II The global economy and terms of trade

The economic recovery in Iceland's trading partners has faltered since mid-2015, and it appears that the episode of weak GDP growth and low inflation will prove somewhat more persistent than was assumed in the Bank's August forecast. The outlook is for global GDP growth in 2016 to be the weakest since the 2009 recession and for the historical weakness in world trade to continue. The unrest in global financial markets has been less than in the beginning of the year despite some volatility in relation to unexpected election results on both sides of the Atlantic, commodity prices have continued to firm up this year, and the economic outlook in emerging countries has improved somewhat. The prospects for Iceland's terms of trade are better than in the August forecast, although the steep rise in the real exchange rate has weakened Iceland's competitive position.

Global economy

Trading partners' economic recovery has stalled …

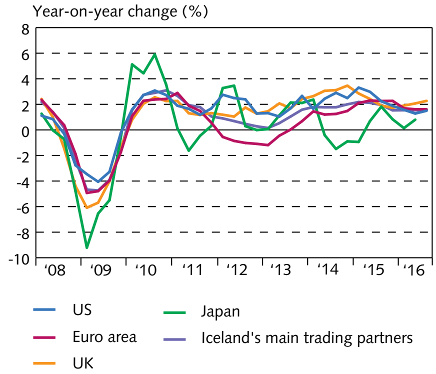
GDP growth among Iceland's trading partners was in line with the Bank's August forecast in H1/2016, measuring 1.6%. This is ½ a percentage point less than over the same period in 2015, when growth had been gaining momentum over a two-year period after the end of the recession in the euro area. Trading partners' economic recovery has stalled since mid-2015; for example, GDP growth has weakened somewhat in both the euro area and the UK, and particularly in the US (Chart II-1). In the US, growth fell by about half year-on-year in the first three quarters, mainly because of weak investment, whereas private consumption growth has been acceptable, spurred on by a robust recovery in the labour market.

… but economic indicators have somewhat improved in the US

Since the publication of the August *Monetary Bulletin*, economic indicators for the US have turned out a bit poorer overall than market agents had expected (Chart II-2), but leading indicators for GDP growth have improved somewhat recently (Chart II-3). The effects of the unexpected result in the US presidential election have not materialised yet, and there is also uncertainty about interest rate hikes by the US Federal Reserve in the coming term. Nevertheless, the foundations for GDP growth are stronger there than in the eurozone and Japan, where legacy issues from financial crises and the lack of confidence in the authorities' ability to support economic recovery persist.

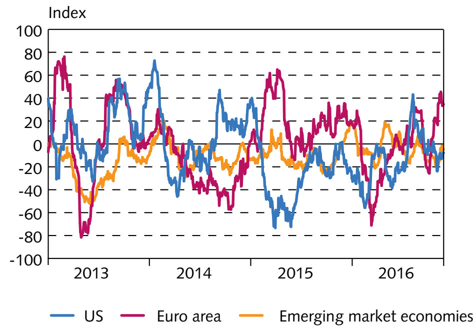
In the UK, economic indicators have improved following a dramatic early response to Brexit. It appears that the depreciation of the pound sterling and accommodative measures by the Bank of England have enhanced confidence and supported demand. On the other hand, indications of a "hard Brexit" are accumulating, even though formal discussions concerning post-Brexit trade and financial frameworks have not yet begun.

Chart II-1
Global GDP growth
Q1/2008 - Q3/2016



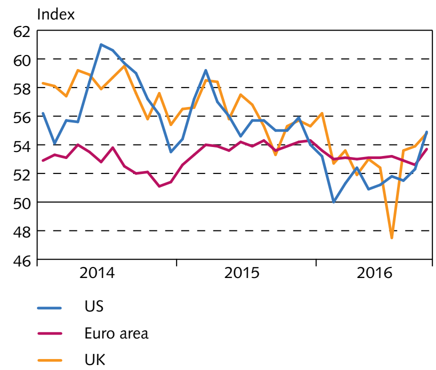
Sources: Macrobond, Central Bank of Iceland.

Chart II-2
Economic surprise index[1]
Daily data 1 January 2013 - 11 November 2016



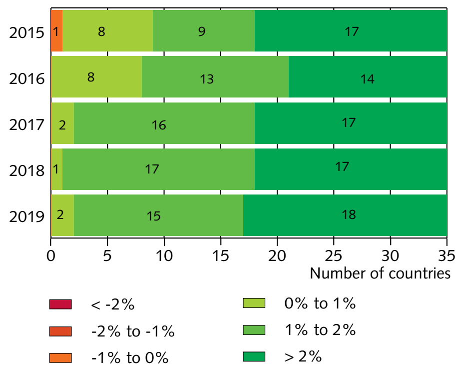
1. When the index is below 0, the indicators are worse than expected; when the index is above 0, the indicators are better than expected. The index does not imply that the indicators are positive or negative.
Source: Macrobond.

Chart II-3
Leading indicators of GDP growth[1]
January 2014 - October 2016



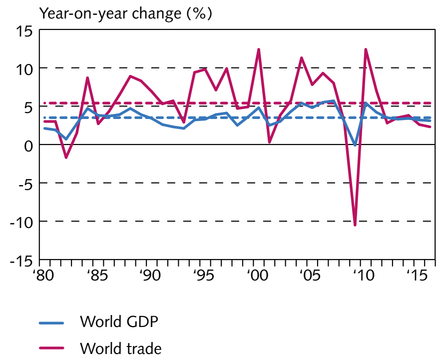
1. Markit composite purchasing managers' index (PMI). The index is published monthly and is seasonally adjusted. An index value above 50 indicates month-on-month growth, and a value below 50 indicates a contraction.
Source: Bloomberg.

Chart II-4
Distribution of GDP growth among
35 industrialised countries



Source: International Monetary Fund.

Chart II-5
World GDP and trade 1980-2016[1]



1. Broken lines show average of 1980-2015. The values for 2016 are based on the IMF's forecast (*World Economic Outlook*, October 2016).
Sources: International Monetary Fund, Central Bank of Iceland.

Global GDP growth at a low ebb in 2016 …

In its new GDP growth forecast for 2016, published in October, the International Monetary Fund (IMF) assumes that global growth will taper off year-on-year, to 3.1%. If the forecast materialises, this year's growth rate will be the weakest since the 2009 recession. The IMF considers the outlook for developed countries to have deteriorated. It projects average year-2016 GDP growth at only 1.6% and expects the number of countries with a growth rate of over 1% to decline in comparison with its spring forecast (Chart II-4). On the other hand, the Fund is of the view that the episode of declining GDP growth among emerging countries has run its course. A key factor is the IMF's increased optimism about the short-term outlook for China and the expectation that China and other Asian countries will remain the main drivers of global GDP growth in coming years. The improved outlook for large commodity exporters that have experienced a contraction in the recent past – Brazil and Russia in particular – is also a factor, as the recovery of global commodity prices and capital flows year-to-date has boosted the economy in these countries. The IMF expects this trend to continue and projects global output growth at 3.4% in 2017, even if growth is tepid in developed countries.

… and the outlook for trading partners' GDP growth during the forecast horizon has deteriorated

Among Iceland's main trading partners, year-2016 GDP growth is expected to be broadly unchanged from the August forecast, at 1.6%, reflecting the offsetting effects of a weaker growth outlook in the US and improved prospects for the euro area and the UK. The outlook for the next two years has deteriorated in comparison with the August forecast, however, not least due to expectations of a harder Brexit than previously anticipated and the associated implications for economic activity in the UK and mainland Europe.

Poorer outlook for world trade and trading partner demand

Growth in world trade has been sluggish in recent years, averaging 3.2% in 2012-2015, which is below average global GDP growth over the same period and less than half of long-term trend growth (Chart II-5). The IMF has lowered its forecast for year-2016 world trade growth by nearly ½ a percentage point since July, to 2.3%. Historically, trade growth rates this low have been seen almost exclusively during global recessions. The IMF attributes the recent weakness of trade to tepid growth in economic activity, investment in particular (see IMF, *World Economic Outlook*, Chapter 2, October 2016). The outlook for trading partner demand has deteriorated as well. This year, import growth among Iceland's trading partners is projected at 2.5%, about a percentage point less than in 2015.

Inflation remains low

Twelve-month inflation measured only 0.6% among Iceland's main trading partners last year, as oil prices fell by nearly half and other commodity prices by almost a fifth, and there was still an output slack in most of the countries concerned. According to the IMF, year-2015 inflation was below long-term expectations in 85 of 120 countries, with deflation in a fifth of them (see IMF, *World Economic Outlook*, Chapter 3, October 2016). In most economies, inflation has picked up slowly as commodity prices have risen and base effects have dropped out of twelve-month measurements (Chart II-6). In September 2016 it measured 1.5% in the US, 0.4% in the euro area, and 0.9% in the UK, whereas there was small deflation in all three economies a year earlier. On the whole, the outlook for trading partner countries during the current forecast horizon is for slightly lower inflation than was projected in August.

Fluctuations in global financial markets

The global financial markets have seen frequent unrest in the recent past, particularly in 2015 and early 2016. Much of it is due to concerns about the Chinese economy, the weak economic recovery in advanced economies, and protracted strain on monetary policy, which has received little support from other policy spheres. Things have stabilised somewhat as 2016 has progressed, however, apart from a flurry of unrest following the Brexit referendum in the UK and again following the US presidential election. In general, concerns about the near-term outlook for the Chinese economy appear to have eased, and market agents expect major central banks to pursue accommodative monetary policy for longer than previously thought (Chart II-7). Risk premia and interest rate spreads have generally been falling (Charts II-8 and II-9), commodity prices have risen slightly in the wake of steep declines (Chart II-10), and capital inflows to emerging countries have picked up again. Financial uncertainty has therefore eased since August, although the situation in the global markets is still unusual, as can be seen in the large outstanding stock of government bonds, from a number of countries, with negative yields. In addition, there is uncertainty with regard to the incoming US president's economic policy actions.

Export prices and terms of trade

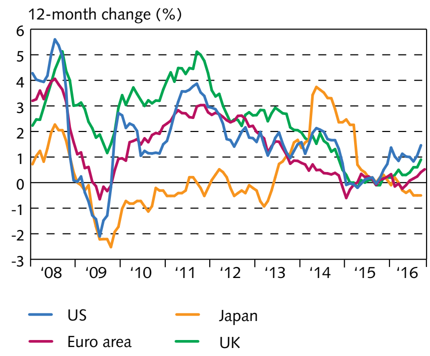
Marine product prices have risen sharply in recent years, and modest increases are expected further ahead …

Marine product prices rose by just under a fifth in foreign currency in 2014-2015. So far in 2016, the pace of the increase has eased, although demersal prices, particularly for fresh and land-frozen products, have continued to climb noticeably. Foreign currency prices of marine products are expected to rise this year by 1%, somewhat less than was assumed in the previous forecast. The outlook is slightly better further ahead, however, as prices are expected to rise overall by about 2% through the end of the forecast horizon (Chart II-10).

… while aluminium prices have suffered year-to-date

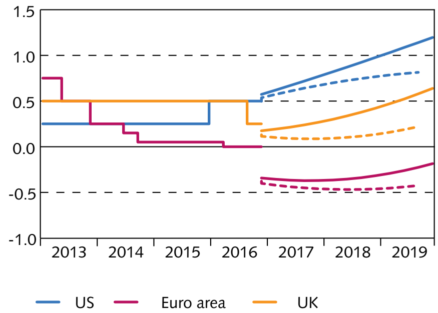
Aluminium prices have plummeted so far this year, both in global markets and in terms of the premium received by companies in Iceland for the production of more valuable aluminium. After adjusting for this premium, 2016 prices in US dollars are projected to fall 14% year-on-year, nearly 2 percentage points more than was assumed in the August

Chart II-6
Inflation in selected industrialised countries
January 2008 - October 2016



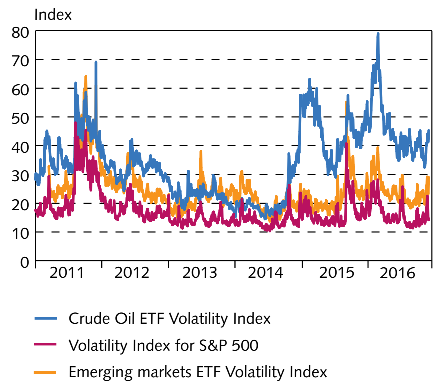
Source: Macrobond.

Chart II-7
Policy rates in selected industrialised economies[1]
January 2013 - November 2019



1. Daily data 1 January 2013 through 11 November 2016, and quarterly data Q4/2016 through Q4/2019. 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 key rate. Forward rates are based on six-month overnight index swaps (OIS) and the Euro Overnight Index Average (EONIA) for the euro area. Solid lines show forward curves from 11 November 2016 onwards and the broken lines from 19 August 2016 onwards.
Sources: Bloomberg, Macrobond.

Chart II-8
Global market volatility[1]
Daily data 3 January 2011 - 11 November 2016

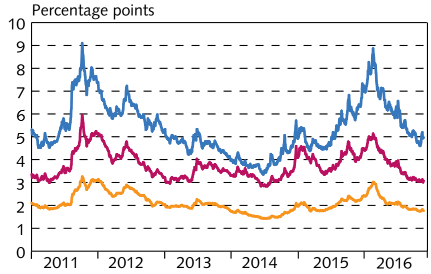


1. The VIX volatility indices indicate the implied volatility of financial products.
Source: Federal Reserve Bank of St. Louis Federal Reserve Economic Data (FRED) database.

Chart II-9

Interest premia on corporate bonds[1]

Daily data 3 January 2011 - 11 November 2016



US firms with speculative-grade credit ratings

Firms in emerging market economies with investment-grade credit ratings

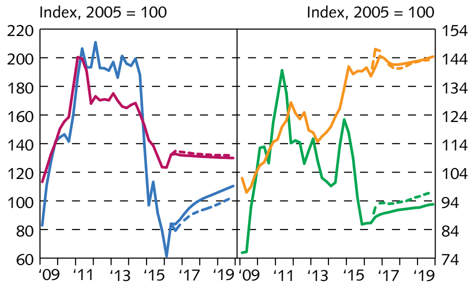
US firms with BBB credit ratings

1. Bank of America Merrill Lynch bond indices.
Source: Federal Reserve Bank of St. Louis Federal Reserve Economic Data (FRED) database.

Chart II-10

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

Q1/2009 - Q4/2019



Crude oil prices (left)

Commodity prices (left)[2]

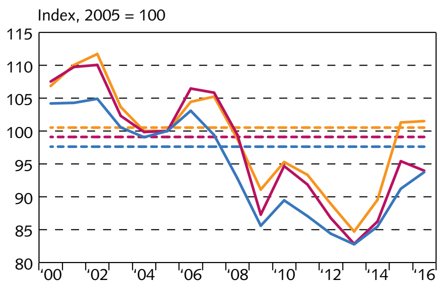
Marine product prices (right)[3]

Aluminium prices (right)[4]

1. Central Bank baseline forecast Q4/2016-Q4/2019. Broken lines show forecast from MB 2016/3. 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 trade-weighted exchange rate index. 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

Terms of trade of goods and services 2000-2016[1]



Terms of trade for goods and services

Terms of trade for goods

Terms of trade for goods (excluding aluminium)

1. Central Bank baseline forecast 2016. Broken lines show 25-year average (1992-2016).
Sources: Statistics Iceland, Central Bank of Iceland.

forecast. Prices are expected to rise by a total of 5% over the next three years (Chart II-10).

Oil prices are expected to be higher than was forecast in August …

Global oil prices have hovered in the range of 47-50 US dollars per barrel in the past six months, after rising by nearly 50% from the January 2016 trough. They spiked in September, after the OPEC countries decided to impose production limits to offset the supply glut in the market, but have eased again in the past few weeks. The OPEC countries will meet again this month, but the outcome of the meeting and its impact on global oil prices are highly uncertain. The outlook is for higher prices than was assumed in the August forecast – and therefore a smaller decline in 2016 than was projected at the time – and for further price hikes in coming years (Chart II-10).

… but non-oil commodity prices to be lower

Global non-oil commodity prices rose marginally year-on-year in Q3, after a continuous slide lasting over three years. Food prices have risen somewhat year-to-date, owing to El Niño, but the increase turned out smaller than previously expected. On the other hand, declines in the price of metals and miscellaneous agricultural products have eased slightly. Non-oil commodity prices are expected to fall by nearly 3% this year instead of the 2% assumed in *Monetary Bulletin* 2016/3 (Chart II-10).

Terms of trade to improve more in H2 than was forecast in August

Terms of trade for goods and services improved by a combined 10% in 2014 and 2015. According to preliminary figures from Statistics Iceland, they improved in Q2/2016 by 2.3% year-on-year, somewhat less than was forecast in August. They are expected to improve more strongly in H2 than was forecast in August and by nearly 3% in 2016 as a whole (Chart II-11), slightly more than was projected in August, despite higher oil prices and weaker aluminium and marine product prices, reflecting more favourable developments in other import and export prices. As Chart II-11 shows, the improvement in terms of trade for goods excluding aluminium is even stronger, or 20% during the period 2014-2016. As is the case for 2016, the outlook for 2017 is for a more pronounced improvement than was forecast in August. Uncertainty has increased, however, due to the weak global economic recovery (see also Chapter I).

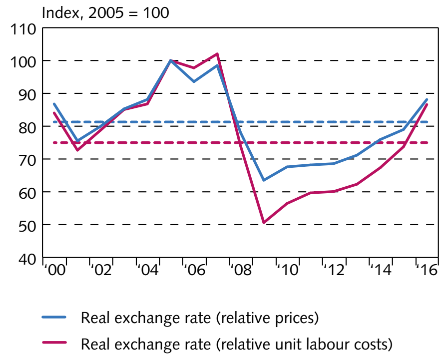
Real exchange rate has risen steeply in the recent term …

In terms of relative consumer prices, the real exchange rate has soared in the recent past, rising in Q3 to its highest value since year-end 2007. It rose 13.3% year-on-year, as the nominal exchange rate rose 12.9% and domestic inflation was 0.3 percentage points above the trading partner average. The real exchange rate is now about 11% above its twenty-five year average.

… eroding Iceland's competitive position

If the Bank's forecast materialises, the real exchange rate in terms of relative consumer prices will rise by 11½% this year (Chart II-12). In terms of relative unit labour costs, the increase is even greater, at 17½%, owing to large wage hikes. In recent years, the rise in firms' wage costs has been much larger in Iceland than in its main competitor countries, which undermines Iceland's competitive position. As is discussed in Chapter I, the Bank's forecast no longer assumes an unchanged nominal exchange rate throughout the forecast horizon; therefore, the outlook is now for a larger rise in the real exchange rate than was projected in the last *Monetary Bulletin*.

Chart II-12
Real exchange rate 2000-2016[1]



1. Central Bank of Iceland baseline forecast 2016. Broken lines show 25-year average (1992-2016).
Source: Central Bank of Iceland.