II The global economy and terms of trade

Global output growth continued to slow in H1/2019, and the overall outlook has deteriorated. Weaker growth is attributable in large part to reduced activity in the manufacturing sector, which has been hit heavily by rising tariffs and the US-China trade dispute. This is reflected in growing corporate pessimism, weaker investment growth, and more sluggish growth in world trade. In addition, inflation has fallen again in many economies. Although China and the US have recently negotiated a temporary halt to planned tariff hikes, the most important issues between them remain unresolved, and the global economic situation is highly uncertain. Iceland's terms of trade deteriorated more than previously expected in H1/2019 and are now projected to worsen slightly for the year as a whole. The real exchange rate has held relatively stable year-to-date but is lower than in 2018, reflecting in part the economy's adjustment to a lower equilibrium real exchange rate.

Global economy

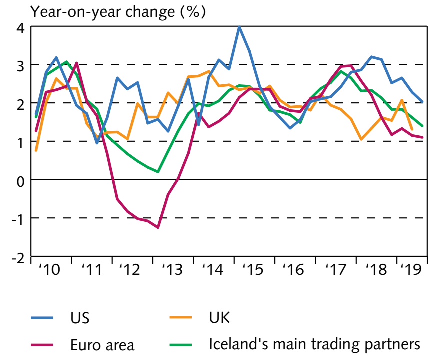
Trading partners' GDP growth slides still further …

GDP growth among Iceland's main trading partners has softened significantly in the recent term (Chart II-1). It measured 1.7% in H1, down by 1 percentage point from its H2/2017 peak. Growth has eased in virtually all trading partner economies, but particularly in the eurozone, where exports have softened in tandem with declining global demand. This is especially the case for Germany, where industrial production has contracted since Q4/2018 and corporate executives report increased pessimism (Chart II-2). The situation is affected to a degree by temporary production problems in the automobile industry and weaker sales worldwide, although the US-China trade dispute also has an impact. Output growth has suffered in France as well, and in Italy, where it has been negligible in recent quarters.

The protracted uncertainty about Britain's exit from the European Union (EU) and its impact has also adversely affected activity in the euro area, and no less in the UK, where GDP contracted between quarters in Q2, for the first time in over six years. This is due in part to a negative contribution from inventory changes, as inventories had increased temporarily in Q1, in preparation for the original Brexit date at the end of March. Furthermore, business investment continues to contract alongside growing pessimism among corporate executives. Although the EU and the UK reached an exit agreement in mid-October, the deal was not approved by the British Parliament, and Britain's departure from the EU has been postponed once again, this time until end-January. In view of this, together with the fact that the new exit agreement gives the UK and EU only until end-2020 to negotiate a permanent trade agreement, the cloud of uncertainty hanging over Brexit is likely to impede firms' decisions on new investment.

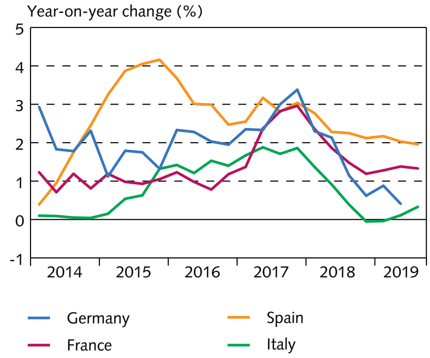
GDP growth has also eased in the US as the effects of last year's tax cuts have tapered off. Investment and exports have lost momentum, but as in the UK and the eurozone, continued growth in private

Chart II-1
Global GDP growth[1]
Q1/2010 - Q3/2019



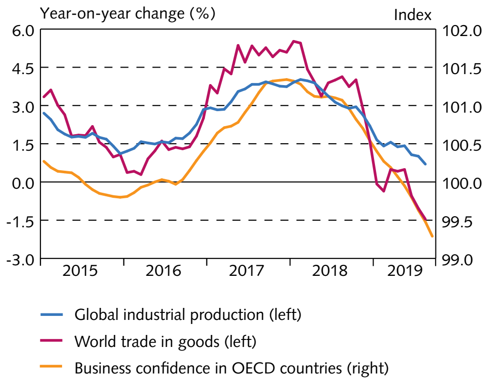
1. Central Bank baseline forecast Q3/2019 for main trading partners.
Sources: Thomson Reuters, Central Bank of Iceland.

Chart II-2
GDP growth in the eurozone
Q1/2014 - Q3/2019



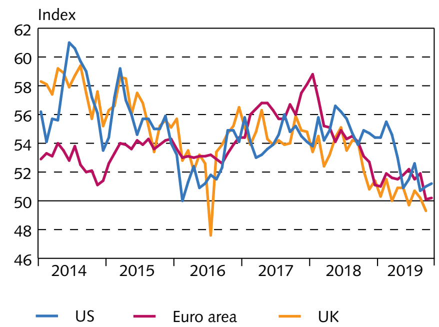
Source: Thomson Reuters.

Chart II-3
Industrial production, trade and business confidence[1]
January 2015 - September 2019



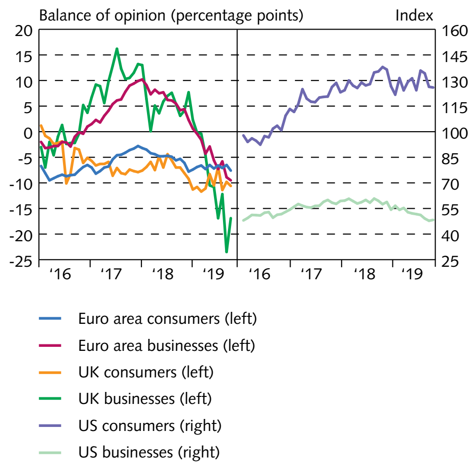
1. OECD business confidence index (BCI). Volume of world trade. Three-month moving average of industrial production and world trade.
Sources: CPB, OECD.

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



1. 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, and a value below 50 indicates a contraction.
Source: Thomson Reuters.

Chart II-5
Private sector expectations[1]
January 2016 - October 2019



1. European Commission expectations index for the eurozone and the UK; ISM Report on Business for the US.
Sources: European Commission, Thomson Reuters.

consumption has mitigated the situation. Despite signs that hiring has slowed, the labour market has been robust on both sides of the Atlantic. Unemployment has either stood still or declined, and wages have risen. This is due mainly to increased activity in the services sector, which has supported domestic demand and consumer sentiment.

… as has global output growth

Global output growth has softened since 2018, driven largely by slowing growth in advanced economies, particularly in the euro area, but also in the US and in developed Asian countries. GDP growth has slowed markedly in emerging and developing economies as well, especially in China, where growth is at its weakest in almost three decades. Reduced global output growth is due in large part to weaker activity in the manufacturing sector, particularly in Germany and Japan. This stems partly from a contraction in the auto industry, but also from reduced economic activity in China. However, declining manufacturing worldwide is probably due in large part to the highly detrimental impact of widely imposed tariff hikes and the US-China trade dispute, which has escalated in the past year (see Chapter I). Trade disputes and ever-increasing uncertainty about the future of world trade have exacerbated pessimism among corporate executives, especially in the manufacturing sector, and had a negative impact on value chains and investment spending, as can be seen in weakened growth in world trade (Chart II-3).

The 2019 GDP growth outlook for major advanced economies has worsened …

Leading indicators and international forecasts suggest that the GDP growth outlook for advanced economies in 2019 has deteriorated. Preliminary figures show that output growth in the eurozone lost momentum in Q3, as could have been expected in view of declining purchasing managers' indices (PMI) and mounting corporate pessimism (Charts II-4 and II-5). This is probably due mainly to continued sluggishness in the manufacturing sector, particularly in Germany, which is likely to see its second consecutive quarter-on-quarter contraction in GDP. In the main, the services sector in the eurozone has held its ground, although there are signs of a slowdown in growth.

Output growth in the eurozone is estimated at only 1.1% for 2019, the weakest since 2013. The GDP growth outlook has also deteriorated for the UK, where PMIs have tumbled and the economy appears to have contracted still further between Q2 and Q3. For the US, however, the outlook is for GDP growth to be broadly in line with the Bank's August forecast, reflecting the offsetting effects of increased corporate pessimism and weaker investment growth, on the one hand, and continued growth in private consumption, on the other. The US administration's recent announcement of a partial accord with China could also have a positive impact on the GDP growth outlook. Among other things, the agreement involves a postponement of tariffs that were to be imposed in mid-October. Uncertainty is still significant, however, and a final resolution of the dispute is far off. For instance, the interim agreement does not extend to tariff hikes already in place, nor does it cover the tariff increases planned for December, which primarily affect consumer goods imported from China. The trade dispute between the US and the EU has also intensified once more with the US administration's plans to impose tariffs on imports from Europe, including on aircraft and agricultural products, and the EU's announcement of corresponding tariff increases on goods imported from the US.

… and global output growth is expected to lose momentum

According to the International Monetary Fund's (IMF) most recent forecast, global output growth will measure 3% this year. This is 0.2 percentage points below the Fund's July forecast and 0.3 points below its April forecast. The downward revision is due primarily to a poorer output growth outlook for some emerging market economies, as well as among advanced economies, as can be seen in leading indicators such as the PMI for the global economy, which has fallen virtually unimpeded since the beginning of 2018. If this forecast materialises, global GDP growth will be the weakest since the financial crisis.

Growth in world trade has slowed markedly in 2019

Growth in world trade has slowed considerably in the recent past (Charts II-6 and II-3 above). Trade increased by only 1% year-on-year in H1, its slowest in seven years. This is due in fair measure to declining imports to China and elsewhere in East Asia, although growth in imports to the US has lost pace as well (Chart II-7). It goes hand-in-hand with the slowdown in investment growth, as investment goods and intermediate goods generally constitute a large share of cross-border trade. The impact of the trade war between the US and China is a major factor in this trend, although the effects of the contraction in the auto industry and weaker growth in spending on consumer durables can be felt as well. The IMF's October forecast assumes that world trade will grow by only 1.1% in 2019, more than 2 percentage points below its spring forecast.

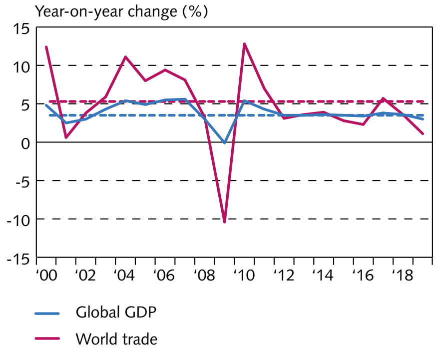
The outlook for trading partner demand and GDP growth has deteriorated …

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 August forecast. Trading partners' GDP growth is projected to average 1.5%, which is 0.1 percentage points below the August forecast. The main reason for the downward revision is the weaker outlook for the euro-zone, the UK, and Sweden. Forecasts for trading partner imports have also been lowered significantly in accordance with weaker growth in world trade. Imports are now projected to increase by 1.9% this year, as compared with 3% in the August forecast.

… and trading partner inflation is set to ease as well

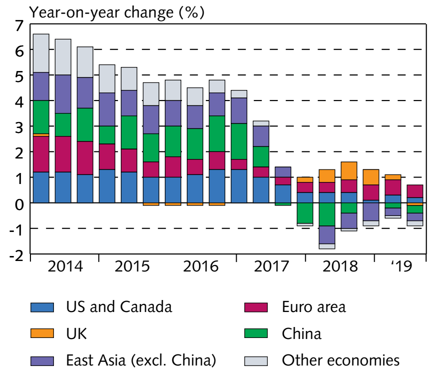
Among Iceland's main trading partners, inflation has subsided again, and inflation expectations have fallen in the wake of the drop in oil prices and weaker growth in overall economic activity (Chart II-8). Inflation measured only 1.3% in Q3, somewhat below the forecast

Chart II-6
Global GDP and trade 2000-2019[1]



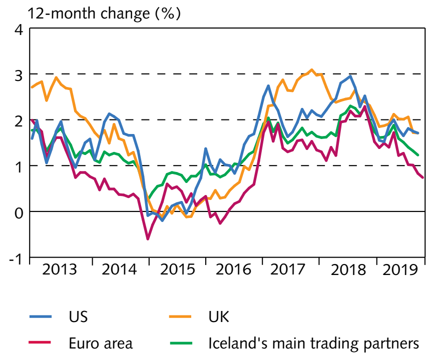
1. Broken lines show average of 1980-2018. The values for 2019 are based on the IMF forecast (*World Economic Outlook*, October 2019).
Sources: International Monetary Fund, Central Bank of Iceland.

Chart II-7
Contribution to global imports[1]
January 2018 - June 2019



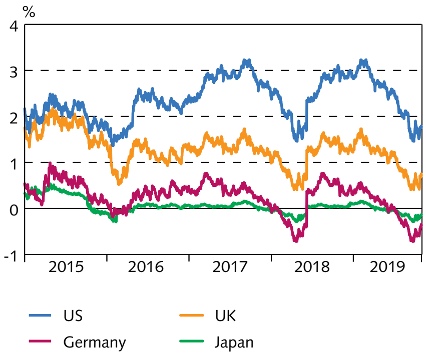
1. Three-month moving average.
Source: International Monetary Fund.

Chart II-8
Global inflation
January 2013 - October 2019



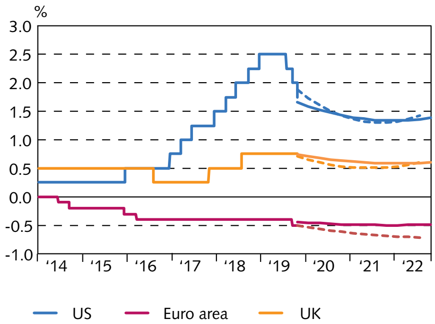
Sources: Thomson Reuters, Central Bank of Iceland.

Chart II-9
10-year government bond yields in selected industrialised countries
1 January 2013 - 1 November 2019



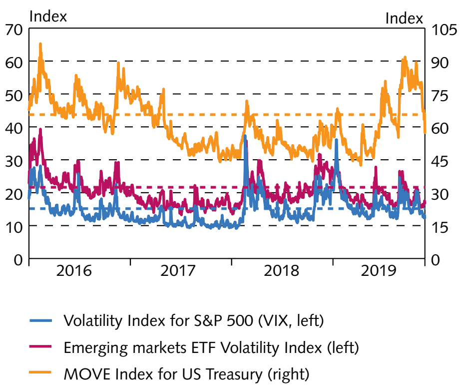
Source: Thomson Reuters.

Chart II-10
Policy interest rates in selected industrialised economies[1]
January 2014 - December 2022



1. Daily data 1 January 2014 through 1 November 2019, and quarterly data Q4/2019 through Q4/2022. 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 28 October - 1 November 2019 and the broken lines during the period 19-23 August 2019.
Source: Thomson Reuters.

Chart II-11
Global market volatility[1]
1 January 2016 - 1 November 2019



1. The volatility indices indicate the implied volatility of financial products. Broken lines show average volatility from 2013.
Source: Thomson Reuters.

in the August *Monetary Bulletin*. It has fallen in nearly all advanced economies and is below target in most of them. Underlying inflation has fallen similarly, in spite of wage increases in some economies and rising import duties. Headline inflation among Iceland's trading partners is projected to average 1.5% in 2019, 0.1 percentage points below the August forecast, and is expected to be slightly lower in 2020 as well.

The monetary stance has eased once again …

The US Federal Reserve lowered its interest rates by 0.25 percentage points in October, to the current 1.5-1.75%, the third rate cut in a short period. Before then, however, the Fed had not lowered rates in a decade. In September, the European Central Bank (ECB) also lowered its key rate by 0.1 percentage points, to -0.5%, after having held it unchanged for more than three years. The ECB also announced that it will either keep interest rates unchanged or lower them further until clear signs emerge to show that inflation has moved closer to the target. The bank also announced plans to reinstate its bond purchase programme after suspending it late last year. The Fed, too, has resumed Treasury securities purchases, but for the purpose of maintaining financial institutions' ample reserve balances and mitigating fluctuations in interbank rates, which have been unusually volatile in the recent term. Central banks in most other advanced economies have kept rates unchanged but signalled that it may take longer before they raise them again, citing the poorer global output growth outlook and increased uncertainty. Unlike the central banks in other advanced economies, Norges Bank has continued to raise interest rates, to the current 1.5%. However, the bank signalled in September, and again in October, that it would probably raise interest rates more slowly than previously planned.

… and long-term interest rates are widely at or near historical lows

Stimulative measures undertaken by leading central banks, falling inflation expectations, and market agents' concerns about weak global output growth are reflected in the bond market (Chart II-9). Bond interest rates have fallen since the spring, and long-term rates are widely at or near historical lows (see Box 1). Furthermore, the stock of negative-yielding bonds has grown rapidly, and by now a significant share of outstanding government bonds bear negative yields, particularly bonds issued by Japan and Germany. Rates on long-term government bonds have also been equal to or below short-term rates in some advanced economies, in a trend not seen for more than a decade, and forward interest rates suggest that market agents expect further central bank rate cuts (Chart II-10). This is also a sign that the market is pessimistic about the economic outlook.

Financial conditions have improved but have been volatile

Global financial markets have been jumpy in the recent term (Chart II-11), owing largely to uncertainty about the global economy, although stimulative measures by leading central banks have acted as a counterweight and have supported asset prices. The postponement of further tariff hikes in the US-China trade dispute will tend to support asset prices and mitigate uncertainty, but it is uncertain how long the economic ceasefire will hold, and the risk is that global output growth will lose further ground.

Export prices and terms of trade

Marine product prices set to rise more in 2019 than was forecast in August …

Marine product prices have been highly favourable in the recent past. They have risen virtually uninterrupted since the beginning of 2018 and were up more than 9% year-on-year in Q3/2019 (Chart II-12). Nearly all species have risen in price, buttressed by strong demand in foreign markets. Prices have risen most for demersal frozen-at-sea products and fresh fish products. The current forecast assumes that foreign currency prices of marine products will rise by 7% this year, as opposed to 6% in the August forecast. The main reason for the upward revision is an even better outlook for H2/2019. For 2020, however, the outlook is unchanged.

… but a larger decline in aluminium prices is expected

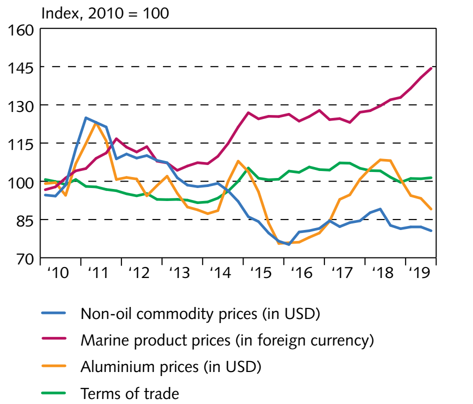
Aluminium prices have fallen virtually without interruption in global markets since this spring, after having held relatively stable in the first four months of the year (Chart II-12). The decline is due largely to excess production in China and reduced demand from the Chinese auto industry. Weaker global output growth and the worldwide contraction in the auto industry have also pushed prices lower. In October, the global market price of aluminium was approximately 1,700 US dollars per tonne, its lowest in three years. According to the Bank's baseline forecast, the average price of aluminium will fall by 13% this year, more than was projected in August. The outlook for 2020 has deteriorated as well.

Oil prices have fallen again but have been volatile

Oil prices have been quite volatile in the past year (Chart II-13). They rose early in 2019, owing mainly to reduced production by OPEC countries, but also to the US embargo on Venezuela and Iran. However, prices reversed early this summer and fell again in August, as international trade disputes escalated. Demand is expected to ease as a result of weaker global GDP growth, and the International Energy Agency (IEA) forecasts a contraction in overall demand in both 2019 and 2020. Moreover, price pressures have eased as a result of unusually large inventories in oil-producing countries. Because of this strong inventory position, the drone strike on oil production facilities in Saudi Arabia in mid-September had only a short-lived impact on oil prices, even though the attack resulted in a temporary 5% contraction in global production.

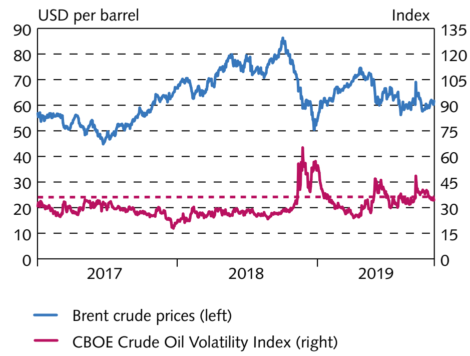
The price of oil is currently just under 62 US dollars per barrel, broadly similar to what it was just before the August *Monetary Bulletin*. Oil futures indicate that prices will remain virtually unchanged through the end of this year, at an average about 11% below the 2018 price (Chart II-14). This is a slightly larger decline than was forecast in

Chart II-12
Commodity prices and terms of trade[1]
Q1/2010 - Q3/2019



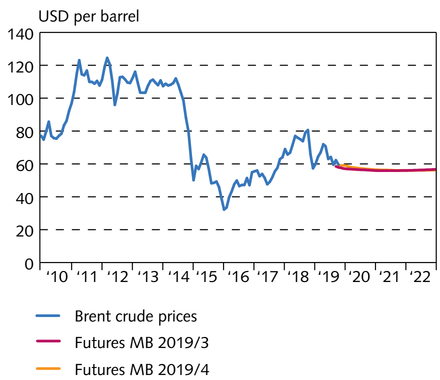
1. Foreign currency prices of marine products are calculated by dividing marine product prices in Icelandic krónur by the trade-weighted exchange rate index. USD prices of aluminium products are calculated by dividing aluminium prices in Icelandic krónur by the exchange rate of the US dollar. Central Bank baseline forecast Q3/2019 for terms of trade.
Sources: Statistics Iceland, World Bank, Central Bank of Iceland.

Chart II-13
Global oil prices[1]
1 January 2017 - 1 November 2019



1. Underlying volatility in crude oil option prices from the Chicago Board Options Exchange (CBOE). The broken line shows the CBOE volatility index average for 2007-2019.
Source: Thomson Reuters.

Chart II-14
Global oil prices[1]
January 2010 - December 2022



1. Brent crude prices based on data through October 2019.
Sources: Thomson Reuters, Central Bank of Iceland.

August. As in August, futures prices suggest that oil prices will be virtually flat for the remainder of the forecast horizon. This is highly uncertain, however, in part because of increased tension between Iran, on the one hand, and the US and Saudi Arabia, on the other. The impact of weaker global GDP growth on demand for oil is a factor as well.

Non-oil commodity prices fall again

After a slight rise early in the year, non-oil commodities have fallen in price once again (Chart II-12). Prices of nearly all types of commodities fell between quarters in Q3, in response to mounting concerns about weaker global GDP growth and reduced demand for commodities, particularly from China. Prices are forecast to rise marginally in Q4, yet remain an average of 4% lower in 2019 than in 2018. This is a larger decline than was forecast in August.

Terms of trade expected to deteriorate further this year

After deteriorating steadily from mid-2017 onwards, terms of trade for goods and services firmed up this year, supported by smaller rises in import prices (Chart II-12). In spite of a slight uptick at the beginning of this year, they were about 3% poorer in Q2 than in the same quarter of 2018. In H1/2019, they were somewhat weaker than was forecast in August, and the outlook for 2019 as a whole is for a marginal deterioration, whereas in August they were projected to remain virtually unchanged year-on-year. The change from the August forecast is due to a larger decline in aluminium prices and a smaller rise in general export prices, offset by a better outlook for marine product prices. As in August, terms of trade are expected to improve again in 2020.

The real exchange rate has been relatively stable in 2019 to date …

The real exchange rate in terms of relative consumer prices has been relatively stable year-to-date, although it was down 5.7% year-on-year in September. The decline, most of which occurred in Q4/2018, was due almost entirely to a nominal depreciation of the króna. In part, the decline in the real exchange rate reflects the fact that the equilibrium real exchange rate – i.e., the real exchange rate that is consistent with internal and external balance in the economy – is considered to have fallen in the wake of the recent negative shocks to Iceland's export sectors, which have led to weaker terms of trade and reduced export growth.

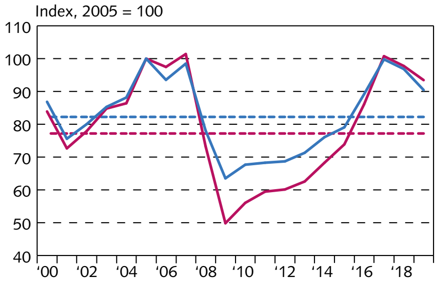
… and looks set to be somewhat below its 2018 average this year

The real exchange rate in terms of relative consumer prices fell by nearly 3% year-on-year in 2018, after an uninterrupted rise dating back to 2010 (Chart II-15). According to the baseline forecast, it will be an average of 6.6% lower this year than in 2018, which is broadly in line with the Bank's last forecast. It is expected to fall in terms of relative unit labour costs as well, and consequently, the outlook is for domestic firms' competitive position to improve for the second year in a row. This is due to a lower nominal exchange rate, albeit offset by wage costs, which have risen relatively more in Iceland than in trading partner countries (Chart II-16).

Chart II-15

Real exchange rate 2000-2019[1]

Index, 2005 = 100



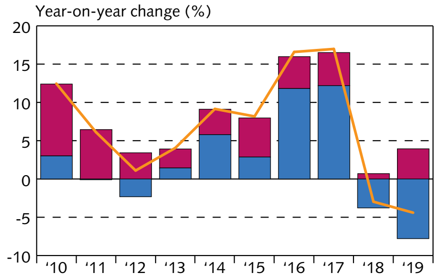
— Real exchange rate (relative consumer prices)
— Real exchange rate (relative unit labour costs)

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

Chart II-16

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

Year-on-year change (%)



Nominal exchange rate
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 of Iceland baseline forecast 2019.
Source: Central Bank of Iceland.