The global economy and terms of trade

I

The global economy

Global GDP growth proved stronger in H1/2022 than was forecast in August …

GDP growth among Iceland's main trading partners measured 0.5% quarter-on-quarter in Q2/2022 (Chart I-1). It was far weaker than in most of 2021 but stronger than was forecast in the August *Monetary Bulletin*. Economic activity grew particularly in the eurozone, propelled by the largely tourism-driven recovery in Southern Europe. There was also a marked turnaround in the Nordic region and Japan, after virtually flat or negative growth in Q1. Growth slowed in the UK, however, and the US recorded a contraction for the second quarter in a row. There was also a significant contraction in China, owing to tighter public health measures and weaknesses in the real estate market.

Trading partner GDP growth measured 4.6% year-on-year in H1/2022, or 0.3 percentage points above the August forecast.

… but the outlook for H2 has deteriorated

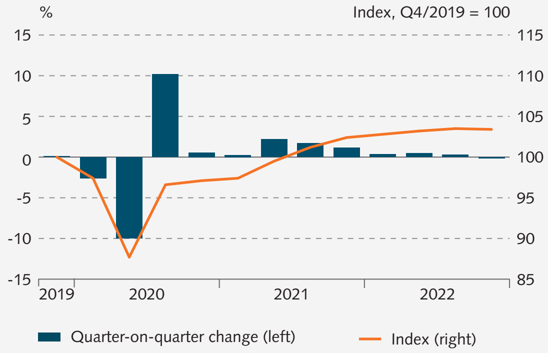
GDP in the UK contracted by 0.2% between Q2 and Q3. Growth slowed to 0.2% in the euro area and 0.5% in Denmark, whereas it picked up to 0.6% in the US and measured 0.7% in Sweden. Trading partner GDP is estimated to have grown by an average of 0.3% between quarters, in line with the Bank's August forecast (Chart I-1).

Leading indicators and international forecasts suggest a worsening output growth outlook for Q4, however. PMI indices have fallen still further, implying that economic activity has all but stagnated or even contracted in the recent term (Chart I-2). Retail sales are down

Chart I-1

GDP growth in Iceland's main trading partners[1]

Q4/2019 - Q4/2022

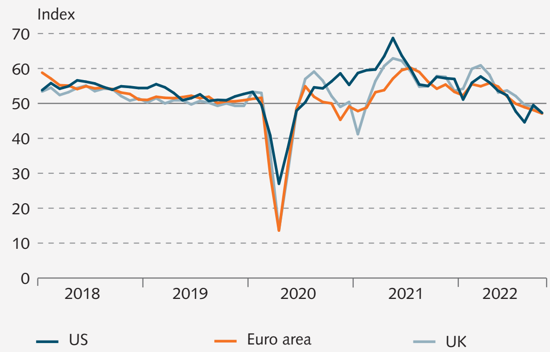


1. Seasonally adjusted data. Central Bank baseline forecast Q3/2022 and Q4/2022.
Sources: Refinitiv Datastream, Central Bank of Iceland.

Chart I-2

Composite PMI[1]

January 2018 - October 2022



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.

as well, and industrial manufacturing has softened, particularly in the UK (Chart I-3). Moreover, consumer sentiment about the economic outlook has remained at or near all-time lows in major advanced economies, and pessimism among corporate executives has been on the rise. On average, a marginal contraction is now forecast for Iceland's trading partners in Q4 instead of the slightly positive growth projected in August.

The cost of living has risen worldwide …

Both the recent setback in the economic recovery and the poorer outlook are due largely to the effects of inflation, which has risen worldwide, hitting four-decade highs in many advanced economies. In addition, financial conditions have deteriorated alongside central bank interest rate hikes in many parts of the world. Households' living costs have therefore surged in a short period of time, and real disposable income has shrunk, cutting into domestic demand (Chart I-4). Higher financing costs, elevated uncertainty, and high input prices also have a dampening effect on firms' investment plans. This cost-of-living crisis is due in large part to the impact of the war in Ukraine, which has pushed energy and food prices sharply upwards and exacerbated economic uncertainty.

… and the European energy crisis has deepened …

The economic outlook in Europe has been affected in particular by growing concerns about energy supplies on the Continent following the invasion of Ukraine, as natural gas imports from Russia have weighed heavily in Europeans' energy consumption. Natural gas imports plunged this summer, alongside escalating tensions caused by the war and the tightening of Western sanctions on Russia, and are now down to only a fifth of the 2021 average, after Russia's closure of the Nord Stream 1 pipeline in late August. European natural gas prices soared thereafter, and concerns about this winter's energy supplies have mounted. Even though prices have fallen again – owing to the recent spell of unusually warm weather, increased natural gas imports from other countries, more favourable inventory levels than previously expected, and increased energy saving – there is pronounced uncertainty about Europe's energy supplies this winter and in the next few years (see also Box 1).

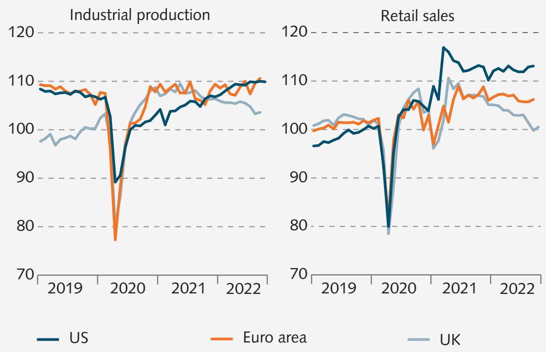
… albeit offset by a favourable employment situation, sizeable accumulated savings, and fiscal support

Labour demand has been strong despite a slowdown in economic activity and a worsening outlook for demand. In major advanced economies, unemployment is at

Chart I-3

Industrial production and retail sales[1]

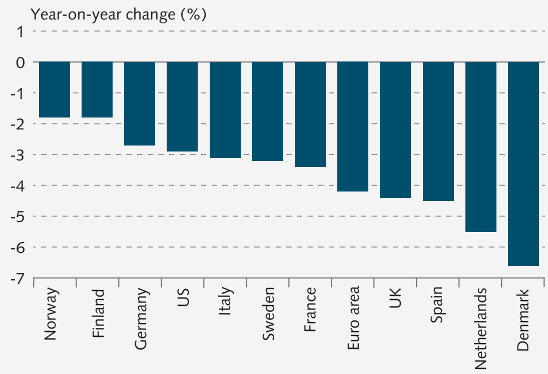
January 2019 - October 2022



1. Seasonally adjusted volume indices (2020 = 100).
Source: Refinitiv Datastream.

Chart I-4

Real wages in Q2/2022[1]



1. Employee compensation per hour worked, deflated with the CPI. Seasonally adjusted data.
Sources: OECD, US Bureau of Labor Statistics.

or near its lowest in decades, job availability is strong, and nominal wages have been rising (Chart I-5). Fiscal authorities have widely adopted discretionary measures to mitigate the impact of rising living costs on households' disposable income. The savings accumulated by households during the pandemic have also cushioned against the dampening effects of higher costs on domestic demand. The saving ratio has fallen perhaps the most in the US, where private consumption has been strong in comparison with other major advanced economies (Chart I-6). It has fallen less in the eurozone and the UK, where it is above its pre-pandemic average. As a result, households in these economies are still setting aside a larger share of their disposable income than they did before the pandemic.

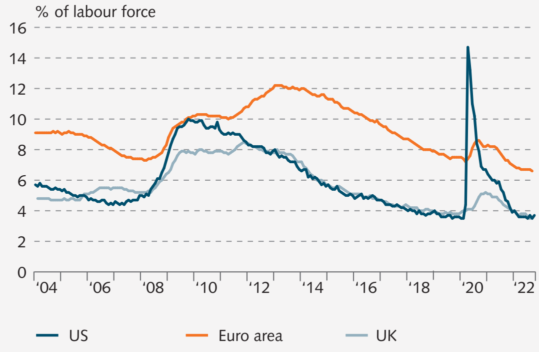
Global GDP growth projected to weaken in 2023 …

According to the International Monetary Fund's (IMF) mid-October forecast, global GDP growth is projected to fall from last year's 6% to 3.2% this year and 2.7% in 2023. The IMF's GDP growth projection for 2022 is unchanged from its July forecast, whereas its 2023 forecast has been revised downwards by 0.2 percentage points. Both projections are considerably below the Fund's April forecast, however, particularly those for advanced economies. The bleaker outlook reflects the detrimental effect of the war in Ukraine on the global economy – especially the European economy – following cutbacks in energy supply from Russia. The Chinese economy has also weakened more than expected. Furthermore, financial conditions have worsened in many parts of the world, in line with expectations of further interest rate hikes by leading central banks, which will curb demand.

… and the GDP growth outlook for Iceland's trading partners has generally worsened

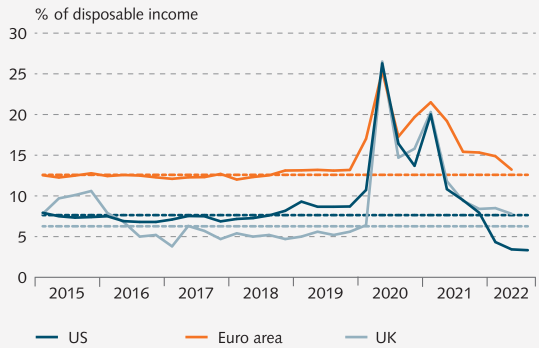
According to the Bank's baseline forecast, GDP growth among Iceland's main trading partners will measure 3.1% this year (Chart I-7), or 0.2 percentage points above the August forecast. The increase is due to stronger growth in H1 following revisions of previously published GDP data, particularly in the UK and Sweden. Prospects for H2 have deteriorated, however, as is mentioned above. A quarter-on-quarter contraction is forecast in Q1/2023 as well as Q4/2022, and trading partner GDP growth is projected at only 0.6% for 2023 as a whole. This is 0.6 percentage points below the Bank's August forecast and 1.7 percentage points below the May forecast. Trading partner GDP growth is also projected to be somewhat weaker in 2024. The outlook for trading partner imports

Chart I-5
Unemployment rate[1]
January 2004 - October 2022



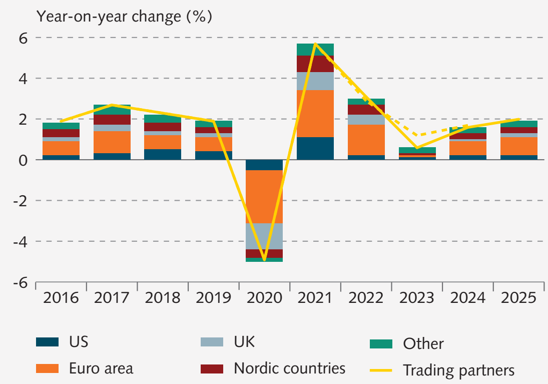
1. Seasonally adjusted data.
Source: Refinitiv Datastream.

Chart I-6
Household saving[1]
Q1/2015 - Q3/2022



1. Broken lines show 2015-2019 average.
Source: Refinitiv Datastream.

Chart I-7
GDP growth in Iceland's trading partners and contribution from selected countries 2016-2025[1]



1. Trade-weighted contribution from selected countries. Central Bank baseline forecast 2022-2025. The broken line shows the forecast in MB 2022/3. "Nordic countries" is the average for Denmark, Norway, and Sweden.
Sources: Refinitiv Datastream, Central Bank of Iceland.

has worsened as well, in line with the poorer GDP growth outlook.

The economic outlook remains highly uncertain. Developments will depend in large part on the repercussions of the war in Ukraine and how long they persist. The outlook could deteriorate if the effects of the war are amplified still further. Furthermore, the European energy crisis could deepen, necessitating widespread energy rationing on the Continent. Inflation could prove more persistent in advanced economies, and financial conditions could erode further. Economic developments will also depend to a large extent on how the pandemic plays out, how the Chinese economy develops, and whether attempts to unwind persistent supply chain problems continue to be successful (see the discussion of key uncertainties in Box 1).

Global inflation has risen further, outstripping previous expectations …

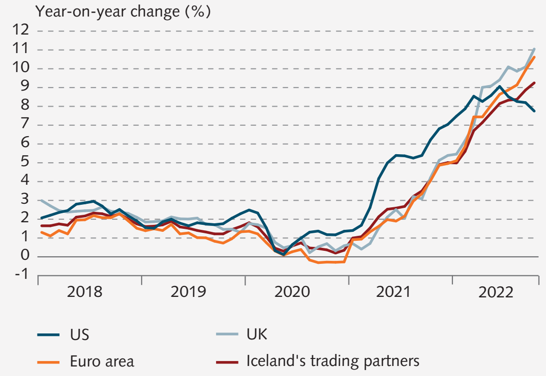
Global inflation has surged since mid-2021, rising much higher than generally expected. Trading partner inflation averaged 8.4% in Q3, its highest in four decades (Chart I-8). This is 0.5 percentage points above the Bank's August forecast and 2.5 percentage points above the May forecast. Inflation among trading partner countries climbed still higher in October, to an average of 9.3%.

Developments in global inflation are still strongly affected by steeply rising energy prices, although food prices are also up sharply year-to-date (Chart I-9). The increase, particularly the surge in European natural gas prices, is due largely to the war in Ukraine. It is offset in part by the recent decline in oil and petrol prices, in accordance with developments in global market prices. The price of other important expenditure items has also continued rising apace, and inflation is growing more and more widespread. In October, goods prices excluding energy and food had risen by an average of 6% year-on-year in trading partner countries (Chart I-10). As has been discussed previously in *Monetary Bulletin*, a large share of the rise in goods prices stems from strong demand and a robust economic recovery from mid-2021 onwards, together with persistent pandemic-related supply chain disruptions and shipping problems. Services prices, too, have risen steeply this year in tandem with the relaxation of public health measures, as pent-up demand is significant.

… and the inflation outlook for trading partners has worsened

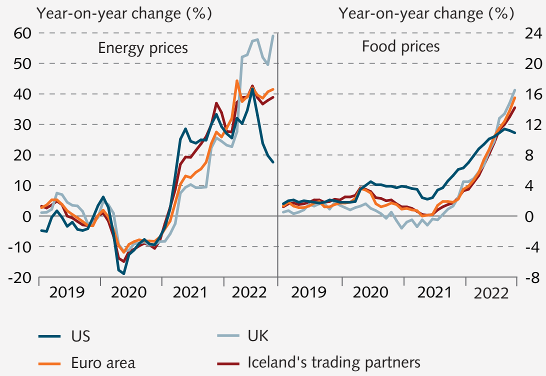
Oil and commodity prices have fallen more in the recent term than was forecast in August, shipping costs have

Chart I-8
Global inflation
January 2018 - October 2022



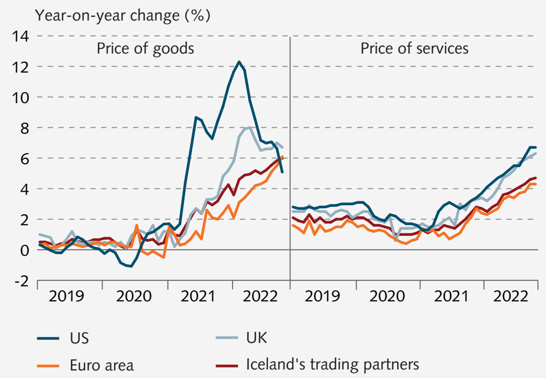
Sources: Refinitiv Datastream, Central Bank of Iceland.

Chart I-9
Global energy and food prices
January 2019 - October 2022



Source: Refinitiv Datastream.

Chart I-10
Global goods and services prices[1]
January 2019 - October 2022



1. Price of goods other than energy and food.
Source: Refinitiv Datastream.

kept falling, and supply chain pressures have eased, yet the global inflation outlook has worsened. The deterioration is due primarily to larger-than-expected energy price hikes in Europe and the prospect of higher prices this winter. Furthermore, the rise in food prices and underlying inflation has proven more persistent in trading partner countries than was assumed in August. The US dollar has surged against many other currencies, pushing other countries' import prices higher, partly because the dollar is used so widely as an invoicing currency in world trade. Trading partner inflation is projected to average 7.7% in 2022, about 0.6 percentage points above the August forecast. It is forecast at 5% in 2023, or 1.2 percentage points higher than was assumed in August, and is expected to be somewhat higher in 2024 as well.

Central banks in major advanced economies have kept raising interest rates …

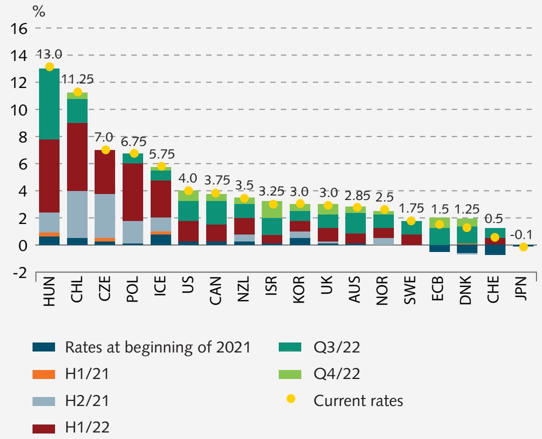
In spite of a weaker GDP growth outlook and elevated uncertainty, central banks in major advanced economies have tightened their monetary stance still further, in line with the deteriorating inflation outlook and a tight labour market. The European Central Bank (ECB) raised its key rate by 0.75 percentage points to 1.5% in late October and has raised it by a total of 2 percentage points since July (Chart I-11). In early November, the US Federal Reserve also raised rates by 0.75 percentage points, to 3.75-4%, its fourth 0.75-point hike in a row. The Federal Reserve's interest rates have now risen 3.75 percentage points year-to-date and are at their highest since early 2008. The Bank of England (BoE) raised its key rate by 0.75 percentage points in early November as well, to 3%. A number of central banks in other advanced economies have hiked interest rates in recent months, in most cases to levels not seen since 2008. Even so, real rates in advanced economies are still generally negative, and far lower than before the pandemic.

… and bond yields are at their highest in more than a decade

Advanced economies' government bond yields rose sharply in H1/2022 and have more or less continued to climb in H2 (Chart I-12). In many cases, bond yields are at their highest in a decade or more. The rise in yields reflects the surge in leading central banks' interest rates and expectations of higher rates in the future than were previously anticipated (Chart I-13). The rise in the breakeven inflation rate in some countries also suggests that inflation expectations have inched upwards recently. Higher breakeven rates could also be due to a rise in uncertainty risk premia, owing to elevated economic uncertainty. This is

Chart I-11

Central bank interest rates in OECD countries and changes since beginning of 2021[1]



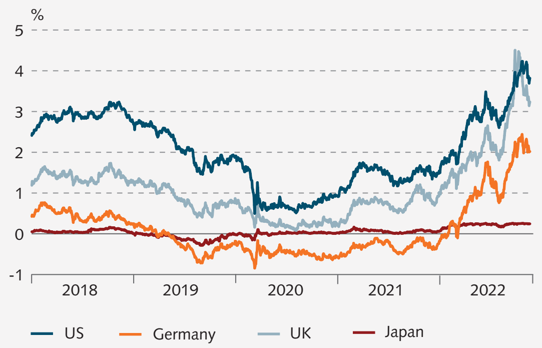
1. US interest rates are the upper bound of the US Federal Reserve Bank's interest rate corridor, and rates for the euro area are the European Central Bank's deposit facility rate.

Source: Refinitiv Datastream.

Chart I-12

10-year government bond yields

1 January 2018 - 18 November 2022

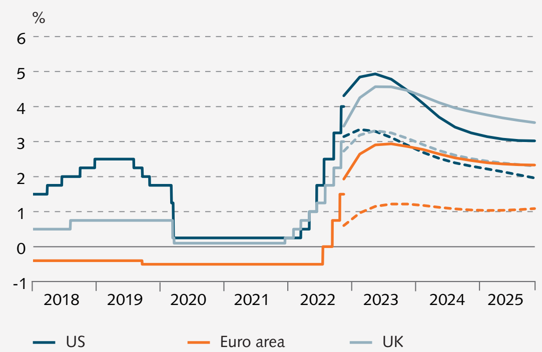


Source: Refinitiv Datastream.

Chart I-13

Central bank policy rates[1]

January 2018 - December 2025



1. Daily data 1 January 2018 through 18 November 2022, and quarterly data Q4/2022 through Q4/2025. 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 2022, and broken lines as of mid-August 2022.

Sources: Bloomberg, Refinitiv Datastream.

reflected, for instance, in term premia on US government bonds, which have risen recently. Term premia on short-term government bonds have risen even more and are now higher than those on long bonds. It is likely, though, that the downward slope of the US yield curve mainly reflects market expectations that central bank interest rates will peak soon and then start falling again as growth in economic activity eases and inflation tapers off.

Larger rate hikes in the US and increased uncertainty have caused the dollar to appreciate strongly

The US Federal Reserve has raised interest rates more and faster in 2022 than most other central banks in advanced economies have. To a degree, this reflects higher and more rapidly rising underlying inflation in the US. Furthermore, the post-pandemic economic recovery was stronger in the US, partly because of the large fiscal stimulus, and the labour market has been tighter. The energy situation is also more favourable in the US than, for instance, in Europe, although prices have certainly risen west of the Atlantic. Larger interest rate hikes and a stronger economy in the US than in many other advanced economies are reflected in the dollar, which has appreciated against many other currencies (Chart I-14). Increased global uncertainty and flight to safe assets because of the poorer global outlook have reinforced this trend. In terms of the average exchange rate vis-à-vis other currencies, the dollar has recently been at its strongest in more than two decades.

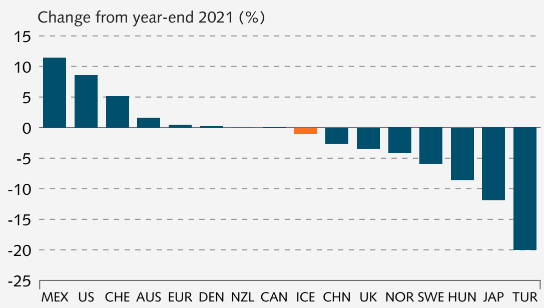
Financial conditions have deteriorated and uncertainty has mounted

Global asset prices have softened markedly this year and grown more volatile (Chart I-15). Credit spreads on riskier financial asset have widened, particularly in Europe, and financing costs have risen. This is probably due in particular to a poorer economic outlook, elevated uncertainty, and larger-than-expected interest rate hikes by leading central banks.

As a result, financial conditions have worsened in many parts of the world and are now tighter in most advanced economies than they have been on average in the past decade. They have deteriorated perhaps most in the eurozone and are now broadly back to their pandemic-era low. Financial conditions have eroded commensurably in a large number of emerging economies, many of which are fragile. Interest rate hikes in the US and the surge in the US dollar year-to-date have made a bad situation even worse for many of them, especially those with substantial dollar-denominated debt and fragile economic fundamentals.

Chart I-14

Change in exchange rate of selected OECD currencies in 2022[1]

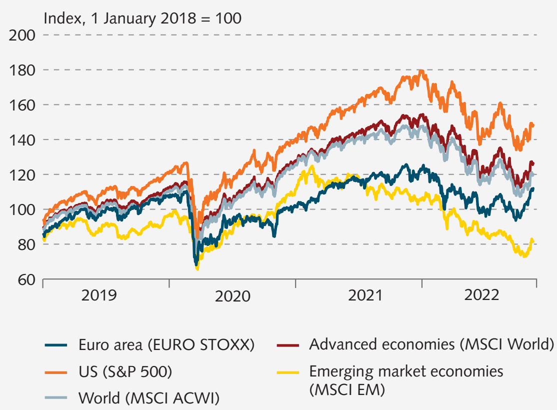


1. Change in trade-weighted exchange rate in 2022 through 18 November.
Sources: Refinitiv Datastream, Central Bank of Iceland.

Chart I-15

Global share prices

1 January 2019 - 18 November 2022



Source: Refinitiv Datastream.

Export prices and terms of trade

Outlook for a larger rise in marine product prices in 2022

The price of Icelandic marine products has risen continuously since Q2/2021, in tandem with improving market conditions as the effects of the pandemic tapered off (Chart I-16). Elevated uncertainty about marine product supplies in the wake of the Western sanctions on Russia also stimulated demand for Icelandic products and fostered further price increases.

Foreign-currency prices of Icelandic marine product exports rose by nearly a fourth year-on-year in Q2/2022, to roughly a fifth above the 2019 average. Contrary to the Bank's August forecast and indications of declining demand in foreign markets this summer, the price of Icelandic exports kept rising in Q3. Mainly because of this, they are now forecast to rise by nearly 20% this year instead of the 13% assumed in August. On the other hand, prices are expected to fall further in 2023, in line with the poorer economic outlook for trading partner countries and increased global economic uncertainty. This will be offset by reduced quotas for cod and capelin, which will lead to smaller declines in prices than could otherwise be expected.

Aluminium prices set to fall further in 2023

Global aluminium prices rose virtually unimpeded from mid-2020 through Q1/2022, partly because of production cuts in China, increased demand in line with the global economic recovery, and greater uncertainty about supplies in the wake of the war in Ukraine. The trend reversed abruptly in Q2, however, and prices fell further in Q3 as the global economic outlook deteriorated. However, in line with the Bank's August forecast, the price of Icelandic aluminium exports continued to rise in Q2, to more than 60% above the Q2/2021 level (Chart I-16). Prices sagged again in Q3, though, and are expected to fall farther in Q4. Aluminium export prices are forecast to average nearly a third higher in 2022 than in 2021, which is a slightly smaller increase than was assumed in August. The outlook for 2023 has deteriorated further, however, as prices are forecast to fall by nearly 18% instead of the previously projected 8%.

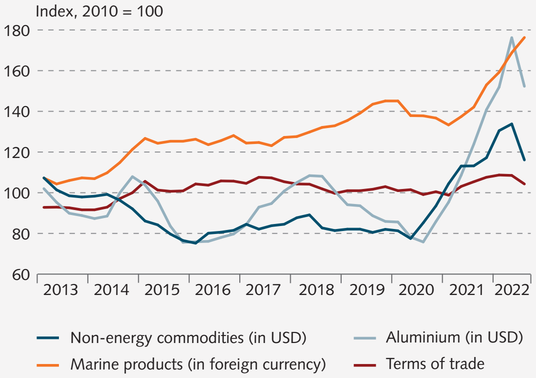
Oil prices have declined since June …

Global crude oil prices skyrocketed early this year, during the lead-up to and aftermath of Russia's invasion of Ukraine. They peaked at nearly 130 US dollars per barrel after the invasion and averaged 112 dollars per barrel in Q2 (Chart I-17), some 60% higher than in Q2/2021.

Chart I-16

Commodity prices and terms of trade[1]

Q1/2013 - Q3/2022

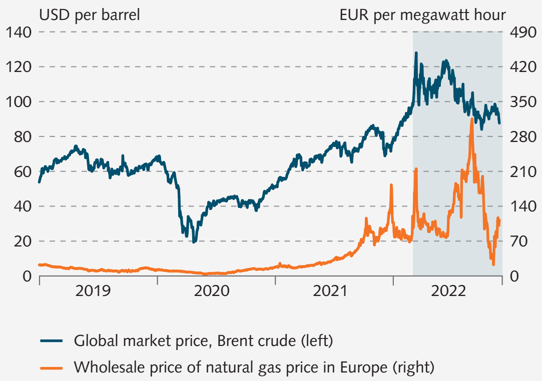


1. Central Bank baseline forecast Q3/2022 for terms of trade.
Sources: Statistics Iceland, World Bank, Central Bank of Iceland.

Chart I-17

Oil and natural gas prices[1]

1 January 2019 - 18 November 2022



1. The shaded are shows the period following the onset of war in Ukraine.
Source: Refinitiv Datastream.

Both the surge and substantial price volatility reflect elevated uncertainty about oil supplies because of the war and the sanctions on Russia, the world's second-largest oil exporter.

Oil prices started to fall again in mid-year, however, in tandem with increased concerns about the global economic outlook, and the International Energy Agency (IEA) now expects demand for oil to rise less than previously forecast. This is offset, however, by reduced production from the OPEC+ countries, announced in early October. The surge in natural gas prices has also mitigated the contraction in demand for oil, therefore impeding the fall in oil prices. Furthermore, prices have been supported by the European Union's (EU) proposed ban on oil imports from Russia. The price of Brent crude averaged 94 US dollars in October, about 20% lower than in June. Even so, it was up nearly a fifth year-to-date and 12% higher than in October 2021 (Chart I-18). Although futures prices suggest that oil prices will fall during the forecast horizon and will be lower over the horizon as a whole than was assumed in August, the situation is highly uncertain. The proposed Western sanctions on Russian oil exports – which are set to take effect in the next few months and entail a ban on imports, a cap on prices, and restrictions on shipping by sea, among other things – could disrupt production in the oil market, for instance, with the associated price hikes. On the other hand, US production could turn out stronger than expected, or exports from Iran could increase if the US government eases its sanctions on the country.

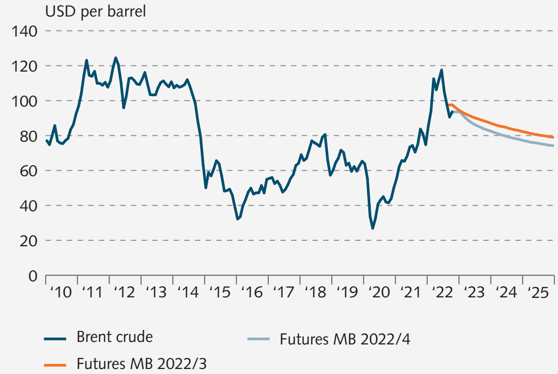
… and European natural gas prices have fallen after the surge this summer

Concerns about energy supplies in Europe have escalated in the wake of the invasion of Ukraine, as is discussed above. Natural gas prices began climbing this summer, alongside reduced flow of gas from Russia and increased uncertainty about supplies this winter. They hit a historical high of 315 euros per megawatt hour in late August (Chart I-17). Increased demand for natural gas this summer also contributed to price hikes, owing both to reduced production of other forms of energy and to inventory stockpiling by European countries in anticipation of the winter. At the same time, energy consumption on the Continent increased because of unusually warm weather this summer. Global coal prices have surged as well in the recent term, boosted by increased demand due to shortages of other energy sources, disruptions in production, and the EU and G7 countries' ban on importation of Russian coal.

Chart I-18

Global oil prices

January 2010 - December 2025



Sources: Refinitiv, Central Bank of Iceland.

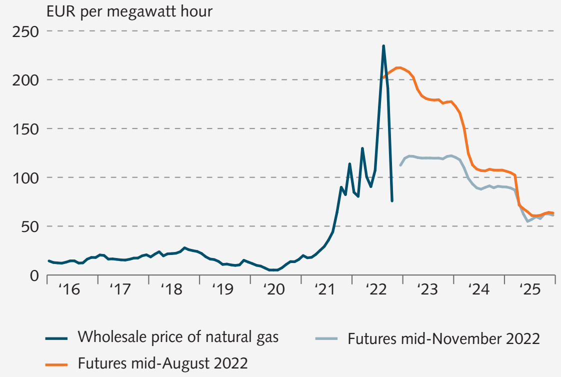
On the other hand, European natural gas prices have fallen rapidly since August and, by October, were back to the level seen in early June. The decline is due in part to reduced energy consumption during a mild autumn and early winter, increased energy saving, a favourable inventory position, and more imports from other countries, particularly liquid natural gas from the US. Even so, the outlook for European natural gas prices is extremely uncertain at present, and it depends on a number of factors, particularly to include this winter's weather and supplies from other countries (see Box 1). Futures prices suggest that natural gas prices will trend upwards this winter and remain high in the next few years (Chart I-19).

Non-energy commodity prices fell again this summer
Non-energy commodity prices mushroomed after the war began, as Russia and Ukraine are important manufacturers of a wide range of commodities such as metals, agricultural products, and fertiliser (see also Box 2 in *Monetary Bulletin* 2022/2). The spike in prices reversed this summer, however, as concerns mounted about the bleaker global economic outlook (Charts I-16 and I-20). Metals prices fell the most and are now a fourth below the pre-invasion level.

Agricultural products also fell steeply in price, owing to expectations of better harvests than previously assumed. In addition, exports of grains and other agricultural products from Ukraine increased after an agreement was reached with the Russians and shipping via the Black Sea was permitted again. Supply chain pressures have continued to ease recently, and shipping costs have fallen after surging in 2021 (Chart I-21). These pressures remain more pronounced than they were before the pandemic, however, and shipping costs and non-energy commodity prices (particularly fertiliser prices) are still above the pre-pandemic level. The outlook is for non-energy commodity prices to rise by an average of 10.4% year-on-year in 2022, whereas the August forecast assumed an increase of 12.1%. They are also expected to fall more in 2023, or by just over 8% instead of the scant 7% forecast in August.

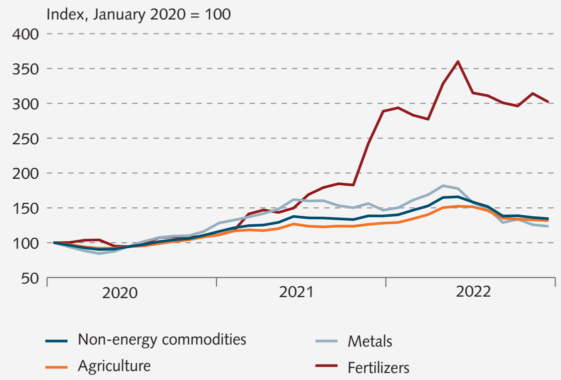
Terms of trade set to improve more in 2022, but the outlook for 2023 has deteriorated
Terms of trade for goods and services improved by 7.5% year-on-year in H1/2022, as was forecast in August (Chart I-16). The improvement is due largely to the continued rise in aluminium and marine product prices. The price of other goods exports also rose markedly between years, particularly silicon products and farmed

Chart I-19
Natural gas prices in Europe
January 2016 - December 2025



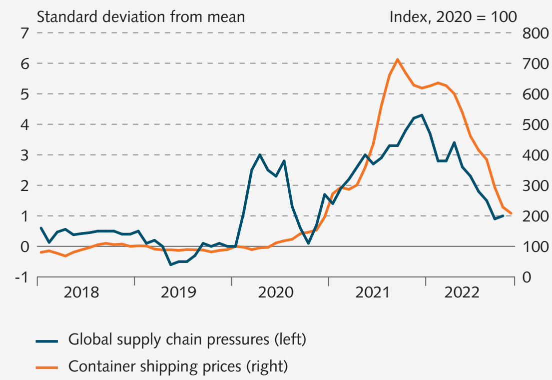
Source: Refinitiv.

Chart I-20
Global commodity prices[1]
January 2020 – October 2022



1. Agricultural products are classified as food (62%), beverages (13%), and raw materials (25%).
Source: World Bank.

Chart I-21
Indicators of supply-side pressures[1]
January 2018 – November 2022



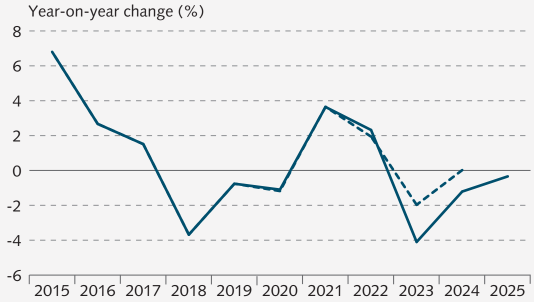
1. The Global Supply Chain Pressure Index (GSCPI) combines the effects of 27 different measures of shipping costs and delivery times, adjusted for demand-side effects. Container shipping based on the Freightos Global Container Index. Data through 18 November 2022.
Source: Refinitiv Datastream.

fish. Export prices overall were up 24% year-on-year in H1, albeit offset by an increase of just over 15% in import prices.

Owing to the prospect of more favourable prices for marine products, terms of trade are now forecast to improve more in H2 than was projected in August. Thus, the outlook for the year as a whole is for a 2.3% improvement instead of the previously forecast 1.9% (Chart I-22). This comes in the wake of a 3.6% improvement in 2021. The outlook for 2023 has deteriorated, however: terms of trade are forecast to deteriorate by 4.1% during the year, twice as much as was forecast in August. A major factor in this downturn is the expectation of larger declines in the price of aluminium and marine product exports, as is discussed earlier in this chapter. Import prices are also expected to rise further, owing to a bleaker global inflation outlook.

Chart I-22

Terms of trade for goods and services 2015-2025[1]



1. Central Bank baseline forecast 2022-2025. The broken line shows the forecast from MB 2022/3.

Sources: Statistics Iceland, Central Bank of Iceland.