Box 1 IMF Global Financial Stability Report

In March 2003 the IMF published its latest Global Financial Stability Report (GFSR) which "provides a regular assessment of global financial markets and identifies potential systemic weaknesses that could lead to crises. By calling attention to potential fault lines in the global financial system, the report seeks to play a role in preventing crises before they erupt, thereby contributing to global financial stability and to the sustained economic growth of the IMF's member countries."

Addressing key developments in major financial centres, the GFSR describes how in the current situation the adjustment in financial markets and the real economy following the bursting of the asset price bubble continues to influence developments. This is reflected in the hesitant and uneven pace of global economic growth and the reluctance of corporations to boost capital expenditure, curtailed risk appetite and a buildup of cash positions. There are signs of more positive developments ahead.

Financial conditions in mature markets have been improving since they hit a low in September 2002 but anxieties were expressed about geopolitical tensions as war loomed in Iraq. In the US, the household sector's balance sheet appears to have stabilised and balance sheets of corporations to be improving. Large internationally active banks remain reasonably well capitalised and liquid and do not seem likely to pose systemic risks, according to the GFSR. The financial condition of most European banks appears to be well supported by the underlying earnings power in their home markets. However, German wholesale banks and the Japanese banking system face problems at home. As a result of equity and corporate bond price declines, partly caused by rising yield spreads, some European insurance companies have been weakened. Problems are particularly acute in the UK, German, Dutch and Swiss insurance sectors.

The report points out the potentially destabilising consequences of a precipitous fall in the dollar, given the buildup of large holdings by foreigners of US financial assets. Over time, the composition of these holdings has changed from equity and foreign direct investment to fixed-income securities. The decline in US yields to levels below those in Europe has reduced the attractiveness of the US fixed-income market and thereby contributed to the dollar's decline. When interest in equities was at a high, growth potential and technological innovation were key driving forces for investments in them and still may be favourable for the United States, but interest rate differentials have now become more important.

Monetary easing in the major economies and the accumulation of cash balances by households and institutions have contributed to improved balance sheet strength. Yet even in this positive scenario, caution is needed, the report says. Short-term and long-term interest rates are likely to rise, creating an interest rate risk as financial institutions have invested substantially in long-term fixed-interest securities but been tempted to fund these positions with short-term money. The potential for sizeable losses could exist for some market participants, on top of losses experienced since the bursting of the equity price bubble and the ensuing flight from corporate risk.

Emerging market financing is in a state of "feast or famine", the GFSR found. Countries at the low end of the credit rating spectrum, especially in Latin America, experienced difficult access to capital markets and high funding costs last year. Easing global financial market conditions in the fourth quarter of last year led to a reopening of capital markets to many, but not to all, issuers. Markets continue to differentiate borrowers by perceived credit rating. Some countries in Latin America continue to face high yield spreads while Asian and Eastern European borrowers benefited from near-record low credit spreads. Most Asian markets are supported by strong growth and macroeconomic fundamentals, regional liquidity and a strong investor base. Eastern European countries have attracted investor interest in anticipation of further credit upgrades stemming in part from progress on their accession to the European Union. Investors' confidence in Russia has continued to improve based on its strong fiscal position and growth performance, both of which have been supported by high oil prices.

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.