

# The global economy and terms of trade



## The global economy

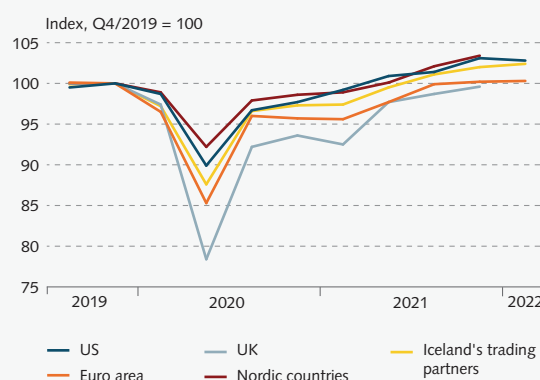
### Strong economic recovery in 2021, although GDP growth slowed as the year drew to a close

The global economic recovery picked up strongly in 2021, as COVID-19 vaccination programmes moved forwards and public health measures were eased (Chart I-1). GDP growth started to lose pace in major advanced economies as the year progressed, however, owing in part to the mounting problems related to pandemic-generated supply-chain disruptions coupled with strong demand for goods. Persistent shortages of important inputs developed, shipping was delayed, and hiring workers became ever more difficult. A setback in the fight against the pandemic and the re-tightening of public health measures also impeded growth in economic activity towards the end of the year. Added to this were the adverse effects of the steep rise in energy prices from autumn onwards. Among Iceland's key trading partners, GDP growth measured 5.6% in 2021, after a 5% contraction in 2020. In nearly all of Iceland's trading partner countries, output had overtaken the pre-pandemic level by the end of 2021.

### Last year's recovery was driven by a rebound in domestic demand

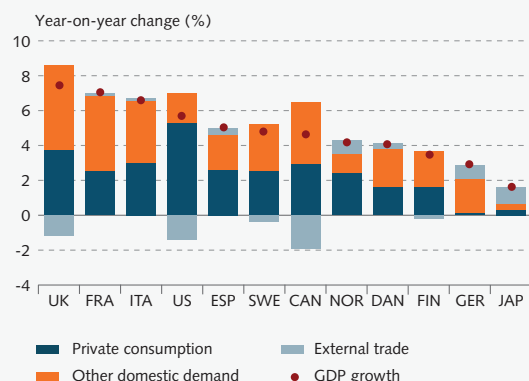
A large share of the 2021 recovery is due to a turnaround in private consumption, which had contracted sharply in 2020 because of the pandemic (Chart I-2). Other domestic spending also grew strongly in major advanced economies. Exports grew as well, albeit offset by a surge in imports concurrent with the recovery of domestic demand. The contribution of net trade to output growth was therefore small or negative.

Chart I-1  
GDP in the wake of the pandemic<sup>1</sup>  
Q3/2019 - Q1/2022



1. Seasonally adjusted data. "Nordic countries" is the average for Denmark, Norway, and Sweden. Central Bank baseline forecast Q1/2022 for main trading partners.  
Sources: Refinitiv Datastream, Central Bank of Iceland.

Chart I-2  
Size and composition of 2021 economic recovery<sup>1</sup>



1. The contribution from other domestic demand is the sum of the contributions from public consumption, gross capital formation, and inventory changes, plus possible errors and omissions, as the sum of components may not equal GDP growth because of chain-volume linking in the national accounts. Figures for Norway exclude the production and shipping of oil and gas.  
Sources: Norges Bank, OECD, Statistics Iceland.

### Public health measures have widely been eased, and the economic impact of the pandemic has receded

The spike in infection rates and the associated tightening of public health measures following the spread of the Omicron variant of COVID-19 slowed global GDP growth even further in early 2022. Economic activity started to pick up quickly, however, once it was clear that Omicron caused less severe illness than previous variants. The authorities in trading partner countries therefore began to ease their public health restrictions once again despite high infection rates, and by now many countries have relaxed them substantially or lifted them in full. PMI indices in major advanced economies rose thereafter, particularly in the services sector, and retail sales increased once again (Charts I-3 and I-4). Unemployment continued to fall as well, in line with brisker economic activity, and there are signs of increased tension in the labour market. Although strain on global supply chains remains significant, there were also signs that bottlenecks were easing after having peaked in late 2021 (see also Box 1). This is reflected in surveys among corporate executives to the effect that commodity shortages had subsided somewhat and delivery times had grown shorter, and industrial manufacturing had also increased (Chart I-4). The past two months' surge in infection rates in China and the aggressive response from the Chinese authorities may well have caused a setback in the resolution of supply-chain problems, however.

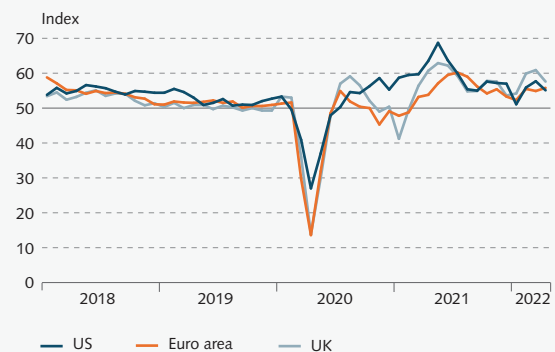
### Uncertainty about the global economic outlook has escalated in the wake of the war in Ukraine ...

The global economic outlook has deteriorated sharply and uncertainty has increased with Russia's invasion of Ukraine in late February and the economic sanctions imposed on Russia by Western countries. Even though Ukraine and Russia are not dominant players in the global economy, world trade, or the global financial system, they are important producers of a wide range of commodities (see below and Box 2). The war and the sanctions have created uncertainty about commodity supplies and caused commodity prices to soar. The war has also put additional pressure on supply chains and disrupted transport by sea and air, in part because of the closure of Russian airspace. Sea-based transport via the Black Sea has already been disrupted, and the cost of shipping commodities has risen. The war will therefore have broad-based impact on the global economy.

### ... and the global GDP growth outlook has deteriorated

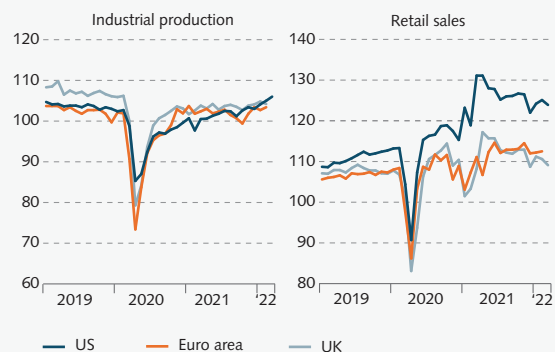
As is discussed in Box 2, the adverse impact of the invasion on the global economy will probably surface primarily in

Chart I-3  
Composite PMI<sup>1</sup>  
January 2018 - April 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.

Chart I-4  
Industrial production and retail sales<sup>1</sup>  
January 2019 - March 2022



1. Seasonally adjusted volume indices (2016 = 100).  
Source: Refinitiv Datastream.

the form of surging commodity prices. Higher commodity prices will lead to higher import prices and will exacerbate inflationary pressures, which were already considerable. Households and businesses will therefore be faced with higher costs, which will dampen domestic demand. The impact will be greatest in the European countries that rely most heavily on energy imports from Russia, natural gas in particular. Higher prices and reduced supplies of energy could also force companies – especially those in energy-intensive industry – to scale back production. In addition, households' expectations about the economic outlook have been eroded, and financial conditions have worsened. Pulling in the opposite direction are the substantial savings that households have accumulated in the past two years. The authorities in many economies have stepped up public investment, including defence spending, and have taken mitigating measures to cushion against the impact of rising energy prices on households' disposable income. For commodity-exporting countries, higher prices for their own exports will also counteract the negative effects of higher import prices on domestic demand.

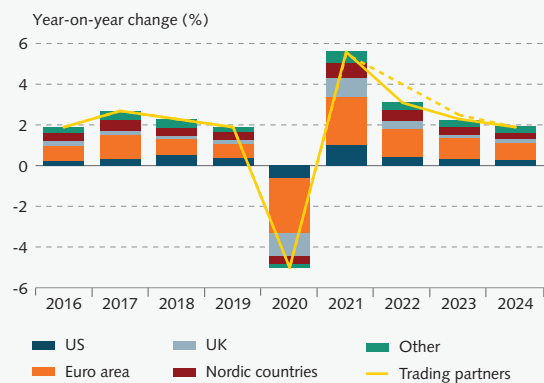
### Global GDP growth set to be weaker in 2022 and 2023 ...

According to the International Monetary Fund's (IMF) mid-April forecast, global GDP growth is projected to measure 3.6% in 2022, or 0.8 percentage points less than in the Fund's January forecast. The downward revision is due largely to the impact of the war in Ukraine and the sanctions against Russia on the global economy. The IMF has lowered its year-2022 GDP growth forecast by 0.6 percentage points for advanced economies and by 1 percentage point for emerging and developing countries. It also projects global GDP growth for 2023 at 3.6%, or 0.2 percentage points below the January forecast. The outlook for world trade has also deteriorated, according to the IMF.

### ... and slower growth is forecast for Iceland's main trading partners

According to the Bank's baseline forecast, GDP growth among Iceland's main trading partners will measure 3.1% this year (Chart I-5). This is 0.9 percentage points below the Bank's February forecast, mainly reflecting the adverse impact of the war. The output growth outlook has worsened in all main trading partner countries, but particularly in the eurozone. The outlook for 2023 has deteriorated as well, and GDP growth is now projected at 2.3%, down from 2.5% in the February forecast. The outlook for trading partner imports has also worsened, in line with the bleaker GDP growth outlook.

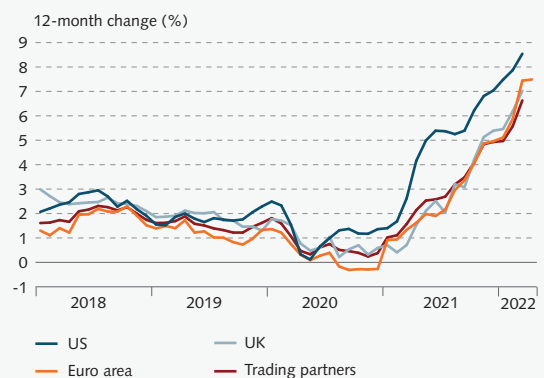
Chart I-5  
GDP growth in Iceland's trading partners and contribution from selected countries 2016-2024<sup>1</sup>



1. Trade-weighted contribution from selected countries. Central Bank baseline forecast 2022-2024. Broken line shows forecast from MB 2022/1. "Nordic countries" is the average for Denmark, Norway, and Sweden.  
Sources: Refinitiv Datastream, Central Bank of Iceland.

Chart I-6  
Global inflation

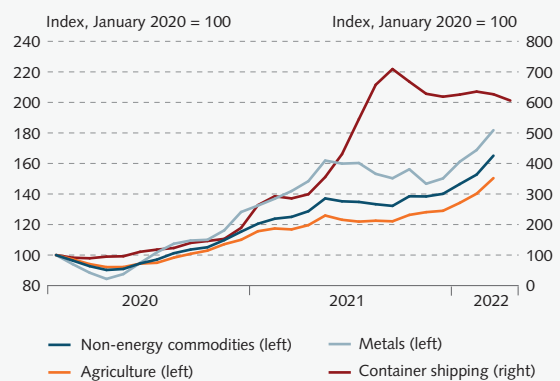
January 2018 - April 2022



Sources: Refinitiv Datastream, Central Bank of Iceland.

Chart I-7  
Global shipping and commodity prices<sup>1</sup>

January 2020 – April 2022



1. Agricultural products are divided into food (62%), beverages (13%), and raw materials (25%). Container shipping based on the Freightos Global Container Index. Based on data through 29 April 2022.  
Sources: Refinitiv Datastream, World Bank.

The economic outlook is still highly uncertain, however. Economic developments will depend in large part on how long the war lasts and whether further sanctions are imposed on Russia. The outlook could grow even bleaker if the war drags on or if energy imports to Europe are severely curtailed. Developments will also be determined to a large extent by the path the pandemic takes and how quickly the persistent supply-chain bottlenecks can be unwound.

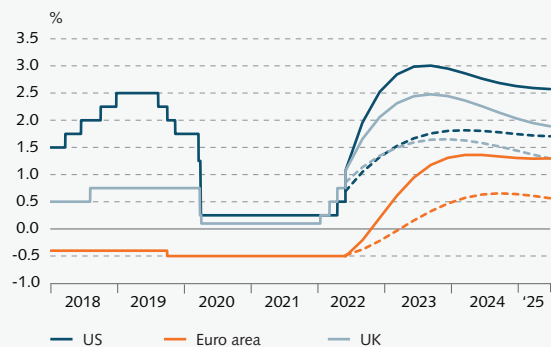
### Inflation among Iceland's trading partners hits a thirty-year high ...

Inflation has soared worldwide and is much higher than was generally forecast. In Q1/2021, it averaged 1.2% among Iceland's main trading partners, but by the same quarter of 2022 it had risen to 5.8% (Chart I-6), or 1.4 percentage points above the Bank's February forecast. It is the highest inflation rate seen in trading partner countries in over three decades. The recent surge in energy prices is a major contributor to the current inflation episode. For instance, higher energy prices account for over one-fourth of headline inflation in the US and about half of inflation in the eurozone. A strong economic recovery and booming demand for goods concurrent with persistent pandemic-related supply-chain disruptions have also pushed consumer prices higher. This can be seen in steeply rising shipping costs and a broad-based increase in commodity prices (Chart I-7). As a result, underlying inflation has risen markedly, especially in the US and the UK. In Q1/2022, for instance, inflation excluding volatile items such as energy and food averaged 3.3% in trading partner countries, up from just over 1% a year earlier.

### ... and the global inflation outlook has deteriorated still further

The global inflation outlook has grown even bleaker since Russia invaded Ukraine, particularly because of additional rises in energy and commodity prices (see Box 2). Furthermore, because of the war and the tightening of public health measures in China, it will probably take longer to resolve the stubborn supply-chain problems that have impeded economic activity and pushed prices upwards in the recent term. Trading partner inflation is projected to average 5.8% in 2022, some 2.3 percentage points above the February forecast. The inflation outlook has deteriorated in particular for eurozone countries that rely heavily on energy imports from Russia. Inflation in trading partner countries is also forecast to be higher in 2023.

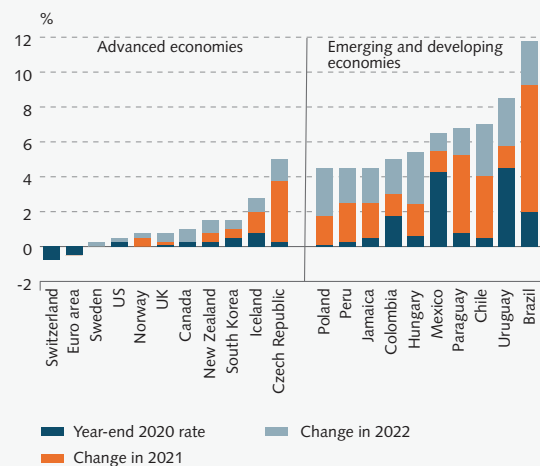
Chart I-8  
Central bank policy rates<sup>1</sup>  
January 2018 - June 2025



1. Daily data 1 January 2018 through 29 April 2022, and quarterly data Q2/2022 through Q2/2025. 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 end-April 2022, and broken lines as of beginning of February 2022.

Sources: Bloomberg, Refinitiv Datastream.

Chart I-9  
Central bank policy rates in selected economies<sup>1</sup>



1. Based on data through 29 April 2022.

Sources: IMF, Refinitiv Datastream.

### Central banks in advanced economies have continued to withdraw support measures ...

Even though the GDP growth outlook has deteriorated and uncertainty has mounted, central banks in major advanced economies have continued to tighten monetary policy. Now they are expected to raise policy rates even more than previously anticipated, owing to a poorer inflation outlook and signs of increased tightening of the labour market (Chart I-8). In early March, the European Central Bank (ECB) announced plans to withdraw its quantitative easing, perhaps discontinuing its bond purchases altogether in Q3/2022. The US Federal Reserve went a step further in mid-March, raising interest rates for the first time since 2018 and signalling plans to raise rates more than it had previously stated. Furthermore, the Fed has halted its bond purchases and is planning to downsize its bond portfolio in coming months. The Bank of England (BoE) also raised interest rates in March, its third rate hike since December. Central banks in several other advanced economies have also continued raising rates, as have those in a number of emerging market economies (Chart I-9).

### ... and long-term interest rates have risen worldwide

Long-term bond yields in advanced economies started rising rapidly in late 2021 and kept climbing in early 2022 (Chart I-10). After a temporary dip following Russia's invasion of Ukraine, yields have risen even further and are now well above the pre-pandemic level. The rise in bond yields reflects expectations that central banks in major advanced economies will tighten policy more quickly in response to the worsening inflation outlook, even though the GDP growth outlook has deteriorated as well. The increase in the breakeven inflation rate in the market also indicates that inflation expectations have risen, mostly over short horizons, although the long-term breakeven rate has risen as well (Chart I-11). The rise in the breakeven rate may also reflect an increase in the term premium on Treasury bonds because of uncertainty about inflation and interest rates, particularly in the next few years. The term premium on ten-year US Treasury bonds is now positive for the first time since late 2018. Term premia on shorter bonds have risen more steeply; for instance, the premium on two-year Treasury bonds is at its highest in nearly twenty years. This is reflected in larger rises in short-term rates than in long-term rates, and the spread between yields on ten-year and two-year Treasury bonds is now close to zero in the US.

### Financial conditions have deteriorated

Asset prices in global financial markets have deteriorated in 2022 to date, and uncertainty has escalated. The

Chart I-10  
10-year government bond yields  
1 January 2018 - 29 April 2022

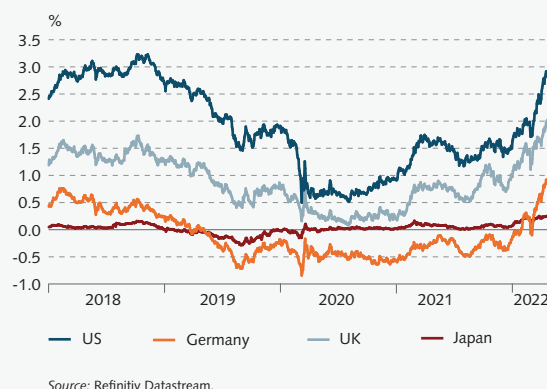


Chart I-11  
Breakeven inflation rates<sup>1</sup>  
1 January 2018 - 29 April 2022

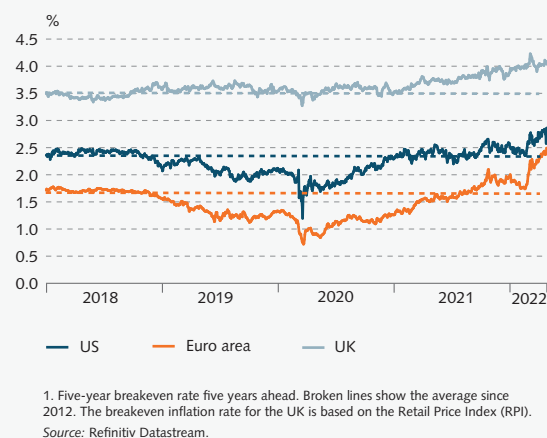
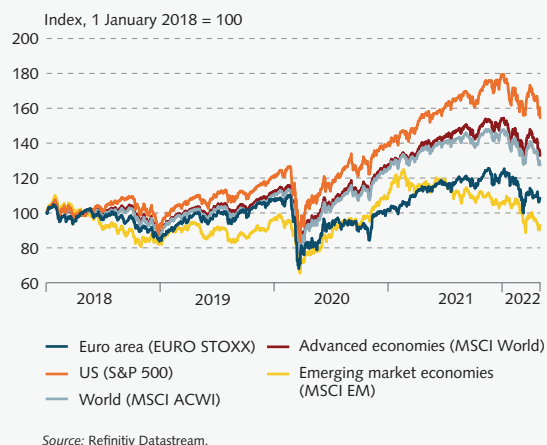


Chart I-12  
Global share prices  
1 January 2018 - 29 April 2022





decline early in the year was due mainly to concerns that major advanced economies' central banks would raise interest rates more rapidly than previously assumed. Share prices fell even further in the wake of the Russian invasion of Ukraine (Chart I-12). Flight to safe assets such as gold and US Treasury bonds increased, and volatility in the financial markets grew more pronounced. Risk premia and interest rate spreads rose as well, particularly on higher-risk assets from emerging market economies. Stock markets in China have also declined sharply in recent months, partly in response to tighter public health measures. Global financial conditions have therefore worsened.

## Export prices and terms of trade

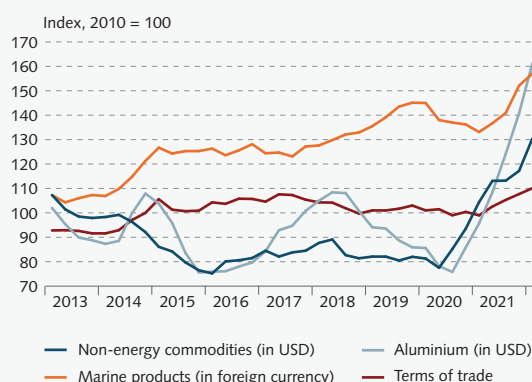
### Outlook for a larger rise in marine product prices ...

Icelandic marine product prices rose swiftly in H2/2021, in line with improvements in market conditions following a steep pandemic-induced drop in 2020 (Chart I-13). Foreign-currency prices were roughly 5% above the pre-pandemic level by the end of the year, in line with the Bank's February forecast. Unexpectedly, though, prices continued to increase in early 2022, and they look set to rise much more this year than was previously forecast. This is due primarily to an improved outlook for demersal product prices, owing both to larger price hikes at the beginning of the year and, no less, to the effects of the sanctions on Russia. Russia is an important exporter of demersal fish, and its restricted market access has boosted demand for Icelandic marine products. Other things being equal, this will push demersal prices even higher during the year. Furthermore, the outlook is for capelin product prices to fall slightly less than previously assumed, as it was not possible to catch the entire quota issued for this season. The baseline forecast assumes that foreign-currency prices of marine product exports will rise by 9% in 2022 instead of 4%, as was projected in February. On the other hand, prices are expected to fall further next year, although they will be somewhat above the February forecast towards the end of the forecast horizon.

### ... and an even greater increase in aluminium prices

US dollar prices of aluminium exports have soared in the recent term, rising by 44% year-on-year in 2021 (Chart I-13). This is due in part to reduced production in China because of the Chinese authorities' environmental policy. Furthermore, energy shortages and rising input prices have led to production cutbacks all over the world. At the same time, demand has been growing as the global economy has recovered. Global aluminium prices rose even more in the wake of the invasion of Ukraine,

Chart I-13  
Commodity prices and terms of trade<sup>1</sup>  
Q1/2013 - Q1/2022



1. Central Bank baseline forecast Q1/2022 for marine product prices and terms of trade.  
Sources: Statistics Iceland, World Bank, Central Bank of Iceland.

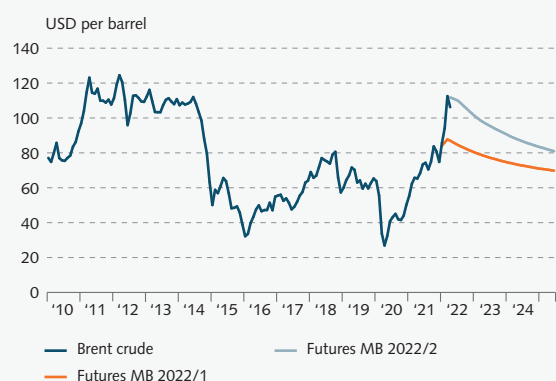
peaking at an all-time high of nearly 3,900 US dollars per tonne in early March. This is due mainly to elevated uncertainty about the impact the war and associated sanctions will have on supply, as Russia accounts for 6% of global aluminium production. Furthermore, there are signs that the surge in energy prices in the wake of the invasion has prompted even more cutbacks in aluminium production, particularly in Europe. Another contributor to high aluminium prices is the steep rise in the price of alumina, which is used in the production process. Aluminium export prices in US dollars are expected to increase by around 37% year-on-year in 2022 instead of the 16% forecast in February. On the other hand, the outlook is for prices to fall more in the coming two years.

### Oil prices have continued to climb ...

Global crude oil prices have risen virtually without interruption in the past two years, after plunging at the onset of the pandemic (Chart I-14). They dipped temporarily in December, owing to concerns about the pandemic and tighter public health measures, but they picked up again in January, rising to an eight-year high. The main drivers of the increase are the improved outlook for demand, declining inventories, and concerns about production by OPEC countries and related oil producers. Prices continued to rise in mid-February, fuelled by growing indications that Russia planned to invade Ukraine, and rose even more once the invasion materialised. Because of the invasion and the sanctions imposed by Western countries, the supply of oil is highly uncertain, as Russia is the world's second-largest oil exporter. This uncertainty is reflected in unusually wide swings in market prices, with Brent crude closing at 130 US dollars per barrel in early March, its highest since 2008. The price of other energy sources surged as well, not least natural gas in Europe, which relies heavily on natural gas imports from Russia.

Oil prices have settled down a bit since March, although they remain far higher than before the war broke out. Increased production in the US and the decision by the US and all of its partner members of the International Energy Agency (IEA) to release an unprecedented supply of strategic oil reserves into the market have mitigated this uncertainty and contributed to lower prices. There is also increased optimism that the US government will ease its sanctions on Iran, which have impeded oil exports from the country in recent years. Growing concerns about the impact of tighter public health measures in China on oil demand have eased prices as well. The price of Brent crude averaged 106 US dollars per barrel in April, some 24% higher

Chart I-14  
Global oil prices  
January 2010 - June 2025



Sources: Refinitiv, Central Bank of Iceland.

than in January 2022 and 63% higher than in April 2021. Although futures prices suggest that oil prices will decline during the forecast horizon, the outlook is for prices to be well above the February forecast over the horizon as a whole.

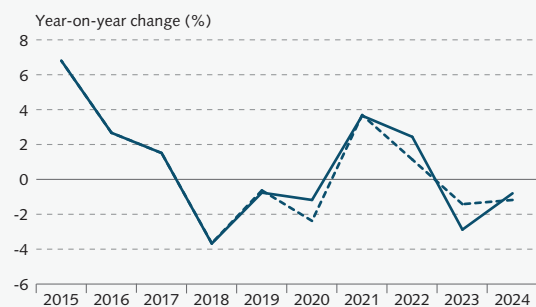
### ... and other commodity prices have surged as well

Non-energy commodity prices also rose steeply year-on-year in 2021, many of them reaching or closing in on historical highs (Charts I-7 and I-13). Demand has soared with increased economic activity, and supply-chain bottlenecks have hampered the production of many commodities. The rise in prices had halted in H2/2021, and prices were expected to decline marginally this year. But they started to climb again early in 2022, alongside the increase in energy prices, and rose still further because of the war. In March, commodity prices were at their highest ever, and about 18% above their end-2021 level. This trend reflects deep concerns about the impact the war and associated sanctions will have on commodity supplies, as both Russia and Ukraine are important producers of many commodities, including metals, agricultural products, and fertiliser (see Box 2). The outlook is for non-energy commodity prices to rise by an average of 15.4% in 2022, whereas the February forecast assumed a decrease of just over 1%. On the other hand, prices are expected to drop further in the next two years, although they will be well above the February forecast for the entire forecast horizon.

### Terms of trade set to improve more strongly

Terms of trade for goods and services improved by 3.7% in 2021, as was forecast in February (Charts I-13 and I-15). The improvement was due primarily to the steep increase in aluminium prices, although the price of marine products and other goods exports, particularly silicon, rose as well. It appears that terms of trade improved even more in Q1/2022, and they are expected to improve by 2.3% over the year as a whole, or 1.2 percentage points more than was forecast in February. The outlook for terms of trade has therefore improved despite the surge in oil and commodity prices following the invasion of Ukraine. Key trading partners' export prices are expected to increase by just under 10% this year, or twice as much as was forecast in February. Iceland's export prices are set to rise more, however, owing to much larger increases in the price of aluminium and marine products. Although terms of trade are expected to deteriorate more in 2023, they will still be more favourable throughout the forecast horizon than was assumed in February.

Chart I-15  
Terms of trade for goods and services 2015-2024<sup>1</sup>



1. Central Bank baseline forecast 2022-2024. Broken line shows forecast from MB 2022/1.  
Sources: Statistics Iceland, Central Bank of Iceland.