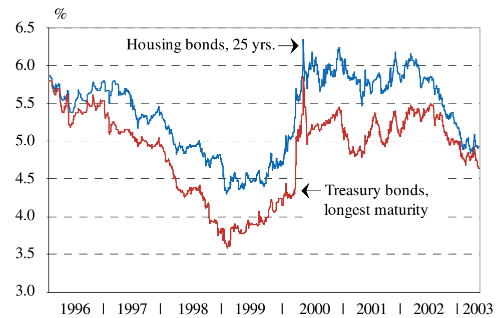
Robust growth in Housing Financing Fund lending

In 2002 the Housing Financing Fund disbursed housing bonds to the market value 34.9 b.kr., a 13% increase from the previous year. Housing authority bond issues amounted to 15.7 b.kr. A heavy need for housing, especially in the Greater Reykjavík Area, has caused supply to increase and the Fund has financed a sizeable share of it. Housing bond disbursements over the first three months of this year amounted to 9.5 b.kr., somewhat in excess of the Fund's forecasts. The average amount per disbursed loan application has risen from 3.4 m.kr. in Q1/2002 to 3.8 m.kr. in the same quarter this year. Even though Housing Financing Fund bonds have ranked with the most secure on the market – price-indexed, generally with a high-priority pledge and backed by a Treasury guarantee of collection – yields on them have been noticeably out of alignment with government bonds, as the Chart shows. There are very strong indications that the main reason is certain features of these bonds, especially the lottery drawing system for redemptions and also the number of smaller bond classes. Changes to the lottery drawing features of electronically registered securities has already narrowed the spread, as the Chart shows. Further changes in the format for Housing Financing Fund bond issues could presumably make them more lucrative, narrowing the gap even further.

Housing bond and Treasury bond yields

Daily data February 1, 1996 - May 2, 2003



Source: Central Bank of Iceland.

Impact on the Icelandic economy

Although the global economy is still subdued and a second recession cannot be ruled out in important trading partner countries, at least one risk factor for Iceland has abated. When the US military supremacy in Iraq was established and it became increasingly likely that the conflict would end without major damage to Iraq's oil wells, oil prices plunged on expectations that the UN boycott would soon be lifted and full production recommence. Oil prices are volatile and it is worth examining the impact that their fluctuation has on Iceland's economy. The impact is both direct and secondary and is difficult to assess in full. The following discussion focuses primarily on the direct impact of a 10% rise in the price of energy (oil and petrol), which is actually a fairly modest change compared with past decades. Much larger swings have been observed.

- Iceland's energy imports last year amounted to 15 b.kr. or roughly 2% of national income. A 10% rise in the price of oil and petrol would therefore cut national income by 0.2%.
- Petrol weighs roughly 4% in the CPI. With the usual assumptions about domestic oil company margins, a 10% higher purchasing price of petrol can be expected to push up its retail price by 6% and cause a 0.3% rise in the CPI, with a corresponding erosion of real disposable income and rise in households' inflation-indexed debt. Both may result in lower private consumption although the scale will probably depend upon whether these changes are viewed as temporary or permanent.
- Imported fuel is a major operational cost component in various sectors, e.g. fisheries. By far the largest user of fuel is the fishing fleet, which consumes imported oil for 7-8 b.kr. a year. Fuel costs are equivalent to 10-12% of total fleet operating expenses and 8-9% of revenues. The changes in fuel prices assumed above would thus cut the profit-to-turnover margin of fishing operations by roughly 1½ percentage points.

Direct effects are naturally only part of the total impact. Changes in energy prices affect the entire global economy. Higher prices squeeze demand and all import prices are ultimately affected. A long-lasting inflationary impact would provoke friction over the relative shares of wages and capital in national income and result in higher interest rates. This is particularly true of sharp and persistent swings such as those witnessed in the 1970s and 1980s. Fiscal policy measures to mitigate the contraction can send interest rates even higher. One factor of concern has been growing public sector deficits in a number of OECD countries. The turnaround has been especially sharp in the USA. At the same time as the subdued state of the economy has struck at public sector revenues, outlays to the military have been stepped up and taxes cut. If this turnaround eventually forces interest rates up, the Icelandic economy could be affected significantly.

Based on Iceland's net debt position at the end of last year, the impact of a 1% rise in foreign interest rates would be equivalent to about 1.7% of export revenues, or 0.7% of national income. The decline in Iceland's net external debt service from roughly 10% of export revenues to 5½% over the period 2000-2002 gives a hint of the possible scale of variation.[1] If the decrease in interest rates that caused this change is reversed, the increased deficit on the balance on income would cause national income to decline by 1½%-2%. Furthermore, the impact of higher foreign interest rates on business investment would need to be taken into account.

The worst risk of shocks to the Icelandic economy can now be said to have passed by. This would have been a scenario of soaring oil prices, leading to higher inflation, lower private consumption in trading partner countries, hence weak export prices and high foreign interest rates. Given Iceland's heavy external debt ratio, it is easy to envisage that such an episode could bring national income down by several percentage points. This is unlikely but the risk remains that when the global economy recovers and interest rates head upwards again, Iceland will benefit less than countries with lower debt levels, especially if private consumption growth is sluggish. On the other hand, economic growth in Iceland in the next few years will largely depend on other factors which are beyond the scope of this analysis.

1. In the 1980s the ratio was much larger despite a lower level of indebtedness, due to far higher foreign interest rates than over the past decade.