



NÁRODNÁ BANKA SLOVENSKA
EUROSYSTEM

CHAPTER 1

THE EXTERNAL ECONOMIC ENVIRONMENT

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1 THE EXTERNAL ECONOMIC ENVIRONMENT

1.1 GLOBAL TRENDS IN OUTPUT AND PRICES

In 2008, the global economy was substantially influenced by the financial crisis as a result of the US sub-prime mortgage market collapse in 2007. The financial crisis deepened in 2008, pushing the economy into a severe global recession with a marked slowdown in real economic activity. In the first three quarters, advanced economies were affected most severely, while emerging economies remained relatively resistant to the financial crisis as a result of buoyant domestic demand. Hence, global economic activity remained relatively strong. At the beginning of the final quarter, however, these economies were also hard hit by the rapidly deepening financial crisis. This development led to the synchronisation of the global business cycle, with all countries recording a slowdown in economic activity. The year-on-year rate of global economic growth slowed to 3.8% in 2008, from 5.2% in 2007. The most significant slowdown took place in advanced economies. In 2007, financial institutions were worst affected, but in 2008 the crisis spread to the non-financial sector, as well as to the real economy. The problems in the financial sector led to risk reassessment, financial market

turmoil, and the tightening of credit standards. The high commodity prices in the first half of 2008 also contributed to the slowdown in economic activity in advanced economies. After the financial crisis deepened still further in the final quarter of 2008, credit conditions were tightened on a global scale, capital flows were greatly restricted, the costs of external financing increased, which led to a decrease in business and consumer confidence. Most seriously affected by these developments were emerging economies, which recorded currency depreciation, coupled with a significant slowdown in economic growth caused by a sharp decline in exports.

The downturn in global economic activity led to a slowdown in the year-on-year growth rate of foreign trade, to 4.1% in 2008, from 7.2% in 2007. Imports in advanced economies experienced a sharp slowdown, which was subsequently reflected in the exports of emerging economies. In the first three quarters, the slowdown in foreign trade was partly offset by an increase in trade between emerging economies, due mainly to intra-regional trade between the countries of South-East Asia. As a result of the deepening financial crisis, the dynamics of

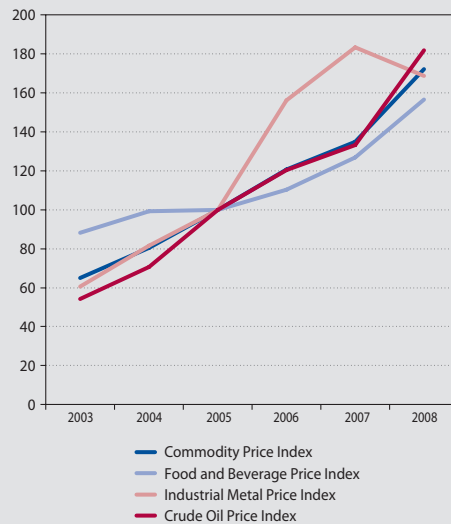
Table 1 World output (year-on-year growth in %)

	2006	2007	2008
World	5.0	5.2	3.2
Advanced economies	3.0	2.7	0.9
United States	2.9	2.0	1.1
Japan	2.4	2.4	-0.6
Euro area	2.8	2.6	0.8
Emerging Asian economies	9.6	10.6	7.7
China	11.1	13.0	9.0
India	9.7	9.3	7.3
Russia	7.4	8.1	5.6
Central and Latin America	5.5	5.7	4.2
Brazil	3.8	5.7	5.1
Middle East	5.8	6.3	5.9

Source: World Economic Outlook, IMF, April 2009, Eurostat.

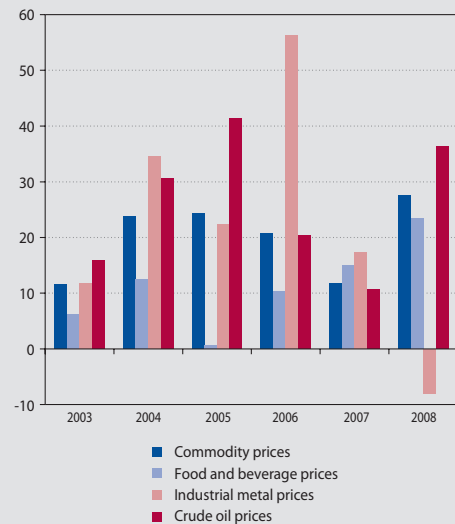


Chart 1 Price developments (USD price indices; year 2005=100)



Source: World Economic Outlook, IMF, April 2009.

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



Source: World Economic Outlook, IMF, April 2009.

foreign trade in this region also weakened to a significant extent.

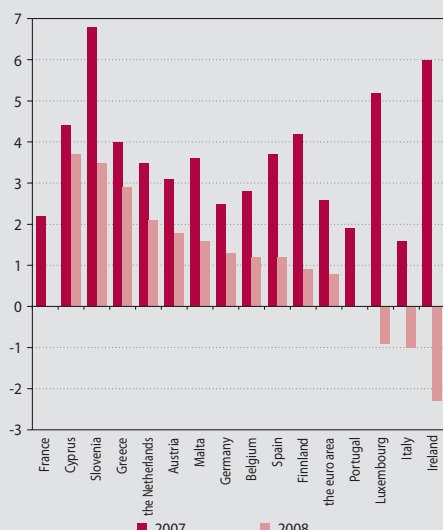
Price developments were highly volatile in 2008, mainly in the first six months when intense inflationary pressures occurred as a result of oil and agricultural commodity price increases. In the second half of the year, after the financial crisis deepening, this movement reversed, as the inflation markedly decelerated and gave rise to concerns about the possibility of deflation in some countries towards the end of the year. The average annual inflation rate stood at 3.5% in 2008, compared with 2.1% in 2007. At the end of 2008, the year-on-year inflation rate reached 5.9%, compared with 5.0% in 2007.

Oil prices were volatile over the course of 2008, mainly as a result of the global economic crisis. In the first half of the year, oil prices reached a historical high, at USD 144/barrel in July 2008. This was the result of strong demand in emerging Asia, while OECD countries recorded a fall in demand for oil owing to the high oil prices and the slowdown in the pace of economic growth. In the second half of the year, the deepening financial crisis was accompanied by a sharp fall in oil prices, which reached a minimum in December, at USD 35.82/barrel. In this period, demand for oil fell not only in the OECD countries, but also in emerging economies, which were severe-

ly hit by the global crisis. The average price of oil stood at USD 97/barrel in 2008. This represented a rise of 33% compared with the average price for 2007 (USD 72.8/barrel). Despite this, the spot price of oil dropped by 37% at the end of 2008, compared with the beginning of the year.

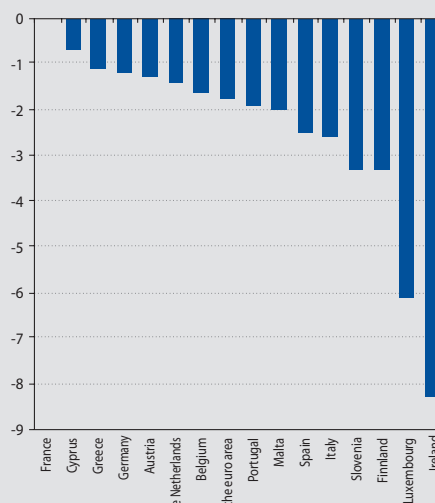
The prices of metals, including nonferrous metals, and agricultural commodities followed a similar course as oil prices. They were also volatile and also reflected the global economic situation. In the first half of the year, they rose mainly as a result of strong demand in emerging Asia. In the second half, when the financial crisis intensified, they recorded a marked fall as a result of growing concerns about the further trend in the global economy. The steepest increases over the first six months took place in agricultural commodity prices, which made a significant contribution to inflation in the emerging economies in particular. In the second and third quarters, however, agricultural commodity prices began to fall as a result of the economic slowdown and the better-than-expected crops. In the first half of the year, the prices of ferrous and nonferrous metals also increased, and reached a peak at the beginning of July 2008. Owing to concerns about the further course of economic development, however, agricultural commodity prices experienced a marked fall in the second half of 2008.

Chart 3 GDP growth in euro-area countries in 2007 and 2008 (%)



Source: Eurostat.

Chart 4 Changes in the economic growth rate in 2008 compared with 2007 (%)



Source: Eurostat.

1.2 ECONOMIC DEVELOPMENT IN THE EURO AREA

Despite growth in the first quarter of 2008, the euro-area economy experienced a decline in the following quarters, which deepened towards the end of the year. Compared with 2007 (2.6%), the rate of economic growth in the euro area slowed considerably in 2008, to 0.8%. This was the result of a sharp downturn in economic activity, driven by a weakening of domestic demand combined with a pronounced slowdown in the world economy. This mainly occurred at the end of the year, which saw a further economic decline and renewed turmoil in the financial markets. This was subsequently reflected in the decline in consumption and the negative contribution of net exports, when exports declined more sharply than imports in the final quarter. This also led to deterioration in unemployment, which increased from 7.2% in December 2007 (a historical low) to 8.1% in December 2008.

In 2008, the average rate of headline HICP inflation reached 3.3%, representing a marked increase compared with the previous two years, when inflation fluctuated around the level of 2.1% and 2.2%, respectively. As in the previous year, inflation in 2008 was largely determined by commodity prices, predominantly by energy and food prices. In the first part of the year, a boom

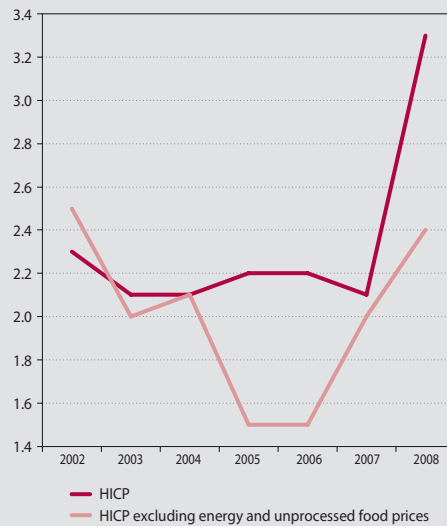
in world demand pushed up commodity prices to extremely high levels, while the rapid slowdown in economic activity in the second part of the year abruptly pushed them down again at the end of 2008. These developments were also reflected in the course of HICP inflation, when food and energy prices peaked in the middle of the year. Thus, headline inflation reached a historical high in July (4%). These components fell sharply in the second half of the year, causing a slowdown in inflation, to 1.6% in December. Compared with December 2007 (3.1%), the dynamics of HICP growth moderated to a significant extent. The rate of HICP inflation, excluding energy and food prices (processed as well as unprocessed), remained virtually unchanged, at the level of 2007 (2.0%).

The year-on-year rate of increase in industrial producer prices reached 5.9% in 2008, more than twice the figure for the previous year (2.8%), as a result of commodity price developments. During the year, the year-on-year dynamics of industrial producer prices peaked in July at 9.2%, and then weakened as a result of the overall trend, to 1.1% in December.

The euro exchange rate against the US dollar depreciated by 5.2% during the year. The financial market turmoil that began in August 2007 continued in 2008. At the beginning of 2008, the

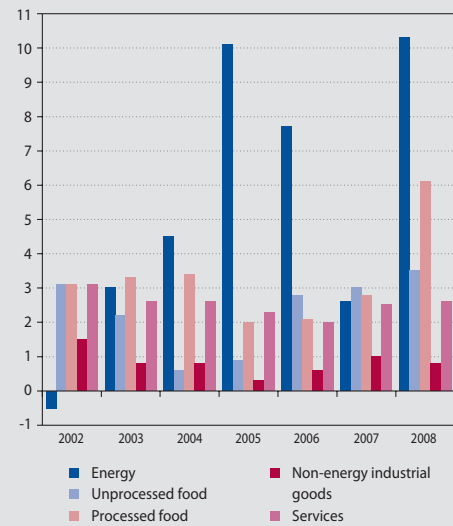


Chart 5 HICP inflation in the euro area (%)



Source: Eurostat.

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



Source: Eurostat.

euro followed the appreciating trend from the previous period and, after reaching a historical peak in April, was broadly stable until August. This appreciation was the result of expectations of a widening interest rate differential in favour of euro assets, reflecting market beliefs that the euro area was going to be affected by the ongoing financial turmoil to a lesser extent than the United States. From that period on, however, data releases began to show that the financial turmoil that originated in the US sub-prime mortgage market was unfolding into economic slowdown or even decline across all major economies. As a result, the euro experienced a sharp depreciation against the US dollar which, in three months, brought it to the level prevailing around mid-2007. The sharp depreciation of the euro was primarily associated with a revision of market expectations about the euro-area economic outlook – as the financial crisis continued to deepen and its global reach began to be realised. Both heightened market uncertainty and global risk aversion had a strong influence on the euro exchange rate against the dollar and other major currencies. The depreciation was also associated with a worldwide dollar liquidity shortage, which commanded a sizeable repatriation of foreign investments and led to concerted central bank policy actions. In December, however, the euro experienced a strong rebound as the impact of the non-cyclical and temporary

Chart 7 USD/EUR exchange rate developments in 2008



Source: ECB.

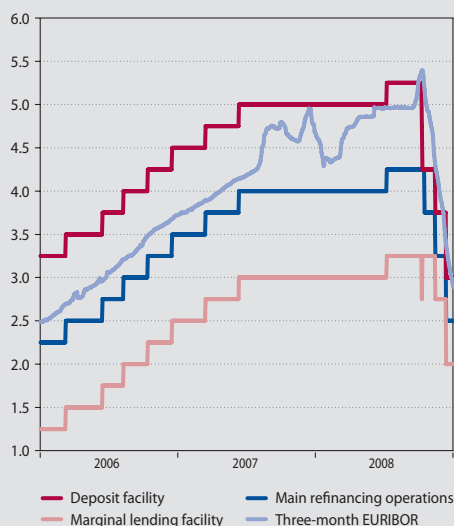
measures adopted in support of the dollar in the autumn waned and foreign exchange markets refocused attention on the growth outlook and interest rate differentials across the major economic areas.

In the course of 2008, the ECB conducted its monetary policy against the backdrop of the financial crisis observed since August 2007. Owing to the



high level of uncertainty caused by the financial market turmoil, the Governing Council raised the key ECB interest rates by 25 basis points in July, before lowering them in three stages by a total of 175 basis points in the final quarter of the year. Developments in the key ECB interest rates in 2008 reflected the evolution of risks to price stability over the medium-term horizon. In the first half of the year, the most significant risk factors were developments in international commodity prices and the economic impact of the ongoing financial turmoil, which intensified in September 2008. The Governing Council of the ECB reacted to this situation by taking a number of temporary liquidity management measures aimed at strengthening its intermediary function and calming the markets which were concerned about the risk of a liquidity shortage. These measures included the expansion of the list of assets eligible to be used as collateral in re-financing operations with the ECB and the introduction of instruments for longer-term liquidity supply. At the same time, instruments for providing sufficient liquidity denominated in US dollars and Swiss francs to the euro-area markets were introduced. A specific measure in October was the narrowing of the corridor of standing facility rates from 200 to 100 basis points around the interest rate on the main refinancing operation.

Chart 8 ECB interest rates and the EURIBOR (%)



Source: ECB.

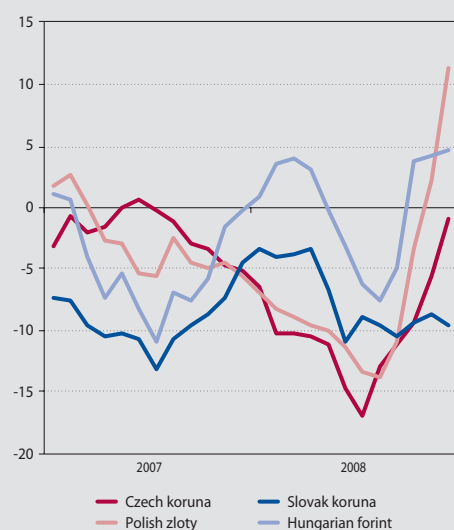
ever, later, in the light of weakening inflationary pressures and the deepening financial crisis, the central banks lowered their key rates.

Compared with 2007, economic growth in the **Czech Republic** slowed by 1.6 percentage points, to 4.4%. In 2008, the average inflation rate accelerated by 3.3 percentage points, to

1.3 ECONOMIC DEVELOPMENT IN THE CZECH REPUBLIC, POLAND AND HUNGARY

In 2008, slower economic growth was recorded in all three countries under review, i.e. the Czech Republic, Poland and Hungary. The slowdown was the result of the deepening financial and economic crisis, coupled with reduced foreign and domestic demand. Hungary reported a slowdown in price inflation, while the CR and Poland recorded higher annual inflation rates as a result of administrative measures. At the end of the year, all three countries recorded inflation within the tolerance band of deviations from the central bank inflation targets. After appreciating in the first half of 2008, the currencies of these countries depreciated against the euro in the second half of the year, as a result of increased risk aversion after the collapse of Lehman Brothers. During the year, the central banks of the region gradually increased their key interest rates, how-

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

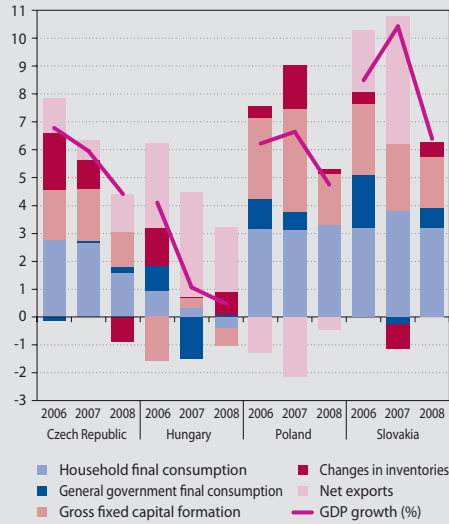


Source: Eurostat, NBS calculations.

Note: Negative values denote appreciation.

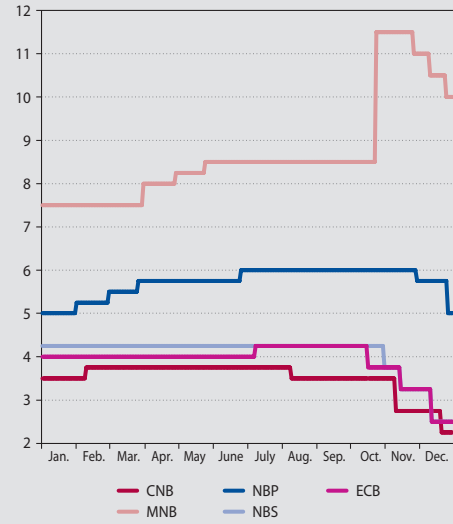


Chart 10 Contributions to GDP growth (percentage points)



Source: Eurostat, NBS calculations.

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



Source: NCB, ECB.

6.3%. The accelerated price increase was mainly due to administrative measures introduced in January 2008, primarily the increase in the lower VAT rates, excise duties, and health care fees. Owing to the slowing global demand, inflationary pressures weakened gradually over the second half of the year and inflation fell in comparison with December 2007 by 2.2 percentage points, to 3.3% at the end of 2008.

The appreciating trend of the Czech koruna from 2007 continued in the first half of 2008, mainly in the second quarter when the Czech koruna belonged to the most rapidly appreciating currencies. Like the Polish zloty and, to some extent, the Hungarian forint, the koruna profited from the tense situation in the advanced economies. Owing to the favourable domestic indicators and the stable environment, the Czech koruna was a relatively safe investment. In the second part of the year, after the crisis had spread to emerging economies causing increased risk aversion, the koruna depreciated at a relatively fast pace. The depreciating trend continued until the end of 2008: the Czech koruna had weakened against the euro by almost 1% since the end of 2007.

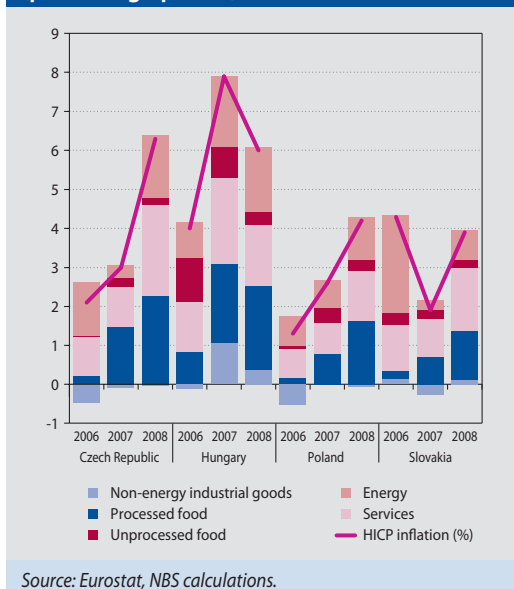
Česká národní banka (CNB) changed its key interest rates on four occasions in 2008. At the beginning of the year, CNB raised its two-week repo rate by 0.25 of a percentage point, mainly

in view of the risk that the higher inflation may be reflected in the inflation expectations. In the second half of the year, CNB was the first central bank in the region that started reducing its key interest rates: the reference rate was cut in three steps by a total of 1 percentage point (to 2.25%), particularly with regard to the economic slowdown and weakening inflationary pressures.

In 2008, **Hungary's** GDP growth slowed to 0.5%, which was 0.6 of a percentage point less than the figure for 2007. In the fourth quarter, the Hungarian economy recorded a negative year-on-year growth rate. Average inflation stood at 6% in 2008, representing a fall of 1.9 percentage points compared with the previous year. Price inflation slowed in all components, except in processed food prices. In the second half of the year, this trend came to a halt and inflation began to fall, mainly in the final quarter of 2008. Thus, the price increase slowed by 4 percentage points in December, to 3.4% (compared with the end of the previous year).

In the first quarter of 2008, the Hungarian forint followed a different course (compared with the other currencies) and depreciated as a result of the emerging financial market crisis. After the Hungarian forint's fluctuation band had been cancelled by the central bank in February, the forint appreciated gradually until the end of the

Chart 12 Contributions to HICP inflation (percentage points)



third quarter. At the end of the year, the forint depreciated relatively quickly as a result of the deepening financial crisis, growing risk aversion, and domestic financial market developments. In comparison with 2007, the forint weakened by more than 5%.

Magyar Nemzeti Bank (MNB) modified its key interest rates on seven occasions during 2008. In the first half of the year, MNB approved a series of interest rate hikes to dampen the secondary effects of the relatively high inflation and to prevent an increase in inflation expectations. To calm the situation in the domestic market, MNB raised its base rate by 3 percentage points in October, to 11.5%. Owing to a further slowdown in economic activity and weakening inflationary

pressures, the Hungarian central bank reduced its base rate three times by a total of 1.5 percentage points, to 10% at end-2008.

In 2008, **Poland's** economy slowed by 1.8 percentage points, to 4.8%. Price inflation accelerated by 1.6 percentage points (to 4.2%), mainly as a result of a rise in food prices, as well as in energy and services prices, due to administrative adjustments made at the beginning of 2008 (as in the CR). Compared with the previous year, the year-on-year inflation rate fell by 0.9 of a percentage point, to 3.3% in December (as in the CR).

In the first half of the year, the exchange rate of the Polish zloty, like the Czech koruna, was influenced by the country's positive economic fundamentals and the growing tensions in advanced economies. The attractiveness of the zloty was also supported by increases in the central bank's key rates. At the beginning of the fourth quarter, the Polish zloty experienced a relatively sharp depreciation as a result of increased risk aversion and deteriorated sentiment in the region. Compared with the end of 2007, the exchange rate depreciated by almost 16%, which was the sharpest currency depreciation in the region.

Narodowy Bank Polski (NBP) modified its key interest rates on six occasions in 2008. Owing to the persistent high inflation, rapid wage growth compared with labour productivity, and concerns about the pro-cyclical impact of the state budget on the economy, NBP increased its reference rate in four steps by a total of 1 percentage point over the first six months, to 6%. In view of the slowdown in economic activity and lower inflation, NBP decided to lower its reference rate to 5% at the end of the year.