Box 1 The economic impact in Iceland of changes in foreign interest rates

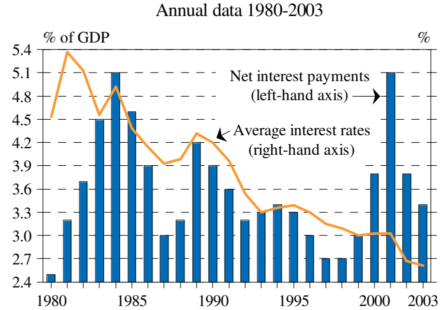
Roughly three-quarters of Iceland's net debt is classified as long-term, although the average maturity is not particularly long. Furthermore, a large proportion of long-term debt carries variable interest rates, which closely reflect changes in short-term rates. Currently this leaves the economy more exposed to changes in short-term interest rates than could otherwise be expected. For each percentage point that foreign interest rates rise, Iceland's long-term debt service increases by roughly 0.7% of GDP. Because 86% of Iceland's long-term borrowing carried variable rates at the end of last year – combined with the significant shortening of their maturity, which requires roughly two-thirds of the outstanding stock to be recapitalised over the next three years – the impact of a rise in short-term rates will be transmitted relatively quickly to the debt service burden.[1] Average interest rates on Iceland's foreign borrowing reached a historical low last year at 3.1%. Fixed-interest loans carried an average interest rate of 6% and variable-rate loans 2.6%. So it is not surprising that the bulk of Iceland's foreign debt is currently on variable-interest terms. However, this entails the risk that rates will rise rapidly when the monetary stance is tightened again in main currency areas. If the US and Europe switch from their present loose monetary stance to a tight policy, Iceland's debt service burden could more than double.

Nonetheless, economic developments among main trading partners suggest a slow increase in short-term rates this year. The changed currency composition of Iceland's long-term debt also reduces the likelihood of a swift rise over the next four quarters. The weight of the US dollar has diminished significantly over the past two years, while the euro weight has increased correspondingly. Roughly two-thirds of Iceland's foreign debt at the end of 2003 was denominated in euros, but less than one-fifth in US dollars. As it happens, part of the explanation for the higher euro weight last year lies in its appreciation against the dollar, which in the early 1990s accounted for roughly half of Iceland's foreign debt. The euro also assumed a much heavier weight in short-term borrowing. Given its economic situation, the euro area seems unlikely to witness a rise in short-term interest rates this year – a reduction cannot even be ruled out entirely. By next year, however, short-term rates are more likely to have begun to climb towards a neutral stance. If the economic recovery remains smooth, there is a possibility that they will turn neutral as early as 2006. However, international forecasts generally assume slower rate hikes.

Although most indications point to gradual changes at first, the Icelandic economy will probably need to make a sizeable adjustment over the next two to five years in order to accommodate higher foreign interest rates. Interest rates on Iceland's overall foreign debt have averaged close to 6% over the past decade. If the recent low rates rise back to this average there will be widespread economic consequences. Net external debt at the end of 2003 was broadly equal to GDP. A return of variable-rate borrowing to the average position, i.e. a rise of 3 percentage points, would raise the net debt service burden, balance on income deficit and current account deficit by the equivalent of almost 3% of GDP. Other things being equal, this extra deficit would need to be funded by further borrowing, which would amplify the impact in the absence of other responses. Nonetheless, such a development would be unlikely to persist for many years. International research shows that a wide current account deficit is normally a short-lived phenomenon and soon forces an

Average interest rates on Iceland's national debt and net interest payments to abroad

Annual data 1980-2003



Source: Central Bank of Iceland.

1. Borrowers have been switching from variable to fixed interest rates to some extent in recent weeks and perhaps months.

adjustment that reverses the deficit.[2] Higher short-term interest rates would weaken the króna, other things being equal. A currency depreciation inherently helps to close a current account deficit through a variety of channels. To achieve the objective of price stability, domestic interest rates would also need to go up. Eventually, higher foreign and domestic rates would dampen domestic demand, reduce imports and drive the economy towards external balance. The necessary landing could be fairly hard if it were to go hand-in-hand with an adjustment following the major wave of investment that the economy will experience over the next three years.

2. See, for example, Edwards, Sebastian: *Thirty Years of Current Account Imbalances, Current Account Reversals and Sudden Stops*, NEBR Working Paper 10276, February 2004.