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Memorandum on the Current Account Balance and Net International Investment Position in Iceland

SA – Vilhjálmur Egilsson

The Central Bank published their Current Account statistics for 2006 on 6 March. The main conclusions are that the Net International Investment position of Iceland was negative by 1,355 billion ISK or 120% of GDP at the end of 2006 and that the Current account deficit amounted in the year 2006 to 305 billion ISK or 26.7% of GDP. These figures are alarming and must be a cause of concern for every stakeholder in the Icelandic economy. Therefore it is interesting to observe that the reality described by the Central Bank's statistics is not perceived in the same way by most market participants and business goes on like usual. The basic reason for this indifference to the Central Bank's figures is a widespread lack of confidence in the accuracy of the statistics.

The Icelandic financial sector has expanded rapidly on foreign markets in the last four years. Icelandic investors have invested heavily abroad and have generally been quite successful. The assets held by Icelanders abroad have increased almost tenfold in four years and now stand at a multiple of 3,8 of the GDP according to the Central Bank. This development has brought a drastic change to the Icelandic economy and there is no particular indication that there will be a halt to the continuing growth of Icelandic investments on external markets. It seems obvious that the methods of the Central Bank for collecting and assessing information to produce their statistics are not sufficient to accurately reflect the extent and nature of the new reality in Iceland. There are two basic reasons for this discrepancy between the perceived outcome and the reality. The first one is that the Bank writes down the value of direct investments and does not make an attempt to find out their real value. The other reason is that capital gains are not treated as income in current account statistics but can be shown separately to reflect the changes in the value of assets. For most normal purposes of a modern financial system capital gains and other forms of income such as dividends or interest payments are interchangeable. Systematic disregarding of capital gains is therefore misleading.

The Central Bank estimates that the stock of direct investments abroad stood at 927.9 billion ISK at the end of 2006. This amount is the sum of 755.3 billion of equity and 172.6 billion of loans granted to related enterprises. If the sum of the flows, or amounts invested each year, 2003 – 2006 is added to the size of the stock at the end of 2002 (all adjusted to the same exchange rate) the outcome is close to 200 billion ISK higher. The conclusion of the Central Bank's statistics is that a substantial share of these investments has been lost and written off in the last four years and that Icelandic investors have continued to invest heavily in equity abroad despite all these losses. The method that the Bank applies indicates that the purchase value of equity in excess of book value is written off. The problem with the Bank's conclusion is that no one of these investors has experienced these losses as real. The Icelandic

investments have generally been quite successful even though some investments have not been as profitable as expected. If a modest general return of 10% - 15% is added to the investment flows the stock's real value could easily have been 1,300 – 1,400 billion ISK at the end of 2006. The real value of average stock in 2006 could easily have been 1080 – 1150 billion ISK giving a return of 100 – 180 billion ISK. This return on equity compares with the total return on equity of 85 billion in the Current Account (which includes also returns on portfolio investments).

Similar calculations for foreign owned direct investments in Iceland also indicate that the Central Bank grossly undervalues the real value of the stock at the end of 2006 and the respective return on this equity. According to the Bank the stock of direct foreign investments in Iceland stood at 499.5 billion ISK at the end of 2006. Just looking at the flows the stock's real value should be close to 100 billion ISK higher and when taking returns into account the stock could easily be at least 170 – 230 billion ISK higher. The return on this equity in 2006 could have been 50 – 90 billion ISK.

When it comes to Icelandic assets in publicly traded securities the Central Bank comes up with another puzzle. At the end of 2005 Icelanders held 589.7 billion ISK in publicly traded stocks. At the end of 2006 this amount had increased to 922.4 billion ISK. The next thing to read is that the flow of investments into these stocks during the whole year 2006 was 93.1 billion ISK. So the stock increases by more than 300 billion ISK and less than 100 billion ISK is due to investments. This should normally lead to the conclusion that there was a considerable profit from holding these securities, maybe in the range of 150 billion ISK when adjusting for exchange rate changes. Not so, according to the Central Bank's statistics. There are only 85 billion ISK to share between return on direct investments and publicly traded stocks when the real amount is probably between 250 and 330 billion ISK.

Foreigners held 234.4 billion ISK in publicly traded stocks at the end of 2005 and 355.8 billion ISK at the end of 2006. The amount for the corresponding flow was 81.2 billion ISK indicating that the profit from these portfolio investments was only minimal after adjustments for different exchange rates. But this is not reflecting the reality of the Icelandic stock market in 2006 when there was a sizeable increase in the value of most stocks. The ICEX-15 index rose by 15.8% and the return to foreign portfolio investors must have been at least 40 – 50 billion ISK. The Central Bank estimates that the total return of foreign investments in Icelandic stocks, both direct investments and publically traded stocks was 100.5 billion ISK in 2006. Looking at the estimated returns on direct investments and portfolio investments together it would not be far off to suggest that the Bank is underestimating this amount by 30 – 40 billion ISK.

Icelandic investments in publicly traded foreign bonds are relatively small compared to other asset forms. This amount was, according to the Central Bank, 106 billion ISK at the end of 2005 but had grown to 277.5 billion ISK at the end of 2006. The corresponding flow was registered to be 141.2 billion ISK. Adjusting for exchange rates there seems to have been a modest return on these investments or around 10 billion ISK. This amount should not be too far from the true amount.

Foreign investments in Icelandic publicly traded bonds are by far the largest component of the Net investment statistics. Foreigners held 2,153.5 billion ISK in bonds issued by Icelanders at the end of 2005 and this amount had increased to

3,666.4 billion ISK at the end of 2006. The flow was 1,028.7 billion ISK according to the Central Bank. Comparing the increase in the stock with the flow and calculating the corresponding interest rate by looking at the deviation and the average stock gives the conclusion that the interest charges should have been close to 150 billion ISK. This is not so unlikely because the Icelandic banks are the leading issuers of these bonds. The Central Bank estimates all interest payments to foreigners to be 162.1 billion ISK in 2006.

Outstanding loans and other receivables by Icelanders to foreigners (except for the Central Bank's reserve) stood at 1,104.9 billion at the end of 2005. This amount was 2,204.4 billion ISK at the end of 2006. The corresponding flow was estimated at 777.8 billion ISK during 2006. Running the same exercise for these numbers with adjustment for exchange rates and also taking likely interest rate margins into account it is likely that the real interest charges generated from foreigners to Icelandic lenders could be 110 – 140 billion ISK. The Central Bank estimates all interest charges to Icelanders to have been 73.1 billion in 2006.

Outstanding loans and other receivables by foreigners to Icelanders were 684.6 billion ISK at the end of 2005 and 1,332.9 billion ISK at the end of 2006. The flow was registered at 461.8 billion ISK during 2006. Analysing these numbers it would be reasonable to expect the corresponding interest charges to be 70 – 80 billion ISK. These amounts and the estimated interest charges to publicly traded bonds should be compared to the 162.1 billion ISK that the Central Bank estimates to be interest payments of Icelanders to foreigners. It seems that the Central Bank underestimates these interest charges by 60 – 70 billion ISK in 2006.

When all the numbers for return on equity investments and lending operations in and out of Iceland are added together it is obvious that the methods and standards used by the Central Bank are not working. They are not showing the reality of financial transactions between Icelanders and foreigners.

The total return on equity and interest charges from lending operations in 2006 is most likely to be 370 – 480 billion ISK into Iceland and 310 – 360 billion ISK out of Iceland. The actual balance in 2006 therefore ranges from 10 billion ISK to 170 billion ISK in what financial income of Icelanders from foreign operations exceeds the financial income of foreigners from operations in Iceland. This is in absolute contrast with a negative balance of around 100 billion ISK estimated by the Central Bank. The current account deficit of 305 billion is definitely overstated. The real current account deficit is probably lower than the 146,7 billion ISK deficit in the trade of goods and the negative current account balance is in any case grossly overstated.

The negative Net International Investment Position is also overestimated. The actual net investment position at the end of 2006 could easily be around 300 billion ISK better than the Central Bank estimates and certainly less than 100% of GDP.

The Central Bank's statistics is presumably based on an approved methodology and this discussion is not aimed at the work of the Bank as such. It is rather the standards and methods that are applied that do not reflect the current changes that are taking place in the Icelandic economy and by using these methods a grave situation is drawn up while the economy is probably stronger than ever before.

What the Bank can do to improve their methods is to stop the systematic write down of direct investments and make an attempt to assess their real value. The prices in most recent transactions are the best indicators of the real value of assets. Furthermore the bank could periodically actively make an attempt to systematically evaluate the value of these assets even if they have not been traded.

Another thing that the Bank can do is to make records of the capital gains and other price changes of listed securities as well as other assets. These figures should be published along with the current account statistics. It is unfortunate that the international standards do not treat capital gains as income in the current account statistics since this type of income is just as relevant as other forms of asset income or financial income. The IMF standard is now up for review and the Bank should make an effort to gather support for different treatment of capital gains since the current method does not reflect the realities of a modern international financial system.