II The global economy and terms of trade

The global economic outlook is facing headwinds. The recovery has lost momentum so far this year, the financial markets were beset by considerable unrest in late summer, and the turmoil has made its mark on terms of trade and currency exchange rates. The outlook for GDP growth and demand among Iceland's main trading partners has deteriorated and uncertainty has mounted, after trading partners' economic recovery had gradually gained momentum from 2013 through mid-2015. On the whole, the global inflation outlook is virtually unchanged from the forecast in the August *Monetary Bulletin*. The outlook for Iceland's terms of trade is slightly poorer and more ambiguous than in August. The real exchange rate has risen sharply and appears set to continue doing so, with the associated erosion of Iceland's competitive position.

Global economy

Trading partners' GDP growth has gradually firmed up in the past two years …

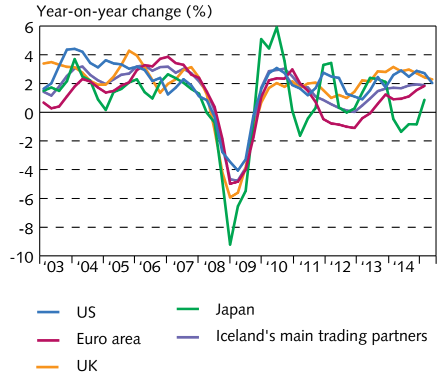
GDP growth in Iceland's trading partner countries measured 1.9% in H1/2015, slightly exceeding the Bank's August forecast. Trading partners' GDP growth has gained ground over the past two years, since the end of the contraction in the euro area. As before, the economic recovery has proven sturdier in the US and the UK than in the eurozone, although it has gradually firmed up there as well (Chart II-1). The recovery is uneven in the Nordic region: the long-standing contraction in Finland has yet to come to an end and the outlook for Norway has deteriorated in the wake of the plunge in oil prices, while Denmark and Sweden have seen gradually increasing GDP growth.

… but indicators imply that the recovery has begun to weaken

On the whole, economic indicators for the euro area have turned out better than market agents had expected (Chart II-2). They suggest a continued slow recovery resulting partly from measures taken by the European Central Bank (ECB), declining oil prices, the depreciation of the euro, and increased success in battling Greece's debt problems. Domestic demand has rallied somewhat in the euro area, with increased purchasing power and improving financial conditions, but exports have been somewhat weaker than anticipated. Leading indicators imply that GDP growth continues but at a slower pace, in line with the weaker global economic outlook (Chart II-3).

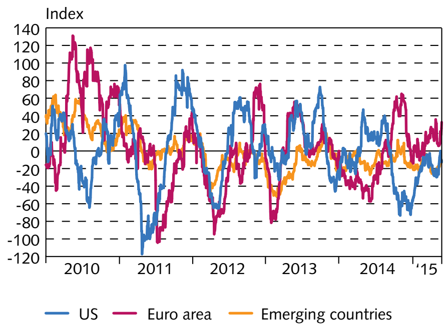
Economic indicators for the US have been weaker than expected since the time of the last *Monetary Bulletin*. After the recovery stalled due to temporary factors in the first quarter, it resumed in Q2, even though the appreciation of the dollar cut into the contribution from net trade. In the recent term, however, job creation and the decline in unemployment have slowed down, and investment in energy-related projects has contracted in the wake of the steep drop in energy prices. Nevertheless, the recovery in the US is projected to outpace that in most other major industrialised countries, and the US Federal Reserve

Chart II-1
Global GDP growth
Q1/2003 - Q3/2015



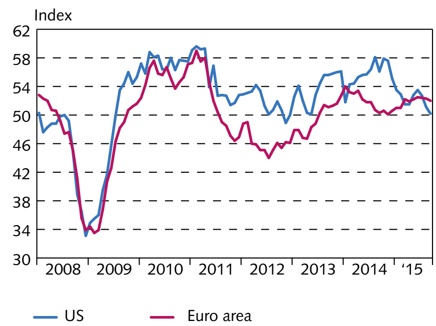
Sources: Macrobond, Central Bank of Iceland.

Chart II-2
Economic surprise index[1]
Daily data 4 January 2010 - 30 October 2015



1. When the index is lower than 0, the indicators are more negative than expected; when the index is higher than 0, the indicators are more positive than expected. The index does not imply that the indicators are positive or negative.
Source: Macrobond.

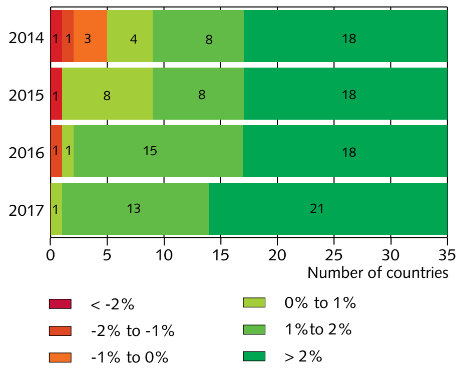
Chart II-3
Leading indicators of GDP growth[1]
January 2008 - September 2015



1. In the US and the euro area, the seasonally adjusted Manufacturing Purchasing Managers' Index (PMI) is published monthly. An index value above 50 indicates month-on-month growth, and a value below 50 indicates a contraction.
Sources: Bloomberg, Macrobond.

Chart II-4

Distribution of GDP growth among 35 industrialised countries

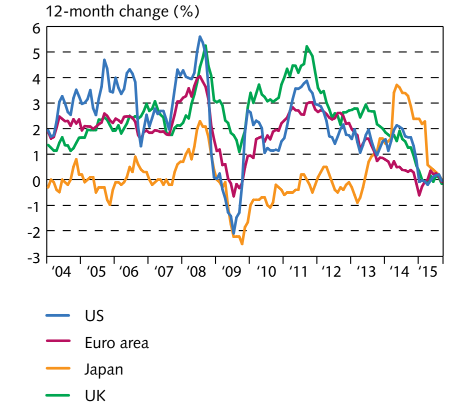


Source: IMF.

Chart II-5

Inflation in selected industrialised countries

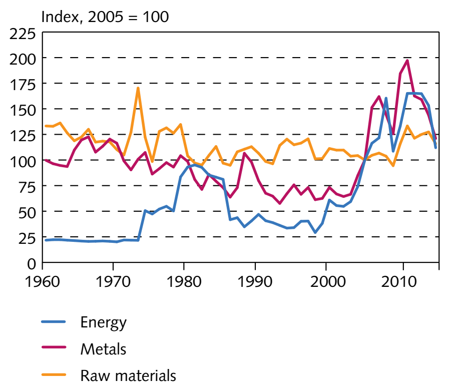
January 2004 - September 2015



Source: Macrobond.

Chart II-6

Real commodity prices 1960-2015[1]



1. The 2015 value is based on first-half figures. The real price index for a commodity group is the trade-weighted average of the global U.S. prices of the commodities in the group deflated by the average economy manufacturing price index.
Source: IMF.

Bank is widely expected to raise interest rates late this year or early in 2016.

Global output growth outlook worsening …

According to the most recent GDP growth forecast from the International Monetary Fund (IMF), growth is expected to contract year-on-year in 2015, falling to only 3.1%, well below the thirty-year average. The IMF forecast is affected by a number of factors: the adjustment to weaker output growth in China and a general realignment of the drivers of growth, the steep decline in oil and commodity prices, volatility of cross-border capital flows, the expected policy rate hike in the US, and tighter financial conditions in emerging markets. The deterioration in the GDP growth forecast is greatest in the near term. The Fund expects global growth to pick up in 2016, measuring 3.6%, which is below its previous forecasts. Compared to the Fund's April forecast, the increase in the number of developed economies with GDP growth exceeding 2% is more moderate (Chart II-4). At the same time, the IMF is of the view that the risks to the baseline forecast are tilted to the downside, particularly among emerging and developing countries.

Although the lion's share of global GDP growth has been borne by emerging countries in recent years, 2015 will be the fifth consecutive year to see a year-on-year decline in GDP growth among emerging economies if the IMF forecast materialises. At the same time, the Fund has reduced its GDP growth forecast for industrialised countries. Prospects have deteriorated in particular for oil and commodity exporters, for instance Australia, Brazil, and Canada.

… as is reflected in poorer prospects for Iceland's trading partners

Year-2015 GDP growth among Iceland's main trading partner countries is projected to remain unchanged year-on-year, at 1.7%. The Bank's forecasts from earlier this year have assumed, however, that the economic recovery would solidify in comparison with 2014. The output growth outlook for the next two years has also deteriorated in comparison with the August forecast, and the downside risks to the baseline forecast have risen.

Growth in world trade and trading partner demand has slipped year-to-date

The outlook for world trade and trading partner demand has also deteriorated from the Bank's August forecast. As is described in the new IMF forecast, it is difficult to assess the extent to which growth in world trade slowed down in the first half because of fluctuations in terms of trade and currency exchange rates. National accounts indicate, for instance, that growth in world trade has slowed somewhat, and various international indicators of trade volumes point unequivocally to a contraction. The IMF's world trade forecast for 2015 has therefore been revised downwards by nearly a percentage point since July – to 3.2% – and the 2016 forecast has been reduced as well. The Fund anticipates somewhat more sluggish import growth in industrialised countries and noticeably weaker growth in emerging and developing countries. As a result, imports among Iceland's main trading partners are projected to be weaker than in the August forecast. They are forecast to grow by 3.3% this year, roughly ½ a percentage point less than in August.

Inflation remains low in developed economies

As before, inflation is low in developed economies, and the main task of most of their central banks is to stimulate inflation so as to avoid deflation and an excessive drop in inflation expectations. Modest deflation was measured in the euro area and the UK in September (Chart II-5). Steep declines in oil and commodity prices (Chart II-6) have pulled in the same direction as the slack in output, reducing inflation once again, whereas inflation has risen in some oil- and commodity-exporting economies, with currency depreciation exacerbating imported inflation. Overall, the inflation outlook among Iceland's trading partners is virtually unchanged since the last forecast, although inflation is expected to be more uneven because of differences in the impact of the drop in oil and commodity prices.

Significant turmoil in global markets

Six years after the deepest financial crisis since the 1930s ended and the global economic recovery began, the recovery remains sluggish and fragile. Economic growth in emerging and developing countries is losing momentum, not least in China, where private consumption and services must increasingly supplant investment and production as the main drivers of output growth. Concerns about a hard landing in China escalated this summer, causing severe turbulence in global markets, with commodity prices plummeting, capital flows to emerging economies tapering off, risk premia rising, and emerging countries' currencies depreciating against the US dollar (Charts II-6 and II-7). This situation differs from that prevailing late in 2014, when a steep drop in oil prices made relatively little impact on global financial markets (Chart II-8) and a number of major industrialised countries' currencies fell against the dollar. This time, however, metals prices, which typically react even more to global activity than oil prices, have also fallen sharply, which they did not do last year. Market agents still anticipate that interest rates will rise earlier in the US and UK than in most other industrialised countries, although the first rate hikes are now expected to take place somewhat later than previously thought. Uncertainty has increased, however, about how well prepared emerging countries are for a rate hike – particularly commodity-exporting countries with significant debt in US dollars (Chart II-9).[1]

Export prices and terms of trade

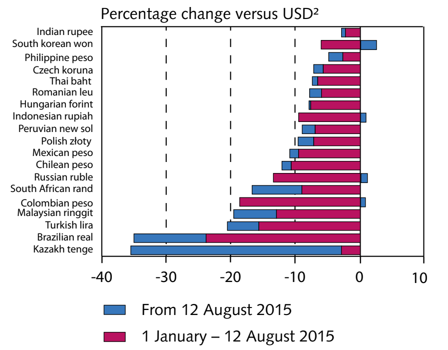
Marine product prices continue to rise, while aluminium prices fall

Foreign currency prices of marine products have risen virtually without interruption since February 2014. They increased by over 17%

1. See, for example, Chapter 3 of International Monetary Fund (2015). *Global Financial Stability Report*, October.

Chart II-7

Developments in emerging countries' currencies before and after the depreciation of the renminbi[1]

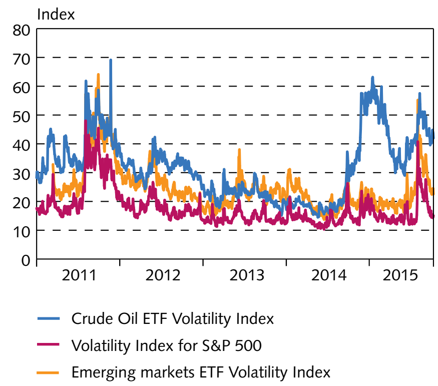


1. On 11 August, the People's Bank of China announced increased flexibility in the listing of the Chinese renminbi. 2. A reduction indicates a depreciation against the US dollar.
Sources: IMF, Macrobond.

Chart II-8

Global market volatility[1]

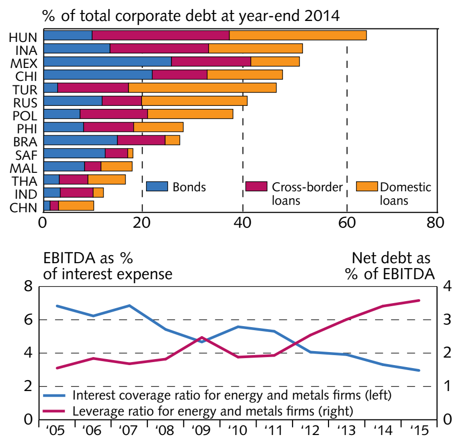
Daily data 3 January 2011 - 30 October 2015



1. The VIX index indicates the implied volatility of financial products.
Source: Federal Reserve Bank of St. Louis, Federal Reserve Economic Data (FRED).

Chart II-9

Foreign-denominated corporate debt in emerging countries[1]

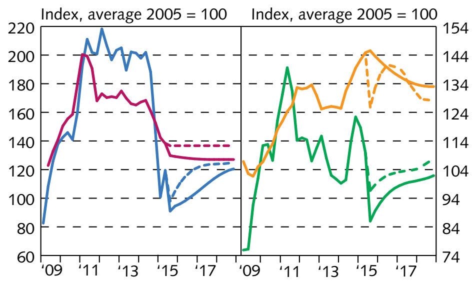


1. HUN: Hungary, INA: Indonesia, MEX: Mexico, CHI: Chile, TUR: Turkey, RUS: Russia, POL: Poland, PHI: Philippines, BRA: Brazil, SAF: South Africa, MAL: Malaysia, THA: Thailand, IND: India, CHN: China.
Source: IMF.

Chart II-10

Prices of marine products, aluminium, oil, and commodities[1]

Q1/2009 - Q4/2018

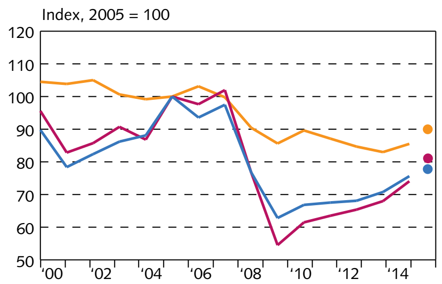


1. Central Bank baseline forecast Q4/2015-Q4/2018. Broken lines show forecast from MB 2015/3. 2. Non-oil commodity prices in USD. 3. Foreign currency prices of marine products are calculated by dividing marine product prices in Icelandic krónur by the export-weighted trade basket. 4. Foreign currency prices of aluminium products are calculated by dividing aluminium prices in Icelandic krónur by the exchange rate of the USD.

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

Chart II-11

Real exchange rate and terms of trade 2000-2015[1]



1. Dots show terms of trade and real exchange rate based on relative prices in 2015 according to Central Bank baseline forecast and real exchange rate based on relative unit labour costs according to the OECD forecast of unit labour cost developments for Iceland's largest trading partners in 2015.

Sources: OECD, Central Bank of Iceland.

year-on-year in Q1/2015 but have risen somewhat more slowly since then. They are expected to rise by about 8½% year-on-year in 2015, as was assumed in the August forecast (Chart II-10). The outlook is more ambiguous than in August, however, owing to the worsening economic outlook, uncertainty about the effects of the Russian import ban and economic difficulties in Nigeria. The price of fishmeal and fish oil is likely to rise in the near future, however, as a result of production cuts in Chile and Peru caused by El Niño.

Aluminium prices fell by 7% year-on-year over the first three quarters of 2015. Global metals prices have tumbled, not least because of reduced economic activity and the changing composition of growth in China, by far the world's largest purchaser of metals. A portion of the decline in prices to domestic aluminium producers is due to a drop in the premium paid to them, which had previously risen significantly, according to figures from Statistics Iceland. Prices are projected to continue falling, and the outlook has deteriorated since August. The price to domestic producers is projected to fall by over 7% this year, some 4½ percentage points more than was forecast in August, followed by a 5½% drop in 2016 (Chart II-10).

Oil prices plunged in late summer and are expected to remain low longer than previously anticipated

Crude oil prices have been falling year-to-date, with a particularly steep drop in Q3, to about half of Q3/2014 prices. It appears that the oil markets will take longer than previously thought to adjust to the glut of supply. Major forecasters' price projections and futures prices both indicate that crude oil prices will remain low for longer than was anticipated in August (Chart II-10).

Non-oil commodity prices fall more than previously assumed

US dollar prices of non-oil commodities have fallen continuously since Q2/2013. Increased supplies and reduced demand have caused food prices to fall 12% year-on-year, and metals prices are at their lowest since 2010. Non-oil commodities are now projected to fall in price by 17% year-on-year in 2015 and another 5% in 2016 – much more than was assumed in August.

Outlook for terms of trade somewhat weaker

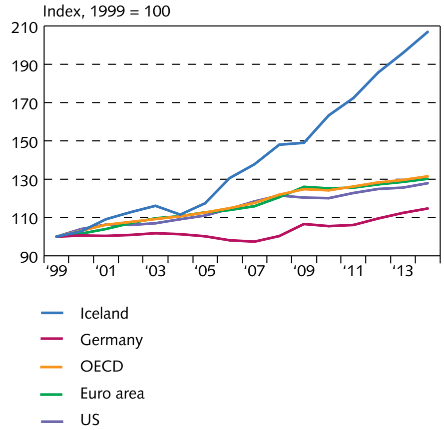
The improvement in terms of trade began in Q2/2014 and accelerated until the first quarter of 2015. Statistics Iceland's preliminary figures now indicate that terms of trade improved by 7.7% year-on-year in Q2, which is broadly in line with the forecast in the August *Monetary Bulletin*. The recovery is expected to lose pace in the latter half of the year, measuring just over 5% for 2015 as a whole, some ½ a percentage point less than in the August forecast (Chart II-11). The difference is due almost entirely to a smaller rise in export prices, which in turn is due to a larger decline in aluminium prices than was forecast in August. The outlook for terms of trade in 2016 is broadly unchanged since August, although uncertainty has grown.

Large pay rises lead to a sharp erosion in competitiveness

In Q3/2015, the real exchange rate of the króna rose to its highest value since mid-2008. It rose by 5.5% year-on-year due to an increase of 4% in the nominal exchange rate and because inflation in Iceland was 1.4 percentage points above the trading partner average. In spite of this increase, the real exchange rate in terms of relative consumer prices is still about 5.6% below its thirty-year average.

If the Bank's forecast materialises, the outlook is for the real exchange rate in terms of relative consumer prices to be, on average, more than 4% higher in 2015 than in 2014 (Chart II-11). Furthermore, given the substantial pay increases provided for in recent wage settlements, the real exchange rate in terms of relative unit labour costs will rise this year by even more – over 10%, if the forecast materialises. This increase comes on the heels of a protracted period of much larger rises in wage costs in Iceland than in competitor countries (Chart II-12). Given the prospects for wage developments in coming years, it is highly likely that Iceland's competitive position will continue to deteriorate. As is discussed in Box 2, this will have an appreciable effect on Iceland's external trade, other things being equal.

Chart II-12
Unit labour costs in developed countries



Sources: Macrobond, Central Bank of Iceland.