

GLOBAL ECONOMIC OUTLOOK – AUGUST

Monetary and Statistics Department
External Economic Relations Division

2012

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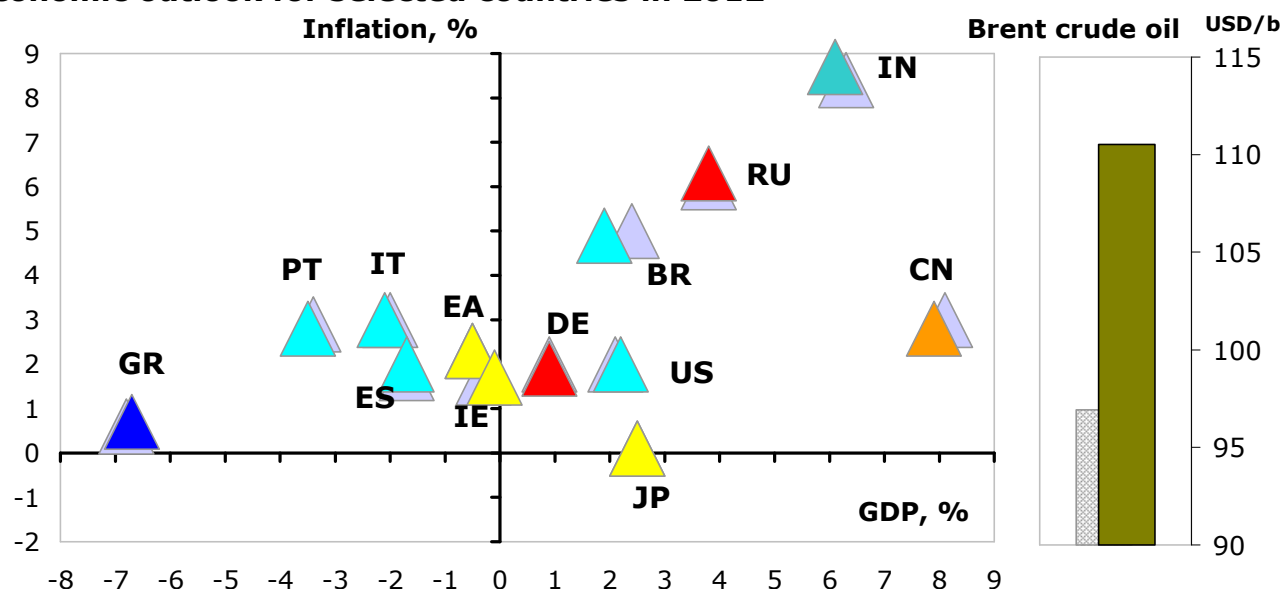
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The August issue of *Global Economic Outlook* presents its regular overview of recent and expected developments in selected territories, focusing on key economic indicators such as GDP, inflation, leading indicators, interest rates, exchange rates and commodity prices. The last section provides a more detailed analysis of changes in the balance of payments of the Czech Republic caused by the global financial crisis. It discusses the reasons for these changes and the mechanisms by which the individual balance of payments items were affected by the crisis.

Although the leading indicators are signalling a deterioration, the outlook for economic growth was changed only slightly in August. The forecast for the German economy saw a modest improvement, whereas the outlook for China was revised downwards slightly. The euro area economy is being held back mainly by those countries with the largest current account problems. They are dragging the European economy into a moderate recession this year. This recession will turn into a sluggish recovery next year. However, a significant slowdown in economic growth this year is also expected in Germany and to a smaller extent in China. By contrast, the condition of the US economy should not worsen any further. However, global economic growth continues to be driven mainly by the BRIC countries (Brazil, Russia, India and China). The inflation forecasts were also little changed. Despite a global economic downturn, only a slight decrease towards 2% is expected in Europe. Inflation should fall faster in the USA and China.

While dollar rates on the interbank market have been flat since the start of this year, euro area interest rates kept falling in response to the cut in the ECB's key interest rate in July. Greater risk aversion is evidenced by record-low yields on German and US government bonds. The EU summit at the end of June injected slightly more optimism into the foreign exchange and commodity markets. The depreciation of the euro against the dollar halted, as did the decline in prices of most commodities. The oil price then surged, mainly because of escalating geopolitical risks in the Middle East. Weather conditions are keeping prices of food – especially cereals and oil crops – near their all-time highs. These are the main risks to inflation going forward.

Economic outlook for selected countries in 2012



Current account
(% of GDP)

-8...-6 ≤ -4 ≤ -2 ≤ 0 ≤ 2 ≤ 4 ≤ 6

outlook XII-2012

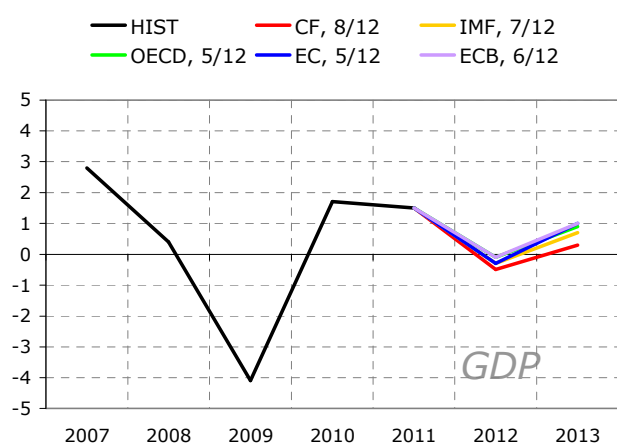
Note: EA – euro area, DE – Germany, US – United States, JP – Japan, CN – China, IN – India, BR – Brazil, RU – Russia, GR – Greece, IE – Ireland, IT – Italy, PT – Portugal, ES – Spain. The points are coloured according to the size of the current account in per cent of GDP in 2012 (estimate). The grey colour is the CF forecast (GDP, inflation) or Bloomberg survey (oil price) from the previous month. [Cut-off date for data: 16 August 2012]

Source: CNB calculation using Bloomberg, Consensus Economics and EIU.

II.1 GDP

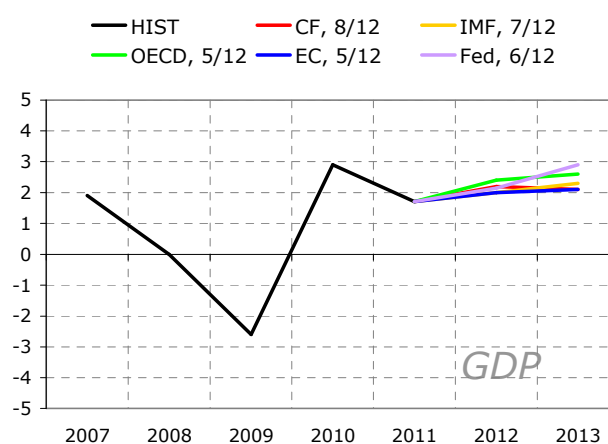
Subdued growth or stagnation in large euro area economies, coupled with a marked contraction in GDP in Italy and other euro area periphery countries suffering from persisting debt problems, is keeping the growth outlook for the entire area negative. According to the new CF and IMF forecasts, economic activity in the euro area will decline by 0.3%–0.5% **this year**. Germany will record weak growth of 1% or less. GDP growth in the USA will be between 2.0% and 2.2%. The Chinese economy will slow to 7.9%–8.0%. Chinese GDP growth last fell below 8% in 2009. A slight economic recovery can be expected **next year**. Euro area growth will turn positive again (0.3%–0.7%) thanks to a gradual improvement in economic activity in all euro area countries; Germany will grow by 1.2%–1.4%. US GDP will rise by 2.1%–2.3%. Growth in China will be between 8.3% and 8.5%.

EURO AREA



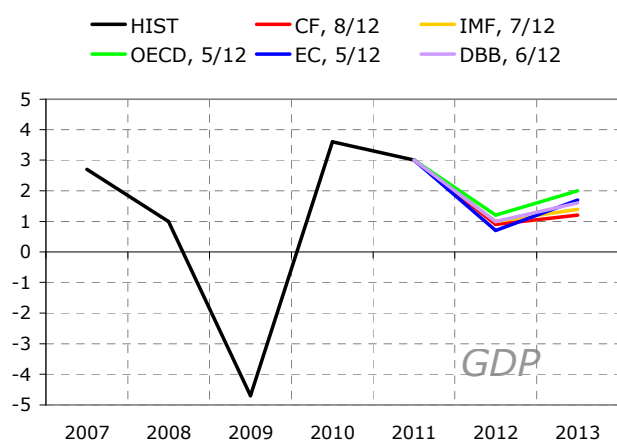
| | HIST | CF | IMF | OECD | EC | ECB |
|------|------|------|------|------|------|------|
| 2011 | 1.5 | | | | | |
| 2012 | | -0.5 | -0.3 | -0.1 | -0.3 | -0.1 |
| 2013 | | 0.3 | 0.7 | 0.9 | 1.0 | 1.0 |

USA



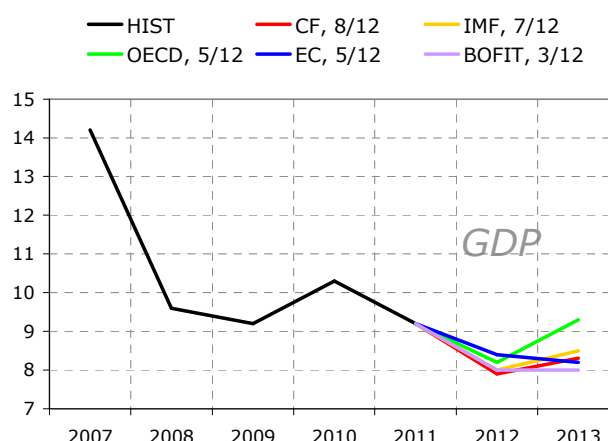
| | HIST | CF | IMF | OECD | EC | Fed |
|------|------|-----|-----|------|-----|-----|
| 2011 | 1.7 | | | | | |
| 2012 | | 2.2 | 2.0 | 2.4 | 2.0 | 2.2 |
| 2013 | | 2.1 | 2.3 | 2.6 | 2.1 | 2.9 |

GERMANY



| | HIST | CF | IMF | OECD | EC | DBB |
|------|------|-----|-----|------|-----|-----|
| 2011 | 3.0 | | | | | |
| 2012 | | 0.9 | 1.0 | 1.2 | 0.7 | 1.0 |
| 2013 | | 1.2 | 1.4 | 2.0 | 1.7 | 1.6 |

CHINA



| | HIST | CF | IMF | OECD | EC | BOFIT |
|------|------|-----|-----|------|-----|-------|
| 2011 | 9.2 | | | | | |
| 2012 | | 7.9 | 8.0 | 8.2 | 8.4 | 8.0 |
| 2013 | | 8.3 | 8.5 | 9.3 | 8.2 | 8.0 |

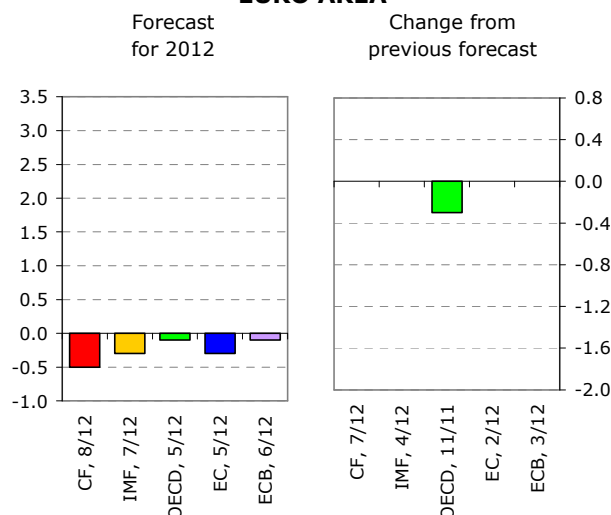
Note: Legend shows latest forecast data in format „Source, month/year of forecast publication“. HIST: historical value. ECB and Fed: midpoint of range. [Cut-off date for data: 17 August 2012]

Source: CNB calculation using Eurostat, CF, IMF, OECD, EC, ECB, Fed, DBB and BOFIT databases.

II.2 Current GDP forecast and change from the previous forecast

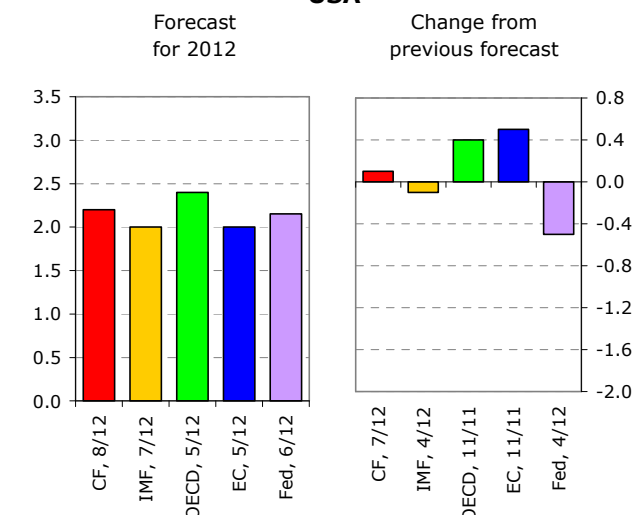
The outlook for euro area GDP growth in 2012 was unchanged in August. The CF outlook for Germany also remained the same. By contrast, the IMF expects growth to be 0.4 pp higher compared to the April forecast. The August outlook for the USA was revised by 0.1 pp towards weaker (IMF) or stronger (CF) growth in economic activity. Both institutions lowered their outlook for China by 0.2 pp.

EURO AREA



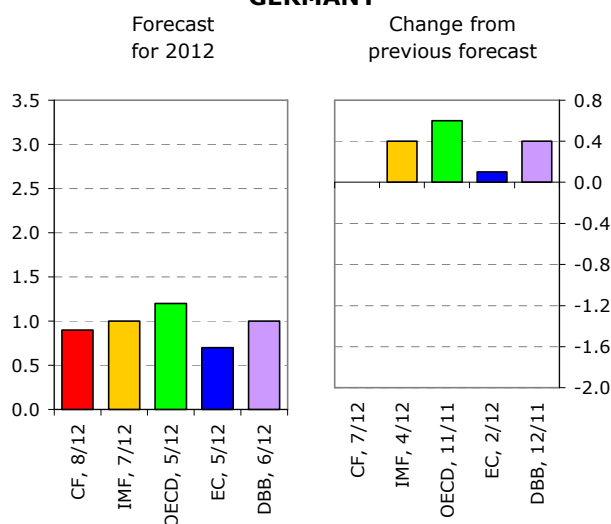
| | 2011 | CF | IMF | OECD | EC | ECB |
|----------|------|------|------|------|------|------|
| Forecast | 1.5 | -0.5 | -0.3 | -0.1 | -0.3 | -0.1 |
| Change | | 0.0 | 0.0 | -0.3 | 0.0 | 0.0 |

USA



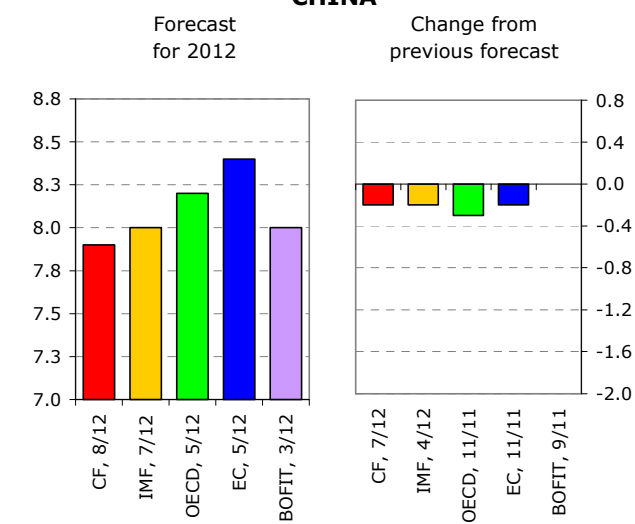
| | 2011 | CF | IMF | OECD | EC | Fed |
|----------|------|-----|------|------|-----|------|
| Forecast | 1.7 | 2.2 | 2.0 | 2.4 | 2.0 | 2.2 |
| Change | | 0.1 | -0.1 | 0.4 | 0.5 | -0.5 |

GERMANY



| | 2011 | CF | IMF | OECD | EC | DBB |
|----------|------|-----|-----|------|-----|-----|
| Forecast | 3.0 | 0.9 | 1.0 | 1.2 | 0.7 | 1.0 |
| Change | | 0.0 | 0.4 | 0.6 | 0.1 | 0.4 |

CHINA



| | 2011 | CF | IMF | OECD | EC | BOFIT |
|----------|------|------|------|------|------|-------|
| Forecast | 9.2 | 7.9 | 8.0 | 8.2 | 8.4 | 8.0 |
| Change | | -0.2 | -0.2 | -0.3 | -0.2 | 0.0 |

Note: Horizontal axis of left-hand (right-hand) chart shows latest (previous) forecast data in format "Source, month/year of forecast publication". HIST: historical value. ECB and Fed: midpoint of range.

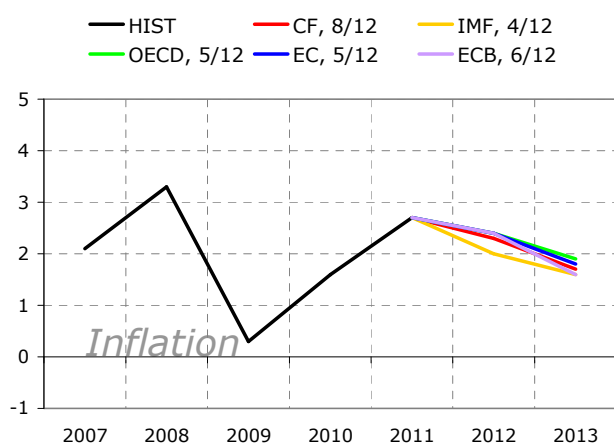
[Cut-off date for data: 17 August 2012]

Source: CNB calculation using Eurostat, CF, IMF, OECD, EC, ECB, Fed, DBB and BOFIT databases.

II.3 Inflation

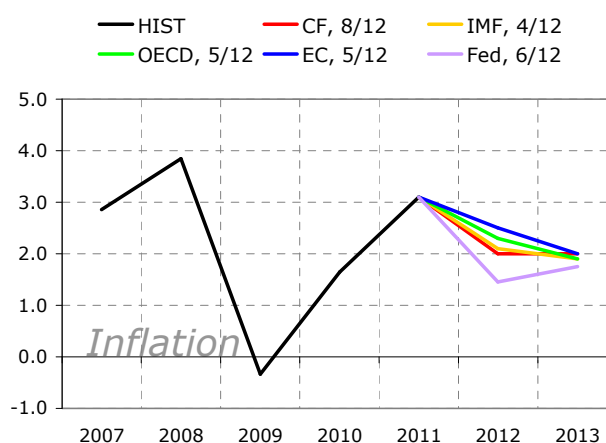
The recent sharp growth in prices of oil and non-energy commodities is reflected in a slightly higher inflation outlook despite the global economic slowdown. According to the August CF, consumer price inflation in the monitored advanced economies will be between 1.9% and 2.3% **next year**. In China, prices will rise by 2.8%. Price growth in advanced economies will slow slightly **next year** (to 1.7%–2.0%). By contrast, inflation in China will pick up to 3.4%.

EURO AREA



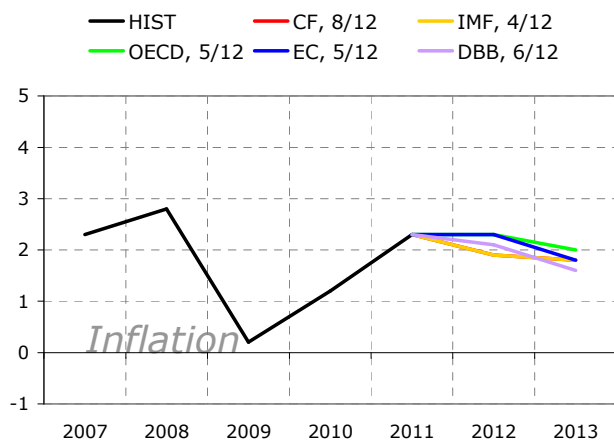
| | HIST | CF | IMF | OECD | EC | ECB |
|------|------|-----|-----|------|-----|-----|
| 2011 | 2.7 | | | | | |
| 2012 | | 2.3 | 2.0 | 2.4 | 2.4 | 2.4 |
| 2013 | | 1.7 | 1.6 | 1.9 | 1.8 | 1.6 |

USA



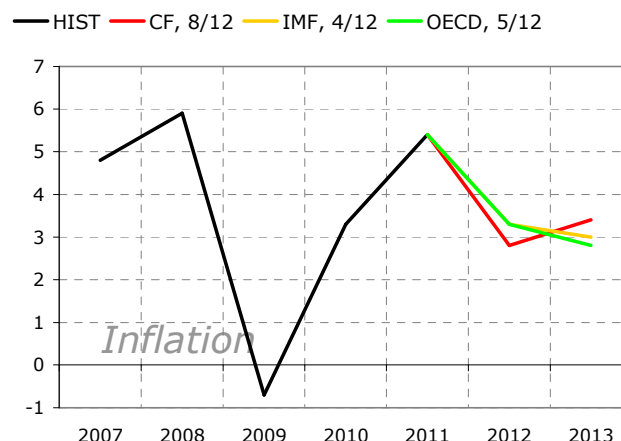
| | HIST | CF | IMF | OECD | EC | Fed |
|------|------|-----|-----|------|-----|-----|
| 2011 | 3.1 | | | | | |
| 2012 | | 2.0 | 2.1 | 2.3 | 2.5 | 1.5 |
| 2013 | | 2.0 | 1.9 | 1.9 | 2.0 | 1.8 |

GERMANY



| | HIST | CF | IMF | OECD | EC | DBB |
|------|------|-----|-----|------|-----|-----|
| 2011 | 2.3 | | | | | |
| 2012 | | 1.9 | 1.9 | 2.3 | 2.3 | 2.1 |
| 2013 | | 1.8 | 1.8 | 2.0 | 1.8 | 1.6 |

CHINA



| | HIST | CF | IMF | OECD |
|------|------|-----|-----|------|
| 2011 | 5.4 | | | |
| 2012 | | 2.8 | 3.3 | 3.3 |
| 2013 | | 3.4 | 3.0 | 2.8 |

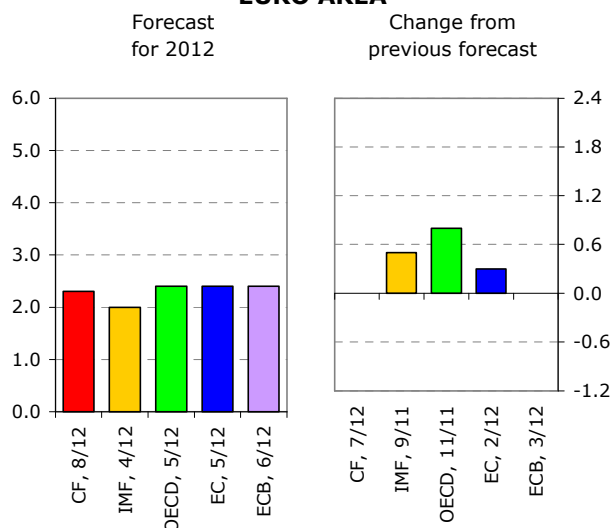
Note: Legend shows latest forecast data in format „Source, month/year of forecast publication“. HIST: historical value. ECB and Fed: midpoint of range. [Cut-off date for data: 17 August 2012]

Source: CNB calculation using Eurostat, CF, IMF, OECD, EC, ECB, Fed, DBB and BOFIT databases.

II.4 Inflation forecast and change from the previous forecast

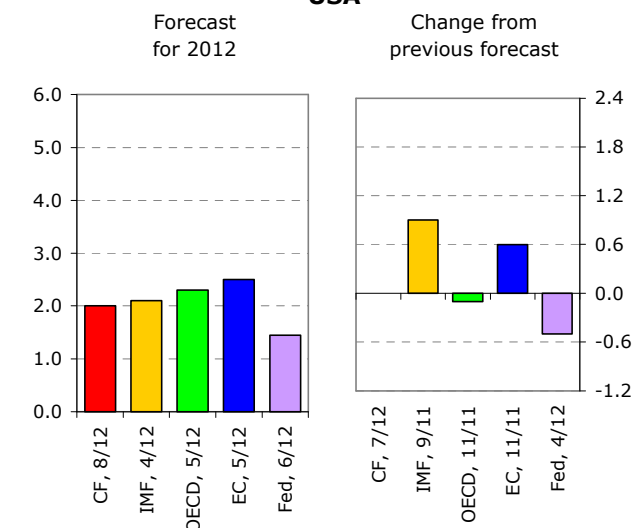
The August CF left the inflation outlook for **2012** for Germany and the United States unchanged from July. CF lowered the consumer price inflation outlook for Germany by 0.1 pp and that for China by 0.2 pp.

EURO AREA



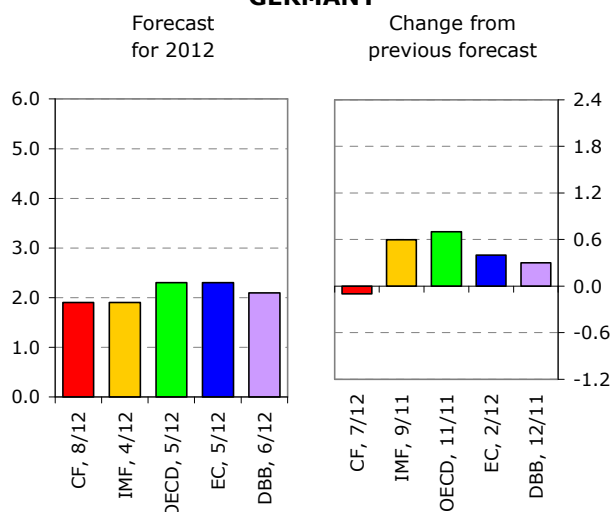
| | 2011 | CF | IMF | OECD | EC | ECB |
|----------|------|-----|-----|------|-----|-----|
| Forecast | 2.7 | 2.3 | 2.0 | 2.4 | 2.4 | 2.4 |
| Change | | 0.0 | 0.5 | 0.8 | 0.3 | 0.0 |

USA



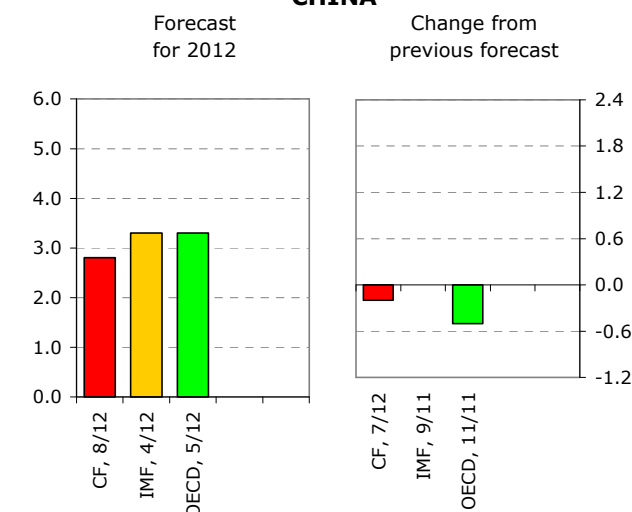
| | 2011 | CF | IMF | OECD | EC | Fed |
|----------|------|-----|-----|------|-----|------|
| Forecast | 3.1 | 2.0 | 2.1 | 2.3 | 2.5 | 1.5 |
| Change | | 0.0 | 0.9 | -0.1 | 0.6 | -0.5 |

GERMANY



| | 2011 | CF | IMF | OECD | EC | DBB |
|----------|------|------|-----|------|-----|-----|
| Forecast | 2.3 | 1.9 | 1.9 | 2.3 | 2.3 | 2.1 |
| Change | | -0.1 | 0.6 | 0.7 | 0.4 | 0.3 |

CHINA



| | 2011 | CF | IMF | OECD |
|----------|------|------|-----|------|
| Forecast | 5.4 | 2.8 | 3.3 | 3.3 |
| Change | | -0.2 | 0.0 | -0.5 |

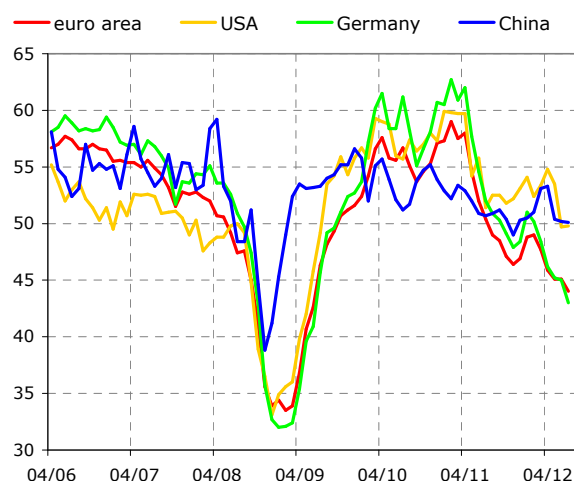
Note: Horizontal axis of left-hand (right-hand) chart shows latest (previous) forecast data in format "Source, month/year of forecast publication". HIST: historical value. ECB and Fed: midpoint of range.

[Cut-off date for data: 17 August 2012]

Source: CNB calculation using Eurostat, CF, IMF, OECD, EC, ECB, Fed, DBB and BOFIT databases.

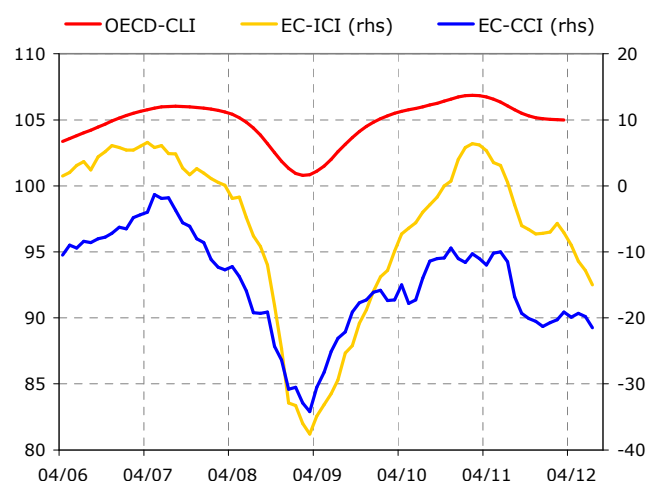
From the perspective of leading indicators, the economic outlook for the second half of this year deteriorated in August compared to the previous month for all the monitored countries and regions. The only exception is the USA, where the outlook improved slightly and the modest recovery can be expected to continue. The Purchasing Managers' Index (PMI) in industry increased moderately (by 0.1 pp), but remains below 50%; other leading indicators were flat or improved slightly. All the monitored leading indicators of economic and consumer sentiment in the euro area and Germany deteriorated considerably compared to the previous month, confirming the negative predictions from other sources. In China, the PMI in industry also declined slightly, but remained just above 50%.

PMI IN MANUFACTURING



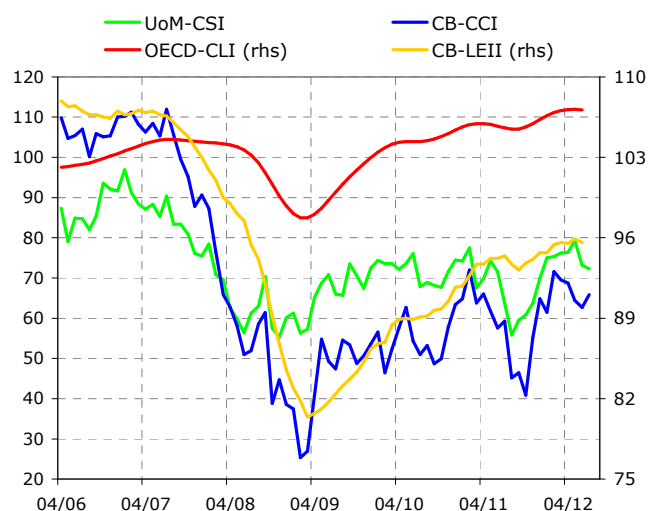
| | EA | US | DE | CN |
|------|------|------|------|------|
| 5/12 | 45.1 | 53.5 | 45.2 | 50.4 |
| 6/12 | 45.1 | 49.7 | 45.0 | 50.2 |
| 7/12 | 44.0 | 49.8 | 43.0 | 50.1 |

EURO AREA



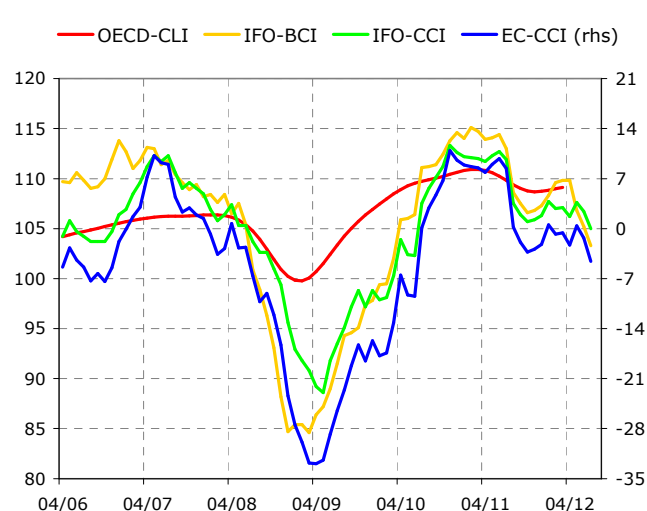
| | OECD-CLI | EC-ICI | EC-CCI |
|------|----------|--------|--------|
| 5/12 | 105.1 | -11.4 | -19.3 |
| 6/12 | 105.1 | -12.8 | -19.8 |
| 7/12 | 104.0 | -15.0 | -21.5 |

USA



| | OECD-CLI | CB-LEII | UoM-CSI | CB-CCI |
|------|----------|---------|---------|--------|
| 5/12 | 107.2 | 95.9 | 79.3 | 64.4 |
| 6/12 | 107.1 | 95.6 | 73.2 | 62.7 |
| 7/12 | 106.0 | 92.3 | 72.3 | 65.9 |

GERMANY



| | OECD-CLI | IFO-BCI | IFO-CCI | EC-CCI |
|------|----------|---------|---------|--------|
| 5/12 | 106.8 | 107.6 | 107.6 | 0.4 |
| 6/12 | 105.2 | 106.7 | 106.7 | -1.3 |
| 7/12 | 103.3 | 105.0 | 105.0 | -4.6 |

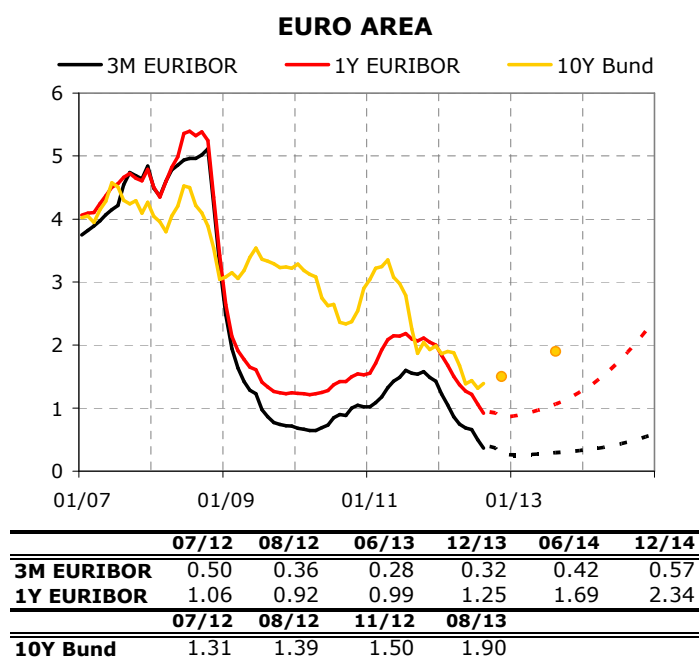
Note: OECD-CLI stands for OECD Composite Leading Indicator, EC-ICI (right-hand scale) for European Commission Industrial Confidence Indicator, EC-CCI (right-hand scale) for EC Consumer Confidence Indicator, CB-LEII for Conference Board Leading Economic Indicator, CB-CCI for CB Consumer Confidence Index, UoM-CSI for University of Michigan Consumer Sentiment Index, IFO-BCI for Institute for Economic Research – Business Climate Index, and IFO-CCI for IFO Consumer Confidence Index. [Cut-off date for data: 10 August 2012]

Source: CNB calculation using OECD, EC, IFO and UoM databases.

IV.1 Outlook for short-term and long-term interest rates: Euro area

The 3M and 1Y EURIBOR interbank rates decreased during July, reflecting the 25 bp cut in the ECB's key interest rate at the July meeting. In the first half of August, the 3M rate was 0.36% and the 1Y rate was 0.92%. The forecast based on implied rates again shifted downwards compared to the previous month. The 1Y rate should start to increase in mid-2013. Risk premia for both maturities declined and are at annual lows.

In the first three weeks of July, the yields on the 10Y German government bond fell to historical lows, reflecting greater risk aversion resulting from the situation in the euro area periphery. However, yields then increased slightly owing to expectations regarding new ECB measures and a lowering of Germany's rating outlook by Moody's. The new CF forecast left expected rates unchanged; the yield on the 10Y Bund one year ahead should be around 0.5 pp higher than it is now.



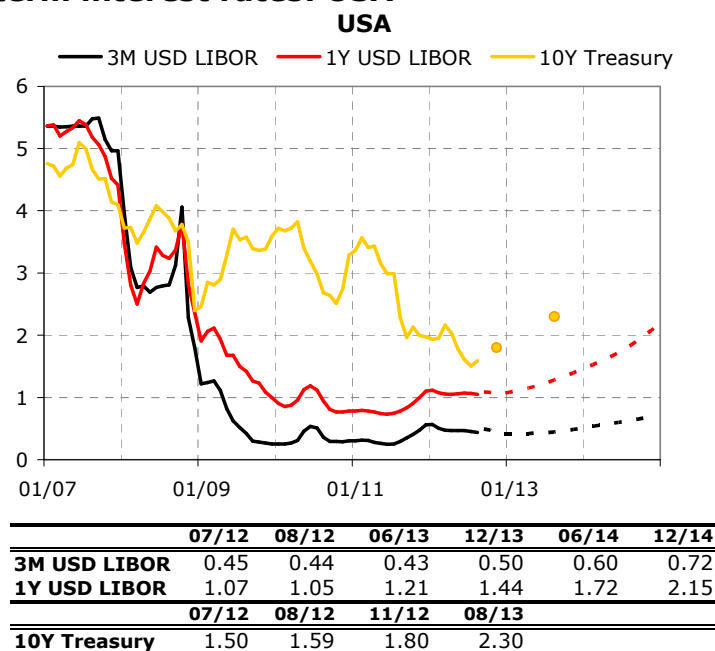
Note: Forecast for EURIBOR rates is based on implied rates from interbank market yield curve (FRA rates are used from 4M to 15M and adjusted IRS rates for longer horizons). Forecast for German government bond yield (10Y Bund) is taken from CF. Dashed lines and points represent outlook. [Cut-off date for data: 16 August 2012]

Sources: Thomson Reuters (Datastream), Bloomberg, CNB calculations.

IV.2 Outlook for short-term and long-term interest rates: USA

The 3M and 1Y USD LIBOR rates have been around 0.45% and 1.07% respectively for some time now. The outlook for 3M rates based on implied rates is stable, with a slight increase expected in 2014. The 1Y LIBOR is expected to start rising in early 2013.

US bond rates continue to reflect risk aversion related to the situation in the euro area. The 10Y government bond yield reached a historical low (1.40%) in the penultimate week of July and increased slightly thereafter until mid-August. The August CF expects a lower rate than in the previous month.

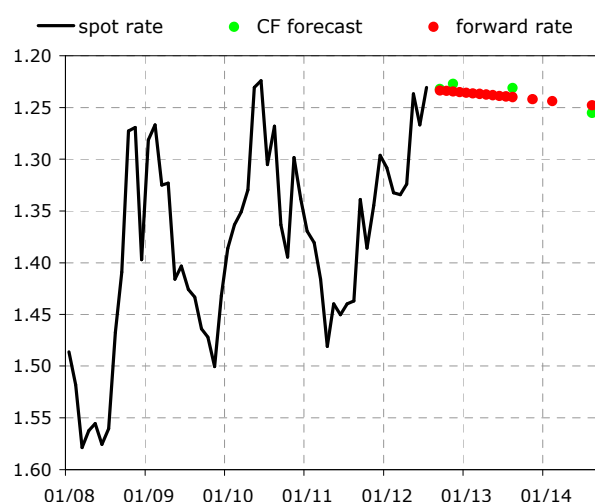


Note: Implied LIBOR rates are derived from London interbank market yield curve. Forecast for 10Y Treasury yield is taken from CF. Dashed lines and points represent outlook. [Cut-off date for data: 16 August 2012]

Sources: Thomson Reuters, Bloomberg, CNB calculations.

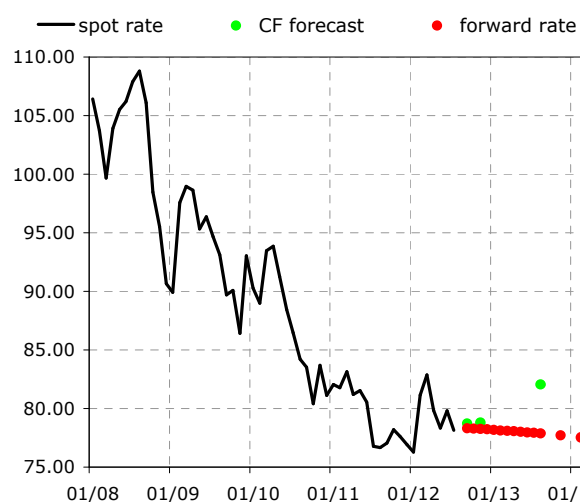
The euro continued to weaken against the US dollar until the third week of July. It then appreciated slightly after statements made by the ECB raised hopes of new measures to resolve the debt crisis. However, the August ECB meeting produced no breakthrough in this respect. Given the previous marked depreciation of the euro, the August CF expects no further weakening and the outlook for the next two years is stable. Very similar developments are expected on the basis of market outlooks. The British pound traded within a narrow band in July and its outlook is also stable, although CF expects it to appreciate at the long end of the forecast. The yen appreciated in July owing solely to risk aversion due to the euro area situation, but this trend halted in August. CF expects it to depreciate over the next 12 months owing to weaker Japanese fundamentals. By contrast, the market outlooks are stable. The Swiss central bank continued to buy foreign currency to maintain the ceiling on the exchange rate against the euro.

US\$ per Euro



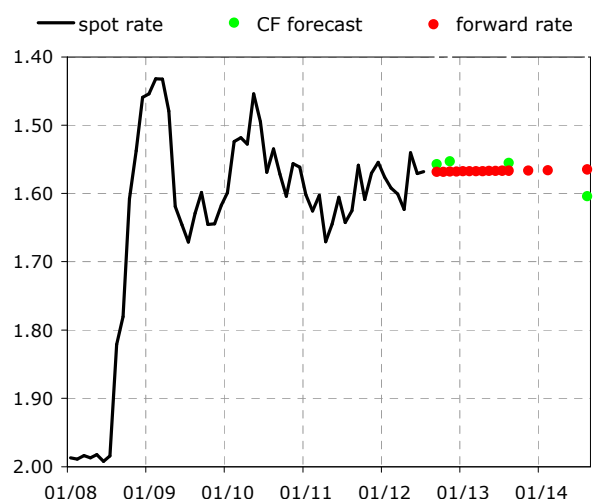
| | 13/8/12 | 09/12 | 11/12 | 08/13 | 08/14 |
|--------------|---------|-------|-------|-------|-------|
| spot rate | 1.233 | | | | |
| CF forecast | | 1.232 | 1.227 | 1.231 | 1.255 |
| forward rate | | 1.234 | 1.235 | 1.240 | 1.248 |

Yen per US\$



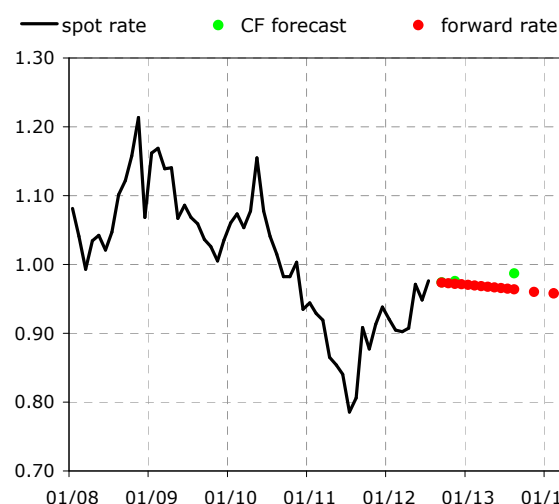
| | 13/8/12 | 09/12 | 11/12 | 08/13 | 08/14 |
|--------------|---------|-------|-------|-------|-------|
| spot rate | 78.32 | | | | |
| CF forecast | | 78.73 | 78.79 | 82.04 | 85.46 |
| forward rate | | 78.30 | 78.24 | 77.88 | 77.11 |

US\$ per UK£



| | 13/8/12 | 09/12 | 11/12 | 08/13 | 08/14 |
|--------------|---------|-------|-------|-------|-------|
| spot rate | 1.568 | | | | |
| CF forecast | | 1.557 | 1.553 | 1.555 | 1.604 |
| forward rate | | 1.568 | 1.568 | 1.567 | 1.565 |

Swfr per US\$



| | 13/8/12 | 09/12 | 11/12 | 08/13 | 08/14 |
|--------------|---------|-------|-------|-------|-------|
| spot rate | 0.974 | | | | |
| CF forecast | | 0.974 | 0.976 | 0.987 | 1.017 |
| forward rate | | 0.973 | 0.972 | 0.964 | 0.952 |

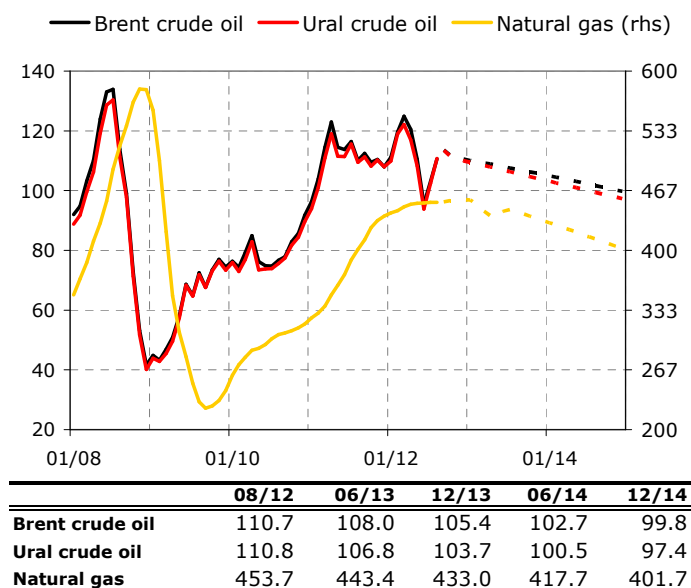
Note: Increase in currency pair represents appreciation of US dollar; data as of the last day of the month. Forward rate does not represent outlook; it is based on covered interest parity, i.e. currency of country with higher interest rate is depreciating. Forward rate represents current (as of cut-off date) possibilities for securing future exchange rate. [Cut-off date for data: 16 August 2012]

Source: CNB calculation using Bloomberg and Consensus Forecasts databases.

VI.1 Oil and natural gas

The Brent crude oil price started to rise rapidly again in late July, moving from USD 90 a barrel back towards USD 115 a barrel in the space of two months. The turnaround was partly due to the EU summit at the end of June. The price then rose mainly because of the escalation of the political situation in the Middle East (Iran, Syria). Despite high oil supplies from OPEC and other producers, growth in industrial inventories of oil and oil products in OECD countries halted in June. This was a signal for speculators to return to the market. The spot price of oil and its forecast both shifted upwards significantly compared to the previous month, especially at the shorter horizon owing to the steeper slope of the falling forward curve. The forecast for long-term natural gas contracts in Europe thus also returned to a higher path; in the previous issue we had expected them to fall quite rapidly until mid-2013. Only a modest decrease is now expected from the start of next year.

OUTLOOK FOR PRICES OF OIL AND NATURAL GAS



Note: Brent oil price in USD/barrel (ICE quotation). Price of Russian natural gas at German border in USD/1,000 cubic m (IMF database). Future oil prices are derived from oil prices. Dashed line represents outlook.

[Cut-off date for data: 13 August 2012]

Source: Bloomberg, IMF, CNB calculations.

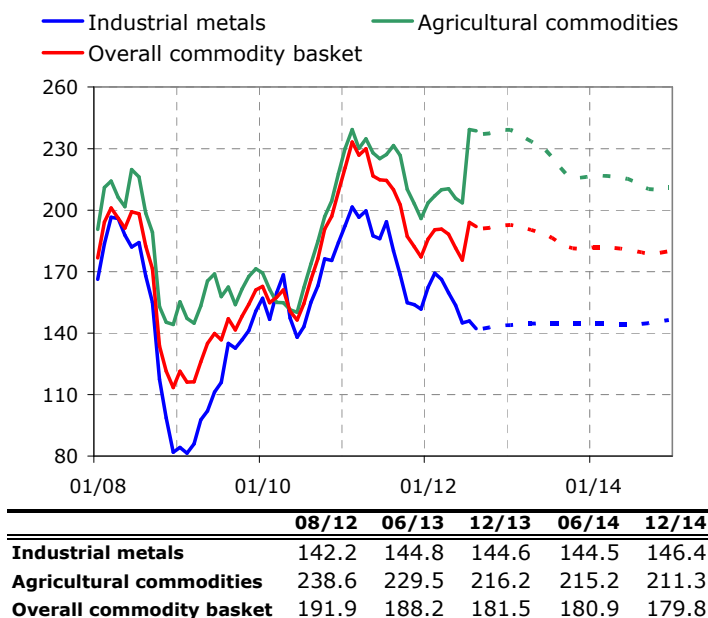
VI.2 Other commodities

The overall index of non-energy commodity prices moved in line with the forecast over the last month, but this was due only to contrary developments in its components.

Wheat prices were flat at a high level (last seen in April 2008) in the previous month. Only a slight fall is expected following the new harvest next year. Maize prices also stagnated, but at all-time highs, and the decrease following the new harvest should be stronger. The same applies to soy. The price of rice is not showing such dramatic developments; it has been following a slight rising trend since 2011, which should continue further. The opposite trend can be observed for the price of sugar, which has been falling markedly since 2011. The sharp decline in coffee and cocoa prices halted. Meat prices remain close to record highs.

By contrast, prices of cotton and rubber are flat following earlier dramatic declines. Only a slight decrease was recorded for prices of industrial metals, whose outlook remains flat.

OUTLOOK FOR OTHER COMMODITY PRICES



Note: Chart shows price indices, year 2005 = 100. Dashed line represents outlook based on futures.

[Cut-off date for data: 13 August 2012]

Source: Bloomberg, outlooks based on futures.

CHANGES IN THE CZECH REPUBLIC'S BALANCE OF PAYMENTS CAUSED BY THE GLOBAL FINANCIAL CRISIS¹

The global financial crisis, which originated in the USA in 2007 and has been strongly affecting Europe since 2008, also hit the Czech Republic quite hard despite the fact that neither its internal nor external imbalances were excessive. In the first phase, the Czech Republic did not need to consolidate its banking sector or public finances. However, the high openness of the Czech economy meant that it was hit indirectly via several different channels (declining exports, falling foreign direct investment inflows, decreasing interest income on investment in foreign debt instruments, and shrinking public budget revenues). Some of the impacts were temporary and affected the Czech Republic soon after the crisis erupted in Europe (a sizeable decline in exports and a worsening of the trade balance); others emerged later on; and some still persist and will be felt for several years to come (falling investment, low interest income on debt assets and public budget imbalances). Given the high openness of the Czech economy, they have been reflected in aggregate terms in changes in the Czech Republic's balance of payments over the last five years.

Introduction

The effects of a financial crisis such as the current one become visible first of all in movements of short-term capital. Investors – usually from advanced countries and investing in emerging and converging economies – spot the increased risks fastest and usually respond by halting capital inflows and later by withdrawing from economies seen – for whatever reason – as risky. Although this was a global phenomenon, the Czech Republic was not hit hard. The Czech Republic was already a low-inflation economy before the crisis broke out.² This allowed the central bank to keep interest rates close to, or below, ECB rates. As a result, speculative short-term capital – attracted by positive interest rate differentials – was not a major factor in the Czech Republic, unlike some other countries of the Central European region. In the following four years there have been no major monetary policy changes affecting the interest rate differential against the euro, so there have been no major movements in this type of capital. The second global crisis factor is a slump in investment activity, including cross-border investment, as reflected in the direct investment account of the balance of payments. The Czech Republic was hit fully here, especially in 2008 and 2009. The final typical phenomenon accompanying a crisis – a decline in foreign trade – also hit the Czech Republic hard, especially in the initial phase. The following article will examine these and other specific effects of the crisis on the Czech economy.

1 The balance of goods and services

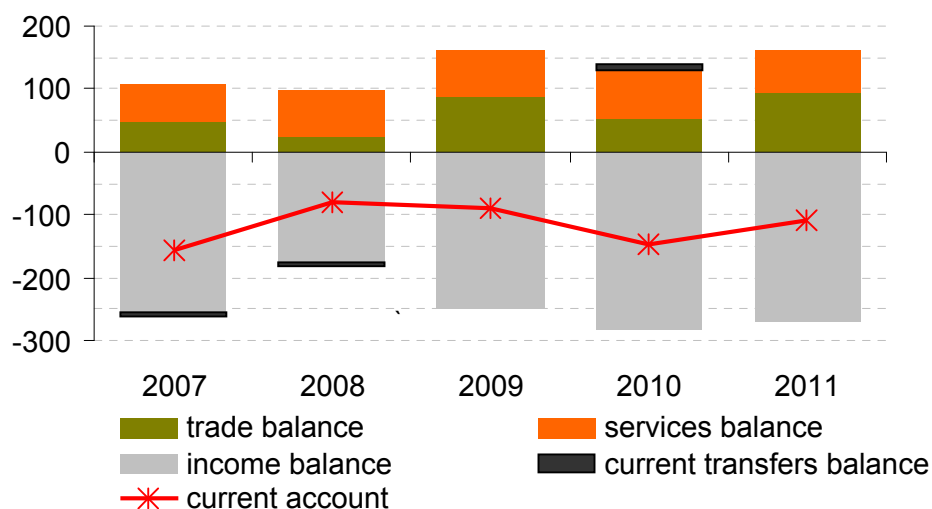
The very export-oriented Czech economy (exports account for around 75% of GDP) was hit by a slump in external demand in 2008 Q4. This led to a year-on-year fall in Czech goods exports of around 15%. Local businesses responded with a lag to the decline in external demand. This led to a significant deterioration in the trade balance of almost CZK 20 billion in the same quarter. The downturn in services was much more modest

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² Partly due to long-term appreciation of the exchange rate.

than that in goods trade. A fall in credits of about 9%, associated with the above decline in goods trade, was observed in transport. Credits in travel declined by around 5%. However, the services balance improved slightly year on year in 2008 Q4, with credits from other services even increasing slightly. External demand continued to contract in 2009. Although exports recorded a year-on-year decline of almost 12%, the trade balance improved year on year, reaching a historical high of CZK 87.3 billion due to declining domestic demand and falling prices of commodities on world markets. No major changes were observed in the services account – only transport was affected by the slowdown in trade.

Figure VII-1: The Czech Republic's current account since the onset of the global financial crisis



Source: CNB calculations.

Strong fiscal impulses fostered renewed economic growth in the EU in 2010 and also led to a rapid increase in the Czech Republic's trade turnover to the pre-crisis level. However, the trade balance deteriorated, mainly because of renewed growth in commodity prices on world markets. A recovery was also apparent in services, although the growth rate of exports and imports of services was roughly half that of goods and the overall services balance was virtually unchanged.

The fading effect of the fiscal stimuli helped maintain economic growth in the EU in 2011. By contrast, domestic demand in the Czech Republic was affected by the government's efforts to gradually restore fiscal balance. Households' private consumption also reflected increased cautiousness of consumers due to rising external risks related to future developments in Europe and very cautious wage policy in both the private and public sectors. In addition, some engineering sectors succeeded in recording export growth at the expense of their foreign competitors, despite declining demand in the EU. These sectors included manufacture of road vehicles and their accessories, general industry machinery, equipment for telecommunications, and electrical equipment, machinery and appliances. On the other hand, a pronounced worsening of competitiveness was seen only in some agricultural sectors (meat production in particular). As a result, the trade surplus surged to a historical high of CZK 94 billion in 2011 (double the 2007 figure – see Figure VII-1). Prices of commodities on world markets were meanwhile higher in 2011 than in 2007 (the Czech Republic is a big net importer of commodities).

By contrast, the services balance changed only marginally after the onset of the financial crisis (it rose by CZK 7 billion, but deteriorated by around CZK 10 billion last year). Numerous minor, contrary changes were recorded in the services account. Owing to an increase in credits, improvements were recorded for commercial services, computer services and, to a lesser extent, construction and assembly work compared to the pre-crisis period. Financial services recorded an improved balance due to lower debits. On the other hand, a relatively significant worsening was recorded for communications, travel and advertising (a fall in credits and a rise in debits), while a less pronounced deterioration was recorded for transport, with growth in debits significantly outpacing growth in credits. Overall, the Czech Republic was not affected significantly by the financial crisis in terms of the external competitiveness of domestic firms. Czech export positions on world (European) markets were maintained thanks also to the exchange rate, as the koruna's previous, almost ten-year, appreciation trend halted during the crisis.

2 The income balance

However, the significant improvement in the goods and services balance since the start of the global financial crisis – of around 50% to a relatively high CZK 160 billion (around 4.2% of GDP) – has been partly offset by a deterioration in the income balance, which has long been highly negative with an increasing deficit trend. Before the financial crisis, growth in non-residents' direct investment earnings was the main factor of the worsening income balance. The deficit shrank temporarily at the start of the crisis due to a decline in these earnings. By 2009, however it had returned almost to the pre-crisis level and over the next two years it fluctuated just above its final pre-crisis level. However, the main factor of the rise in the deficit to a record level was not "traditional" growth in non-residents' FDI earnings, but a sharp fall in income related primarily to a decline in interest income. This was linked mainly with a significant decline in interest rates in advanced countries in response to the spread of the financial crisis and led to a sharp fall in income in 2009. To a lesser extent, the decline in income was also due to a decrease in residents' holdings of foreign debt instruments. The fall in interest income accounted for almost 70% of the total decline in income from the pre-crisis level (about CZK 60 billion a year to a current level of almost CZK 100 billion). Dividends on portfolio investment, income from residents' work abroad and residents' direct investment earnings recorded less significant falls.

The fall on the debit side of the income balance was far less pronounced in percentage terms, although in 2008 the decline was roughly the same in absolute terms. In 2009 the decline halted and in the next two years it stabilised at CZK 30–40 billion below the pre-crisis level. However, the structure of the fall was significantly different from the credit side. This was due to the significantly different structure of non-residents' assets in the Czech Republic (predominantly direct investment) as compared to residents' assets abroad (mostly debt instruments). A decline in the value of reinvested earnings in the Czech Republic, which exceeded CZK 50 billion, was therefore the most significant change.³ A decline in interest income of non-residents, amounting to only CZK 15 billion, was the second, far less important, change.⁴ By contrast, dividends paid abroad are currently more than CZK 20 billion above the pre-crisis levels. The true negative impact of the changes in the income balance caused by the financial crisis is therefore

³ This is the only income balance item whose growth on the debit side is clearly positive for the Czech economy.

⁴ The decline would have been more pronounced but external government debt recorded a relatively significant increase during the crisis.

much greater for the Czech Republic than indicated by the slight aggregate deterioration in the income balance relative to its pre-crisis level. Before the crisis, non-residents' earnings were split roughly 50/50 between dividends and reinvestment in the Czech Republic. Now, the ratio is approximately 2:1 in favour of dividends.

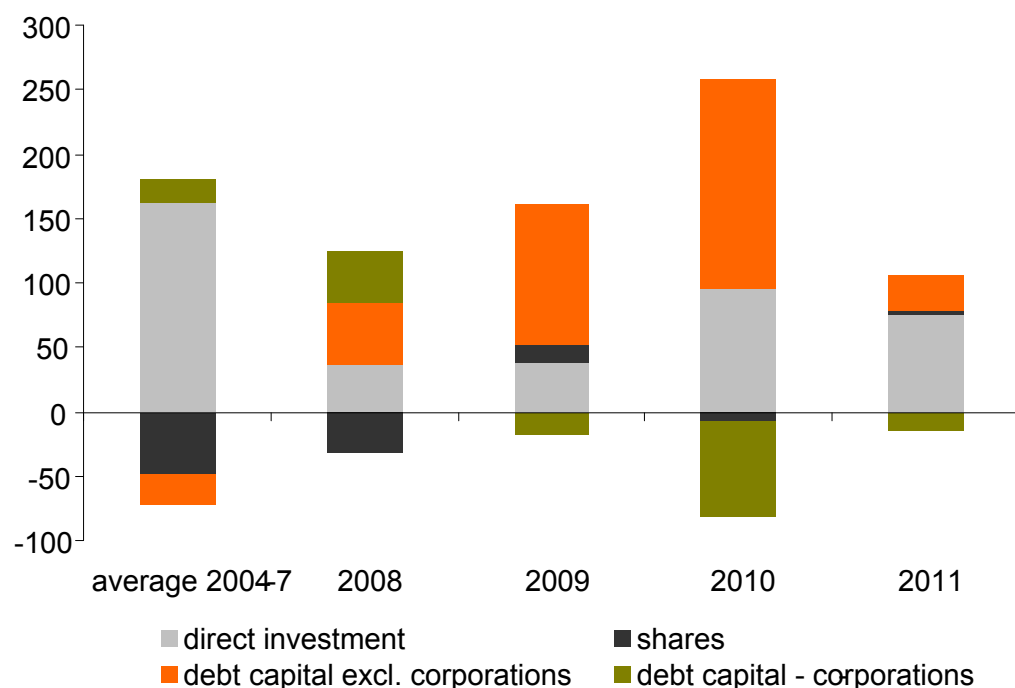
Current transfers are not a major item in the external relations area for the Czech Republic. They have shown a very slight improvement in their overall balance compared to the pre-crisis period, related exclusively to higher net drawdown of funds from the EU by the government sector. However, the improvement in the current transfers balance has been lessened by an upward trend in transfers of labour income abroad.

The current account deficit has declined by about one-third compared to the pre-crisis level and is now just below 3% of GDP. The decline in the deficit has been driven mainly by the improving trade balance. The current figures indicate that companies operating in the Czech Republic are highly competitive. This competitiveness has not been harmed significantly by the several years of financial crisis. On the other hand, detailed statistics on major exporters and the income balance reveal that the performance of the Czech economy is determined mainly by foreign-owned companies, which currently transfer well over half of their profits abroad. The value of reinvestment has dropped sharply since the onset of the crisis. In the long term, this may negatively affect the competitiveness of the Czech economy, especially by comparison with non-European countries, where investment constraints are nowhere near as prevalent as in Europe.

3 Current account financing

The global financial crisis has also caused significant changes in how the current account deficit is financed. In the last decade (until 2007), foreign direct investment inflow was the dominant – and in some years sole – form of current account deficit financing. With the onset of the crisis and the sharp decline in FDI inflows, the financing has come from multiple sources.

The previously negligible capital account has increased in significance since 2007, i.e. since the outbreak of the current financial crisis. The peak occurred in 2009, when a surplus of over CZK 50 billion was generated on the capital account. However, it then started to decline relatively quickly, reaching CZK 15 billion in 2011. The rise and fall of the importance of the capital account is associated with two items. The economic boom first of all resulted in greater interest in emission allowances, which the Czech Republic and its companies – due to structural changes after the 1989 revolution – had and have quite a large excess of. This initially generated a significant rise in income. However, the negative impact of the global financial crisis on economic growth in advanced countries led to a reduced purchasing need, a subsequent decline in prices and a de facto collapse of the emission allowance market last year. The second important item, changes in which caused major changes in the capital account balance, was the drawdown of EU funds. Following a period of hesitant drawdown in the initial years after EU accession, the Czech Republic gradually increased its drawdown of EU funds in 2007–2010. In 2011, however, a relatively large decline was observed, associated mainly with administrative problems with the drawdown of EU funds and the EU's refusal to pay for numerous projects.

Figure VII-2: Changes in the manner of current account deficit financing

Source: CNB calculations.

The inflow of foreign direct investment, which was the main factor underlying the restoration of external competitiveness of the Czech Republic in 2008, recorded a significant decline (see Figure VII-2). However, only part of the decline was related to the onset of the crisis; part was related to the saturation of the Czech Republic with a particular type of investment, a shortage of labour force, and reduced incentives for most investments. Since investment has been relatively volatile from year to year, it is more appropriate to compare the averages for several years cumulatively. In this case, the situation in the four “crisis” years is compared with the average for the last four pre-crisis years. The statistical data are adjusted for sizeable “pre-crisis” sales of state-owned property. The overall average inflow of direct investment (excluding sales of state-owned property) decreased by around 40% during the crisis (to less than CZK 100 billion). However, if we adjust the direct investment figures for reinvested earnings generated in the Czech Republic and concentrate only on the inflow of new capital from abroad, the decline amounts to around 60% (CZK 26 billion on average). Moreover, its structure changed significantly. In particular, the inflow of capital from abroad into manufacturing, which is the most important sector in terms of the future competitiveness of the Czech Republic, halted.⁵ The outflow of capital has also seen a similar decline in percentage terms since 2009, although in financial terms the decline was only around CZK 10–12 billion.

Portfolio investment therefore took over the key role in financing the current account deficit from direct investment (in 2009 and 2010). The dominant role was played by government bonds. A sharp deterioration of the Czech Republic’s fiscal balance – also linked with the onset of the financial crisis and government concerns of an increase in interest expenses on the domestic market – led the Ministry of Finance to decide to finance the fiscal deficit largely on foreign markets. Non-residents’ holdings of

⁵ There were some signs of a recovery in the inflow in 2011.

government debt thus almost doubled in 2009 and 2010 (to around CZK 460 billion). Deficit financing was also fostered to a smaller extent by a decline in holdings of foreign debt assets by residents, especially in 2009. By contrast, changes in holdings of equity securities played a much smaller role. The domestic equity market has recorded a slight decline in holdings of shares by non-residents since 2007. A one-off short-term decline in holdings of domestic shares by non-residents of a further CZK 20 billion or so was observed in 2008. A decrease in share holdings of similar magnitude was also observed for residents, although not until 2010.⁶

The final major change in the balance of payments related to the onset of the crisis is a clear sharp decline in the net external debt of the business sector. However, the main driver is a rise in short-term assets, which is linked with trade credits (an increase in the average loan ratio of exports related either to an expansion of machinery exports, which are more loan-intensive, or to worsening payment discipline during the financial crisis) and the creation of corporate banks by large international companies (in order to cut their financial costs). On the basis of the evidence available, therefore, this relatively significant change cannot be assessed as being unequivocally positive or negative in terms of its impact on the Czech Republic.

Overall, the changes in financial flows associated with the financial crisis, which has turned into a debt crisis in the euro area, can be summed up as follows. As regards direct investment, the business sector (both domestic and foreign) responded as usual in the crisis period, i.e. it significantly cut investment. This had a sizeable negative impact on the Czech economy. As regards financial investment, a large increase in government debt was the most significant change. Although the debt level is far from critical, the fact that it practically doubled in just two years is worthy of note for the Czech economy. The increase in the government's international credit commitments in 2009 and 2010 leads, via a higher interest payment burden, to a deeper income deficit.

Similar developments to those in the Czech Republic can be observed in Slovakia, where, however, the inflow of foreign investment started with a lag. Relative to the size of the economy, its impacts are even more intensive than in the Czech Republic. As a result, the trade balance switched from deficit to surplus only during the crisis. The positive effect of the improvement in the trade balance on the Slovak economy is, like in the Czech Republic, largely offset by the transfer of funds abroad.⁷ The decline in the net inflow of direct investment is optically even larger than in the Czech Republic. However, the difference is concentrated in reinvested (more specifically, retained) earnings. These may be transferred abroad later on, so no major conclusions can be drawn from this difference. Some similar traits can be observed in the balance of payments in Hungary, although here domestic factors (in particular, the need to cut debt at virtually all levels) also contributed significantly to the changes.

⁶ Unlike non-residents, residents seem to have left the market only after the pronounced price decline

⁷ Moreover, it should be taken into account that the Slovak figures, unlike the Czech ones, have not been adjusted for branding, i.e. funds retained directly by foreign parent companies (for the value of the brand).

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| BOFIT | Bank of Finland Institute for Economies in Transition |
| BR | Brazil |
| BRIC | Brazil, Russia, India and China |
| CB-CCI | Conference Board Consumer Confidence Index |
| CB-LEII | Conference Board Leading Economic Indicator Index |
| CBOT | Chicago Board of Trade |
| CF | Consensus Forecasts |
| CN | China |
| CNB | Czech National Bank |
| DBB | Deutsche Bundesbank |
| DE | Germany |
| EA | euro area |
| EC | European Commission |
| ECB | European Central Bank |
| EC-CCI | European Commission Consumer Confidence Indicator |
| EC-ICI | European Commission Industrial Confidence Indicator |
| EIU | The Economist Intelligence Unit database |
| ES | Spain |
| EU | European Union |
| EUR | euro |
| EURIBOR | Euro Interbank Offered Rate |
| Fed | Federal Reserve System (the US central bank) |
| FRA | forward rate agreement |
| GBP | pound sterling |
| GDP | gross domestic product |
| GR | Greece |
| CHF | Swiss franc |
| ICE | Intercontinental Exchange |
| IE | Ireland |
| IFO | Institute for Economic Research |
| IFO-BCI | IFO – Business Climate Index |
| IFO-CCI | IFO – Consumer Confidence Index |
| IMF | International Monetary Fund |
| IN | India |
| IRS | Interest rate swap |
| IT | Italy |
| JP | Japan |
| JPY | Japanese yen |
| LIBOR | London Interbank Offered Rate |
| N/A | not available |
| OECD | Organisation for Economic Co-operation and Development |
| OECD-CLI | OECD Composite Leading Indicator |
| PT | Portugal |
| RU | Russia |
| UoM | University of Michigan |
| UoM-CSI | University of Michigan Consumer Sentiment Index |
| US | United States |
| USD | US dollar |

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