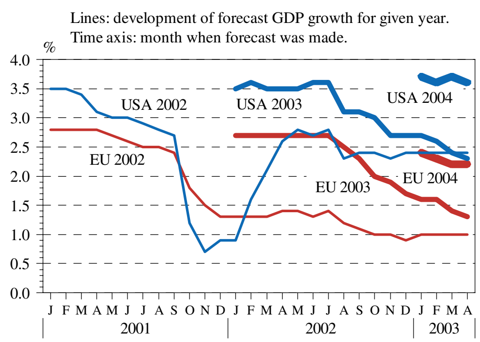
Box 1 The global economic situation and prospects and their impact on the Icelandic economy

Global economic prospects

In the first half of 2002 there were many indications that the global economy was recovering and for most of the year substantial economic growth was foreseen in 2003. In the autumn, however, expectations of continued growth were dampened. The most recent statistics, including those for the USA and UK, indicate even lower first-quarter growth this year than anticipated. Growth forecasts have therefore been revised downwards (see chart). Industrial production on both sides of the Atlantic is still depressed and unemployment has remained high or increased. Outlook indicators are weak. The IMF is currently forecasting a global growth rate of 3.2% this year, 2.2% in the USA and 1.1% in the euro area. OECD's forecast is along similar lines (see Table 20 in the Appendix of Tables and Charts).

Forecast economic growth in the USA and EU 2002-2004



Source: Consensus Forecasts.

Various reasons lie behind the sluggish recovery. Oil prices were volatile and climbed rapidly from late in 2002 until the war in Iraq. Businesses and households were reluctant to commit themselves in the climate of uncertainty caused by the war. Investments have been stifled by large-scale excess production capacity, a legacy from the last upswing which ended with an equity bubble and overinvestment. The end of the war in Iraq has dispelled various uncertainties and oil prices are stabilising at well below pre-war levels. Equity markets are still depressed, but have rebounded a little since before the war.

Demand has recently widely been sustained by private consumption, and investment has not gained sufficient momentum to support growth. In particular private consumption has been important in the USA, as the table shows. In 2001 and 2002 private consumption there well outpaced GDP growth, but more balanced growth is forecast over the next two years. In the euro area private consumption growth has been more in line with GDP growth over these years.

GDP and private consumption growth 2001-2004

Consensus Forecasts projections for 2002-2004

	USA				*Euro area*			
%	*2001*	*2002*	*2003*	*2004*	*2001*	*2002*	*2003*	*2004*
Economic growth	0.3	2.4	2.3	3.6	1.4	0.8	1.0	2.0
Private consumption growth	2.5	3.1	2.3	3.3	1.8	0.6	1.1	1.8

Low interest rates and housing price inflation have kept consumption buoyant in the USA, UK and elsewhere, to a large degree financed by mortgage equity withdrawal. Interest rates are currently at a historical low and there seems to be little scope for further reductions. The rate of growth in housing prices has been slowing down and an episode of real estate disinflation may lie ahead. Also, the labour market on both sides of the Atlantic is being squeezed, which naturally erodes real disposable income. Under such circumstances, the risk is that private consumption will give way before investment recovers. In a worst-case scenario the outcome could be another recession, although forecasts generally do not foresee this happening.

A slow economic recovery is considered more probable this year, and is more likely in 2004. There are risks for the outlook as always. The SARS outbreak in Asia has been spreading. It has already had a marked economic impact in China and Hong Kong. A worldwide epidemic would have serious consequences, but currently there does not seem to be much risk of this happening. The huge US treasury deficit and smaller ones in Germany and other European countries are also worrying. A persistent deficit could cause interest rates to rise.

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.