalisation of the banking system and the Central Bank amounted to 14% and 10%, respectively, of year-2009 GDP. At year-end 2015, króna-denominated liabilities, including pension liabilities, amounted to 73% of GDP, compared to 31% of GDP in 2007. Overall, total central government liabilities amounted to 87% of GDP in 2015 (61% according to the Maastricht criteria[3]), as opposed to 42% in 2007, after peaking at 113% in 2011.

Local government

Prior to the financial crisis, the local government balance sheet was quite strong. With the onset of the crisis, local governments' gross debt rose from 4.5% of GDP to 8.9% in 2009, while net liabilities rose from 1.8% of GDP to 5.4%. Since 2009, local government gross debt has been on a declining path, helped by a new fiscal debt rule stipulating that debt may not exceed 150% of regular revenues (see Box 4.2), and was down to 7.5% of GDP in 2015.

Local governments' foreign debt declined considerably in the years before the crisis, from 3.4% of GDP in 2002 to 1.5% in 2007, but local governments had to realise a loss equivalent to 1% of GDP on their foreign debt in 2008 because of the depreciation of the króna. To minimise risk, most of local governments' foreign debt has been refinanced; it amounted to only 0.2% of GDP at year-end 2015.

As is the case with the central government, local governments have financed their deficit spending primarily in the domestic credit market, increasing their króna-denominated debt from 3.2% of GDP in 2007 to 7.3% in 2015.

Local governments' financial assets were stable at approximately 8-9% of GDP from 2005 to 2012 but had fallen to 5.4% in 2015, due mostly to a decline in outstanding loans and other accounts receivable. Cash and deposits declined because of improved asset management, while the nominal value of shares remained stable over the period but declined as share of GDP because of a rise in nominal GDP. Therefore, all asset groups declined as a share of GDP from 2012 onwards.

Private sector balance sheets

Iceland's private sector has seen dramatic developments in its balance sheets since the turn of the century, mainly because of movements in debt levels. Private sector debt as a share of GDP was similar to that in other developed countries until 2004, when it increased rapidly, outpacing neighbouring countries. The increase in debt during the run-up to the financial crisis in 2008 was due mainly to a surge in corporate debt (Chart 7.4).[4]

2. Net debt is defined here as gross debt less currency and deposits; i.e., readily available funds that can be used to pay down debt.
3. Debt as defined by the Maastricht criteria is total financial liabilities less insurance technical reserves and other accounts payable.
4. Holding companies are excluded.

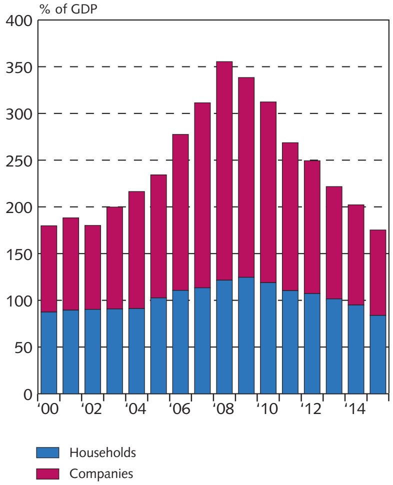
In comparison with other countries, Iceland's share of foreign-denominated debt was high at the start of the financial crisis, measured as a share of both GDP and exports. Furthermore, the share of CPI-indexed loans was high. With the depreciation of the króna in 2008 and the resulting surge in inflation, the value of both foreign-denominated and CPI-indexed loans rose sharply, weakening the balance sheets of many households and businesses. Consequently, private sector debt increased, peaking at 357% of GDP in 2008. At year-end 2015, write-offs, financial restructuring, bankruptcy, deleveraging, court rulings,[5] and Government-sponsored programmes[6] had reduced private sector debt to 175% of GDP, some 3 percentage points lower than at the beginning of the century. This position places Iceland among countries with moderate debt levels (Chart 7.5).

In recent years, private sector financial conditions have improved significantly, in line with improved economic activity, reduced debt, and rising asset prices. Private sector financial restructuring is moving forward, as can be seen, for example, in the three large commercial banks' non-performing loan ratios, which have fallen from 20% at year-end 2010 to 1.7% as of year-end 2015.

Corporate balance sheets

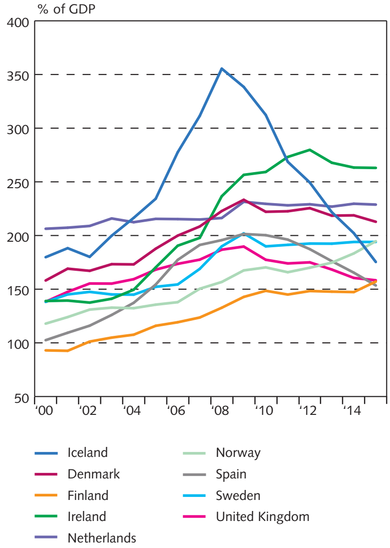
Corporate balance sheets grew considerably during the pre-crisis years, as companies stepped up acquisitions and accumulated debt. Following the collapse of the banking system, the posi-

Chart 7.4
Private sector debt[1]



1. Debt owed to financial undertakings and market bonds issued. Excluding debt owed by holding companies.
Sources: Statistics Iceland, Central Bank of Iceland.

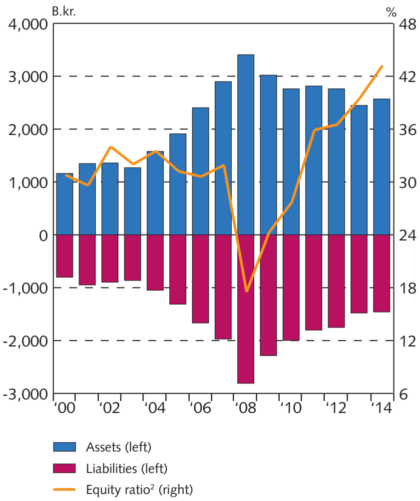
Chart 7.5
Private sector debt in selected European countries



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

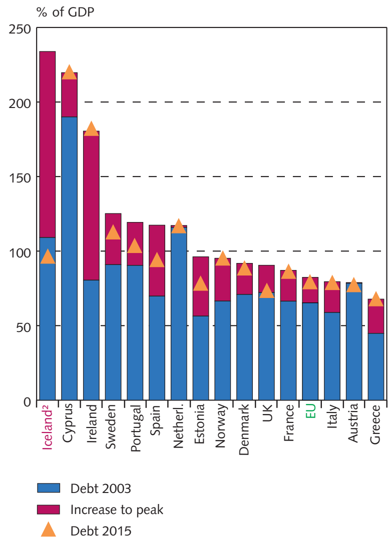
5. See Box 3.2 in the 2012 edition of *Economy of Iceland*.
6. See Box 7.1 in the 2014 edition of *Economy of Iceland*. Total household debt is estimated to decline by roughly 5½ percentage points of GDP through the Government debt relief measures.

Chart 7.6
Corporate assets and liabilities and equity ratio[1]



1. The 500 largest firms in terms of operating revenues. Assets and liabilities at 2014 price level. 2. The equity ratio is the ratio of total equity to total assets.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 7.7
Corporate debt in selected European countries[1]



1. The blue columns show corporate debt at year-end 2003. The red columns show the increase in debt to the highest year-end value, and the triangles show the position at year-end 2015. Data for 2014 used if 2015 data are not available. 2. Debt owed to financial undertakings and market bonds issued.
Sources: Eurostat, Central Bank of Iceland.

tion of many companies deteriorated severely. The debt position and debt service burden of overleveraged firms increased considerably, due especially to the depreciation of the króna, as a large share of corporate debt was foreign-denominated and many firms did not have revenues in foreign currency; furthermore, their revenues declined at the same time. Corporate debt peaked at 235% of GDP in 2008, and the equity ratios of Iceland's 500 largest companies declined from 32% to 18%, on average. Consequently, corporate bankruptcies and unsuccessful distraint actions against companies increased and, in 2011, 4.6% of firms were declared insolvent, up from 2.3% in 2008.

Relatively strong economic growth since 2010 (average 2.7%), along with financial restructuring, has helped to strengthen and solidify the position of many firms. In contrast to the pre-crisis situation, higher corporate equity ratios and increased corporate sector wealth are primarily the result of deleveraging and declining debt, not higher asset prices, as was the case in 2005-2008. The equity ratio of Iceland's 500 largest companies was 43% on average at year-end 2014, more favourable than it has been for decades, and is estimated to have risen to 45% in 2015. Furthermore, companies' ability to service their debt has improved substantially, as the 500 largest firms' ratio of profit (EBIT) to interest expense has increased from 0.7 in 2008 to 2.9 in 2014.

At year-end 2015, total corporate debt – i.e., loans from both domestic and foreign financial institutions and outstanding marketable bonds – totalled about 91% of GDP, a decline of about 142% of GDP from the 2008 peak. Furthermore, the proportion of foreign-denominated debt has declined markedly in recent years. At the end of 2015, foreign debt comprised 40% of total corporate debt, down from 70% at year-end 2008. In international comparison (Chart 7.7), Iceland's ratio of corporate debt to GDP is now more in line with that in neighbouring countries, whereas it previously had one of the highest in the comparison group.

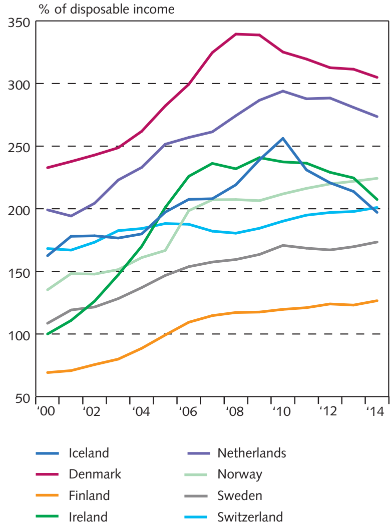
Household balance sheets

As in most Western countries, growth in household debt in Iceland exceeded real income and GDP growth for most of the first decade of the 21st century (Chart 7.8). Credit became more accessible, real lending rates dropped, debt service fell as loan durations increased, and real disposable income rose sharply along with asset prices. By 2008, Icelandic households ranked among the most indebted in the world. As 90% of household debt was either inflation-indexed or foreign-dominated, household balance sheets sustained severe damage from the financial crisis and the depreciation of the króna in 2008. The share of indebted households in financial distress grew from 12½% in early 2007 to 23½% on the eve of the banks' collapse. It is estimated to have peaked at 27½% in autumn 2009, but had already declined to 20% by year-end 2010.

Household debt relative to GDP peaked in 2009 at 125%. Debt restructuring, write-offs due to Supreme Court decisions on the legality of exchange rate-linked loans, and Government debt relief measures have since reduced Iceland's household indebtedness. Furthermore, households have been more hesitant to take on debt than before, and many households have made extra payments on their loans, due to the large spread between lending and deposit rates. Iceland's household indebtedness had fallen to 84% of GDP as of year-end 2015, or by nearly 41% of GDP from its peak. This is a dramatic change in comparison with other countries with high household debt levels.

The Government elected in 2013 enacted a general debt relief programme in 2014, entailing a direct Treasury-financed reduction of households' indexed mortgages and authorising borrowers to allocate third-pillar pension savings tax-free towards mortgage debt. The final 25% of the direct write-down was posted to mortgage loans at the beginning of January 2016. As of July 2016, over 68,000 households had taken advantage of the write-down of mortgage debt, and 27,000 had opted to use part of their third-pillar pension savings to pay down their mortgages. Between November 2014 and July 2016, direct write-downs totalled 599 million euros (79.4 b.kr.), and 179 million euros (23.8 b.kr.) in third-pillar savings had been channelled towards mortgage loans. Hence household debt has been reduced by 778 million euros (103.2 b.kr.) as of end-July 2016 and is expected to fall by an additional 128 million euros (17 b.kr.) by the time the programme concludes at the end of 2017, or by a total of 5.5% of year-2015 GDP.

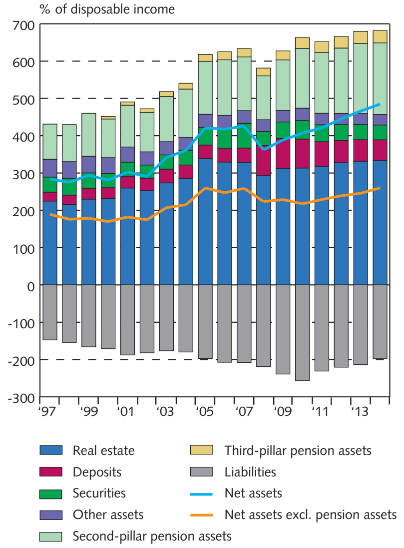
Chart 7.8
Household debt in selected European countries



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

Households' financial position has improved considerably in recent years. With strong GDP growth since 2011, there has been robust employment growth, and real disposable income rose by an average of almost 3% per year from 2011 to 2014. Because growth in disposable income has outpaced growth in private consumption in recent years, households have been accumulating savings. Higher asset prices have also led to a stronger household equity position. Households' net wealth relative to disposable income has therefore increased markedly, or by 122 percentage points between 2008 and year-end 2014, when it stood at 485% (Chart 7.9). Excluding pension assets, households' net wealth amounted to 260% of disposable income at the end of 2014. Because of reduced debt and increased income, the debt-to-income ratio has fallen by 59 percentage points in only five years, to 197% of disposable income as of year-end 2014.

Chart 7.9
Household assets and liabilities[1]



1. Pension fund assets are based on payouts after deduction of 30% income tax.
Sources: Statistics Iceland, Central Bank of Iceland.