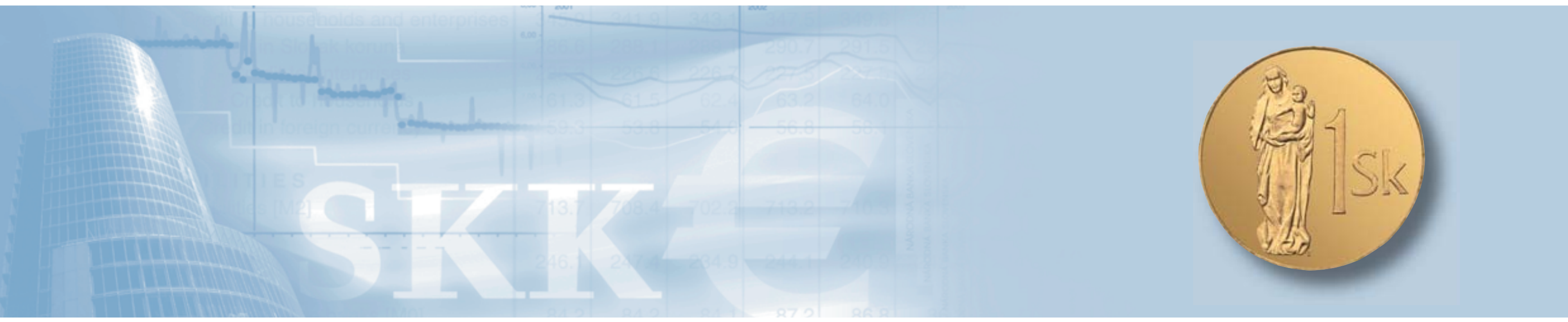
External Economic Environment



1 External Economic Environment

1.1 Global trends in output and prices

The relatively strong growth of the world economy continued in 2006. In comparison with 2005, growth accelerated slightly, reaching roughly the level of 2004. The increased economic activity benefited from favourable financing conditions, strong corporate profits and an overall strengthening of the corporate sector. The dynamic growth recorded in emerging Asian economies played a key role in the global economy. The euro area saw a renewed upturn in economic growth, even if at lower levels than in emerging markets. Economic growth likewise rose slightly in the United States, despite fears of a slowdown. These fears were mainly related to the uncertainty regarding housing market, with a possible impact on final household consumption, to interest rate growth and global imbalances. Following a long period of stagnation, Japan saw some signs of a recovery, primarily in the form of a growth in exports. These were accompanied by the end of a period of deflation and a slight price growth, pointing to a gradual recovery taking place in the economy. High oil and industrial commodity prices in 2006 contributed to faster growth in Russia, the Middle East and Latin America.

World prices saw a stable development in 2006, and inflation remained relatively low. Despite the fact that prices for oil and industrial commodities on world markets remained at a high level, they did not significantly influence global price growth nor threaten global economic growth. Global tensions partially weakened over 2006 and the hurricane season in the Gulf of Mexico was milder than expected. This contributed to a decrease in the risk premium on the oil market. After reaching a peak of 78 USD per barrel in mid 2006, world oil prices fell partially over the last quarter to 60 USD per barrel, which was in line with its level at the end of 2005. Thus, oil prices had a favourable effect on global inflation in the second half of 2006. Besides economic factors, oil prices were also influenced by activities of speculative investors and hedge funds, betting on changes in oil prices and thus contributing to the growth in their volatility.

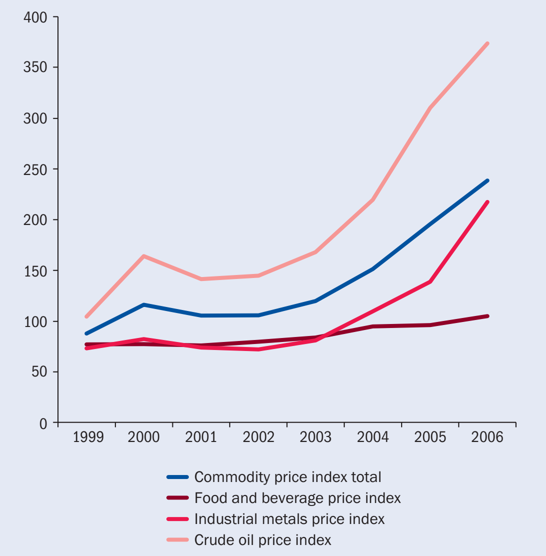
Fast economic growth in China and India was reflected in the strong demand for ferrous and non-ferrous metals. This together with the low level of inventories of non-ferrous metals and low processing capacities for industrial metals led to a growth in prices of these commodities. In an attempt to diversify their portfolios and reduce risks, investment funds also had a certain

Table 1 **Global output** **(year-on-year growth in %)**

	2004	2005	2006
Global output	5.3	4.9	5.4
Developed economies	3.3	2.5	3.1
The United States	3.9	3.2	3.3
Japan	2.7	1.9	2.2
The euro area	2.0	1.4	2.7
Emerging Asian economies	8.7	9.2	9.4
China	10.1	10.4	10.7
India	7.8	9.2	9.2
Russia	7.2	6.4	6.7
Central and Latin America	6.0	4.6	5.5
Brazil	5.7	2.9	3.7
Middle East	5.6	5.4	5.7

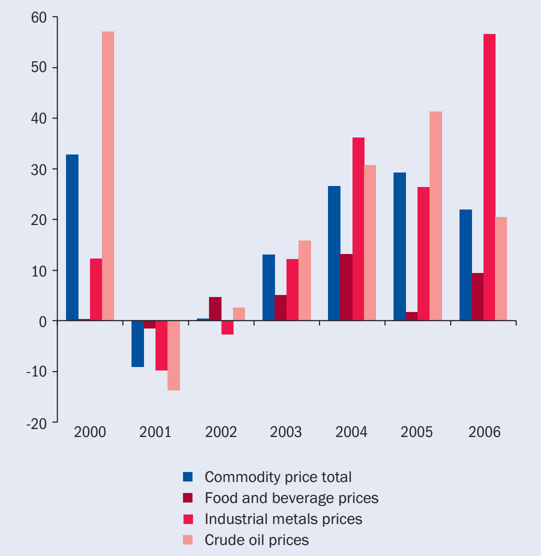
Source: World Economic Outlook, IMF, April 2007, Eurostat.

Chart 1 **Price development (index, year 1995 = 100)**



Source: World Economic Outlook, IMF, April 2007.

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



Source: World Economic Outlook, IMF, April 2007.

effect on commodity prices. Nevertheless, their activities affected mostly gold and silver prices.

Prices of agricultural and food commodities and goods recorded a more pronounced growth, primarily in the second quarter of 2006. Despite that, their overall rise was relatively moderate.

Exchange rates around the world were affected by the euro continuing appreciation against the US dollar, the Japanese yen and the Swiss franc. However, the euro lost ground against the British pound. Exchange rates in 2006 were primarily influenced by expectations regarding interest rate changes in the United States and the euro area. Monetary policy in China and Japan was of significant influence as well, primarily as regards the slight loosening of the exchange rate regime in China.

The US dollar depreciation against the euro, particularly at the beginning of the year, was influenced by the growing US double deficit (current account and fiscal deficit) and the negative outlook for economic growth. Conversely, the economic recovery in the euro area was reflected in the strengthening of the euro against the major world currencies.

The developed economies in 2006 again recorded a deepening of their balance of payments current account deficits. However, this growth in the deficits was only moderate, having slowed against the previous year. Risks flowing from global imbalances decreased, primarily due to the slower growth of the US current account deficit.

1.2 Economic development in the United States

Economic growth in the United States increased slightly in 2006 to 3.3%, compared to 3.2% a year earlier. The economy's continued acceleration from 2005 was seen particularly at the beginning of 2006, while in later periods the rate of economic growth slowed. Economic growth was supported by private consumption and increased federal and state spending. Favourable financing conditions and profit growth stimulated corporate investment. The gradual slowdown in the rate of economic growth over the course of 2006 was connected with a fall in investments in the real estate sector and a slowdown in housing construction. The rate of growth in private consumption by households, representing the largest contribution to GDP creation, fell from 3.5% in 2005 to 3.2% in 2006. The largest fall was recorded in household spending on non-durables. Household spending was suppressed by high energy prices and increased housing costs. On the other hand, household consumption benefited from wage and employment growth.

The average twelve-month inflation in 2006 fell slightly from 3.4% in 2005 to 3.2%. Price growth accelerated as a result of the rise in energy prices and also higher utilisation of production capacities in the first half of the year. From the summer though, the year-on-year rate of inflation slowed to 2.5% at the year-end.

The current account deficit, in comparison with the 6.4% of GDP recorded in 2005, rose only slightly in 2006 to 6.5% of GDP. Influenced by global economic growth and the depreciation of the USD real effective exchange rate, a positive trend was recorded in export dynamics, particularly in the export of goods. On the other hand, imports were influenced by relatively strong consumer demand.

A positive development was seen in the fiscal area, when the public finance deficit ended the year at USD 248 billion, representing a decrease on 2005 from 2.6% of GDP to 1.9% of GDP. This improvement was due to increased tax revenues from legal and natural persons.

Over the course of the first half of 2006, the Federal Open Market Committee (FOMC) of the Federal Reserve System raised its target rate for federal funds four times, each time by a quarter of a percentage point. By the end of June, the rate had thus risen by 100 basis points to 5.25%. Interest rates then remained unchanged over the course of the year, despite the FOMC repeatedly stating that inflationary risks persisted.

1.3 Economic development in Japan

In 2006 the Japanese economy continued recovering from the long lasting crisis, with GDP growth reaching 2.2%. Similarly as in other industrialised countries, however, the rate of economic growth slowed over the year. Economic activity was stimulated in particular by faster growth in private investment, reflecting the favourable financial conditions and corporate profitability. Increased export activity, supported by the JPY weaker exchange rate and strong demand for mechanical equipment, contributed to the growth. A substantial upturn in industrial output, rising from 1.6% in 2005 to 4.6% in 2006 was also connected with this.

Over the course of 2006, deflationary fears weakened in Japan, with consumer prices growing year-on-year by 0.2%, compared with their decline in 2005 by 0.3%. Price development remained subdued, primarily due to downward pressures on wages.

The banking sector's gradual recovery led to a credit growth for the first time since 1996. Corporate investment rose to 7.7%, compared to 6.6% in 2005. The TANKAN index, an indicator of manufacturers' sentiment published by the Bank of Japan, again recorded a rise on the preceding year and reflected the growing confidence of the business sector in Japan. The current account again recorded a surplus growth, supported in particular by exports, and reached USD 170.4 billion, representing 3.9% of GDP compared to 3.6% of GDP in 2005.

In 2006 the Bank of Japan stopped its "quantitative easing policy", which it had been applying since 2001, and increased the key interest rate from 0% to 0.25%. Likewise it also withdrew excess liquidity from the banking sector.

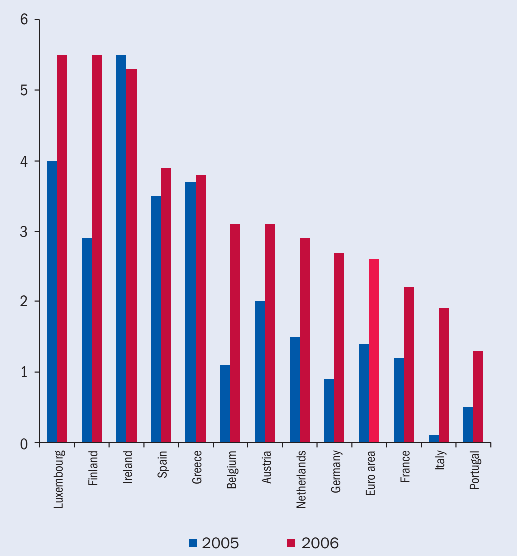
1.4 Economic development in the euro area

In 2006 economic growth in the euro area almost doubled from its level in 2005 (1.4%) to reach 2.7%. Following a gradual and slight recovery in growth in the second half of 2005, the first half of 2006 saw a more substantial upswing. This development was reflected in an improvement in consumer and business confidence, as well as in labour market conditions. The rate of growth was the highest seen since 2000.

The sluggish economic growth since 2001 had been connected with the fall in prices of financial assets followed by subsequent restructuring of corporations' balance sheets, though at the cost of a decline in investment and job creation. It was this successful process of restructuring corporations' balance sheets in the preceding period that in 2006 led to an upturn in investment demand and in the demand for labour. The main driver of this growth was domestic demand, primarily fixed investments. Although exports accelerated substantially in 2006 as a consequence of the world economy's continued expansion, the external sector's contribution to GDP growth was neutral, since the faster domestic demand was also reflected in higher imports.

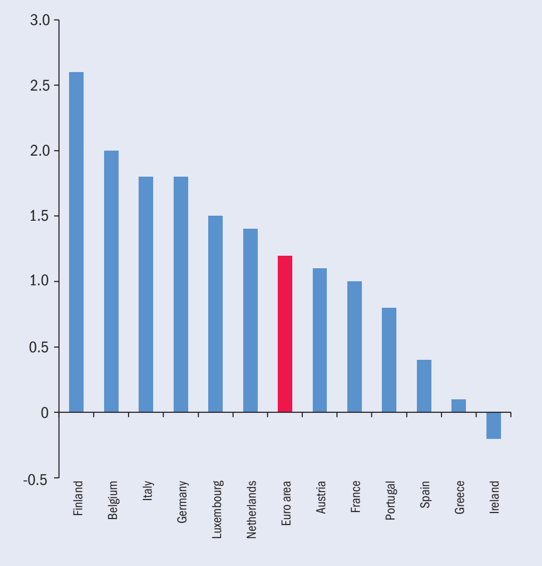
Investment growth in 2006 reached its highest rate since 2000 (4.3%), being connected in particular with

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



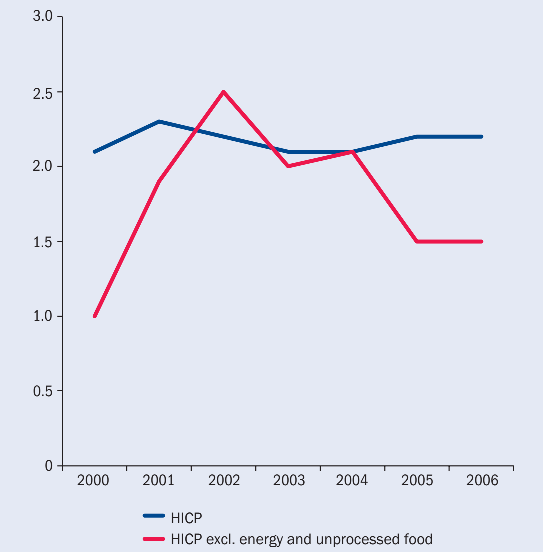
Source: Eurostat.

Chart 4 **Changes in the economic growth rate in 2006 compared to 2005 (% points)**



Source: Eurostat.

Chart 5 **Inflation in the euro area (%)**



Source: Eurostat.

rising corporate profitability and low external financing costs. In comparison with the previous year, in 2006 an increase in the rate of growth also in private consumption was recorded (from 1.5% to 1.8%), the main source of which was higher growth in real disposable income. Despite the negative effects of energy prices on household purchasing power, real income growth was higher as a consequence of strong growth in employment and non-wage income. The moderation of consumer spending had a positive influence on household savings.

The divergence between rates of GDP growth among the individual countries of the euro area lessened in 2006, and most of the countries recorded an increase in the rate of growth on 2005.

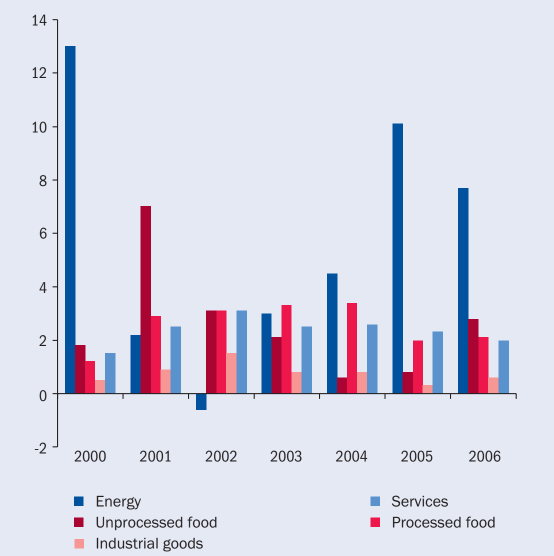
Labour market conditions improved substantially in 2006. Employment grew primarily in the service sector, while its decline in construction and industry abated. The rate of unemployment continued to fall in 2006 to 7.5% in the fourth quarter. Although these figures suggest a cyclical response of the labour market, part of the fall in unemployment was also due to structural reforms in several euro area countries.

Labour productivity growth continued to accelerate over 2006. This acceleration was most pronounced in industry, while labour productivity growth in services remained stable, though at a considerably lower level than in industry. An increase in labour productivity was connected with the cyclical development of the economy; nevertheless the achieved level still remains below expectations. On the one hand, this reflects the impact of structural reforms undertaken in the labour market aimed at increasing the engagement of low-qualified workers, and on the other hand, an insufficient utilisation of productivity-increasing technologies, as well as a lack of competition and a strict regulatory framework of markets in goods.

In 2006, overall average HICP inflation remained unchanged from 2005 at 2.2%. The year-on-year rate of inflation, however, recorded a relatively significant volatility during the year, caused mainly by the development in energy prices. Inflationary pressures were also related to the rise in world non-energy commodity prices, which was reflected in substantial price growth in intermediate goods. The slight increase in producer prices of consumer goods may signal secondary effects of the earlier growth in commodity prices, though as yet these remain suppressed. The slight growth in wage costs and the euro's appreciation also had a dampening effect on prices. The average price of Brent crude oil (in euro) grew in 2006 by 20%, following a 45% rise in 2005.

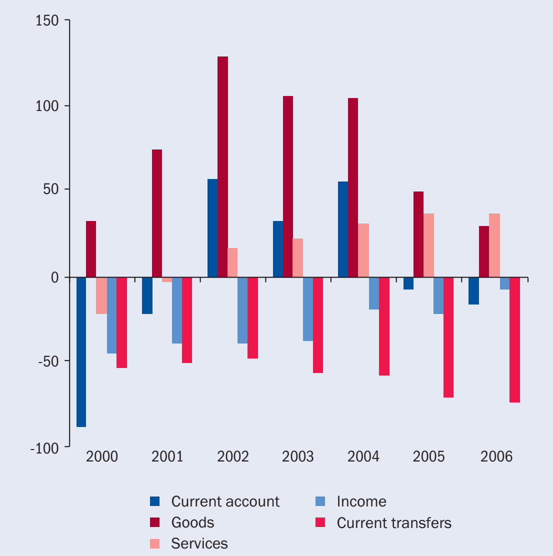
In comparison with 2005 the contribution of unprocessed food prices to the growth in consumer prices was more pronounced, particularly as a result of adverse weather conditions in the second half of the year. In 2006, the average HICP inflation excluding energy and unprocessed food remained unchanged at the level of 2005 (1.5%). Over the course of the year, however, the year-on-year rate of inflation accelerated slightly. This was connected with the rise in non-energy industrial goods prices. The rate of growth of prices in services remained stable at 2.0%. Overall it may be said that

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



Source: Eurostat.

Chart 7 **Balance of payments current account (EUR billion)**



Source: Eurostat.

in 2006 inflationary pressures in the euro area were contained and the impact of the growth in oil and non-oil commodity prices on consumer prices was limited. Long-term inflation expectations remained anchored at levels consistent with price stability.

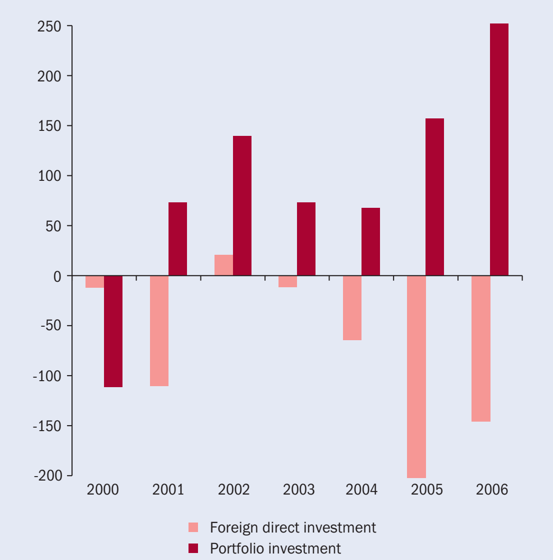
The year-on-year rate of growth in industrial producer prices grew from 4.1% in 2005 to 5.1% in 2006. This growth was primarily caused by energy prices, though an upward trend was also recorded in producer prices excluding energy. This may be particularly ascribed to the rising prices of non-energy commodities and the indirect impacts of higher oil prices. By all plausible measures, labour costs in 2006 remained moderate, as in 2005, though the situation in individual countries differed. Overall, labour costs continued to contribute to domestic inflationary pressures to a lesser extent. The main factor behind this was the pressure of strong global competition. Other contributing factors were the positive influence of monetary policy on inflation expectations, reduced membership of labour unions and an increase in the share of part-time and short-term labour contracts.

In 2006 the euro area recorded a current account deficit of EUR 16.2 billion (0.2% of GDP) in comparison with a deficit of EUR 6.8 billion (0.1% of GDP) in 2005. The higher deficit resulted mainly from a lower trade surplus in goods, where imports of goods grew faster (16.1%) than exports (13.8%). The slightly higher deficit in current transfers was only partially compensated for by a lower deficit in the income balance, whereas the balance of services remained unchanged.

The financial account in 2006 was marked by a significant net inflow of direct and portfolio investment, in contrast to the net outflow of capital in 2005. These developments were primarily the result of a significantly lower net outflow of foreign direct investments from the euro area and a higher net inflow of portfolio investments.

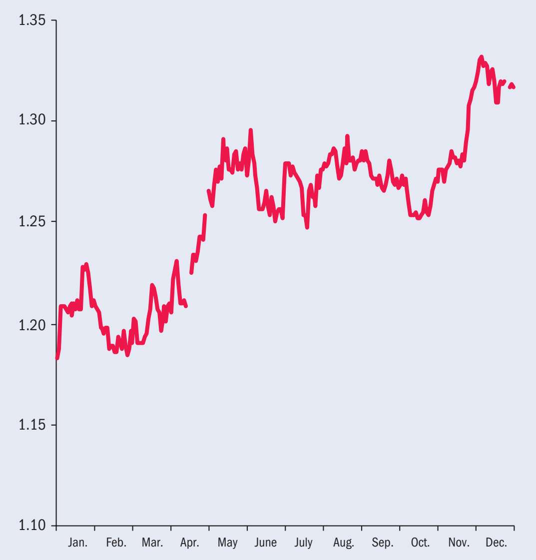
Over the course of 2006 the euro exchange rate appreciated against the US dollar by 11.4%. This trend

Chart 8 **Direct and portfolio investment in the euro area (EUR billion)**



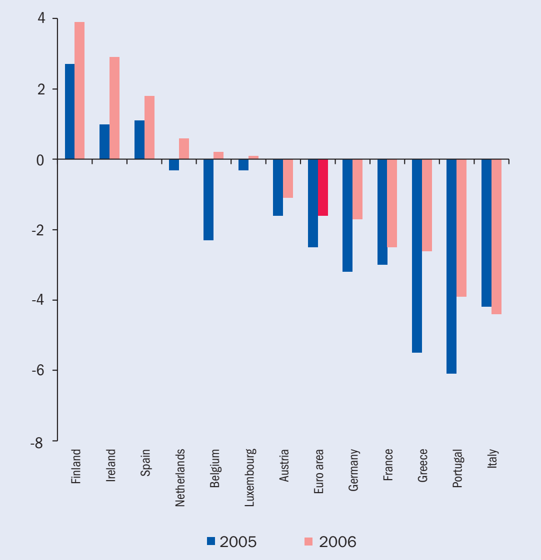
Source: Eurostat.

Chart 9 **USD/EUR exchange rate in 2006**



Source: ECB.

Chart 10 **Public finance positions of the euro area countries (% of GDP)**



Source: Eurostat.

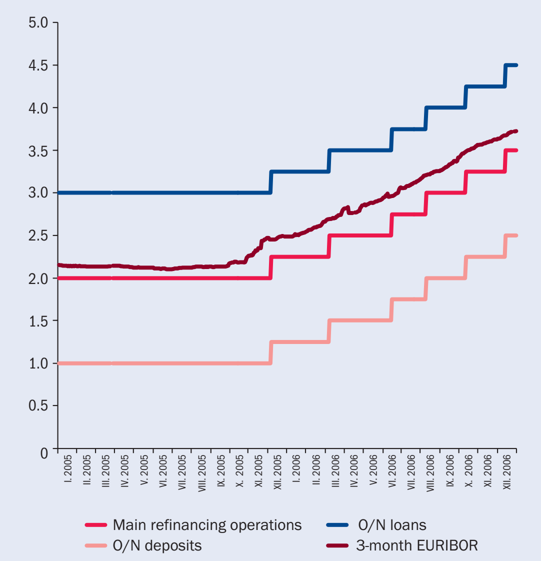
primarily reflected the markets' more favourable expectations regarding the euro area's economic development. At the beginning of the year, one of the main reasons of appreciation of the euro was the deepening US double deficit, though gradually the main reason for this trend became the differing position of the economic cycle in the United States and the euro area, as well as the future settings of monetary policy in these two economic areas.

With regard to relatively strong economic growth and higher revenues, fiscal performance in the euro area in 2006 may be considered to be positive, even if greater efforts in the field of budgetary consolidation were still lacking. The public finance deficit in the euro area in 2006 was 1.6% of GDP, compared to 2.5% of GDP in 2005. Of the five countries against which the excessive deficit procedure was initiated in 2006, three (Germany, Greece, France) managed to bring their deficits below the reference value of 3%. Italy and Portugal remained with a deficit exceeding the reference value. In comparison with 2005, all countries except Italy succeeded in lowering their public finance deficits in 2006.

In line with these developments in public finances, the public debt fell slightly below 70% of GDP in the euro area (in 2005 public debt was 70.5% of GDP, in 2006 69.0%). This reflected the reduction in public debt achieved in all countries, except Italy (the country with the highest public debt ratio to GDP among the euro area countries) and Portugal.

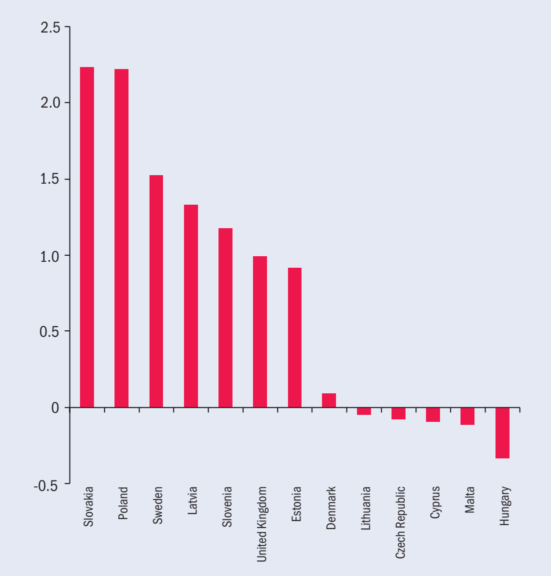
Over the course of 2006, the ECB raised its key interest rate in total by 1.25 percentage points from 2.25% in January 2006 to 3.50% at the year-end. The main reason was the increase in inflationary risks to price stability. These risks included a stronger than expected pass-through of the past growth in oil prices, a possible further increase in regulated prices and indirect taxes, and the possibility of renewed growth in oil prices, as well as stronger wage growth. The monetary policy was tightened in an environment of robust economic growth, significant monetary and credit expansion and surplus of liquidity in the euro area.

Chart 11 **ECB and EURIBOR interest rates (%)**



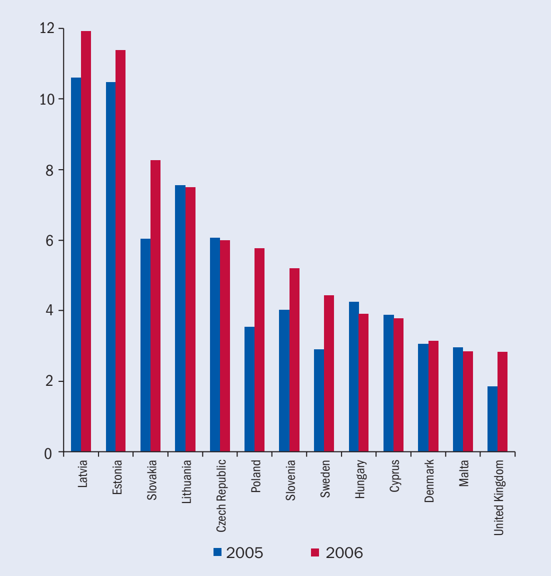
Source: ECB.

Chart 12 **Change in economic growth in 2006 on 2005** **(% points)**



Zdroj: Eurostat.

Chart 13 **Economic growth in 2006 and 2005** **(%)**



Source: Eurostat.

1.5 Economic development in the non-euro area Member States

Economic growth in the Member States outside the euro area accelerated in 2006, though the levels of growth differed markedly among individual countries. Economic growth accelerated most in Slovakia, Poland and Sweden, although the highest levels were achieved in the Baltic States, especially in Latvia and Estonia, but also in Slovakia. Economic growth in the other economies of the central Europe region was also relatively robust.

In most of the countries was the dynamic economic growth driven by domestic demand. Private consumption was stimulated by increased disposable income connected with dynamic wage growth, a fall in unemployment and rising real estate prices. Growth in investment demand reflected the relatively favourable financing conditions and an improved business environment, and, in some countries, also by substantial inflows of foreign direct investment.

Besides domestic demand, an upsurge in exports was also recorded in several countries. This was largely connected with the inflow of foreign direct investment in the previous years and the favourable development of foreign demand. Nevertheless, the dynamic development of exports in most countries was also accompanied by fast growth in imports. This was a consequence of the relatively strong domestic demand and high import intensity of exports in certain countries. The contribution of net exports to GDP growth was, then, in general neutral. A positive contribution from the net export to economic growth was recorded by Hungary, the Czech Republic, Malta, Slovakia and Sweden.

Inflation measured by the harmonised index of consumer prices rose in most non-euro area Member

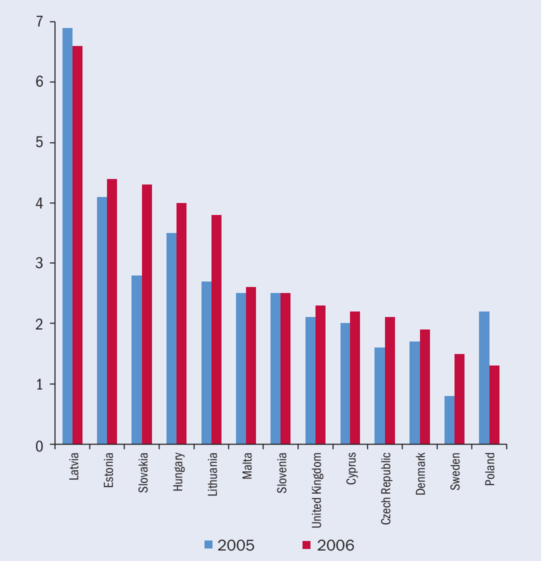
Chart 14 **Imports to the euro area and exports from EU 10** **(year-on-year change in %, constant 2000 prices)**

Source: Eurostat, NBS calculations.
Note: EU-10 – countries which entered the EU in 2004.

Chart 15 **Change in the twelve-month average rate of inflation (HICP) in 2006 (% points)**

Source: Eurostat.

Chart 16 **Twelve-month average rate of inflation (HICP) (%)**



Source: Eurostat.

States. The highest level was reached in the Baltic States, Hungary and Slovakia. The lowest rate of inflation, significantly below the euro area average, was reported by Poland and Sweden.

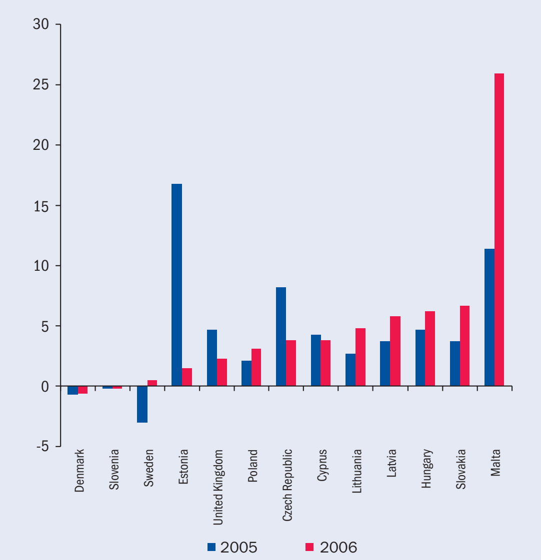
The acceleration of price growth in several countries was a consequence of administrative measures. Price development was also influenced by higher oil prices and the subsequent growth in energy prices. Food prices also contributed to higher price growth in some countries. Fast growing domestic demand in some economies, however, also contributed to a rise in inflationary pressures.

The balances of the combined current and capital account of the balance of payments in individual countries continued to differ significantly. While Sweden and Denmark achieved surpluses, other countries reported

Chart 17 **Combined current and capital account of the balance of payments (% of GDP)**

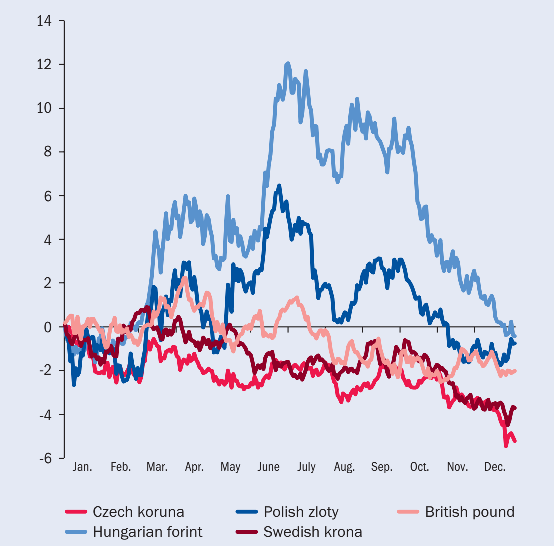
Source: ECB.
Note: Data for Estonia, Malta, Sweden and the United Kingdom are cumulative for the four quarters preceding the third quarter of 2006.

Chart 18 **Net FDI inflow (% of GDP)**



Source: ECB.
Note: Data for Estonia, Malta, Sweden and the United Kingdom are cumulative for the four quarters preceding the third quarter of 2006.

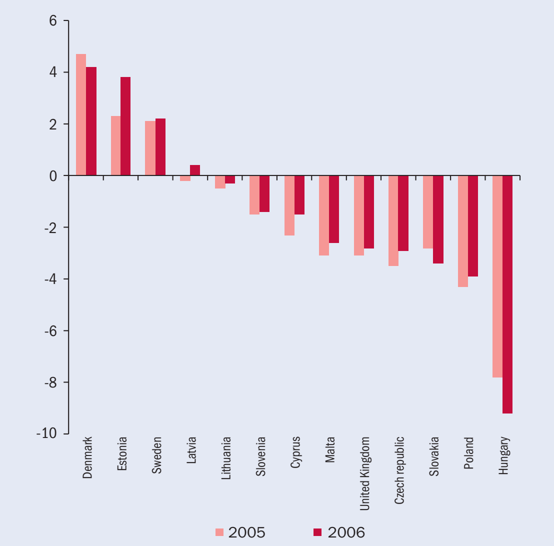
Chart 19 **Changes in daily exchange rates of the currencies of the EU countries outside ERM II against the beginning of 2006** (%)



Source: Eurostat.
Note: Negative values represent appreciation.

Chart 20 **Public finance deficit**

(% of GDP)



Source: Eurostat.

deficits. Overall, in comparison with 2005, there was a moderate deterioration. An extraordinarily high deficit of almost 20% of GDP was recorded in Latvia, and deficits in Estonia and Lithuania ranged above 10% of GDP. The current and capital account deficits in those countries that entered the EU in May 2004 were in part related to the catching up process. In certain countries, however, these deficits reflected strong consumer demand and credit growth, which may signal a risk to the sustainability of the external position.

The net inflow of foreign direct investment in most non-euro area countries increased in comparison with 2005. In several countries net foreign direct investments represented a significant source of financing of combined current and capital account deficits, though they were insufficient, in particular in the Baltic States.

The developments in the non-euro area Member State exchange rates reflected to a significant extent the individual countries' exchange rate regimes. The national currencies of Denmark, Estonia, Cyprus, Latvia, Lithuania, Malta, Slovenia and Slovakia were participating in ERM II. These countries' exchange rates, with the exception of Slovakia's, hovered closely around their central parities.

The exchange rate developments of the currencies that did not participate in ERM II differed across individual countries. From the first months of the year, the Czech koruna and Swedish krona shifted to an appreciation trend and in comparison with the beginning of the year strengthened by 5.2% and 3.7% respectively. The British pound also began to gradually appreciate from July 2006 (having strengthened as at the year-end by 2.0%). The Polish zloty and Hungarian forint recorded increased volatility and a trend of significant depreciation over the course of the first half of 2007, reflecting the global risk aversion to emerging markets. In the case of Hungary, the pressure on the currency was also the result of the fiscal situation and fears of external imbalances. In the second half of the year the trend in the exchange rate developments reversed and both currencies recorded gradual appreciation. This reflected the renewed global appetite for risks, and in the case of Hungary, also the increased level of interest rates. At the end of the year both countries' exchange rates had returned close to their initial levels at the beginning of the year.

In the field of public finances, relatively large differences persisted among individual countries in 2006. While Denmark, Sweden and Estonia recorded fiscal surpluses, other countries reported deficits. With the exception of Hungary, the budgetary outcomes were in line with the 2005 convergence programmes. The fiscal position in several countries was positively influenced by robust economic growth.

As at the end of 2006, the Czech Republic, Malta, Hungary, Poland, Slovakia and the United Kingdom were subject to excessive deficit procedure. In July 2006, the excessive deficit procedure against Cyprus was abrogated, while in January it was initiated against the United Kingdom. Of the six countries to which the excessive deficit procedure related, the United Kingdom, the Czech Republic and Malta succeeded in bringing their public finance deficits below the 3% reference value.

During 2006 the central banks of most countries whose currencies participated in ERM II adopted measures for tightening their monetary policies. In several cases these reflected interest rate changes by the ECB, which increased the rate for the main refinancing operations in total by 125 basis points in 2006.

In mid-February 2006 the Danmarks Nationalbank raised its key rates by 10 basis points to 2.5% in response to an outflow of capital connected with purchases of foreign securities by Danish investors. Over the further course of the year the Danish central bank adapted its rates to changes in the ECB key rates, gradually raising its key interest rate to 3.75%. With regard to currency board arrangements, the central banks of Estonia and Lithuania do not set key interest rates. Both these countries thus automatically adopted the monetary policy decisions of the ECB. Furthermore, the Eesti Pank implemented several preventive measures in the financial sector. These were aimed at eliminating risks to financial stability, connected primarily with fast credit growth. These measures included an increase in the reserve requirement ratio from 13% to 15%. Also the Latvian central bank tightened its monetary policy, raising interest rates from 4% to 5% in two steps. At the same time, the Latvijas Banka expanded the reserve base to include bank liabilities with a maturity exceeding two years. As a result of the narrowing short-term interest rate differential against the euro, Malta's central bank increased its key rate in three steps by a total of 75 basis points to 4%. Cyprus's central bank likewise increased rates slightly, by 25 basis points to 4.5%. This step was connected with the tightening of ECB monetary policy and growing inflationary pressures. The Banka Slovenije took account of fact that the country's short-term interest rates should converge with those prevailing in the euro area prior to adopting the euro on 1 January 2007. Thus, during the first half of 2006, it gradually lowered its main policy rate and from August onwards kept it stable at 3.5%.

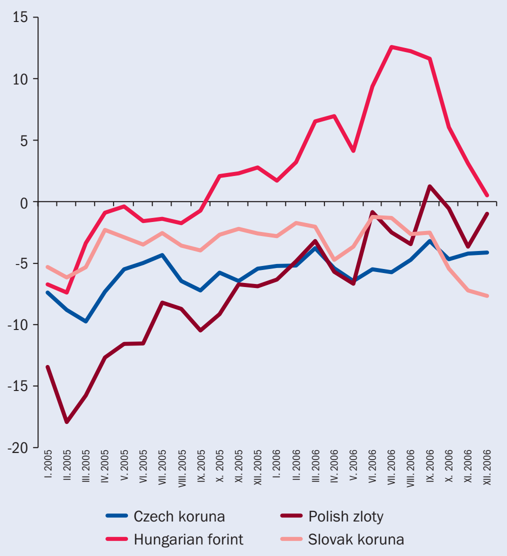
The central banks of most non-euro area Member States not participating in ERM II increased their key rates in consequence of growing fears of upside risks to price stability. The Česká národní banka raised its key rate by 50 basis points to 2.5%, largely on account of its inflation forecast. A deteriorating inflation outlook was the reason for increasing rates also in Hungary, where the Magyar Nemzeti Bank cumulatively in five steps raised its key rates by 200 basis points to 8%. A relatively high level of inflation, moving above the target, was also the reason for raising rates in the case of the Bank of England. Sweden's Sweriges Riksbank raised its key interest rate from 1.5% to 3.0% with an aim to maintain inflation close to target.

The only central bank of the non-euro area Member States not participating in ERM II that lower its key rates was Poland's Narodowy Bank Polski. Rates were lowered in two steps from 4.5% to 4%. The reason was the greater than expected decrease in inflation, as well as a more favourable inflation outlook.

1.6 Developments in V4 countries

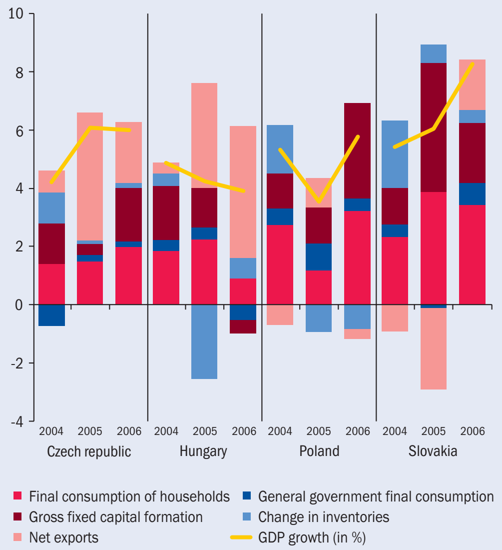
Economic growth in the V4 countries maintained its dynamic rate from 2005, where favourable impulses to the region's economic activity included gross investment including foreign direct investment and net exports. Inflation in the region accelerated in comparison with the previous year (with the exception of Poland), though in the last third of the year it was favourably influenced by falling oil prices. Central banks in the region (except for the Narodowy Bank Polski) raised key interest rates over the course of the year by 50 to 200 basis points. The Czech and Slovak korunas recorded a year-on-year appreciation, which in connection with the renewed attraction of the Central European region strengthened even further in the last third of the year. A change in investors' mood concurrently contributed to a slowdown in the Hungarian forint's depreciation. The relatively strong trend of appreciation recorded by the Polish zloty in 2005 continued in 2006, though this trend lessened over the course of the year. In autumn the governments presented their convergence programme updates, which imply that the euro introduction

Chart 21 **Development in exchange rates of the currencies of V4 countries against euro (year-on-year change in %)**



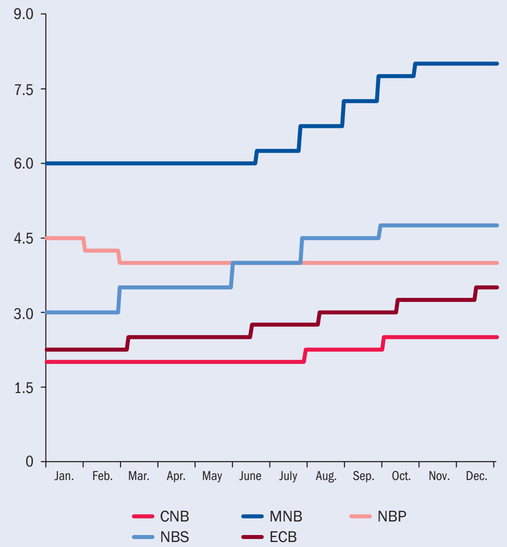
Source: Eurostat, NBS calculations.
Note: Negative values represent appreciation.

Chart 22 **Contributions to GDP growth (% points)**



Source: Eurostat, NBS calculations.

Chart 23 **Key rates of national central banks (%)**



Source: NCB, ECB.

in the three neighbouring countries was postponed beyond 2010.

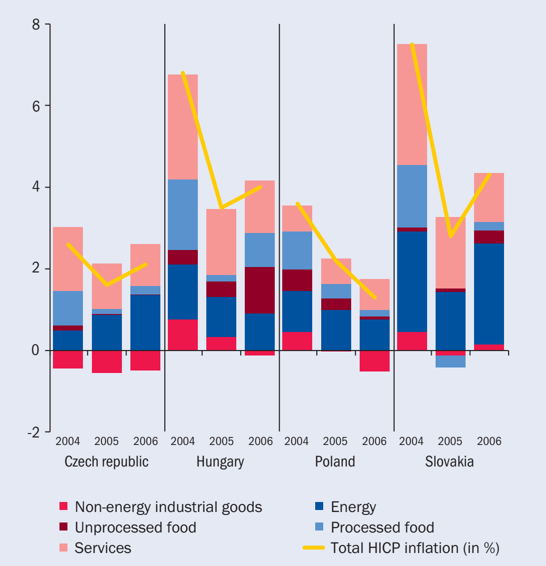
As in the previous year, the **Czech economy** grew in real terms by 6.0%, though the structure of growth changed. The previously dominant impulse from the side of foreign trade decreased, and, on the other hand, gross investment and household consumption contributed significantly to growth. The growth in gross value added was fostered mainly by the manufacturing industry, particularly manufacturing of transport vehicles. A significant increase in the number of jobs was reflected in a fall in the rate of unemployment to 7.1% (compared to 7.9% in 2005). The average rate of HICP inflation reached 2.1%, rising by 0.5 percentage points in comparison with 2005. Non-energy industrial goods continued to have a dampening effect on price development, whereas energy prices rose. Over the course of the year, the development of inflation was influenced by an increased contribution from regulated prices in the first three quarters and its significant decrease in the last quarter (a fall in prices of housing). In the same period the pro-growth influence of food prices also weakened. A decrease in inflation in the last quarter was encouraged by falling prices of energy commodities, as well as by the Czech koruna appreciation. At the close of the year the Czech koruna reached its historically highest level against the euro and the USD.

The deficit in the current and capital account of the balance of payments rose against the preceding year from 1.9% to 4.5% of GDP. This deterioration reflected the outflow of dividends and reinvested earnings in the income balance[1]. The trade deficit as a proportion of GDP improved against 2005. Fiscal development on the revenue side was influenced by the economy's strong growth. On the other hand, the expenditure side reflected higher pension and social security benefits, as well as the early repayment of a guarantee towards the Česká národní banka for claims the bank took over in connection with the stabilising of the banking sector. Thus, the public finance deficit (according to the excessive deficit procedure definition) totalled 2.9% of GDP (compared to 3.5% of GDP in 2005). The Česká národní banka raised its key rate in total by 50 basis points, even though this the negative interest-rate differential towards the ECB rate deepened as at the year-end by 0.75 percentage points to 1 percentage point. The Česká národní banka's decisions were based on the inflation forecast, which predicted an upward shift in the cyclical position of the economy. These decisions also took account of risks identified in fiscal developments and rise of rates in the euro area.

Economic development in **Hungary** in 2006 was substantially influenced by the adoption of a fiscal consolidation plan in the second half of the year. The adopted stabilisation measures put a brake on economic growth and led to an increase in inflation. GDP growth slowed slightly to 3.9%. The dominant contribution of net exports to growth recorded in 2005 became even more pronounced. Exports, concentrated primarily on machinery, chemical and metal products, found support in a recovery in external demand

[1] *The evaluation of the structure of the current account of the balance of payments for the Czech Republic, Hungary and Poland is based on the data for the first to third quarters of 2006.*

Chart 24 **Contributions to HICP inflation (% points)**



Source: Eurostat, NBS calculations.

(particularly as a consequence of German economic growth), as well as in the weakening forint. Conversely, the impulse from the side of household consumption and gross investment weakened against the preceding year. A milestone in the economic development was the introduction of a fiscal consolidation plan in June with a restrictive influence on consumer and investment decisions (the introduction of a solidarity tax for legal and natural persons, and a tax on interest income and capital gains from September). The rate of unemployment grew slightly against 2005 to 7.5%. The average HICP inflation reached 4%, increasing by 0.5 percentage points in comparison with 2005. In the first months of the year the year-on-year rate of inflation hovered at relatively low levels, but began to increase gradually as a result of growing inflationary expectations. Price development recorded a further acceleration in August, as a result of energy price increases for households and under the influence of an increase in indirect taxes. With effect from September, VAT was increased for basic foods, along with an excise duty on cigarettes and alcohol. Thus, over the course of the year, the year-on-year rate of inflation rose from 2.5% in January to 6.6% in December.

The current and capital account deficit fell slightly against 2005, by 0.3 of a percentage point to 5.6% of GDP. The financial account achieved a significant surplus, partly due to the high inflow of net foreign direct investment of 6.2% of GDP (e.g. the sale of the Budapest airport). The worsening of the public finance deficit (according to the excessive deficit procedure definition) to 9.2% of GDP in comparison with 7.8% in 2005 was influenced by expenditures on anti-flood measures, the waiving of the Iraqi debt, army purchases, as well as by the inclusion of costs for the construction of motorways and pension reform in the deficit (in contrast to the practice in the previous years). The deficit was partly compensated by an increase in revenues in connection with the fiscal consolidation plan. In fear of an increase in inflationary expectations and of emergence of secondary effects following administrative price adjustments, the Magyar Nemzeti Bank felt the need to tighten monetary policy. In raising the key rate in total by 200 basis points it also took account of the higher risk premium of Hungarian assets and the forint's weakening.

The **Polish economy's** real growth in comparison with 2005 increased by 2.3 percentage points to 5.8%, reflecting the favourable development of gross investment and strong household consumption resulting from a growth in real disposable income and consumer credit. Robust growth in investment demand (a growth in fixed capital by 16.7%) was connected in particular with investments in the aviation and electronic industries, logistics, and other sectors. The favourable effects of this were reflected in job creation and in the fall of the rate of unemployment to 13.8% (from 17.7% in 2005). As a result of the continuing emigration of workers and of structural changes (in health care, mining, construction, and the textile industry) the problem of a shortage of workers deepened in certain market segments. This, despite the fact that for the Central European region Poland has relatively high labour market flexibility, was characterised by the highest share of part-time and fixed-term contracts. However, the resultant growth in total labour costs (strongest in the construction sector) represents an inflationary risk. Price development in 2006 slowed, when the average HICP inflation decreased to 1.3%, in comparison with 2.2% in 2005. The zloty's appreciation coupled with a marked fall in prices of clothing and falling oil prices in the second half of the year all had a dampening effect on inflation. A further factor was the setting of regulatory policy that did not fully internalise the rise in energy prices since 2004.

The current and capital account deficit, as in the preceding year, reached 1.4% of GDP. In the current account, the deficit of the trade balance and income balance worsened slightly. As in the preceding year, the financial account was in surplus, particularly as a result of foreign direct investment inflow. The public finance deficit (according to the excessive deficit procedure definition) fell in comparison with 2005 by 0.4 percentage points to 3.9% of GDP. The fiscal improvement was influenced by the revenue side in connection with faster economic growth and with an increase in indirect taxes. The Narodowy Bank Polski reduced its key rate in total by 0.5 percentage points in the first quarter, and in view of the favourable development of inflation, it left the rate unchanged at 4% till the end of the year.