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CZECH ECONOMY: A YEAR AFTER THE EU ENTRY

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1. ECONOMIC GROWTH

In the first quarter of 2005, GDP increased by 4.4 %, primarily fuelled by the development of external trade. The increase in the exports of goods (19.5 %) strongly exceeded the growth of imports of goods (13 %). Net trade surplus (CZK 27.3 bill. at average prices of 2004) has been the highest since 1993.

The weakening of consumer demand continued: in the first quarter of 2005, the consumption of households increased by 1.3 %, y/y. This was the weakest figure since the fourth quarter of 1998. Government consumption continued to affect the GDP growth adversely, falling down by 3.8 %. Despite a slowdown, investment demand still kept solid growth of 5.5 %.

On the supply side, trade and services made the biggest contribution to the GDP growth. Gross value added in trade and transport grew by 10.3 %, in financial and commercial services by 6.5 %. Gross value added in industry increased by 2.8 %, in manufacturing by 1.3 %.

The industrial output has been experiencing slowdown since the beginning of 2005. January - April 2005, industrial output rose by 4.4 %, y/y, industrial sales increased by 6.8 %, y/y. Out of three leading manufacturing industries from 2004 (metal, electrotechnics and car industry) only the car industry kept solid growth in 2005, with the output growing by 11 %, January – April 2005. Electronics slowed to an average growth path of the whole industry (with growth of 4.4 %, January to April), while metal industry registered a contraction of 1.6 %. Generally, the world demand for metals declined dramatically, affecting the output and exports of the Czech producers. As new leaders, petrochemical industry and production of selected machinery emerged, not however able to fill the gap provoked by the drop of metal and slowdown in electrotechnics mechanics.

As in the past, growth in industry was supported by exports. The direct export sales rose by favourable 19.3 %, y/y, indicating that the sluggish growth in the eurozone hit the Czech industry only in a limited extent. Both total sales (12.1 %, y/y) and direct export sales (14.7 %, y/y) continued to grow more rapidly in the segment of foreign-controlled companies. The difference in growth of sales between domestic and foreign controlled companies thus was quite low, in April 2005.

The beginning of 2005 was characterised by a statistical compensation of the construction boom from the first four months of 2004 provoked by the expected VAT change. While first four months of 2004 witnessed an extremely high growth of construction output - 30 %, in the same period of 2005 the construction output fell by 14 %. Adjusted for statistical factor, construction output increased by 0.1 %, January to April 2005, confirming that space for growth in construction still exists. The fact that the construction companies continue to hire new employees (employment in construction rose by 4 %, January to April 2005) supports this conclusion.

First months of 2005 confirmed slight recovery in retail trade, retail sales increasing by 3.6 %, January to April 2005. This recovery was driven in particular by the revived car sales. The automotive segment registered an acceleration of sales to 5.7 %. Fuel sales rose by 6.2 %, however, increasing prices of petrol have been gradually hitting the demand. On the other hand, car sales have been recovering continuously since February, increasing by 5.3 %, January to April 2005. Retail trade without the automotive segment registered rather a weak growth of 2.6 %. Food sales continued to keep the long-term trajectory of 3 % (2.9 % January to April). Non-food sales with the growth of 2.4 % (in the first four months of 2005) have been rather weak – consumer demand has been gradually shifting towards services in majority of the Czech households.

2. FOREIGN TRADE AND EXCHANGE RATE

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same time, a slowdown in foreign trade exchange was registered. In all the first five months of 2005, the trade balance ended in surplus. January to May 2005, the trade surplus amounted to CZK 30.5 bill., which has been the best result in the course of existence of the Czech Republic. Because of very favourable development of foreign trade, the first quarter Czech current account ended in a surplus of CZK 14.6 bill.

Slowdown in both exports and imports has been probably a consequence of weaker activity in the Eurozone, in particular in Germany. Also, the impact of strong exchange rate is visible: the growth both of exports and imports in EUR was higher (17.4 %, y/y, and 10.2 %, y/y, respectively).

The slowdown in foreign trade was significant in the EU area. The exports to EU rose by 2.5 %, y/y, the imports fell by 0.6 %,y/y. The trade surplus with EU amounted to CZK 23.1 bill. Sluggish economic growth in Germany (GDP is expected to increase by mere 0.7 %, in 2005) hit the Czech exports to Germany, which declined by 4.4 %, in March 2005. The imports from Germany declined by 3.9 %, y/y, and the trade surplus amounted to CZK 5.6 bill., which was by 0.5 bill. less than a year before.

In Q1 2005, the Czech current account ended with surplus of CZK 14.6 (2.1 % of GDP), which was the first surplus after 43 quarters of continuous deficits. Surplus on the financial account was achieved due to the improvement of trade balance. On the other hand, financial account registered a deficit of CZK 14.9 bill. ((2.2 % of GDP), for the first time since Q4 1997. While the FDI inflow was the same as in Q1 2004 (CZK 28.6 bill.), the deficit was caused by net outflows of portfolio and other investments.

In the first half of 2005, the exchange rate of CZK/EUR oscillated in the very narrow range of 30.3 to 29.8 CZK/EUR (23.0 – 23.8 CZK/USD). It means that the Czech currency slightly appreciated against the EUR and significantly against USD. The appreciation of the Czech currency towards the USD compensated – partially – the strong increase of oil prices registered in the world markets in the first half of 2005. The appreciation of the CZK has been sustainable, as far as the competitiveness of the Czech exports on EU markets, is concerned.

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3. INFLATION

Fundamental inflationary pressures in the Czech economy are still very low. The first half of 2005 was the period of declining inflation: year over year inflation rate reached 1.3 %, in May 2003. Strong competition driven in particular by multinational retail chains helped to absorb the price hikes from the first half of 2004 due to two waves increase of VAT. Moreover, the strong Czech currency keeps import prices under control. Competition acts with higher intensity on the markets with goods. Generally, prices of goods in May 2005 (in yearly comparison) increased by mere 0.3 %, while prices of services grew by 3.0 %. The main item of Czech consumer basket – food prices – registered an under-average growth of 0.2 %, due to competitive pressures combined with extremely good harvest in 2004.

First half of 2005 was also characterized by strong decline of producer prices. In the course of previous seven months, the PPI declined from its record high October 2004 level of 8.6 % y/y, to May 2005 4.0 % y/y. World prices of metals stabilised, while oil prices continued in growth, remaining the only factor pushing the PPI up. Therefore, two main leaders of PPI growth from last year registered slightly different developments: metal production reported a significant slowdown to 11.7 % y/y, while the prices of coke and refined petroleum products stood at 17.2 %, y/y, in May 2005.

Strong contraction of agricultural prices continued as a consequence of excellent harvest in 2004. Prices of agricultural producers were by 15.4 % lower than a year before. Along with the decline of agricultural prices also prices in food industry attenuated – in May 2005, they registered a year over year drop by 0.8 %.

Strong competitive pressures among producers have been attenuating the pass-through of high raw material prices into prices of final production. In May 2005, the prices of inter-mediate products rose by 3.1 % y/y, while the prices of final production reported growth between 1 and 2 % (investment products rose by 1.7 %, y/y, consumer durables by 1.2 %, y/y). Nevertheless, there is a danger of spill-over of increasing energy prices to other segments: prices of energy were by 11.5 % higher than a year before.

In the course of the first half of 2005, the Czech National Bank cut the basic interest rates three times. The first cut came on January 27, another one was realised on March 31. The third cut on April 28, brought the Czech repo rate to 1.75 %. In the course of three months, the repo rate declined by 75 basis points. The main reason seems to be slow growth of CPI which continues to move more and more below the lower band of the CNB's inflation target. At present, the repo rate is by 25 basis points below the ECB's basic rate. The CNB thus seems not to be restrained by the ECB decisions. At the same time, it is clear that the new CNB board will be more aggressive and we can await more changes of the repo rate than in the past.

In the first half of 2005, the 3M PRIBOR – the main interest rate in the business sector – decreased from the average value 2.5 % in January to 1.8 % in May. For the present, the 3M PRIBOR is by 20 basis points below 3M EURIBOR.

4. UNEMPLOYMENT

The first half of 2005 registered moderate improvement of the overall situation on the labour market due to strong economic activity. In particular, a turnover observed in the developments of employment in industry was helpful for the labour market conditions. Employment in manufacturing industries increased by 1.6 %, in the course of the first four months of the year. In May 2004, the unemployment rate stood at 8.6 %, which was by 0.5 percentage points lower than a year before. In addition, the ratio between unemployed and vacancies improved to 8.7, down from 11.7, observed in May 2004.

The data published by the Eurostat for April 2005 indicate quite favourable position of the Czech Republic in international comparison. The Eurostat methodology sets the Czech unemployment rate to 8.2 %, below the EU 25 average of 9.0 %. Within the Visegrad countries, Hungary with 6.6 % still keeps the best position. However, the unemployment rate in Poland and Slovakia is roughly double than the Czech one (18.3 % and 16.0 %, respectively).

5. OUTLOOK

In 2005, we expect the GDP growth around 4 %. The main driving forces will be investment demand and net exports of goods. The trade with services will continue to affect the economic growth adversely. Investment demand will follow a solid growth-path between 5 – 7 %. The domestic demand will moderately recover in the forthcoming quarters, to 2.5 – 3 %. The government will ease its spending in the second half of the year; therefore, government consumption will register full-year stagnation.

Growth of exports will be above the growth of imports, and the improvement of trade

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Table 1: Main Macroeconomic Indicators

		2000	2001	2002	2003	2004	02/05	03/05	04/05	2005F
GDP	%, y/y	3.9	2.6	1.5	3.2	4.4	-	-	-	4.0
Inflation	%, y/y	**3.9**	**4.1**	**0.6**	**1.0**	**2.8**	1.7	1.5	1.6	**2.1**
Inflation	%, m/m	-	-	-	-	-	0.2	-0.1	0.1	-
Industrial prices	%, y/y	**5.0**	**0.8**	**-0.7**	**0.9**	**7.7**	7.1	6.4	5.6	**3.5**
Industrial prices	%, m/m	-	-	-	-	-	0.2	0.2	0.1	-
Unemployment rate*	%, eop.	**8.8**	**8.9**	**9.8**	**10.3**	**9.5**	9.6	9.4	8.9	**9.0**
Industrial production	%, real	5.1	6.8	4.8	5.8	9.9	5.6	0.1	5.7	6.0
Construction output	%, real	**5.3**	**9.6**	**2.5**	**8.9**	**9.7**	3.8	-16.0	-29.5	**2.0**
Retail sales	%, real	4.6	4.3	2.7	5.0	2.5	0.7	3.9	2.7	3.0
State budget	CZK bill.	**-46.1**	**-67.7**	**-45.7**	**-109.1**	**-93.5**	3.7	-4.1	-50.7	**-110**
Trade balance	CZK bill.	-120.8	-119	-71.3	-71.2	-20.6	5.2	8.0	5.1	35
FOREX reserves	USD bill.	**13.1**	**14.8**	**23.7**	**27.0**	**28.4**	27.9	27.5	27.8	**28.0**
PRIBOR 3M	% average	5.36	5.2	3.55	2.3	2.4	2.25	2.08	2.03	2.0
CZK/EUR	Average	**35.6**	**34.1**	**30.81**	**31.84**	**31.9**	29.96	29.78	30.13	**31.0**
CZK/USD	Average	38.6	38.0	32.74	26.32	25.7	23.02	22.58	23.29	23.0

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

*Note: As of July 2004, the unemployment rate is published according to the new methodology balance will continue. The growth rates of both exports and imports will be relatively low in the course of the whole year, also due to high basis for comparison from 2004. In 2005, we expect a full-year trade surplus around CZK 35 bill. However, the current account deficit will improve only slightly from 5.2 % of GDP to 4.5 %, in 2005. The improvement in trade balance will be partly offset by continuous deepening of the deficit on the balance of incomes.

The experience of the three cuts in repo rate between January and April 2005 showed that even a quite aggressive monetary policy of CNB is unable to stop the currency appreciation. CZK will keep the path of slight strengthening against the EUR, appreciating by another 2-4 % in 2005. The main factors of appreciation continue to be good results of exports, low inflation, solid economic growth and ongoing activities of foreign investors. The appreciation of the Czech currency towards USD will be more moderate than during the last year. CNB will keep basic repo rate unchanged in the rest of the year; for this reason, the difference of 25 basis points between Czech repo rate and eurozone's refi rate will persist. The same will be valid for 3M PRIBOR – the main interest rate in the business sector will be below the 3M EURIBOR by roughly 20 basis points.

Growth in industry will continue to be driven by the exports Therefore, along with slowdown of exports, also Czech industry will register a slowdown, in 2005. In 2005, growth in industry will amount to 6 %.

Projects in infrastructure and activities of foreign investors will continue to support construction output. Nevertheless, high statistical basis from the first four months of 2004 will affect the full-year 2005 growth in a notable extent. After a drop in construction output by 14 %, January to April, a recovery is expected in the forthcoming months. However, even under expectation of 5 – 6 % growth path in the rest of the year, the best possible result for 2005 will be a mild growth around 2 %.

We continue to 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 have already registered a recovery, which is expected to continue in the following months. Automotive segment will thus register better results than in 2004. The rest of the retail trade will continue to grow by mid-term dynamics of 3 %, which is also the expected growth of total retail sales in 2005.

The year 2005 is and will be the year of moderate inflation. Competition on the internal market is strong and limits the price increases. Moreover, the strong Czech currency keeps import prices under control. As indicated above, CNB will not change the present level of interest rates until the end of 2005 (or until the first quarter of 2006). For 2005, we expect end-of-year inflation slightly under 2 %, and average inflation in the interval 1.2 to 1.6 %.

While world metal prices stabilised, oil prices remain the main factor pushing the PPI up. On the other hand, competition and strong exchange rate of CZK will compensate – to some degree - the effects of high oil (and gas) prices. We keep our PPI forecast: the year-end level of PPI will amount to 3.5 %.

Solid economic growth will continue to improve the situation on the labour market, though only slowly and moderately. At the end of 2005, we expect the unemployment rate to be around 9 %. At the same time, structural character of Czech unemployment, growth of long-term unemployment and rigidities on the labour market continue to be the main problems of Czech labour market and the whole economy.

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RUSSIA AND EASTERN EUROPE[1]

Kamil Janáček

Present paper will analyze recent economic trends in two types of countries, differing by economic strength, extent of reform, and degree of democracy in the political system: on one side, the group of four new Central-European member countries of the European Union (Poland, Hungary, Slovakia and the Czech Republic); on the other, Russia.

1. FOUR CENTRAL EUROPEAN NEW MEMBER STATES

All the four Central-European new EU members have undergone 15-year long, sometimes very painful, transformation from autocratic state and centrally-planned economy toward democracy and more or less standard market economy. They also succeeded (better to say, they were forced) to re-orient their exports from soft markets of the former Soviet bloc to tough markets of advanced market economies, mainly, the EU-15. Privatization and fast growth of the private sector led to the present situation when more than 80 % of GDP is created in private firms. Getting ready for EU accession, the four countries applied the "acquis communnautaire", and were members of the Single Market since the end of the 1990s. Hence the accession in 2004 brought them no abrupt shock (as some commentators, and politicians, had feared).

Improving economic and political conditions have attracted foreign investors into the Central-European region. Foreign capital participated in privatization of state-owned property (with perhaps the exception of Poland, privatization has now practically been completed). Foreign investors also started numerous greenfield investments, especially after Poland, Hungary and Czech Republic joined NATO in March 1999 (and Slovakia in May 2002); the flow of greenfield investment further increased after EU accession. Measured by FDI per head, Czech Republic is the leader, followed by Hungary, Slovakia and Poland. From an outsider, Slovakia has become the centre of interest of foreign investors in the last three years – mainly in the field of car production.

Of course, the four new EU members have their weak points. Their economic level is much lower than EU-25 average (see Table 1). Catching up, these countries grow two to 2.5 times faster than the Eurozone – but even for the Czech Republic it will take almost two decades to catch up with EU average. Markets in these countries have standard parameters, but they are still fragile. Acquis Communnautaire was taken

[1] Based on paper prepared for ICCBE 2005 Annual Conference, held in Salvador, Brazil, from July 6 to July 9, 2005.

Table 1: Relative Economic Levels of EU Countries in 2004
(GDP per head in PPP, EU-25 = 100)

Ireland	139
Austria	122
Netherlands	120
United Kingdom	119
Sweden	116
Finland	115
France	111
Germany	109
Italy	105
Spain	98
Portugal	73
Czech Republic	72
Hungary	61
Slovakia	52
Poland	47

Source: Eurostat

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over into national legislatures, but the countries are still learning to adopt it in practice. Public administration does not support free enterprise as needed. Legal and institutional environment in all four countries has improved tremendously over the last 15 years - yet generally it can be said that in this field, the lag of these countries behind EU-15 is larger, than in their economic levels. Improved functioning of the institutional and legislative framework is a conditio sine qua non for the needed acceleration of the catch-up process.

POLAND

Although economic growth exceeded 5 % in Poland (see Table 2), the end of 2004 and the start of 2005 were marked by a visible slowdown, mainly due to weaker domestic consumption and exports. Accelerated fixed capital investment could not compensate and avert the slowdown.

Growth slowdown was accompanied by a decrease in inflation, mainly due to food prices. But political uncertainty before elections (and after elections) led the National Bank of Poland to a very prudent policy: in spite of lower inflation, the central bank so far has hesitated to cut the basic interest rate.

The growth slowdown, and the outlook of another highly fragmented Parliament, will make it practically impossible to realize the Government plans to cut the public budgets deficit to 3 % in 2007. Present weak and unpopular Government has no power to push through the needed reforms in the generous social system. Reforms have to wait for the next government, after the election in September 2005.

Unemployment in Poland remains at the level of 19 % (highest among the four Central-European new EU members). Main cause of this structural unemployment lies in an inflexible labour market. The Government is not willing – or able – to start the necessary reforms to increase labour market flexibility and to force the unemployed to seek new jobs more actively.

Out of the four countries discussed, Poland has the largest number of state-owned firms awaiting privatization: examples are BGZ – the agricultural bank, or two of the largest regional energy producers, BOT and PKE. Due to complicated political situation and differing opinions on the speed and form of privatization between the probable future Government coalition partners (right-of-centre Citizen's Platform and Law and Justice Party), privatization will be postponed till 2006 or later.

The need to cut the deficit of public finance will be complicated by the fact that the Citizen's Platform, in case of winning the election, promised to realize a tax reform and to introduce the flat-tax system, on Slovak model. That makes the official program of Eurozone entry in 2009 unfeasible; 2011 looks like a more realistic term.

HUNGARY

Hungarian economic growth was, in 2004, driven mainly by accelerating exports and fixed capital investment. Household demand slowed down due to increased inflation (tax changes connected with EU entry). Permanent problem of Hungarian economy is the high current account deficit, persisting within the interval of 8-9 % of GDP (with a very weak, if any, tendency for improvement). On the other hand, Hungary has by far the lowest unemployment rate among the four discussed countries, although the trend of unemployment has been rising recently.

The original, ambitious Government plan to bring the deficit of public finance below 3 % of GDP till 2006 has been revised and softened both for 2004 and 2005

Table 2: Poland – Main Economic Indicators, 2003-2005

	2003	2004	2005F
GDP (growth in %)	3.7	5.4	3.6
Inflation (average, in %)	0.8	3.5	2.5
Unemployment rate (average, in %)	19.9	19.6	19.0
Current account (as % of GDP)	-1.9	-1.5	-2.5
WIBOR 3M (average)	5.6	6.1	5.5
PLN/EUR (average)	4.4	4.5	4.3
Public budgets (as % of GDP)	-6.2	-6.8	-5.9

Source: Central Statistical Office, National Bank of Poland. Forecasts by Komerční banka.

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Table 3: Hungary – Main Economic Indicators, 2003-2005	2003	2004	2005F
GDP (growth in %)	3.0	4.2	3.4
Inflation (average, in %)	4.7	6.8	4.0
Unemployment rate (average, in %)	5.9	6.0	6.8
Current account (as % of GDP)	-9.2	-8.9	-8.5
HUF/EUR (average)	253.5	251.7	250.0
Public budgets (as % of GDP)	-6.2	-4.5	-4.5

Source: Central Statistical Office, National Bank of Hungary. Forecasts by Komerční banka.

(see Table 3). The weak Government coalition has no power to continue the reform of health-care system and social care, and to start the announced reform of public administration. 2006 being an election year, further pronounced steps in the reform of public finance can only be expected in 2007 (or at the end of 2006). That shifts out the date of eurozone entry to 2010 (or beyond).

National Bank of Hungary, in reaction to the rapidly falling forint, at the start of 2003 increased the basic interest rate to 12.5 %. After the forint stabilized, in March 2004 began a period of gradual rate cuts, 12 in a row, to the present level of 7.25 %. It is evident that after the Bank Council has been extended by six new members, monetary policy is much more oriented on inflation than on defending the exchange rate. Another rate cut below 7 % can be expected for the present year, in response to decreasing inflation.

Growth slowdown within the eurozone has brought down Hungarian exports, and pressed Hungarian GDP growth below 3 % (2.9 % y/y) in the first quarter of 2005. In spite of lower exports, increased fixed capital investment will however keep GDP growth above 3 % for 2005 as a whole.

SLOVAKIA

In the last two years Slovakia has the highest GDP growth rate among the four Central-European new EU members. GDP grew by 5.5 % in 2004, mainly thanks to revived household consumption and continuing acceleration of fixed capital investment. Strong inflow of foreign direct investment (mainly to car production) boosted both investment demand, and imports of capital goods. That, in turn, led to increased deficit of the current account of balance of payments.

Inflation decreased markedly during 2004 and the start of 2005. Appreciating currency was able to compensate to a large extent the growing prices of oil and other raw materials in the world markets. Thus Slovakia will in 2005, for the first time, fulfil the Maastricht limit for inflation.

Far-reaching reforms of financing the health care and social care, a tax reform, and the start of a pension reform have allowed a substantial consolidation of public finance. The deficit of public finance will in all probability fall below 3 % in 2007, making it possible to reach the Government goal of eurozone entry in 2009. Slovakia has done most in stabilizing and reforming the public finance, and is in the best position among the four countries discussed.

Deep, and politically courageous, reforms have not only created conditions for a middle- and long-term stability of public finance; they have also improved the business environment substantially. Tax reform has simplified the tax system, made it transparent, and improved tax compliance. The system of health care financing has been reformed largely. Changes introduced at the end of 2004 have as a target to reduce by one per cent of GDP the health-care deficit by

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Table 4: Slovakia – Main Economic Indicators, 2003-2005	2003	2004	2005F
GDP (growth in %)	4.5	5.5	5.0
Inflation (average, in %)	8.5	7.5	3.0
Unemployment rate (average, in %)	17.4	18.1	16.5
Current account (as % of GDP)	-0.8	-3.5	-4.5
BRIBOR 3M (average)	6.2	4.7	2.7
SKK/EUR (average)	41.5	40.0	38.0
Public budgets (as % of GDP)	-3.7	-3.3	-3.8

Source: Slovak Statistical Office, National Bank of Slovakia. Forecasts by Komerční banka.

2006, reducing excess capacity and limiting the range of services to be covered by government-financed health insurance. Also, the reform introduced small co-payments for patients and tightened the criteria for accessing the health care facilities. Other steps are aimed at lowering the cost, and improving the targeting, of social assistance. The most important change is the linking of unemployment benefits to active job seeking.

The pension reform launched from January 1, 2005, establishes a fully funded second pillar. Participation will be mandatory for all new entrants to the labour market, and voluntary for current workers (except those over 40). The retirement age will be increased gradually till 2015, to 65 for men (from the present 60) and to 60 for women (from 55).

Improved institutional environment, structural reforms and FDI inflows will keep economic growth around 5 % in the medium term, too. Slovak koruna will continue to appreciate, in spite of efforts of the central bank.

Most serious medium-term risks for the Slovak economy are the following:

First, Slovakia has as a "two-speed" economy. Bratislava and western part of Slovakia attract most of the foreign investment and achieve fast growth, while the rest of the country lags behind, is unable to use its economic potential, and has double-digit unemployment rates.

Second, high dependency of industry on the strongly cyclical car production increases the potential for deep fluctuations, in industry and in GDP. Attracting other higher-value-added industries is a priority number one.

Finally, high unemployment persists. Unemployment rate, though decreasing slightly, still remains above 16 – 17 %. Reducing it to, or under, 10 % is a long-term task, requiring a balanced combination of structural policy, increased flexibility of the labour market, better infrastructure, and a substantial reform of the educational system. Failure to solve this problem could become the biggest obstacle of future catch-up.

CZECH REPUBLIC

Czech economic growth speeded up to 4.4 % in 2004 and remained at that level also in the first quarter of 2005. It was boosted mainly by fixed capital investment, and, since the second half of 2004, by exports. Household consumption grew at a lower pace (around 2.5 %).

European Union accession removed the last administrative (and psychological) barriers, and enhanced exports mainly to the EU-15 countries. Trade balance, after decades of permanent deficits, turned to surplus. In the first four months of 2005, trade balance reached the highest surplus in the history of Czech Republic. Dynamic export growth, to a large extent, results from the past inflows of FDI: more than half of Czech industrial exports are produced by firms owned by foreign capital - firms that export more than three quarters of their output.

Inflows of foreign direct investment continue although the privatization has been practically completed (out of large firms, only the electricity company ČEZ remains to be privatized). Along with greenfield investments, foreign investors also show more and more interest in medium-sized and small Czech firms. The outlook for FDI inflows in the medium term is EUR 3-4 bill. per year.

Inflation increased temporarily in 2004, due to two value-added-tax changes (to a large part necessitated by harmonization of Czech VAT with EU rules). Afterwards,

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Table 5: Czech Republic – Main Economic Indicators, 2003-2005

	2003	2004	2005F
GDP (growth in %)	3.2	4.4	4.0
Inflation (average, in %)	0.1	2.8	1.5
Unemployment rate (average, in %)	9.6	9.4	9.0
Current account (as % of GDP)	-6.3	-5.0	-4.5
BRIBOR 3M (average)	2.3	2.4	2.0
CZK/EUR (average)	31.8	31.9	31.0
Public budgets (as % of GDP)	-11.7	- 3.0	-5.5

Source: Czech Statistical Office, Czech National Bank. Forecasts by Komerční banka.

inflation returned again under 2 %, and in all probability it will remain close to 2 % during 2006 and 2007. The Czech National Bank does not see a danger of inflation increase; in 2005 the CNB continued to cut the basic repo rate. At present, the basic repo rate is at 1.75 %, i.e. 25 basis points below that of ECB. As a result, the 3M Pribor has stayed below 3M Euribor since the end of 2004.

A persistent, now already long-term, problem of Czech economic policy lies in the deficits of public finance. The figure for 2004 in Table 5 (deficit of 3 %, fulfilling the Maastricht limit) was a result of "creative accounting": the Government shifted CZK 30 bill. of government budget expenditures, representing 1.2 % of GDP, from 2004 to 2005. Without that manoeuvre, public finance deficit for 2004 would have been 4.2 %.

Worse than the level of deficit, is its persistency. In spite of Convergence Programmes agreed with the EU, Czech government is not able (or willing) to bring the deficit down. Reform of public finance – mainly, reform of the pay-as-you go pension system, and of health care financing – is being repeatedly postponed, now till after the June 2006 election. In contrast to Slovakia, Czech Governments have in the last 7 years not started any real steps in preparation of these reforms (though there was no lack of rhetoric proclamations). In this context, the official goal of bringing the deficit of public finance permanently below 3 % in 2008 - and entering the eurozone in 2010 – is not realistic. The earliest date of eurozone entry is thus shifted to, or beyond, 2011.

2. RUSSIA

According to macroeconomic indicators, Russia is in good economic and financial shape. GDP growth exceeded 7 % in 2003 and 2004, supported both by exports and robust domestic demand. High current account surpluses, fed by growing oil prices, resulted in a fast increase of foreign currency reserves – which today cover one-year imports. Healthier public finance (after the 1998 crisis), and the use of the so-called Stabilization Fund (holding part of oil exports incomes) made it possible for Russia to cut foreign indebtedness of the country.

However, behind this façade of favourable macroeconomic indicators, big weaknesses and structural problems remain hidden. Since the start of this decade, economic growth of Russia is driven by domestic demand, based on export incomes. Between 1999 and 2004, Russian GDP increased cumulatively by 40%, private demand by 50 % and investment by 70 %. Yet 70 % of exports of the Russian Federation consist of oil, natural gas, and metals. This mono-culture structure of exports has not changed in the least over the last decade. Moreover, more than three quarters of fixed capital investment go into raw material (extracting and basic processing) industries. Manufacturing, and high-tech industries, remain strongly underinvested. As a result, the sharp growth of private demand mainly increases imports: Russian manufacturing is not competitive and cannot cope with imported goods of much higher quality. Underinvested manufacturing leads to further lags in technology, and to insufficient renewal of the obsolete capital stock.

Inflows of foreign direct investment to Russia (0.7 % of GDP on average in 2002 – 2004) are totally insufficient, and again are primarily oriented on extracting and basic processing of raw materials. In absolute terms, Russia in the last five years attracted less FDIs than Czech Republic! Diversification of the economy is insufficient, consumer-oriented industries do not profit from the present boom of extracting industries. One reason is that the sector of small- and medium-sized firms, (as core of the consumer-oriented industries) grows very slowly. Small and medium firms have almost no access to bank credit, and more than others suffer from the bureaucratic, and corrupted, public administration.

The Yukos affair has affected very negatively the investment and business climate in Russia. Investors are disquieted, and - in contrast to start of this decade – capital is massively fleeing from Russia. Market-oriented reforms slowed down, or even stopped, after the 2003 parliamentary election and the 2004 presidential election. Plans for deregulating the gas and electricity markets have been postponed. Reform of public administration was stopped, unless one understands under "reform" the permanent increase of powers of the Federal Government. Public administration lacks transparency; it is Byzantine, strongly corrupted – and it forms the strongest lobby preventing liberal, market-oriented reforms.

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Freezing of reforms, together with existing structural weaknesses of the Russian economy, can slow down economic growth significantly, in spite of continuing growth of oil and gas prices in exports. Russian oil industry is on the margin of its capacity, production cannot be increased in the short and medium term. Other industries have low export potential and are also unable to increase it. Hence the Russian economy will be, till the end of this decade, very sensitive to price fluctuations in the world commodity markets, volatility having heavy impacts on Russian business cycle.

In all probability, Russia will not be able to fulfil the goal declared by President Putin in 2003 – namely, to double Russian GDP till 2010. That goal was to assure a rapid increase of living standards of the bulk of the population, with the possibility to solve some sensitive (and explosive) social problems – such as most pensioners living close to subsistence levels. Russia also faces very adverse demographic trends (very low birth rate, decrease of average age – now age of 58 for men, 72 for women). These demographic and social factors can form a substantial barrier for economic growth in the coming decades.

Table 3: Russia – Main Economic Indicators, 2003-2005

	2003	2004	2005F
GDP (growth in %)	7.3	7.1	5.4
Inflation (average, in %)	13.6	11.0	14.5
Unemployment rate (average, in %)	9.3	9.5	9.7
Current account (as % of GDP)	6.7	7.9	5.6
RUB/USD (average)	30.7	28.7	27.8
Public budgets (as % of GDP)	1.7	4.1	2.5

Source: Federal Statistical Office, Central Bank of Russia. Forecasts by Komerční banka.

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FDI IN THE CZECH REPUBLIC: BENEFITS AND COSTS

Eva Zamrazilová

In the today's strongly globalised world, the multinational companies produce approximately one third of world GDP; at the same time, they account for almost one third of total world trade volumes. The share of new EU member countries on total world foreign direct investments (FDI) is low, not exceeding 2 %, however, FDI is a factor of key importance for these economies. The inflow of FDI per capita to the Czech Republic has been one of the highest among newly accessing countries. The total volume of FDI inflow during previous 15 years amounted to almost CZK 1300 bill. At the beginning of the transition process, the inflow of FDI was weak, strengthening since 1998. The purchases of domestic companies were advantageous for the foreign investors after the economic recession in 1997 – 1998. During 1999 – 2002, the inflow of FDI oscillated around 10 % of GDP each year, with a notable weakening in 2003 and slight recovery in 2004 (see Figure 1).

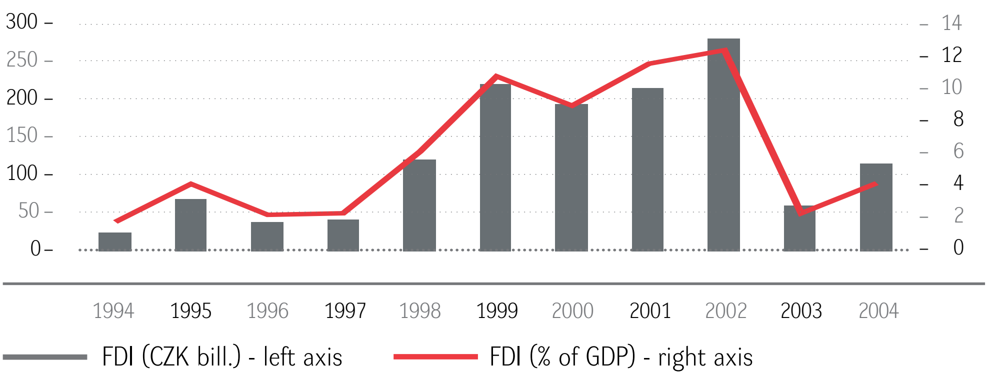
Major part of FDI (about 90 %) came from Western Europe. The most significant investor was the Netherlands with one third of total inflow, followed by Germany (20 %) and Austria (12 %).

Almost one-half of total FDI inflow was oriented to the sector of services, with the most important share of the banking sector due to the privatisation of big Czech banks. In addition, the retail trade registered massive FDI inflows connected with the activities of great multinational retail chains. Manufacturing industries attracted 42 % of total FDI inflow, the leader being automotive industry. Food industry, refining of oil products and metal industry registered the volume of FDI exceeding CZK 50 bill. Foreign investors acquired key position not only in the Czech banking but also in the automotive industry and electrotechnics. In the case of banking and automotive industry, the privatisation played major role in the activities of foreign investors, while in the case of electrical and optical industry, large greenfield projects were carried out.

Growing Importance of Foreign Controlled Sector in Czech Industry and Trade

The segment of foreign controlled companies has been gaining on importance in both the Czech industry and trade. In 2004, foreign controlled companies accounted for 58 % of profit before taxation produced by the Czech industry, for 55 % of value added and for 45 % of total industrial employment. Figure 2 indicates the shares of

Figure 1: Inflow of FDI, 1994-2004



Source: Czech National Bank

Table 1: Structure of FDI Inflow, 1993-2004

	CZK bill.	Share in %
FDI – total	**1276.5**	**100**
Manufacturing industries	**541.8**	**42.4**
- automotive industry	118.7	9.3
Services	**602.0**	**47.1**
- trade	162.6	12.7
- banking and finance	208.2	16.3

Source: Czech National Bank

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The export activity and efficiency of industries with highest FDI inflows from the past (automotive industry, telecommunications and sound-recording equipment, consumer electronics, computer technology) has been gradually increasing.

foreign controlled companies on value added, profit before taxation and employment in the whole manufacturing and eight manufacturing industries (which total for 80 % of production in manufacturing industry). It is obvious that in all cases the shares on value added and profit exceed the shares on employment, indicating higher efficiency and productivity in comparison with the sector of domestic companies. Note that in the automotive industry, production of electrical appliances, food industry, rubber, plastic and paper products, the share of profit generated by foreign controlled companies on profit generated by the respective industry amounts to 80 % and more, confirming again the key position of this sector. Foreign controlled companies have been gaining on importance also in the retail trade. In the sector of big retail (companies above 100 employees), the multinational companies account for 62 % of employment and for 71 % of sales.

Foreign direct investments and consequently the sector of foreign controlled companies have thus a strong impact on the Czech economy, some effects being unanimously positive, some of them less favourable. Among the most significant benefits, the important role in the creation of full-fledged market economy and successful trade integration to the Single EU market may be assigned.

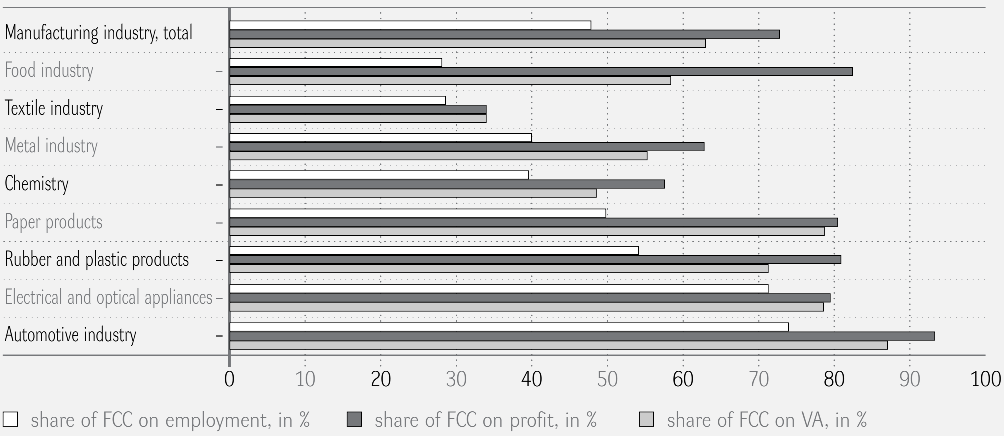
Major Benefits: Restructuring and Export Boom

Let us remind that at the beginning of transformation, the Czech economy was capable to produce goods in a quality and structure demanded on foreign markets to a very limited extent. In the mid-nineties, the EU-15 countries accounted for major share of extensive Czech trade deficits, which threatened the macroeconomic stability of the country. The turning point may be placed to 1999 – 2000: later on, a trade surplus with these economies has been rapidly increasing since 2001 - see Figure 3. In 2004, a trade surplus of CZK 123 bill. was achieved in the trade with the eurozone countries.

The main factor behind the adaptation of Czech trade to developed markets was the strong inflow of FDI. Foreign investors brought not only investments, modern technologies and equipment, but also management skills, marketing techniques, access to developed markets and better adaptation to the changes on the world markets. All these factors contributed to increasing productivity of labour, competitiveness and export efficiency within the sector of foreign controlled companies. Generally, the export activity and efficiency of industries with highest FDI inflows from the past (automotive industry, telecommunications and sound-recording equipment, consumer electronics, computer technology) has been gradually increasing. Car industry, office machinery and data processing machines, telecommunications and sound-recording equipment recorded highest surpluses in trade with the EU-25 in 2004 (CZK 100 bill., CZK 63 bill. and CZK 40 bill., respectively) – all these industries have been almost fully under the foreign control.

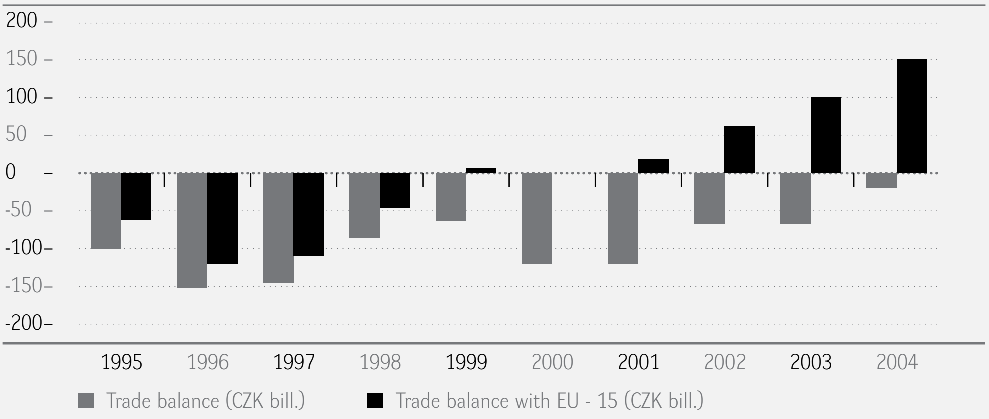
Foreign direct investments have thus direct impact through the channel of foreign controlled sector to domestic economy, such as increasing export efficiency, increasing flexibility of exporters and improving of trade balance. This is because the foreign controlled companies dispose with higher productivity of labour, higher profitability,

Figure 2: Shares of Foreign Controlled Companies on Value Added, Profits and Employment



Source: Ministry of Industry and Trade

Figure 3: Trade Balance with EU - 15, 1995-2004, (CZK bill.)



Source: Czech National Bank

higher investment activity and are strongly export-oriented. Direct export sales account for more than 70 % of their total sales. At the same time, the share of foreign controlled companies on total Czech direct export sales has reached 54 %, in mid-2005.

A question is about the spillovers of FDI to the sector of purely domestic companies. There seem to be doubts in the economic literature about the existence of spillovers, indicating rather vertical effects (positive effects in supplying industries) than horizontal (effects in the same industry) ones. Also in the case of Czech Republic, the contacts of multinationals with their domestic suppliers seemed to lead to upgrading management and technologies in cooperating companies. Generally, also growing competition and improvement of entrepreneurship milieu should not be forgotten. Foreign investors replaced substandard production by world-class products. This catch up in quality has been undoubtedly one of the major progresses of transition, interfering also with the whole restructuring process. Czech economy has thus gone through a very significant change in structure and quality and major part of these changes was driven by foreign direct investments. In addition, foreign investors probably played an important role in reducing the level of inflation in the second half of the nineties.

FDI and Inflation

Though direct exact evidence could not be probably found, it seems probable, that the multinational retail chains have been an important factor preventing demand inflationary pressures. Sophisticated models used by the central bank and other institutions have been expecting the closure of the output gap and emerging demand inflationary pressures as of the second half of 2003. However, the demand inflationary pressures have not emerged ever since, although they should have been the main factor of inflationary pressures in 2005. However, the reality has been different. Which are the reasons behind different behaviour of the inflation models and reality?

The pressures of multinational retail chains on competition have been relatively recent. Therefore, precise assessment of their effects on individual items of the consumer basket is difficult. Having omitted the factor of increasing competition in macroeconomic models may lead to overstatement of the inflation forecasts. At the same time, it is clear, that the FDI played a very important role in the pressing down of the Czech inflation path. Until 1998, the inflation rate oscillated around 10 % and the cut for mere 1 percentage point seemed to be a heroic task and a great success for monetary policy. Since there is a time correlation between the entry of big retail chains to the Czech Republic and a rapid and sustainable decline in the inflation figures, the role of FDI seems undisputable. During 1993 – 1997, the FDI inflow to trade industries amounted to CZK 514 bill., accelerating strongly as of 1998 to CZK 4947 bill. during 1998 – 2004. FDI thus most probably help to keep the inflationary pressures under control.

The Effects of FDI on External Balance

The statement about major contribution of FDI to the consolidation of trade balance seems undeniable. On the other hand, they are also the main reason for continuously high current account deficits, due to increasing deficits on the balance of incomes. While the trade balance was the main negative item of the current account

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While the trade balance was the main negative item of the current account until 2001, the deficit of the balance of incomes has been the major burden of the current account in the last three years.

Table 2: Current Account: Trade Balance and Balance of Incomes

	2000	2001	2002	2003	2004
Current Account (in % of GDP)	**4.9**	**5.4**	**5.6**	**6.3**	**5.2**
Trade Balance (CZK bill.)	-120.8	-116.7	-71.3	-69.8	-22.3
Balance of Incomes (CZK bill.)	-53.0	-83.5	-115.6	-119.9	-139.5
Balance of Incomes: *revenue (CZK bill.)*	*75.4*	*84.9*	*66.8*	*75.5*	*70.2*
Balance of Incomes: *expenditure (CZK bill.)*	*128.4*	*168.4*	*182.4*	*195.4*	*209.7*

Source: Czech National Bank

until 2001, the deficit of the balance of incomes has been the major burden of the current account in the last three years. The main expenditure items of the incomes balance are the reinvestment and repatriation of profits. Czech Republic thus has confirmed the experience of other host countries: the positive impact of FDI on trade balance is accompanied by the negative impact on the balance of incomes – see eg. Brada and Tomšík (2003).

Reinvestments of profits have been exceeding CZK 60 bill., each year since 2002 (they are estimated at CZK 62 bill for 2004) representing thus approximately one third of the expenditure of the incomes balance. However, as for the balance of payments, reinvestments of profits represent a double-entry item. On the financial account, the reinvestments of profits are situated on the credit column. On the current account, they are written on the debit part. Balance of incomes thus represents a sort of feed-back between the current and financial account of the balance of payments. Anyway, the economic interpretation of the reinvestments of profit is rather controversial for there is no real cash flow abroad. Reinvestments of profit thus cause rather an optical increase of the current account deficit not representing essential risk for external stability of the country.

On the other hand, repatriation of profits, namely payment of dividends, represents real cash flow. The volumes of dividends have been quite rapidly increasing – payments of dividends amounted to CZK 65 bill., in 2004, out of which CZK 59 bill. stood for the yields from FDI stock and CZK 6 bill. stood for dividends paid from portfolio investments. The rate of return from FDI has been reaching approximately 10 %. At present, the profit generated by foreign controlled companies seem to be equally distributed between reinvestment and repatriation (as indicate the above-mentioned figures), however, the tendency to repatriation of profits seems to be increasing. Annually, the stockholders decide whether the profit will be reinvested or paid. At the same time, reminding that companies under foreign control account for more than 70 % of profit generated in the Czech manufacturing industry, the outflow of large scope of the profit is not very favourable for domestic economy.

Foreign Direct Investments and the Labour Market

There is a relatively widespread opinion about the positive impact of FDI on employment due to increasing offer of new jobs. However, the reality is somewhat different. The foreign direct investment in the form of acquisitions (direct sales or privatizations) is always connected with fundamental organizational changes leading to the dismissals of employees due to the pressures on profitability and effectiveness. The foreign direct investments in the form of greenfield projects generally create new jobs; however, also in this case the effect on employment is disputable due to several reasons. Foreign investors demand predominantly qualified labour force and not the unqualified jobless, which form major part of Czech unemployment. Almost three quarters of unemployed have only basic (or unfinished secondary) education. If these people were not able to get job under softer criteria of domestic companies, it is not realistic to presume that the more demanding foreign company would employ them. In addition, the entry of foreign investors to industry was accompanied by increasing competition among producers leading to closure of domestic, less effective companies. Generally, foreign direct investments bring new labour saving technologies.

Therefore, the entry of foreign direct investors led to increasing pressures on the labour market. The most severe situation occurred in industry, where the employment was badly hit by the restructuring process led by foreign investors. The restructuring in industry has started to affect the industrial labour market in the second quarter of 2001. The most intensive dismissals were realised in 2002, with the decline of

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unemployment exceeding 50 thousands people. Until the end of 2003, the decline in employment in industry amounted to almost 100 thousands workers. Major part of dismissed labour force was not able to find another job due to low qualification and/or generally low flexibility. Therefore, the inflow of foreign direct investments led to the increase of long-term unemployment. The share of long-term unemployment oscillated around 20 % until 1997, which was a very favourable figure in comparison with developed West European countries. However, the long-term unemployment was rapidly increasing in the following years, amounting to approximately 50 % at present. According to the Czech Statistical Office, the duration of the unemployment exceeding two years represents 30 % of total unemployment. At the same time, the companies willing to hire new labour force are often not able to find workers with appropriate skills. The restructuring has thus revealed predominantly structural weaknesses of the Czech labour market.

Concluding Remarks

Foreign direct investments played an important role in the transition towards full-fledged market economy. Foreign investors have been the leaders of the restructuring processes on the supply side of the economy, in particular in the Czech industry. Czech economy did not avoid the risk of emergence of „dual economy", however, some spillover effects seem to emerge. In particular, vertical spillover effects from the contacts of foreign companies with their domestic suppliers have positive effects on the domestic economy. Total restructuring of the supply side helped the Czech economy to grow on solid background with sustainable solid growth as of 2000. However, similar to other host countries, the inflow of FDI had also some less positive impacts on the Czech economy.

There appeared a rather paradoxical influence of FDI on external balance. On the one hand, FDI strongly contributed to the consolidation of the trade balance, which registered a turnover to the black, in the beginning of 2005. On the other hand, FDI are the main factor behind preserving deficits of the current account above 5 % of GDP due to increasing reinvestments and repatriations of profits. At the same time, it is undisputable that these repatriations and reinvestments will continue to be a strong expenditure burden of the current account in the future. Experience of other host countries indicates that the repatriations of profits will probably exceed the level of FDI inflow.

Modernization and restructuring led by foreign investors revealed strong weaknesses of the labour market. With a time lag of several years, restructuring discovered the facts that have not been generally recognized at the beginning of transformation – namely that the Czech labour market is inflexible and the qualification of significant part of Czech labour force does not correspond with the demands of modern market economy.

The restructuring has thus revealed predominantly structural weaknesses of the Czech labour market.

Foreign direct investments played an important role in the transition towards full-fledged market economy.

Total restructuring of the supply side helped the Czech economy to grow on solid background with sustainable solid growth as of 2000.

On the one hand, FDI strongly contributed to the consolidation of the trade balance, on the other hand, FDI are the main factor behind preserving deficits of the current account above 5 % of GDP due to increasing reinvestments and repatriations of profits.

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