

The global economy and terms of trade



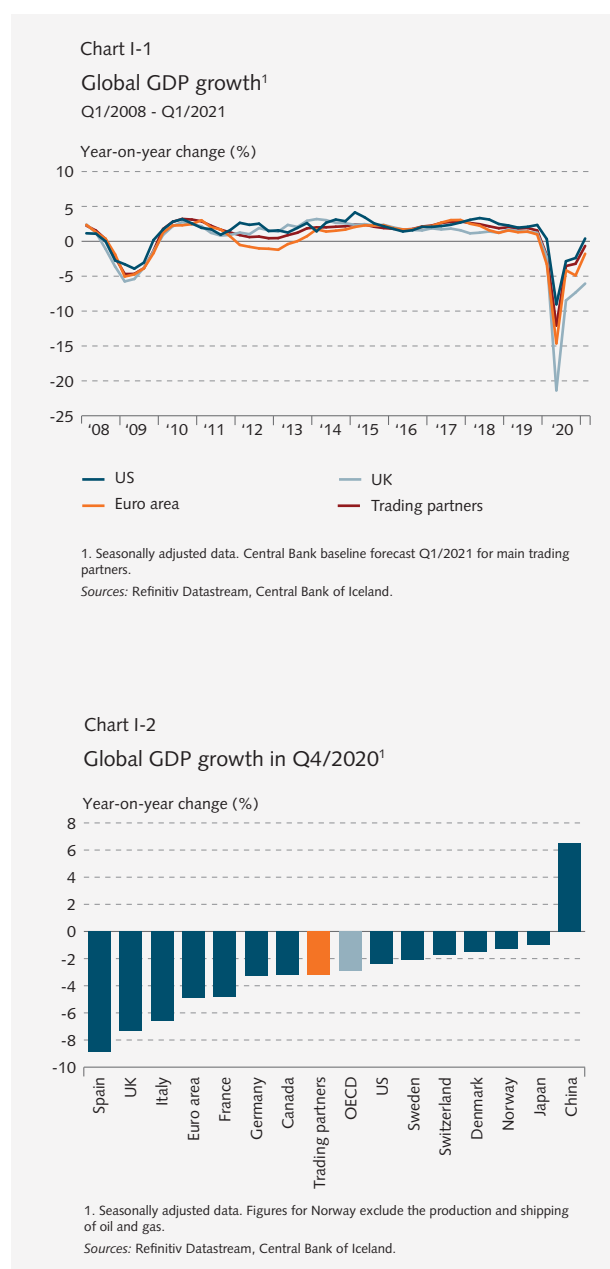
The global economy

Global GDP growth gave way in Q4/2020, following the resurgence of the pandemic ...

Global economic activity picked up strongly when the first wave of the COVID-19 pandemic subsided in summer 2020, putting an end to the record contraction in H1 (Chart I-1). But it slowed again as the year advanced, with a new wave of the pandemic bringing much more rapid spread of the disease than the first one did (Chart 1 in Appendix 1). Authorities in a number of countries re-tightened public health measures in an attempt to contain the spread of the disease and reduce strain on healthcare systems. Many of them took steps similar to those taken in the first wave, including closing schools and retail stores, placing stringent restrictions on public gatherings and, in some instances, imposing curfews. GDP growth among Iceland's main trading partners fell as a result, from 10.2% quarter-on-quarter in Q3 to 0.5% in Q4. Economic activity suffered most in the euro area, which recorded a contraction of 0.7% between quarters. In Q4, Iceland's trading partners recorded an average contraction of 3.2% year-on-year (Chart I-2). The contraction for 2020 as a whole measured 5.2%, a post-war record (for further discussion of the magnitude and composition of the 2020 contraction, see Box 2).

... but economic activity in Q4 proved stronger than expected

Although most advanced economies experienced a slowdown in economic activity in Q4, they proved to be generally more resilient than had been assumed in the Bank's February forecast. This was particularly true of the eurozone and the UK, where the strictest public health



measures were imposed, suggesting that the public health measures were less of a drag on GDP growth than the corresponding measures from spring 2020 were. In part, this is because the measures were more targeted the second time around and less directed at manufacturing. Furthermore, with increased e-commerce and more effective telework, households and businesses are better able to keep economic activity up and running under such conditions. In addition, the sectors affected most by closures and related restrictions were already deeply affected, especially tourism and contact-intensive services. As a consequence, the tighter measures in the autumn and winter had a smaller proportional impact on those sectors than they did at the beginning of the pandemic.

In many advanced economies, economic activity lost further ground in early 2021 ...

The continued rapid spread of the disease and tight public health restrictions in the early months of 2021 have constrained the economic recovery in major advanced economies. Retail sales slid still further in the eurozone and the UK in Q1, and production indices suggested that a contraction in GDP was imminent because of reduced activity in services sectors (Charts I-3 and I-4). Manufacturing largely held its ground, however, as it was less affected by the public health measures. Changed consumption patterns and pent-up demand in the wake of the pandemic were also important factors. Demand for many goods, including electronic equipment and consumer durables, has increased. This can be seen in an abrupt turnaround in global goods trade, which was nearly 4% stronger in February 2021 than before the pandemic struck (Chart I-5). A shortage of intermediate goods – the result of disruptions in production and cross-border goods transport – has put a damper on manufacturing output, however, and somewhat lengthened delivery times (for further discussion, see below and in Chapter V). Particularly noticeable is the shortage of semiconductors, which are important for the manufacture of all sorts of electronic equipment and computerised goods.

Leading indicators for the US suggested, however, that GDP growth was starting to pick up there in Q1 despite extraordinarily cold weather in February, which temporarily cut into domestic demand and interrupted business operations. Production indices imply that activity in both services and manufacturing has been on the rise in the US. In part, the more rapid economic recovery in the US reflects less restrictive public health measures, which some states have relaxed even further.

Chart I-3
Industrial production and retail sales¹
January 2019 - April 2021

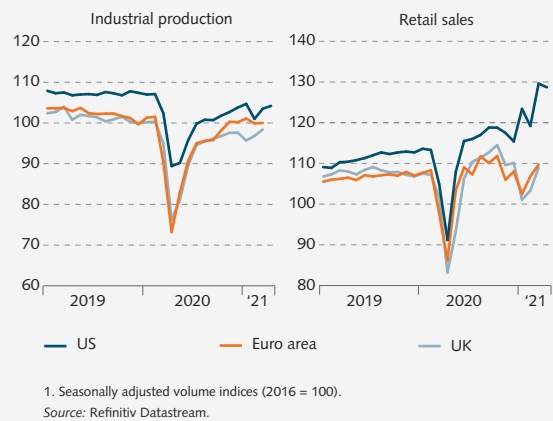


Chart I-4
Composite PMI¹
January 2016 - April 2021

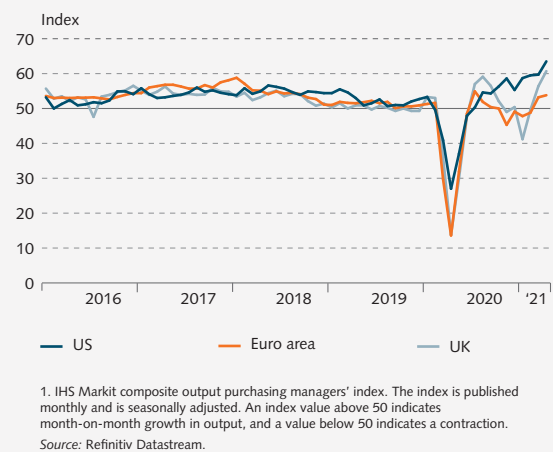
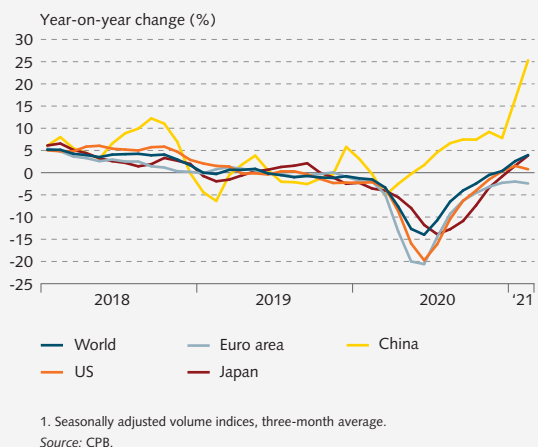


Chart I-5
Global trade in goods¹
January 2018 - February 2021



The fiscal stimulus measures approved in December 2020 and March 2021, which included one-time payments to households and an expansion of unemployment benefits, also played a major role in supporting domestic demand at the beginning of the year, even though most of the measures have yet to be implemented (for further discussion, see below). This can be seen in a surge in retail sales in Q1.

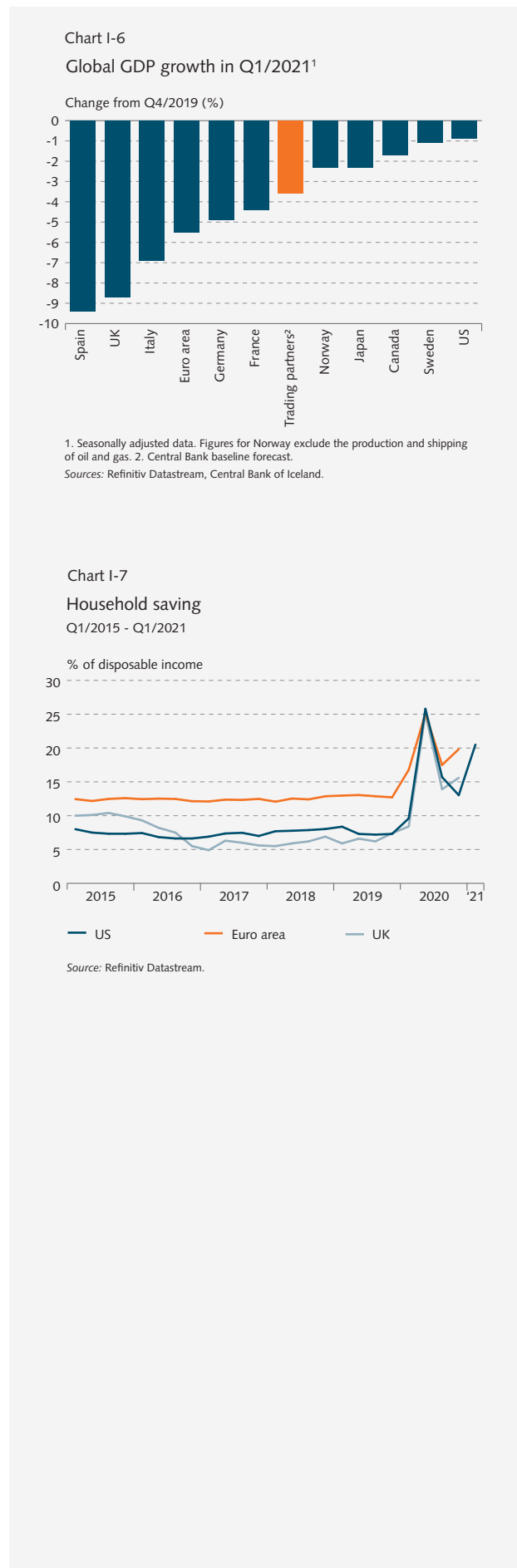
... and trading partner GDP is estimated to have contracted again in Q1 ...

According to newly published preliminary figures, GDP in the US grew by 1.6% quarter-on-quarter in Q1/2021. GDP was therefore 0.4% more than in Q1/2020 but nearly 1% less than before the pandemic (Chart I-6). GDP also grew between quarters in Sweden and China, but in most other trading partner countries it contracted again. On average, trading partner GDP is estimated to have contracted by 0.3% quarter-on-quarter in Q1, when it was just under 1% less than in Q1/2020 and 3.6% less than before the pandemic.

... but leading indicators suggest that a recovery is on the horizon

Even though the number of new COVID cases was still high at the beginning of Q2, there are signs that global economic activity is starting to recover. This is particularly the case for the US and the UK, where the vaccination roll-out has proceeded more quickly than in most other developed countries and more steps have been taken towards lifting restrictions on business operations and individuals' freedom to travel. Purchasing managers' indices (PMI) for March and April indicate a swift economic recovery once public health measures are relaxed, especially in services sectors, as there is considerable pent-up demand and households have accumulated significant savings (Chart I-7). Traffic data suggest that people are moving about more than before, and seeking out retail stores and recreational activities in greater measure (Chart 1 in Appendix 1). Even though the labour market situation has remained broadly unchanged in many major advanced economies in the recent past, the recovery has continued in the US, and the number of new applications for unemployment benefits is at its lowest since early 2020. Nevertheless, a full recovery of the labour market is still relatively far off.

Overall, the global GDP growth outlook for 2021 has improved, and it appears that economic activity will rebound quickly this summer, once vaccinations are well in hand and public health measures are relaxed



again. Iceland's main trading partner countries (excluding China) have already vaccinated about 35% of the population, and it is still assumed that a majority will have been fully vaccinated by around mid-year (see Box 1). Additional government support measures in major advanced economies play an important role in the improved GDP growth outlook, particularly in the US, where stimulus measures amounting to 1.9 trillion US dollars were approved in March, in addition to the 900 billion dollar package approved in December (amounting to a combined 13½% of GDP). Further fiscal stimulus measures are in preparation in the US. The outlook for the world's largest economies has therefore improved significantly, and this will stimulate economic activity worldwide.

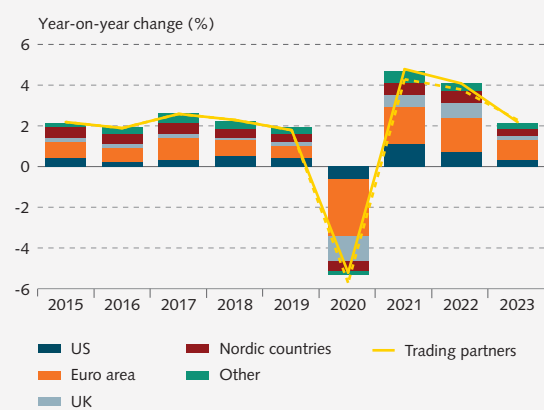
Global GDP growth set to rise this year ...

According to the International Monetary Fund's (IMF) most recent forecast, global output growth will measure 6% this year. This is 0.5 percentage points above the Fund's January forecast and 0.8 points above its October forecast. Furthermore, global GDP growth is forecast at 4.4% in 2022, or 0.2 percentage points above the IMF's most recent forecasts. World trade is also expected to recover strongly. The improved outlook reflects in particular the increased fiscal stimulus provided by several large economies and the expectation of a vaccine-driven recovery in H2/2021.

... and the GDP growth outlook for Iceland's trading partners has improved

According to the Bank's baseline forecast, GDP growth among Iceland's main trading partners is projected at 4.8%, some 0.5 percentage points above the February forecast (Chart I-8). Prospects have improved for most of them, but especially for the US, the UK, Sweden, and Canada. GDP growth is also expected to be stronger in 2022, while the outlook for 2023 is broadly unchanged. The outlook for trading partner imports has also improved, in line with the brighter GDP growth outlook. Imports by trading partner countries are expected to grow by an average of 9.1% this year and 6.1% in 2022. The outlook remains highly uncertain, however, not least because it is unclear how successful efforts to control the pandemic will prove to be, given the proliferation of new variants of the virus and uncertainty about vaccination rates. Moreover, the economic recovery will also be determined in large part by how households use the savings they have accumulated in the wake of the pandemic (for further discussion, see the analysis of key uncertainties in Box 1).

Chart I-8
GDP growth in Iceland's trading partners and contribution from selected countries 2015-2023¹



1. Trade-weighted contribution from selected countries. Central Bank baseline forecast 2021-2023. Broken line shows forecast from MB 2021/1. The Nordic countries is the average for Denmark, Norway, and Sweden.
Sources: Refinitiv Datastream, Central Bank of Iceland.

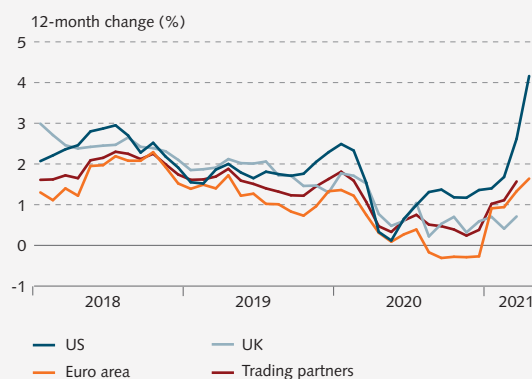
Global inflation has risen, but the inflation outlook for the next two years is broadly unchanged

Global inflation was low in 2020, concurrent with a steep drop in energy prices and a pandemic-induced contraction in demand. In Q4/2020, twelve-month inflation among Iceland's main trading partners averaged only 0.3%, over 1 percentage point lower than in Q1 of the same year (Chart I-9). This trend reversed abruptly in early 2021, however, and inflation rose in nearly all trading partner countries, particularly in the eurozone, Sweden, and Norway. This is due in part to the recent spike in energy and commodity prices, which had fallen sharply in spring 2020. The uptick in inflation early in 2021 is affected to a large degree by adverse base effects, temporary factors, and one-off measures. These include the hike in Germany's value-added tax, which was lowered temporarily in H2/2020, changes in the weight of consumption items in price indices, and pandemic-related shifts in the timing of winter sales. The rise in oil and other commodity prices, together with base effects from the steep drop in prices last year and the impact of less restrictive public health measures, pushed inflation even higher in March and April. Inflation has risen most in the US, to its highest since 2008. On the other hand, underlying inflation, which excludes energy prices and other volatile items, has risen less strongly. Inflation in these countries is expected to average about 2% for the remainder of the year and 1.8% in 2021 as a whole. This is 0.5 percentage points more than was assumed in the February forecast. Inflation is expected to taper off again at the beginning of 2022, however, when the effects of the above-mentioned temporary factors diminish. The inflation outlook for 2022 and 2023 is therefore broadly in line with the Bank's February forecast.

Central banks have held a steady course despite a brighter growth outlook and higher inflation ...

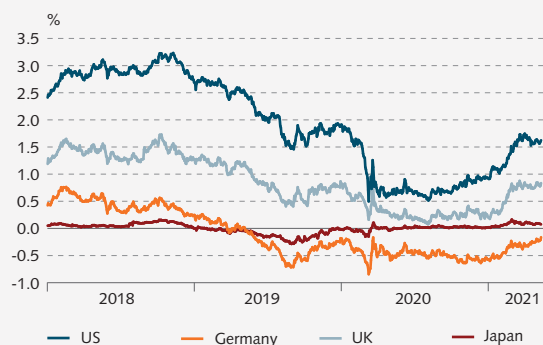
In addition to the vast increase in government stimulus measures, leading central banks have continued to support the economic recovery with low interest rates and other stimulative measures. Even though the growth outlook has improved and inflationary pressures have grown, most central banks have held to their chosen path and announced plans to keep interest rates unchanged until there are clear indications that the recovery has taken hold and inflation will remain at target in the long run. The European Central Bank (ECB) has also expedited its bond purchases in order to lean even more strongly against a rise in long-term rates. Among central banks in major advanced economies,

Chart I-9
Global inflation
January 2018 - April 2021



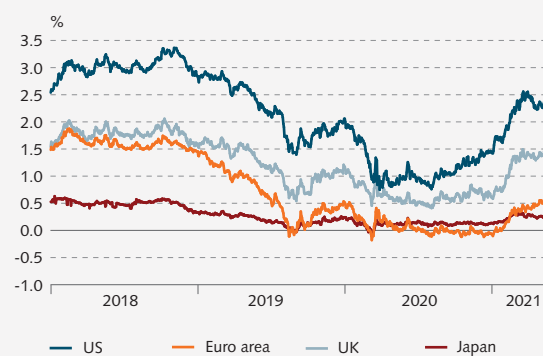
Sources: Refinitiv Datastream, Central Bank of Iceland.

Chart I-10
10-year government bond yields
1 January 2018 - 14 May 2021



Source: Refinitiv Datastream.

Chart I-11
Breakeven inflation rates¹
1 January 2018 - 14 May 2021



1. Five-year, five-year forward breakeven inflation rate.
Source: Refinitiv Datastream.

Norges Bank alone has signalled a rate hike in H2/2021, although the Bank of Canada announced in April that it would scale down its weekly bond purchases.

... but long-term rates have risen worldwide

Long-term interest rates in developed countries rose swiftly in Q1 and in many places were roughly back to pre-pandemic levels (Chart I-10). The increase reflects greater optimism about the global economic outlook as vaccination efforts proceed and government stimulus measures are enacted, particularly in the US, where the spread between long and short rates is at its widest in four years. Market agents' inflation expectations appear to have risen as a result, and market participants now expect central bank rates to rise faster than before (Charts I-11 and I-12). However, the rise in long-term bond rates probably stems in large part from an increase in the term premium, reflecting investors' demand for higher returns to compensate for a longer commitment period due to the associated uncertainty about future developments in inflation and short-term interest rates. Expectations of continued increases in the supply of government bonds issued for fiscal stimulus measures play an important role in this, although central banks' bond purchases pull in the opposite direction.

Financial conditions have improved overall

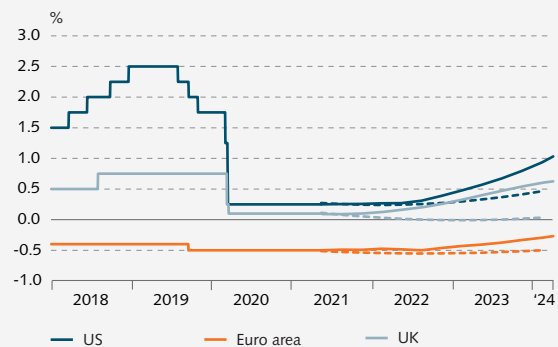
Greater optimism about the growth outlook has been reflected in share prices in advanced economies, which are widely above pre-pandemic prices (Chart I-13). Furthermore, share price volatility has continued to decline. In addition, risk premia on riskier financial assets have fallen even further, and capital flows to emerging market economies have continued. Therefore, notwithstanding the rise in long-term bond rates, financial conditions have held their ground, and on the whole, they are broadly as they were before the pandemic.

Export prices and terms of trade

Brighter outlook for marine product prices ...

The price of Icelandic marine products cratered in 2020, as market conditions have been difficult because of the pandemic, particularly in the hotel and restaurant sector (Chart I-14). As a result, prices fell in most product categories during the year, and in Q1/2021, prices were down by an average of 9% year-on-year in foreign currency terms. There are signs that the markets for important demersal products will be in balance in Q2, and that product prices will start rising again later this year. In addition, capelin product prices have developed very

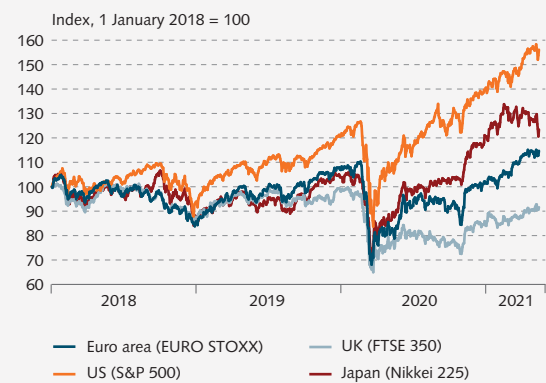
Chart I-12
Central bank policy rates¹
January 2018 - June 2024



1. Daily data 1 January 2018 through 14 May 2021, and quarterly data Q2/2021 through Q2/2024. 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 in mid-May 2021, and broken lines in end-January 2021.

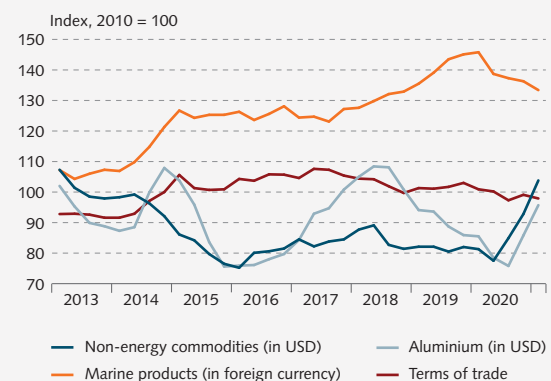
Sources: Bloomberg, Refinitiv Datastream.

Chart I-13
Global share prices
1 January 2018 - 14 May 2021



Source: Refinitiv Datastream.

Chart I-14
Commodity prices and terms of trade¹
Q1/2013 - Q1/2021



1. Central Bank baseline forecast Q1/2021 for terms of trade.

Sources: Statistics Iceland, World Bank, Central Bank of Iceland.

favourably, and indicators imply that the price of other pelagics will rise as the year progresses. Foreign currency prices of marine product exports are expected to remain unchanged year-on-year in 2021, instead of falling by 2%, as was forecast in February. The outlook for the next two years is broadly unchanged, however.

... and aluminium prices are set to move higher

Global aluminium prices have recovered from the plunge in early 2020 (Chart I-14). Demand has grown concurrent with increased economic activity and the need to restore inventory levels. Prices have risen by nearly 60% since May 2020, the biggest price increase in a decade. The average price of aluminium is expected to be 27% higher this year than in 2020, and not 9% higher, as was forecast in February. Prices are also set to rise more strongly in 2022.

Oil prices have reached pre-pandemic levels ...

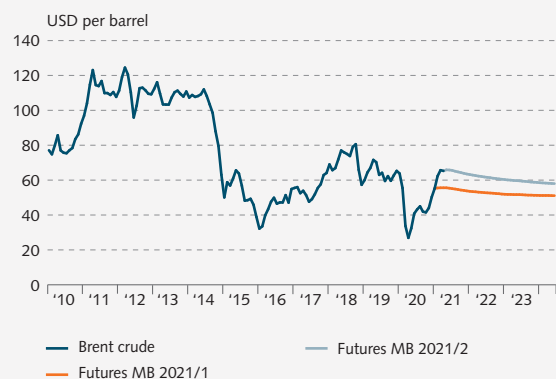
Global crude oil prices have risen virtually without interruption after plunging in March and April 2020 (Chart I-15). The pace of the increase has been particularly quick since November, following positive news reports about the development of vaccines, and prices are now roughly at pre-pandemic levels. This is the sharpest turnaround in oil prices ever measured. The recent increase reflects expectations that demand for oil will recover more rapidly, in light of increased optimism about the economic outlook. Continued production cuts by OPEC countries and other oil producers have also supported prices. On the other hand, prices dipped slightly in April, in response to growing concerns about the upsurge of the pandemic in many countries and oil-producing countries' announcements of a gradual increase in production in coming months.

Brent crude was selling at an average of 65 US dollars per barrel in April, about one-fourth higher than at the turn of the year. Oil futures prices suggest, however, that prices will decline during the forecast horizon, yet remain above the February forecast over the entire period.

... and other commodity prices are at their highest in nearly a decade

Non-energy commodity prices have also risen virtually unabated since spring 2020 and are at their highest in eight years (Chart I-14). The price of nearly all commodity types is now higher than before the pandemic, with metals and food prices rising the most. The main driver of the increase is an abrupt jump in demand concurrent with growing economic activity, particularly in China.

Chart I-15
Global oil prices
January 2010 - June 2024



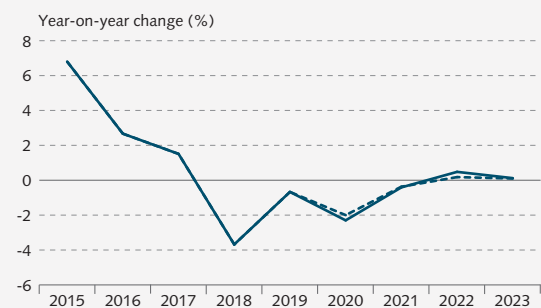
Sources: Refinitiv, Central Bank of Iceland.

Supply-side difficulties have also made their mark, impeding the production of many commodities, especially copper and miscellaneous foodstuffs. This is exacerbated by the enormous increase in shipping costs due to the shortage of shipping containers and the blockage of the Suez Canal (for further discussion, see Chapter V). The outlook for 2021 has deteriorated markedly as a result, and commodity prices are projected to be nearly 19% higher this year than in 2020, whereas in February, the Bank had forecast an increase of just under 3%. On the other hand, prices are expected to fall by just over 3% in 2022.

Continued deterioration in terms of trade

Terms of trade for goods and services deteriorated by 2.3% in 2020, mainly because of rising imported goods prices, although higher imported services prices played a part as well. They worsened more than was assumed in the Bank's February forecast, which provided for a deterioration of 2% year-on-year (Chart I-16). The deviation is due primarily to the larger increase in import prices in Q4. It appears that terms of trade worsened still further in Q1/2021, and they are expected to deteriorate by 0.4% in 2021 as a whole, as was forecast in February. The price of oil and other commodities is projected to increase considerably more this year than was assumed in February, and the rise in general import prices is expected to be greater. On the other hand, the outlook for aluminium and marine product prices is more favourable.

Chart I-16
Terms of trade for goods and services 2015-2023¹



1. Central Bank baseline forecast 2021-2023. Broken line shows forecast from MB 2021/1.
Sources: Statistics Iceland, Central Bank of Iceland.