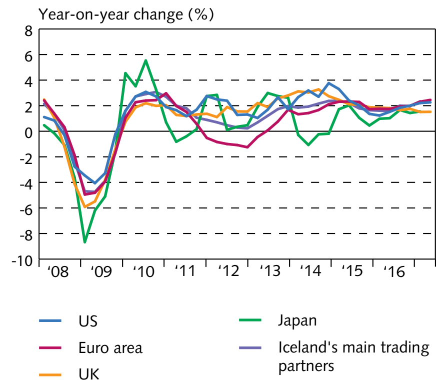
II The global economy and terms of trade

The global economic outlook has brightened, and prospects for GDP growth among Iceland's main trading partners have improved slightly from the forecast in the August *Monetary Bulletin*. The uptick in investment is expected to continue in key advanced economies, and world trade is also expected to grow more strongly than previously assumed. Global inflation has picked up, concurrent with rising energy and commodity prices, although underlying inflation remains low in many economies. Iceland's terms of trade have improved markedly in the past two years, although marine product prices appear to have fallen in Q3 and terms of trade are therefore expected to improve less this year than previously forecast. The real exchange rate fell in Q3, after rising virtually uninterrupted since end-2013. Even so, it is higher than it was a year ago, and the recent increase is considered to reflect the adjustment of the economy to a higher equilibrium real exchange rate concurrent with Iceland's improved external position.

Chart II-1
Global GDP growth
Q1/2008 - Q3/2017



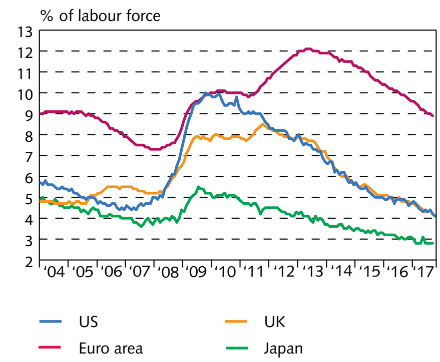
Sources: Thomson Reuters, Central Bank of Iceland.

Global economy

Trading partners' economic recovery gains pace …

GDP growth among Iceland's main trading partners measured 2.2% in H1/2017, slightly outpacing the forecast in the August *Monetary Bulletin.* This is just over ½ a percentage point more than in the first half of 2016. Growth has picked up steadily since mid-2016, alongside increased activity on both sides of the Atlantic (Chart II-1). The recovery has been on a stronger footing in the euro area and the US than in the UK, where GDP growth has gradually receded. In H1/2017, the GDP growth rate in the UK was the weakest in six years, yet unemployment is at a forty-year low and job creation has exceeded expectations (Chart II-2). Conditions in the labour market have improved in many other economies. For example, unemployment has declined more than expected in both the euro area and the US, where it is at its lowest since 2001, as well as in Japan, where it is at a quarter-century low. GDP growth has also livened up in emerging market economies. In the Nordic countries, GDP growth has generally been solid, albeit least so in Norway, where the effects of a marked deterioration in terms of trade due to falling oil prices are still being felt.

Chart II-2
Unemployment rate[1]
January 2004 - October 2017

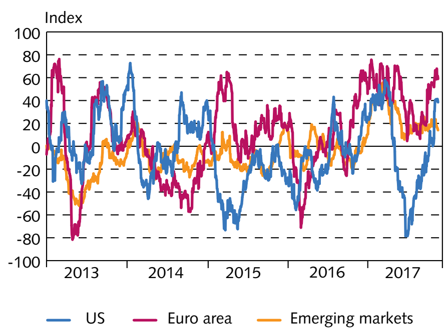


1. Seasonally adjusted data.
Source: Thomson Reuters.

… and indicators give cause to expect the recovery to continue

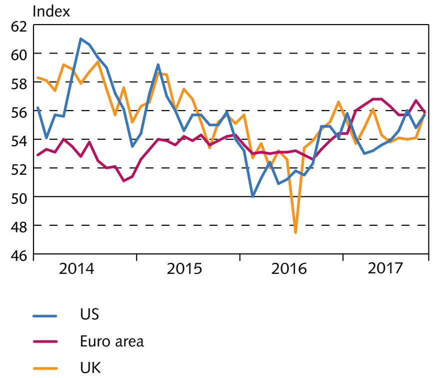
Since the publication of the August *Monetary Bulletin*, economic indicators for the euro area have exceeded expectations (Chart II-3), particularly those pertaining to manufacturing and the labour market. Indicators of consumer and corporate sentiment have risen steeply as a result and are at their highest since before the financial crisis. Growth in private sector credit has been recovering steadily since 2014 and has finally turned positive in all core countries in the region. The recovery of business and residential investment is expected to continue, and leading indicators of output growth imply that GDP growth will remain at the H1/2017 level, which was the strongest in two years (Chart II-4).

Chart II-3
Economic surprise index[1]
Daily data 1 January 2010 - 10 November 2017



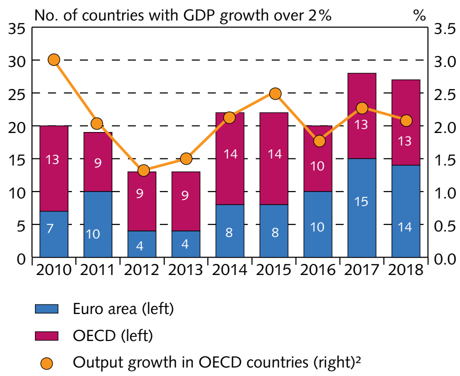
1. When the index is below 0, the indicators are worse than expected; when the index is above 0, the indicators are better than expected. The index does not imply that the indicators are positive or negative.
Source: Thomson Reuters.

Chart II-4
Leading indicators of GDP growth[1]
January 2014 - October 2017



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: Thomson Reuters.

Chart II-5
Output growth in OECD countries[1]



1. Including Lithuania, Malta, and Cyprus, which belong to the euro area but not the OECD. 38 countries in all. 2. The 2017-18 values are based on the IMF forecast (*World Economic Outlook*, October 2017).
Sources: International Monetary Fund, OECD.

Leading indicators suggest that growth will accelerate in the US, and since the beginning of October indicators have slightly exceeded expectations. In the UK, however, households are more pessimistic about the economy than at any time since the Brexit referendum. Leading indicators of GDP growth suggest that growth in the UK will remain tepid, although increased exports will offset weaker private consumption growth to some extent.

Improved GDP growth outlook for advanced and emerging economies …

The International Monetary Fund's (IMF) October forecast assumes that global GDP growth will be somewhat stronger this year than the Fund had projected in the spring. This is due primarily to improvements in the outlook for Europe, Japan, Russia, and China, tempered slightly by prospects of weaker growth in India and the UK. The IMF has lowered its GDP growth forecast for the US, as it no longer expects as much fiscal slack. Global GDP growth is projected at 3.6% in 2017, up from only 3.2% in 2016, the weakest global growth rate since the 2009 recession. There is increased optimism about the short-term economic outlook, but the Fund is still of the view that the risk to the long-term GDP growth outlook is concentrated on the downside. The Fund expects global output growth to pick up to 3.7% in 2018, although growth will weaken in advanced economies and the number of countries with growth over 2% will fall slightly (Chart II-5). In particular, it will taper off in Japan and in the eurozone, where weak productivity growth and public and high private sector debt levels will cut into growth.

… and prospect of slightly stronger growth among Iceland's key trading partners in 2017

Among Iceland's main trading partners, GDP growth is projected to average 2.2% this year, or 0.1 percentage point more than was forecast in August, owing mainly to expectations of stronger growth in the eurozone, the US, and the Nordic region, whereas the outlook for the UK is poorer. For the next two years, however, the outlook is unchanged from the August forecast.

World trade has continued to pick up since mid-2016, alongside more robust investment growth in major industrialised economies. Trading partners' imports are expected to grow as well, and as in August, the growth rate for 2017 is forecast at 4.1%. The outlook is for broadly similar growth in the next few years.

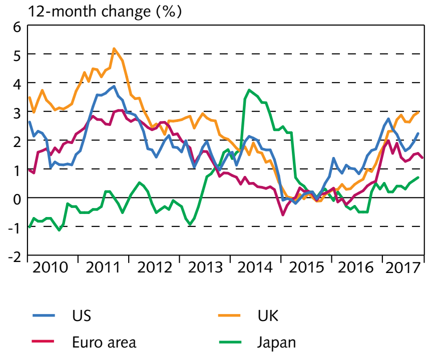
Inflation has risen less than forecast despite strong economic activity

Inflation has been slightly below expectations in major advanced economies. Growing economic activity and the recovery of the labour market have thus far made little impact on wage developments, which is the main reason underlying inflation is widely low.[1] That said, it has

1. See, for example, Chapter 2 of the International Monetary Fund's October 2017 *World Economic Outlook*.

begun to inch upwards in most trading partner countries. In the euro area, underlying inflation has risen in the past year, albeit less than in many other economies. It remains well below the European Central Bank's (ECB) 2% inflation target. In the US, it is rising towards the US Federal Reserve's target, whereas in the UK it is above the target set by the Bank of England. In September, underlying inflation measured 2.7% in the UK, the highest since 2012. In the Nordic countries, inflation has also been inching upwards, particularly in Sweden, where in Q3 it overtook the central bank's 2% inflation target for the first time since 2011. Even though underlying inflation is generally on the rise in trading partner countries, headline inflation has subsided as 2017 has progressed and the base effects of last year's increase in commodity and oil prices have dropped out of twelve-month inflation figures (Chart II-6). For the forecast horizon as a whole, the outlook among trading partners is for slightly lower inflation than was forecast in August, particularly in emerging market economies, although it is also down slightly in the euro area.

Chart II-6
Inflation in selected industrialised countries
January 2010 - October 2017

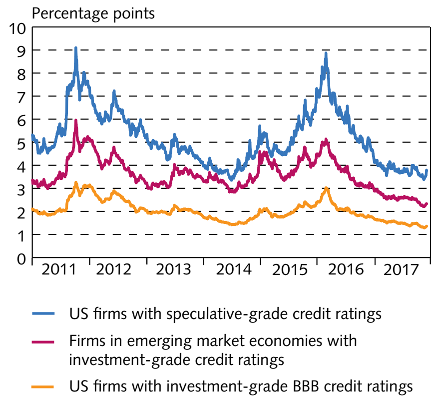


Source: Thomson Reuters.

Asset prices have continued to rise and financial conditions to improve …

In advanced economies, share prices have risen as the economic recovery has firmed up and optimism about the economic outlook has grown. Political uncertainty has affected asset prices in Spain, but in other respects asset prices have been relatively stable in the recent term, and financial conditions have improved. Evidence of this can be seen in interest premia on corporate bonds, which are at a post-crisis low (Chart II-7). Capital flows to riskier investments have increased as a result, as have capital inflows into emerging market economies. This stability in the asset markets could prove fleeting, however: increased geopolitical tensions or growing imbalances in the Chinese financial system could trigger a turnaround.

Chart II-7
Interest premia on corporate bonds[1]
Daily data 3 January 2011 - 10 November 2017

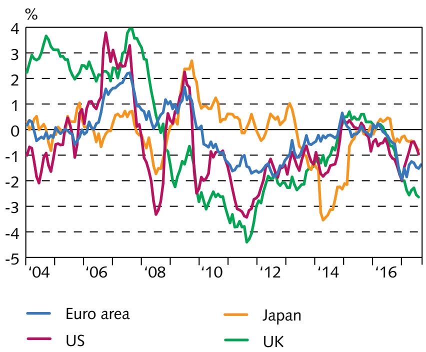


1. Bank of America Merrill Lynch bond indices.
Source: Federal Reserve Bank of St. Louis Federal Reserve Economic Data (FRED) database.

… and a gradual monetary tightening phase is expected among advanced economies

The ECB has kept its policy interest rate unchanged, and at the end of October it decided to extend its monthly bond purchase programme, which was set to conclude in December. The US Federal Reserve Bank has raised interest rates four times since December 2015, however, and the Bank of England and the Bank of Canada have also raised rates recently. Central banks in other advanced economies have kept the monetary stance unchanged since August, however. Central banks in several emerging market economies, including Brazil, Russia, and Indonesia, have lowered interest rates recently, in line with an improved inflation outlook. In most advanced economies, real rates are still very low, as a sizeable slack remains in most of them even though GDP growth has begun to pick up (Chart II-8).

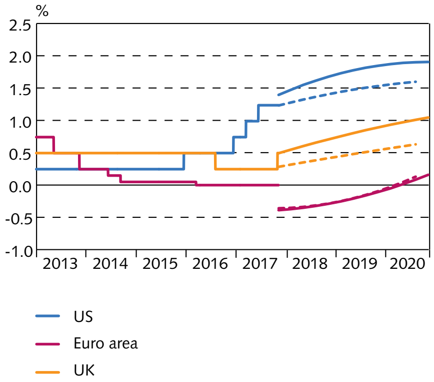
Chart II-8
Real central bank interest rates
January 2004 - October 2017



Source: Macrobond.

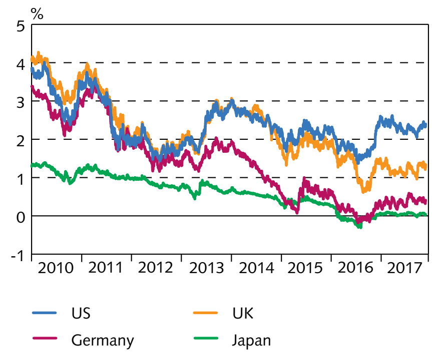
Forward interest rates suggest that the ECB is expected to wait until 2019 before starting to raise rates (Chart II-9). Market participants expect the US Federal Reserve to raise rates again this December, but a gradual tightening phase is still expected thereafter. This has surfaced in a decline in long-term rates, which in early September were

Chart II-9
Policy rates in selected industrialised economies[1]
January 2013 - December 2020



1. Daily data 1 January 2013 through 10 November 2017, and quarterly data Q4/2017 through Q4/2020. 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 10 November 2017 onwards and the broken lines from 18 August 2017 onwards.
Sources: Bloomberg, Macrobond.

Chart II-10
10-year government bond yields in selected industrialised countries
1 January 2010 - 10 November 2017



Source: Macrobond.

at their lowest since the November 2016 presidential election (Chart II-10). In recent weeks, however, they have begun to rise again with the publication of the president's proposals for broad-based corporate tax cuts. Long-term rates have risen in the UK as well, while in Germany and Japan they are virtually unchanged. Even though the interest rate spread versus the eurozone has widened in the US and the UK, the euro has appreciated against the dollar and the pound sterling. At the beginning of September, the exchange rate of the euro versus the US dollar rose above 1.2 for the first time in three years. The euro has appreciated steadily since the spring as economic conditions in the eurozone have improved, while the dollar has weakened due to expectations of a more gradual rise in US interest rates. The pound sterling has depreciated by 11% in trade-weighted terms since before the Brexit referendum in summer 2016.

Export prices and terms of trade

Outlook deteriorates for marine product prices but improves for aluminium prices

Favourable developments in marine product prices have been a significant driver of the past few years' marked improvement in terms of trade. In Q2, prices rose by more than 1% year-on-year in foreign currency terms and were up by over a fifth since mid-2013 (Chart II-11). Preliminary figures suggest, however, that prices gave way in Q3 instead of continuing to rise, as was assumed in the Bank's August forecast. This changes the outlook for marine product prices for 2017 as a whole, as prices are now projected to remain flat year-on-year instead of rising by 2.5%, as was forecast in August. For the next few years, however, the outlook for marine product prices is broadly in line with the August forecast.

Global aluminium prices have continued rising after a sudden jump in August, following the closure of several smelters in China. The smelter closures, an element in the Chinese authorities' attempts to reduce pollution, will result in a 10% reduction in Chinese aluminium production this year. This will have a major impact on global aluminium prices, as China is the largest producer in the world. The price of aluminium has been at or above 2,100 US dollars per tonne, a situation not seen in the global market since 2011. Futures prices and analysts' assessments imply that prices will keep rising. There is growing demand for aluminium produced using renewable energy sources, which generally sells at higher prices than other aluminium. This renewables-generated aluminium includes all of Iceland's production. The price paid to domestic aluminium manufacturers is projected to rise by nearly 19% this year and another 5% in 2018 (Chart II-11), somewhat outpacing the Bank's August forecast.

Petrol prices have risen in excess of the August forecast

Oil prices rose after hurricanes affected production in the US. They rose above 60 US dollars per barrel at the end of October, the highest Brent crude price in two years (Chart II-11). Oil inventories are down in key producer countries, and the projected surge in demand for petrol due to an improved global GDP growth outlook is expected to support prices. The year-on-year rise in oil prices is projected at about 19%, somewhat more than was forecast in August. Both futures prices and market analysts' forecasts suggest that oil prices will rise by an average of just under 3% per year for the remainder of the forecast horizon.

Non-oil commodity prices have also risen more than expected

Non-oil commodity prices rose more than expected in Q3/2017. The increase was driven by metals prices, whereas food prices remained flat quarter-on-quarter. The uptick has reversed in part in recent weeks, however, and food prices have fallen slightly once again. Non-oil commodities had risen in price by 9% year-on-year in Q3, although prices are still much lower than they were before the downturn started in mid-2014 (Chart II-11). Prices are projected to rise by more than 8% this year, a full 2 percentage points more than was forecast in August.

Terms of trade have improved markedly in the past three years but look set to remain unchanged in the near future

Terms of trade have improved virtually without interruption since the beginning of 2014. Preliminary figures from Statistics Iceland indicate that they improved by 3.8% year-on-year in Q2/2017, just over ½ a percentage point more than was assumed in the last *Monetary Bulletin* (Chart II-11). The improvement since the beginning of 2014 is therefore close to 17%. There are signs that terms of trade deteriorated in Q3, however, as a result of the aforementioned decline in marine product prices. The improvement for the year as a whole will therefore measure just under 1%, or 1.3 percentage points less than was forecast in August, owing to the combined effect of unfavourable developments in marine product prices and higher imported petrol and commodity prices, versus the rise in aluminium prices. The outlook for the next few years is broadly unchanged, however.

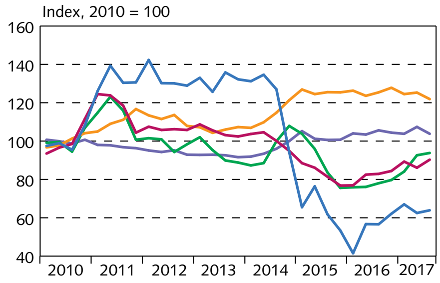
Real exchange rate declined between quarters in Q3 …

The real exchange rate in terms of relative consumer prices declined between quarters in Q3, after rising virtually unchecked since the end of 2013. However, it was up 3% year-on-year in October and about 17% above its twenty-five year average (Chart II-12). As has been discussed in previous issues of *Monetary Bulletin*, this steep rise in the real exchange rate reflects a higher equilibrium real exchange rate; i.e., the real exchange rate that is consistent with the economy's internal and external balance (see, for instance, Box 3 in *Monetary Bulletin* 2016/2). Indications of a rise in the equilibrium real exchange rate can be seen, for example, in a large and persistent current account surplus despite steep rises in the real exchange rate. The prospect of a less pronounced improvement in terms of trade and a more rapid narrowing of the current account surplus (see also Chapter IV) suggests, however, that the equilibrium real exchange rate will not be as high in the coming term as previously assumed.

… with an erosion of Iceland's competitive position

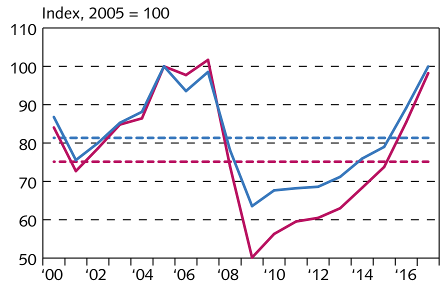
If the forecast in this *Monetary Bulletin* materialises, the real exchange rate will rise by a full 12% this year in terms of relative unit prices and

Chart II-11
Commodity prices and terms of trade[1]
Q1/2010 - Q3/2017



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. Terms of trade in Q3/2017 are based on the MB 2017/4 baseline forecast.
Sources: IMF, Statistics Iceland, Central Bank of Iceland.

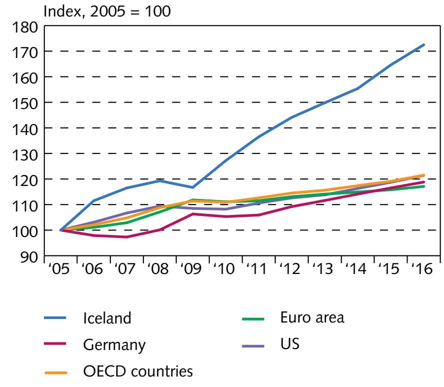
Chart II-12
Real exchange rate 2000-2017[1]



1. Central Bank of Iceland baseline forecast 2017. Broken lines show 25-year average (1992-2016).
Source: Central Bank of Iceland.

by even more, or over 16%, in terms of relative unit labour costs. Firms' wage costs have risen much more in Iceland than in competitor countries in recent years, and the competitive position of companies in the tradable sector has therefore deteriorated (Chart II-13).

Chart II-13
Unit labour costs in developed countries
2005-2016



Sources: Macrobond, Central Bank of Iceland.