NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

REPORT ON THE INTERNATIONAL ECONOMY

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Abbreviations

CPI	Consumer Price Index
EA	euro area
ECB	European Central Bank
EC	European Commission
EIA	Energy Information Administration
EMU	Economic and Monetary Union
EONIA	euro overnight index average
ESA 95	European System of National Accounts 1995
EU	European Union
Eurostat	Statistical Office of the European Communities
FDI	foreign direct investment
Fed	Federal Reserve System
EMU	Economic and Monetary Union
EURIBOR	euro interbank offered rate
FNM	Fond národného majetku – National Property Fund
GDP	gross domestic product
GNDI	gross national disposable income
GNI	gross national income
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
IPI	industrial production index
IRF	initial rate fixation
MFI	monetary financial institutions
MF SR	Ministry of Finance of the Slovak Republic
MMF	money market fund
NARKS	National Association of Real Estate Offices of Slovakia
NBS	Národná banka Slovenska
NEER	nominal effective exchange rate
NPISHs	Non-profit Institutions serving households
OIF	open-end investment fund
p.a.	per annum
p.p.	percentage points
qoq	quarter-on-quarter
PPI	Producer Price Index
REER	real effective exchange rate
SASS	Slovenská asociácia správcovských spoločností – Slovak Association of Asset Management Companies
SO SR	Statistical Office of the Slovak Republic
SR	Slovenská republika – Slovak Republic
ULC	unit labour costs
VAT	value-added tax
yoy	year-on-year

Symbols used in the tables
. – Data are not yet available.
- – Data do not exist / data are not applicable.
(p) – Preliminary data

1 The global economy

Global economic growth remained modest in the first quarter of 2016. Going forward, however, the outlook for global activity appears more favourable given that assessments about the world economy are not as downbeat as they were earlier in the year and that financial market sentiment has subsequently picked up, and given also the trend shift in commodity prices. The international environment was also affected by several other factors in the first quarter. On the one hand there was the ongoing impact of low commodity prices, the prospect of financial conditions in emerging market economies (EMEs) becoming tighter as a result of monetary policy normalisation in the United States, and the divergence of US monetary policy from other advanced world policy stances. At the same time, global economic growth was dampened by the Chinese economy's structural slowdown and gradual rebalancing, as well as by geopolitical tensions in certain regions.

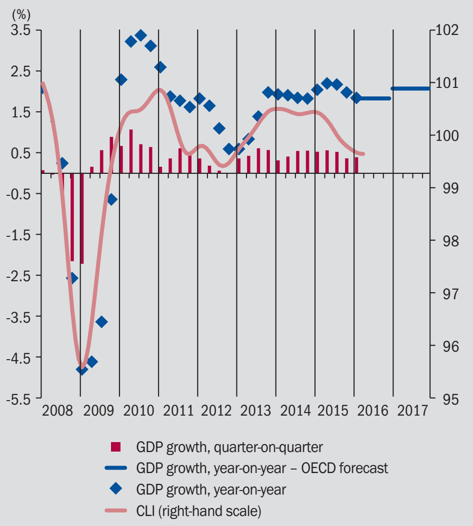
GDP growth across advanced economies was moderate on average and continued to show cross-country heterogeneity. In some countries growth slowed, while in others it was stronger than projected. US economic growth fell again owing to a slowdown in private consumption growth, a decline in non-residential investment and a deterioration in net exports. At the same time, however, residential investment picked up strongly. Looking ahead, employment growth, restocking and the end of the adjustment in the energy sector are expected to support growth. On the other hand, current strengthening of the US dollar and weak growth in foreign demand could be a drag on activity. In the United Kingdom, too, economic growth was lower in the first quarter than in the last quarter of 2015, owing to declining exports and despite a pick-up in investment demand and moderate strengthening of private and government consumption expenditure. Japan saw its economy emerge from a technical recession at the beginning of 2016, as private and public consumption growth enabled it to cope quite well with the slowdown in China and an appreciating domestic currency. This year's higher than expected economic growth has partly been caused by the revision of data for the last quarter of 2015, which resulted in a trimming of the economy's contraction for that period. The favourable developments in early 2016 imply that a deferral of the consumption tax increase planned for next year would not be warranted. The euro area economy also outdid expectations, with its growth being driven by domestic demand and in particular the consumption component.

The picture across EMEs also remained mixed. In China, the economy slowed, but growth continued to be supported by a recovering property market as well as by infrastructure spending under additional stimulus measures. Looking ahead, it is assumed that infrastructure spending will only partly offset the slowdown in business investment, since some industrial sectors no longer have spare capacity. India's economy also decelerated slightly towards the end of last year, but its growth gained momentum again at the beginning of 2016 and activity outlooks remain bright. Private consumption is expected to be boosted by public sector wage growth and falling inflation, while investment will increase owing to the reduction in overcapacity. The Russian economy remained in deep recession in the first quarter, but there are signs that the economy is bottoming out as it benefits from higher oil prices. Although Brazil, the largest economy in Latin America, also continued to contract (for a fifth successive quarter), its decline was significantly moderated by heavy government spending. The further trajectory of the Brazilian economy remains uncertain amid high political uncertainty.

Average economic growth across OECD countries in the first quarter of 2016 remained unchanged, in quarter-on-quarter terms, from its level for the last quarter of 2015 (at 0.4%). The annual growth rate fell from 2.0% to 1.8%. The average Composite Leading Indicator (CLI)[1] for the OECD's member countries maintained its downward trend in the first quarter, therefore implying that global activity growth will decelerate in the short term. The average CLI in April was unchanged from the previous month.

1 *The CLIs for OECD countries are published on a monthly basis, and the most recent, published in June 2016, are for the period up to April 2016.*

Chart 1 GDP growth and the CLI



Source: OECD.
Note: Composite Leading Indicator (CLI).

Global economic growth is expected to pick up gradually on the basis of continuing growth in advanced economies and the progressive easing of the deep recessions in some large emerging market economies. Favourable trends in financial conditions and the labour market are expected to support growth in advanced economies. Emerging market economies may be constrained by the impact of the gradual deceleration of the Chinese economy as well as by tightening financial conditions and by political uncertainty and geopolitical tensions. On the other hand, the current increase in commodity prices may partly mitigate the negative consequences of the dampening factors.

Annual consumer price inflation in the OECD area was 0.8% in March, marginally lower than the rate in December 2015 (0.9%). The inflation rate did, however, accelerate briefly in January. Since food price inflation and core inflation remained relatively stable during the period under review, the changes in the headline rate were again attributable to energy prices. Their rate of decrease moderated in January, before accelerating again and therefore making a negative contribution to overall inflation. Core inflation remained unchanged throughout the period, at 1.9%. In April, energy price inflation became less negative, but the headline rate also reflected the impact of declines in food prices and core inflation (1.8%) and was therefore unchanged from the previous month (0.8 %).

Global inflation is expected to remain subdued in the short term, owing to the fall in commodity prices at the start of the year. With prices of commodities, oil in particular, now increasing, however, the inflation rate is expected to begin rising in the second half of 2016. At the same time, abundant spare capacity at the global level is expected to weigh on inflation over the medium term.

2 Commodities

The average price of a barrel of Brent crude oil maintained its downward trend in the first quarter of 2016, as it fell by around USD 8, quarter-on-quarter, to USD 35. That decline, was heavily influenced by a sharp drop in oil prices in the first half of January, when they hit a 12-year low in response to stock market turmoil in China and related fears about a 'hard landing' for the Chinese economy. The oil price also came under downward pressure from the lifting of the embargo on oil exports from Iran. Subsequently, however, the oil price began to increase significantly following news that ECB's Governing Council would be conducting a thorough review of the monetary policy stance at its meeting in March, and also after Russian and several OPEC countries struck a deal to freeze oil production. At the same time, the oil price was sensitive to rising expectations that a meeting of OPEC and non-OPEC oil producers in Qatar April would result in a production freeze. When in the end no agreement was reached, the oil price weakened briefly, before upward pressures on the price returned to the fore. These included falling oil inventories in the United States, as well as fears that output in Canada would fall due to the impact of wildfires. The combination of these supply-side factors and increased forecasts for global demand pushed the oil price to USD 50 per barrel at the end of May.

The downward trend in non-energy commodity prices came to an end in the first quarter of 2016. In January, these prices were still falling in response to oversupply and weakening global demand, but in February their trend shifted, mainly because metal prices increased amid falling production and a pick-up in demand. The iron ore price increased more than other metal prices, as it responded to increased demand from China ahead of the summer building season. Other metals that increased in price included in particular copper, zinc and tin. Due to these factors, the metal price index continued to increase in April, before declining in May owing mainly to decreases in prices of iron ore and nickel. Agricultural commodity prices also made a positive contribution to the increase non-energy commodity prices in the first quarter of 2016. While agricultural commodity prices began increasing moderately in late 2015 and early 2016, it was not until March 2016 that they began to have a notable upward impact on the non-energy commodity price index. Agricultural commodity prices also reflected reduced supply (including the impact of adverse weather on wheat, soya and sugar harvests) and increased demand. These prices continued to rise in April and May.

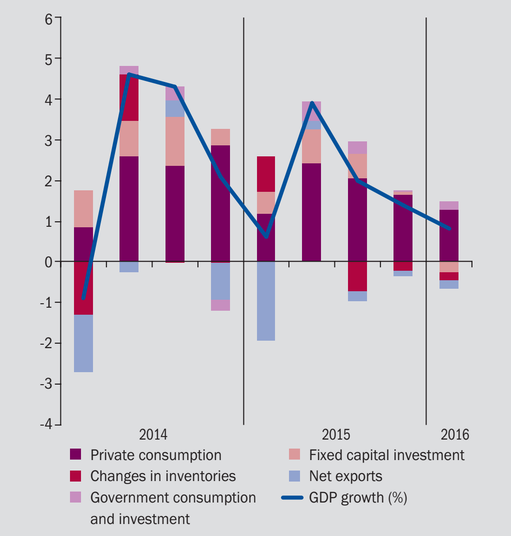
3 The United States

In the United States, the annualised rate of economic growth slowed in the first quarter of 2016 for a third consecutive quarter, down to 0.8% (from 1.4% in the previous quarter). The year-on-year growth rate remained unchanged, at 2.0%. Despite the slower GDP growth, the US economy reached a state of almost full employment and consumer price inflation picked up. A number of the factors that weighed on economic growth in the first quarter are expected to have a gradually diminishing impact in the subsequent period, and so growth is expected to increase.

The main driver of US activity growth in the first quarter of 2016 was private consumption. Even so, private consumption growth slowed as spending on motor vehicles fell back from its record level in the fourth quarter of 2015. The easing of private consumption growth came as somewhat of a surprise, given that real household disposable income maintained stable growth. Government consumption and investment expenditure at both the federal and state level made positive contributions to GDP growth. In contrast, fixed capital investment had a negative impact, as it declined for the first time in five years. Non-residential fixed capital investment was affected by developments in structural investment, as falling oil prices caused a drop in extraction investment. With the oil price now rising, the impact of this factor is expected to gradually fade. The downward trend in investment in equipment became more pronounced in the first quarter amid falling profitability. On the other hand, residential investment picked up, and its annualised growth rate of 17% significantly reduced the overall decline in fixed capital investment. Foreign trade was also a factor in the weakening of economic growth, as export growth eased more than import growth and therefore net exports contributed negatively to overall growth. Changes in inventories also had a negative impact.

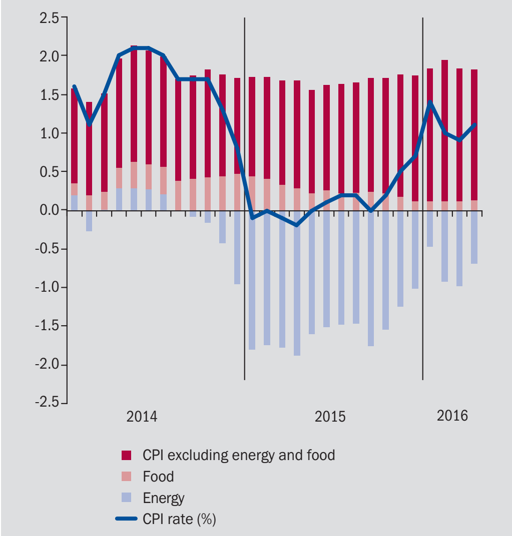
Consumer price inflation in the United States maintained its accelerating trend in the first quarter of 2016. The rate increased, however, only at the start of the year, when the decline in energy prices was moderated by the base effect of the slump in automotive fuel prices in the same period of the previous year. Domestic price pressures also contributed to the acceleration in headline inflation, with the core inflation rate increasing to its highest level for three and a half years. The core rate remained elevated in subse-

Chart 2 Annualised GDP growth and its composition (percentages; percentage point contributions)



Source: Bureau of Economic Analysis.

Chart 3 Annual consumer price inflation and its composition (percentages; percentage point contributions)



Sources: Bureau of Labor Statistics and NBS calculations.

quent months and, with food price inflation also remaining stable, it was energy prices that determined the course of the headline inflation rate. As their rate of decrease accelerated again, energy prices pushed down consumer price inflation, which nevertheless remained higher than its level for the last quarter of 2015. The annual inflation rate in the United States therefore increased from 0.7% in December 2015 to 0.9% in March 2016. Inflation excluding food and energy edged up from 2.1% to 2.2%. Subsequently the inflation rate began to reflect the acceleration of commodity prices. A sharp rise in petrol prices offset the impact of falling energy prices, and in April it contributed to an increase in the headline inflation rate, to 1.1%. Core inflation fell to 2.1% in April owing to a base effect. Given the current upward path of commodity prices, headline inflation is expected to increase in the second half of 2016.

The US Federal Open Market Committee (FOMC) decided at its meetings in January, March, April and June 2016 to leave the target range for the federal funds rate unchanged, at 0.25% to 0.50%. According to the FOMC, the stance of monetary policy remains accommodative, thereby supporting further improvement in labour market conditions and a return to 2 per cent inflation. In its statements following these meetings, the FOMC reiterated that in determining the timing and size of future adjustments to the target range for the federal funds rate, it would assess realised and expected economic conditions relative to its objectives of maximum employment and 2 per cent inflation This assessment would take into account a wide range of information, including measures of labour market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

4 The euro area

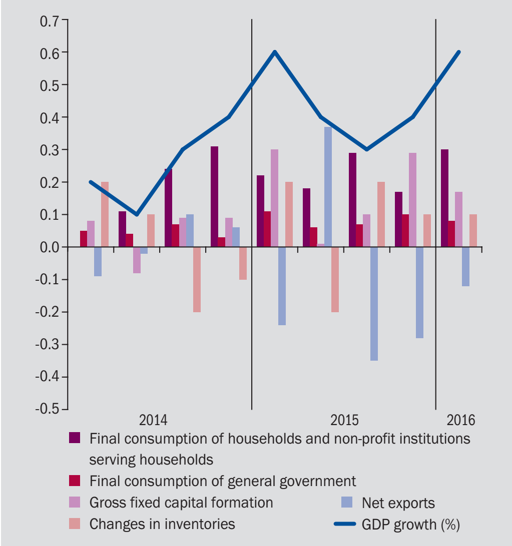
The euro area economy grew in the first quarter of 2016 by 0.6% in quarter-on-quarter terms, and so surpassed its growth rate for the previous quarter (0.4%). Among the larger national economies in the euro area, Germany recorded the strongest growth (from 0.3% in the fourth quarter of 2015 to 0.7%), followed by France (from 0.4% to 0.6 %), the Netherlands (from 0.3% to 0.5%) and Italy (from 0.2% to 0.3%). Spain's GDP growth remained unchanged, at a relatively high 0.8%. The euro area's annual GDP growth rate was the same in the first quarter of 2016 as in the fourth quarter of 2015, at 1.7%.

As in the previous two quarters, GDP growth in the first quarter was driven by domestic demand. Within domestic demand, household consumption growth increased for a twelfth consecutive quarter. Government final consumption expenditure also increased quite strongly. Investment demand contributed positively, too, although its growth rate moderated. Investment demand data for the five largest economies showed continuing investment growth in the construction sector in Germany, the Netherlands and France.

Chart 4 Economic growth (constant prices; percentages)

Source: Macrobond.

Chart 5 Quarterly GDP growth and its composition (percentages; percentage point contributions)

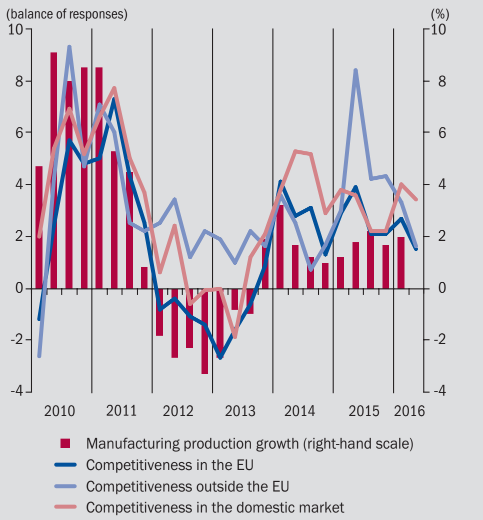


Sources: Macrobond and NBS calculations.

Increased investment in machinery and equipment was also observed in several countries (Germany, France, Italy and Spain). Domestic demand continued to be supported by the ECB's accommodative monetary policy stance. In contrast, net exports contributed negatively to GDP growth for a third quarter in a row.

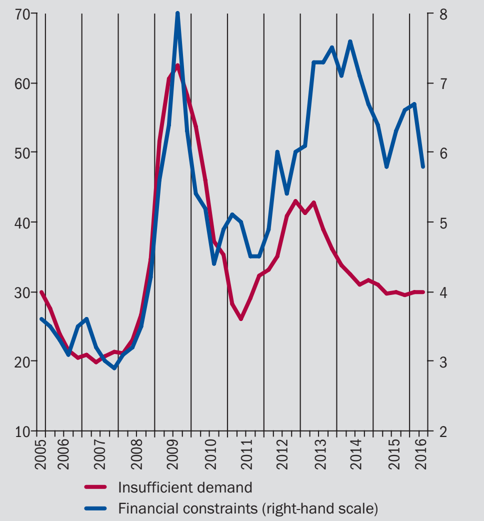
Despite the relatively favourable performance of export-oriented manufacturing production in the first quarter of 2016 (its growth increased from 0.3% in the previous quarter to 1.1%), growth in goods exports slowed. At the start of the second quarter, economic agents in industry became less optimistic in assessments of their competitive position, particularly in extra-EU markets. Their attitudes may have stemmed from the appreciation of the euro's effective exchange rate in both nominal and real terms, as well as from the subdued growth of the global economy. At the same time, export outlooks deteriorated, leaving little reason to expect that growth in either manufacturing production or exports will increase notably in the near term.

Chart 6 Competitiveness in industry (balance of responses) and growth in manufacturing production (annual percentage changes)



Sources: European Commission, Eurostat and NBS calculations.

Chart 8 Factors limiting production in industry (percentages)

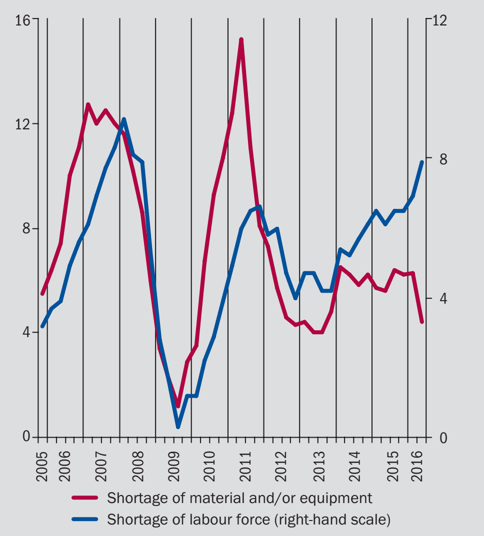


Source: European Commission.

Chart 7 Export expectations in industry (balance of responses) and growth in exports and manufacturing production (annual percentage changes)

Sources: European Commission, Eurostat and NBS calculations.

Chart 9 Factors limiting production in industry (percentages)



Source: European Commission.

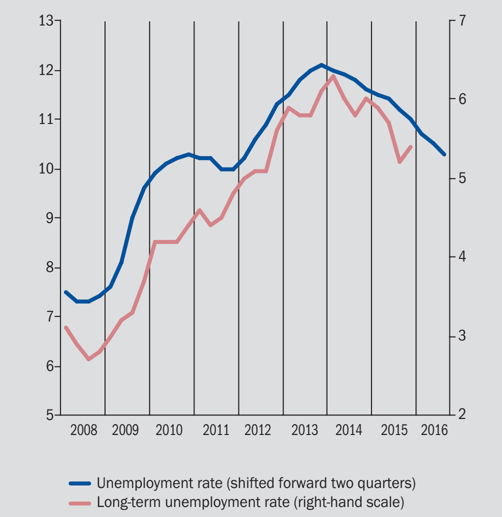
According to survey data, the importance of insufficient demand as a factor limiting industrial production remained unchanged in the second quarter of 2016, for a fifth successive quarter. Because demand is weak, industrial production is not expected to accelerate. In contrast, the importance of financial constraints fell quite significantly, probably as a result of the ECB expanding its non-standard monetary policy measures. Somewhat surprisingly, given that investment has been very weak since the outbreak of the financial crisis and remains far below pre-crisis levels, shortages in material and equipment became less important as a production-limiting factor. On the other hand, the gradual amortisation of existing plant and equipment is expected to increase the importance of this factor. Overall, however, the assessments of shortages in material/equipment may indicate the relative weakness of investment demand. The importance of labour shortages increased, reflecting the continuing improvement in the labour market situation.

The unemployment rate continued its downward trend in the first quarter, as it fell to 10.2%, 0.3 percentage point lower than its level at the end of 2015. The rate remained unchanged in April. The strengthening of the labour market, which began back in 2014, is providing the conditions for a gradual reduction in the long-term unemployment rate. After worsening in the first quarter, employment expectations in certain sectors, mainly industry and services, improved slightly in April and May.

Leading indicators for the euro area economy are sending mixed signals. The Purchasing Managers' Index (PMI) for the euro area remained almost unchanged in April and May, slightly below its average for the first quarter. In contrast, the European Commission's Economic Sentiment Indicator (ESI) increased in each of these months. Confidence strengthened in all sectors, with the highest increases in construction, services and retail trade. A clear improvement was observed in the ESI's consumer confidence indicator, including in consumers' assessments of conditions for making major purchases. This suggests that private consumption growth will remain relatively favourable in the next period. Overall, however, the indications are that economic growth in coming quarters will not be as strong as in the first quarter.

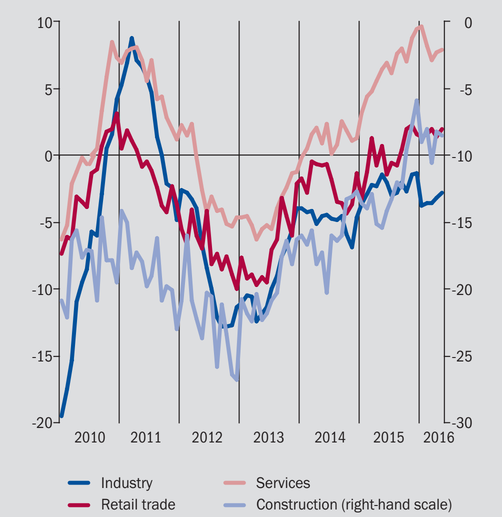
Euro area annual HICP inflation fell from 0.2% in December 2015 to 0% in March 2016. This drop

Chart 10 Unemployment rate and long-term unemployment rate (percentages)



Source: Eurostat.

Chart 11 Employment expectations by sector (balance of responses)

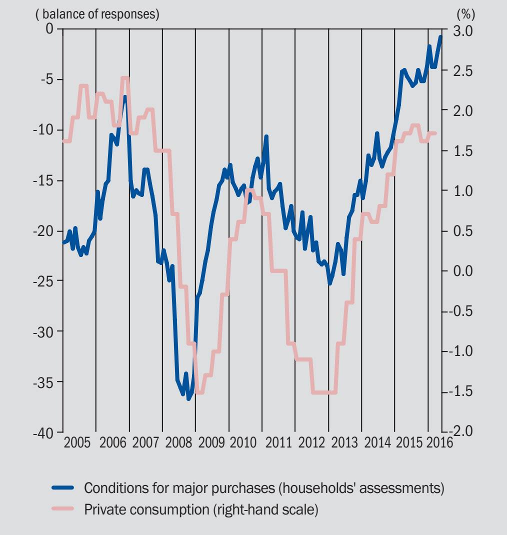


Source: European Commission.

Chart 12 Euro area leading indicators and quarterly GDP growth

Sources: European Commission, Eurostat, Bloomberg and NBS calculations.
Note: ESI – normalised index.

Chart 13 Conditions for major purchases (balance of responses) and private consumption (annual percentage changes)

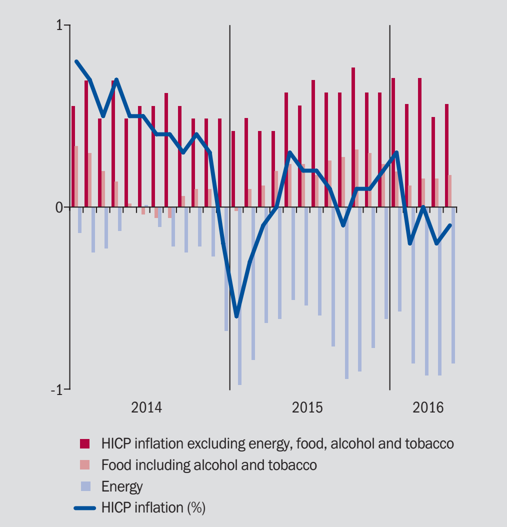


Source: Macrobond.
Note: Year-on-year growth in consumption in the individual months of each quarter is approximated by the growth rate for the quarter as a whole.

was largely accounted for by an accelerated decline in energy prices and by lower food price inflation. The inflation rate excluding energy and food edged up, from 0.9% in December to 1.0% in March. HICP inflation fell back into negative territory in April (to -0.2%) and then increased slightly in May (to -0.1%). These changes reflected mainly the elevated volatility in inflation excluding energy and food, particularly in services price inflation. That volatility was related to a calendar effect, namely the fact that Easter fell in March 2016 and in April 2015. This pushed annual services price inflation up in March 2016 and down in April 2016. May's slight increase in HICP inflation reflected the fading of that effect, with inflation excluding energy increasing back to its level of the previous February (0.8%). Overall, headline HICP inflation remains subdued and shows no clear signs of picking up.

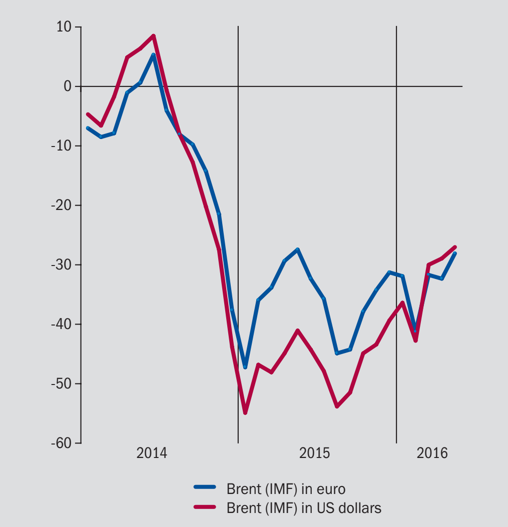
Consumer price trends in both the first quarter of 2016 and in the next two months were significantly affected by global oil price movements. The decline in energy prices accelerated in the first quarter after a marked drop in oil prices at the turn of the year passed through to energy prices in February and March. From February, however, the oil price began gradually to increase, and likewise its annual rate of change became less negative. In their response to these commodity market trends, however, energy prices were stickier than they had been in the previous period, and so their annual rate of decline did not begin to moderate until May.

Chart 14 Annual HICP inflation rate and the contributions of selected components (percentages; percentage point contributions)



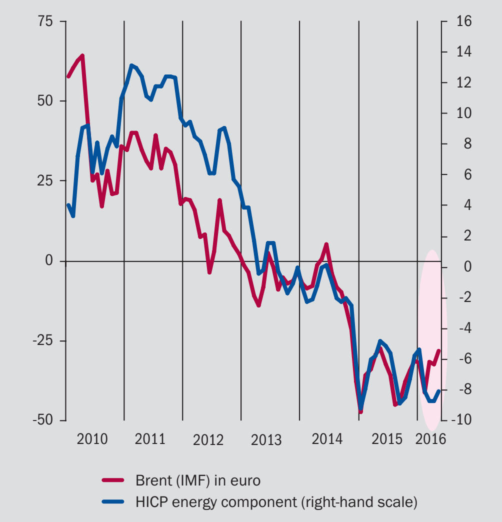
Sources: Macrobond and NBS calculations.

Chart 15 Oil prices in euro and US dollars (annual percentage changes)



Sources: IMF and NBS calculations.

Chart 16 Oil prices in euro and the HICP energy component (annual percentage changes)



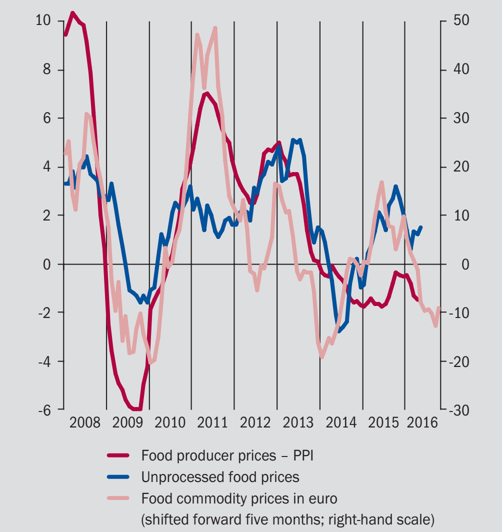
Sources: Macrobond, IMF and NBS calculations.

Chart 18 Food producer prices and processed food prices (annual percentage changes)

Source: Macrobond.

As food commodity price inflation became more negative, it passed through, with a lag, to both food producer prices and to consumer-level unprocessed food price inflation. The latter fell by 0.7 percentage point in the first quarter, to 1.3%, before accelerating slightly in May, to 1.5%. The negative rate of annual food commodity price inflation moderated from May, reflecting a recovery in the food commodity market. As a result, the downward impact of food commodity prices on unprocessed food prices and food producer prices is expected to ease. Processed food price inflation also fell slightly in the first quarter (by 0.3 percentage point, to 0.4%), but then picked up again (reaching 0.6% in May). Thus the pass-through from the ongoing decline in producer prices to processed food prices remains only partial.

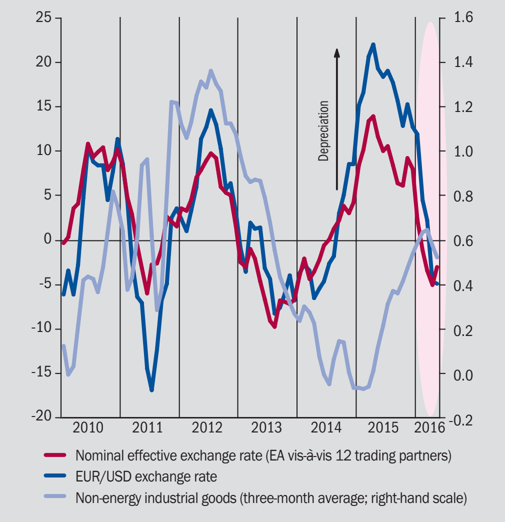
Chart 17 Food prices: commodity, producer and consumer prices (annual percentage changes)



Sources: Macrobond and NBS calculations.

Price dynamics of demand-sensitive items remained subdued in an environment of strong competition. In addition, services price inflation experienced volatility due to calendar effects related to Easter. Services price inflation stood at 1.0% in May 2016, only marginally lower than its December 2015 level. While the recent gradual strengthening of consumer demand implies an acceleration in services inflation, no such pass-through was observed yet. After accelerating in January and February, non-energy industrial goods inflation eased in March, back to its December 2015 level (0.5%), where it remained for the next two months. Its rate was dampened by the fading impact of euro depreciation, with euro already trading stronger in April and May than it was in the same months of the previous year.

Chart 19 Non-energy industrial goods prices and the nominal exchange rate (annual percentage changes)

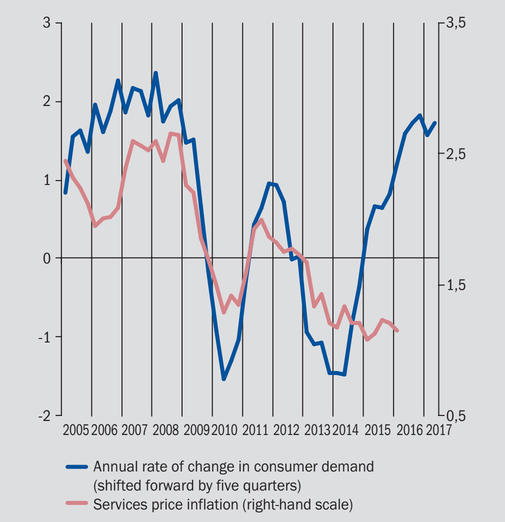


Source: Macrobond.
Note: Positive values for the exchange rate denote depreciation of the euro.

Chart 21 Price expectations in industry, services and retail trade (balance of responses)

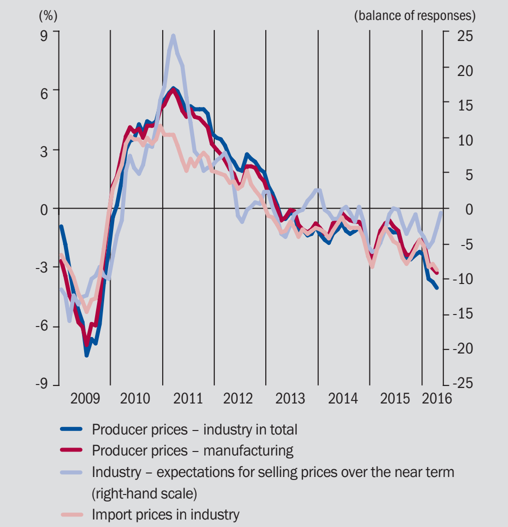
Sources: European Commission and Eurostat.

Chart 20 Consumer demand and services price inflation (annual percentage changes)



Sources: Eurostat and ECB.

Chart 22 Selling price expectations in industry (balance of responses) and producer prices (annual percentage changes)



Sources: European Commission, Eurostat and Macrobond.

Price expectations remain extremely subdued. The European Commission's survey indicators have since March, however, been signalling a slight increase in price expectations in industry, particularly in regard to prices of intermediate products. This increase is expected to have stemmed from rising oil prices, which by May, in euro terms, had climbed more than 43% (average monthly level) from their 12-year low in January. Price expectations increased in other sectors as well. The upward price expectations in industry have not as yet, however, passed through to producer prices, whose annual rate of change became increasingly negative from the beginning of the year until April and reflected an accelerating decline in import prices.

At its monetary policy meeting in March 2016, the ECB's Governing Council decided on a set of monetary policy measures in pursuit of its price stability objective. This comprehensive package is intended to exploit the synergies between the different instruments and has been calibrated to further ease financing conditions, stimulate new credit provision and thereby reinforce the momentum of the euro area's economic recovery and accelerate the return of inflation to levels below, but close to, 2%.

The first of these measures was to lower the ECB's interest rates with effect from 16 March 2016. The main refinancing rate was reduced by 5 basis points, to 0.00%, the marginal lending rate by 5 basis points, to 0.25%, and the deposit facility rate by 10 basis points, to -0.40%.

Second, it was decided to expand the monthly purchases under the APP from €60 billion to €80 billion. They are intended to run until the end of March 2017, or beyond, if necessary, and in any case until the Council sees a sustained adjustment in the path of inflation consistent with its medium-term inflation objective. To ensure the continued smooth implementation of the ECB's asset purchases, the Council decided to increase the issuer and issue share limits for the purchases of securities issued by eligible international organisations and multilateral development banks from 33% to 50%.

Third, it was decided to include investment-grade euro-denominated bonds issued by non-bank corporations established in the euro area in the list of assets that are eligible for regular purchases under a new corporate sector purchase programme (CSPP) forming part of the APP. Purchases under the CSPP will start towards the end of the second quarter of 2016.

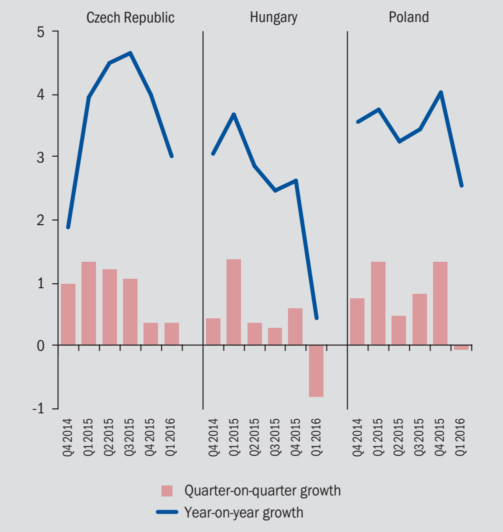
Fourth, it was decided to launch a new series of four targeted longer-term refinancing operations (TLTRO II), each with a maturity of four years. They will be conducted from June 2016 to March 2017 at a quarterly frequency. Counterparties will be able to repay the amounts borrowed under TLTRO II at a quarterly frequency starting two years from the settlement of each operation. The interest rate applied to TLTRO II will be fixed for each operation at the rate applied in the main refinancing operations prevailing at the time of allotment. For counterparties whose eligible net lending in the period between 1 February 2016 and 31 January 2018 exceeds their benchmark, the rate applied to the TLTRO II will be lower, and can be as low as the interest rate on the deposit facility prevailing at the time of take-up. There will be no requirement for mandatory early repayments under TLTRO II, and switches from TLTRO I will be allowed[2].

2 *Further details about the different instruments are or will be published on the ECB's website, at www.ecb.europa.eu*

5 The Czech Republic, Hungary and Poland

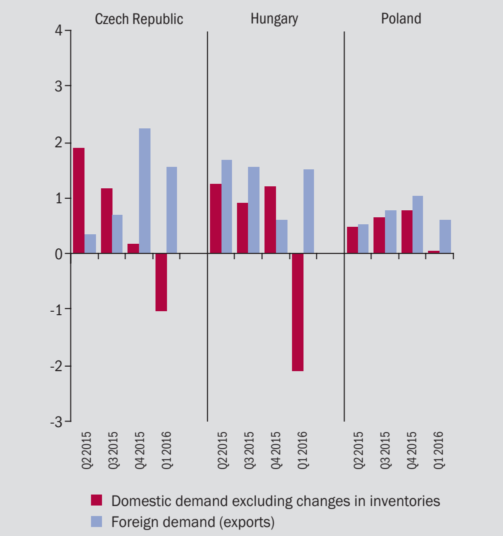
All three countries under review recorded lower annual GDP growth in the first quarter of 2016 than in the previous quarter. In the Czech Republic growth fell by 1.0 percentage point (to 3.0%), while in Hungary it fell by 2.2 percentage point (to 0.4%), and in Poland by 1.4 percentage point (to 2.6%).

Chart 23 GDP growth (percentages)



Source: Eurostat.

Chart 24 Contributions to quarterly GDP growth (percentage points)



Sources: Eurostat and NBS calculations.

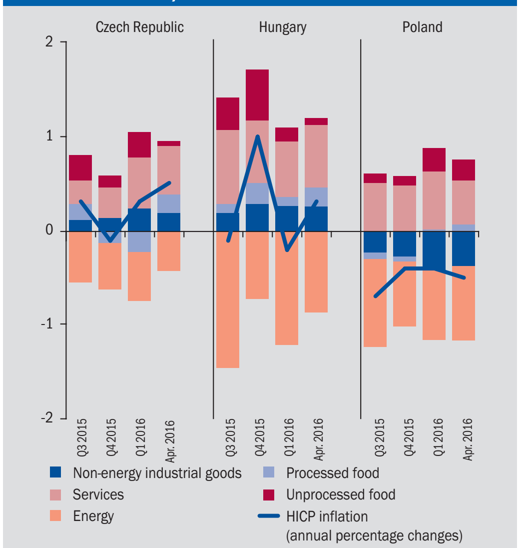
Economic growth across the countries was affected by the weakening of investment activity, which is likely to have been caused by the end of the absorption of EU funds under the 2007-2013 programming period. In quarter-on-quarter terms, the Czech Republic's economic growth was unchanged from the previous quarter, at 0.4%. In Hungary and Poland, on the other hand, GDP growth turned negative, falling by 1.4 percentage points in each case, to -0.8% and -0.1% respectively. Looking more closely at the Czech economy, the downward trend in investment activity became more pronounced. Net exports also had a negative impact on GDP growth, with import growth accelerating and export growth decelerating. Offsetting the impact of these components were positive contributions from changes in inventories and government final consumption expenditure. Household final consumption was largely unchanged from the previous quarter. In Hungary, the economic contraction was largely attributable to investment and net exports. Investment demand went from positive growth in the previous quarter to significantly negative in the first quarter. The negative contribution from net exports was the result of import growth increasing more than export growth. Changes in inventories had a positive impact on GDP growth, but not sufficient to counterbalance the negative contributions. Household final consumption was virtually unchanged from the previous quarter and government final consumption also stagnated. In Poland, the economic contraction reflected a decline in investment, but to a lesser extent than in the other countries. Net exports also had a negative impact on GDP growth, as imports grew faster than exports. There were positive contributions from changes in inventories and from household final consumption. Government final consumption remained flat.

Annual consumer price inflation in the Czech Republic was higher in March 2016 than in December 2015. In Hungary the inflation rate was lower in March than in December, while in Poland it was at the same negative level. The acceleration of inflation in the **Czech Republic** (to 0.3%, from -0.1%) was driven mainly by appreciable increases in price inflation for non-energy industrial goods, unprocessed food, and services. In contrast, the annual rates of change for prices of processed food and energy became more negative. In April, the Czech inflation rate increased further, with processed food price inflation moving from negative to positive territory. In **Hungary**, annual consumer price inflation was negative in March (-0.2 %), after coming in positive (1.0%) in December 2016. All inflation components contributed to this change, with the exception of non-energy industrial goods inflation, which remained practically unchanged. Energy price inflation was more negative in the first quarter than in the previous quarter, while the positive rates of food and services inflation decreased. In April, Hungary's inflation rate rebounded, with an increase in processed food inflation, a more moderate easing of services price inflation, and less pronounced decline in energy prices. The negative consumer price inflation rate in **Poland** in March was unchanged (at -0.4%) from its level in December 2015. While prices of non-energy industrial goods and energy had a negative impact on the headline rate, prices of food and services contributed positively. In April, the annual inflation rate edged further into negative territory, as price dynamics moderated in all components with the exception of processed food.

Looking at the currencies of the three countries, the Czech koruna was marginally weaker against the euro at the end of the first quarter of 2016 than at the end of the previous quarter (by 0.10%), while the Hungarian forint and Polish zloty were slightly stronger (by 0.60% and 0.15% respectively). It remains the case that the koruna is constrained to follow a largely strengthening trajectory, since the Czech central bank is still committed to using foreign-exchange interventions to maintain accommodative monetary policy conditions (the bank's purchases in the foreign exchange market in the first four months of 2016 amounted to €3.2 billion). All three exchange rates, but more so the forint and zloty, were affected by financial market sentiment in the first quarter. This sentiment was shaped mainly by fears about global growth outlooks, by the monetary policy stances of the world's major central banks and by information from the oil market. Risks related to GDP growth in emerging market economies (especially China) moderated during the quarter.

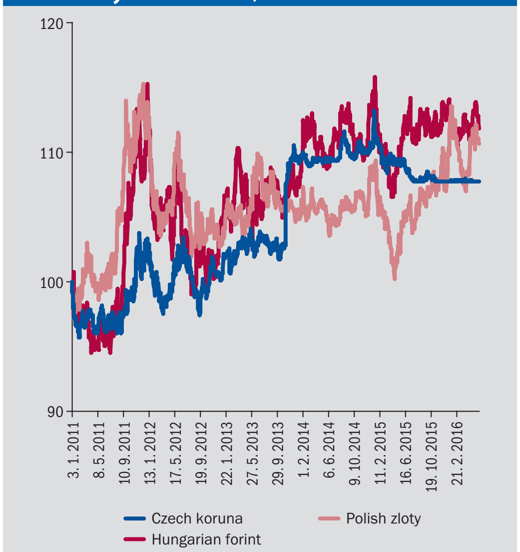
The Czech koruna's exchange rate stabilised in the first quarter of 2016 at just above CZK 27.0 per euro, after being slightly more volatile vis-à-vis the euro in the fourth quarter of 2015 (within the terms of the central bank's exchange rate commitment) owing to the fallout from Volkswagen emissions scandal and to subsequent interventions by the central bank. The forint's exchange rate against the euro, after a volatile performance

Chart 25 HICP inflation and its composition (percentages; percentage point contributions)



Sources: Eurostat and NBS calculations.

Chart 26 Exchange rate indices of national currencies vis-à-vis the euro (index: 3 January 2011 = 100)

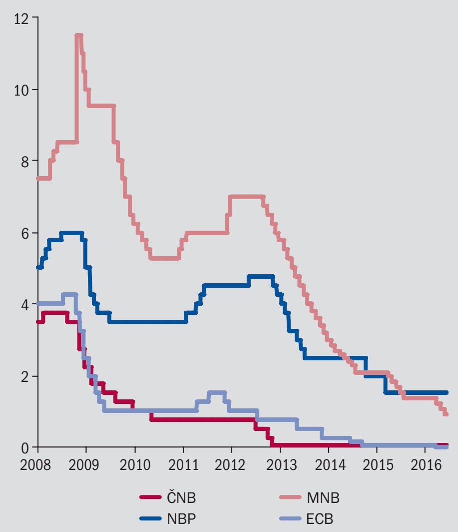


Sources: Eurostat and NBS calculations.
Note: A fall in value denotes appreciation.

in the fourth quarter of 2015, appreciated in the first quarter of 2016 until the end of March, when the Hungarian central bank unexpectedly cut its key rates. The currency responded to the rate cut by weakening, but then later appreciated following the release of favourable economic news (including positive fiscal figures for 2015). Overall, the interest rate reductions in April and May had a downward impact on the exchange rate. The zloty had shown depreciation tendencies in previous quarters and after Standard & Poor's downgraded its rating on Poland in January, but it rallied in the last two months of the quarter and only stopped appreciating in April. The zloty's exchange rate was affected by not only external but also internal factors (political risks associated with the new government and the related risk of deterioration of the country's fiscal position).

As regards monetary-policy settings in the three countries, only the Hungarian central bank made any adjustments in the first quarter of 2016. In the Czech Republic, **Česká národní banka** (ČNB) kept its base rate unchanged at 0.05 % (zero lower bound). At its monetary policy meetings in the first quarter of 2016, ČNB reaffirmed its commitment to use the exchange rate as an additional instrument for easing monetary policy, and not to discontinue it until 2017. According to the ČNB Bank Board, sustainable fulfilment of the inflation target, which is a condition for a return to conventional monetary policy, will occur in the first half of 2017. Consistent with the forecast is an increase in market interest rates in 2017. In the statement following its meeting in May, the ČNB Bank Board noted the risk of undesirable second-round effects of foreign cost factors and, in that context, reiterated its readiness to shift the exchange rate commitment to a weaker level if there were to be a further decrease in inflation expectations. At its meeting in March, the Monetary Council of the **Magyar Nemzeti Bank** (MNB) decided to the reduce the base rate by 15 basis points, to 1.20% (with effect from 23 March 2016) and also cut the overnight deposit rate to -0.05% (by 15 basis points). According to the post-meeting statement, persistently low cost-side inflationary pressure, the slowdown in global growth and the historically low level of inflation expectations have heightened the risk of second-round effects which result in below-target inflation over a sustained period. Furthermore, the Monetary Council affirmed its readiness to use every instrument at its disposal to contain second-round inflationary effects. The MNB further loosened its monetary policy stance in April and and May, cutting the base rate by 15 basis points in each month, down to 0.9% (with effect from 25 May 2016). It noted that the risk of second-round inflation effects had diminished. In January 2016, the MNB decided to phase-out its main two-week deposit facility by the end of April 2016, thereby completing the reform of the MNB's monetary policy instruments. (The main policy instrument is now the three-month, fixed-interest rate deposit that was introduced in September 2015.) The reason for discontinuing the two-week deposit facility is to encourage banks to buy Hungarian government debt as an alternative to depositing funds with the central bank. In Poland, **Narodowy Bank Polski** (NBP) left its monetary-policy settings unchanged in the first quarter of 2016 (keeping the reference rate at 1.5%). In the statement after its March meeting, NBP's Monetary Policy Council (MPC) said it expected that inflation would remain negative in coming quarters due to the earlier strong fall in global commodity prices and that economic growth would be stable. Consumer demand growth is expected to accelerate. According to the MPC, the risks to the inflation outlook remain global economic conditions and the volatility of commodity prices. In the assessment of the MPC, the current level of interest rates is conducive to keeping the Polish economy on a sustainable growth path and to maintaining macroeconomic equilibrium.

Chart 27 Key interest rates of national central banks (percentages)



Sources: National central banks and the ECB.

Box 1

THE ECB'S CONVERGENCE REPORT 2016

The Convergence Report 2016 was produced by the ECB in accordance with Article 140 of the Treaty on the Functioning of the European Union ('the Treaty'), which requires that at least once every two years the ECB report on the progress made by non-euro area EU Member States (except for Denmark and the United Kingdom) in fulfilling their obligations regarding the achievement of economic and monetary union. For the 2016 report, the ECB examined the seven EU countries that have a derogation in fulfilling these obligations, in other words the countries that are committed to adopting the euro and therefore to fulfilling all the convergence criteria. The European Commission has also prepared a convergence report, and both reports were submitted to the EU Council in parallel.

In the report, the ECB uses the assessment framework applied in its previous Convergence Reports. It examines, for the seven countries concerned, whether a high degree of sustainable economic convergence has been achieved, whether the national legislation is compatible with the Treaties and the Statute of the European System of Central Banks and of the European Central Bank (Statute), and whether the statutory requirements are fulfilled for the relevant NCB to become an integral part of the Eurosystem.

From 4 November 2014, any country whose derogation is abrogated must join the Single Supervisory Mechanism (SSM) at the latest on the date on which it adopts the euro. From then on all SSM-related rights and obligations apply to that country. It is, therefore, of utmost importance that the necessary preparations are made. In particular, the banking system of any Member State joining the euro area, and therefore the SSM, will be subject to a comprehensive assessment.

In producing Convergence Reports, the ECB uses the following guiding principles:

1) the individual criteria are interpreted and applied in a strict manner;
2) the convergence criteria constitute a coherent and integrated package, and they must all be satisfied;
3) the convergence criteria have to be met on the basis of actual data;
4) the application of the convergence criteria should be consistent, transparent and simple.

Moreover, convergence must be achieved on a lasting basis and not just at a given point in time.

Economic developments in the countries concerned are reviewed from a backward-looking perspective, covering, in principle, the past ten years, In addition, a forward-looking perspective (concerning expectations) is adopted. The cut-off date for the statistics included in the report was 18 May 2016. The report was adopted by the General Council of the ECB on 31 May 2016.

For the assessment of economic convergence in terms of the inflation criterion, the ECB applied the concept of **"outlier"** in the 2016 report, as it had previously done in the 2012, 2013 and 2014 reports. A Member State is considered to be an "outlier", and therefore excluded from the calculation of the price stability criterion, if two conditions are fulfilled:

1) its 12-month average inflation rate is significantly below the comparable rates in other Member States; and
2) its price developments have been strongly affected by exceptional factors.

Neither condition is applied mechanically, but rather assessments as to whether they are met are made case by case. On this basis, the inflation rates of **Cyprus** and **Romania** were excluded from the calculation of the reference value in the 2016 report (for Cyprus, the 12-month average inflation rate in April 2016 was -1.8%, and for Romania it was -1.3%).

In both **Romania** and **Cyprus,** the relevant inflation rates were significantly lower than the comparable rates in other Member States, and this was due, in both countries, to exceptional factors. In **Romania,** the VAT cuts introduced recently and in the pipeline are strongly affecting price developments, and inflation is expected to remain in negative territory until the second half of 2016. As for **Cyprus**, which was already being treated as an outlier back in 2014, its price developments have been affected by an exceptionally large negative output gap.

The price stability criterion

For the 2016 report, the calculation of the price stability criterion uses the average inflation rate for the 12 months from May 2015 to April 2016. In this case, the three best performing of the reviewed Member States in terms of price stability were Bulgaria (-1.0%), Slovenia (-0.8%) and Spain (-0.6%). As a result, the average rate was -0.8% and, adding 1.50 percentage points, the reference value was 0.7%. **In six of the seven countries examined in the report,** the 12-month average inflation rate was **below the reference value**. In Sweden inflation was above the reference value.

The government budgetary position criterion

A country is deemed to have a sustainable government financial position if it has achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6) of the Treaty (i.e. it is not subject to an excessive deficit procedure). This means the ratio of the planned or actual government deficit to GDP does not exceed the reference value (defined in the Protocol on the EDP as 3% of GDP) and the ratio of government debt to GDP does not exceed the reference value (defined in the Protocol on the EDP as 60% of GDP). At the time of the report's publication, **only Croatia was subject to an EU Council decision on the existence of an excessive deficit. All other countries under review posted a fiscal deficit-to-GDP ratio at or below the 3% reference value. The debt ratio was above 60% of GDP only in Croatia and Hungary** (in Hungary the debt has been falling since 2012).

The exchange rate criterion

With regard to exchange rate stability, the ECB examines whether the country has participated in ERM II (which superseded the ERM as of

Table A Overview of economic indicators of convergence

	Price stability	Government budgetary developments and projections			Exchange rate	Long-term interest rate[5]
	HICP inflation[1]	Country in excessive deficit[2] [3]	General government surplus (+)/ deficit (-)[4]	General govern-ment debt[4]	Currency participat-ing in ERM II[3]	
Bulgaria	-1.0	no	-2.0	28.1	no	2.5
Czech Republic	0.4	no	-0.7	41.3	no	0.6
Croatia	-0.4	yes	-2.7	87.6	no	3.7
Hungary	0.4	no	-2.0	74.3	no	3.4
Poland	-0.5	no	-2.6	52.0	no	2.9
Romania	-1.3	no	-2.8	38.7	no	3.6
Sweden	0.9	no	-0.4	41.3	no	0.8
Reference value[6]	0.7	-	3.0%	60.0%	-	4.0

Sources: European Commission (Eurostat, DG ECFIN) and European System of Central Banks.
1) Average annual percentage change. Data for 2016 refer to the period from May 2015 to April 2016.
2) Refers to whether a country was subject to an EU Council decision on the existence of an excessive deficit for at least part of the year.
3) The information for 2016 refers to the period up to the cut-off date for statistics (18 May 2016).
4) As a percentage of GDP. Data for 2016 are taken from the European Commission's Spring 2016 Economic Forecast.
5) Average annual interest rate. Data for 2016 refer to the period from May 2015 to April 2016.
6) The reference values for HICP inflation and long-term interest rates refer to the period from May 2015 to April 2016; for the general government balance and debt, the reference values are defined in Article 126 of the Treaty and the related Protocol (No 12) on the excessive deficit.

January 1999) for a period of at least two years prior to the convergence examination without severe tensions, in particular without devaluing against the euro. The reference period for the 2016 report is from 19 May 2014 to 18 May 2016. In the assessment of compliance with this convergence criterion, it was noted that **none of the countries under review participates in ERM II.**

The long-term interest rate criterion

The criterion on the convergence of interest rates referred to in Article 140(1) of the Treaty means that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability. The reference period for the 2016 report was from May 2015 to April 2016. Over that period, the long-term interest rates of the three best performing countries in terms of price stability were 1.7% (Slovenia), 1.7% (Spain) and 2.5% (Bulgaria). As a result, the average rate was 2.0% and, adding 2 percentage points, the reference value was 4.0%.

According to the report, **all seven countries under review** recorded long-term interest rates **below the reference value**.

SUMMARY OF GDP GROWTH PROJECTIONS OF SELECTED INSTITUTIONS

Table 1 Global economy

	Release	2016		2017		2018	
IMF	April 2016	3.2	(-0.2)	3.5	(-0.1)	-	-
OECD	June 2016	3.0	(=)	3.3	(=)	-	-
EC	May 2016	3.1	(-0.2)	3.4	(-0.1)	-	-
ECB 1	June 2016	3.1	(-0.1)	3.7	(-0.1)	3.8	(-0.1)

Table 2 United States

	Release	2016		2017		2018	
IMF	April 2016	2.4	(-0.2)	2.5	(-0.1)	-	-
OECD	June 2016	1.8	(-0.2)	2.2	(=)	-	-
EC	May 2016	2.3	(-0.4)	2.2	(-0.4)	-	-
Federal Reserve	June 2016	1.95	(-0.25)	2.05	(-0.1)	1.95	(=)

Table 3 Euro area

	Release	2016		2017		2018	
IMF	April 2016	1.5	(-0.2)	1.6	(-0.1)	-	-
OECD	June 2016	1.6	(0.2)	1.7	(=)	-	-
EC	May 2016	1.6	(-0.1)	1.8	(-0.1)	-	-
ECB	June 2016	1.6	(0.2)	1.7	(=)	1.7	(-0.1)

Table 4 Czech Republic

	Release	2016		2017		2018	
IMF	April 2016	2.5	(-0.1)	2.4	(-0.2)	-	-
OECD	June 2016	2.4	(0.1)	2.6	(0.2)	-	-
EC	May 2016	2.1	(-0.2)	2.6	(-0.1)	-	-
ČNB	May 2016	2.3	(-0.4)	3.4	(0.4)	-	-

Table 5 Hungary

	Release	2016		2017		2018	
IMF	April 2016	2.3	(-0.2)	2.5	(0.2)	-	-
OECD	June 2016	1.6	(-0.8)	3.1	(=)	-	-
EC	May 2016	2.5	(0.4)	2.8	(0.3)	-	-
MNB	March 2016	2.8	(0.3)	3.0	(=)	-	-

Table 6 Poland

	Release	2016		2017		2018	
IMF	April 2016	3.6	(0.1)	3.6	(=)	-	-
OECD	June 2016	3.0	(-0.4)	3.5	(=)	-	-
EC	May 2016	3.7	(0.2)	3.6	(0.1)	-	-
NBP	March 2016	3.8	(0.5)	3.8	(0.3)	3.4	-

1) Global economic growth excluding the euro area.
Note: Data in brackets denote the change in percentage points from the previous projection.