Box VII-1

The outlook for Iceland's external debt and payment flows

In February 2011, a paper entitled "What does Iceland owe?" by Central Bank staff was published in the Bank's publication series *Economic Affairs*.[1] In the paper, the authors peered through the dust that swirled up with the collapse of Iceland's financial system and caused the official accounting of its external assets and liabilities to give a misleading view of the country's long-term debt position, as the majority of the liabilities still recognised officially as Icelandic liabilities are related to the estates of the failed banks. The authors estimated the value of external assets and liabilities that are likely to remain after the dust has settled. Also discussed was the impact of the international pharmaceuticals company Actavis, which significantly affects headline figures on Iceland's debt position.

As is emphasised in the paper, some of the information on which it was based was highly uncertain. Now, a year later, a great deal of new information has surfaced. In this Box, the main findings in "What does Iceland owe?" are re-evaluated in view of the new data. The reassessment shows larger underlying net debt than in the earlier assessment, although it is still Iceland's best debt position in quite a long time. Furthermore, the outlook is for external debt

1. Arnór Sighvatsson, Ásgeir Daníelsson, Daníel Svavarsson, Freyr Hermannsson, Gunnar Gunnarsson, Hrönn Helgadóttir, Regína Bjarnadóttir, and Ríkardur B. Ríkardsson (2011), „What does Iceland owe?", *Economic Affairs* no. 4, February 2011.

to decline rapidly in coming years. It concludes with an estimate of developments in the balance of payments in the next few years.

Assets and division of the failed banks' claims

In order to estimate Iceland's international investment position (IIP) after the failed banks' bankruptcy proceedings are completed, it is necessary to consider the settlement of the failed banks' estates. In Section III of "What does Iceland owe?", an attempt is made to estimate how Iceland's IIP will be affected by the fact that the failed financial institutions' domestic and foreign assets will ultimately be settled or sold and the proceeds allocated to domestic or foreign creditors, while claims exceeding the value of reclaimed assets are written off. It should be noted that even though the estates' liabilities will never exceed their assets, obligations between residents and non-residents could develop during the bankruptcy proceedings.

There is still considerable uncertainty about the value of the estates' assets. The failed banks' creditors have declared their claims against the estates, but a number of disputes related to the legitimacy of the claims have yet to be resolved. As a result, the ultimate division of the claims between residents and non-residents is still unknown. Nonetheless, a number of factors have been ascertained in the year since the valuation was last made, and the current assessment gives a more accurate portrayal of the expected division between domestic and foreign creditors. The majority of the old banks' assets are foreign, although there are substantial domestic assets as well. The old banks' main domestic assets, which will ultimately revert to creditors, are their holdings in the new banks and the debt instrument between old and new Landsbanki. Even though a sizeable amount of the foreign assets and a portion of the domestic assets have been recovered and there is greater certainty about the value of certain assets, the overall asset value is still unknown. The timing of the final settlement is also uncertain. Therefore, as before, the figures presented here must be interpreted with caution.

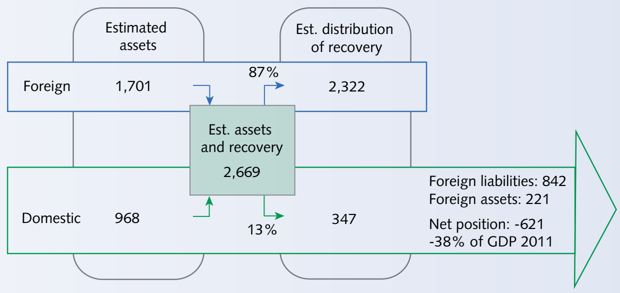
Net foreign debt grows once failed banks' estates are settled

The division of claims varies by bank. For purposes of simplification, as in the paper, it is assumed that all old Landsbanki creditors are foreign but that some of Glitnir and Kaupthing's creditors are domestic. It is estimated that, in all, 13% of the creditors of old Landsbanki, Glitnir, and Kaupthing are residents and 87% are non-residents. These figures are similar to those from a year ago, when it was estimated that 15% of the claims were domestic.

At the end of 2011, expected recovery from the three banks' estates was estimated at 2,669 b.kr., including 1,701 b.kr. in foreign assets and 968 b.kr. in domestic assets. This takes into account the disbursement from the old Landsbanki estate in December 2011, and the bank's total assets has been reduced by that amount. Offsetting this, the value of a number of assets in the three banks' portfolios is now considered to be higher than at the time the paper was prepared a year ago. The valuation of individual assets has been carried out with extreme caution. As a result, the estimated value has been gradually rising as outstanding debt has been collected and foreign assets sold. In this Box, account is also given to the fact that foreign-denominated deposits with the Central Bank of Iceland are offset by foreign assets that the estates delivered to the Bank when they were established. These are classified as foreign Central Bank assets. As a result, this domestic asset is now considered foreign. This presentation affects the division of the underlying IIP between financial institutions in winding-up proceedings (now estimated to be less negative than in last year's paper by 5% of GDP) and other parties, but it does not affect the overall results.

Based on the above estimate of the estates' assets and the division between creditors, it can be expected that 2,322 b.kr. will revert to non-residents and 347 b.kr. to residents when the estates are settled. Both here and in "What does Iceland owe?", an estimate is made of residents' net external debt when the proceeds of sold assets have been paid to creditors. This is the equivalent of dividing current domestic and foreign assets among domestic and foreign creditors according to the percentages listed above. Thus 842 b.kr. of domestic assets would revert to non-residents and create external debt. In addition, 221 b.kr. of foreign assets would revert to residents and create an external asset. The result is net foreign debt in the amount of 621 b.kr., or 38% of year-2011 GDP (see Chart 1).

Chart 1



Amounts in ISK billions. Based on portfolio balances as of end-2011. Deposits with the Central Bank and domestic assets that have foreign collateral are considered foreign assets.
Source: Central Bank of Iceland.

For payments to creditors to take place without affecting the balance of payments, those who buy the estates' assets must finance them entirely with foreign credit or equity. This is not a given, of course. Some of the recovery will be in krónur or foreign currency deriving from Icelandic residents' foreign currency revenues. Since the failed financial institutions' general exemptions from the Foreign Exchange Act were revoked in mid-March, the authorities can set the winding-up committees conditions or ensure through contracts that assets will be sold to a large extent for foreign currency that is eligible for reinvestment (exempt from repatriation requirements) according to the Foreign Exchange Act. In this context, it should be noted that the estates' largest assets, apart from Central Bank deposits against the Bank's foreign exchange holdings, are shares in Arion Bank and Íslandsbanki and the debt instrument between old and new Landsbanki. If the new Landsbankinn can refinance the debt instrument, and stakes in the other banks are sold to investors that can pay with foreign currency (exempt from repatriation requirements) that they own or acquire through foreign long-term loans, what remains is 349 b.kr. that must be paid to non-residents from the proceeds of the sale of other domestic assets, as opposed to the 221 b.kr. that residents will receive from the sale of foreign assets, according to current estimates. This amount is not likely to cause substantial balance of payments problems given the current outlook for the current account balance, particularly if a portion of the amount is converted to long-term debt that can be sold in foreign markets.

Underlying IIP improving

Iceland's underlying IIP can be defined as the position that will be most important in determining long-term developments in the balance of payments. As a result, it is necessary, on the one hand, to take into account the position that will result when the estates' domestic and foreign assets have been sold and the proceeds distributed among domestic and foreign creditors, and on the other, to set aside large international companies' assets and liabilities, which will not affect those flows. According to currently available data, it is assumed that the net position excluding financial institutions in winding-up proceedings was negative by just over 60% of GDP as of end-2010, as compared with liabilities equivalent to just over six times GDP according to official information. This is similar to, or even lower than, the IIP of other OECD countries (see Chart 2).

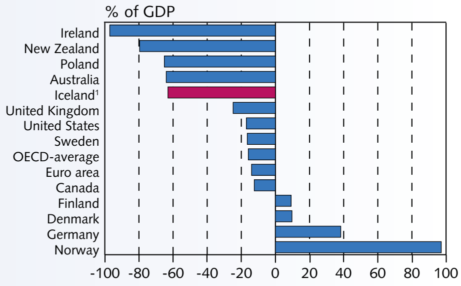
This large deviation from headline figures can be attributed to the fact that a large share of Iceland's assets and liabilities were those of the failed banks and that, according to standardised calculations, their liabilities far exceeded their assets, particularly after they collapsed. Had all of the estates' assets been sold at the then-current price and their value distributed to creditors, net debt equivalent to 43% of GDP would have been added to the total. The net balance of these two factors combined would have amounted to -119% of GDP at year-end 2010.

If the net debt of the pharmaceuticals company Actavis is also excluded, the net position at year-end 2010 amounted to about -60% of GDP. The sale of the firm to US pharmaceuticals company Watson has now been finalised, and the impact of Actavis' assets and liabilities on Iceland's external balance will change substantially. It is not yet clear, however, exactly what the effect will be on the external position. It will depend in part on what position the Actavis companies in Iceland occupy in the Watson organisational structure. It will also depend on whether foreign firms owned by Actavis Iceland are placed under Watson or continue to be owned in Iceland. Moreover, the impact on the external position will depend on whether the domestic holding companies are wound up. In any case, though, the impact is likely to be substantial; therefore, Actavis' net debt will be only a small proportion of its present level.

Even though the underlying IIP is thus estimated to be only a fraction of that indicated by headline figures, and less than half of Iceland's net debt prior to the collapse of the banks, it is a poorer position than was assumed in the paper written a year ago. The difference lies mainly in a revaluation of foreign direct investment. Preliminary figures for the first quarters of 2010 revealed that the value of foreign assets held by residents was overestimated in previous figures. This applied in particular to assets that had been appropriated by the banks' winding-up committees but were previously included in the assessment of the net position excluding the failed banks. In many instances, when the banks have appropriated these assets, they have written them off to a large extent. Given the experience of recent years, however, that valuation is probably cautious.

Offsetting the less favourable historical data, preliminary figures for 2011 indicate that the underlying position has improved markedly, as was assumed in the previous forecast. The estimated underlying IIP is thought somewhat worse than in previous estimates. Further ahead in time, the difference between current and previous forecasts narrows. According to the Central Bank's most recent baseline forecast, Iceland's underlying IIP will amount to only -30% of GDP at the end of 2013. It is assumed that the State, firms with a State guarantee, and the private sector will refinance their foreign debt to some degree and that some new borrowing will occur. The timing and terms of such refinancing and new borrowing are highly uncertain, however. As a result, forecasts of the external position are extremely uncertain. It is expected that there will be an underlying surplus on the current account in coming years, and that the public and private sectors will continue deleveraging. The

Chart 2
International investment position of OECD countries 2010



1. IIP excluding DMBs in winding-up proceedings.
Sources: IMF, Central Bank of Iceland.

impact of liberalisation and other assumptions behind the estimate, the results show that the Central Bank's foreign exchange reserves are sufficient to cover unexpected outflows should they occur.

Table 2 Balance of payments (% of GDP)

	2011	*2012*	*2013*	*2014*
Current account balance[1]	3,1	4,1	3,8	2,6
Trade balance	8,2	7,0	7,3	6,2
Balance on income	-5,1	-2,9	-3,5	-3,6
Financial account balance (excl. reserves)	27	-6	-17	0
Foreign exchange reserves (% of short-term liabilities)	106	123	132	132

1. The table shows the trade balance and balance on income excluding Actavis and the DMBs in winding-up proceedings.
Source: Central Bank of Iceland.