GLOBAL ECONOMIC OUTLOOK - OCTOBER

2014

Monetary and Statistics Department
External Economic Relations Division

CZECH NATIONAL BANK

Cut-off date for data
13 - 17 October 2014

CF survey date
13 October 2014

GEO publication date
24 October 2014

Notes to charts

ECB and Fed: midpoint of the range of forecasts.
The arrows in the GDP and inflation outlooks indicate the direction of revisions compared to the last GEO. If no arrow is shown, no new forecast is available. Asterisks indicate first published forecasts for given year.

Forecasts for EURIBOR and LIBOR rates are based on implied rates from interbank market yield curve (FRA rates are used from 4M to 15M and adjusted IRS rates for longer horizons). Forecasts for German and US government bond yields (10Y Bund and 10Y Treasury) are taken from CF.

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The October issue of Global Economic Outlook presents its regular overview of recent and expected developments in selected territories, focusing on key economic variables: inflation, GDP growth, leading indicators, interest rates, exchange rates and commodity prices. In this issue, we also analyse the changes in FDI inflows and FDI returns in the Czech Republic and Central European countries. FDI returns have been much higher (especially since 2008) in the Czech Republic than in the other Central European countries. This is due to the structure of FDI, the absence of additional tax measures reducing FDI earnings and to differences in the scale and sectoral effects of the economic and financial crisis.

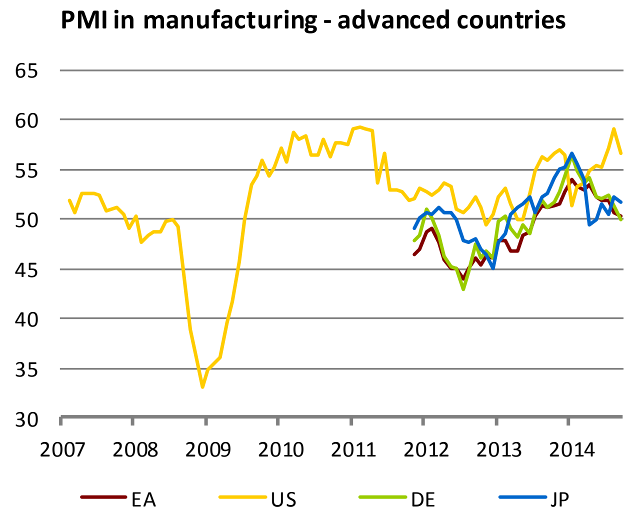
The picture of economic growth in advanced countries is crystallising into two main tendencies. The first indicates that the US economy, which is recording robust growth for the fourth consecutive year, will remain the main driver of economic performance. The strongest world economy is expected to grow by more than 3% next year. The PMI is also still indicating a solid rate of US growth. The second tendency, however, consists in gradually worsening economic outlooks for other advanced countries. The countries of the euro area, including its traditional economic engine Germany, have recorded a visible deterioration in expected economic performance. Deteriorating outlooks are evident not only in terms of economic growth, but also in terms of subdued price inflation. The outlooks for the Japanese economy are also a cause for some concern, as the optimistic outlook for an economic recovery has yet to materialise and a further step towards fiscal sustainability is thus endangered.

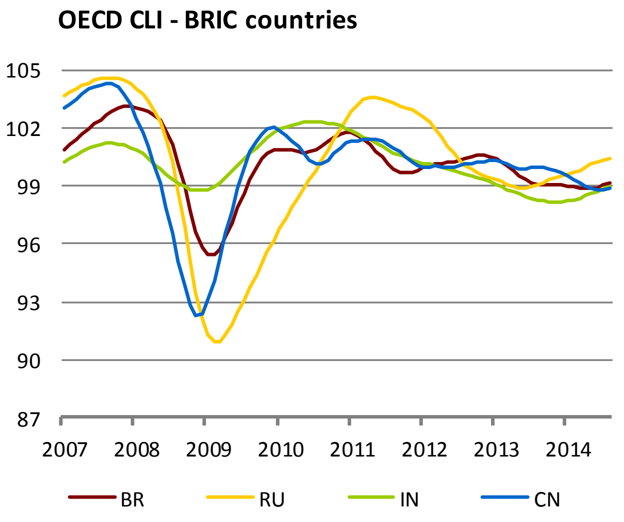
The outlooks for the BRIC countries remain mixed. Despite none-too-optimistic news, the Chinese economy is best off, as it will remain able to keep its rate of growth above 7% amid relatively low inflation. By contrast, Russia is showing the weakest growth of the emerging economies under review. This mainly reflects the sanctions imposed on it by the international community. The Russian economy is thus on the brink of recession in a situation of rising inflation and a steadily depreciating rouble. Similarly, the outlooks for Brazil are still none too bright. Its GDP growth rate will remain very low (below 2%) amid fairly high inflation and a weakening real. By contrast, the outlooks for the Indian economy are still mostly positive, with growth expected to increase gradually and the disinflationary trend expected to continue into 2015, when inflation should drop below 7%.

The outlooks for euro area interest rates are very low due to a further easing of monetary policy by the ECB, and there is no sign of them rising before the end of 2015. As for the USA, interest rates might start to increase in the second half of 2015. According to Consensus Forecasts, the US dollar will appreciate against all the monitored currencies over the one-year horizon, except for a modest weakening against the Chinese renminbi and against the Russian rouble if the conflict in Ukraine calms down.

Oil prices shifted visibly downwards at the end-2015 forecast horizon and are expected to stand at around USD 90 a barrel at the one-year horizon. Nevertheless, owing to a stronger dollar, the effects of cheaper oil will not be felt by consumers who do not pay in dollars. The outlooks also suggest a pronounced decline in natural gas prices, which will be larger than the rise in oil prices. Agricultural commodity markets recorded a decline in prices thanks to a good harvest worldwide, although the current developments and outlook are slightly rising at the end-2015 horizon. Industrial metals prices, by contrast, declined slightly further last month and have a slightly rising outlook.

Available PMI time series for countires monitored in the GEO



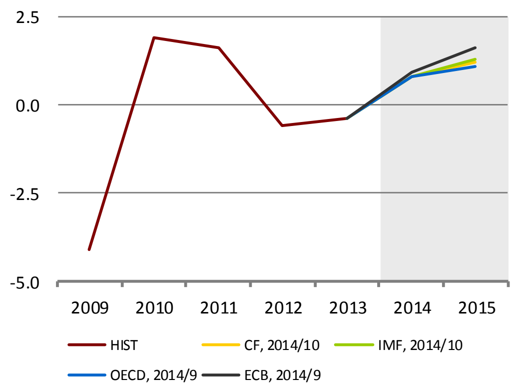


II.1 Euro area

Growth in the euro area was flat in 2014 Q2, and the available data for Q3 signal continued subdued growth. In August, the industrial production index declined by 1.8% compared to July, with a strong contribution from the hitherto engin of the euro area, Germany, where industrial production fell by 4.3%. This gave rise to concerns of recession both in Germany, whose economy contracted in Q2, and in the euro area as a whole. Leading indicators are also unfavourable. The PMI in manufacturing declined to a 14-month low in September (50.3). New orders were particularly worrisome, decreasing for the first time in more than a year. The ZEW economic sentiment indicator is just above the level signalling stagnation. The negative developments are reflected in revisions to the new CF, IMF and OECD outlooks. According to them, the economy should grow by 0.8% this year and accelerate by less than 0.5 pp next year.

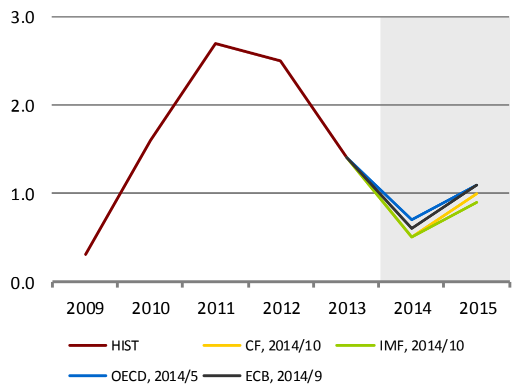
Inflation decreased from 0.4% in August to 0.3% in September, the lowest level since October 2009. Five euro area countries recorded year-on-year falls in the price level. The decline was due to smaller contributions of all consumer basket components except food. A longer period of low inflation is also expected at the forecast horizon in the euro area, with the October CF and the IMF's WEO revising their forecasts slightly downwards. According to the two forecasts, inflation should stand at 0.5% this year and rise to 1% and 0.9% respectively next year. On 18 September, the ECB launched the first round of targeted longer-term refinancing operations (TLTROs), but their take-up was well below market expectations. At its meeting in October, the ECB announced its intention to increase its balance sheet back to early-2012 levels. Further rounds of the TLTRO programme (the next in December 2014), direct purchases of the ABSs of non-financial corporations and the third covered bond purchase programme will be used to this end. The interest rate outlook path declined at the monitored maturities compared to the previous month.

GDP growth, %



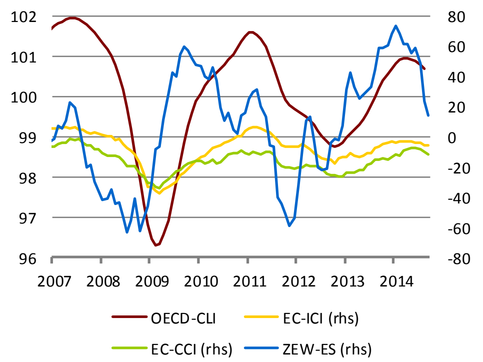
	CF	IMF	OECD	ECB
2014	0.8 ↘	0.8 ↘	0.8 ↘	0.9 ↘
2015	1.2 ↘	1.3 ↘	1.1 ↘	1.6 ↘

Inflation, %



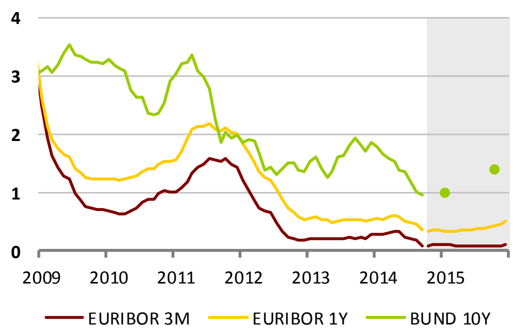
	CF	IMF	OECD	ECB
2014	0.5 ↘	0.5 ↘	0.7	0.6 ↘
2015	1.0 ↘	0.9 ↘	1.1	1.1 →

Leading indicators



	OECD-CLI	EC-ICI	EC-CCI	ZEW-ES
7/14	100.8	-3.8	-8.3	48.1
8/14	100.7	-5.3	-10.0	23.70
9/14		-5.5	-11.4	14.20

Interest Rates



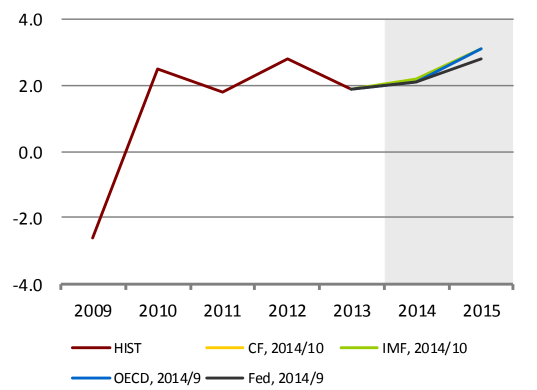
	09/14	10/14	06/15	12/15	06/16	12/16
3M EURIBOR	0.10	0.08	0.09	0.10		
1Y EURIBOR	0.36	0.33	0.36	0.50		

	09/14	01/15	10/15
10Y Bund	0.97	1.0	1.4

II.2 United States

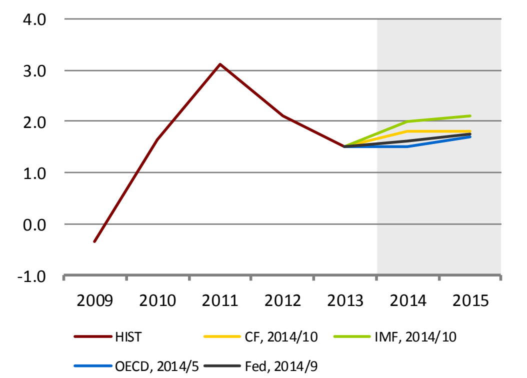
The US GDP outlook for 2014 and 2015 is favourable compared to other advanced countries. Annual GDP growth was 2.2% in 2014 H1 and the same rate of growth is expected for the rest of the year. The economy is expected to pick up further in 2015 (by around 1 pp). All GDP components except government expenditure rose in 2014 Q2. The current account deficit has been stable at 2.3% and the government expenditure deficit at around 3% of GDP since early 2014. Industrial production growth remained positive in 2014 Q3. Although the manufacturing PMI leading indicator edged down in September, growth expectations prevail. The Michigan Consumer Sentiment Index improved in September, while consumer confidence (Conference Board) fell compared to the previous month. Retail sales at current prices continued to show year-on-year growth in September, but fell slightly in month-on-month terms in contrast to the previous 7-month period of expansion. The labour market is showing positive developments, with the unemployment rate falling below 6% in September. Consumer price inflation is expected to stay below 2%. According to CF, moreover, inflation expectations fell. Actual inflation slowed to 1.7% in August, down slightly from July. The lower inflation pressures are naturally stirring up a discussion about the Fed postponing its first interest rate hike. Market outlooks are indicating that the first rate increase will happen in mid-2015. However, the one-year outlook for ten-year bond yields fell slightly. The dollar continued to appreciate against the euro in October and CF expects it to appreciate by a further 4% at the one-year horizon.

GDP growth, %



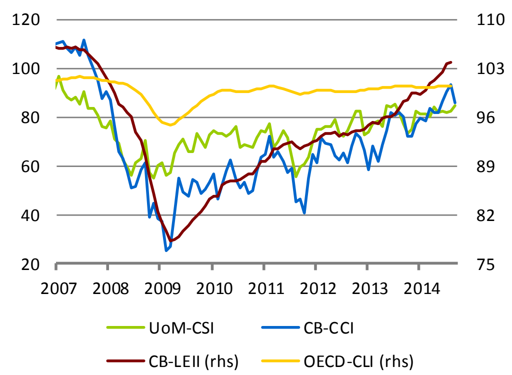
	CF	IMF	OECD	Fed
2014	2.2	2.2	2.1	2.1
2015	3.1	3.1	3.1	2.8

Inflation, %



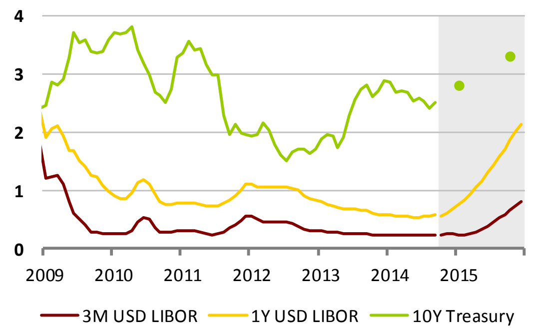
	CF	IMF	OECD	Fed
2014	1.8	2.0	1.5	1.6
2015	1.8	2.1	1.7	1.8

Leading indicators



	CB-LEII	OECD-CLI	UoM-CSI	CB-CCI
7/14	103.6	100.4	81.8	90.3
8/14	103.8	100.4	82.5	93.4
9/14			84.6	86.0

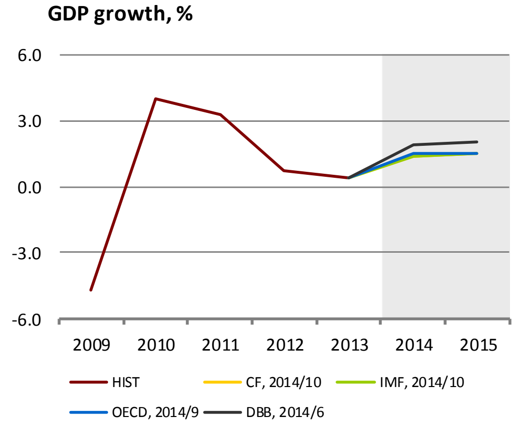
Interest Rates



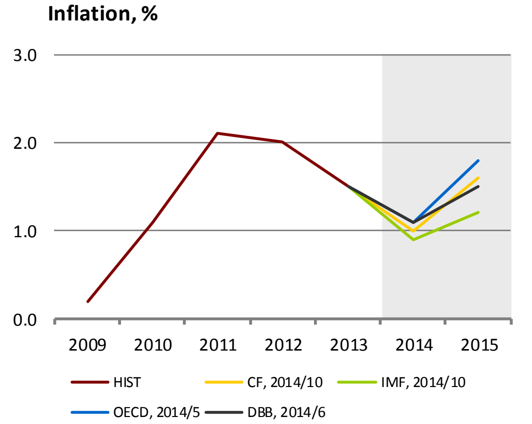
	09/14	10/14	06/15	12/15	06/16	12/16
3M USD LIBOR	0.23	0.23	0.38	0.82		
1Y USD LIBOR	0.58	0.56	1.30	2.14		
	09/14	01/15	10/15			
10Y Treasury	2.52	2.8	3.3			

II.3 Germany

Economic growth in Germany weakened considerably in 2014 Q2 compared to Q1. No major improvement in economic growth is expected for Q3; a quarter-on-quarter stagnation or even a further economic decline cannot be ruled out. This is indicated by falls in industrial production (both monthly and annual), industrial orders and exports in August. Leading indicators mostly fell in August and September, and the PMI in industry even dropped slightly below 50 points. The unfavourable economic developments are mainly due to the crisis in Ukraine and weak global growth. The expected growth rates for 2014 and 2015 are falling sharply. In October, the German government reduced its outlook for the two years to 1.2% and 1.3% respectively and major German economic institutes likewise changed their estimates. Inflation remained at 0.8% for the third consecutive month. It is expected to rise slightly to 1.2% in the rest of this year.



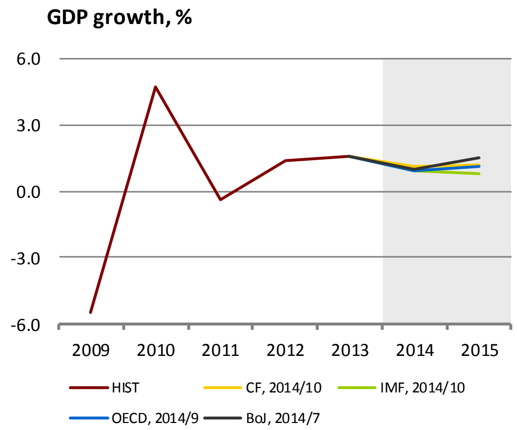
	CF	IMF	OECD	DBB
2014	1.4	1.4	1.5	1.9
2015	1.5	1.5	1.5	2.0



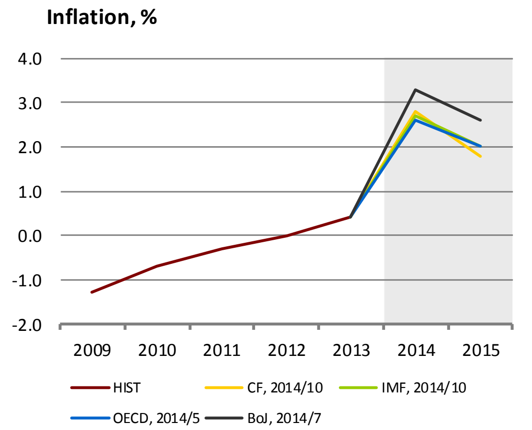
	CF	IMF	OECD	DBB
2014	1.0	0.9	1.1	1.1
2015	1.6	1.2	1.8	1.5

II.4 Japan

The new figures on the Japanese economy have not convinced investors that the slowdown due to higher taxes was only temporary. Concerns are rising that further stimuli will be needed to boost the economy. Industrial output recorded an unexpected month-on-month decline of 1.5% in August, and the outlook for September is not very positive according to the PMI for manufacturing. Household consumption and real wages fell further in August. Inflation did not accelerate but slowed further in August in year-on-year terms (to 3.1% for core inflation excluding food and 3.3% for headline inflation). The new figures forced the central bank to repeat its commitment to ease monetary policy further if the economy and inflation diverge significantly from the forecast. On the other hand, the BoJ welcomed the depreciation of the yen against the dollar as a further boost for Japanese exporters. Given the new information, the October CF reduced its GDP growth outlook by 0.1 pp in 2014 and 2015 but left its inflation forecast unchanged. The IMF and the OECD also revised their growth forecasts for the Japanese economy downwards. Compared to the previous forecast, the IMF expects inflation to be lower in 2014 and higher in 2015.



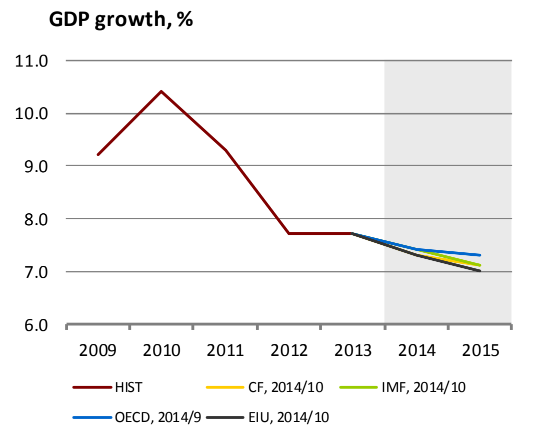
	CF	IMF	OECD	BoJ
2014	1.1	0.9	0.9	1.0
2015	1.2	0.8	1.1	1.5



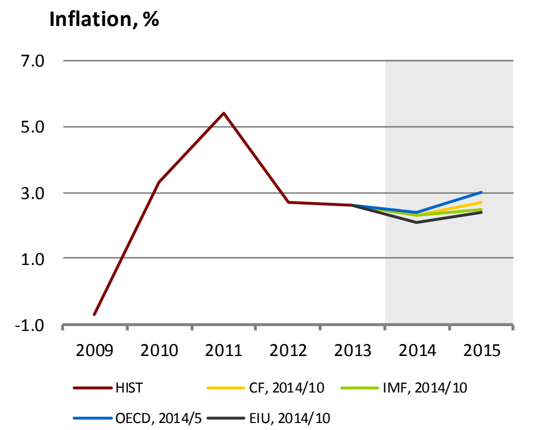
	CF	IMF	OECD	BoJ
2014	2.8	2.7	2.6	3.3
2015	1.8	2.0	2.0	2.6

III.1 China

After declining by 0.3 pp to 7.4% in 2014 Q1, annual GDP growth in China picked up to 7.5% in Q2 due to government microstimuli aimed at supporting the country's economic activity. A further slowdown in the growth rate of industrial production (to 6.9% in August) and short-term indicators (the HSBC PMI in industry just above the 50-point level) reduce the probability of China hitting its 7.5% growth target this year. The new CF, EIU, IMF and OECD outlooks expect Chinese GDP to grow by 7.3%–7.4% this year. The growth rate will slow further to 7.0%–7.3% next year. According to the IMF's WEO, weaker growth will be fostered by the financial sector, where weaker credit growth in the banking and non-banking sectors and a subsequent slowdown in investment activity are expected. Property market developments are another risk. The new inflation outlook decreased and currently stands in the range of 2.1%–2.3%.



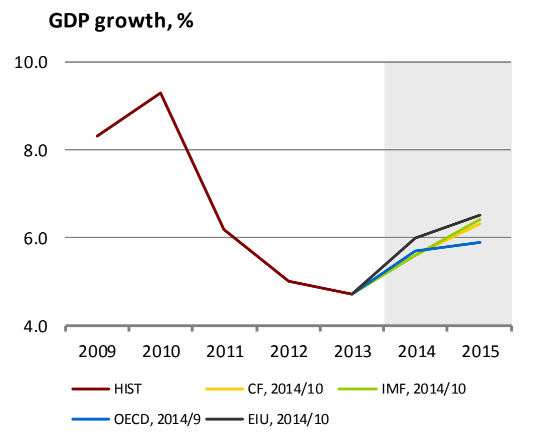
	CF	IMF	OECD	EIU
2014	7.3	7.4	7.4	7.3
2015	7.1	7.1	7.3	7.0



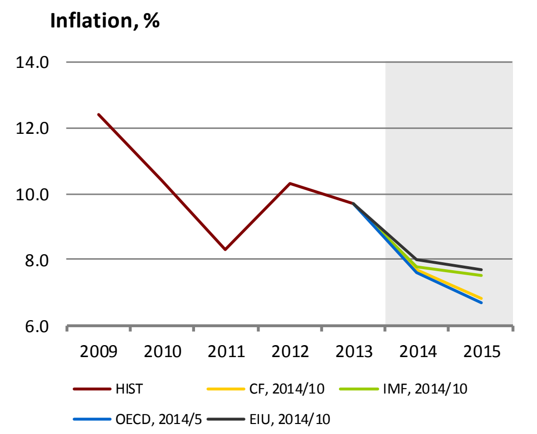
	CF	IMF	OECD	EIU
2014	2.3	2.3	2.4	2.1
2015	2.7	2.5	3.0	2.4

III.2 India

Inflation in India gradually slowed in August and September to the lowest level since January 2012 (6.5%), mainly because of a smaller contribution from food and fuel prices. Despite the slowing inflation, the central bank left its key rate at 8% for the fourth time in a row, as it still sees major risks of exceeding the 6% inflation target set for January 2016. However, a further drop in industrial production growth and a decline in the PMI in manufacturing in August and September are bad news. The new Indian government announced several programmes to boost industry and investment, and its strong mandate will also allow it to implement pro-growth structural reforms. In October, CF and the IMF increased their GDP growth forecasts for 2014 by 0.1–0.2 pp and the OECD revised its May forecast upwards by 0.8 pp. CF and the EIU also increased their GDP growth outlooks by 0.1 pp for 2015. Inflation, which was reduced by 0.2–0.4 pp for this fiscal year, was also assessed positively; CF lowered also its 2015 inflation outlook by 0.3 pp.



	CF	IMF	OECD	EIU
2014	5.6	5.6	5.7	6.0
2015	6.3	6.4	5.9	6.5

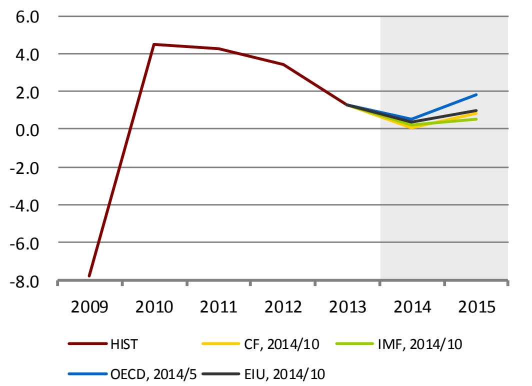


	CF	IMF	OECD	EIU
2014	7.7	7.8	7.6	8.0
2015	6.8	7.5	6.7	7.7

III.3 Russia

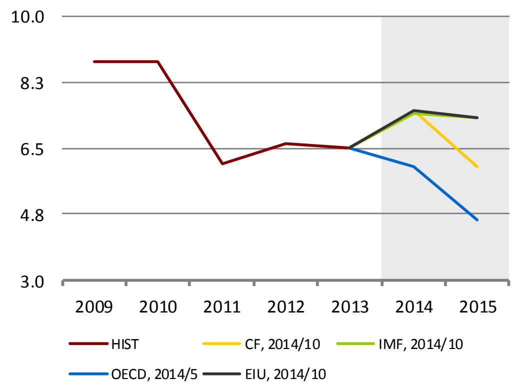
The situation in eastern Ukraine has calmed slightly, but the risk and uncertainty regarding future developments in Russia remain high. Although industrial production growth was surprisingly positive (partly due to import substitution), economic sanctions are likely to have a strong negative impact on the Russian economy – as much as 0.6%–2.0% of GDP in 2014 according to RBC Daily (quoting TASS, Interfax and Pervyj Kanal). The rouble continued to depreciate, weakening by 17% year on year in September and exceeding the notional threshold of RUB 40 to the dollar in early October. The depreciation of the rouble is also due to a lower dollar price of oil. The Russian central bank widened the rouble's fluctuation band in the dual-currency basket and increased the volume of interventions. As of 1 October, Russia's international reserves were down by 18% year on year to USD 454.2 billion. The key interest rate remained unchanged. The new CF, EIU and IMF outlooks expect GDP growth of 0.1%–0.4% and inflation of 7.4%–7.5% this year.

GDP growth, %



	CF	IMF	OECD	EIU
2014	0.1	0.2	0.5	0.4
2015	0.8	0.5	1.8	1.0

Inflation, %

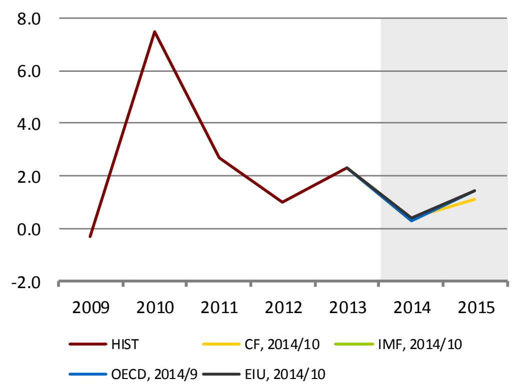


	CF	IMF	OECD	EIU
2014	7.5	7.4	6.0	7.5
2015	6.0	7.3	4.6	7.3

III.4 Brazil

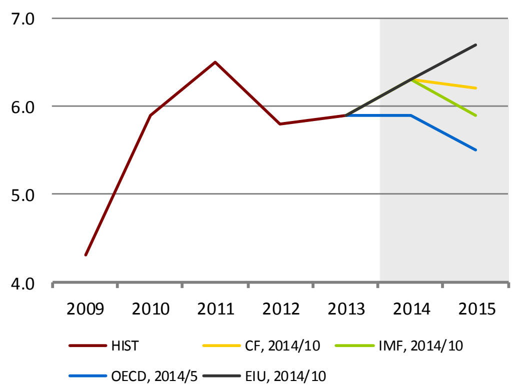
The Brazilian economy is still grappling with high inflation and low economic growth. The price level rose by 6.75% year on year in September, exceeding the upper boundary of the central bank's target. The central bank left its interest rate at 11% again in September. Industrial production fell year on year in August, although a rise in retail sales of 1.1% in August compared to July is good news. The Brazilian economy will be affected by the result of the presidential elections, in which the incumbent President Rousseff and the opposition candidate Aécio Neves, on whom the markets pin greater hope of an economic recovery and government spending cuts, have a roughly equal chance of winning the run-off. Given also the technical recession in Brazil in 2014 H1, the IMF, CF, the EIU and the OECD have reduced their GDP growth outlooks to a mere 0.3%–0.4% in 2014; the outlook for GDP growth in 2015 has also been revised downwards by 0.3–0.8 pp. Inflation of 6.3% is expected for this year.

GDP growth, %



	CF	IMF	OECD	EIU
2014	0.4	0.3	0.3	0.4
2015	1.1	1.4	1.4	1.4

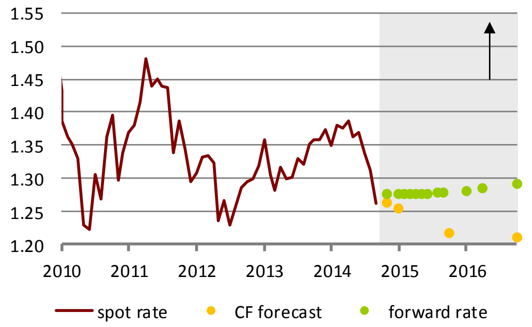
Inflation, %



	CF	IMF	OECD	EIU
2014	6.3	6.3	5.9	6.3
2015	6.2	5.9	5.5	6.7

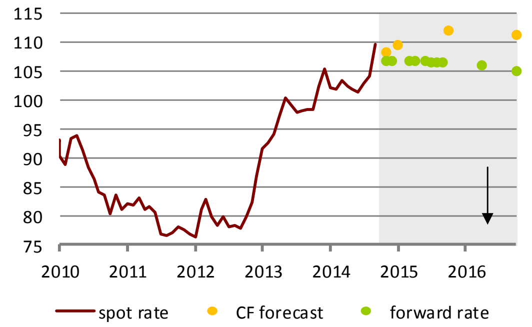
IV. Outlook of exchange rates vis-à-vis the US dollar

THE EURO



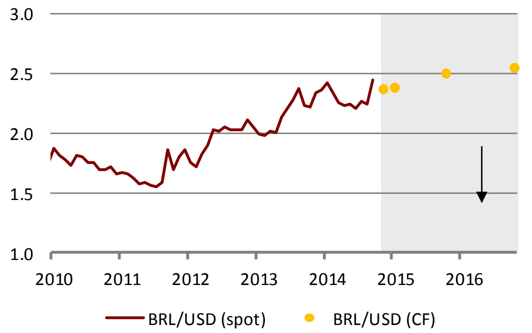
	13/10/14	11/14	01/15	10/15	10/16
spot rate	1.268				
CF forecast		1.263	1.254	1.217	1.211
forward rate		1.275	1.276	0.000	1.292

THE JAPANESE YEN



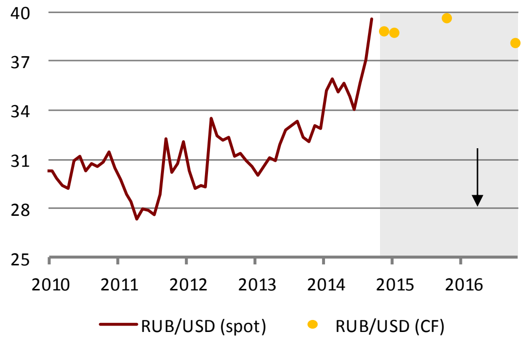
	13/10/14	11/14	01/15	10/15	10/16
spot rate	107.40				
CF forecast		108.30	109.40	112.00	111.20
forward rate		106.84	0.00	0.00	105.01

THE BRAZILIAN REAL



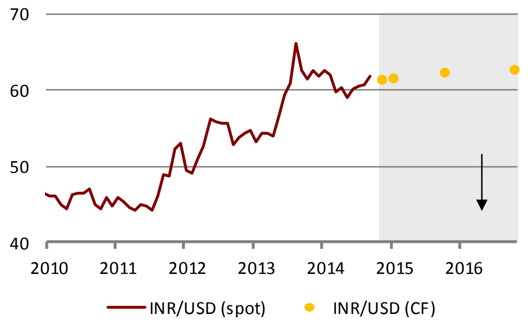
	13/10/14	11/14	01/15	10/15	10/16
spot rate	2.39				
CF forecast		2.37	2.38	2.50	2.55

THE RUSSIAN ROUBLE



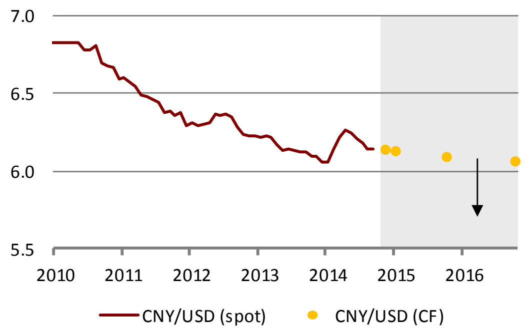
	13/10/14	11/14	01/15	10/15	10/16
spot rate	40.49				
CF forecast		38.80	38.76	39.63	38.10

THE INDIAN RUPIE



	13/10/14	11/14	01/15	10/15	10/16
spot rate	61.19				
CF forecast		61.35	61.49	62.27	62.68

THE CHINESE RENMINBI



	13/10/14	11/14	01/15	10/15	10/16
spot rate	6.13				
CF forecast		6.14	6.13	6.09	6.06

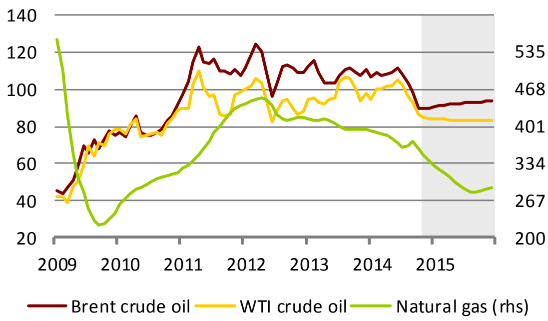
Arrow indicates currency appreciation against US dollar. Exchange rates as of last day of month. Forward rate does not represent outlook; it is based on covered interest parity, i.e. currency of country with higher interest rate is depreciating. Forward rate represents current (as of cut-off date) possibility of hedging future exchange rate.

V.1 Oil and natural gas

The decline in the Brent crude oil price, observed since mid-June, continued into September and picked up further in October. In mid-October, the price fell below USD 90 a barrel (bbl) for the first time since November 2010. This was mainly due to a pronounced appreciation of the dollar throughout the above period. Other reasons include slackening growth of the global economy, and thus also of oil consumption, and fast growth in extraction, especially in North America. The price decline accelerated in October, when it became clear that most OPEC members were not intending to curb production in response to the low prices in order to avoid losing market share. OPEC representatives, who only recently were claiming that the price decline was seasonal, now expect prices to drop further below USD 80/bbl, where they should stimulate demand growth (and possibly also a global economic recovery) and rein in the fast growth in unconventional extraction in North America (shale, oil sands), which will cease to be viable in some places. This should restore balance on the market. Although the strong dollar is reducing producers' losses, it is limiting the benefits of cheap oil for consumers who do not pay in dollars. Cheap oil reduces consumer price growth and also aids refineries (including European ones), whose margins rise.

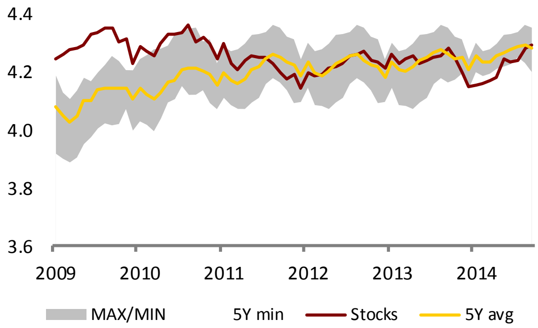
Long-term contracts for Russian natural gas (at the German border) increased to around the June level after a temporary decline in July. Spot prices of market contracts in Europe are also rising steadily. The outlook for prices of long-term contracts is strongly declining, as it takes into account current oil prices with a lag. LNG prices in Asia are continuing to fall due to weak demand in Japan and South Korea and also because they are linked to the price of oil.

OUTLOOK FOR PRICES OF OIL AND NATURAL GAS

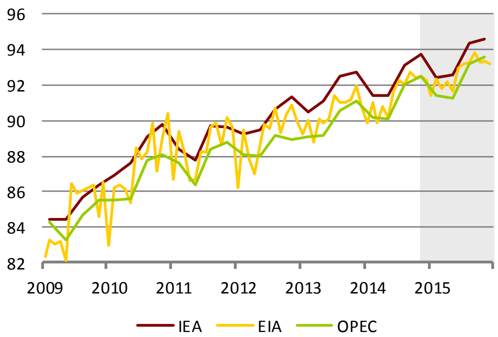


	Brent	WTI	Natural gas
2014	-5.56	-1.97	-7.93
2015	-9.95	-12.82	-19.49

TOTAL STOCKS OF OIL AND OIL PRODUCTS IN OECD

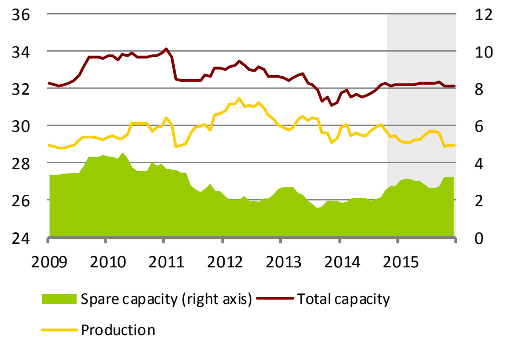


GLOBAL CONSUMPTION OF OIL AND OIL PRODUCTS



	IEA	EIA	OPEC
2014	0.76	1.13	1.33
2015	1.19	1.35	1.29

PRODUCTION, TOTAL AND SPARE CAPACITY IN OPEC COUNTRIES



	Production	Total capacity	Spare capacity
2014	-0.80	-0.56	2.78
2015	-1.49	1.12	36.52

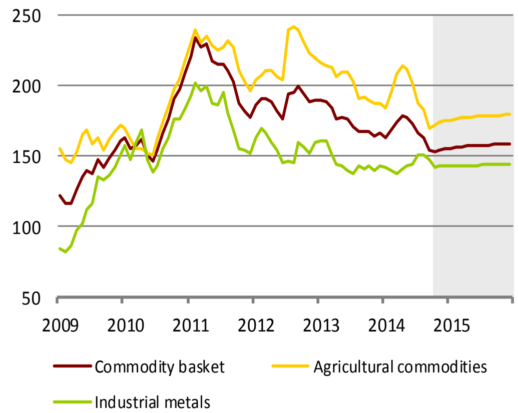
Note: Oil price in USD/barrel, price of Russian natural gas at German border in USD/1,000 m3 (IMF data, smoothed by the HP filter). Future oil prices (grey area) are derived from futures and future gas prices are derived from oil prices using model. Tables show annual percentage changes. Total oil stocks (commercial and strategic) in OECD countries including average, maximum and minimum in past five years in billions of barrels. Global consumption of oil and oil products in millions of barrels a day. Production and extraction capacity of OPEC in million barrels a day (EIA estimate).
Source: Bloomberg, IEA, EIA, OPEC, CNB calculations

V.2 Other commodities

Prices of cereals and industrial metals declined across the board in September. This led to a sharp fall in the total non-energy commodity price index. However, this fall slowed in the first half of October as the food commodity price index switched to growth, while the industrial commodity price index continued to decline. Nevertheless, the forecasts for both indices are slightly rising. Commodity prices are being pushed down by the appreciating dollar, which reached its strongest level in four years, and by favourable supply-side developments. There is a good outlook for this year's grain and oilseed harvests, which should lead to an increase in stocks in the USA. The harvest in Ukraine is not expected to be threatened by the ongoing conflict, which has recently eased. Prices of cereals in the USA are also falling in response to uncertainty regarding future production of alcohol from wheat and corn. The soy price is facing increased competition from palm and rapeseed oil. The decline in industrial metals prices is also due to demand-side factors in the form of slower Chinese industrial growth.

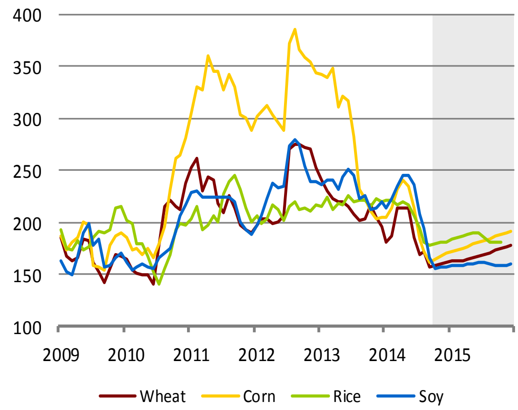
Turning to food commodities, only beef prices recorded sharp growth. They moved to a new historical high and have almost doubled since 2009. Prices of pork also rose slightly, offsetting their previous sharp fall. Prices of sugar rose sharply following a strong decline, and coffee prices also went up. The price of rubber continued to trend downwards, reaching the low recorded in December 2008. The price of cotton also edged down. Excess extraction capacity resulted in a decline in the price of iron ore to a four-year low. Prices of aluminium decreased after three months of growth as the higher price attracted new producers. The price of copper continued to fall after Indonesian exports returned to normal.

PRICES OF NON-ENERGY COMMODITIES



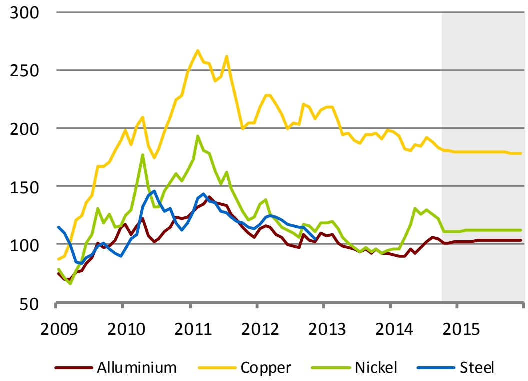
	Overall	Agricultural	Industrial
2014	-5.5	-5.9	-1.2
2015	-4.5	-6.2	-0.1

FOOD COMMODITIES



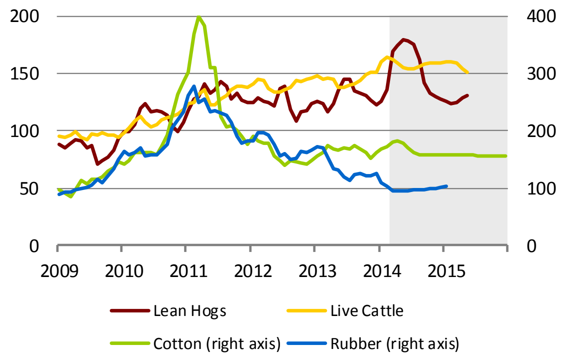
	Wheat	Corn	Rice	Soy
2014	-15.8	-29.3	-9.0	-12.6
2015	-6.7	-7.6	-7.3	-21.3

METALS



	Aluminium	Copper	Nickel
2014	0.4	-6.5	13.3
2015	5.6	-3.4	-2.8

MEAT, NON-FOOD AGRICULTURAL COMMODITIES



	Lean hogs	Live Cattle	Cotton	Rubber
2014	17.2	9.5	1.1	-26.5
2015	-16.9	-0.9	-6.1	

Note: Structure of non-energy commodity price indices corresponds to composition of The Economist commodity indices. All prices are given as indices, 2005 = 100 (charts) and percentage changes (tables).
Source: Bloomberg, CNB calculations.

Changes in FDI inflows and FDI returns in the Czech Republic and Central European countries [1]

Interest in foreign direct investment (FDI) in the Czech Republic declined after 2008. This decline was out of step with the very fast growth in non-residents' FDI returns recorded in that period. This led us to compare the situation in the Czech Republic with that in other countries in the region. Our analysis revealed that a marked slowdown in FDI inflows was observed in all countries in the region, although it was smaller in Poland and Slovakia. The return on FDI is significantly higher in the Czech Republic than in the other Central European countries, especially since 2008. The main causes of the higher returns seem to lie in the structure of FDI (particularly a high proportion of investment in sectors with above-average profitability and regulated entry), the absence of additional tax measures reducing such earnings (in contrast to Hungary and Slovakia) and differences in the scale and sectoral effects of the economic and financial crisis.

Changes in financial flows linked with FDI in the Czech Republic

In 1998–2007, FDI inflow played a key role in the structural changes in the Czech economy and was the main driver of the country's economic growth and rising competitiveness. But in 2008, the inflow began to slow sharply. In 1998–2007 the average FDI inflow had been almost 7% a year, but in 2008–2013 it was only around 2.5% (see Chart 1), most of it (about 70%) being reinvested earnings, i.e. money generated in the Czech Republic. There were several reasons for this sudden change, but the two most significant were the onset of the economic and financial crisis and the ensuing long period of weak demand in Europe, and a virtual halt in the sale of state-owned property to non-residents. The less significant factors included falling local support for the construction of new, environmentally unfriendly factories, local labour force availability and a gradual shift in demand towards investment in (far less capital-intensive) services.

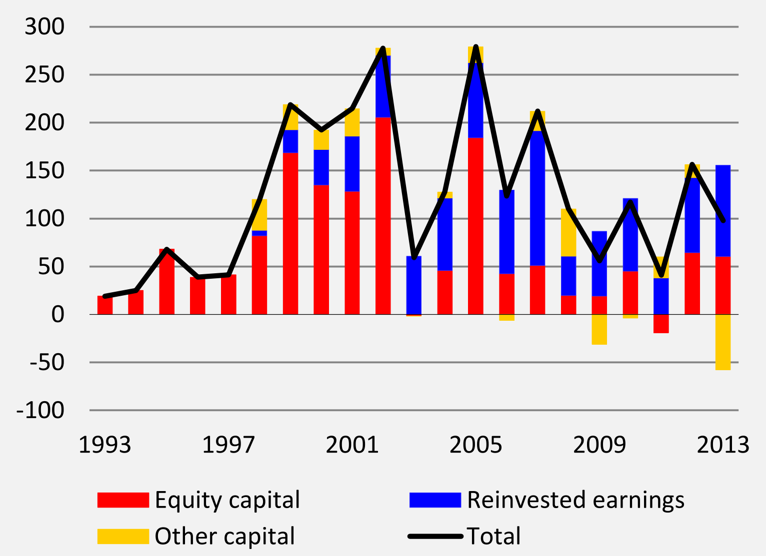


Chart 1: Evolution and structure of FDI inflows into the Czech Republic, CZK billions

Source: CNB

Besides a sharp fall in FDI inflows, there was a change of at least equal significance in flows out of the Czech Republic linked with earlier FDI. The average amount of dividends paid to non-residents in 2008–2013 was four times that in 1998–2007. This rise was partly due to the investment life cycle and was already apparent before the economic and financial crisis erupted. The share of non-residents' dividends in total profits rose gradually (at the expense of re-investment), and in 2006 dividends exceeded reinvested earnings for the first time. However, the economic and financial crisis in Europe caused financial problems in many foreign parent companies, leading to another (this time sharp) fall in reinvested earnings at the expense of dividends and to the withdrawal of much of the retained earnings that subsidiaries had on accounts in the Czech Republic. It should be added, however, that non-residents had been keeping part of this liquidity on accounts in the Czech Republic because of higher returns there (including koruna appreciation returns). The average annual dividend returns on FDI of non-residents in the Czech Republic rose from just 1.7% of GDP on average in 1998–2007 to 5.3% of GDP in 2008–2013 (see Chart 2). In 2013, they amounted to 5.8% of GDP (with a modest upward revision likely, according to preliminary data).

[1] Written by Vladimír Žďárský (Vladimir.Zdarsky@cnb.cz). The views expressed in this article are those of the author and do not necessarily reflect the official position of the Czech National Bank. In this article, the term Central European countries refers to the Czech Republic, Slovakia, Poland, Hungary and Slovenia.

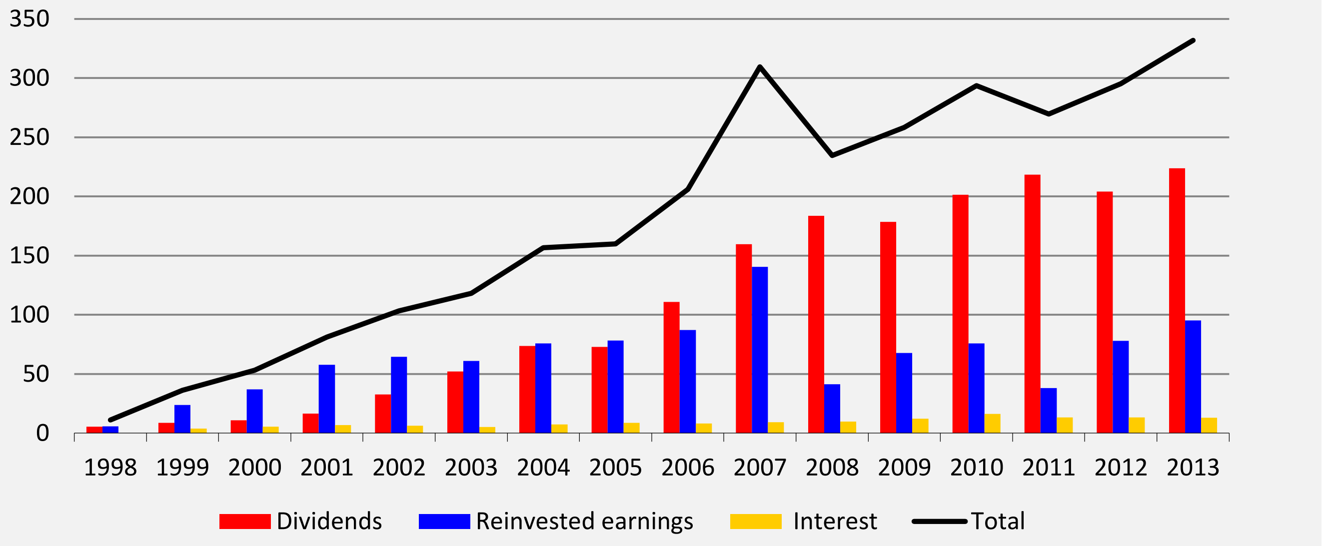


Chart 2: Returns on FDI, CZK billions

Source: CNB

Besides dividends, however, foreign parents of exporting firms started to use other forms of participation in their subsidiaries' financial results, in particular "branding" (the splitting off of a portion of export revenues representing countervalue for a brand, know-how, a sales network or other services in favour of a foreign parent).[2] In the Czech Republic, this form of profiting from investments started to be used by non-residents in 2005 and expanded considerably after 2008. According to CZSO data, the average "branding" paid to foreign parents in 2008–2013 amounted to 4.5% of GDP, i.e. almost equal to the value of dividends (as much as 6.3% of GDP in 2012 and 2013).

In 2008–2013, the funds transferred by foreign parents from the Czech Republic exceeded the value of new direct investment in the Czech Republic almost four times. The average value of funds transferred from FDI abroad was almost 10% of GDP (and about 12% of GDP in 2012 and 2013).[3] The negative impact of the net outflow of capital linked with direct investment[4] in the Czech Republic was about 9% of Czech GDP. In 2013, when the foreign capital inflow was virtually zero, the figure was almost 12% of GDP. The extent to which this trend is normal can be determined by making a comparison with similar CEE countries. Unfortunately, such comparison is complicated by the limited availability of detailed statistical information. All we have available is non-residents' total returns on direct investment, not the breakdown of such earnings into dividends, reinvested earnings and interest. Branding data are not available for every CEE country studied in this article. For these reasons, the only option available is to make a simple comparison of FDI and FDI returns across the individual countries.

Comparison of FDI and FDI returns across CEE countries

To compare FDI and FDI returns on the international scale, we used Eurostat data, which are easier to compare than national statistics data.[5] Comparison with other Central European countries[6] was chosen because of their approximately comparable economic level, their transition from central planning to a market economy, and their common period of investment inflow motivated by EU entry.

Poland was the largest FDI recipient in the Central European region in terms of the stock of FDI. However, if we take the countries' different sizes into account (converted per capita), the largest FDI recipient is the Czech Republic (except in 2004–2006, when the biggest recipient was Hungary). According to the situation at the end of 2012, FDI per capita in the Czech Republic was about 25% higher than in Slovakia and Hungary, 75% higher than in Slovenia and more than twice as high as in Poland. In the period since the outbreak of the global financial and economic crisis in Europe, all the countries have recorded significant slowdowns in FDI inflows. Compared to the Czech Republic, however, the decline in investment growth is

[2] In some firms, the value of branding is 50% of the export price.

[3] In 1998–2007, the average amount of funds transferred abroad by foreign parents was only 2.6% of GDP.

[4] FDI adjusted for reinvested earnings created and retained in the Czech Republic.

[5] We compare a sub-item of the balance of payments – non-residents' returns on direct investment – with the stock of FDI at the end of the previous year.

[6] Data for the above countries are available for 2003–2012.

smaller in Poland and Slovakia and much larger in Slovenia and Hungary. The increase in FDI in 2012 compared to the stock in 2007 was two and a half times higher in Poland than in Hungary. When assessing the amount of investment per capita for the whole period under review, it is important to bear in mind that sales of state-owned property to non-residents in sectors with regulated entry, such as banking and energy, did not play as important a role in Slovenia and Poland as in the other CEE countries.

Given the rather large swings in rates of return on FDI in individual years, the averages over several years would seem to be the most relevant information for comparison purposes. Returns have declined in every country since the outbreak of the economic and financial crisis in Europe.

Table 1: Average FDI earnings in the Central European region (in %)

	2003–2008 average	2009–2012 average
Czech Republic	13.8	12.5
Hungary	10.8	8.4
Poland	10.8	9.4
Slovenia	8.8	3.3
Slovakia	14.7	9.4

Source: Eurostat and authors' calculation

Table 1 shows that the relatively large cross-country differences in FDI returns (up to 6 pp in the pre-crisis period) widened further during the crisis amid declining rates of return. At the end of the period under review, the rate of return on FDI in the Czech Republic was about 3 pp higher than in Slovakia and Poland, 4 pp higher than in Hungary and four times higher than in Slovenia. This implies indirectly that such a high net outflow of capital relative to GDP generated by FDI as in the Czech Republic (since 2008) could probably not have occurred in any of the other countries under review (if we take into account the evolution of FDI since 2008, the weight of FDI in the economy and the significantly lower FDI returns). Theoretically, the only other possible factor, and only in the cases of Slovakia and Hungary, is a much higher share of "branding" than in the Czech Republic. However, data unavailability makes it impossible to perform this comparison in practice.

The large cross-country differences in the rate of return on FDI raise the question of what caused them. The overview provided below provides only a partial explanation. The first cause is the much higher share of foreign owners in sectors typically showing above-average profits (banking, energy) in the Czech Republic, Hungary and Slovakia compared to Poland and Slovenia, where these sectors are still largely in the hands of domestic owners (usually the state).

The second cause has to do with certain forms of additional taxation of firms operating in sectors with limited competition, such as energy, telecommunications, banking, insurance, pharmaceuticals and retail sales in Hungary and Slovakia, applied since 2011.

Table 2: Additional taxation of firms in selected sectors in Hungary and Slovakia

as of 31 Dec. 2012

	Banks	Non-banks
Hungary	0.5% on deposits 0.02% on financial transactions 0.03% on cash withdrawals	temporary sectoral taxes of 1%–6% on turnover for telecommunications, energy and wholesale and retail trade
Slovakia	0.4% on deposits 4.356% on profits exceeding EUR 3 million	4.356% on profits exceeding EUR 3 million in the following sectors: energy, telecommunications, insurance, pharmaceuticals, air transport

Note: These measures are modified quite frequently

In addition, Hungary has introduced an "energy tax" and some other measures. In both countries these measures are constructed so as to apply in a non-discriminatory way[7] to large firms in selected sectors, i.e. usually foreign firms operating predominantly on the domestic market in sectors with limited competition. The measures hardly apply at all to exporting firms because of concerns about the relocation of production or services to other countries.

The big differences in FDI returns are probably due in third place to different impacts of the economic and financial crisis across countries and across sectors of their economies.

Overall, we can conclude that the rate of return on investment in the Central European region remains relatively high (except in Slovenia since the outbreak of the economic and financial crisis). The currently observed weak inflow of FDI into the Central European region is mostly due to insufficient demand in Europe, not to economic problems in these host countries.[8] The second reason for the present low inflow of foreign investment is the subsiding of a one-off factor associated with the privatisation of state-owned property (although there is still some room for selling off assets, especially in Poland and Slovenia). If Europe were to see a more pronounced economic recovery, FDI inflows would probably rise again, although not to the pre-crisis level. The visibly higher return on foreign investment in the Czech Republic than in the other countries in the region is probably due largely to the structure of such investment, i.e. the high proportion of sectors with above-average profitability combined with no additional taxation of those sectors. The scale of the economic and financial crisis explains the sharp fall in returns in Slovenia very well, but the almost identical fall in Slovakia is difficult to explain. It is impossible to compare the size of FDI-related capital outflows because the necessary data are unavailable for the other countries. However, the available data show that the net outflow will probably be much lower. The high and rising net outflow of FDI capital from the Czech Republic is probably contributing significantly to a stagnation in living standards, even though developments on the supply side of the economy – in particular growth in production and exports of goods and services and a relatively[9] favourable employment trend – would allow living standards to rise. Moreover, this massive outflow of capital is contributing to an absence of appreciation pressures on the koruna in a situation of a steadily improving current account (which is likely to record a surplus in 2014 for the first time in 21 years, whereas in 2007 it showed a deficit of 4.3% of GDP).

[7] In order to ensure that they are internationally acceptable, particularly in the EU.

[8] The higher investment inflows into Poland and Slovakia since 2008 compared to the other countries in the region are probably due to the relocation of part of export production from the relatively expensive Western Europe to cheaper parts of the region. In the case of Poland the higher inflow may also be due to investment associated with the sale of foreign products in a large market that has been little affected by the crisis.

[9] In the European context.

A1. Change in GDP predictions for 2014

	CF		IMF		OECD		CB / EIU	
EA	-0.1	2014/10 2014/9	-0.3	2014/10 2014/7	-0.4	2014/9 2014/5	-0.1	2014/9 2014/6
US	0.1	2014/10 2014/9	0.5	2014/10 2014/7	-0.5	2014/9 2014/5	-0.1	2014/9 2014/6
DE	-0.3	2014/10 2014/9	-0.5	2014/10 2014/7	-0.4	2014/9 2014/5	0.2	2014/6 2013/12
JP	-0.1	2014/10 2014/9	-0.7	2014/10 2014/7	-0.3	2014/9 2014/5	-0.1	2014/7 2014/4
BR	-0.6	2014/10 2014/9	-1.0	2014/10 2014/7	-1.5	2014/9 2014/5	-0.6	2014/10 2014/9
RU	0.1	2014/10 2014/9	0.0	2014/10 2014/7	-1.8	2014/5 2013/11	0.0	2014/10 2014/9
IN	0.1	2014/10 2014/9	0.2	2014/10 2014/7	0.8	2014/9 2014/5	0.0	2014/10 2014/9
CN	-0.1	2014/10 2014/9	0.0	2014/10 2014/7	0.0	2014/9 2014/5	-0.2	2014/10 2014/9

A2. Change in inflation predictions for 2014

	CF		IMF		OECD		CB/ EIU	
EA	-0.1	2014/10 2014/9	-0.4	2014/10 2014/4	-0.5	2014/5 2013/11	-0.1	2014/9 2014/6
US	-0.1	2014/10 2014/9	0.6	2014/10 2014/4	-0.3	2014/5 2013/11	0.0	2014/9 2014/6
DE	-0.1	2014/10 2014/9	-0.5	2014/10 2014/4	-0.7	2014/5 2013/11	-0.2	2014/6 2013/12
JP	0.0	2014/10 2014/9	-0.1	2014/10 2014/4	0.3	2014/5 2013/11	0.0	2014/7 2014/4
BR	-0.1	2014/10 2014/9	0.4	2014/10 2014/4	0.9	2014/5 2013/11	-0.2	2014/10 2014/9
RU	0.4	2014/10 2014/9	1.6	2014/10 2014/4	0.3	2014/5 2013/11	0.0	2014/10 2014/9
IN	-0.4	2014/10 2014/9	-0.2	2014/10 2014/4	-1.4	2014/5 2013/11	-0.4	2014/10 2014/9
CN	-0.1	2014/10 2014/9	-0.7	2014/10 2014/4	0.0	2014/5 2013/11	-0.2	2014/10 2014/9

A3. List of abbreviations

BoJ	Bank of Japan
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
EEA	European Economic Area
ES	Spain
EU	European Union

EMI	European Monetary Institute	**JP**	Japan
EURIBOR	Euro Interbank Offered Rate	**JPY**	Japanese yen
Fed	Federal Reserve System (the US central bank)	**LIBOR**	London Interbank Offered Rate
FRA	forward rate agreement	**N/A**	not available
GBP	pound sterling	**OECD**	Organisation for Economic Co-operation and Development
GDP	gross domestic product	**OECD-CLI**	OECD Composite Leading Indicator
GR	Greece	**PMI**	Purchasing Managers' Index
CHF	Swiss franc	**PT**	Portugal
ICE	Intercontinental Exchange	**RU**	Russia
IE	Ireland	**UoM**	University of Michigan
IFO	Institute for Economic Research	**UoM-CSI**	University of Michigan Consumer Sentiment Index
IFO-BE	IFO Business Expectations	**US**	United States
IMF	International Monetary Fund	**USD**	US dollar
IN	India	**ZEW-ES**	ZEW Economic Sentiment
IRS	interest rate swap		
IT	Italy		

A4. List of thematic articles published in the GEO

2014

	Issue
Changes in FDI inflows and FDI returns in the Czech Republic and Central European countries (Vladimír Žďárský)	2014-10
Competitiveness and export growth in selected Central European countries (Oxana Babecká Kucharčuková)	2014-9
Developments and the structure of part-time employment by European comparison (Eva Hromádková)	2014-8
The future of natural gas (Jan Hošek)	2014-7
Annual assessment of the forecasts included in GEO (Filip Novoný)	2014-6
How far the V4 countries are from Austria: A detailed look using CPLs (Václav Žďárek)	2014-5
Heterogeneity of financial conditions in euro area countries (Tomáš Adam)	2014-4
The impacts of the financial crisis on price levels in Visegrad Group countries (Václav Žďárek)	2014-3
Is the threat of deflation real? (Soňa Benecká and Luboš Komárek)	2014-2
Forward guidance – another central bank instrument? (Milan Klíma and Luboš Komárek)	2014-1

2013

	Issue
Financialisation of commodities and the structure of participants on commodity futures markets (Martin Motl)	2013-12
The internationalisation of the renminbi (Soňa Benecká)	2013-11
Unemployment during the crisis (Oxana Babecká and Luboš Komárek)	2013-10
Drought and its impact on food prices and headline inflation (Viktor Zeisel)	2013-9
The effect of globalisation on deviations between GDP and GNP in selected countries over the last two decades (Vladimír Žďárský)	2013-8
Competitiveness and determinants of travel and tourism (Oxana Babecká)	2013-7

Annual assessment of the forecasts included in GEO (Filip Novotný)	2013-6
Apartment price trends in selected CESEE countries and cities (Michal Hlaváček and Luboš Komárek)	2013-5
Selected leading indicators for the euro area, Germany and the United States (Filip Novotný)	2013-4
Financial stress in advanced economies (Tomáš Adam and Soňa Benecká)	2013-3
Natural gas market developments (Jan Hošek)	2013-2
Economic potential of the BRIC countries (Luboš Komárek and Viktor Zeisel)	2013-1

2012

	Issue
Global trends in the services balance 2005–2011 (Ladislav Prokop)	2012-12
A look back at the 2012 IIF annual membership meeting (Luboš Komárek)	2012-11
The relationship between the oil price and key macroeconomic variables (Jan Hošek, Luboš Komárek and Martin Motl)	2012-10
US holdings of foreign securities versus foreign holdings of securities in the US: What is the trend? (Narcisa Kadlčáková)	2012-9
Changes in the Czech Republic's balance of payments caused by the global financial crisis (Vladimír Žďárský)	2012-8
Annual assessment of the forecasts included in the GEO (Filip Novotný)	2012-7
A look back at the IIF spring membership meeting (Filip Novotný)	2012-6
An overview of the world's most frequently used commodity indices (Jan Hošek)	2012-5
Property price misalignment around the world (Michal Hlaváček and Luboš Komárek)	2012-4
A macrofinancial view of asset price misalignment (Luboš Komárek)	2012-3
The euro area bond market during the debt crisis (Tomáš Adam and Soňa Benecká)	2012-2
Liquidity risk in the euro area money market and ECB operations (Soňa Benecká)	2012-1

2011

	Issue
An empirical analysis of monetary policy transmission in the Russian Federation (Oxana Babecká)	2011-12
The widening spread between prices of North Sea Brent crude oil and US WTI crude oil (Jan Hošek and Filip Novotný)	2011-11
A look back at the IIF annual membership meeting (Luboš Komárek)	2011-10
Where to look for a safe haven currency (Soňa Benecká)	2011-9
Monetary policy of the central bank of the Russian Federation (Oxana Babecká)	2011-9
Increased uncertainty in euro area financial markets (Tomáš Adam and Soňa Benecká)	2011-8
Eurodollar markets (Narcisa Kadlčáková)	2011-8
Assessment of the forecasts monitored in the GEO (Filip Novotný)	2011-7
How have global imbalances changed during the crisis? (Vladimír Žďárský)	2011-6

	Issue
Winners and losers of the economic crisis in the eyes of European investors (Alexis Derviz)	2011-5
Monetary policy of the People’s Bank of China (Soňa Benecká)	2011-4
A look back at the IIF spring membership meeting (Jan Hošek)	2011-3
The link between the Brent crude oil price and the US dollar exchange rate (Filip Novotný)	2011-2
International integration of the Chinese stock market (Jan Babecký, Luboš Komárek and Zlatuše Komárková)	2011-1