# The global economy and terms of trade

I

## The global economy

**After a setback in Q1, the global economic recovery resumed in Q2 …**

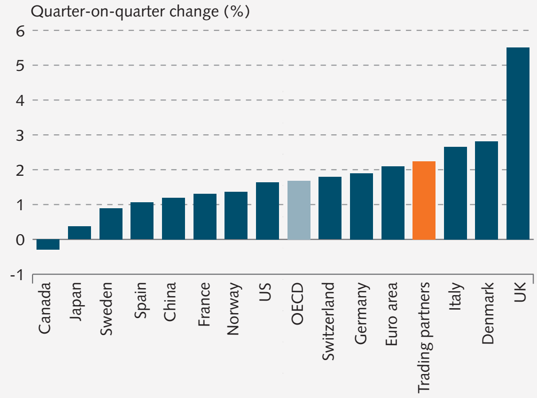
Among Iceland's main trading partners, GDP contracted by 0.1% between quarters in Q1/2021, in the wake of tightened public health measures imposed to halt the increased spread of the pandemic (Chart 1 in Appendix 1). Economic activity started to pick up swiftly in Q2, however, with GDP rising by 2.2% quarter-on-quarter as vaccination rates rose and public health measures were eased (Chart I-1). This is one of the strongest quarterly average GDP growth rates recorded in trading partner countries. Even so, it was considerably weaker than following the rebound in Q3/2020, after the first wave of the pandemic subsided. GDP growth was particularly robust in the UK, where very stringent public health measures in Q1 had weighed heavily on economic activity. There was also a marked turnaround in Denmark, Norway, and the eurozone. In spite of this, GDP was still nearly 3% below the pre-pandemic level both in the UK and the eurozone (Chart I-2). In the US and Denmark, however, output was above the pre-pandemic level, and in China it was a full 8% higher. Trading partner GDP rose by 6.3% year-on-year in H1/2021, about 0.3 percentage points above the Bank's August forecast.

**… driven mainly by private consumption**

In Q2/2021, global GDP growth was driven mainly by the recovery of private consumption (Chart I-3), which followed the relaxation of the public health measures that have limited consumers' spending opportunities. Other domestic demand also grew in major advanced economies. In many of these countries, however, this was offset by a negative contribution from net trade,

Chart I-1

Global GDP growth in Q2/2021[1]

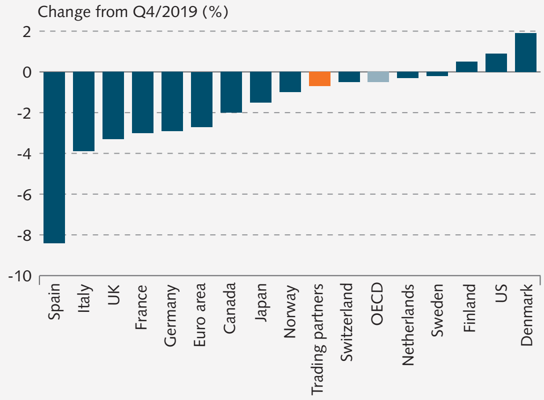



1. Seasonally adjusted data. Figures for Norway exclude the production and shipping of oil and gas.

*Sources:* Refinitiv Datastream, Central Bank of Iceland.

Chart I-2

Global GDP growth in Q2/2021[1]




1. Seasonally adjusted data. Figures for Norway exclude the production and shipping of oil and gas.

*Sources:* Refinitiv Datastream, Central Bank of Iceland.

which was fuelled by growth in imports alongside the recovery of private consumption. Furthermore, many countries recorded a negative contribution from inventory changes, as firms have widely been destocking because global production has been unable to keep pace with growth in demand for goods. Increased demand for goods is due in large part to changes in consumption patterns, with households shifting their spending from services to goods in response to the effects of the pandemic and public health measures.

**The recovery is set to continue in major advanced economies …**

COVID infection rates surged worldwide this summer, following the spread of the Delta variant of the virus (Chart 1 in Appendix 1). They began to decline again in September, but in recent weeks the pandemic has gained ground once more, particularly in Europe. In spite of this, major advanced economies are expected to continue recovering, largely because of high vaccination rates. Although the vaccines have not protected against infection to the degree previously hoped, they have greatly reduced the probability of severe illness and hospitalisation. Reduced strain on healthcare systems has given governments the flexibility to maintain less stringent public health measures than in previous waves of the pandemic, and in many areas restrictions have been eased further despite a continued rise in case numbers. The economic impact of the pandemic has therefore receded, although significant uncertainty remains, particularly about the efficacy of vaccines against new variants of the virus. Therefore, the possibility that governments will have to tighten public health measures once more cannot be ruled out.

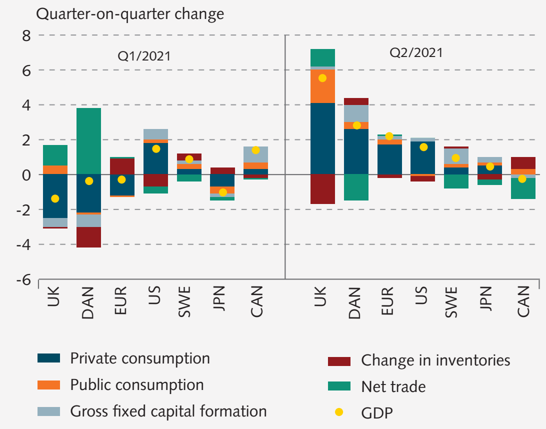
**… but the outlook is for slower growth in economic activity in H2 …**

Leading indicators and global forecasts suggest that economic activity will continue to grow in H2/2021. It appears, however, that the pace has eased recently, largely because of weaker activity in manufacturing sectors, owing to persistent shortages of important inputs and continued shipping problems. This situation has caused protracted disruptions in production and lengthened delivery times, prompting firms to raise prices significantly.

Weaker activity in manufacturing sectors can be seen in reduced industrial production and lower PMI indices (Charts I-4 and I-5). Indicators imply as well that growth in services sectors has slowed in the wake of the Delta wave of the pandemic, and firms have experienced

Chart I-3

GDP growth and contribution of underlying components

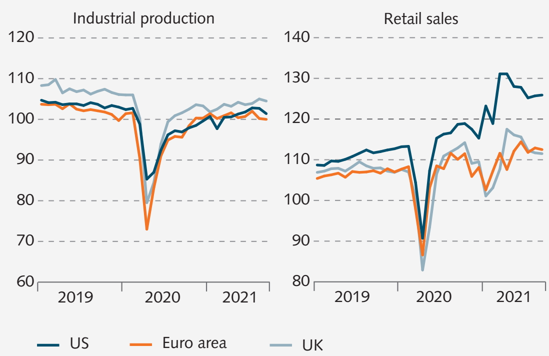



*Source:* Refinitiv Datastream.

Chart I-4

Industrial production and retail sales[1]

January 2019 - September 2021

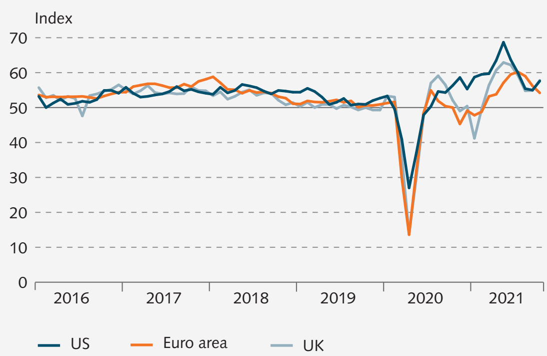



1. Seasonally adjusted volume indices (2016 = 100).
*Source:* Refinitiv Datastream.

Chart I-5

Composite PMI[1]

January 2016 - October 2021




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.

continuing difficulties in filling job vacancies in order to meet the increase in demand. Retail sales have weakened recently in major advanced economies, and households and businesses appear more pessimistic about the economic outlook, particularly in the US and the UK. To some degree, this could be due to concerns about the pandemic, although high-frequency data on traffic, retail sales, and recreational activity show little change in mobility among the general public (Chart 1 in Appendix 1). Furthermore, energy prices have risen steeply in the recent term because of limited supply – especially of natural gas in Europe – pushing households' and businesses' costs higher and potentially slowing down the economic recovery even further.

### … as is indicated by preliminary GDP growth figures for Q3

According to newly published preliminary figures for Q3/2021, GDP grew by 0.5% quarter-on-quarter in the US, 1.3% in the UK, and only 0.2% in China (Chart I-6). This is weaker growth than in Q2 in all three countries, and well below the projections in the August forecast. GDP growth turned out stronger, however, in the eurozone and Sweden, and this is the main reason the trading partner average for Q3 is still forecast at 1.5%. The GDP growth outlook for Q4 has deteriorated relative to the August forecast, however.

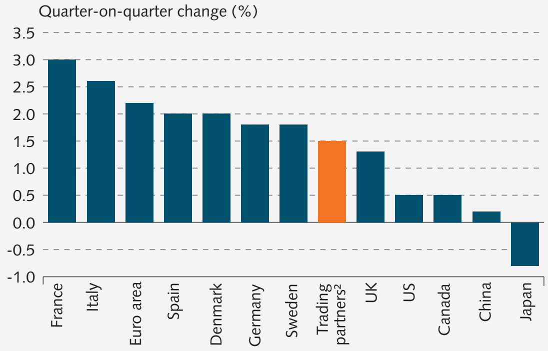
### Global GDP growth for 2021 set to be marginally weaker than previously forecast …

According to the International Monetary Fund's (IMF) mid-October forecast, global GDP growth is projected to measure 5.9% in 2021, which is 0.1 percentage points below the Fund's July forecast. The slight downward revision stems from weaker output growth in advanced economies, mainly the US, Canada, Japan, and Germany. Elsewhere in the euro area, however, the outlook has improved, and stronger GDP growth is now forecast for the region as a whole. On the other hand, the IMF expects stronger growth in emerging and developing economies despite the prospect of slightly weaker output growth in China. For 2022, global output growth is forecast at 4.9%, as in July. World trade is projected to continue recovering apace in 2021 and 2022.

### … but the outlook has improved for Iceland's main trading partners

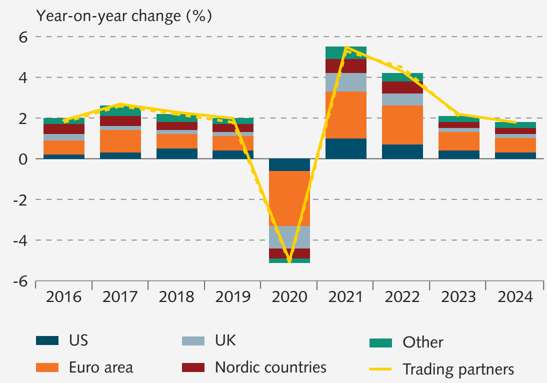
According to the Bank's baseline forecast, GDP growth among Iceland's main trading partners will measure 5.5% this year, after a contraction of 5% in 2020 (Chart I-7). The projection for this year is 0.2 percentage points

Chart I-6
Global GDP growth in Q3/2021[1]




1. Seasonally adjusted data. Figures for Norway exclude the production and shipping of oil and gas. 2. Central Bank baseline forecast.
*Sources:* Refinitiv Datastream, Central Bank of Iceland.

Chart I-7
GDP growth in Iceland's trading partners and contribution from selected countries 2016-2024[1]



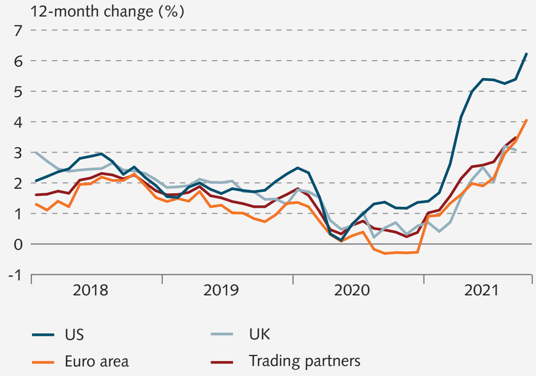

1. Trade-weighted contribution from selected countries. Central Bank baseline forecast 2021-2024. Broken line shows forecast from MB 2021/3. "Nordic countries" is the average for Denmark, Norway, and Sweden.
*Sources:* Refinitiv Datastream, Central Bank of Iceland.

above the August forecast, owing to stronger output growth in H1. The outlook for 2021 has improved for the euro area and Denmark in particular, but also for the UK and Sweden, while it has deteriorated for the US, Japan, Canada, and China. Trading partners' GDP growth is projected to measure 4.3% in 2022, or 0.2 percentage points below the August forecast. Trading partners' imports are forecast to grow strongly, in line with more robust economic activity. According to the baseline forecast, trading partner countries' imports will grow year-on-year by an average of 8.3% in 2021 and 7.2% in 2022.

The economic outlook is still highly uncertain, however, not least as regards developments in the pandemic and whether a re-tightening of public health measures will be required. Moreover, the economic recovery will also be determined in large part by how households use the savings they have accumulated in the wake of the pandemic and how successfully the persistent supply-chain bottlenecks can be resolved (for further discussion, see Box 1).

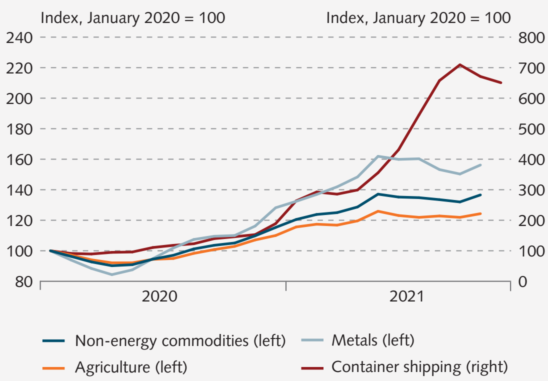
**Global inflation has risen still higher, in line with commodity price hikes and disruptions in value chains …**
Inflation averaged 3.1% among Iceland's trading partners in Q3/2021 (Chart I-8), or ½ a percentage point above the August forecast. It has now risen by 2½ percentage points year-to-date, mostly in the US, but also in the eurozone and the UK. Increased inflation is due largely to higher energy and commodity prices, in line with relaxation of public health measures and increased economic activity in the past year (Charts I-9 and I-16). The surge in demand for goods and the disruptions in production brought on by the pandemic have thrown global value chains into disarray and have also contributed to rising prices. This can be seen in the long waiting lines that have developed at many important shipping harbours, as well as in the shortage of shipping containers, which has caused shipping costs to snowball since the beginning of 2020. The problem has been compounded by the continued rise in energy prices in the recent term, especially natural gas prices in Europe. Furthermore, the relaxation of public health measures has caused the price of many consumer items to rise again after last year's pandemic-induced decline. This applies in particular to used cars, accommodation, and airfares in the US, although there are signs that prices are starting to subside again. Underlying inflation, which excludes volatile items such as food and energy, has also risen rapidly, particularly in the US, where it is now at its highest in over thirty years.

Chart I-8
Global inflation
January 2018 - October 2021




*Sources:* Refinitiv Datastream, Central Bank of Iceland.

Chart I-9
Global shipping and commodity prices[1]
January 2020 – November 2021




1. Agricultural products are divided into food (62%), beverages (13%), and raw materials (25%). Container shipping based on the Freightos Global Container Index. Based on data through 12 November 2021.
*Sources:* Freightos Limited, World Bank.

### ... and the global inflation outlook continues to deteriorate

As before, a large share of increased twelve-month inflation in trading partner countries is due to base effects from limited inflationary pressures in 2020 and temporary government measures, particularly the value-added tax cut in Germany. As a consequence, inflation is still projected to ease in the coming year. In addition, it is expected that the supply-chain disruptions will gradually be unwound over the course of 2022 and that household demand will shift more decisively from goods to services at the same time. However, more persistent supply-chain problems and steeper energy price hikes will cause inflation to be higher than in the Bank's previous forecasts. Inflation in trading partner countries is expected to average 2.7% this year and 2.4% in 2022, or 0.4 and 0.6 percentage points, respectively, above the August forecast. It is expected to be just under 2% in 2023 and 2024. The outlook is highly uncertain, however, and global inflationary pressures could prove even more persistent. Box 1 discusses the potential impact of this on the domestic economic outlook.

### Central banks in advanced economies have begun withdrawing support measures ...

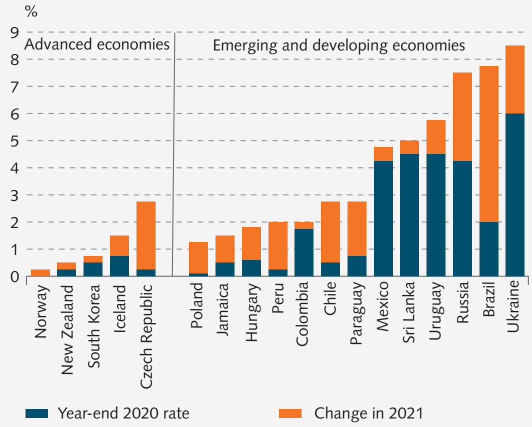
Central banks in major advanced economies have supported the economic recovery with low interest rates and other stimulative measures. Until now, they have held their policy rates unchanged despite an improving economic outlook and higher inflation, and they have announced their intention to maintain this stance until it becomes clearer that the economic recovery has gained a foothold. In September, however, the European Central Bank (ECB) announced that it would reduce the pace of its monthly bond purchases in response to the improved outlook. The US Federal Reserve made a similar announcement in early November. Furthermore, the Bank of England signalled that it may start raising interest rates earlier than previously planned, owing to the deteriorating inflation outlook. On the other hand, central banks in several other developed countries have already raised rates, joining the ranks of emerging country central banks that have started tightening their monetary stance (Chart I-10).

### ... and long-term interest rates have risen worldwide

Long-term bond interest rates have surged once again this autumn, after falling during the summer (Chart I-11), and they are widely at or above the pre-pandemic level. The increase reflects expectations of a more rapid rise in central bank rates, in light of the continued eco-

Chart I-10

Central bank policy rates in selected economies[1]

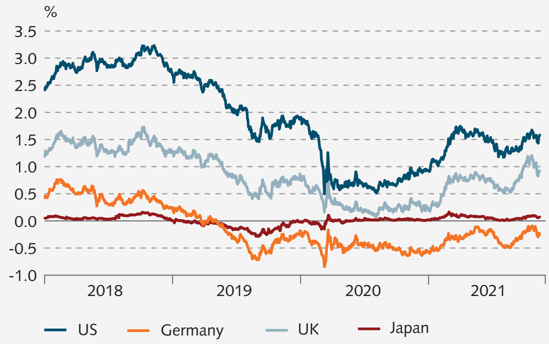



1. Based on data through 12 November 2021.
*Sources:* IMF, Revinitiv Datastream.

Chart I-11

10-year government bond yields

1 January 2018 - 12 November 2021

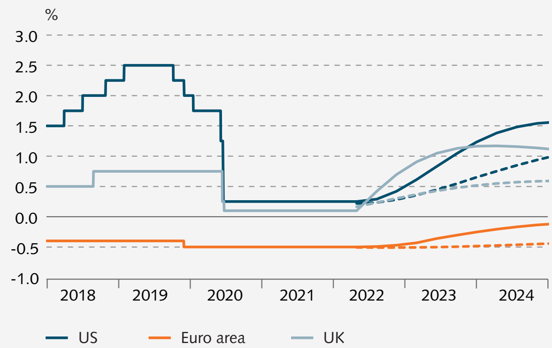



*Source:* Refinitiv Datastream.

Chart I-12

Central bank policy rates[1]

January 2018 - December 2024




1. Daily data 1 January 2018 through 12 November 2021, and quarterly data Q4/2021 through Q4/2024. 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 as of mid-November 2021, and broken lines as of mid-August 2021.
*Sources:* Bloomberg, Refinitiv Datastream.

nomic recovery and the poorer inflation outlook (Chart I-12). Market agents' inflation expectations have risen as well, particularly in the eurozone, and are now in line with the ECB's inflation target (Chart I-13). Furthermore, there is greater uncertainty about future developments in inflation and interest rates, which has prompted a rise in term premia on government bonds. In the US, the premium on long-term bonds is now ½ a percentage point higher than at the beginning of the year. Expectations of reduced bond purchases by major central banks play an important role in this trend and have contributed to a rise in bond interest rates.

**Financial conditions are still favourable**

Global share prices sagged in September, in tandem with increased concerns about developments in inflation and the pandemic (Chart I-14). Greater uncertainty about developments in US fiscal affairs also contributed to the decline, as did concerns about the Chinese real estate market. Share prices in major advanced economies have rebounded, however, in response to strong corporate earnings reports in Q3. Market agents' concerns about US fiscal developments have also receded. Moreover, share price volatility has subsided and premia on riskier financial assets have tapered off. Financial conditions therefore remain particularly favourable in spite of the recent rise in bond rates.

## Export prices and terms of trade

**Outlook for a smaller rise in marine product prices …**

Icelandic marine product prices fell steeply in 2020, owing to the impact of the pandemic (Chart I-15). They started to rise again in Q2/2021 and picked up even more in Q3, as trading partners eased public health restrictions and market conditions improved. However, the increase in Q3 was below the August forecast, and the foreign currency price of marine product exports therefore looks set to hold broadly steady year-on-year in 2021, instead of rising by 2%. Prices are projected to rise in coming years as market conditions normalise, albeit a bit more slowly than was forecast in August. One contributing factor here is the probability that the expected surge in the capelin catch will cause the market price of capelin products to fall somewhat.

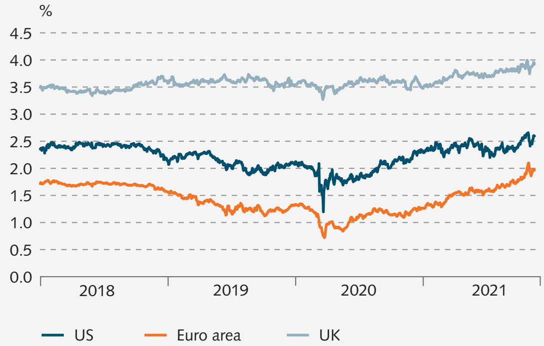
**… but a larger rise in aluminium prices**

Global aluminium prices have risen steadily after bottoming out in mid-2020 (Chart I-15). They jumped more than 10% between Q2 and Q3/2021, to their highest in thirteen years. The rise in Q3 is due largely to production

Chart I-13

Breakeven inflation rates[1]

1 January 2018 - 12 November 2021

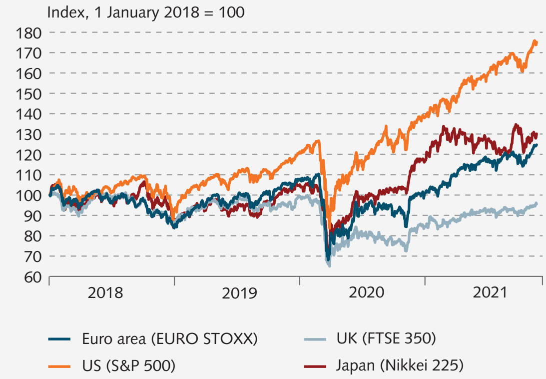



1. 5-year, 5-year forward breakeven inflation rate. The breakeven inflation rate for UK is based on the Retail Price Index (RPI).
*Source:* Refinitiv Datastream.

Chart I-14

Global share prices

1 January 2018 - 12 November 2021

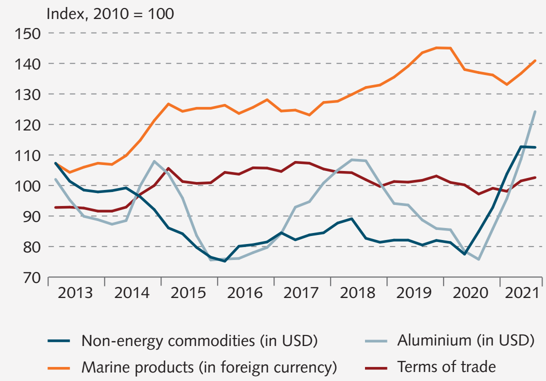



*Source:* Refinitiv Datastream.

Chart I-15

Commodity prices and terms of trade[1]

Q1/2013 - Q3/2021




1. Central Bank baseline forecast Q3/2021 for terms of trade.
*Sources:* Statistics Iceland, World Bank, Central Bank of Iceland.

cuts in China, which in turn stem from a change in the Chinese government's environmental policy, leading to a reduction in the supply of energy for power-intensive manufacturing. Production also contracted in India because of a shortage of coal, and in Brazil because of reduced hydropower plant output. Furthermore, the price of alumina, a key ingredient in aluminium manufacture, has risen because of supply disruptions in Brazil and Jamaica, contributing to higher aluminium prices. The price of Iceland's aluminium exports is expected to be 43% higher this year than in 2020, instead of 37% higher, as in the August forecast. For next year, the price increase is projected at 16%, twice as much as was assumed in August.

**Oil prices have kept rising, hitting a seven-year high …**

Global crude oil prices have risen virtually without interruption after plunging in March and April 2020, following the onset of the pandemic (Chart I-16). They softened slightly in August, after the spread of the Delta variant of the virus, but have risen still further since then. The recent increase is attributable to reduced output after production was disrupted by a hurricane in the US. Furthermore, it has taken longer than previously envisioned to lift the production limits in OPEC nations and other oil-producing countries. At the same time, demand for oil has increased in line with growing economic activity, and a limited supply of other energy sources, natural gas in particular, has pushed prices upwards and contributed to greater demand for oil. Reduced production and increased demand can be seen in a drop in oil inventories, which are now below the average of the past five years.

The price of Brent crude averaged just under 84 US dollars per barrel in October, its highest in seven years. Although futures prices suggest that oil prices will decline during the forecast horizon, the outlook is for prices to be well above the August forecast over the horizon as a whole.

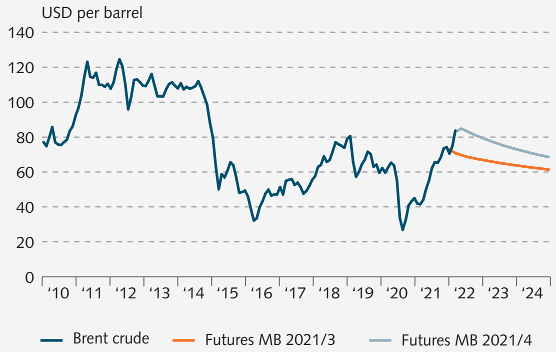
**… but other commodity prices have started falling, after rising steeply in the recent term**

The price of non-energy commodities declined marginally in Q3, after having risen virtually unimpeded since spring 2020 (Chart I-15). Commodity prices are still more than a third above their pre-pandemic level, however. Metals prices fell 1.4% quarter-on-quarter in Q3, owing to lower iron ore and copper prices. The drop in iron ore prices is due largely to reduced demand in China, which in turn stems from the aforementioned environmental policy shift by the Chinese government.

Chart I-16

Global oil prices

January 2010 - December 2024




*Sources:* Refinitiv, Central Bank of Iceland.

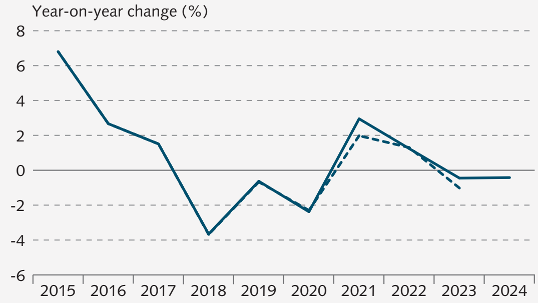
This was offset, however, by continuing rises in the price of other metals, owing to increased global economic activity and to disruptions in production caused by the energy shortage. Food prices also fell in Q3, while the price of beverages kept rising. Despite the decline in Q3, non-energy commodity prices were higher than was assumed in the Bank's August forecast. The outlook is for commodity prices to rise by an average of just under a third this year and not one-fourth, as was forecast in August. The decline projected for 2022 is also expected to be smaller than was assumed in August, but prices are expected to be broadly in line with that forecast in the latter part of the forecast horizon. The outlook is highly uncertain, and one of the alternative scenarios in Box 1 explores the potential impact on the domestic economy if price hikes turn out more persistent than in the baseline forecast.

**Terms of trade set to improve more strongly this year**

Terms of trade for goods and services improved by 1.3% year-on-year in Q2/2021, more than was forecast in August. The main reason for the deviation is the larger increase in the price of exported goods, ferrosilicon in particular. In addition, the price of imported alumina rose less than anticipated. Terms of trade appear to have continued improving in Q3, and in 2021 as a whole they are expected to improve by 2.9%, or 1 percentage point more than was forecast in August. The difference is due primarily to a larger rise in aluminium prices, which outweighs the larger rise in the price of imports, especially oil and commodities. The outlook for the next two years is broadly unchanged from the August forecast, however (Chart I-17).

Chart I-17

Terms of trade for goods and services 2015-2024[1]




1. Central Bank baseline forecast 2021-2024. The broken line shows the forecast from MB 2021/3.

*Sources:* Statistics Iceland, Central Bank of Iceland.