II The global economy and terms of trade

Output growth globally and among Iceland's main trading partners declined in 2018, and the outlook for 2019 has deteriorated. Escalating tariffs and international trade disputes have slowed down growth in world trade and in trading partner demand. Global inflation has picked up again as a result of rising oil prices, although underlying inflation remains low in most instances. Iceland's terms of trade deteriorated markedly in 2018, and the outlook is for a smaller improvement this year than previously forecast. After a steep rise in the past few years, the real exchange rate fell in 2018, partly reflecting the economy's adjustment to a lower equilibrium real exchange rate.

Global economy

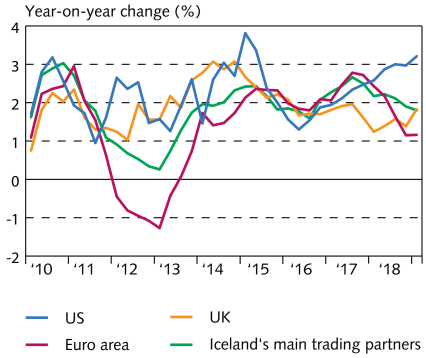
Trading partners' GDP growth softened in 2018 …

GDP growth among Iceland's main trading partners gave way in H2/2018, after robust growth in the period beforehand. It measured 2% in H2/2018, down from 2.2% in H1 and 2.5% in 2017 (Chart II-1). Growth receded in most trading partner countries and turned out weaker than was assumed in the Bank's February forecast, particularly in the eurozone, where private sector optimism has diminished and export growth has slowed. This shift is affected in particular by weaker developments in large core countries in the region (Chart II-2). For example, GDP growth slowed markedly in Germany, owing in part to temporary production problems in the motor vehicle industry, but also to a general slowdown in economic activity. In Italy as well, output growth slowed significantly in 2018 and then contracted in Q4. This was due largely to fiscal uncertainty and rising risk premia on the sovereign, which, together with a downturn in corporate sentiment, had a negative impact on investment spending. GDP growth also lost pace in France, where mass protests played a major role. Mounting concerns about the possibility that Britain will leave the European Union (EU) without an exit agreement probably dampened investment spending in the eurozone as well. Brexit has been postponed twice, and the deadline for the exit deal, if one is reached, is now the end of October 2019. Uncertainty about Brexit has also taken a toll in the UK, with growing pessimism, particularly among businesses, sluggish investment, and a slowdown in hiring in the services sector. In the US, however, GDP growth gained steam, measuring 3% in H2/2018 and 2.9% for the year as a whole.

… as did global output growth

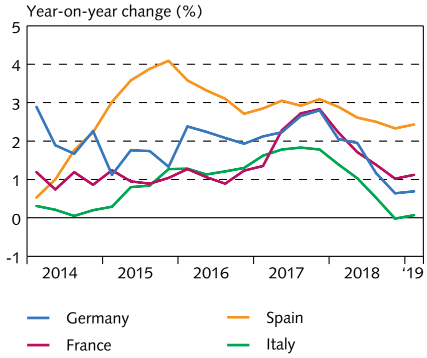
Global output growth lost ground in H2/2018 after rising strongly in the period beforehand, mainly as a result of falling growth rates in leading advanced economies. Global GDP growth measured 3.2% in H2, after approaching 4% in H1 and in 2017. The negative impact of escalating tariffs and international trade disputes took its toll, exacerbating pessimism among businesses and investors as the year progressed. Tighter financial conditions in many emerging market

Chart II-1
Global GDP growth[1]
Q1/2010 - Q1/2019



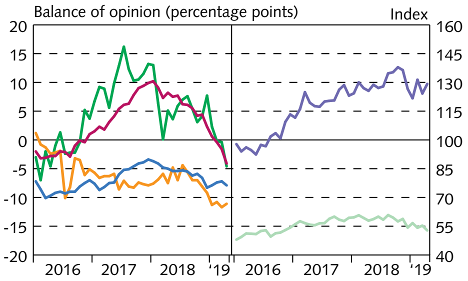
1. Central Bank baseline forecast Q1/2019 for main trading partners.
Sources: Thomson Reuters, Central Bank of Iceland.

Chart II-2
GDP growth in the eurozone
Q1/2014 - Q1/2019



Source: Thomson Reuters.

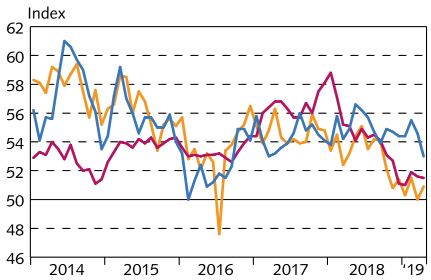
Chart II-3
Private sector expectations[1]
January 2016 - April 2019



Euro area consumers (left)
Euro area businesses (left)
UK consumers (left)
UK businesses (left)
US consumers (right)
US businesses (right)

1. European Commission expectations indices for the eurozone and the UK; ISM Report on Business for the US.
Source: Thomson Reuters.

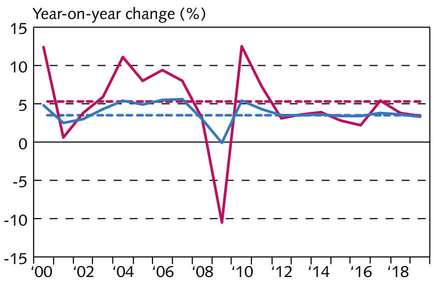
Chart II-4
Composite PMI[1]
January 2014 - April 2019



US
Euro area
UK

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

Chart II-5
World GDP and trade 2000-2019[1]



World GDP
World trade

1. Broken lines show average of 1980-2018. The values for 2019 are based on IMF's forecast (World Economic Outlook, April 2019).
Sources: International Monetary Fund, Central Bank of Iceland.

economies (EME) – and in advanced economies – also cut into global demand. GDP growth among EMEs weakened abruptly in H2/2018, largely reflecting reduced economic activity in China in the wake of government measures aimed at curbing credit growth and shadow banking activity, as well as placing output growth on a sustainable footing. These measures put a damper on investment, but in addition, the increase in import tariffs in the US has had a negative effect on exports from China.

The 2019 growth outlook for leading advanced economies has worsened …

Leading indicators and forecasts imply that GDP growth in advanced economies will also be weaker this year than previously projected, particularly in H1. In the eurozone, GDP growth was weaker in Q1 than had been assumed in February, and the outlook for the year as a whole has deteriorated. Although labour market conditions have continued to improve, pessimism has increased among consumers and businesses (Chart II-3), economic indicators have turned out poorer than expected, and purchasing managers' indices (PMI) have weakened (Chart II-4). This is particularly the case for Germany, Italy, and France. GDP growth in the euro area is projected to fall from 1.8% in 2018 to only 1.2% this year, which would be the region's weakest growth rate since 2013. In the UK, Q1 GDP growth turned out marginally stronger than expected in February, at 1.8%, reflecting in part temporary build-up of inventories by UK firms. The growth outlook has deteriorated for the year as a whole, however, as the PMI for the UK has tumbled to a three-year low. According to the index, the British economy is likely to contract in Q2. In the US – despite the decline in the PMI, declining optimism among households and businesses, and the impact of the temporary federal government shutdown – GDP growth exceeded forecasts in Q1. It is expected to soften as the year progresses, however, and measure 2.4% for 2019 as a whole, slightly below the February forecast.

… and global growth is expected to lose pace

The International Monetary Fund's (IMF) most recent forecast estimates global GDP growth at 3.3% in 2019, some 0.2 percentage points below the Fund's January forecast and 0.4 percentage points below its October forecast. The weaker growth rate is due in particular to a poorer outlook for advanced economies, especially in the eurozone, and also for some developing and emerging countries.

Growth in world trade has eased

Growth in world trade slowed markedly in 2018, after a robust 2017 (Chart II-5). This is due mainly to the negative impact of trade disputes and tariff wars – particularly between the US and China – on investment-related spending by many companies around the world, as capital goods are usually heavily traded. The slower growth rate also appears to stem from overall sluggishness in global output, which looks set to slow even further this year. The IMF forecasts that world trade will increase by 3.4% this year instead of the previously projected 4%. Significant uncertainty remains, however, including about the output growth outlook and the outcome of the trade negotiations between the US and China.

Outlook for GDP growth and demand in trading partner countries has worsened …

In line with the poorer outlook for global GDP growth and trade, growth in output and imports among Iceland's main trading partners is now projected to be weaker than was assumed in the Bank's February forecast. Trading partners' GDP growth is projected to average 1.7%, which is 0.2 percentage points less than was forecast in February. This is due mainly to the poorer outlook for the euro area. Forecasts of trading partner imports have also been revised downwards, with the growth rate for this year now projected at 3.3% instead of the 3.8% assumed in the February forecast.

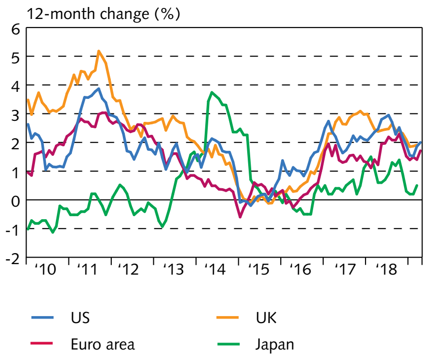
… but the outlook for trading partner inflation is broadly unchanged

Among Iceland's main trading partners, inflation declined in Q4/2018, following a sharp drop in oil prices. That trend continued in early 2019 (Chart II-6). Trading partner inflation averaged 2% in 2018 but had fallen to 1.6% in Q1/2019, somewhat below expectations. It was particularly low in the euro area and the US. The outlook is for inflation to pick up again as a result of the steep increase in oil prices in recent months. The inflation outlook for Iceland's trading partners is therefore broadly unchanged for 2019 as a whole, and inflation is expected to average 1.7% during the year. Core inflation is still low in many economies, however, despite the past two years' surge in domestic demand. It has risen in the eurozone but is still below the European Central Bank's (ECB) inflation target. In the US and the UK, however, core inflation is at target.

Leading central banks change their tone

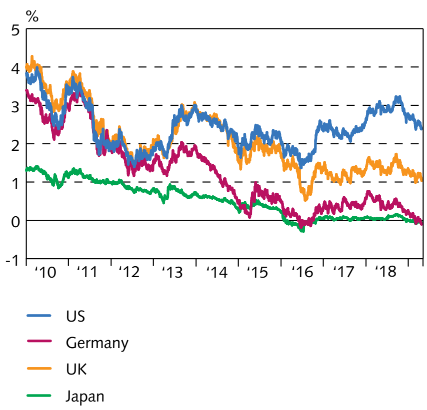
Central banks in most advanced economies have held their policy interest rates unchanged in 2019 to date, in response to the weaker GDP growth outlook and reduced inflationary pressures. In addition, many of them have signalled that the adjustment towards a neutral policy stance will be slower than previously assumed. This is particularly so for the US Federal Reserve, which has kept the policy rate flat this year after raising it by 1 percentage point in 2018 and a total of 2.25 percentage points since December 2015. The Fed had previously assumed that the policy rate would continue to rise this year, but it now expects to keep it unchanged through the year-end. The bank has also announced that it will reduce the net bond holdings on its balance sheet more slowly than previously planned and will end the balance sheet roll-off programme this autumn. The ECB also announced in March 2019 that policy rate hikes would be postponed at least until the end of the year. In addition, it announced new stimulative measures to bolster economic activity, whereas in December 2018 it had scaled back

Chart II-6
Inflation in selected industrialised countries
January 2010 - April 2019



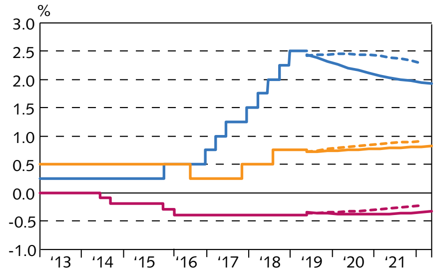
Source: Thomson Reuters.

Chart II-7
10-year government bond yields in selected industrialised countries
1 January 2010 - 17 May 2019



Source: Thomson Reuters.

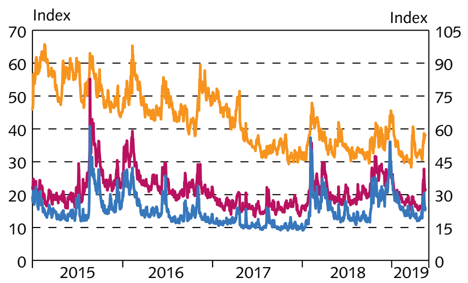
Chart II-8
Policy rates in selected industrialised economies[1]
January 2013 - June 2022



US — Euro area — UK

1. Daily data 1 January 2013 through 17 May 2019, and quarterly data Q2/2019 through Q2/2022. US interest rates are the upper bound of the US Federal Reserve bank's interest rate corridor, and rates for the euro area are the European Central Bank's deposit facility rate. Forward rates are based on overnight index swaps (OIS). Solid lines are based on forward rates during the period 13-17 May 2019 and the broken lines during the period 28 January - 1 February 2019.
Source: Thomson Reuters.

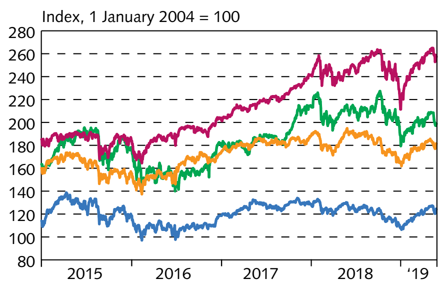
Chart II-9
Global market volatility[1]
1 January 2015 - 17 May 2019



Volatility Index for S&P 500 (left)
Emerging markets ETF Volatility index (left)
MOVE Index for US Treasury (right)

1. The MOVE and volatility indices indicate the implied volatility of financial products.
Source: Thomson Reuters.

Chart II-10
Global equity prices
1 January 2015 - 17 May 2019



EURO STOXX 50
S&P 500
FTSE 350
NIKKEI 225

Source: Thomson Reuters.

those measures by ending its net asset purchase programme. Moreover, the Bank of England and the Bank of Japan have announced their intention to exercise caution in their next monetary policy steps. This is not the case for Norges Bank, however, which raised its policy rate by 0.25 percentage points in March, to 1%.

The changed tone from leading central banks is reflected in the bond market, where interest rates have fallen, particularly on long government bonds (Chart II-7). Forward interest rates in the market also suggest that market agents expect smaller and more gradual rate hikes than they did earlier this year (Chart II-8). The change is perhaps the greatest in the US, where market participants increasingly think rates will start falling again.

Financial conditions improve again after upheaval in late 2018
Volatility in the global financial markets increased in late 2018, and financial conditions deteriorated, with falling asset prices and rising risk premia (Charts II-9 and II-10). This is due largely to the slowdown in global output growth, reduced corporate profits, and market agents' growing concerns that the Fed was tightening the monetary stance too quickly in the US. The situation turned around at the beginning of this year, however, as asset prices started to recover and risk premia eased. The turnaround was attributable mainly to changed forward guidance from the Fed and other major central banks, which alleviated market agents' concerns about further rate hikes this year. Market optimism about the outcome of the negotiations between the US and China supported this development. Significant uncertainty remains, however, including concerning international trade disputes, developments in global GDP growth, and the future relationship between the UK and the EU and its impact. The US administration's recent decision to raise import tariffs on Chinese goods and China's retaliation have further exacerbated uncertainty, raising market volatility again and cutting into equity prices.

Export prices and terms of trade

Marine product prices set to rise by about the same in 2019 as in 2018 …
Foreign currency prices of Icelandic marine products rose by 4.7% in 2018 and appear likely to rise by a similar amount this year (Chart II-11). The market for Icelandic marine products has retained its strength, and nearly all product types have risen in price, owing to strong and steady demand in foreign markets, coupled with limited supply. In recent months, exports to the US and the UK have increased particularly strongly, perhaps due to uncertainty associated with tariffs, trade disputes, and Brexit. In the past few weeks, last year's remaining inventories of frozen capelin products have been reduced substantially because of strong excess demand, which in turn is due to capelin catch failures in both Icelandic waters and the Barents Sea. As was forecast in February, the rise in Icelandic marine product prices is forecast to ease in the next two years.

… but the outlook is for aluminium prices to fall more than previously forecast

Global aluminium prices have held relatively stable in 2019 to date, after a marked decline towards the end of 2018. In the first four months of this year, the average price was about 1,860 US dollars per tonne, some 15% lower than in the same period of 2018 (Chart II-11). The decline was due in part to the removal of US sanctions on Russian aluminium giant Rusal and expectations of increased alumina supplies following news that production at Brazilian company Alunorte, the largest alumina factory in the world, is returning to normal after difficulties in the recent term. The average price of aluminium is forecast to fall by 9% this year, over 2 percentage points more than was projected in February.

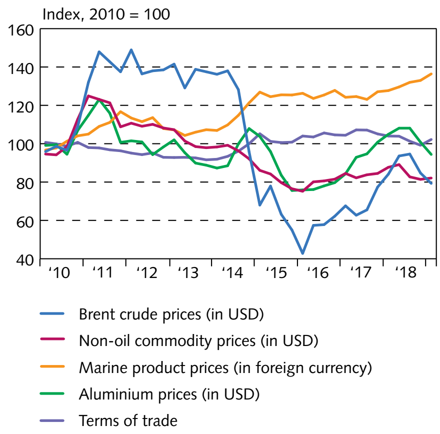
Oil prices up again as supplies decline

Global oil prices fell steeply in Q4/2018, after surging in the quarters beforehand. But this year they have risen again, more or less as they did at the same time in 2018. Prices are now just above 72 US dollars per barrel, up from about 52 dollars at the end of last year (Chart II-11). The jump is due mainly to a drop in supply because of reduced production in the OPEC countries, Saudi Arabia in particular, as well as in several countries outside OPEC. This is compounded by negative supply-side effects of the US government's embargo on Venezuela and Iran, as well as unrest in other oil-producing countries, especially Libya. The recent escalation of US sanctions on Iran has put even more upward pressure on oil prices. Pulling in the other direction, though, are the steady increase in production in the US and an overall dip in demand because of the slowdown in global output growth. Futures prices indicate that oil prices will remain broadly unchanged until the year-end and that the average 2019 price will be about 2% below the 2018 average. This reduction is a full 11 percentage points smaller than was assumed in the February forecast. As in February, futures prices suggest that oil prices will fall in the next two years but will be somewhat above the February forecast for the entire forecast horizon (Chart II-12). Developments in oil prices are more uncertain than usual at present. In particular, it is highly uncertain how other oil-producing countries will respond to the effects of tightened sanctions on Iran, as well as the effects of international trade disputes and the demand-side impact of weaker global output growth.

Non-oil commodities prices up slightly

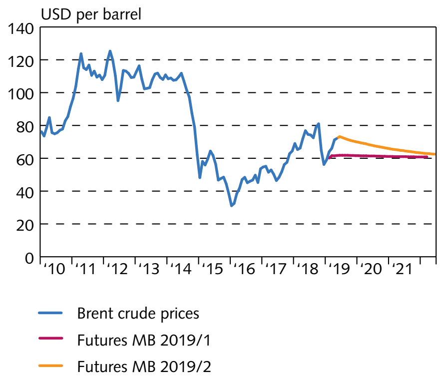
Non-oil commodities prices softened in H2/2018, after rising early in the year (Chart II-11). To a large extent, the decline reflects the impact of the international trade disputes and escalating tariffs, although reduced economic activity and weaker demand – particularly from China – are important factors as well. Virtually all types of commodities fell in price, although metals declined most. Commodities prices have picked up again slightly this year, metals and minerals prices in particular. This is attributable to the improved GDP growth outlook for China and dwindling supplies in several markets, including a disruption in iron ore supplies following the collapse of a dam at a mine in Brazil. Prices are

Chart II-11
Commodity prices and terms of trade[1]
Q1/2010 - Q1/2019



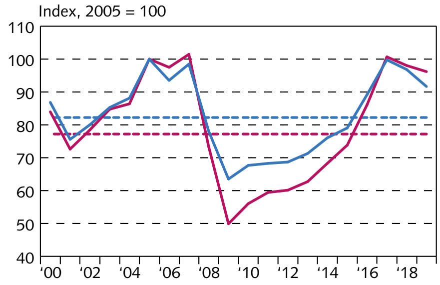
1. Foreign currency prices of marine products are calculated by dividing marine product prices in Icelandic krónur by the trade-weighted exchange rate index. USD prices of aluminium products are calculated by dividing aluminium prices in Icelandic krónur by the exchange rate of the USD. Central Bank baseline forecast Q1/2019 for terms of trade.
Sources: Statistics Iceland, Thomson Reuters, World Bank, Central Bank of Iceland.

Chart II-12
Global oil prices[1]
January 2010 - June 2022



1. Brent crude prices based on data until 17 May 2019.
Sources: Thomson Reuters, Central Bank of Iceland.

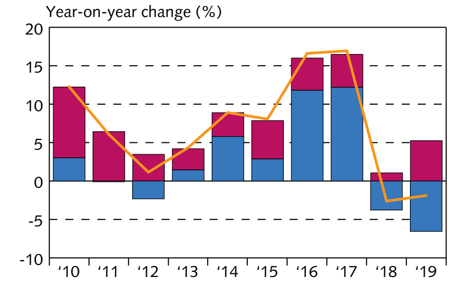
Chart II-13
Real exchange rate 2000-2019[1]



Real exchange rate (relative prices)
Real exchange rate (relative labour costs)

1. Broken lines show 25-year average (1994-2018). Central Bank baseline forecast 2019.
Source: Central Bank of Iceland.

Chart II-14
Real exchange rate in terms of relative unit labour costs 2010-2019[1]



Nominal exchange rate of the króna
Relative unit labour costs
Real exchange rate in terms of relative unit labour costs

1. Relative unit labour costs are defined as the ratio of unit labour costs in Iceland to unit labour costs abroad, measured in the same currency. Central Bank baseline forecast 2019.
Source: Central Bank of Iceland.

expected to keep rising throughout 2019 but are still projected to be marginally lower, on average, than in 2018.

Terms of trade improve more slowly this year after deteriorating in 2018

After a virtually continuous improvement dating from mid-2014, terms of trade for goods and services deteriorated by 3.9% in 2018 (Chart II-11), mainly because of the steep rise in oil and alumina prices. Overall import prices rose last year, which is the main reason why the erosion in terms of trade in 2018 was greater than previously projected. Despite indications that they continued to worsen in Q1/2019, the outlook is for terms of trade to improve by 0.3% this year, somewhat less than was forecast in February. This is due to the prospect of a smaller decline in oil prices and a larger decline in aluminium prices, offset by the prospect of a larger drop in alumina prices, particularly in H2.

Real exchange rate fell year-on-year in 2018, for the first time in nearly a decade …

The real exchange rate in terms of relative consumer prices fell by 3% year-on-year in 2018, after having risen uninterrupted since 2010 (Chart II-13). The decline occurred almost entirely in Q4, after being relatively stable earlier in the year. In 2019 to date, it has risen slightly once again, but it is still 10.6% lower than at the same time in 2018. As has been discussed previously in *Monetary Bulletin*, the past few years' steep rise in the real exchange rate is considered a reflection of a higher equilibrium real exchange rate; i.e., the real exchange rate consistent with internal and external balance. The rise in the equilibrium real exchange rate reversed in part last year, owing to poorer terms of trade and weaker export growth. The decline is expected to continue this year, in response to the external shocks that have hit Iceland's export sectors recently.

… and is expected to fall further this year

According to the baseline forecast, the real exchange rate in terms of relative consumer prices will be 5.3% lower, on average, in 2019 than in 2018, which is broadly in line with the February forecast. In terms of relative unit labour costs, the real exchange rate will be a scant 2% lower this year than in 2018. This represents a drop of nearly 5% in two years. Therefore, even though unit labour costs are rising faster in Iceland than in major trading partner countries, the outlook is for the competitive position of domestic companies in the tradable sector to improve for the second year in a row (Chart II-14).