# 1. External economic environment

The main features of the world economy in 2007 included the economic growth slow-down, increase of price level, growth of financial turbulences and extension of macroeconomic imbalance between the world regions.

- ***Slow-down of economic growth in the world***

According to preliminary estimates the growth of the world economy slowed down from 5% after 2006 to 4.9% in 2007. The growth rate advanced the long-term average from the period 2000 to 2006 by 0.7 p.p.

Less developed countries benefiting from globalisation were continuously reducing the gap between their gross domestic products per capita and that of the advanced countries. This is attested by the double digit growth rate of economy in China and big economic growth in India and Russia exceeding 7%. The contribution of these three countries made a half of global growth. In addition, the changes in the character of economic growth in the main world regions were recorded.

**Table 1.1 Development of gross domestic product in real terms**

y-o-y change in %

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|
| World | 4.8 | 2.5 | 3.1 | 4.0 | 5.3 | 4.8 | 5.2 | 4.9 |
| USA | 3.7 | 0.8 | 1.6 | 2.5 | 3.6 | 3.1 | 2.9 | 2.2 |
| Eurozone | 4.0 | 1.9 | 0.9 | 0.8 | 1.8 | 1.6 | 2.9 | 2.6 |
| Germany | 3.5 | 1.4 | 0.0 | -0.2 | 0.6 | 1.0 | 3.1 | 2.6 |
| Japan | 3.9 | 0.2 | 0.3 | 1.4 | 2.7 | 1.9 | 2.2 | 1.9 |

Source: OECD, UNO

- ***Regional differentiation in GDP growth continued***

The American economy, i.e. the main drive of the world growth, slowed down, y-o-y, from 2.9% in 2006 to 2.2% in 2007 due to several reasons. Principal reasons included the decrease of investment activity due to the drop of saving rate both among the population and the companies. The reduction of growth potential was contributed to also by marked growth of prices of energy sources reducing budgets of businesses. Over the major part of the year, the interest rates of credits were set relatively high which, as a consequence, curbed the economic activity of business sector. The above factors resulted to a slowdown of investment and consumer demand growth and thereby also to the slowdown of gross domestic product growth.

In the EU 27 the slowdown of economic growth was smaller, i.e. from 3.0% in 2006 to 2.9% in 2007. This performance as opposed to the average reached in the period 2000 to 2006 was by 0.4 p.p. lower. High economic growth rates were recorded in Slovakia, Estonia, Lithuania, CR and Poland. The growth was contributed to mainly by export and investment activities advancing the long-term averages. However, the forces slowing down the economic growth began to take effect. They included high interest rates, appreciation of EUR and more strict credit terms. These factors impacted especially the Eurozone countries where the economic growth decelerated from 2.9% in 2006 to 2.6% in 2007.

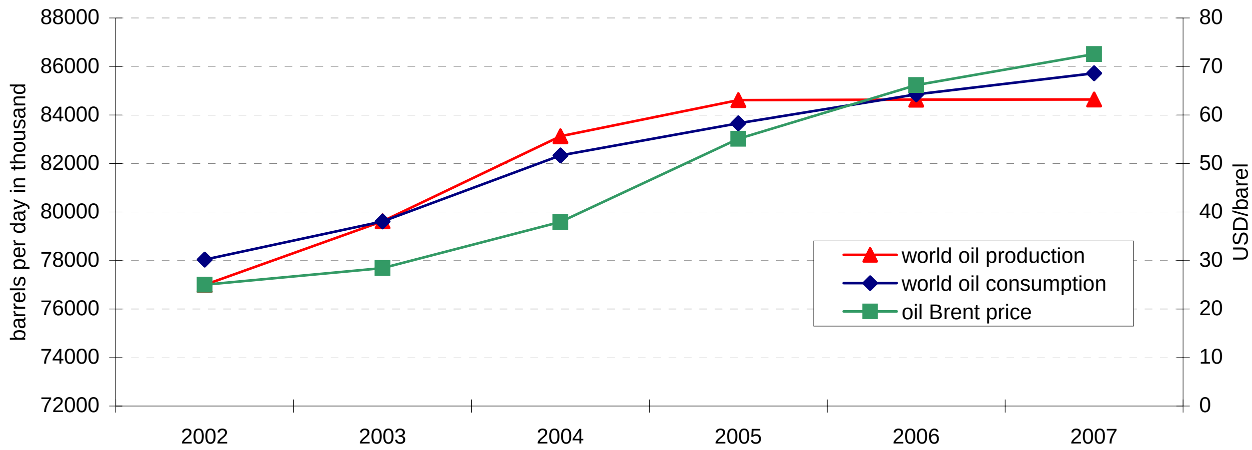
Specific features were recorded also for the economic development in Russia. GDP in 2007 increased, y-o-y, by 7.3% advancing the average economic growth in 2000 to 2006 by 6.5%. The share of oil and gas in the GDP was increasing incessantly to reach in 2007 almost one third as the contribution of natural resources to the exports reached 80%. The problem is an absorption of income from export of crude materials by the development of manufacturing which showed smaller growth-rate compared with the GDP. The insufficient supply of goods and services in the internal market led to significant growth of inflation which in 2007 reached a two-digit figure.

The economic growth forecasts for 2008 indicate that the downward trend of economic cycle will take effect. According to revised data of the British Economic Intelligence Unit (E. I. U.) published in March 2008 in the Economist the following GDP growth rates were forecast for 2008 in the leading territories: USA 1.6%, Japan 1.3%, China 9.9%, Eurozone 1.8%, Germany 1.8%. The above mentioned data come closer to forecasts updates indicating the slow-down of economic growth published by the United Nations Organisation and International Monetary Fund.

- ***Price level increase***

The upsurge of inflation wave in 2007 and in the first months of 2008 referred not only to the advanced countries but also to majority of medium advanced countries and developing countries. The accelerating growth rate of inflation was contributed to mainly by prices of oil and food. While in the period from 2001 to 2006 the average growth rate of oil price was 14%, in December 2007 the oil price increased, y-o-y, by 45%. Reasons of the oil price wobbles were various. On the supply side the production wobbles of principal producers were recorded due to technical and geo-political reasons. The main reason of changes in price development was the dynamics of demand in the countries with fast development of industry and transport including especially China and India.

**Graph 1.1 World production and consumption of oil, oil Brent price**




Source: Energetic Information Administration, CZSO

**Table 1.2 Commodity prices in the world market** (Commodity-price Index; 2000 = 100)

| Index | Index February 2008 | Change in % | |
|---|---|---|---|
| | | 1 month | 1 year |
| I. USD index<br>all items | 258 | +11.2 | +31.1 |
| Food | 257 | +11.3 | +61.1 |
| Industrial products | 259 | +11.1 | +10.4 |
| Metals | 294 | +12.4 | +5.7 |
| II. Euro index<br>All items | 160 | +10.3 | +19.3 |
| Oil ($/barrel) | 101 | +10.2 | +67.0 |
| Gold ($/oz) | 942 | +1.7 | +38.8 |

Source: The Economist, 15 March 2008

Following the price increase in the world markets the acceleration of producer and consumer prices took effect. In January 2008 prices of industrial producers increased y-o-y by 5.8% on average in EU 27 (by 5.6% in the CR) while in a number of countries a two-digit price growth was recorded. Consumer prices increased in February 2008 in EU, y-o-y, by 3.4%, in the Eurozone by 3.3% which was by 1.6% more than a year ago. The price growth in the CR was above-average, i.e. by 7.6%, especially due to simultaneous growth of prices of energy and food, increase of rentals and the VAT growth.

International institutions (OECD and IMF) assume that the cost price shock in 2008 and partly in 2009 will go away and the inflation will return to its low and stabile level. However, it should be considered that the process of disinflation develops more slowly compared to the speed of inflation pressures of cost shock.

**Table 1.3 Consumer prices**

y-o-y change in %

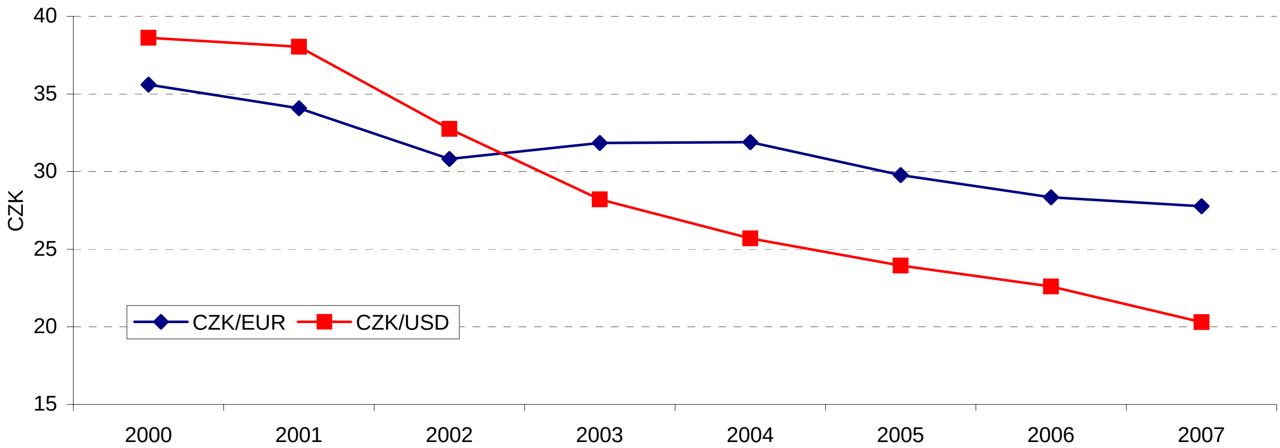
| | January 2007 | February 2008 | 2008 forecast |
|---|---|---|---|
| USA | 2.1 | 4.0 | 2.9 |
| Eurozone | 1.8 | 3.3 | 2.4 |
| Germany | 1.6 | 2.8 | 2.1 |
| CR | 1.3 | 7.5 | 5.7 |
| Hungary | 7.8 | 6.9 | 4.7 |
| Japan | 0.3 | 0.7 | 0.6 |
| China | 2.2 | 8.7 | 4.0 |
| Austria | 8.2 | 12.7 | 11.5 |

Source: Eurostat, The Economist, 22 March 2008

- ***CZK continued to strengthen***

The exchange rate development of the leading works currencies followed in 2007 the previous trends but changes took place with higher intensity. USD continues to weaken against euro which, in contrast, appreciated in compliance with the development of real economy foundations. In 2007, CZK strengthened to USD by 11.9%, y-o-y, and to EUR by 2.2%. The average exchange rate of CZK to EUR reached in Q4 2007 26.8 CZK/EUR and strengthened by 4.3%, y-o-y. The acceleration came from a few parallel factors contributing to the strengthening of CZK. These included mainly: i) on-going turbulences in financial markets making the short-term investors to transfer their money from risky assets especially in USD to safer assets; ii) on-going growth of economic performance and positive external trade balance increasing attractiveness of the CR for foreign investors; iii) mitigation of negative interest differential of CZK against euro due to the interest rate increase.

**Graph 1.2 Exchange rates of CZK against EUR and USD**




Source: CNB

- ***Growing financial instability***

Facts on crisis development of mortgage market in the USA come from figures indicating the bank losses estimated in October 2007 by the International Monetary Fund at USD 200 billion and ever since the loss has been growing. The price index of housing in the period 1989 to 2005 increased at extra fast rate, on average by 8% per year which substantially exceeded the long-term trend. In 2005, the price index increased by 10% (record value) and the rocketing stage of cyclic increase of real estate prices has been started since.

- ***Several causes of mortgage credit crisis in the USA***

Based on conditions and characteristic features of macroeconomic development in the USA and from the type of banking sector risks the mortgage market crises can be considered as a parallel of several trends including:

– a downward trend of business cycle reduced the level of the population income which as a consequence limit the ability to pay-up credit;

– weakening of USD and interest rate reduction which limits the inflow of foreign capital to the banking sector and increases the risk of insufficient liquidity;

- too soft bank terms for mortgage credits granting;
- continuing interest of the population to invest into housing without consideration of the growing market and credit risks;
- introduction of innovated debt products to the mortgage market which are not sufficiently transparent to their users;
- delayed decrease of bank rating which are jeopardized by insufficient liquidity.

- ***Downturns of prices in security markets exceeded 20 %***

Financial instability impacted the financial market development. In March 2008, for the fifth month in a row the values of indices in security markets dropped. In the stock market the downturns were the biggest mostly exceeding 20% compared with values recorded in October 2007.

**Table 1.4 Stock market indices**

in points

| Sock market index | 10 October 2007 | 10 March 2008 | Change in % |
|---|---|---|---|
| USA (DIJA) | 14 078 | 11 893 | -15.5 |
| Japan (NIKKEI) | 17 177 | 12 782 | -25.6 |
| Germany | 7 986 | 6 513 | -18.4 |
| Netherlands | 544 | 435 | -20.0 |
| Czech Republic | 1 881 | 1 467 | -22.0 |
| UK | 6 433 | 5 699 | -11.4 |

Source: BCPP, Economist

- ***Many countries suffer from external imbalance***

The macroeconomic aspect of financial instability shows the development of external economic (im)balance. Approximately a fifth of the OECD countries showed the same. External imbalance is measured by balance of payment current account deficit which should not exceed 5% of GDP. It is a limit considered on the basis of empiric knowledge a signal of risk as regards financing sustainability and related economic growth. This limit was exceeded in 2008 by the USA (-5.6%), Greece (-11.9%), Portugal (-8.1%), Spain (-9.8%), UK (-7.7%), Australia (-6%) and New Zealand (-7.9%).

- ***Marked growth of income of oil importers***

In the period of dynamic growth of oil prices the income of countries exporting oil markedly increase and, in contrast, burden by expenditures the oil importing countries. Significant surplus of trade balances showed in 2007 e.g. the Saudi Arabia (USD 146 billion), Russia (USD 124 billion), Norway (UASD 56 billion) and, on the other hand, a big deficit showed e.g. USA (USA -806 billion). Oil thereby markedly contributed to the free capital availability in the world.

- ***Increasing resistance of the Czech economy to external shock***

The most important features of the review of development changes in external economic environment included also the fact that oil prices increased, the growth of the GDP in Europe slowed down and the CZK strengthened which in its consequences reduced the competitiveness of the export of Czech products and services. Yet the performance of the Czech economy increased which showed its resistance to changes reducing growth potential.