I The global economy and terms of trade

The global economy

The pandemic has upended the global economy …

The COVID-19 pandemic started spreading all over the globe early this year, causing turmoil the world over, with enormous health implications. Over 55 million people have now been diagnosed with the disease, and more than 1.3 million have died of it. Governmental authorities all over the world have put broad-based public health measures in place in a bid to slow the spread of the disease, thereby reducing strain on healthcare systems and limiting the health implications of the pandemic. The measures undertaken have included temporary closure of businesses and schools, social distancing requirements and strict bans on public gatherings, and significant limitations on individuals' freedom to travel domestically and internationally.

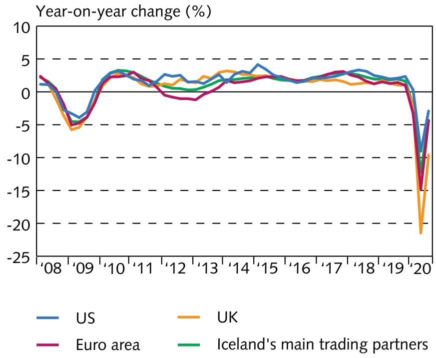
Both government-imposed public health measures and social distancing undertaken voluntarily by the public due to fear of contagion have had enormous economic repercussions, particularly in Q2/2020, when a sizeable share of the global economy came to a halt.[1] The abrupt contraction in private consumption and investment during the period led to the largest single-quarter contraction in the global economy in the history of quarterly national accounts data, and for 2020 as a whole, the outlook is for the largest contraction since World War II.

… causing a record contraction among Iceland's trading partners …

GDP among Iceland's main trading partners contracted by an average of just over 12% year-on-year in Q2 (Chart I-1). This is nearly three times the size of the largest single-quarter contraction during the global financial crisis just over a decade ago. The contraction was most pronounced in the UK and core countries in the southern part of the eurozone, but less so in the US and the Nordic countries (Chart I-2). The variation from one country to another reflects in part the pace and assertiveness with which governmental authorities have implemented public health measures. The composition of the national economy in the countries concerned is also an important factor, as countries heavily reliant on tourism and other sectors requiring close contact between people suffered the most. In China, which recorded the first cases of the virus and was the first country to bring it under control, year-on-year GDP growth measured 3.2% in Q2, after a 6.8% contraction in Q1. Even though the Q2 contraction in trading partner countries was the largest on record, it was ½ a percentage point less than was assumed in the Bank's August forecast.

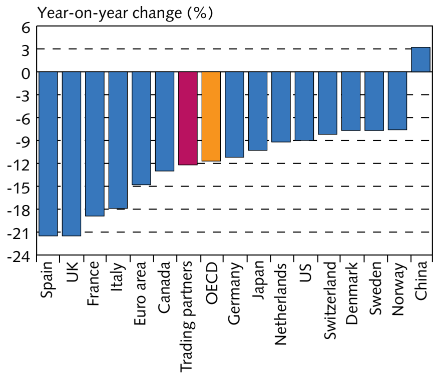
1. A recent analysis from the International Monetary Fund (*World Economic Outlook*, Chapter 2, October 2020) indicates that, during the first three months after the pandemic struck each country, voluntary social distancing and government-mandated measures affected travel behaviour in broadly equal measure. However, in advanced economies, where people are better equipped, on average, to work remotely and can better afford a temporary loss of income (by tapping into savings or relying on social welfare systems), voluntary social distancing has had a greater impact than mandated measures.

Chart I-1
Global GDP growth[1]
Q1/2008 - Q3/2020



1. Seasonally adjusted data. Central Bank baseline forecast Q3/2020 for main trading partners.
Sources: Refinitiv Datastream, Central Bank of Iceland.

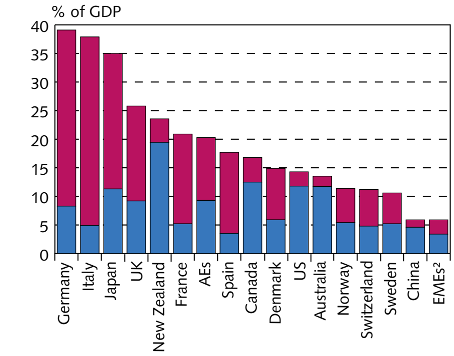
Chart I-2
Global GDP growth in Q2/2020[1]



1. Seasonally adjusted data.
Sources: Refinitiv Datastream, Central Bank of Iceland.

Chart I-3

Fiscal policy responses to the COVID-19 pandemic[1]

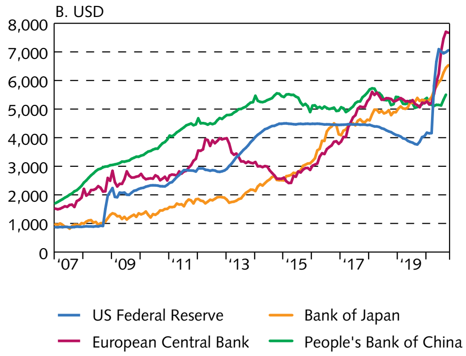


1. Announced measures as of mid-September 2020. The timeframe of the measures varies by country, but most will be implemented in 2020-2021. 2. Emerging market and middle-income economies.
Source: International Monetary Fund.

Chart I-4

Central bank balance sheets

January 2007 - October 2020

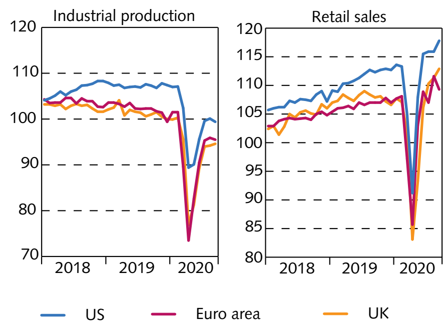


Source: Refinitiv Datastream.

Chart I-5

Industrial production and retail sales[1]

January 2018 - September 2020



1. Seasonally adjusted volume indices (2016 = 100).
Source: Refinitiv Datastream.

… albeit mitigated by unprecedented policy measures from governments and central banks

The global economic contraction would most likely have been even deeper if governmental authorities had not taken unprecedented mitigating action in order to support healthcare systems and cushion against the shock sustained by households and businesses. The discretionary fiscal measures announced by governments in connection with the pandemic are estimated at 11.7 trillion US dollars worldwide, or nearly 12% of global GDP. The percentage is even higher in advanced economies, at about 20% of their GDP, as they generally have more fiscal space to absorb increased debt (Chart I-3). Approximately half of announced measures have taken the form of increased expenditures or relinquished revenues, including temporary tax cuts or deferrals, direct monetary transfers, partial employee wage subsidies, and more generous unemployment benefits in order to mitigate temporary income losses. The other half entails measures including unprecedented equity injections for firms, support loans, and debt guarantees.

In addition to governmental support measures, central banks all over the world have applied measures unparalleled in both scope and speed, in an attempt to support demand, push inflation back up to target levels, and ensure that the financial system functions as normally as possible. Among other measures, interest rates have been lowered significantly, financial institutions' access to liquidity facilities has been expanded, and other actions have been taken to boost households' and businesses' access to liquidity. An ever-increasing number of central banks have bought Treasury bonds in order to prevent governments' pandemic-related borrowing needs from pushing long-term interest rates too high. Some of them have even bought corporate bonds or are lending money directly to companies. Central banks have also both tapped and expanded US dollar credit lines among themselves in response to surging worldwide market demand for dollars. In addition, the US Federal Reserve began offering other central banks access to US dollar liquidity through a temporary repurchase agreement facility. Central banks' large-scale asset purchases can be seen in the expansion of their balance sheets and a surge in money holdings (Chart I-4).

Leading advanced economies recovered more strongly this summer than was forecast in August …

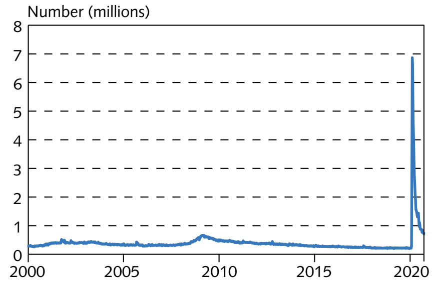
The wide-ranging public health measures imposed in most advanced economies appeared to bear fruit this spring, and in most of the countries concerned – particularly those that took the most aggressive action – the pandemic had receded by early summer. As the situation improved, governmental authorities began relaxing their public health measures, and leading indicators suggested that a strong turnaround would take hold as the summer progressed and economies began to normalise. A particular example of this could be seen in retail sales, which had risen above pre-pandemic levels by the summer (Chart I-5). The surge was due to strong pent-up demand and increased household saving prompted by the steep drop in private consumption in Q2, at the same time as disposable income more or less held steady due to government support measures. Industrial production and world trade have also increased since April, albeit not to the same extent as retail sales. This suggests that investment has not recovered, as uncertainty remains pronounced and business executives are probably exercising increased caution in their spending decisions. Furthermore, the labour market has recovered more strongly than generally expected, particularly in the US, where unemployment is now just under 7%, after peaking at slightly less than 15% this spring. But US unemployment is still high in historical terms, and the number of new applications for unemployment benefits exceeds the peak during the financial crisis a decade ago (Chart I-6).

Indications of a strong economic turnaround among leading industrialised economies this summer were confirmed recently, when preliminary GDP figures for Q3 were published. GDP grew by 7.4% quarter-on-quarter in the US, although it was still down 2.9% year-on-year (Chart I-1). A stronger quarter-on-quarter increase in the eurozone (12.6%) and the UK (15.5%) reflects an even steeper decline in the first half of the year. In Q3, there was still a contraction of 4.4% year-on-year in the eurozone and 9.6% in the UK. China's rapid recovery held its ground, with GDP growth measuring nearly 5% year-on-year during the quarter. GDP among Iceland's main trading partners is estimated to have been an average of 4.3% lower in Q3 than in the same quarter of 2019, which translates to a contraction over 3 percentage points smaller than was assumed in the August forecast.

… but the recovery slowed in the autumn, and a contraction is likely in Q4

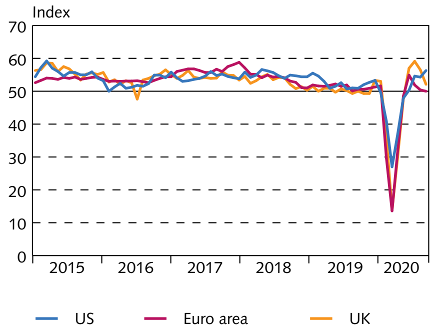
Despite a sharp turnaround in economic activity in advanced economies in Q3, leading indicators suggest that the recovery lost steam in some of them as the autumn progressed. Purchasing managers' indices (PMI) started to fall again following a strong rebound after April, particularly in the eurozone, owing to reduced activity in services sectors. On the other hand, manufacturing has held its ground (Chart I-7). In addition, high-frequency indicators suggested a steady decline in mobility: international travel slowed once again, and retail and recreational activity declined as well (Chart 1 in Appendix 1). This is probably due in large part to developments in the pandemic, which began to escalate among trading partner countries in the autumn, prompting governmental authorities to tighten public health measures. In almost all of these countries, new COVID cases exceeded the springtime peaks, possibly due in part to increased testing, which has improved detection rates and thus enabled healthcare authorities to implement less onerous disease prevention measures (Charts I-8 and I-9). On the other hand, the continued escalation of the pandemic in recent weeks has led to even more stringent government-mandated measures, including lockdowns, particularly in Europe. Some authorities have even resorted to measures similar to those imposed in the first wave of the pandemic, in response to increased strain on their healthcare systems. The GDP growth outlook for Q4 has therefore deteriorated in most

Chart I-6
US unemployment claims[1]
1 January 2000 - 7 November 2020



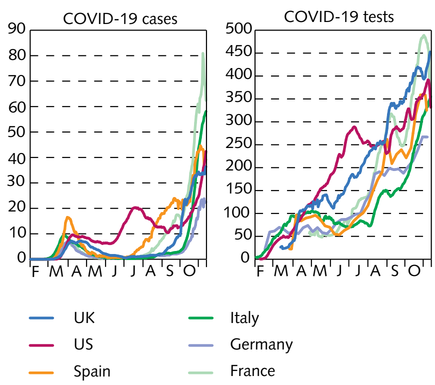
1. Number of initial claims for US unemployment insurance. Seasonally adjusted weekly data.
Source: Federal Reserve Bank of St. Louis FRED-database.

Chart I-7
Composite PMI[1]
January 2015 - October 2020



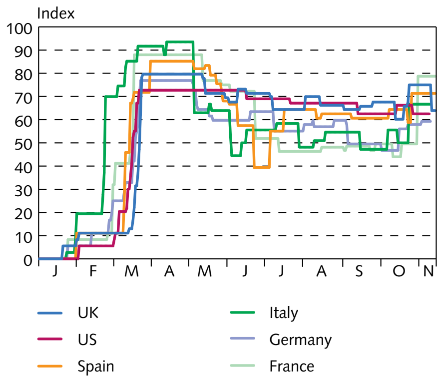
1. IHS Markit composite output purchasing managers' index. The index is published monthly and is seasonally adjusted. An index value above 50 indicates month-on-month growth in output, and a value below 50 indicates a contraction.
Source: Refinitiv Datastream.

Chart I-8
Daily new cases of COVID-19 and number of tests conducted[1]
1 February - 13 November 2020



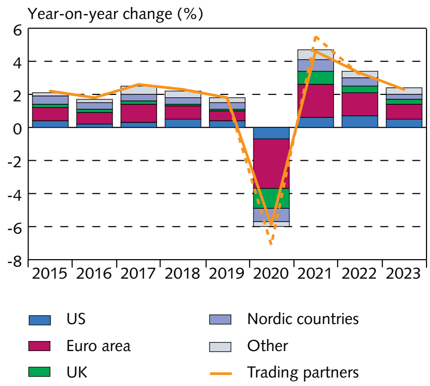
1. Daily number of tests conducted and diagnosed cases of COVID-19 per 100,000 inhabitants. Seven-day moving average.
Sources: Johns Hopkins University, OECD, Our World in Data, WHO.

Chart I-9
Scope of governments' public health measures[1]
19 January - 13 November 2020



1. The scope of public health measures weights together nine measures of the extent of government restrictions in order to curb the spread of COVID-19, including the scope of school and workplace closures, bans on public gatherings, and travel restrictions.
Sourcs: Oxford COVID-19 Government Response Tracker.

Chart I-10
GDP growth in main trading partners and contribution from selected countries 2015-2023[1]



1. Central Bank baseline forecast 2020-2023. Broken line shows forecast from MB 2020/3. The Nordic countries is the average for Denmark, Norway, and Sweden.
Source: Refinitiv Datastream, Central Bank of Iceland.

of Iceland's trading partner countries, especially in the eurozone, and trading partner GDP growth is expected to contract again quarter-on-quarter.

Global economic contraction in 2020 set to be smaller than previously feared …

According to the International Monetary Fund's (IMF) most recent forecast, the global economy will contract by 4.4% this year. This is 0.8 percentage points smaller than the contraction forecast by the Fund in June, but 1.1 percentage points larger than it projected in April. The revision since June is due to an improved outlook for advanced economies, which in turn is due primarily to a smaller Q2 contraction in the US and the eurozone than the Fund had anticipated. GDP growth in China has also rebounded more quickly than expected, but because of the poorer outlook for other emerging market economies (EME) – India in particular – a slight contraction is expected for EMEs as a whole. Even though the IMF considers global economic prospects to have improved this year, the outlook is still for the largest peacetime contraction since the Great Depression in the 1930s.

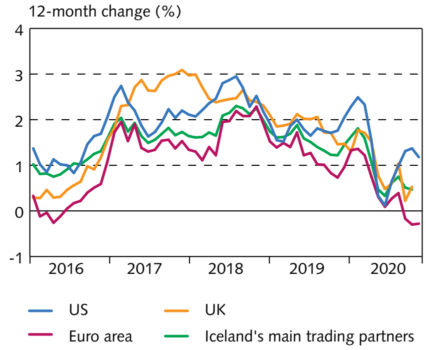
… and the outlook for Iceland's trading partners has improved

In line with the smaller economic contraction in Q2 and the prospect of a stronger recovery in Q3, GDP among Iceland's main trading partners is now expected to contract less in 2020 than the Bank assumed in August. The revision is due mainly to the improved outlook for the US and the eurozone, but also for the Nordic countries. Despite the weaker outlook for Q4, the contraction among trading partners is projected to average 5.9%, 1.2 percentage points smaller than in the August forecast (Chart I-10). Forecasts of trading partner imports have also improved in line with the brighter outlook for global GDP and world trade, and the contraction for this year is now forecast at 10.4%. Even though the GDP growth outlook has improved since August, it appears that the contraction among Iceland's main trading partners will be nearly twice as large in 2020 as in 2009, and the largest since World War II.

Prospect of strong GDP growth in 2021, but the outlook is highly uncertain

The global economic situation for the coming term is highly uncertain, owing mainly to uncertainty about how successful efforts to control the pandemic will be. International forecasts assume that a COVID-19 vaccine will be available for general use early next year and that a significant share of the population in Iceland's main trading partner countries will have been vaccinated by mid-year. With the arrival of a vaccine and other successful medical treatment for the disease, it is expected that public health measures can gradually be scaled down and economic activity can start to normalise. If this assumption is borne out, economic activity could rebound strongly in 2021. According to the Bank's baseline forecast, GDP growth among Iceland's trading partners will average 4.6% in 2021, which nevertheless is slightly weaker than was forecast in August. The outlook for the latter half of the forecast horizon is broadly unchanged, however. These assumptions are subject to considerable uncertainty, however, not least because it not known how successful efforts to quell the pandemic will prove to be (for further discussion, see Box 1).

Chart I-11
Global inflation
January 2016 - October 2020



Sources: Refinitiv Datastream, Central Bank of Iceland.

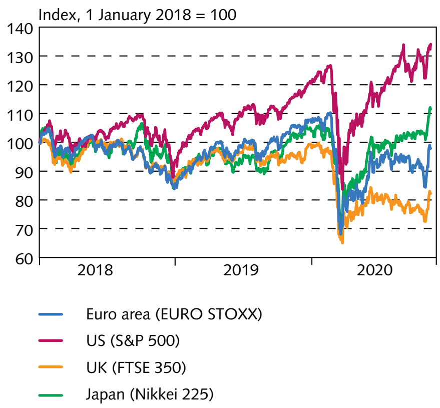
Global inflation has eased, but the inflation outlook is broadly unchanged

Global inflation fell rapidly in the spring, in tandem with a steep drop in energy prices and the COVID-19-driven contraction in overall demand, although the price of some goods rose – food in particular – because of various production problems and shortages (for further discussion, see Box 2). Among Iceland's trading partners, year-on-year inflation averaged only 0.5% in Q2, after falling by more than 1 percentage point since the turn of the year (Chart I-11). This trend has reversed in part, however, and inflation has risen again in most trading partner countries, as economic activity picks up and oil and commodity prices rise. On the other hand, inflation sagged even further in the eurozone in late summer, and measurements now show slight deflation for the first time in four years. This is due to a decline in underlying inflation, which is at an all-time low in the region, partly because of lower services inflation as a result of the pandemic. Lower inflation in the eurozone is the main reason the inflation outlook for trading partner countries has remained more or less unchanged since August. Trading partner inflation is expected to average 0.8% this year but then rise to 1.7% by the latter half of the forecast horizon.

Financial conditions have improved after significant turmoil early in the year, but considerable uncertainty remains

After being thrown into disarray by the COVID-19 outbreak in February and March, international financial markets have rallied in response to increased economic activity and greater optimism about the development of a COVID vaccine in the near future. Mitigating measures taken by central banks and governmental authorities have played a key role in supporting markets, facilitating government and corporate bond issues, boosting market agents' confidence in the economic outlook, and preventing the shock from having an even more profound impact on the global financial system. Share prices in leading advanced economies have therefore risen since the spring, and volatility has subsided (Chart I-12). This is particularly the case for share price indices in the US and Japan, which are now above pre-pandemic levels. The rise in risk premia and interest rate spreads on riskier financial assets has also reversed in large part. Capital flows to EMEs have stabilised after strong outflows earlier in the year, and inflows to some EMEs have begun to pick up again. Long-term interest rates in leading advanced economies have also risen somewhat but remain at or near historical lows. As a result, financial conditions have improved overall, but the situation remains fragile and highly uncertain.

Chart I-12
Global share prices
1 January 2018 - 13 November 2020



Source: Refinitiv Datastream.

Export prices and terms of trade

Outlook for marine product prices to fall in 2020 after a two-year surge …

The price of Icelandic marine products has been relatively stable in the recent term, after a significant pandemic-induced decline in H1 (Chart I-13). Market conditions for Icelandic products have remained difficult, however, due to reduced restaurant sector activity in trading partner countries. Marine product prices were down 4.3% year-on-year in foreign currency terms in Q3, and the outlook for H2/2020 has deteriorated since August. In 2020, marine product export prices are expected to fall by 0.6% year-on-year instead of rising by 3%, as was forecast in August. On the other hand, the rise in 2021 is projected to be larger than was assumed in August.

… and aluminium prices are expected to fall for the second year in a row

Global aluminium prices fell steeply in Q1/2020, owing mainly to weaker demand from China as a result of pandemic-related lockdowns there (Chart I-13). Furthermore, demand in the US and Europe began to slide towards the end of the quarter, when the resurgence of the pandemic in the West prompted governments to impose stricter public health measures. Aluminium prices have bounced back since then, however, in tandem with China's swift recovery, and are higher than at the turn of the year. In spite of this, the price of Iceland's aluminium exports is now expected to fall by just over 11% instead of the 8% forecast in August. As in August, aluminium prices overall are projected to continue rising throughout the forecast horizon.

Oil prices have held relatively stable after righting themselves this spring …

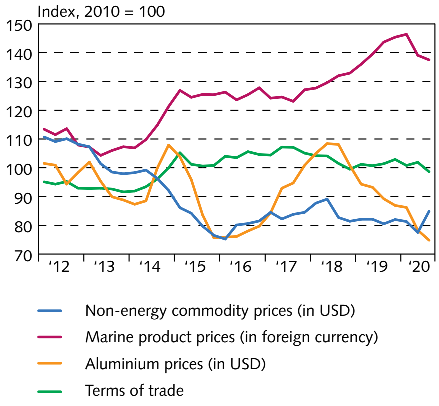
After plunging early in the year, global oil prices picked up in the spring and early summer. The increase reflected both reduced production among leading oil manufacturing countries and increased demand following the relaxation of public health measures and growing economic activity. Prices remained relatively stable during the summer but then fell in the autumn, primarily because of growing concerns that rising COVID-19 case numbers could cause a setback in the global economy and dampen demand for oil. In addition, increased production by OPEC countries and other non-OPEC producers may have contributed to lower prices, although production levels are still much lower than at the beginning of the year.

Brent crude prices averaged just under 42 US dollars per barrel in October, a full third lower than at the turn of the year, and the outlook is for prices to remain low in the next few years (Chart I-14). According to a recent forecast from the International Energy Agency (IEA), demand for oil is expected to average 8% lower this year than in 2019, which would represent a decline roughly twice the size of the largest single-year contraction in at least the last eight decades. Furthermore, demand is forecast to increase by 6% in 2021 but will not return to pre-pandemic levels until 2023. At the same time, rising

Chart I-13

Commodity prices and terms of trade[1]

Q1/2012 - Q3/2020

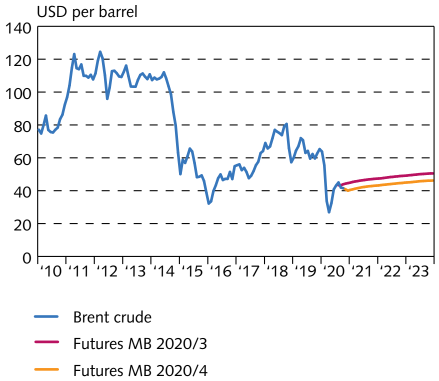


1. Foreign currency prices of marine products are calculated by dividing marine product prices in Icelandic krónur by the trade-weighted exchange rate index. USD prices of aluminium products are calculated by dividing aluminium prices in Icelandic krónur by the exchange rate of the US dollar. Central Bank baseline forecast Q3/2020 for terms of trade.
Sources: Statistics Iceland, World Bank, Central Bank of Iceland.

Chart I-14

Global oil prices

January 2010 - December 2023



Sources: Refinitiv, Central Bank of Iceland.

production and destocking of large inventories are expected to keep oil prices in check.

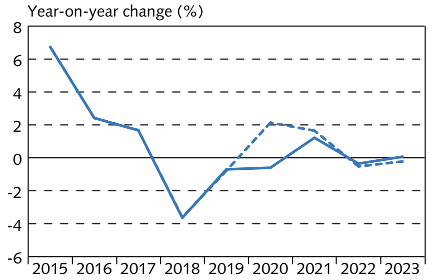
… while the price of other commodities has fallen still further

The price of non-energy commodities has risen steadily since the spring, after falling steeply in response to the pandemic, and is now higher than at the turn of the year (Chart I-13). Metals prices have risen the most, mainly because of increased demand from China, but also due to pandemic-related disruptions in mining, which affected supplies. Agricultural product prices have also recovered, driven mainly by rising food and beverage prices. Commodities are expected to rise in price by 1.1% year-on-year in 2020 instead of falling by 2.6%, as was assumed in August. On the other hand, the increase in 2021 is now expected to be smaller than was forecast in August.

Terms of trade expected to deteriorate further in 2020

Terms of trade for goods and services improved by just over 1% quarter-on-quarter in Q2/2020 (Chart I-13). They appear to have deteriorated again in Q3, however, and will therefore worsen by 0.6% over the year as a whole, whereas the August forecast assumed an improvement of 2.1% (Chart I-15). The outlook for 2021 has deteriorated as well.

Chart I-15
Terms of trade for goods and services
2015-2023[1]



1. Central Bank baseline forecast 2020-2023. Broken line shows forecast from MB 2020/3.
Sources: Statistics Iceland, Central Bank of Iceland.