

# External Economic Environment







# 1 External Economic Environment

## 1.1 Global trends in output and prices

The year-on-year growth of the world economy slowed down slightly to 4.9% in 2007 compared to 5.0% in 2006. Nevertheless, the global economic growth remained quite robust. A favourable development of the global economy was recorded particularly in the first half of 2007. The second half of the year was negatively affected by the financial market turmoil and by unfavourable prospects for the development of the US economy. The financial tension, which was associated with the development in the US real estate sector, resulted in a sudden shortage of liquidity in financial markets and increased risk aversion. Risk reassessment and a shift from risky assets to secure assets came to the fore. This activity was accompanied by an increased volatility on the financial markets and by fears of a more considerable pass-through of this turmoil into the global growth. The financial turbulences have primarily affected financial institutions; the effect on non-financial institutions was not significant. The crisis also did not have a strong impact on global economic growth, except for a short-term market volatility and fluctuations in the development of exchange rates. Strong economic activity in the emerging economies constituted a dampening factor hindering a more considerable

deepening of the impact of the financial turmoil on the world economy.

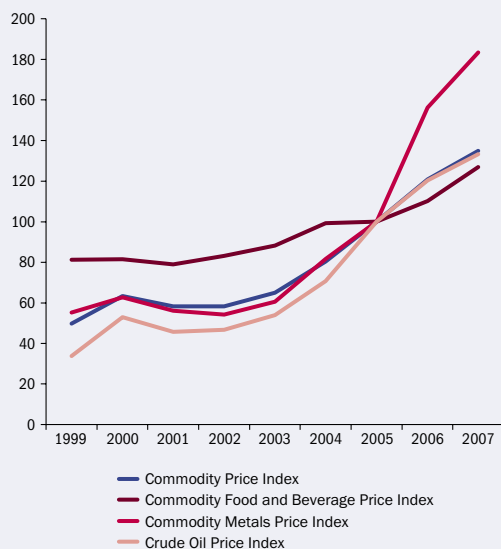
Another factor having dampened the world economy growth at the end of 2007 was a slowdown of the US economy and fears of its subsequent pass-through to the global economy. The impact of the economic slowdown in the United States on the global economy, however, has ultimately not been as strong as expected.

As a result of the slowdown of global economic activity, the growth rate of foreign trade decreased in 2007, with year-on-year growth reaching 6.6% as compared to 9.2% in 2006. The slowdown of foreign trade between developed economies has been compensated for by the growth of trade between the emerging economies, above all by mutual intraregional trade of South East Asia countries.

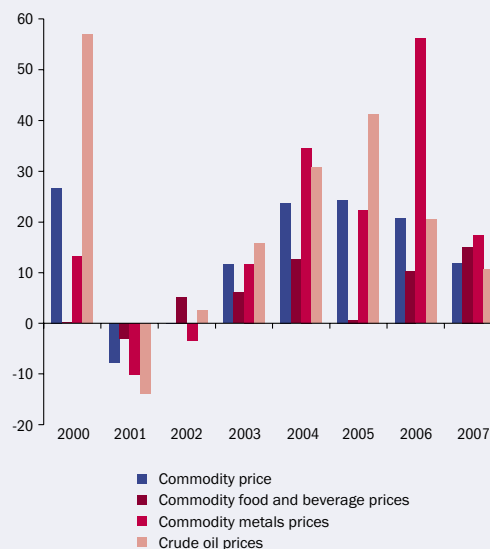
The price development in the first half of 2007 was stabilized and inflation remained at relatively low levels. In the second half of 2007, the growth rate of inflation accelerated as a result of high prices of oil and agricultural commodities. The average annual inflation for 2007 reached 3.9% against 3.4% in 2006. The year-on-year change in the price level at the end of 2007 reached 4.8% against 3.5% in 2006.

Table 1 World output	(year-on-year growth in %)		
	2005	2006	2007
World	4.4	5.0	4.9
Advanced economies	2.6	3.0	2.7
United States	3.1	2.9	2.2
Japan	1.9	2.4	2.1
Euro area	1.6	2.8	2.6
Emerging Asian economies	9.0	9.6	9.7
China	10.4	11.1	11.4
India	9.1	9.7	9.2
Russia	6.4	7.4	8.1
Central and Latin America	4.6	5.5	5.6
Brazil	3.2	3.8	5.4
Middle East	5.7	5.8	5.8

Sources: World Economic Outlook, IMF, January 2008, Eurostat.

**Chart 1 Price development**  
(prices in USD; index, year 2005 = 100)

Sources: World Economic Outlook, IMF, April 2008.

**Chart 2 Year-on-year changes in commodity prices** (%)

Sources: World Economic Outlook, IMF, April 2008.

During 2007, oil prices were permanently growing, mainly in the second half of the year, when the year-on-year oil price growth rate was accelerating. In comparison with the beginning of the year, the oil price increased by 56.9% at the end of 2007 and reached its maximum value of 95.55 USD/barrel in November. The average oil price in 2007 was 72.80 USD/barrel. Compared to the average price in 2006, when the average reached 66.30 USD/barrel, it increased by 9.8%. The demand for oil in OECD countries fell as a result of the high oil prices. This fall was compensated for by a demand growth in the emerging economies. Despite higher income of the oil countries and new investments in the oil industries, the extraction and refining capacities remain limited. This factor, as well as global tensions, the dollar depreciation, activities of speculative investors and hedge funds, continue to keep oil prices at high levels.

In the first half of 2007, the prices of metals and nonferrous metals recorded a considerable growth, primarily as a result of strong demand in the emerging Asian economies, as well as due to low processing capacities of industrial metals. In the second half of the year, however, their year-on-year growth rate decreased. Nevertheless, the prices of industrial metals showed the highest year-on-year price growth rate among commodities in 2007.

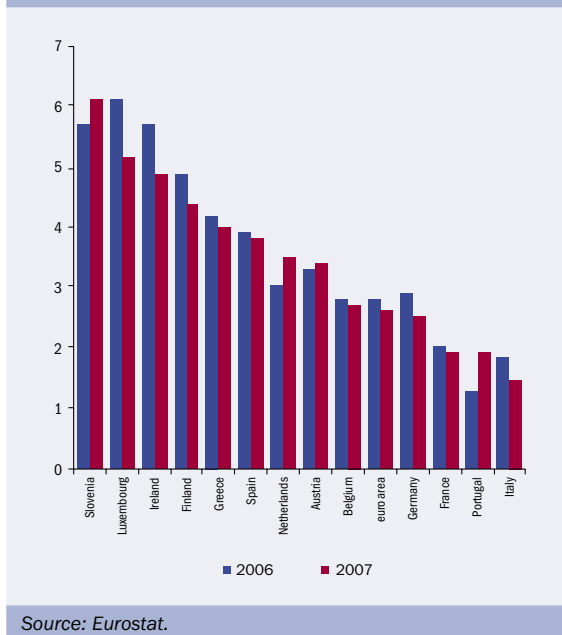
The negative price development in the second half of the year was considerably driven by the prices of agricultural and food commodities. The prices were growing as a result of strong demand on the part of Asian emerging economies. Another negative factor

affecting the price development was an increased bio fuels production, which primarily had an impact on the growth of cereal prices. Unfavourable climatic conditions have caused crop failures of agricultural commodities and thereby also lower crops than expected, implying a pressure on price increases. The price growth of agricultural commodities was considerably promoted by historically high oil prices, which have caused the cost for agricultural producers to increase. The year-on-year change in the prices of agricultural commodities recorded a 15% growth in 2007.

The development of exchange rates in the world was characterized by a continuing euro appreciation against the US dollar, Japanese yen, pound sterling and the Swiss franc. The euro achieved the highest appreciation against the US dollar. The development of foreign exchange rates in the first half of 2007 was influenced primarily by a weak economic development in the United States and by expectations of changes in the US and euro area interest rates. The development of foreign exchange rates in the second half of 2007 was considerably influenced by the financial market turbulences.

## 1.2 Economic development in the euro area

In 2007 the economic growth in the euro area slightly slowed down to 2.6% from its level in 2006 (2.8%). This development was influenced by the one-off impact of the VAT increase in Germany, as well as by

**Chart 3 GDP growth in euro area countries (%)**


Source: Eurostat.

**Chart 4 Changes in the economic growth rate in 2007 compared to 2006 (p.p.)**


Source: Eurostat.

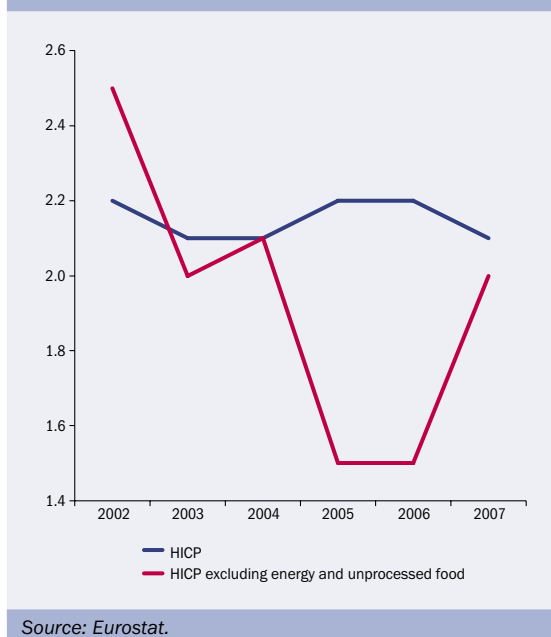
a negative impact of higher food and energy prices on the level of the disposable income of households and consumer confidence. The development of inflation, as well the money market turmoil contributed to a deterioration of consumer expectations in the second half of 2007. Despite the growing uncertainty in the second half of 2007, the euro area economy achieved relatively favourable results. In December 2007, unemployment fell considerably to 7.2% (it reached 7.8% in December 2006) and was at historically lowest levels.

Overall average HICP inflation in 2007 reached 2.1%, i.e. 0.1 of a percentage point less than in the previous two years. The average of 2007, however, is the result of two different development trends. In general, the year-on-year rate of inflation was stable at a level below 2% till the end of the summer. Its level increased slightly in September 2007 – for the first time since August 2006 – and it kept growing up to 3.1% (in November and December 2007).

In 2007, inflation was to a great extent determined by a strong increase in the energy and food prices. The oil price increase at the beginning of 2007 and its influence on energy prices was reduced by the base effect till the end of August 2007. However, subsequently, the conjunction of the oil price increase and the unfavourable base effect caused a substantial increase in the level of the overall HICP. The contribution of prices of unprocessed food to growth of consumer prices was higher all over 2007. Prices of processed food started to rise from the late summer and they contributed to a higher inflation during the last months of the year.

In general, food prices went up faster both at the producer and at the consumer level.

The year-on-year rate of growth in industrial producer prices reached 2.8% in 2007, which is a level considerably below that of the preceding two years (4.1% in 2005 and 5.1% in 2006). The main reason for this development was the base effect, which influenced the energy components to a considerable extent and

**Chart 5 Development of HICP inflation in the euro area (%)**


Source: Eurostat.



Chart 6 Year-on-year changes in individual components of HICP inflation in the euro area (%)

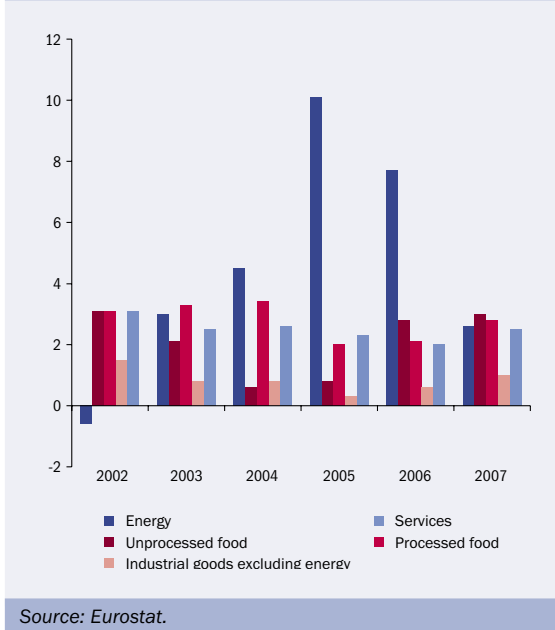


Chart 7 USD/EUR exchange rate development in 2007



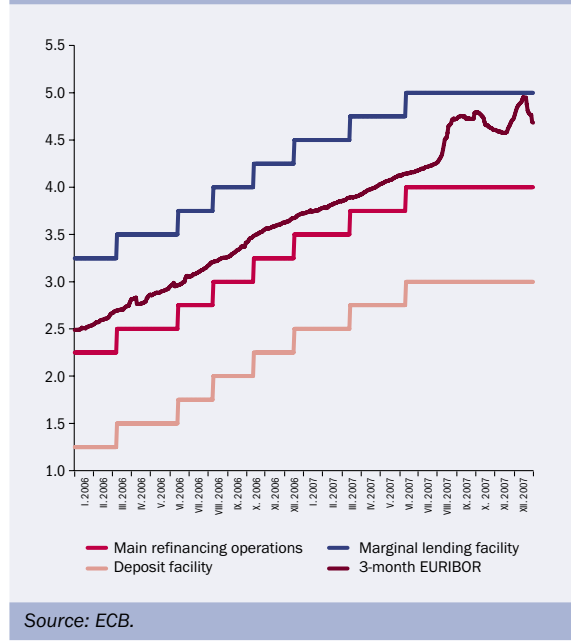
lasted till the beginning of the second half of the year. From September, the year-on-year growth rate of energy producer prices started to be pushed up by the increase in the prices of oil, agricultural commodities and by the base effect.

The euro exchange rate against US dollar appreciated by almost 11% during the year. At the beginning of 2007, the euro showed a depreciation trend against other currencies. As a result of a positive economic development in the euro area, however, the depreciation trend came to a halt and the euro started to gradually appreciate against other currencies. The financial market crisis, which resulted in an increase in risk aversion and risk reassessment, brought about considerable volatility in the development of exchange rates. Due to concerns regarding liquidity on the money market stemming from financial crisis, the euro appreciated significantly, in particular against the US dollar. Weak economic data and the continuing mortgage turmoil have contributed to the dollar depreciation. All over the year, this trend was influenced by fears of a considerable economic growth slowdown in the United States, as well as of the recent development in the US real estate market. In May and August, the euro appreciation mitigated as a result of favourable confidence indicators in the United States and a lower willingness of European banking houses to keep investments in the US real estate market. After the September cut in federal funds rates by 0.5 of a percentage point to 4.75%, the euro appreciation continued in the following months. It continued to be influenced by persistent fears that the impact of the real estate market turmoil in the

United States on the US economy could be more serious than expected.

In 2007 the ECB conducted its monetary policy in an environment of sound economic growth. Throughout the year, the ECB reacted to risks that could endanger price stability and increased the key interest rates twice, in May and June, by a total of 50 basis points. The ECB key interest rate moved up from 3.5% in De-

Chart 8 ECB interest rates and EURIBOR (%)



ember 2006 to 4.0% in June 2007. Despite growing risks associated with the development in financial markets – which could negatively affect price stability – from August 2007 onwards, the ECB Governing Council decided to keep the key interest rates unchanged in the second half of the year.

In connection with the volatility in the financial markets, the ECB decided to conduct two supplementary longer-term refinancing operations.

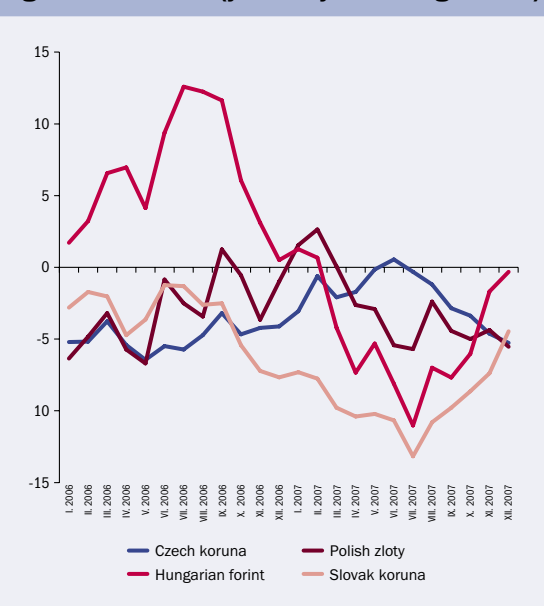
### 1.3 Development in Visegrad countries

In 2007, the economies of the Czech Republic and Poland recorded a slightly higher economic growth as compared to the previous year, driven mainly by consumption and investment. The GDP growth rate in Hungary, on the other hand, decreased, which represented a continuation of the trend towards a slowdown in the economy from the previous year. Year-on-year inflation accelerated in all Visegrad countries (V4 countries), primarily due to growing food and energy prices. As a result of positive investors' mood in the region, the Hungarian forint and Polish zloty were appreciating against the euro in the first half of the year; however, these appreciation tendencies came to a halt in the second half of the year, as a result of the turmoil in international financial markets. Compared to the zloty and forint, the Czech koruna showed conflicting trends, which were associated with the use of the Czech koruna as a funding currency in “carry trades”. Česká národní banka (ČNB) and Narodowy Bank Polski (NBP) increased their interest rates; Magyar Nemzeti Bank (MNB), on the other hand, reduced its interest rates.

The **Czech Republic** maintained its relatively high economic growth from the previous periods. In comparison with 2006, GDP growth accelerated by 0.1 of a percentage point to 6.5%. Investments and consumption – mainly household consumption – participated to an important extent in the growth of the economy. The household consumption growth was influenced by a falling rate of unemployment, growing gross disposable income and high consumer confidence. The rate of unemployment fell by 1.8 percentage points to 5.3%.

The average annual rate of HICP inflation stood at 3%, 0.9% of a percentage point above the 2006 level. Compared to the previous year, the highest price increase occurred with processed food prices, where an increase in the consumption tax on tobacco influenced the price level in the first half of the year. In the second half of the year, the food prices were primarily affected by global factors. In addition to food prices, energy prices also recorded an increase.

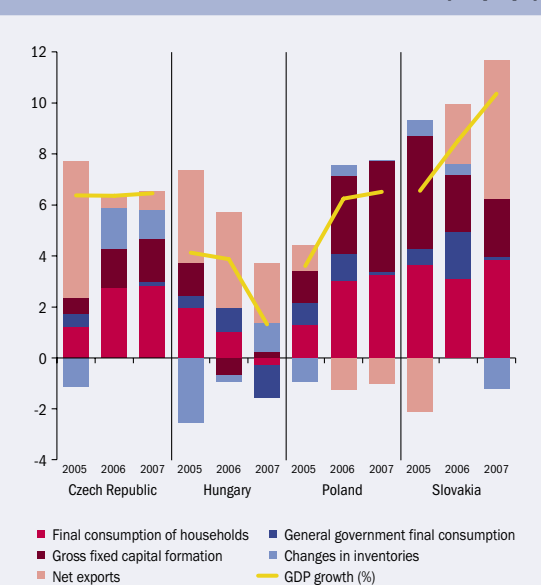
Chart 9 Exchange rates of V4 currencies against the euro (year-on-year changes in %)



Sources: Eurostat, NBS calculations.  
Note: Negative values denote appreciation.

The development of the Czech koruna exchange rate was partly different as compared to that of other currencies in the region. In the first quarter, the Czech koruna was lagging behind slightly, probably due to a negative interest rate differential against the other currencies of the V4 countries. The depreciation of the Czech koruna in the second quarter was brought about by opening of “carry trades”, in which borrowed

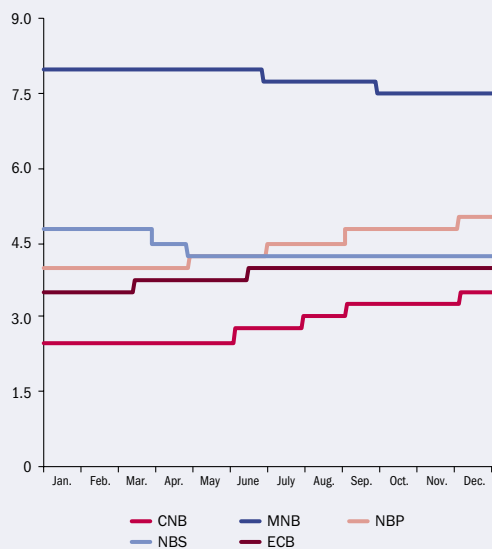
Chart 10 Contributions to GDP growth (in p. p.)



Sources: Eurostat, NBS calculations.

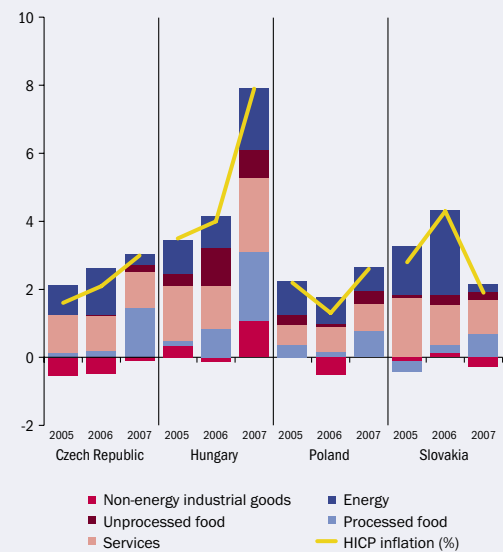


Chart 11 Key rates of national central banks (% p.a.)



Sources: National central banks, ECB.

Chart 12 Contributions to HICP inflation (in p.p.)



Sources: Eurostat, NBS calculations.

korunas were invested up to the level of interest-bearing foreign currency assets. In the second half of the year (as a result of growing risk aversion and subsequent closing of “carry trades”), the koruna started to appreciate again. The exchange rate appreciation was driven inter alia by CNB interest rate hikes and market expectations regarding their further increases.

Over the course of the year, Česká národní banka raised its key interest rate by a total of one percentage point to 3.5%, due to higher than expected inflation. Another reason for the increase in interest rates was an increasing production gap and its possible negative impact on the Czech economy.

In 2007, the **Hungarian** economy's slowdown continued, with GDP growth having decreased by 2.6 percentage points to 1.3%. The GDP growth decline was due to a decrease in household consumption and government spending as a result of administrative changes and fiscal measures of 2006. The growth of the economy was fuelled primarily by net exports and changes in inventories. Compared to 2006, the rate of unemployment fell slightly to 7.4%.

Inflation increased by 3.9 percentage points against the previous year, to a level of 7.9%. Services, food and changes in regulated prices in January 2007 contributed most to the acceleration of price level growth. The effect of the September 2006 VAT increase was also reflected in the prices of goods and services. At the end of the year, inflation accelerated as a result of the global growth of food and oil prices.

The Hungarian forint exchange rate appreciated from January 2007 onwards as a result of positive investors' mood and interest in currencies of the Central European region. The longer lasting appreciation trend (from August 2006) ended in the second half of the year, when the exchange rate began to be affected by the incipient liquidity tension in the United States and the related uncertainty in the financial markets. Among the V4 countries, the increase in investors' risk aversion was reflected most in the Hungarian forint exchange rate, which was subsequently depreciating until the end of 2007.

MNB reduced the interest rates twice in the course of the year. At its June meeting, it decreased the interest rate by 0.25 of a percentage point as a result of a decreasing inflation, which according to the inflation forecast had passed its peak and was supposed to decrease further. Another reduction, by 0.25 of a percentage point to 7.5%, was performed in September due to a slowdown of the economy and a persistent decline in the domestic demand.

The economic growth of **Poland** accelerated by 0.3 of a percentage point to 6.5%. Similarly to the situation in the Czech Republic, the sources of growth were investment and household consumption. Investment activity climbed in all sectors, however, primarily in the corporate sector. Consumer spending was influenced by a growth in real household income, which grew faster than labour productivity. The growth of domestic demand was also the result of improved conditions on the labour market, where the rate of





unemployment fell by 4.2 percentage points against 2006, to 9.6%.

Inflation in Poland accelerated by 1.3 percentage points and reached 2.6%. Similarly to other countries of the Visegrád group, prices of food and energy, influenced by global factors, grew most. The price level was also influenced by a growth of household income and the subsequent higher demand. The dampening effect of industrial goods prices came down at the same time.

In the first half of the year, the exchange rate of the Polish zloty was primarily influenced by domestic factors. An improved rating, a good macroeconomic situation and expectations of interest rate increases

accompanied by a decrease in risk aversion on emerging markets resulted in an exchange rate appreciation against the euro. The depreciation of the Polish zloty in the second half of the year was connected to the financial market turmoil. At the end of the year, the exchange rate appreciated again due to interest rate increases.

The NBP raised its reference interest rate four times over the course of 2007, by a total of one percentage point to a level of 5%. The main reasons for increasing the rates include a growth of the economy above its potential, faster growth of wages compared to labour productivity, as well as growing inflation towards the end of the year, which exceeded the upper limit for deviations from the NBP inflation target.