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CZECH ECONOMY IN 2005: SOLID ECONOMIC GROWTH CONTINUES

Kamil Janáček, Eva Zamrazilová

1. ECONOMIC GROWTH

In the second quarter of 2005, gross domestic product increased by 5.1 %, y/y, after revised growth of 4.7 %, y/y in the first quarter. The GDP growth was primarily fuelled by the development of external trade. The exports of goods rose by 7.6 %, y/y, while the imports stagnated. Trade balance surplus in constant prices reached CZK 24.6 bill. Second quarter of 2005 registered a revival of consumer demand: the consumption of households increased by 2.1 %, y/y. Government consumption grew by 0.9 %, y/y. Fixed capital investment grew by 2.3 %, y/y, due to growth of investments in machines and technology. Construction investment decreased, but highly due to statistical reasons – was affected by high base from 2004 due to VAT changes.

In the first half of 2005, GDP grew by 4.9 %, y/y. Household consumption increased by 1.9 %, y/y, government consumption fell by 1.2 %, y/y. Fixed capital investment registered a growth of 2.6 %. Exports (goods and services) grew by 11.9 %, imports by 4.7 %. On the supply side, the share of services on GDP is slightly above 60 %, the share of industry remaining high (33 %). Retail and wholesale trade registered highest growth, with gross value added increasing by 23.7 %, y/y, financial and commercial services rose by significant 12.9 %, y/y. Gross value added in industry increased by 2.5 %, y/y, in manufacturing by 1.7 %.

The industrial output was experiencing slowdown since the beginning of 2005, with an improvement in July and August. January to August 2005, industrial output rose by 5.6 %, y/y, industrial sales increased by 7.3 %, y/y. Slowdown in industry, along with slowdown of exports, has been a consequence of weak economic activity in the eurozone, in particular in Germany – Czech major trading partner.

Structure of growth somewhat changed in

comparison with last year. 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 14.7 %, January – August 2005. Electrotechnics rose by 3.7 %, y/y, metal industry fell by 4.9 %, y/y. Having in mind that the share of metal industry on industrial output exceeds 15 %, its drop had quite a strong adverse effect on total industrial growth. New leaders emerged in industry in 2005, special machinery, refined oil products and production of plastics – with growth of 15.0 %, 17.9 % and 10.7 %, y/y, respectively.

Intermediate products, accounting for major part of industrial production (40 %) registered highest growth of 8.1 %, y/y, January – August 2005. Investment goods increased by mere 2.1 %, y/y and consumer goods by 2.3 %. Direct export sales increased by solid 10.9 %, y/y. Companies under foreign control registered above average growth of direct export sales, the share of foreign controlled companies on industrial sales further increasing to 54.2 %.

January – August 2005, the construction output grew by 1.0. However, statistical results in 2005 do not tell much about the real growth being still affected by the up and downs due to May 2004 change of VAT. January – August slow growth was strongly influenced by high reference base for comparison. The fluctuations of the growth rates will stabilise as of August 2005, which was the first month, when the May 2004 change of VAT should not affect the statistical results.

Rapid growth of mortgage market continues: total volume of mortgages granted to Czech households exceeded CZK 150 bill. in July 2005, year over year growth reaching 45 %. Housing construction will not probably weaken until final decision about the VAT rate – for the time being the effective date for the VAT rate increase (from 5 to 19 %) is January 2008.

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In 2005, the improvement of trade balance continued.

January to August, 2005, the trade surplus amounted to CZK 41.3 bill. Czech exports are driven in particular by machinery exports; trade with machinery registered a record high surplus of CZK 143.3 bill.

Financial account revealed a surplus of CZK 90.4 bill., in the first half of 2005. Strong net FDI inflow 168.2 was positively influenced by privatisation sales of Telecom and Unipetrol (more than CZK 90 bill.). In addition, green-field projects continued.

January to August 2005, retail sales rose by 4.2 %, y/y, which is a significant acceleration against the same period of last year (1.9 %, y/y). This recovery was driven in particular by the revived car sales as of February 2005: January to August 2005, car sales and repairs rose by 6.2 %, y/y. Retail trade without the automotive segment registered a growth of 3.3 %, which fully corresponds to long-term trajectory. Food sales rose by 2.9 %, non-food sales increased by 3.7 %, y/y. Non-food sales have been pulled in particular by clothing, footwear and domestic appliances, with sales promoted by price policy of big retail chains – e.g., clothing and footwear prices were by 5.5 % lower than a year before, in August 2005. Anyway, domestic demand has been gradually shifting towards services in majority of the Czech households. In addition, growth of mortgages has an adverse effect on spending on consumer durables.

2. FOREIGN TRADE AND EXCHANGE RATE

In 2005, the improvement of trade balance continued. In all the first seven months of 2005, the trade balance ended in surplus; August registered a small deficit due to one-off increase in imports (military aircrafts). January to August, 2005, the trade surplus amounted to CZK 41.3 bill. Czech exports are driven in particular by machinery exports; trade with machinery registered a record high surplus of CZK 143.3 bill. High world oil and gas prices have a negative impact on the Czech trade balance. In the first eight months, this deficit was at CZK 64.9 bill., which is a deterioration of CZK 22.5 bill. against last year.

In spite of weak demand in "old" EU countries, the trade with EU produces growing surpluses. In the first eight months of 2005, the trade surplus with EU amounted to CZK 191.4 bill, which is an improvement of CZK 43.2 bill. in comparison with the same period of last year. The trade surplus with Germany – Czech major trading partner increased, too, reaching CZK 55.5 bill.

In the first half of 2005, the Czech current account ended in a deficit of CZK 11.3 bill. (0.8 % of GDP), which is a significant

improvement. Under the positive trade balance, the deficit of the current account is fuelled by the deficits on the balance of incomes. The balance of incomes registered a deficit of CZK 77.8 bill., in the first half of the year, which is a deterioration of CZK 22.5 bill. in comparison with the first half of 2004. Czech Republic fully confirmed the experience of other countries with strong FDI inflows: the positive impact on exports and trade balance is accompanied by negative impact on the balance of incomes due to increasing reinvestments and repatriations of profits.

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In the first three quarters of 2005, the exchange rate of CZK/EUR oscillated in a narrow range of 29.3 to 30.3 CZK/EUR (23.0 – 25.0 CZK/USD). It means that the Czech currency continued in slight appreciation both against the EUR and significantly against USD. The exporters got used to live under the strong currency and the competitiveness of the Czech exports on the EU markets did not deteriorate.

3. INFLATION

At the end of the third quarter, headline inflation stood at 2.2 %, year over year. The average inflation in the last twelve months increased by 2.0 %. Consumer prices have continued to be affected by favourable developments of food prices, which declined by 0.3 %, y/y. On the other hand, transport prices registered significant growth of 6.8 %, y/y, due to the oil and gas prices hike. Petrol prices were by 21.6 % higher than a year before, gas prices increased by 14.7 %.

Cost inflationary pressures affect predominantly the prices of services, which grew by 3.6 %, y/y, while competitive pressures press down prices of goods, which

rose by 1.4 %, y/y. The inflation in the Czech economy is under the inflation in the eurozone: Czech harmonised index of consumer prices was at 2.0 %, y/y, while the estimate for eurozone reached 2.6 %, y/y, in September 2005.

In spite of high world oil and gas prices, year over year slowdown of PPI continued by a very rapid pace. In the course of previous ten months, PPI declined from October peak of 8.6 % y/y, to September 1.0 % y/y. The spill-over of high world oil prices to domestic PPI has been prevented by strong CZK and strong competitive pressures in the domestic economy.

Overall slowdown of PPI was also supported by the decline of prices in food industry (which accounts for 21 % of total PPI). PPI in food industry declined by 2.3 %, y/y, driven by the decline of agricultural prices (by 6.7 %, y/y) and strong pressures on food prices provoked by international retail chains. Strong competition has been pressing down also the prices of electronics and cars. Due to stabilisation of world metal prices, also prices

in metal industry started to decline. Therefore, for the time being, high world oil prices affect merely the PPI of coke and refined petroleum products, which reported a growth of 16.4 %, y/y, in September 2005. In addition, the prices of electricity, gas and water kept high growth of 7.4 %, y/y, in particular due to the increase of world gas prices.

In the last six months, the Czech National Bank kept the repo rate at 1.75 %, i.e. 25 bases points below the refi rate of ECB. CNB now is closely watching the inflation development and the (in)activity of the ECB. It is clear that the possible future changes will be influenced by these two factors, nevertheless, it is highly improbable that the CNB will increase the basic rates until the end of the 2005.

After a rapid decline from January to May 2005, the 3M PRIBOR – the main interest rate in the business sector – keeps moving in a very narrow range around 1.8 %. The 3M PRIBOR thus continues to stay by 25 basis points below 3M EURIBOR.

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Table 1: Main Macroeconomic Indicators

		2000	2001	2002	2003	2004	06/05	07/05	08/05	2005F
GDP	%, y/y	3.9	2.6	1.5	3.2	4.4	-	-	-	4.5
Inflation	%, y/y	3.9	4.1	0.6	1.0	2.8	1.8	1.7	1.7	3.0
Inflation	%, m/m	-	-	-	-	-	0.6	0.3	0.0	-
Industrial prices	%, y/y	5.0	0.8	-0.7	0.9	7.7	2.7	2.0	1.1	2.0
Industrial prices	%, m/m	-	-	-	-	-	-0.2	0.1	0.0	-
Unemployment rate*	%, eop.	8.8	8.9	9.8	10.3	9.5	8.6	8.8	8.9	9.0
Industrial production	%, real	5.1	6.8	4.8	5.8	9.9	3.7	11.2	8.6	6.0
Construction output	%, real	5.3	9.6	2.5	8.9	9.7	19.0	6.1	6.7	3.5
Retail sales	%, real	4.6	4.3	2.7	5.0	2.5	4.4	1.6	6.3	4.0
State budget	CZK bill.	-46.1	-67.7	-45.7	-109.1	-93.5	6.8	10.3	10.0	-70
Trade balance	CZK bill.	-120.8	-119	-71.3	-71.2	-20.6	6.5	1.2	-1.9	50
FOREX reserves	USD bill.	13.1	14.8	23.7	27.0	28.4	30.1	29.9	30.2	29.0
PRIBOR 3M	% average	5.36	5.2	3.55	2.3	2.4	1.75	1.78	1.79	1.9
CZK/EUR	Average	35.6	34.1	30.81	31.84	31.9	30.03	30.19	29.59	30.0
CZK/USD	Average	38.6	38.0	32.74	26.32	25.7	25.05	24.07	23.90	24.0

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

4. UNEMPLOYMENT

In the first three quarters of 2005, Czech labour market continued to follow the mid-term tendency of moderate improvement corresponding to strong economic activity and the favourable phase of the business cycle. At the end of September 2005, unemployment rate stood at 8.8 %, which represents a small improvement (0.3 percentage point) in comparison with the same period of last year. However, serious structural and regional weaknesses of the labour market have not improved yet and the improvement is relatively slow, regarding the economic growth rate around 5 % and favourable demographic conditions. The inflow of graduates entering the labour market has been weaker than in previous years, while the strong post-war cohorts retire. Czech National Bank considers the low flexibility of Czech labour market as one of the major obstacles for the adoption of Euro.

The data published by the Eurostat for August sets the harmonised Czech unemployment rate (7.7 %) below the EU-25 average of 8.6 %. Within the Visegrad countries, Hungary with 6.2 % still keeps the best position. However, the unemployment rate in Poland and Slovakia is roughly double than the Czech one (17.2 % and 14.7 %, respectively). On the other hand, Greece (10.4 %), Germany (9.7 %), France (9.5 %), Spain (9.3 %) and Belgium (8.4 %) are the only "old" EU countries with the rate of unemployment higher than the Czech one.

5. OUTLOOK

In 2005, the GDP growth will amount to approximately 4.5 %. The main driving force will remain net exports of goods. Investment demand will continue in slowdown, with full-year growth not exceeding 3 %. In the second half of 2005, private consumption will continue in moderate recovery up to 3 %, therefore, consumption of households will increase by 2.5 %. The government will ease its spending in the second half of the year,

government consumption will thus register year over year stagnation, in 2005.

Growth of exports will keep above the growth of imports, therefore the improvement of trade balance will continue. The growth rates of both exports and imports will be relatively low in the rest of the whole year, also due to high basis for comparison from 2004. For 2005, we expect a full-year trade surplus around CZK 50 bill. The current account deficit will therefore considerably improve, declining to 3.5 % of GDP, down from 5.2 % of GDP observed in 2004.

Even after acceleration observed in the third quarter of 2005, the full-year growth in industry will be lower than last year. Weak economic activity in the eurozone, in particular in Germany, will hinder industrial activity and exports in the forthcoming months. The full-year 2005 growth in industry will be around 6 %.

Government projects in infrastructure will continue, as well as new projects of foreign investors. Construction continues to hire new workers, which confirms that the expectations of the construction companies are positive. After January to August average growth of mere 1 % (due to the statistical effects of May 2004 of VAT), the rest of 2005 will most probably register an average growth between 6 - 7 %. The full-year 2005 growth in construction will thus reach 3 - 4 %.

The growth in retail trade in 2005 will be strongly above the 2004 figure. Improvement has been caused by the recovery of car sales. Food and consumer durables will keep the long-term growth path of approximately 3 %. Automotive segment will register a growth about approximately 5 %. The full-year 2005 growth of retail sales will amount to 3.5 - 4 %.

In the last quarter of 2005, the prices of oil and price increase of gas for households will push CPI up. The spill-over of the oil prices hike will affect the prices of transport. Therefore, the year-end level of 2005 CPI will stand at 3.0 % and average inflation will reach approximately 2 %.

At the end of September 2005, unemployment rate stood at 8.8 %, which represents a small improvement (0.3 percentage point) in comparison with the same period of last year. However, serious structural and regional weaknesses of the labour market have not improved yet and the improvement is relatively slow, regarding the economic growth rate around 5 % and favourable demographic conditions.

In 2005, the GDP growth will amount to approximately 4.5 %. The main driving force will remain net exports of goods. Investment demand will continue in slowdown, with full-year growth not exceeding 3 %.

Even after acceleration observed in the third quarter of 2005, the full-year growth in industry will be lower than last year. Weak economic activity in the eurozone, in particular in Germany will hinder industrial activity and exports in the forthcoming months. The full-year 2005 growth in industry will be around 6 %.

While world metal prices stabilised, oil and gas 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. Anyway, the PPI in December 2005 - expected at 2 %, y/y, - will be considerably lower than a year before.

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 %, which will be a slight improvement in comparison with 9.3 % observed at the end of 2004. However, long-term unemployment will continue to increase. At the same time, structural and regional problems of the Czech labour market continue to be the main challenge for the government policy.

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OIL PRICES AND WORLD ECONOMY

Kamil Janáček

Persistent growth of oil prices, which started in mid-2003 and accelerated in 2005, naturally leads to the question of the impact of high oil prices on economic growth in global view. Recently, hurricanes in the Mexico Bay, as well as some other events (instability in Iraq) have made the oil markets even more nervous. In any case, it is clear that forecasts made at the start of 2005, expecting the oil price to move within the interval of USD 44-48 per barrel, have been beaten by reality in the second and third quarters of 2005.

Factors of Oil Price Increase

The price of oil which was around USD 30 per barrel in mid-2003 is now double. What are the factors behind the more-or-less permanent increase?

First, demand for oil is high and growing, owing to the relatively fast growth of world economy. World economic growth reached almost 4 % in 2003, more than 5 % in 2004, and this year the growth will also be above 4 % (see Table 1). Mainly, the rapidly increased demand by China and India (estimated at 1.5 million barrels per day) driven by their fast economic growth, is pushing oil prices up.

Second, the market is more and more influenced by insufficient refining capacity. While the oil-producing countries are still able to increase output (though in a limited extent), refineries now working at full capacity are unable to process any additional supply. Moreover, especially in Europe there is lack of refineries able to process the so-called

heavy oil. Low investment into modernization of refineries in the last years has caused a "technological bottleneck" which can only be overcome after several quarters. This technological problem is also the cause why the present situation is worse for Europe, than for USA or other countries outside Europe.

And, third, also the short-time "supply shock" caused mainly by hurricanes in the Mexico Bay has pushed oil prices up. However, this factor is really short-term and it has a tendency to recede since the start of October 2005.

A Third Oil Crisis Started?

Some journalists (and some economists fond of disasters) predict that the present situation will result in a third global oil crisis, similar to those of 1973 and 1982. Are these predictions justified? There are several reasons leading to a conclusion that, most probably, they are not:

1) In the 1970s and 1980s, crises were caused by a sudden supply shock, that is, by an immediate reduction of supply by the oil-producing countries of OPEC. Reasons for the sharp reduction were political, not caused by lack of oil or by interruption of supply due to some natural disaster. The world economy could not be prepared for this type of shock, and it resulted in an abrupt slowdown of economic growth, going hand-in-hand with substantially increased inflation (stagflation).

Presently, growing prices are primarily

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The market is more and more influenced by insufficient refining capacity. While the oil-producing countries are still able to increase output, refineries now working at full capacity are unable to process any additional supply.

Table 1: World Economy in 2004–2006
(GDP Growth in %)

	2004	2005F	2006F
USA	4.2	3.5	3.3
Eurozone	2.0	1.2	1.8
- Germany	1.6	0.8	1.2
- France	2.1	1.5	1.8
- Italy	1.2	0.0	1.4
- Spain	3.1	3.2	3.0
UK	3.2	1.9	2.2
Japan	2.7	2.0	2.0
Canada	2.9	2.9	3.2
China	9.5	9.0	8.2
India	7.3	7.1	6.3
World Economy	5.1	4.3	4.3

Source: IMF

pulled by high demand, and the price increase has already gone on for two years. Economies of the oil-importing countries had time to adapt to this situation – and they have adapted. So far, higher oil prices have been "absorbed" without causing a shock and an abrupt fall of world economic growth.

2) While in the Seventies and Eighties of the last century oil, and trade with oil products, represented 8 % of world GDP, presently it is roughly 2 %. Growth of oil prices in the last decades has stimulated technological progress, oil-saving technologies and replacement of oil by other resources. Hence, for example, a doubling of oil prices today has four times lower impact on world economic growth than a quarter century ago.

3) It is also to be mentioned that the present oil price – around USD 62 per barrel – is in real terms lower, than the price of oil in the Seventies.

No shock is to be expected, either, from a fall (or slowdown) of the U.S. economy due to the combination of high oil prices with the impact of hurricane Katrina. The states Mississippi and Louisiana, hit by the hurricane, represent 2% of U.S. GDP. In the short time, the standstill of refineries and other production, and the sudden unemployment of 400 thousand people, will slow U.S. economic growth in the third and fourth quarters of 2005. However, in the medium term, more than USD 100 billion of federal aid to the hit areas, and USD 50 billion of receipts from insurance, will mean a strong demand stimulus for the U.S. economy. It can be expected that 2006 growth will reach about 3.5 % (some American economists say 3.5 – 4 %). Forecast of the IMF (see Table 1) thus is rather conservative, and represents the bottom end of the predictions interval.

We may conclude that there are no serious reasons to regard the present situation in the oil market a "third oil shock".

Growth of Oil Price and the Czech Economy

For the Czech economy – small and very open, with exports and imports combined representing over 130 % of GDP – the increase

in oil prices, and the situation in the world economy, are strong determinants of domestic growth.

The impact of oil price increase on the Czech economy is double: a) direct, through the effect on domestic prices; b) indirect, through the slowing effect on other - mainly Eurozone – economies, with the result that export opportunities for Czech firms shrink.

With regard to the first impact, Table 2 demonstrates that in 2005 and 2006, the main reason for inflation staying at the 2.5 – 3 % levels will be the oil prices (and their spillover to prices of other goods and services on the Czech market). This represents an important change against the year 2004, when the 2.8 % inflation (both average and end-of-year) was mainly caused by two increases in the VAT, obligatory before the European Union accession.

Evaluation of the indirect impact is more difficult, yet feasible. The 24 European Union countries have 85 % share in Czech exports, the Eurozone roughly a two-thirds share. Moreover, the three slowest-growing EU countries (Germany, Italy and France) have a combined share of about 45 %. As data in Table 1 show, high oil prices have a substantially bigger impact on economic growth of the Eurozone, than on that of USA, Canada, China and India. This is due to structural rigidities and low flexibility of the Eurozone economies. Sluggish (and lower-than-potential) growth in the Eurozone will in the coming years hinder the growth of Czech exports, and pull down Czech economic growth below the potential, too. The will to push through reforms making the economy more flexible is weak in the EU (especially in the core countries of Eurozone). One cannot expect that the Eurozone could reach a growth trajectory of 2.5 – 3.0 % in the coming two or three years. That will negatively influence Czech economic growth.

In empirical terms, the negative impact of rising oil prices (both direct and indirect) on the Czech economy can be estimated as a loss of economic growth in the extent of 0.2 – 0.4 percentage points.

While in the Seventies and Eighties of the last century oil, and trade with oil products, represented 8 % of world GDP, presently it is roughly 2 %. Growth of oil prices in the last decades has stimulated technological progress, oil-saving technologies and replacement of oil by other resources. Hence, for example, a doubling of oil prices today has four times lower impact on world economic growth than a quarter century ago.

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In empirical terms, the negative impact of rising oil prices (both direct and indirect) on the Czech economy can be estimated as a loss of economic growth in the extent of 0.2 – 0.4 percentage points.

Table 2: Economic Growth and Inflation (in %)

	2004	2005F	2006F
GDP (constant prices)	4.4	4.5	4.2
Inflation (average)	2.8	2.0	2.5 - 3.0
Inflation (end of period)	2.8	3.0	2.5 - 3.0

Source: Czech Statistical Office; forecasts by Komerční banka

CZECH TRADE BALANCE IN 2005: UNEXPECTED IMPROVEMENT

Eva Zamrazilová

In spring 2005, majority of Czech analysts strongly understated the forecasts of the developments of the trade balance. The consensual forecast of 19 analytical teams expected the full-year 2005 trade result as roughly balanced. Forecasts ranged from CZK – 30 bill. to CZK +30 bill. The upper range of the interval was represented by the forecasts of KB and ABN AMRO. Nowadays it seems, that the full-year result will be almost double than the highest spring estimates. Therefore, a question arises, which were the factors behind the unexpectedly favourable developments of trade balance in 2005.

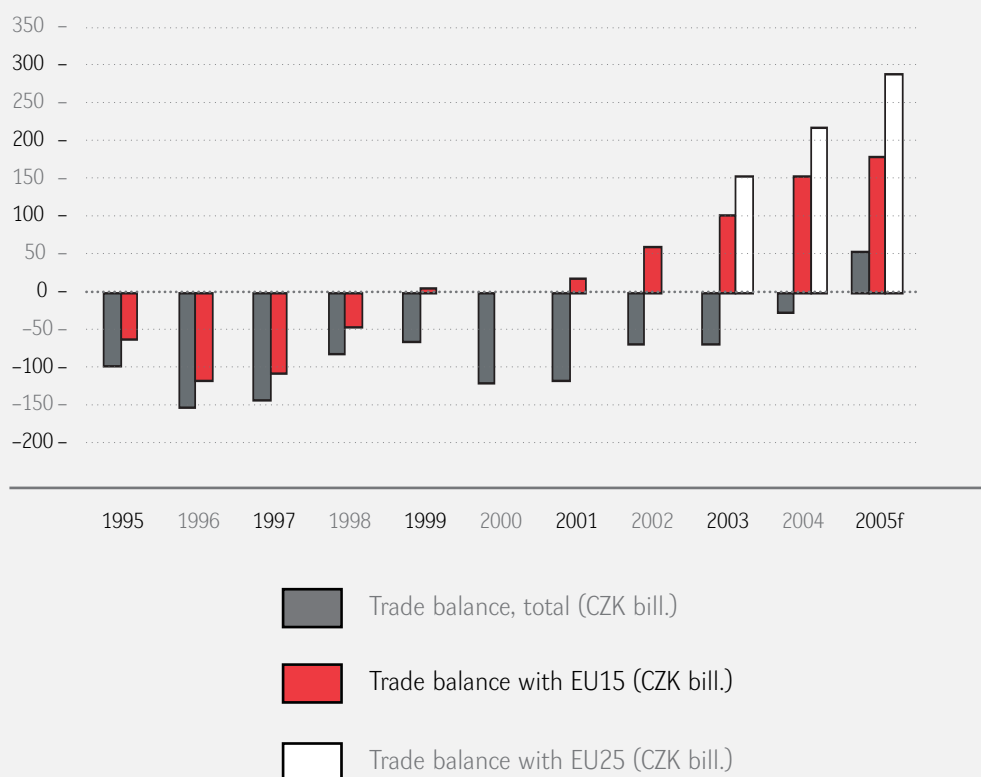
It is clear that there was a change in trend in the development of Czech trade balance. To capture the change in trend or to distinguish between a long term upturn and usual short-term fluctuation is the crucial and most difficult part of forecasting activity. For this reason, it is important to specify the moment

of the upturn in the development of the trade balance as well as to reveal its reasons.

The improvement of trade balance within the last decade was significant and most visible with the EU area – see Figure 1. The EU 15 was the major source of trade deficits in the second half of the Nineties. The trade deficit in the Nineties was generated by massive growth of imports, in particular from the West Europe. The economic growth in the first stage of post-transformation recovery was driven by strong domestic demand, which could not be satisfied by obsolete supply side of the Czech economy and thus provoked massive imports. This led to massive trade deficits, which threatened the macroeconomic stability of the country.

Price for the consolidation of the external disequilibrium was very high: deep economic recession in 1997 – 1998, with the renewal

Figure 1: Trade Balance, Total and with EU, 1995–2005



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Source: Czech Statistical Office

of growth only in 2000. Even in 2000, there arose concerns whether the re-emergence of economic growth will not lead to new round of external imbalance. These fears did not realise and the trade balance has started to improve slowly, this improvement being more intensive in the EU area. Nowadays, the economic growth over 4 % is accompanied by the improvement of trade balance.

When and Why Did the Improvement Start?

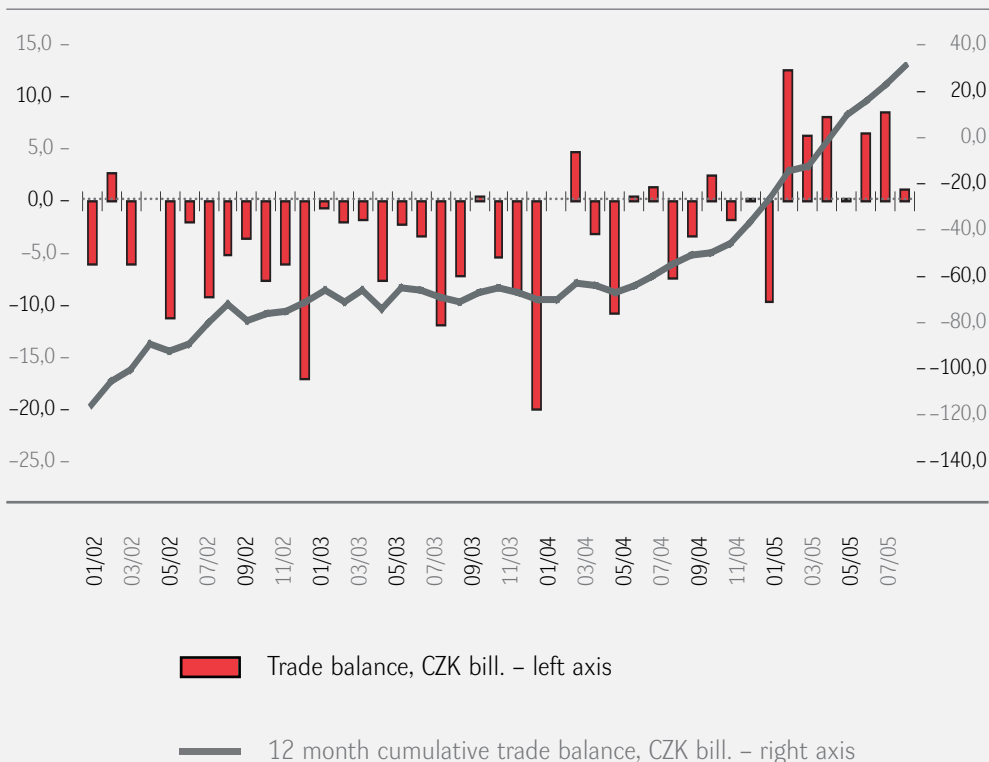
It is obvious that the improvement of the trade balance was only slow and hesitating in 2002 and 2003. The year 2004 seems to be the year of turnover in the trade balance developments. Figure 2 shows that the rapid improvement of the trade balance may be situated to the second quarter of 2004. The exports have started to grow more rapidly than the imports and the cumulative 12 months deficit has been improving significantly as of the second quarter of 2004. Higher dynamics of exports in comparison with the imports or in other words declining import intensity of exports is the key factor behind continuing improvement of the trade balance. The

growth rates of exports have exceeded the growth rates of imports as of May 2004 – this is for 16 consecutive months. At the same time, the year over year improvement of trade balance figures for individual months has continued for 16 consecutive months. The trade balance improvement (in year over year comparison) continues in spite of slower rates of growth in foreign trade. Along with slowdown of exports, the slowdown of imports is even more intensive, so that the trade balance continues to improve – see Figures 2 and 3.

To summarize the above-mentioned facts: long-term step-by-step improvement of the trade balance observable in recent years (and more pronounced in the EU area), accelerated in the second quarter of 2004. Which were the factors behind this improvement?

The exports strongly accelerated after the EU accession. The exports increased by 16.3 %, January to April 2004, accelerating to 27.4 %, May to December. The imports increased by 20.8 %, May to December, after growth of 15.8 %, January to April 2004. The

Figure 2: Trade Balance: Monthly and Cumulative 12-months Figures, (CZK bill.)



Source: Czech Statistical Office

The year 2004 seems to be the year of turnover in the trade balance developments. Higher dynamics of exports in comparison with the imports is the key factor behind continuing improvement of the trade balance.

Long-term step-by-step improvement of the trade balance observable in recent years (and more pronounced in the EU area), accelerated in the second quarter of 2004.

acceleration of exports (10 percentage points) was thus higher than the acceleration of imports (five percentage points). On the other hand, as of February 2005, the exports showed a considerable slowdown as a consequence of the sluggish demand in Eurozone, in particular in Germany. The slowdown of imports was, however, even higher – see Figure 3.

It is not reasonable to assume that the import intensity of the exports has decreased exactly at the moment of the EU entry. However, it is realistic to presume that mix of a couple of favourable factors had a synergic effect. As the main factors may be identified:

– **Long-term effect of FDI on promotion of exports was intensified by the EU entry.** Even though the effects of EU entry may be disputable from some points of view, its positive effect on exports seems undisputable. EU entry opened new opportunities to medium, and small sized companies by abolishing not only the last administrative barriers but also some psychological ones. All procedures simplified.

– **Slowdown in domestic demand attenuates the imports.** Consumer demand weakened gradually in the course of 2004, the full-year growth of 2 % being the weakest since 1998. The recovery of consumer demand is slow and gradual in the first half of 2005. In addition, investment demand started to weaken as of the beginning of 2005 – see Figure 4.

– **The export-supportive effects of FDI started to exceed the import-inducing ones.**

– The investors came to the Czech Republic with the main aim – to make profits, the volume of which is limited in the small economy, so that the companies under foreign control are strongly export-oriented – direct export sales account for 71 % of their sales;

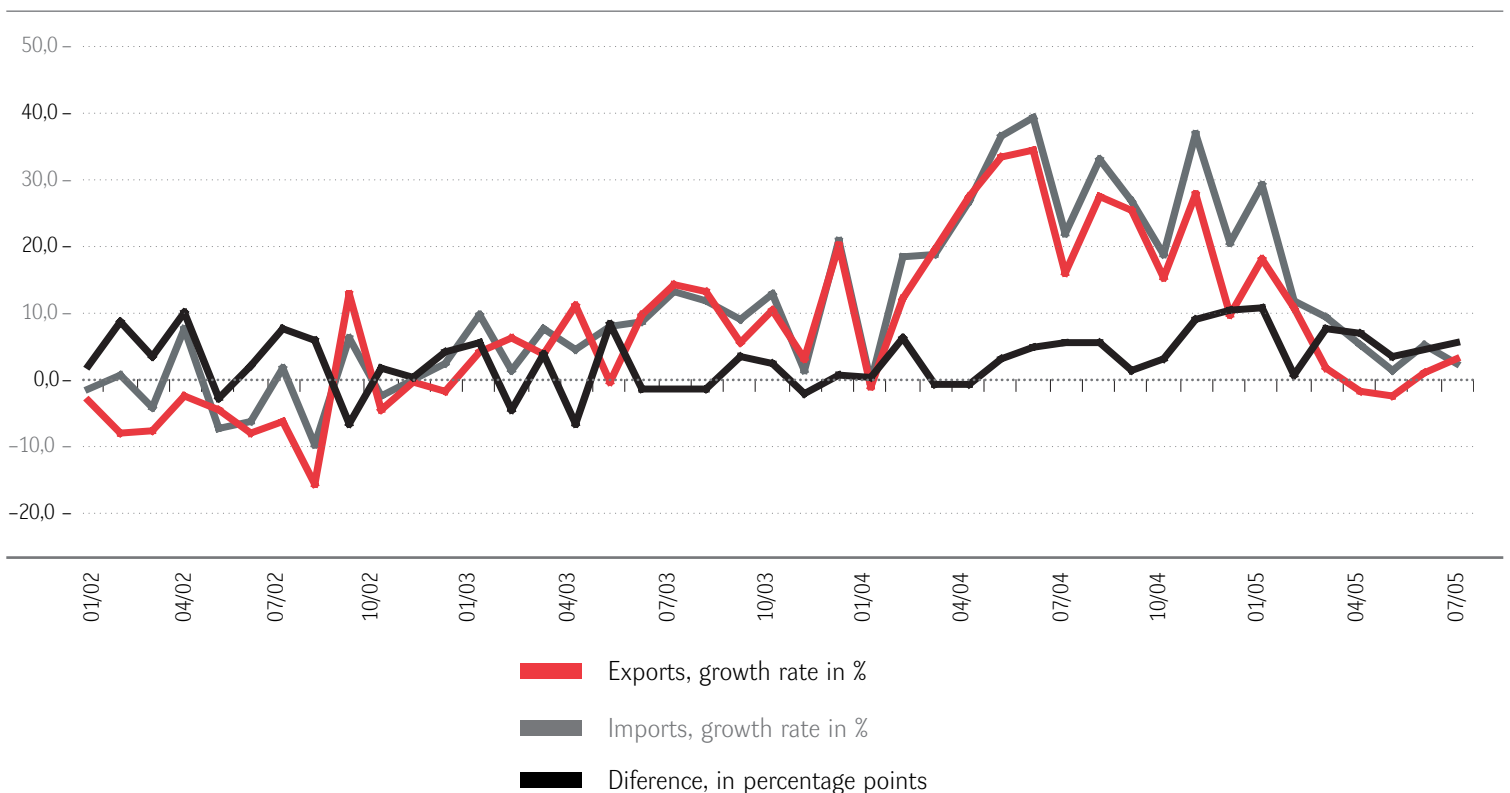
– In the first stage, the investors have induced massive import wave. At present, major part of the investment import wave provoked by foreign investors in the process of industrial restructuring has been over;

– Vertical spill-over effects -companies

It is not reasonable to assume that the import intensity of the exports has decreased exactly at the moment of the EU entry. However, it is realistic to presume that mix of a couple of favourable factors had a synergic effect.

At present, major part of the investment import wave provoked by foreign investors in the process of industrial restructuring has been over.

Figure 3: Exports and Imports, growth rates in %



Source: Czech Statistical Office

under foreign control gradually replace originally imported components by the components produced in the Czech Republic. Foreign investors also exercise strong pressures on costs, which may partly hinder the imports;

– The pro-export effects and pro-import effects go hand in hand in real time – gradually, the export-supportive effects gain on intensity and exceed the import provoking ones, which is most probably temporary Czech reality.

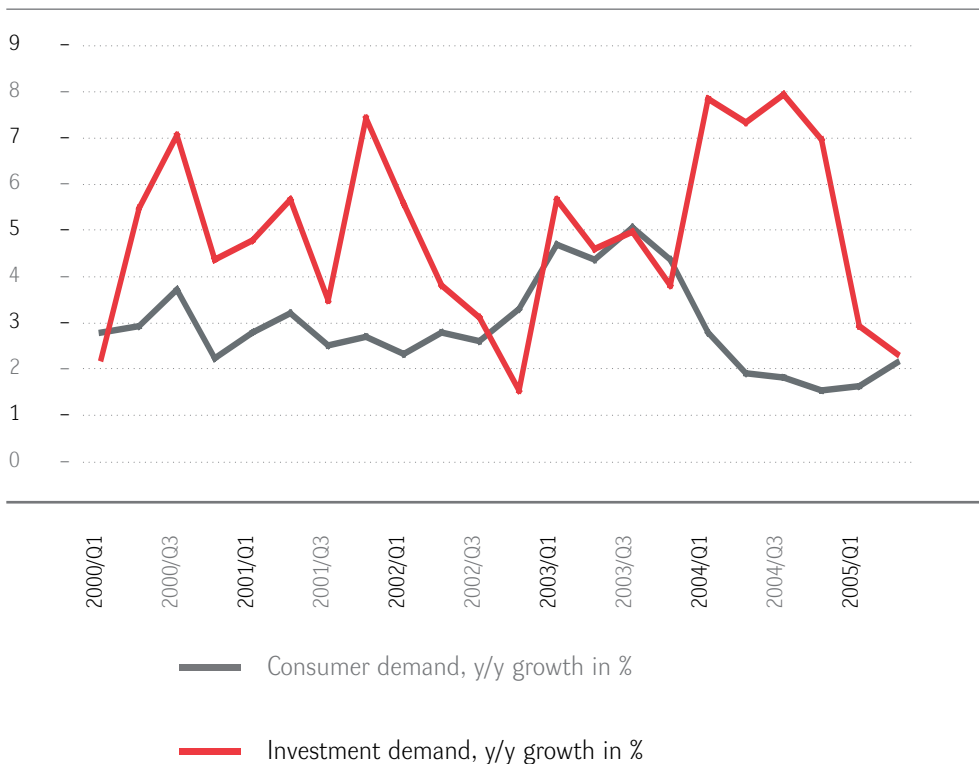
Commodity Structure of Czech Trade Balance

The main important players in the Czech trade balance are machinery, fuels and chemicals. Figure 5 shows the heroic match of increasing surpluses produced by trade with machinery and cars with the deficits in the trade with fuels and chemicals. The trade surplus with machinery and cars increased strongly in the first seven months of 2005 (by CZK 52.5 bill.) compensating for the increasing deficit with fuels (which rose by CZK 18.2 bill. in the course of the first seven months of 2005). The negative impact of high world prices of oil and gas is quite strong.

Machinery and cars is thus the key industry behind improvement of the total trade balance. It is interesting to remind that Czech machinery industries attracted a large volume of FDI – CZK 228 bill (until mid-2005). This represents approximately 20 % of the total FDI inflows. Again, the importance and influence of the foreign investors is very important.

The impact of the trade with machinery and cars is decisive for increasing trade surpluses with EU – see Figures 6 and 7. In 2005, the full-year surplus in the trade with machinery and cars may be estimated at CZK 200 bill., in the EU area this surplus will amount to record high level of approximately CZK 300 bill. The share of the trade with cars on this surplus is about 70 %, which indicates that also some other machinery industries produce increasing surpluses (especially the industry of special machinery). On the other hand, the importance of the car industry for the industrial growth, exports and trade balance represents possible long-term risk for the Czech economy, having in mind the strong cyclical profile of the car industry.

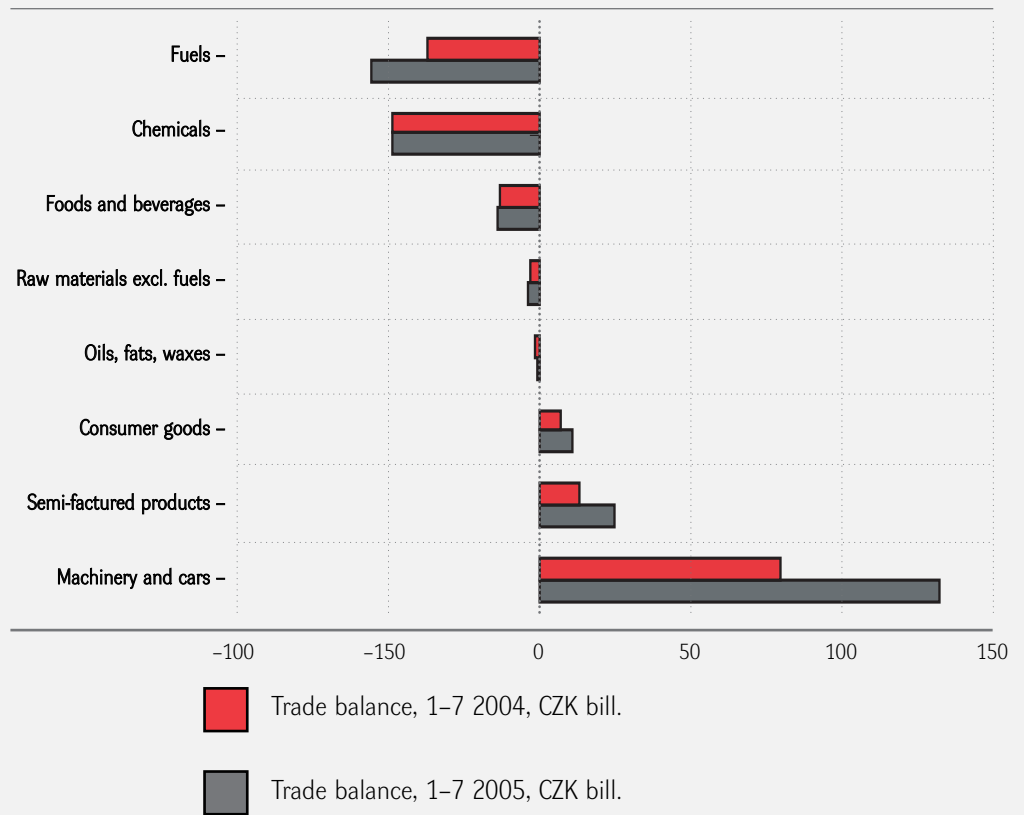
Figure 4: Growth of Consumer and Investment Demand, 2000 – H1 2005



The pro-export effects and pro-import effects of FDI go hand in hand in real time – gradually, the export-supportive effects gain on intensity and exceed the import provoking ones, which is most probably temporary Czech reality.

Source: Czech Statistical Office

Figure 5: Commodity Structure of Czech Trade Balance



Source: Czech Statistical Office

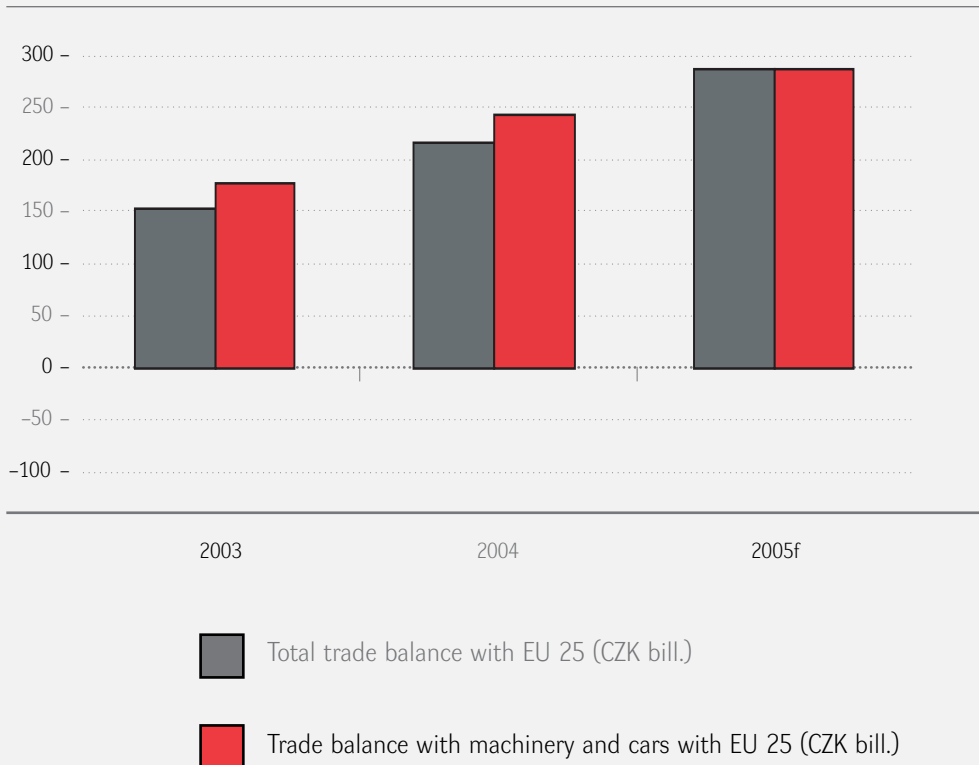
Figure 6: Trade Balance, CZK bill.



Source: Czech Statistical Office

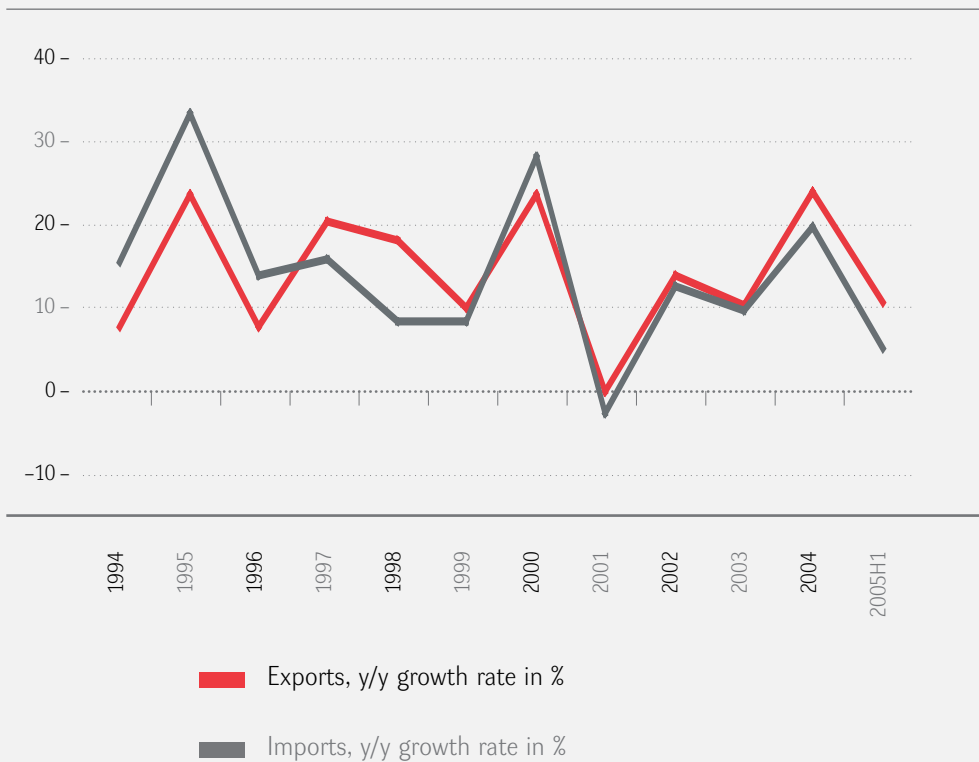
The main important players in the Czech trade balance are machinery, fuels and chemicals. The trade surplus with machinery and cars increased strongly in the first seven months of 2005 compensating for the increasing deficit with fuels.

Figure 7: Trade Balance with EU 25, CZK bill.



Source: Czech Statistical Office

Figure 8: Exports and Imports, growth rates in %



Source: Czech Statistical Office

Machinery and cars is thus the key industry behind improvement of the total trade balance.

Since 2000, the exports have been growing more rapidly than the imports, with notable positive difference in 2004 and 2005.

Prospects of the Trade Balance

– Fundamental factors causing the improvement of the trade balance should preserve. The inflow of FDI has been continuing: in the first half of 2005, the inflow of FDI amounted to CZK 180 bill, almost half of which not connected with privatisation.

– Next year, also the long-time expected recovery in the eurozone should start, with potential positive effects on Czech exports.

– Production in new car industry (TPCA) will reach its full capacity, which will increase industrial output and exports. The positive effect on the trade balance can be estimated at CZK 30 bill.

– Consumer demand has been recovering only moderately, so that any significant pressures on imports are not expected. The same applies for investment demand.

The major conclusion made in the first part of this article stated that the improvement of the trade balance is caused by the difference

between the dynamics of export and imports (the exports have started to grow much more rapidly than the imports as of May 2004). Therefore, the final part of this article will outline different scenarios of the trade balance under different assumptions of the growth of exports and imports. Before analyzing individual scenarios, brief outline of the so-far developments is presented in Figure 8 – which shows the dynamics of the growth of both exports and imports from 1994 to H1 2005.

Since 2000, the exports have been growing more rapidly than the imports, with notable positive difference in 2004 and 2005.

The trade balance for H1 2006 would end in red under the assumption that the growth of imports was at least 10percentage points more rapid than the growth of exports. E.g., the trade balance for H1 2006 would reach CZK -45 bill., if the exports stagnated and the imports increased by 10 %, y/y. Reminding Figure 8, this situation has almost never occurred in the past. The highest difference between the growth rates of imports and exports in

Table 1: Scenarios of the Trade Balance in H1 2006, different growth rates

SCENARIOS OF THE TRADE BALANCE	Exports, growth rate in %				
	Imports, growth rate in %	-5 %	0 %	5 %	10 %
15 %	-135	-89	-44	0	48
10 %	-91	-45	0	46	92
5 %	-47	0	44	90	136
0 %	0	43	88	134	180
-5 %	41	87	132	178	224

Source: Komerční banka

favour for imports, was observed in 1995 (10 percentage points). This was caused by the above-mentioned post-transformation boom in imports, which cannot be repeated. This scenario is thus completely unrealistic and may be omitted from our investigations.

Zero trade balance would be an outcome of the scenario with the growth of imports above the growth of exports, the difference amounting to 5 percentage points. E.g., the exports would stagnate and the imports would rise by 5 %. The 5 percentage point outpace of imports is not a very probable scenario, as well, this situation having occurred in 2000 for the last time.

Equal growth rates of exports and imports

would produce trade surpluses around CZK 45 bill., increasing along with increasing dynamics of foreign trade. This surplus is estimated only for the first half of the year, so that the full-year trade surplus would be higher. More rapid growth of exports in comparison with the growth of imports will produce increasing trade surpluses. More rapid growth rates of exports against the imports amounting to 5 percentage points would lead to the surpluses of CZK amounting around CZK 85 bill., for H1 2006. The scenario with the growth rates of exports at the same level or slightly above the dynamics of imports seems to be realistic. Therefore, in 2006, under these quite realistic assumptions, the full-year trade balance will almost surely end in a surplus around CZK 100 bill.

Zero trade balance would be an outcome of the scenario with the growth of imports above the growth of exports, the difference amounting to 5 percentage points. The 5 percentage point outpace of imports is not a very probable scenario, as well, this situation having occurred in 2000 for the last time.

The scenario with the growth rates of exports at the same level or slightly above the dynamics of imports seems to be realistic. Therefore, in 2006, under these quite realistic assumptions, the full-year trade balance will almost surely end in a surplus around CZK 100 bill.

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