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CZECH ECONOMY AT THE BEGINNING OF 2005

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1. ECONOMIC GROWTH

In the first three quarters of 2004, Czech economy continued in solid growth. In the third quarter of 2004, GDP increased by 3.6 %, after a revised growth of 3.7 %, in the first half of the year. The main growth factor of GDP in the first three quarters of 2004 was fixed capital formation (9.9 %), followed by household consumption (2.6 %). Despite higher inflation and persistent high unemployment, the Czech households continued to spend, albeit at a slower pace than a year ago – facing to slower growth of real incomes. Government consumption fell (by 2.6 %). Foreign trade continued to influence the GDP growth adversely. However, the negative impact of foreign sector has been diminishing, growth of exports (19.8 %) exceeded slightly the growth of imports (19.0 %).

As indicated by the data, there is a visible shift from household consumption to fixed capital investments and exports as a main driving force of GDP growth. While the impact of total net exports is still negative, the trade with goods has started to have a positive impact on GDP growth as of 2003, while the trade with services continues to be a negative contributor to GDP. The picture about the impact of trade on GDP has been changing along with the revisions of GDP made by the Czech Statistical Office in the process of harmonisation with the Eurostat standards after the EU accession.

Industry has been witnessing solid growth in the course of the whole year – the full year growth of industrial output will be around 10 % (9.9 %, January to November 2004). The growth was driven by manufacturing industries, in particular by the trinity of metal industry, car industry and electro-technical industry. Metal industry has been supported by strong demand for metal products in Asia (in particular by the Chinese one). Car industry and production of electrical appliances belong almost completely to the sector of companies under foreign control, the production of which is strongly export oriented. The exports are one of the main driving force of Czech industry, with foreign controlled companies

being the main leaders of exports. Their share on industrial direct export sales increased to 52.8 %. The competitiveness of Czech industrial exporters on foreign markets is supported by relatively rapid decline of unit labour costs which is one of the reasons behind solid growth in industry even under the strong CZK.

In the course of 2004, construction has passed through strong fluctuations. First four months witnessed an extremely strong investment activity before the increase in VAT, the construction output increasing by 30 %, January to April 2004. This boom was then replaced by a strong slowdown observable from May to July 2004. As of August, activity in construction recovered, again. However, the growth path around 6 % has been lower than in the beginning of the year. The full year growth in construction will amount to approximately 10 % (10.4 %, January to November). Housing construction continued in growth, signalling, however, a slowdown, in the second half of 2004. The volume of mortgages increased by more than 30 %, in 2004.

Retail trade has been registering a slowdown in 2004. January to November 2004, the growth of retail sales reached 2.4 %, y/y. The full-year growth of retail sales will not exceed 2.5 % in 2004, which will be quite a significant slowdown against previous year (retail sales increased by 5 % in 2003). The slowdown in 2004 has been caused by the developments in the automotive segment. Car sales increased by only 0.7 %, January to November which was a compensation of extremely strong growth in 2003 (when car sales had increased by almost 5 %). Fuel sales increased by 4.7 %, which was also a considerable slowdown against previous year caused especially by high prices of fuels. Food sales witnessed a slowdown to 2.7 %. Consumer durables were the winners in retail trade being able to keep similar growth as in previous year, with growth rate of 3.5 %. This part of consumer basket was strongly promoted by continuous growth of consumer credits, which increased by 13 %, in 2004.

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The full year growth in construction will amount to approximately 10 %. Housing construction continued in growth, signalling, however, a slowdown, in the second half of 2004.

2. FOREIGN TRADE AND EXCHANGE RATE

Growth both of exports and imports accelerated, after the EU accession, which may be partly attributable to elimination of some administrative barriers. In 2004, exports rose by 23.8 %, y/y, the imports increased by 19.2 %, y/y. The trade deficit amounted to CZK 20.6 bill., which was a decline of almost CZK 50.0 bill., in comparison with 2003. Regarding high growth both of exports and imports and record-high prices of oil and metals on world markets, year over year decline of deficit must be assessed as a very favourable outcome. This has been the best result since 1994. At the same time, 2004 may be depicted as the year of significant turnover in foreign trade.

January to May 2004, the exchange rate of CZK/EUR oscillated in the range of 32.3 to 33.0 CZK/EUR (26.0 – 27.0 CZK/USD). In the first half of June, due to favourable macroeconomic fundamentals, the Czech currency started to appreciate reaching, 31.3 CZK/EUR in mid-June. Later on, following the disaster results of coalition parties in the European elections and following government crisis, the Czech crown depreciated till the level of 32 CZK/EUR. Then, the formation of new government, and as a consequence of favourable macroeconomic data, the Czech currency started, anew, to appreciate, reaching 31.46 CZK/EUR and 22.36 CZK/USD at the end of December 2004. The full-year average exchange rate of CZK/EUR reached 31.9, practically the same level as in 2003. In the course of 2004, the CZK followed the appreciation path of EUR with respect to USD. Average exchange rate of CZK against the USD was 25.7 CZK/USD representing 9 % appreciation of the Czech currency.

In the first three quarters of 2004, current account deficit amounted to CZK 105.3 bill., up from CZK 93 bill. in the same period of previous year. With the trade balance improving and balance of services stagnating, the deterioration of the current account is fully attributable to balance of incomes, the deficit of which amounted to CZK 109 bill., in Q1 – Q3, 2004. The reinvestments of profits and payments of dividends have been continuously growing due to strong inflow of FDI. Current account deficit will thus reach approximately 5.5 % of GDP in 2004. Since this relatively high level is kept – to a notable extent - by increasing reinvestments of profits from FDI, which do not represent real

financial flows, the macroeconomic stability of the country is not still threaten.

The surplus on the financial account reached CZK 103 bill., in the first three quarters of 2004. The balance of payments thus ended as roughly balanced. The inflow of FDI continued amounting to CZK 90 bill., in Q1 – Q3 2004, which was the same value as a year before. Anyway, the importance of the reinvestments of profits has been growing: according to the CNB estimates, reinvested profits accounted for more than half of FDI inflows. The total amount of FDI assets has amounted to CZK 1330 bill so far. In Q1 – Q3 2004, the net inflow of portfolio investments amounted to CZK 63 bill., while net outflow of other investments reached CZK 52 bill.

3. INFLATION

During 2004, the CPI developments were affected by several factors: first, by two waves of tax changes (January and May) and by the rise of food and fuel prices. These led to the peak of CPI in October 2004 (3.5 %). In the last two months of the year, the decline of all prices and stagnation of food prices led to decline in CPI. Both the year on year CPI and the average rate of inflation reached 2.8 % at the end of 2004.

Fundamental inflationary pressures in the Czech economy are still very low. Competitive pressures are even stronger after the EU accession – fears about possible jump in price level due to the accession did not realise. Competition acts with higher intensity on the market with goods, services were more influenced by changes in VAT realised in January and May, 2004. For the reasons indicated above, prices of goods rose in 2004 by 0.9 % , while prices of services grew by 6.1 %, y/y.

The increase of producer prices was faster than that of consumer ones due to the record high world prices of oil and metals. The oil price hike was caused by high demand for oil in the USA and China, metal prices were driven in particular by East Asian demand. High world prices of raw materials have affected in particular domestic PPI in manufacture of coke and refined oil products and in metal industry, which were the main drivers of general PPI growth.

The peak of PPI increase was registered in October 2004, the year over year PPI

The trade deficit in 2004 amounted to CZK 20.6 bill. This was significant improvement against 2003 (CZK 70 bill.) and the best result since 1994.

The full-year average exchange rate of CZK/EUR reached 31.9, practically the same level as in 2003. In the course of 2004, the CZK followed the appreciation path of EUR with respect to USD. Average exchange rate of CZK against the USD was 25.7 CZK/USD representing 9 % appreciation of the Czech currency.

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amounting to 8.6 %. In October 2004, also the PPI in manufacture of coke and iron metal industry amounted to record high levels of 55.1 % and 29.1 %, respectively. Nevertheless, strong competitive pressures among the producers limited the spillover to other manufacturing industries as the above figures prove. Later slight decrease of world metal and oil prices pushed the PPI down, to 7.7 % at the end of the year. The full-year average stood at 5.7 %.

In 2004, the Czech National Bank raised the basic interest rates two times. The first increase came on June 24, another one occurred on August 26, 2004, each time by 25 basis points. This step placed the basic repo rate to 2.50 %, 50 basis points above the ECB's basic rate. In the second half of 2004, the 3M PRIBOR – the main interest rate in the business sector – has been exceeding the 3M EURIBOR by 40 basis points. In spite of this increase in the interest rates differential, it still was the lowest one among the four Visegrad countries. In January 2005, the CNB cut the repo rate by 25 basis points to 2.25 %, partly due to revision of GDP growth made by the Czech Statistical Office.

4. UNEMPLOYMENT

At the end of 2004, the rate of unemployment amounted to 9.5 %, exactly the same level as at the end of 2003 (under comparable methodology). Some stabilisation seems to be visible in the first place due to strong growth of the Czech industry. As a

consequence of strong demand, some industrial branches started to hire new workers, especially production of plastics, electrical and optical machinery and metal industry. Also, the main part of the effects of restructuring in industry on labour market are over. At the same time, permanent stagnation of the unemployment rate (around 10 % under the old methodology and above 9 % under the new one) even under quite solid growth of GDP close to 4 % has been proving the predominantly structural character of Czech unemployment. Therefore, more significant improvement may come only after adoption of some measures focused in particular on higher activity of the unemployed.

According to the EUROSTAT, the Czech unemployment rate was slightly lower than under the new methodology used by Czech Ministry of Labour and Social Affairs, amounting to 8.4 %, in November 2004. Czech unemployment rate was thus slightly lower than in EU 25 (8.9 %), Germany (9.9 %) and France (9.6 %). In comparison with new Central European EU member states, the Czech unemployment rate is higher than in Hungary (6.1 %) but significantly lower than in Slovakia (17.3 %) and Poland (18.4 %).

5. EXTERNAL ENVIRONMENT

As indicated in Table 2, growth looks set to slow down slightly in 2005, but still to be robust (we expect world growth in 2005 at 4.1 %, down from 4.8 % in 2004). The US and the emerging market economies will likely to

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Table 1: Main Macroeconomic Indicators

		2000	2001	2002	2003	09/04	10/04	11/04	2004	2005 F
Inflation	%, y/y	3.9	4.1	0.6	1.0	3.0	3.5	2.9	2.8	2.5
Inflation	%, m/m	-	-	-	-	-0.8	0.5	-0.1	-	-
Industrial prices	%, y/y	5.0	0.8	-0.7	0.9	8.0	8.6	8.2	7.7	2.5
Industrial prices	%, m/m	-	-	-	-	0.3	1.1	0.0	-	-
Unemployment rate*	%, eop.	8.8	8.9	9.8	10.3	9.1	8.9	8.9	9.5	9.0
Industrial production	%, real	5.1	6.8	4.8	5.8	6.6	8.1	10.9	10.0	8.0
Construction output	%, real	5.3	9.6	2.5	8.9	3.5	2.9	9.9	10.0	6.0
Retail sales	%, real	4.6	4.3	2.7	5.0	1.0	1.3	8.0	2.5	3.0
State budget	CZK bill.	-46.1	-67.7	-45.7	-109.1	3.7	-4.1	-50.7	-93.5	-110
Trade balance	CZK bill.	-120.8	-119	-71.3	-69.8	3.7	-4.1	5.2	-20.6	0
FOREX reserves	USD bill.	13.1	14.8	23.7	27.0	26.8	27.3	28.2	28.4	28.0
PRIBOR 3M	% average	5.36	5.2	3.55	2.3	2.72	2.67	2.61	2.4	2.8
CZK/EUR	Average	35.6	34.1	30.81	31.84	31.60	31.48	31.29	31.9	31.0
CZK/USD	Average	38.6	38.0	32.74	26.32	25.88	25.23	24.09	25.7	23.0
GDP	%, y/y	3.9	2.6	1.5	3.7	-	-	-	3.6	3.8

Source: Czech National Bank, Czech Statistical Office, forecasts by Komerční banka (bold figures)

*Note: As of July 2004, the unemployment rate is published according to the new methodology

remain the main engines of growth: they will expand at rates slightly under and over 4 %, respectively. Eurozone will continue to lag, posting growth rates of less than 2 % (our forecast for 2005 is 1.6 % growth). The expected further depreciation of the USD will weigh on export growth of eurozone; with domestic demand slow to recover, this will likely to dampen its overall economic activity.

The adjustment to a lower dollar will mean a transition from export-oriented growth in eurozone towards domestic demand. This transition will be difficult and will last some time. Having in mind that the Czech exports towards eurozone are heavily dependent on the dynamics of eurozone's exports, the deceleration in eurozone exports represents one of the biggest risks for the Czech economy in 2005.

6. OUTLOOK

Development of world prices of oil, metals and other raw materials at the beginning of 2005 indicates that the peak is over. Nevertheless, their level in 2005 will be significantly higher than a year before. For this reason, IMF and other international institutions are predicting lower world economic growth for this year. This will dampen the growth of world trade as well.

The domestic demand will continue to be the major driving factor of economic growth. After a slowdown observable in 2004, we expect a slight acceleration of household consumption, fuelled by growth of real incomes and consumer credits. On the other hand, extremely high growth of investment demand from 2004 will not continue in 2005. The growth of gross capital investment will follow medium-term path of 5-7 %. Negative impact of external sector to GDP growth will slightly diminish: while the foreign trade with goods will have positive impact on GDP growth, trade with services will continue to affect the GDP adversely. We expect the growth of GDP in 2005 at 3.8 %, after 3.6 % in 2004.

We cannot expect another jump in Czech exports as was the case in 2004, at least due to two factors. First, the growth under 2 % and strong EUR will adversely affect eurozone's exports and – indirectly – the Czech exports as well. Second, the comparative bases for growth of exports will be high due to extremely strong export activity in 2004. On the other hand, ongoing activities of export oriented industrial companies under foreign control and new capacities in the car industry will affect positively the trade balance. Therefore, the trade balance will be roughly balanced in 2005. However, the current account deficit will improve only slightly from 5.8 % of GDP to 5.5 % in 2005. The improvement in trade balance will be almost offset by continuous deepening of the deficit on the balance of incomes.

CZK is expected to keep the path of slight strengthening against the EUR, appreciating by another 3-4 % in 2005. The main factors of appreciation continue to be good macroeconomic prospects and ongoing activities of foreign investors. The appreciation vis-à-vis the USD will be more significant - approximately 10 % on average. Due to low inflationary pressures and strong CZK, CNB will keep basic rates unchanged in the whole 2005. 3M PRIBOR – the main interest rate in the business sector will exceed the 3M EURIBOR by 25-30 basis points. This interest rates differential will most probably persist during 2005.

Czech industry will continue in solid growth, however, a slight slowdown must be expected, along with lower growth of exports. Foreign-owned companies, will remain the most dynamic driving force in Czech manufacturing. In 2005, growth in industry will amount to 8 %.

Projects in infrastructure and activities of foreign investors will continue to support construction also in 2005. The recovery of new construction permits has been giving some reasons for optimism. However, double-digit growth rates will be rather an

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The appreciation vis a vis the USD will be more significant - approximately 10 % on average.

Table 2: World Economy 2003-2005

	2003	2004F	2005F
USA	3.0	4.4	3.6
Eurozone	0.5	1.8	1.6
France	0.6	2.2	1.9
Germany	-0.1	1.7	1.2
Austria	0.7	1.6	2.1

Source: Société Générale, Komerční Banka

exception than a rule, in 2005. The dynamics will be more close to the trajectory from the second half of 2004. It is necessary to account for the impact of high bases for comparison, for the first four months of 2005. In 2005, growth in construction will amount to approximately 6 %.

We expect a slight improvement in retail trade in 2005, supported not only by growth of real incomes but also by continuing growth of consumer credits. There is still a space for consumer credits to increase by at least another 10 % in 2005. Car sales will probably slightly recover in 2005 and prices of fuels should not hit the retail sales as was the case in 2004. Therefore automotive segment will register better results than in 2004. The rest of the retail trade will continue to grow by mid-term dynamics of 3 %. The growth of total retail sales will amount to approximately 3 %, as well.

Fundamental inflationary pressures in the Czech economy are weak. Moreover, the appreciation of the Czech currency helps to keep inflation low. Also, the growth of services prices will be attenuated due to absorption of tax changes realised in the first half of 2004. There will be no such tax hikes in 2005. We expect the year-end headline inflation to reach 2.5 %; average inflation will be under 2 %, in 2005. The spill-over effect from producer prices to consumer ones will be very limited. As mentioned above, the development of world prices of oil, metals and other raw materials indicates that the peak is over. This will positively affect the PPI in the months to come – we can await the further decline of producer price level. Strong competition among industrial producers will be another factor pressing the PPI down. For 2005, we expect the year-end PPI at 2.5 %.

Structural character of Czech unemployment will persist in 2005. Growth of long-term unemployment will continue to be the main problem of Czech labour market. Rigidities on the labour market may be overcome only in the long-term horizon. Continuing economic growth may improve the situation on the labour market only moderately. At the end of 2005, we expect the unemployment rate to be around 9 %.

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Kamil Janáček

For catching-up economies like the Czech Republic, foreign analysts often use foreign investment as one of the criteria of success. Foreign investment "proves the trust of foreign investors" – but, more importantly, it is supposed to have a clear positive effect on economic growth. In particular, positive effects for employment and labour productivity are emphasized.

Are these positive effects really so big that countries as the Czech Republic should actively entice foreign investors by offering them above-standard conditions? Let us consider, first, the effect of foreign investment on the labour market or on:

- employment (unemployment)
- labour productivity
- the wage level.

In the second part we can analyze the relation between foreign investment and the labour market from the opposite view. Main factors that attract foreign investment to the Czech Republic will be considered from the point of view of economic theory and empirical evidence. Consequences for economic policy will be drawn.

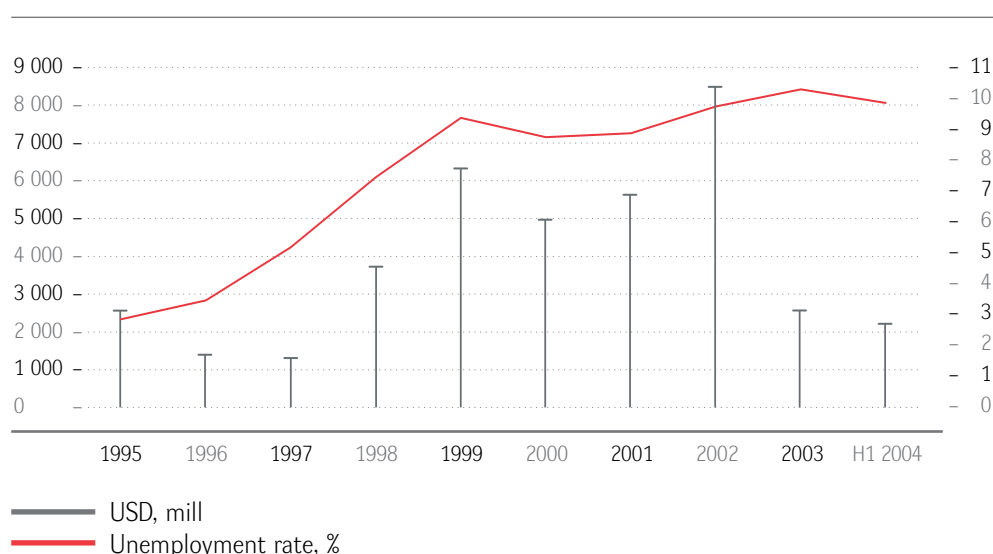
1. FOREIGN INVESTMENT – IMPACT ON EMPLOYMENT

Conventional pledges of Government representatives, the Czechinvest, or the foreign investors, say that "this particular investment will create so many tens, hundreds, or thousands of new jobs". That is supposed to justify special incentives offered to foreign investors (subsidies for new job creation, tax holidays, pre-equipped building sites, etc.). However, what is the reality?

At macroeconomic level no relation can be found between the size of foreign capital inflow, and total employment (or, unemployment) rate. As shown in **Figure 1**, in the Czech Republic the growing inflow of foreign capital (during 1998-2002) went hand in hand with a substantial increase of the rate of unemployment, which practically doubled – and with stagnation (or a moderate decrease only) of total employment. Unemployment in this country has been mainly determined by structural factors and by the economic cycle. No positive effect of foreign investment has been seen.

Supporters of special rewards for foreign investors, however, argue that there is a positive effect on employment at a local level

Figure 1: FDI Inflows and Unemployment, 1995 – 2004



At macroeconomic level no relation can be found between the size of foreign capital inflow, and total employment (or, unemployment) rate.

Source: Czech National Bank, Ministry of Labour and Social Affairs

– in individual regions. Yet as Table 1 indicates, even at the level of districts no positive relation between foreign direct investment and lower unemployment can be proven.

Table 1 shows the quarterly trends of unemployment in three types of districts. The first type is represented by the districts Karviná and Louny, characterized by over-average unemployment rates since the start of economic transition. There has been hardly any foreign investment in these districts till now, and they are coping with the single-industry structure which was typical here over the whole 20th century. The second type is represented by three districts which, each, house at least one successful foreign-investment project: in the district Přerov, it is Phillips, in the district Svitavy the concern Saint-Gobain, and in Pilsen, Japanese "greenfield" investments which have changed Pilsen to the town with highest concentration of electronics production in the country. And, finally, the third type of districts is represented by Prague with highly above-average volume of direct foreign investment over the last decade.

Comparing these three types of districts (low or none FDI, specific investments of the "success story" type, and Prague), we again see that foreign investment made **no difference** in trends of unemployment – not even at local level. Unemployment in all three groups of districts followed the overall unemployment trends in the country, rather than reflecting the volume of FDI attracted.

Why is it that empirical data do not prove the conventional wisdom expecting positive effects of foreign investment on employment?

There are two types of foreign direct investment. First, there is acquisition investment (getting hold of existing Czech firms, via privatization or direct sale). This type of FDI has a clear labour-saving effect. Foreign investors raise productivity in the acquired firms, by organizational change, by labour-saving investment, etc. That leads to savings of the labour force, often in the order of tens of percent, compared to the situation before the entry of the foreign owner.

To illustrate this, let us show, in **Table 2**, the changing numbers of employees in

Table 1: Unemployment Rates in Selected Districts, 1997 – 2004 (in %)

	Karviná	Louny	Přerov	Svitavy	Plzeň-město	Praha
12/97	10.4	11.3	9.0	7.2	4.9	0.9
03/98	10.8	11.0	9.6	7.0	5.3	1.2
06/98	11.6	12.0	10.3	6.8	5.7	1.3
09/98	13.0	13.4	12.0	8.2	6.9	1.9
12/98	13.8	15.5	12.5	8.9	6.7	2.3
03/99	15.5	15.7	13.3	9.8	7.6	2.9
06/99	16.4	15.1	13.3	9.4	8.3	3.1
09/99	17.6	15.6	14.1	10.3	8.7	3.7
12/99	18.2	17.5	14.5	11.6	8.3	3.5
03/00	18.8	17.6	14.8	11.5	8.3	3.7
06/00	18.5	15.9	14.0	10.2	7.8	3.5
09/00	18.6	16.1	14.2	10.3	7.8	3.7
12/00	18.0	17.1	14.2	10.8	7.3	3.4
03/01	17.7	16.4	13.8	10.7	7.2	3.4
06/01	17.5	15.3	12.4	10.0	7.0	3.2
09/01	17.8	16.0	12.2	10.3	7.2	3.4
12/01	18.0	17.2	12.5	11.3	7.2	3.4
03/02	18.5	17.3	12.4	10.9	7.4	3.5
06/02	18.5	16.6	11.9	10.5	7.2	3.4
09/02	19.3	17.5	12.4	11.2	7.6	3.9
12/02	19.6	18.6	12.8	12.4	7.4	3.7
03/03	20.4	18.3	13.1	12.3	7.5	3.8
06/03	20.2	17.3	12.6	11.5	7.4	3.8
09/03	20.4	17.5	12.9	12.2	7.8	4.1
12/03	20.4	18.9	13.8	13.4	7.6	4.0
03/04	21.3	17.7	14.5	13.4	7.6	4.4
06/04	21.0	15.7	13.2	12.3	7.5	4.2

Source: Ministry of Labour and Social Affairs

Even at the level of districts no positive relation between foreign direct investment and lower unemployment can be proven.

banking after the four largest Czech banks were privatized: the CSOB in 1999, Česká spořitelna in March 2000, the IPB (re-privatized) in June 2000, and Komerční banka in 2001. In each case, privatization was followed by vast organizational change and rationalization, and by a sizable reduction of staff.¹

The second group of foreign investment is „greenfield investment“. Intuitively, that should create new jobs and increase total employment. However, even here the effect is ambiguous. The building of new capacities is often accompanied by closedowns of weaker Czech competitors. Also, foreign investors pull out highly qualified workers from existing firms. The overall effect on employment in the given industry or region is neutral, often even negative. To give an example, the arrival of large supranational retail chains liquidated many small retailers, so that this typical "greenfield" investment had, at best, a neutral effect on employment in retail trade. Similar situation is in manufacturing. A clear suck-out effect of foreign investment can be seen in some high-tech services (consulting, accounting): situation in the labour market in these specific professions (especially in Prague and other large cities) is such that most staff is acquired from within other firms – Czech or foreign. The existing firms then often have to restrict their activities.

The conclusion is that foreign investment, in sum, has a labour-saving effect, as it kills more jobs than it creates.

¹The impact of privatization exceeded the previous cuts in staff, connected with improved computer equipment and done in the pre-privatization period.

2. THE EFFECT OF FOREIGN INVESTMENT ON LABOUR PRODUCTIVITY

On the other hand, the effect of foreign investment on productivity of Czech labour is clearly positive. As shown in Table 3, foreign-owned firms have a visibly higher productivity per worker (measured by value added in industry and construction, by turnover in trade) than "national" private firms – firms owned by domestic capital.

There are several factors behind the faster productivity increase in foreign-owned firms. Foreign capital brings technological, managerial and marketing know-how. The business model and organization of the "mother" is transferred to the daughter company. Synergy can be achieved in developing and producing new goods. The staff – in particular the managers – are sent to schooling abroad, and they can quickly apply the acquired knowledge and experience to the Czech daughter company. Foreign investment also raises the productivity of the whole industry – as there are "spillovers" of foreign know-how to firms owned by Czech capital.

Table 2: Staff Numbers in Banks (in thousands, end of the year)

1998	1999	2000	2001	2002	2003
52,8	49,4	45,5	40,9	40,6	39,0

Source: Czech National Bank

Table 3: Effects of FDI on Labour Productivity, 2003
(value added or turnover per worker, in CZK thousand)

	A: private, domestic owned	B: private under foreign control	B : A (in %)
Industry	441,8	752,3	170,3
Construction	1 519,1	2 881,3	189,7
Trade	2 150	2 970	138,1

Source: Ministry of Industry and Trade

The effect of foreign investment on productivity of Czech labour is clearly positive. Foreign-owned firms have a visibly higher productivity per worker than "national" private firms – firms owned by domestic capital.

3. THE EFFECT OF FOREIGN INVESTMENT ON WAGES

The effect of FDI on wages is, again, positive. As **Table 4** indicates, the average wage in firms owned by foreign capital is higher than in Czech-owned firms, the difference representing one quarter to two fifths. Thus, foreign investors contribute to higher living standards of Czech labour.

This positive effect, of course, has its inverted side. The higher wage level in foreign-owned firms contributes to the wage drift, pushing up wages in Czech firms (especially in selected professions, industries and micro-regions where foreign- and Czech-owned firms exist side by side). As the Czech-owned firms seldom reach the same level of productivity, the wage drift takes away part of their profits. If we compare Table 3 (productivity) with Table 4 (wages), we can see that differences between foreign- and Czech-owned firms are much larger in productivity than in wages.

Empirical data thus confirm what one of the most important incentives for FDI inflows is: the search for regions with an advantageous wage/labour quality ratio – or, for regions with low unit labour costs. The Czech Republic is one of such regions. Foreign investors can find here qualified labour for a wage which is low from their point of view, not only in manufacturing but in high-tech services as well.

4. CZECH EXPERIENCE IN THE LIGHT OF THEORY

How does the Czech experience with the impact of foreign direct investment on the labour market fit into the more general framework of economic theory?

Economic theory dealing with FDI aims at answering the question why firms transfer production abroad, rather than simply exporting their goods or services. The theory offers four or five explanations.²

1. Ownership theory. Foreign investment is motivated by lucrative acquisition of a given capacity – the price per unit of capacity is significantly lower than in the home country.

2. Localization theory. Convenient geographical position (lower transport costs) and a chance to conquer new markets is the motive for investing abroad.

3. Skipping trade barriers (custom or non-custom). Exports, or the needed licences, are so costly that the goods cannot be competitive in the foreign market. Costs are lowered by internalization (transferring production into the territory protected by trade barriers).

4. Use of local benefits. Foreign investment is motivated by natural resources (raw materials), qualified labour at lower wage (beneficial unit labour costs), or by lower taxes.

5. OLI theory. This theory is eclectic, combining factors 1 to 3 (ownership, localization, internalization) in explaining the flows of foreign investment.

Whatever of the above mentioned factors is decisive as a motive for foreign investment, the result is always higher profitability of capital invested abroad, compared to the home country.

From economic theory, empirical evidence, and statements of foreign investors, it follows that in the Czech case the main motives of FDI inflows were lucrative acquisition (theory 1) and beneficial unit labour costs (theory 4).

The "golden age" for lucrative acquisitions came into the Czech Republic mainly after the recession of 1997-1998. In his original study analyzing the transformation of the Czech economy,³ Václav Klaus revealed the combination of factors and policy steps (mainly monetary policy) that, from the half of 1997, led to economic recession, the

² See, e.g., Blomström, M. – Kokko, A. (1998): Multinational Corporations and Spillovers, *Journal of Economic Surveys*, 12. pp. 247-277, or Hymer, S. (1976): *The International Operations of National Firms: A Study of Foreign Direct Investment*, Cambridge, MA.

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Table 4: Effect of FDI on Wages, 2003
(average monthly wage in CZK)

	A: private, domestic owned	B: private under foreign control	B : A (in %)
Industry	15 052	18 378	122,0
Construction	16 462	23 373	142,0

Source: Ministry of Industry and Trade

credit crunch, and a sharp deterioration of economic position of Czech banks.

What followed were forced sales of Czech firms, and cheap privatization of government-held assets. It is not by chance that FDIs of the acquisition type grew sharply in 1999-2002, when they formed the bulk of foreign direct investment, and contributed to a significant rise of its total sum (see **Figure 1**).

In the next period, the inflow of foreign direct investment again stabilized at a lower level which reflects the long-term benefits tied with lower unit labour costs. This feature of the Czech labour market has been, and for some time will remain, the main long-term incentive for foreign investors.

Strong international corporations always seek the most beneficial location of their capital. Foreign direct investment motivated by lucrative acquisitions, or by use of lower unit labour costs, will flow into the country, irrespective of the existence of special government-offered incentives and benefits for foreign investors. FDI is rather insensitive to such special offers. We can formulate a strong hypothesis that without special benefits, FDI inflow in the Czech Republic would have been the same in the last decade, as it was with the special incentives and rewards.

Foreign investors themselves declared a whole range of factors that led, or lead, to placing their investment on the Czech territory. Among the first ten most important factors cited by them, special government-offered benefits are not listed. Of course, on the other hand, foreign investors will make use of them gladly – if offered – as each of us would take a free lunch without protest.

Special benefits for foreign investors are often hidden even behind investment incentives offered to "anyone". The conditions are mostly so formulated that Czech firms, with their lower capital strength, cannot get to the benefits.

³⁾ Klaus, Václav: Dynamics of post-communist transformation and alternative explanations.(in Czech) Praha, 1.4.2004. www.klaus.cz. (Also as: Klaus, Václav: Spor o devadesátá léta. Ekonom, 40/2004).

5. CONCLUSION

For the national economy it would be much more efficient to shift the money spent on incentives for (mainly) foreign investors to other uses. Good examples are improved infrastructure, and more efficient institutions serving the entrepreneurs (the courts, the land register, the corporate register). This would improve the economic environment for **all businesses**, domestic or foreign, on the principle of equal treatment. Further important ways to support business, and economic growth in the Czech Republic are lower taxes and a more flexible labour market.

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WHAT IS THE LAST REVISION OF GDP DATA TELLING US?

Eva Zamrazilová

YEAR 2003 AND THE REVISION

The data on Czech GDP were anew revised, in December 2004. This new revision has again changed the history of the Czech business cycle. Both the GDP volume and growth rate were revised upwards. The growth rate of GDP was increased to 3.7 %, up from 3.1 %. At the same time, the dynamics of main growth factors was revised, some changes being quite significant as indicated by Table 1. The consumption of government accelerated to 4.2 % - this is an increase of 2 percentage points. On the other hand, fixed capital investments slowed to 2.9 %, down from previously presented 5.7 %. This is quite a significant change: contrary to previous knowledge, investment demand did not grow more rapidly than consumer demand but – according to new data - the growth rates both of these main economic drivers were roughly the same.

First sight at volume indicators in constant prices of previous year (from which the growth rates were derived) may indicate that a simple shift occurred between fixed capital investments and government consumption. Such a change could be explained (as happened in the past) by different classification of some individual basic items. However, this has not been confirmed by the developments of GDP components in current prices which serve as the basis for transfer to constant prices. Fixed investments in

current prices registered only a very slight change. The reason for significant change in volume of fixed investments was thus the change of the deflator (price index used for transfer from current to constant prices).

After this preliminary look at original and newly revised data we come to a conclusion that the review of old and new data both in current and constant prices must be combined with the look at the deflator to get a comprehensive picture of revision. Table 2 indicates that in the case of final consumption and capital investments both the data in current prices and the deflators were changed, while in the case of exports and imports only the deflators were revised.

KEY IMPORTANCE OF THE DEFLATORS

The most significant change in the data in current prices occurred in the area of final consumption, which was increased by CZK 21.1 bill. (of which the consumption of households and the government consumption accounted for CZK 10.7 bill. and CZK 9.8 bill. respectively). However, the picture in constant prices looks different, along with the change of the deflator. For instance, final consumption of households, which increased significantly in current prices (by the above mentioned CZK 10.7 bill.), changed only negligibly in constant

Table 1: GDP and Its Components

growth rates in %	Original data	Revised data	Difference (in percentage points)
GDP	3.1	3.7	0.6
Final consumption			
- total	4.1	4.7	0.6
- households	4.9	4.9	0.0
- government	2.2	4.2	2.0
Investments			
- total	5.7	2.8	-2.9
- fixed capital	7.4	4.8	-2.6
Exports			
-total	5.7	7.3	1.6
- goods	7.9	9.8	1.9
-services	-6.0	-6.0	0.0
Imports			
- total	7.9	7.9	0.0
- goods	9.4	8.9	-0.5
- services	-2.0	1.9	3,9

Source: Czech Statistical Office

Contrary to previous knowledge investment demand did not grow more rapidly than consumer demand but – according to new data - the growth rates both of these main economic drivers were roughly the same.

The review of old and new data both in current and constant prices must be combined with the look at the deflator changes to get a comprehensive picture of revision.

prices (decline by CZK 0.2 bill.). The reason was that the change in the deflator – the deflator increased by almost 1 percentage point - offset the increase in current prices. The situation was different in the case of government consumption: the increase of CZK 9.8 bill in current prices was accompanied by slight decline of the deflator (0.4 percentage point) which resulted in quite a strong increase of government consumption in constant prices.

Investments to fixed capital showed only a moderate change in current prices (slight increase of CZK 1.1 bill.). Strong revision of the deflator upwards (the price level of investments increased instead of previously reported decline) has, however, caused a strong decline in investments volume (CZK 16.2 bill.). As a result, the growth rate of investments strongly declined, in 2003.

A more detailed insight in original and revised data thus indicates that the differences in growth rates in the case of government consumption and investments were caused by the changes in the deflators rather than by changes in primary data in current prices.

The most significant difference was registered in the external sector. The exports of goods in constant prices increased by CZK 24.1 bill. This increase has been fully attributable to the change of the deflator, for the exports in current prices were not changed by the revision. On the other hand, the deflator was revised quite strongly – the price level of exports declined by 1.7 percentage point. The imports of goods in

constant prices were also changed only due to the change of the deflator. In the case of imports of goods the deflator was changed in the opposite direction (the price level was increased) which pressed the volume of imports of goods down. Net exports of goods improved by CZK 31.4 bill., which represents more than 1 % of GDP. The change in the net exports of goods was thus a very significant one - and was caused only by the changes of the deflators both of exports and imports.

At the same time, the revision also broke the widespread idea that foreign trade with goods had a negative impact on economic growth. Foreign trade with goods affected the GDP positively in 2002. According to the new data, the contribution of trade with goods was positive also in 2003. On the other hand, trade with services has been affecting the GDP adversely since 2001.

The revision opens some questions as far as the deflators are concerned. On one hand, the revision may be welcome because the changes go along with the intuitive expectations of many economists about the improved performance of Czech foreign trade. On the other hand, neither the changes in the deflators nor the changes in consumption and investments were explained by the Czech Statistical Office. Each unexplained change of such a scope opens the space for speculations. Why was the price level of investments increased by 2 percentage points? Why was the price level of exports of goods cut by almost 2 percentage points while the statistics of prices in foreign trade were not changed? Were the changes in quality of exports accounted more

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Table 2: 2003 GDP and Its Components, Original and Revised Data

	Constant prices of previous year, CZK bill.			Current prices, CZK bill.			Deflator		
	Original	Revised	Difference	Original	Revised	Difference	Original	Revised	Difference
GDP	2489.8	2504.4	14.6	2532.4	2550.8	18.4	101.7	101.9	0.2
Final consumption, Total	1862.7	1873.8	11.1	1889.7	1910.8	21.1	101.5	102.0	0.5
- households	1280.8	1280.6	-0.2	1272.4	1283.1	10.7	99.3	100.2	0.9
- government	567.3	578.5	11.2	602.8	612.6	9.8	106.3	105.9	-0.4
Investments, Total	712.6	693.1	-19.5	698.8	696.1	-2.7	98.1	100.4	2.3
- fixed capital	690.7	674.5	-16.2	676.9	678.0	1.1	98.0	100.5	2.5
Exports, Total	1570.5	1594.4	23.9	1590.5	1590.5	0.0	101.3	99.8	-1.5
- goods	1353.2	1377.3	24.1	1371.3	1371.3	0.0	101.3	99.6	-1.7
- services	217.3	217.2	-0.1	219.2	219.2	0.0	100.9	100.9	0.0
Imports, total	1656.1	1656.9	0.8	1646.6	1646.6	0.0	99.4	99.4	0.0
- goods	1450.9	1443.6	-7.3	1440.7	1440.7	0.0	99.3	99.8	0.5
- services	205.2	213.3	8.1	205.9	205.9	0.0	100.4	96.5	-3.9
Net exports total	-85.5	-62.4	23.1	-56.1	-56.1	0.0	n.a.	n.a.	n.a.
- goods	-97.7	-66.3	31.4	-69.4	-69.4	0.0	n.a.	n.a.	n.a.
- services	12.1	3.9	-8.2	13.3	13.3	0.0	n.a.	n.a.	n.a.

Source: Czech Statistical Office

Table 3: Increase in GDP and Its Components

(prices of previous year, CZK bill.)

	GDP	Final consumption	Gross capital	Net exports of goods	Net exports of services
2000	79.40	31.20	50.40	-17.10	15.00
2001	56.70	47.60	39.20	-20.20	-9.90
2002	34.50	56.60	23.10	11.60	-56.80
2003 - old data	75.20	72.80	38.45	-26.4	-9.70
2003 - new data	89.7	83.8	18.9	5.0	-18.0

Source: Czech Statistical Office

intensively and was this the factor behind the change in the price level of exports?

led to a notable increase in the growth rate to 19.1 % (up from 16.4 %).

All these changes led to quite a different picture of the business cycle within previous six quarters, as well as to the different impact of major growth factors to overall economic growth.

REVISION AND THE FIRST HALF OF 2004

December revision had also some impact on data for the first half of 2004 – see Table 4. We are not going into a more detailed description of the differences between the old and new data, because the data for Q1 – Q3 2004 are only preliminary and will be - with a high probability - revised again.

In any case, it is interesting to note that the changes are quite significant for the major growth factors. Consumption of households looks worse under the new data, with the growth rate cut to 2.9 %, down from previously reported 3.7 %. The growth of investment demand is also lower according to the revised data: instead of previously reported growth of 11.3 %, the present figure stands at 9.9 %. On the other hand, exports of goods (in constant prices of previous year) were revised upward by CZK 14.5 bill., which

REVISION AND THE BUSINESS CYCLE

While the analysts were confirmed that the economy is in the upward phase of the business cycle until December 2004, the revision postponed the peak of business cycle back to the second half of 2003 - as shown by Figure 1. The difference between the old and new trajectory both of households consumption and investment demand is indicated in Figure 2. The consumption of households seemed to register a slowdown already since the third quarter of 2003 according to the old data. However, the intensity of the slowdown seems even more intensive according to the new ones. A very similar conclusion applies

The revision opens some questions as far as the deflators are concerned.

While the analysts were confirmed that the economy is in the upward phase of the business cycle until December 2004, the revision postponed the peak of business cycle back to the second half of 2003.

Table 4: H1 2004 GDP and Its Components, Original and Revised Data

	Constant prices of previous year, CZK bill.			Current prices, CZK bill.			Growth rate		
	Original	Revised	Difference	Original	Revised	Difference	Original	Revised	Difference
GDP	1302.0	1309.4	7.4	1347.1	1351.6	4.5	3.8	3.7	-0.1
Final consumption,									
Total	928.8	932.7	3.9	948.8	957.4	8.6	2.1	1.7	-0.4
- households	636.0	635.7	-0.3	645.6	650.9	4.7	3.7	2.9	-0.8
- government	284.6	288.8	4.2	295.4	298.1	2.7	-1.5	-1.0	0.5
Investments,									
Total	395.8	389.4	-6.4	401.0	395.4	-5.6	13.5	10.3	-3.2
- fixed capital	359.0	355.3	-3.7	363.1	359.1	-4.0	11.3	9.9	-1.4
Exports,									
Total	905.4	919.9	14.5	935.1	940.8	5.7	16.0	23.2	7.2
- goods	789.1	803.6	14.5	818.0	823.6	5.6	16.4	19.1	2.7
- services	116.3	116.3	0.0	117.0	117.1	0.1	13.4	13.2	-0.2
Imports, total	928.1	932.6	4.5	937.8	941.9	4.1	18.2	18.6	0.4
- goods	820.2	820.4	0.2	828.7	832.8	4.1	18.9	18.6	-0.3
- services	107.9	112.2	4.3	109.0	109.0	0.0	13.2	17.6	4.2
Net exports total	-22.7	-12.7	10.0	-2.6	-1.1	1.5	n.a.	n.a.	n.a.
- goods	-31.1	-16.8	14.3	-10.7	-9.2	1.5	n.a.	n.a.	n.a.
- services	8.4	4.1	-4.3	8.1	8.1	0.0	n.a.	n.a.	n.a.

Source: Czech Statistical Office

even for the second major factor of economic growth, - investment demand. The December revision has clearly depicted the Q2 2004 as the peak of investment demand growth. The first half of 2004 was a period of extremely strong investment activity due to May change in VAT.

The last revision thus indicates that the economic growth has been registering a slight slowdown in the course of 2004. There is no need to widely describe why it is very important to have a clear picture of the business cycle. Nor is it necessary to stress potential risks stemming from the false data. Monetary policy may serve as an example. In the period of June to August 2004, when two series of basic rates increases were made, the central bankers were led by false idea about the Czech economy being on the upwards trajectory of economic growth. The data indicated that the economic growth in Q1 2004 continued at the same pace of 3.1 % as in Q4 2003. The September revision more than confirmed this optimistic view – the Q1 2004 data were upward revised to 3.5 % and the new Q2 2004 data were even more optimistic indicating acceleration of growth to 4.1 %. However, December data revealed completely different picture of the cycle, with Q1 2004 growth being far behind the dynamics from H2 2003. Anyway, we can only speculate today, whether the new GDP data would have led to the same monetary policy decisions – the January 2005 rate cut indicates that most probably not.

The revision of data has also an impact on GDP forecasts. Before the end of 2004, the

economists were rather surprised by the dichotomy of macroeconomic forecasts of two Czech major institutions – Czech National Bank and Czech Ministry of Finance (see Table 5).

For 2004, CNB October forecast expected further acceleration of economic growth above 4 %, driven especially by strong investment demand (gross fixed capital was expected to grow by double-digit 12 %) and supported by strong demand of households which were expected to increase their expenditures by almost 4 %. The assumptions of Ministry of Finance have been more prudent, with 3.8 % growth of GDP and correspondingly slower growth of major growth factors.

As mentioned above, the area which was affected to a greatest extent by the revisions was the foreign sector. In particular, the growth of exports of goods was significantly upwards revised. Having their forecasts based on the lower data on real exports, both the institutions did not naturally expect the growth of exports above the growth of imports. One of the main messages stemming from revisions is the rapidly improving impact of foreign trade with goods on economic growth. At the same time, the uncertainty about the reasons for the revisions of the deflators in foreign trade (both for 2003 and 2004) represents one of the major risk factors for GDP forecasts.

The latest data from Q1-Q3 2004 show that the less optimistic scenario has been more realistic. The previous CNB assumption of 4 %

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Before the end of 2004, the economists were rather surprised by the dichotomy of macroeconomic forecasts of two Czech major institutions – Czech National Bank and Czech Ministry of Finance

Figure 1: Data Revisions and the Business Cycle (GDP growth in %)

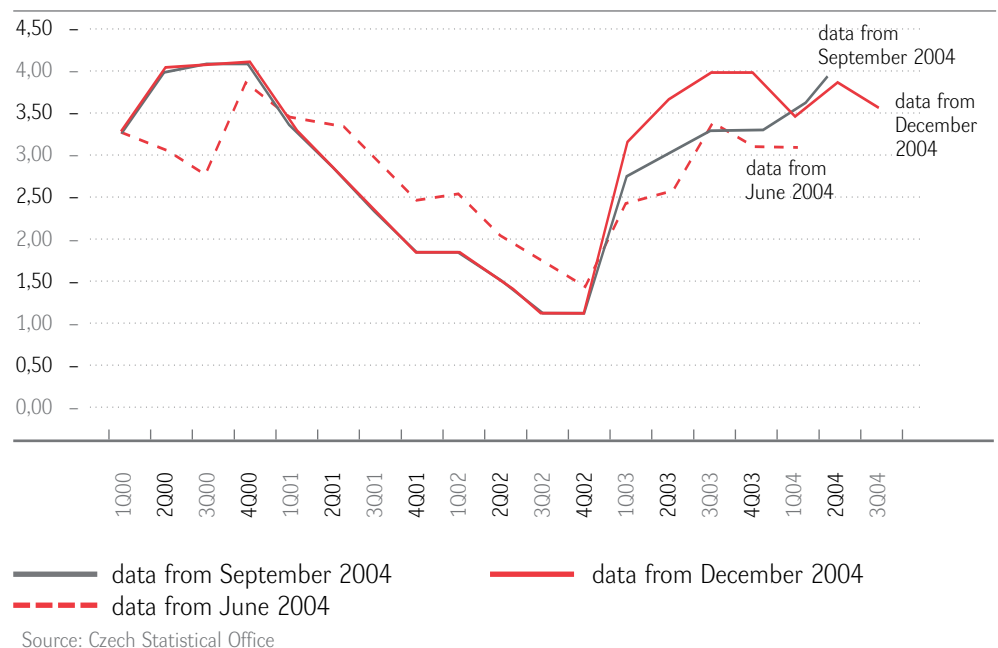


Table 5: GDP Forecasts

(growth rates in %)

	Reality		Forecasts			
	2003	Q1-Q3 2004	2004 MF	2004 CNB*	2005 MF	2005 CNB*
GDP	3.7	3.7	3.8	4.1	3.6	4.5
Consumption of households	4.9	2.6	3.6	3.9	3.4	4.5
Government consumption	4.2	-2.6	-0.2	-0.8	-0.2	0.6
Gross fixed investments	4.8	9.9	9.3	12.0	7.0	9.8
Exports	7.3	19.8	16.5	17.6	11.1	13.7
Imports	7.9	19.0	16.8	17.8	11.1	12.8

Source: Czech Statistical Office, Ministry of Finance, Czech National Bank

* forecast from October 2004

growth of consumption of households seems to be completely unrealistic regarding that the cumulative growth for Q1-Q3 2004 was at 2.6 %. Even though it is possible that consumer demand may slightly accelerate in the last quarter of 2004 and some forthcoming revision may change the Q1-Q3 growth upwards, the consumption of households will not exceed full-year growth of 3.5 % in 2004. The same applies for the investment demand. Although the investment demand has been growing at a very solid pace, the dynamics from the first half of 2004 will not sustain. Therefore, the revision of GDP and its components was

probably one of the reasons why CNB decided to cut down its forecast of GDP 2004 growth to 3.6 %, in January 2005.

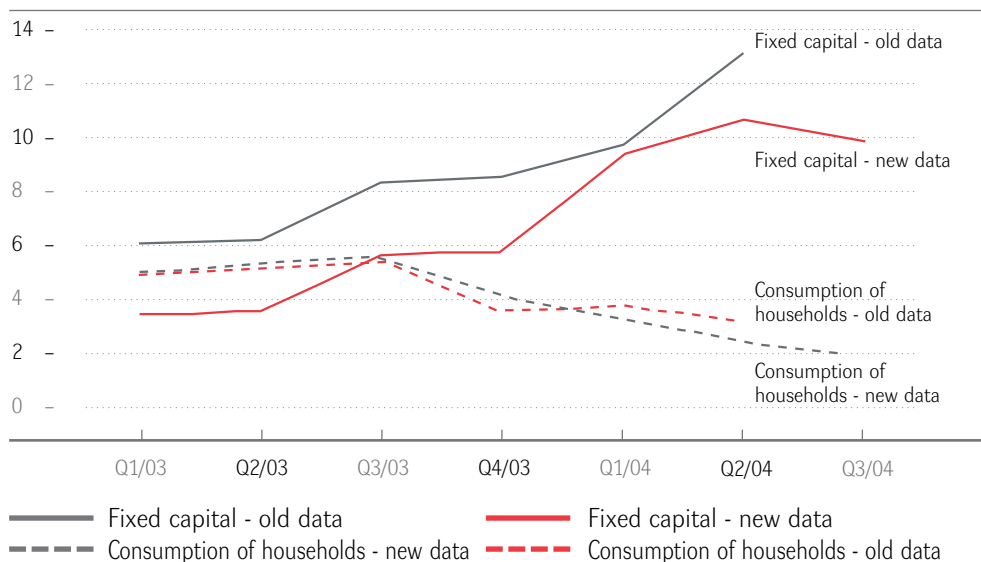
The CNB had to change also its optimistic scenario expecting further acceleration of GDP in 2005. The growth of GDP was expected at 4.5 % driven by further acceleration of households' consumption (4.5 %) and continuously strong investment demand (9.8 %). The January 2005 forecast cut the GDP growth to 3.8 %. At the same, Ministry of Finance increased its 2005 GDP forecast to 3.8 %, leading to unusual consent between these two institutions.

One of the main messages stemming from revisions is the rapidly improving impact of foreign trade with goods on economic growth.

The revision of GDP and its components was probably one of the reasons why CNB decided to cut down its GDP forecast in January 2005.

Figure 2: Revision and Main Growth Factors

(growth rates in %)



Source: Czech Statistical Office

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