

II The global economy and terms of trade

Economic growth has picked up worldwide, and the outlook for 2017 has brightened. Forecasts for trading partners' GDP growth have been revised upwards since the Bank's February forecast. There is also the prospect that GDP growth will be increasingly investment-driven; therefore, growth in trading partner imports has been revised upwards. Global inflation has picked up in recent months, with growing economic activity and rising energy and commodity prices. Iceland's terms of trade have improved significantly since mid-2014 and are expected to continue doing so. The real exchange rate has continued to rise and, by Q1/2017, was one-fifth above its historical average, in a reflection of improved terms of trade and export growth, which has led to a sizeable current account surplus and improved Iceland's external position.

Global economy

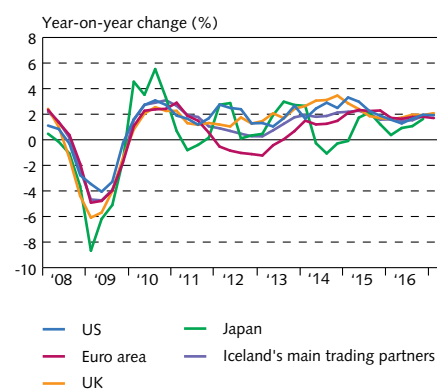
Trading partners' economic recovery weaker in 2016, but Q4 growth exceeded expectations ...

As was assumed in the Bank's February forecast, trading partners' GDP growth measured 1.6% in 2016, somewhat less than in the previous two years. GDP growth for the year as a whole turned out weaker than the year before in nearly all trading partner countries. However, it increased in most advanced economies in H2/2016, averaging 1.9% among Iceland's main trading partners in Q4 (Chart II-1). Investment gained ground on both sides of the Atlantic in H2, supported by increased demand, low interest rates, and rising commodity prices, which have stimulated investment in energy-intensive industry. The labour market has recovered strongly in the US, the UK, and Japan, where unemployment is at its lowest since before the financial crisis (Chart II-2). Even though the recovery in the eurozone slowed down in 2016, it now extends to more countries within the currency area, and unemployment is at its lowest since May 2009. GDP growth was positive in all euro area countries and measured 2% or more in nine of them. At the same time, economic activity has slowed in the Nordic countries except in Finland where growth has accelerated after a long recession came to an end in 2015. In Denmark and Norway, GDP growth measured just over 1% in 2016, while Sweden recorded more than 3% growth for the second year in a row.

... and global GDP growth is at its weakest since the financial crisis

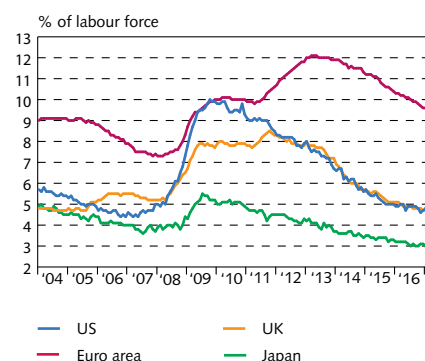
Global GDP growth measured 3.1% in 2015, the slowest rate of growth since 2009, reflecting the weaker economic recovery in both advanced and emerging market economies. GDP growth averaged 1.7% in advanced economies, the weakest growth rate since 2013. In emerging market economies, GDP growth measured 4.1%, some 1½ percentage points below the average for the previous six years. However, these economies, particularly the two largest commodity importers, China and India, continue to be the main drivers of global growth.

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



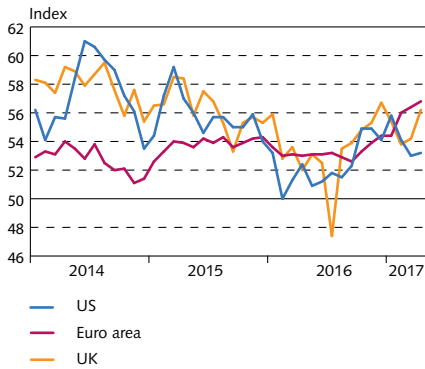
Sources: Macrobond, Central Bank of Iceland.

Chart II-2
Unemployment rate¹
January 2004 - April 2017



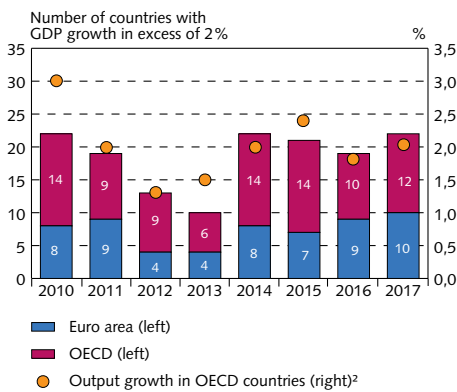
1. Seasonally adjusted figures.
Source: Macrobond.

Chart II-3
Leading indicators of GDP growth¹
January 2014 - April 2017



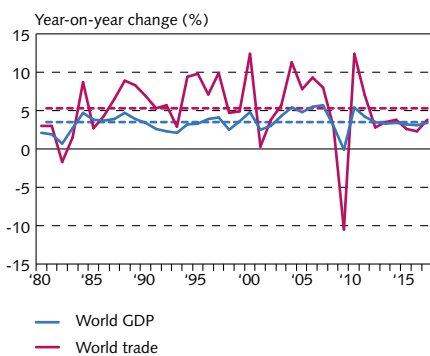
1. Markit composite purchasing managers' index (PMI). The index is published monthly and is seasonally adjusted. An index value above 50 indicates month-on-month growth, and a value below 50 indicates a contraction.
Source: Bloomberg.

Chart II-4
Output growth in OECD countries¹



1. Including Lithuania, Malta, and Cyprus, which belong to the eurozone but not the OECD. 38 countries in all. 2. The 2017 value is based on IMF's forecast (*World Economic Outlook*, April 2017).
Sources: International Monetary Fund, OECD.

Chart II-5
World GDP and trade 1980-2017¹



1. Broken lines show average of 1980-2016. The values for 2017 are based on IMF's forecast (*World Economic Outlook*, April 2017).
Sources: International Monetary Fund, Central Bank of Iceland.

A turnaround can also be detected in Russia and Brazil in the wake of the recent rise in oil and commodity prices.

Signs of growing economic activity in advanced economies

Economic indicators for the UK have exceeded market expectations. Even though a sudden uptick in inflation has cut into real wage growth, economic indicators suggest that private consumption growth has slowed less than previously expected. The depreciation of the pound sterling is expected to emerge in a more positive contribution from net trade, with further support from the recent pickup in global GDP growth. Indicators imply that GDP growth will ease slightly in the UK, but less than previously thought. Economic indicators for the eurozone and the US have also turned out more positive than previously projected. The euro area PMI is at its highest since April 2011, as are indicators of economic sentiment in the region (Chart II-3). In the US, investment picked up at the end of 2016. Signs of growth in leading manufacturing sectors and increased private sector optimism indicate that this trend will continue.

Outlook for rising GDP growth in 2017 ...

According to the International Monetary Fund's (IMF) most recent forecast, global output growth will increase to 3.5% this year. The output growth outlook has improved since the Fund's January forecast, particularly for advanced economies, with projections for the UK improving most, while the forecast for emerging market economies is unchanged. According to the forecast, GDP growth will increase year-on-year in both advanced and emerging market economies, and a larger number of advanced economies will record GDP growth in excess of 2% (Chart II-4).

The IMF projects that global output growth will be broadly similar next year, with emerging market economies gaining ground and advanced economies' growth rate holding unchanged between years. There is increased optimism about the short-term economic outlook, but the Fund is of the view that significant uncertainty remains, particularly as regards the medium-term outlook (see also Chapter I), with the risk profile tilted to the downside in the next few years.

... with growth in world trade set to overtake global GDP growth once again

The IMF forecasts that growth in world trade will exceed global GDP growth in 2017. This is a change from the situation in the past two years, when world trade has been outpaced by GDP growth (Chart II-5). In 2016, world trade grew 2.2%, the weakest growth rate since 2009 and well below the long-term average. Last year's sluggish growth is due primarily to weaker growth in imports and exports in advanced economies, which in turn stems from low investment levels and a contraction in inventories, particularly in H1. Key indicators imply that growth in investment is on the horizon, with increased economic activity that should stimulate world trade in the coming term. A shift in policies towards increased protectionism could reverse this trend.

The outlook for GDP growth and demand in trading partner countries has improved since February ...

In line with an improving outlook for global output growth and world trade, it is now expected that growth in output and imports will be stronger in 2017 than was projected in February. Trading partners' GDP growth is forecast at 1.9%, which is 0.2 percentage points more than was in February. The main factors in the improvement are the expectation of stronger growth in the UK and the eurozone, as growth in the US is projected to remain broadly as was forecast in February. Trading partners' import growth is expected to be about ½ a percentage point stronger this year than was forecast in February, averaging 3.8%. The upward revision is due in part to base effects from increased import growth in H2/2016 and to signs that trading partners' GDP growth will be more investment-driven than previously anticipated. For these reasons, growth in imports is expected to exceed GDP growth in trading partner countries during the forecast horizon.

... and inflation has risen more than previously projected

Inflation in advanced economies has picked up in recent months, alongside growing economic activity and rising energy and commodity prices (Chart II-6). Developments in inflation in the UK and commodity-exporting countries have also been affected by exchange rate movements. Inflation is above target in the UK and the US but eurozone inflation remains below the European Central Bank's (ECB) target. Underlying inflation is still low in most economies, however. In all of Iceland's trading partners except Norway and Brazil, inflation is expected to rise year-on-year in 2017, averaging 2%, some 0.2 percentage points above the February forecast.

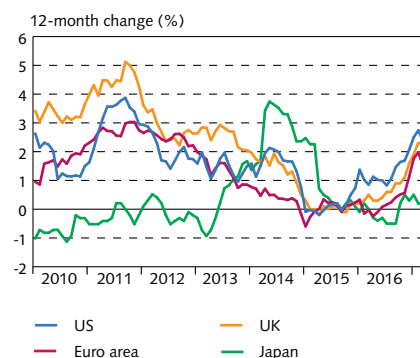
Difference in monetary stance widens in advanced economies

Share prices have risen in advanced economies as economic indicators have exceeded expectations and optimism about the economic outlook has increased. Asset price volatility has also diminished in the recent past (Chart II-7).

The US Federal Reserve Bank raised interest rates by 0.25 percentage points in March, to 0.75-1%, but the monetary stance in other advanced economies remains unchanged. With a wider interest rate spread, the US dollar and other commodity-exporting countries' currencies have appreciated, while the euro and the Japanese yen have weakened. The pound sterling is 10% weaker in trade-weighted terms than it was prior to the Brexit referendum last summer. The spread between long-term interest rates in the US and the UK has also grown wider and is now at its largest since 1980. The spread between US and German long-term rates has widened as well, after investors began shifting to German bonds in response to political uncertainty during the run-up to elections in France, Italy, and Spain (Chart II-8).

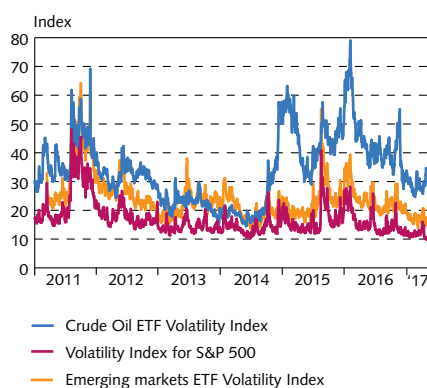
Interest rates in advanced economies are expected to continue diverging. Forward interest rates indicate that investors now expect a more rapid tightening phase in the US than they did in February (Chart II-9). Markets expect that there will be two more rate hikes this year, bringing interest rates to 1.25-1.5% by the year-end. At the

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



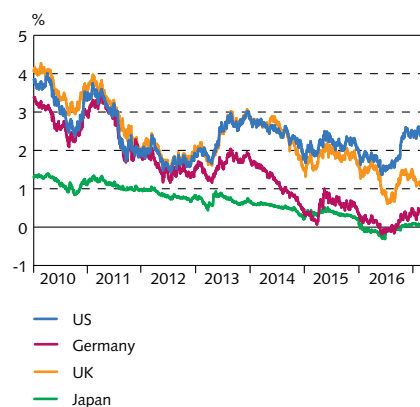
Source: Macrobond.

Chart II-7
Global market volatility¹
Daily data 3 January 2011 - 12 May 2017



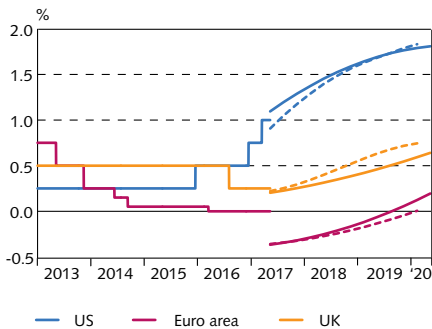
1. The VIX volatility indices indicate the implied volatility of financial products.
Source: Federal Reserve Bank of St. Louis Federal Reserve Economic Data (FRED) database.

Chart II-8
10-year government bond yields in selected industrialised countries
1 January 2010 - 12 May 2017



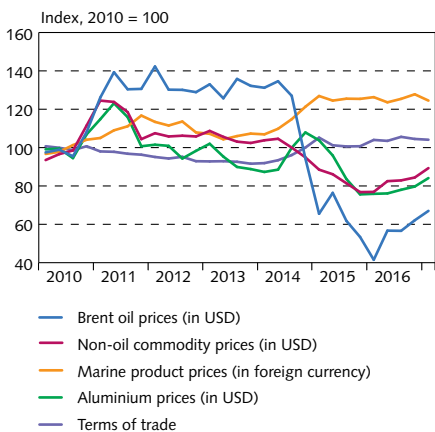
Source: Macrobond.

Chart II-9
Policy rates in selected industrialised economies¹
January 2013 - June 2020



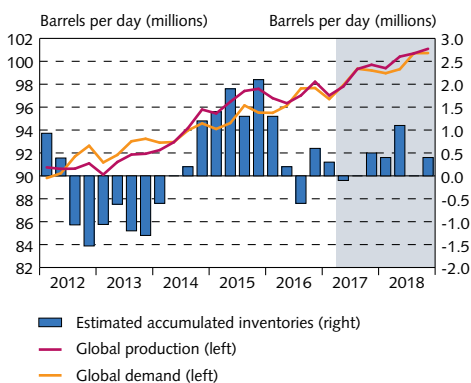
1. Daily data 1 January 2013 through 12 May 2017, and quarterly data Q2/2017 through Q2/2020. US interest rates are the upper bound of the US Federal Reserve bank's interest rate corridor, and rates for the euro area are the European Central Bank's key rate. Forward rates are based on six-month overnight index swaps (OIS) and the Euro Overnight Index Average (EONIA) for the euro area. Solid lines show forward curves from 12 May 2017 onwards and the broken lines from 3 February 2017 onwards. Sources: Bloomberg, Macrobond.

Chart II-10
World price development and terms of trade¹
Q1/2010 - Q1/2017



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 Q1/2017 are based on *Monetary Bulletin* baseline forecast 2017/2. Sources: IMF, Statistics Iceland, Central Bank of Iceland.

Chart II-11
Liquid fuels – supply and demand¹
Q1/2012-Q4/2018



1. Liquid fuels. Forecast for Q2/2017-Q4/2018. Estimated accumulated inventories are the difference between global supply and global demand. Source: U.S. Energy Information Administration.

same time, an accommodative monetary stance is expected in Japan, the UK, Sweden, and the eurozone. Higher interest rates in the US could have an adverse impact on the GDP growth outlook for emerging market economies, many of which are vulnerable to rising cost of capital and US dollar exchange rates because of widespread dollar-denominated corporate debt.

Export prices and terms of trade

Foreign currency price of exports set to continue rising

Foreign currency prices of marine exports were unchanged in 2016, after rising by more than 18% in the two preceding years combined (Chart II-10). Key market agents project that prices will rise marginally this year, particularly due to a positive outlook for demersal prices, although price developments for frozen pelagics, fishmeal, and fish oil are highly uncertain. As in February, the forecast assumes a slight additional price increase as the forecast horizon progresses.

Global aluminium prices have risen somewhat over the past five quarters, and the average price in Q1/2017 was 20% higher year-on-year, a much larger increase than was projected in February (Chart II-10). Aluminium inventories in the global market are still relatively strong, although they have shrunk rapidly in the past two years. Futures prices and analysts' assessments indicate that prices will continue to rise, as demand is projected to grow in tandem with increased global output growth. Another expected factor is reduced production in China due to the government's decision to cut back on production in a bid to reduce pollution, as China's aluminium manufacturing is among the most carbon-intensive in the world. Prices are expected to rise to about 2,000 US dollars per tonne by the end of the forecast horizon.

Petrol prices expected to rise less than was forecast in February

The price held stable at 55 US dollars per barrel from the beginning of December to early March when it fell to 50 dollars. It recovered to 55 dollars in late March before falling again to 50 dollars prior to the publication of this *Monetary Bulletin*. Even though the price is nearly double that at the mid-January 2016 trough, it is still about 55% below the level before the plunge began in late 2014 (Chart II-10). At the same time, the mismatch between supply and demand for petrol has diminished (Chart II-11). The year-on-year rise in oil prices is projected at 22%, somewhat less than was forecast in February. Both oil futures and market analysts' forecasts suggest that prices will remain relatively flat for the remainder of the forecast horizon.

Non-oil commodity prices have risen considerably

Non-oil commodities have risen in price since mid-2016, although prices are still much lower than they were before the downturn started in mid-2014 (Chart II-10). In Q1/2017, commodity prices were up 16% year-on-year, more than had been expected in February. The increase has been driven largely by rising metals prices, although food prices are up as well. Commodity prices as a whole are expected to remain relatively stable through the year-end. Non-oil commodities are

projected to rise in price by 8.7% this year, some 6 percentage points more than was forecast in the last *Monetary Bulletin*.

Terms of trade have improved substantially in the last two years, with further improvement expected in 2017

Iceland's terms of trade have improved virtually without interruption since Q2/2014 and have developed much more favourable than those in other advanced economies, particularly other commodity exporters (see Box 1 in *Monetary Bulletin* 2016/2). According to preliminary figures from Statistics Iceland, terms of trade improved by 3.8% year-on-year in Q4/2016 (Chart II-10) and have improved by some 14% since mid-2014. However, in spite of this marked improvement, they were still nearly 11% below the pre-crisis peak. Indicators imply that they have improved even further year-to-date. They are expected to improve by nearly 1% in 2017 as a whole and then remain more or less flat for the following two years.

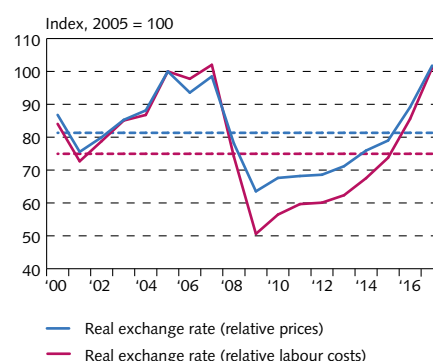
Steep rise in the real exchange rate since 2009 ...

The real exchange rate in terms of relative consumer prices has risen sharply from the autumn 2009 trough and is now only 6.5% below its 2005 peak. The increase has continued so far in 2017, with the real exchange rate about a fifth above its twenty-five year average in Q1 (Chart II-12). The rise is due for the most part to the nominal appreciation of the króna, although higher inflation in Iceland than in trading partner countries has also contributed. Iceland's external position has improved markedly in recent years, with better terms of trade and strong export growth. Unlike the pre-crisis situation, the recent rise in the real exchange rate is considered to reflect to a large degree the adjustment of the economy to a higher equilibrium real exchange rate.¹

... with an erosion of Iceland's competitive position

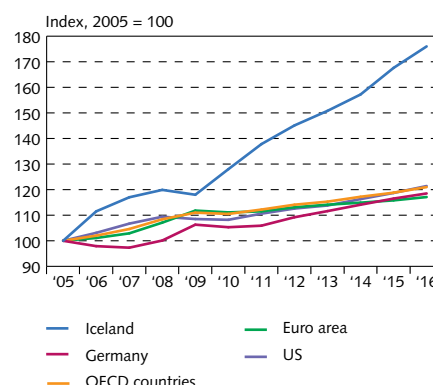
If the forecast in this *Monetary Bulletin* materialises, the real exchange rate in terms of relative consumer prices will be nearly 13% higher this year than in 2015. In terms of relative unit labour costs, it is expected to rise even further, or by just over 16%. Firms' wage costs have risen much more in Iceland than in trading partner countries in recent years, which – all else being equal – erodes the competitive position of companies in the tradable sector (Chart II-13). As is discussed in Chapter I, it is assumed that the króna will appreciate further through 2018 and thus that the real exchange rate will continue to rise.

Chart II-12
Real exchange rate 2000-2017¹



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

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



Sources: Macrobond, Central Bank of Iceland.

1. For further information on the Central Bank's assessment of the equilibrium real exchange rate, see Box 3 in *Monetary Bulletin* 2016/2 and Appendix 1 in *Monetary Bulletin* 2007/3.