CHAPTER 1

THE EXTERNAL ECONOMIC ENVIRONMENT

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1 The External Economic Environment

1.1 GLOBAL TRENDS IN OUTPUT AND PRICES

In 2009, global economic activity recorded its steepest downturn since the times of the Great Depression. The adverse economic developments of 2008 were transmitted to the global economy largely through a slump in foreign trade and they reached their peak in the first half of 2009. The sharpest decline in global economic activity was recorded in the first quarter of 2009. Several countries sought to revive their economies by taking extensive fiscal and monetary stimulus measures. The principal aim of the fiscal stimuli was to boost domestic demand and sustain domestic economic activity, while the level and form of these stimuli varied from one country to another. Whereas in advanced countries the stimulus measures were largely directed at maintaining domestic demand, in emerging economies they focused mainly on infrastructure projects. Non-standard monetary-policy measures were implemented predominantly in advanced economies, where they helped to stabilise the financial sector. The effects of these measures gradually began to be felt in the second and third quarters of 2009, when the global economy stopped contracting and made a tentative return to growth. The trend recovery of global economic activity continued in the fourth quarter. For the whole of 2009, the world economy declined by 0.6% year-on-year, compared with a rise of 3.0% in 2008. The downturn was more pronounced in advanced economies, certain European emerging economies, and Latin American countries. In advanced countries, the economic slump was attributed mainly to falls in both domestic demand and export activity, while in Latin America, the Middle East and Russia, it was driven by a decline in world commodity prices. In emerging market countries, the primary cause of the slowdown in economic activity was the drop in foreign trade, although another key factor was the flight of foreign capital and investments from these countries. As for emerging Asian countries, they managed to record growth (albeit at a far slower pace than in 2008) on the basis of relatively robust domestic demand.

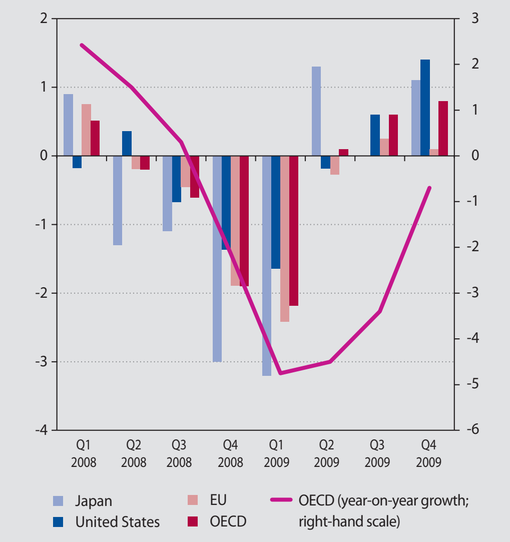
It was through the collapse in external trade that the financial crisis spilled over from advanced economies to the global economy. After recording a year-on-year decline of 2.8% in 2008, external trade plunged by 10.7% in 2009. The sharp contraction of imports in advanced economies had an adverse effect on the exports of emerging economies, particularly those in Asia. This effect could not be offset either by the intrar-

Table 1 World output (annual percentage growth)

	2007	2008	2009
World	5.2	3.0	-0.6
Advanced economies	2.7	0.5	-3.2
United States	2.0	0.4	-2.4
Japan	2.4	-1.2	-5.2
Euro area	2.6	0.6	-4.1
Emerging Asian economies	10.6	7.9	6.6
China	13.0	9.6	8.7
India	9.3	7.3	5.7
Russia	8.1	5.6	-7.9
Central and Latin America	5.7	4.3	-1.8
Brazil	5.7	5.1	-0.2
Middle East	6.3	5.1	2.4

Source: World Economic Outlook, IMF, April 2010, Eurostat.

Chart 1 Quarterly GDP growth (%)



Source: OECD.

egional trade of South-East Asian countries or by the relatively robust domestic demand in these countries. The result of this development was a synchronisation of global economic activity and a slump in external trade in the first half of 2009, with export-oriented countries being harder hit. As the economy gradually began to recover in the second half of 2009, so external trade increased, too.

Global price developments in 2009 were dominated by the sharp decline in commodity prices that began in the second half of 2008 and by the related base effect. In first half of 2009, partial concerns about inflation were prevalent and some countries recorded temporarily negative inflation. In the second six months, however, consumer price inflation rose gradually, reflecting developments in energy prices and the steady recovery in economic activity. The average annual inflation rate for 2009 was 2.4%, compared with 6.0% in 2008. The year-on-year inflation rate as at the end of 2009 was 2.9%, compared with 4.5% a year earlier.

Oil prices were less volatile in 2009 than in the previous year. Following a sharp fall in the second half of 2008 (due to a the crisis and a drop in demand for oil), oil prices gradually steadied in the first quarter of 2009 and they then rose gradually in the second quarter amid a more positive outlook for the global economy's recovery. Demand for oil was again strongest among emerging Asian economies, especially China. The average price of oil in 2009 was USD 62 / barrel, representing a drop of 36% compared with the average price in 2008 (USD 97 / barrel). The steep decline in oil prices in the second half of 2008 continued into the first quarter 2009, with the average price reaching a low of USD 39 / barrel in February. As economic activity gradually rebounded, the oil price recorded an uninterrupted rise until it peaked at USD 78 / barrel in December 2009. At the year-end, the spot price of oil was 81% higher than at the beginning of the year, even though it was less than the average for 2008.

As for prices of metals, non-ferrous metals, and agricultural commodities, their development was similar to that of the oil price. They, too, were relatively stable and rose gradually over the course of the year. Like oil prices, these prices were affected by the global economic situation and the outlook for economic recovery. Prices of metallic and non-metallic commodities increased mainly in the second half of 2009. The increase in demand for these commodities was particularly high in China, owing to the fiscal measures taken by that country to support infrastructure development. In the case of these prices, too, the gradual recovery of the global economy put them under upward pressure mainly in the last quarter of 2009. Prices of agricultural commodities during 2009 were determined by developments in the global economy and their movement was not significantly different from that of other commodity prices.

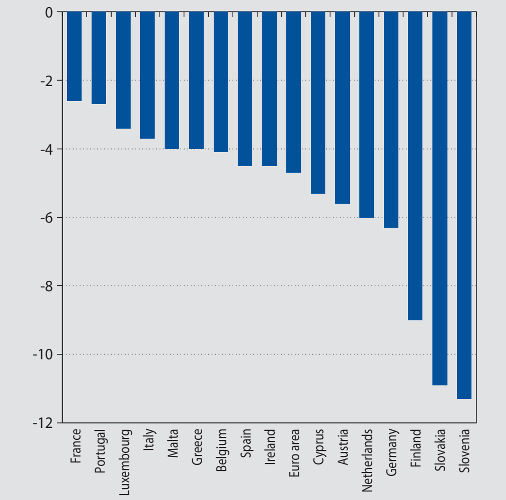
1.2 ECONOMIC DEVELOPMENTS IN THE EURO AREA

After growing by 0.6% in 2008, the euro area economy contracted by 4.1% in 2009. This was largely attributable to the global slowdown and the consequent decline in domestic demand. The economy was adversely affected by the negative contribution of net exports to GDP as well as by the decline in gross fixed capital formation. A combination of mounting uncertainty and an unfavourable situation in the labour market (unemployment rose from 8.2% in December 2008 to 9.9% in December 2009) translated into

Chart 2 GDP growth in euro area countries in 2008 and 2009 (%)

Source: Eurostat.

Chart 3 Changes in the economic growth rate between 2009 and 2008 (%)

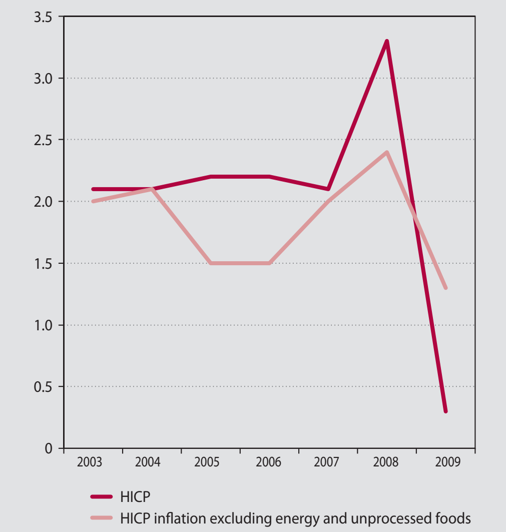


Source: Eurostat.

a downturn in consumer demand. During the year, individual governments adopted stimulus packages aimed at reviving the economy by supporting industry, the labour market and consumer demand. These measures, together with automatic stabilisers, tempered the economic slump. The contraction of economic activity in 2009 was most severe in the first quarter of the year, when GDP, after recording a steep decline at the end of 2008, fell even further. GDP stopped declining in the second quarter, and economic activity made a moderate recovery in the second half of the year. Over the last two quarters of the year, exports increased, the slump in investment demand was mitigated, the inventory cycle entered a restocking phase, and consumer demand stabilised.

In 2009, the overall average inflation rate as measured by the Harmonised Index of Consumer Prices was 0.3%, a considerable slowdown compared with the 3.3% recorded for 2008. In the months from June to October (inclusive), the rate temporarily entered negative territory. The marked decline in inflation in 2009 was largely caused by the dampening effect of commodity prices, especially energy prices and to a lesser extent food prices. Prices were also held in check by the downturn in economic activity over the year. The annual inflation rate rose more slowly in December 2009 (by 0.9%) than in December

Chart 4 HICP inflation in the euro area (%)

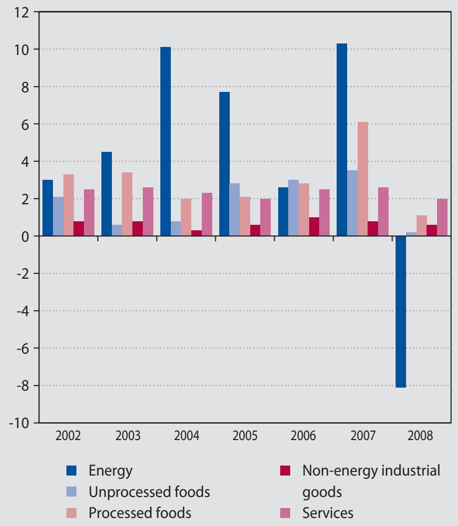


Source: Eurostat.

2008 (1.6%). The rate of core inflation (HICP inflation excluding prices of energy and unprocessed food) fell gradually during 2009 and its average for the year represented 1.3% (compared with 2.4% in 2008).

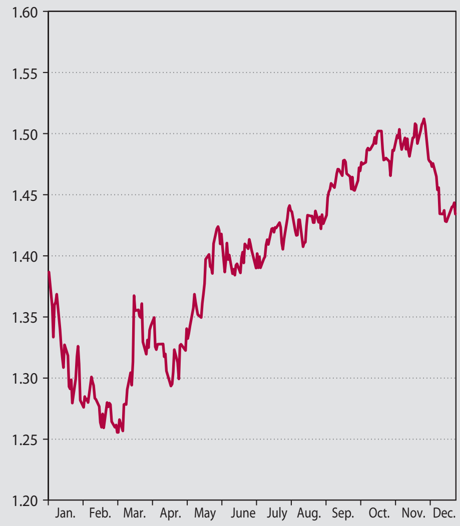
Industrial producer prices fell by of 5.1% in 2009, after rising 6.1% in 2008. The decline in industrial producer prices bottomed out in July (when

Chart 5 Components of HICP inflation in the euro area (annual percentage changes)



Source: Eurostat.

Chart 6 USD/EUR exchange rate in 2009



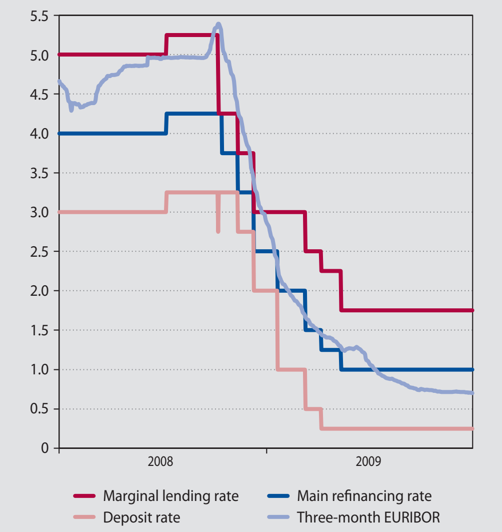
Source: ECB.

prices fell by 8.4% year-on-year) and thereafter became more moderate (in December they decreased by 2.9%).

The euro's exchange rate against the US dollar in 2009 was to great extent determined by conditions in the global economy and by economic indicators coming out of the euro area and the United States. During the first two months of the year, amid expectations of a worsening economic situation in the euro area, the euro weakened against the dollar, and by the end of February it had lost almost 9% of its value against the beginning of the year. From March to the end of November, the euro made incremental gains due to a gradual easing of pressures in financial markets and an increase in risk appetite among investors. This period also saw a return to carry trades (i.e. transactions in which funds are borrowed in a low-yielding currency and then invested in a high-yielding currency), which at the same time supported strengthening the euro. From the beginning of March up to December 2009, the euro appreciated by around 20% against the dollar. During December, however, the emergence of widespread concerns about fiscal developments in certain euro area countries resulted in the euro falling by 5% against the dollar. At the end of 2009, the euro's exchange rate against the dollar was 3.4% stronger than at the end of 2008.

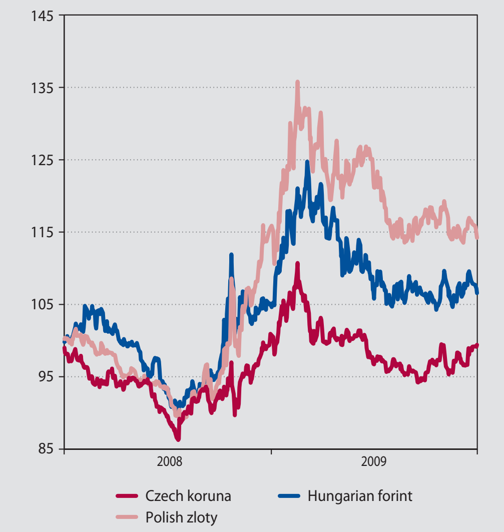
In 2009, the implementation of the ECB's monetary policy continued to be influenced by the ongoing financial crisis. Since October 2008, the ECB had been reacting to the situation by gradually cutting key interest rates. In the last quarter of 2008, the ECB Governing Council decided on three occasions to reduce rates – bringing them down by 175 basis points in total – and with effect from 9 October 2008 it temporarily reduced the standing facilities corridor to 100 basis points. Given the unfavourable outlook for economic development and the absence of inflationary pressures, the ECB continued cutting its main interest rates also in 2009, reducing the rate on the main refinancing operations by a further 150 basis points between January and May. The Governing Council then left the key rates unchanged for the rest of the year, with the rate on the main refinancing operations staying at 1.0%, interest rate on the marginal lending facility and deposit facility 1.75% and 0.25% respectively. In response to money market developments, the ECB continued in 2009 to take further non-standard measures aimed at easing market tensions and at providing access to sufficient liquidity. The ECB expected that these measures would create more favourable financial conditions and support the flow of credit to both households and enterprises. Lending conditions gradually began to improve, money market spreads narrowed, and the markets became less volatile.

Chart 7 ECB interest rates and the EURIBOR (%)



Source: ECB.

Chart 8 Exchange rate indexes of V4 currencies against the euro (30.06.2008 = 100)



Source: Eurostat, NBS calculations.
Note: A fall in value denotes appreciation.

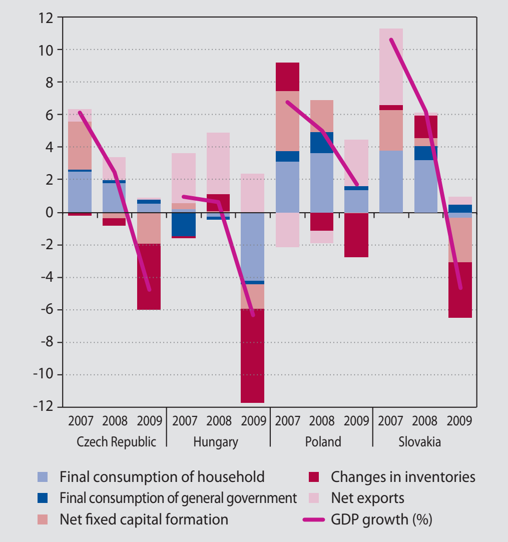
The non-standard measures used by the ECB in 2009 included providing of liquidity in a fixed–rate tender procedure with full allotment in all refinancing operations against eligible collateral. At the same time, the maturity spectrum at which the ECB offered refinancing operations was broadened to include longer term refinancing operations with a maturity of one year. The set of eligible collateral was expanded, and liquidity was provided in foreign currencies. Other non-standard measures included outright purchases in the covered bond market. At its meeting on 3 December 2009, the Governing Council decided for the gradual phasing out of these non-standard measures.

1.3 ECONOMIC DEVELOPMENTS IN THE CZECH REPUBLIC, POLAND AND HUNGARY

Economic developments in the central European region in 2009 were shaped by the ongoing global financial crisis. The Czech and Hungarian economies contracted in comparison with the previous year, and only the Polish economy managed to grow, albeit at a far slower pace than in 2008. Economic growth was dampened mainly due to destocking and the decline in investment, and also because of the sharp fall in exports stemming from weak external demand. The average annual rate of inflation declined in all countries, but particularly so in the Czech Republic. Inflation pressures were subdued mostly by a combination of commodity price developments and weak domestic demand. In the case of energy and unprocessed food prices, the slowdown in annual inflation was particularly marked. Exchange rates at the beginning of 2009 continued to depreciate at a relatively rapid pace. With global risk aversion diminishing and central banks making a joint verbal intervention, exchange rates began to correct from the second quarter and appreciated against the euro at a relatively rapid pace. From around August to the end of the year there was a certain stabilisation. In seeking to contain the effects of the economic crisis, to revive domestic economic activity and to support the banking sector, all of the region's central banks cut interest rates. In the Czech Republic and Poland, key interest rates fell to all-time low levels.

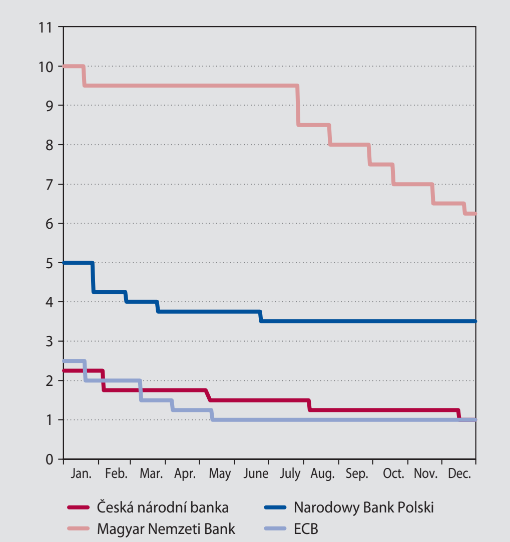
Gross domestic product in the **Czech Republic** slumped by 4.8% in 2009, after growing by 2.5% in the previous year. Destocking was substantial and investment demand plummeted. At the same time, domestic consumption growth and

Chart 9 Contributions to GDP growth (in p.p.)



Source: Eurostat, NBS calculations.

Chart 10 Key interest rates of national central banks in 2009 (% p.a.)



Source: NCBs, ECB.

the contribution of net exports to GDP were lower compared with 2008. Average price inflation in 2009 slowed by 5.7 percentage points, to 0.6%, caused mainly by commodity price developments as well as by the base effect of high price rises in the previous year (due to changes in regulated prices and tax rates). Prices of energy, services and processed foods all rose at a slower pace year-on-year, and prices of unprocessed foods and industrial goods decreased.

The exchange rate of the Czech koruna weakened at the start of 2009, reflecting above all the negative mood towards the emerging market countries of central and eastern Europe. From the beginning of the year to mid-February, the koruna depreciated by almost 9% against the euro. Over the rest of 2009, amid a gradual reduction in risk aversion, the Czech koruna regained the value it had lost earlier in the year. Compared with the end of 2007, the koruna's exchange rate against the single currency appreciated by 1.5%.

The Česká národní banka cut its key interest rates four times during 2009. The two-week repo rate was reduced to 1%, after being cut by 0.5 of a percentage point in February and then by 0.25 of a percentage point in May, August and December. In cutting interest rates, ČNB was attempting to partially mitigate the repercussions of the global economic crisis on the domestic economy and banking sector. The easing of monetary policy was also made plausible by the absence of substantial inflation pressures.

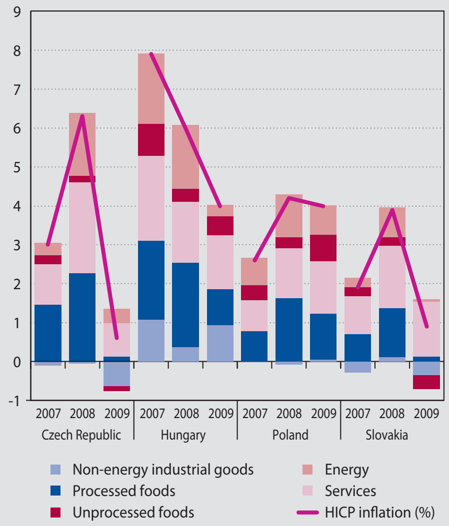
The **Hungarian economy** contracted by 6.3% in 2009, after growing by 0.6% in the previous year. At the same time, gross capital formation fell sharply and the decline in domestic consumption became more pronounced. With imports decreasing more substantially than exports, net exports was the only component that positively contributed to GDP growth. Price inflation, which has been gradually accelerating in 2010, was affected by the forint's depreciation and in particular by the rise in VAT and excise duties that took effect in July 2009. Weak domestic demand dampen pass through of higher taxes into consumer prices, and thus the average inflation rate for 2009 fell by two percentage points year-on-year, to 4.0%. The slowdown in inflation was particularly marked in prices of energy, processed foods, and services.

Like the currencies of neighbouring countries in central Europe, the Hungarian forint's exchange rate begin the year by depreciating and it continued to weaken until the beginning of March. Apart from global factors, the exchange rate reflected also the weak position of the Hungarian economy. The gradual reduction of high risk aversion in financial markets, as well as the partial restoration of confidence in the Hungarian economy and the country's success in borrowing from the International Monetary Fund, resulted in the forint appreciating against the euro in the next period. This relatively sharp correction of the previous development lasted until the beginning of August, at which point the exchange rate partially stabilised. In comparison with the previous year, however, the forint weakened by 1.4%.

The Magyar Nemzeti Bank reduced key interest rates on seven occasions in 2009, bringing them down by 3.75 percentage points overall, to 6.25%. The key rates were cut mainly in the second half of the year (the exception being January's reduction), with the principal aim of stimulating weak demand and the domestic economy. The policy of reducing rates from their relatively high level was facilitated by the ebbing of risk aversion in global markets and the revival of confidence in the Hungarian economy, as well as by the more stable forint's exchange rate and the favourable development of inflation. Also in 2009, the Magyar Nemzeti Bank entered into a swap agreement with central banks of euro area countries and Switzerland on supplying liquidity in Swiss francs and it introduced new refinancing instruments. These measures were aimed at strengthening and stabilising the domestic financial market and supporting the banking sector.

The only economy in the region (and in the EU as a whole) that managed to record growth in 2009 was the **Polish economy**, although its pace of growth slowed by 3.3 percentage points year-on-year, to 1.7%. Unlike the Czech and Hungarian economies, the Polish economy benefitted above all from continuing growth in domestic consumption, a lower decline in investment demand, and less severe destocking. The Polish currency's substantial weakening may also have had a favourable effect on foreign trade – the contribution of net exports to GDP was the highest in any of the V4 countries. Following the adjustment of certain regulated prices and excise duties at the beginning of January, the inflation rate rose gradually until July. From then until the year-end, price inflation was somewhat dampened and remained stable. Compared with the previous year, the average inflation rate in 2009 fell by 0.2 of a percentage point, to 4%, the slow-

Chart 11 Contributions to HICP inflation (p.p.)



Source: Eurostat, NBS calculations.

down being particularly pronounced in prices of energy and unprocessed foods.

Because of persisting risk aversion at the beginning of 2009, the Polish zloty lost almost 15% of its value in the period up to the middle of February. The subsequent correction and strengthening against the euro was partially curbed by tense developments in the Baltic states. The zloty's movement over the first six months was partially affected also by expectations about the currency possibly joining the exchange rate mechanism ERM II. In addition, the IMF's announcement in April to extend a flexible credit line to Poland had a short-term effect on the exchange rate. In line with the regional pattern, the exchange rate stabilised in the second half of the year, particularly from August. Compared with the end of the previous year, the zloty appreciated by 1.2%.

Narodowy Bank Polski cut its reference interest rate four times in 2009 – by 0.75 of a percentage point in January and by 0.25 p.p. in February, March and June – thereby reducing it to 3.5%. Interest rates remained unchanged during the second half of the year. In cutting rates, Narodowy Bank Polski was reacting to the slowdown in economic growth as well as to the low level of lending in the banking sector. The central bank's efforts to stimulate lending also included its decision in May to reduce the required reserves and its introduction in September of new facilities to support commercial bank lending activities. As in Hungary, the stability of the interbank market throughout the year was supported by the active use of swap lines for increasing liquidity in Swiss francs.