

## CONTENTS

Czech Economy in 2005: Low Inflation and Robust Growth	1
Slovakia on the Road to Euro	6
Credits in the Czech Economy: Recent Trends	8
Some Questions About the Inflation Forecasts of the Czech National Bank	13

Also available at [www.kb.cz](http://www.kb.cz)

Editor: © Komerční banka. a.s., Prague - Chief Economist

Tel.: + 420 2 24 21 46 66

Fax: + 420 2 24 22 28 39

Released for printing on February 7, 2006

Economic Trends reflect the view of the Chief Economist Team of Komerční banka. It is published for information purposes only. Neither the information nor the opinion expressed constitutes an offer or solicitation to buy or sell any investments. Information contained herein has been obtained from sources believed to be reliable but Komerční banka does not guarantee its accuracy or completeness. Discretion with respect to suitability should be prudently exercised.

# CZECH ECONOMY IN 2005: LOW INFLATION AND ROBUST GROWTH

Kamil Janáček, Eva Zamrazilová

## 1. ECONOMIC GROWTH

In the third quarter of 2005, GDP increased by 4.9 %, y/y. The figure for Q2/ 2005 was revised upwards from 5.1 % to 5.2 %. In the first three quarters of 2005, GDP grew by 5.0 %. As in the first half of the year, the economic growth was primarily fuelled by net exports, when the increase in the exports of goods (10.9 %) was almost by 5 percentage points higher than the growth of imports of goods (6.1 %), both figures in constant prices.

The third quarter of 2005 registered continuing revival of final consumption: the consumption of households increased by 2.9 %, y/y, after a growth of 2.5 % in the first half of the year. Government consumption grew by 6.1 %, y/y, not only due to purchase of Gripen aircrafts, but also due to start of spending boom before the next election. Fixed capital investment accelerated to 3.2 %, after 2.7 % in the first half of 2005, due to growth of both investments in machines and technology (2.1 %), and building investments (2.4 %).

In the first three quarters of 2005, GDP grew by 5.0 %. Exports grew by 11.5 %, imports by 5.3 %; net exports were thus the main engine of growth. Household consumption increased by 2.6 %, government consumption by 1.9 %. Fixed capital investment registered a growth of 2.9 %.

Although the industry did not repeat record growth from 2004 (9.9 %), the growth rate of 5.7 % remains impressive in the European context. The main reason behind the slowdown was a slump in world demand for steel products, which had been one of the main drivers of 2004 high growth rate. The best performing industries in 2005 were: automotive industry, rubber and plastic products and coke and refined oil products. Electrotechnics grew by 5.2 % (i.e. slightly under the average industrial growth).

The automotive industry was – by far – the most successful industrial sector in 2005, with annual growth approaching to 20 %. The impact of new TPCA production has been visible, as well as increasing production of

automotive components. Another positive fact is that the import input of car production has been decreasing in recent years; more and more automotive parts are produced by the Czech-based companies. Regarding the key importance of automotive industry in both industrial output (around 15 %) and exports (18 %), risks for the whole economy are not negligible. The growing dependence on car production is increasing the sensitivity of the Czech economy to external cyclical shocks, so typical for the automotive industry.

Intermediate products, accounting for major part of industrial production (40 %) registered highest growth of 10.3 %, y/y, in 2005. Investment goods increased by mere 3.0 %, y/y, and consumer goods by 2.2 %. Direct export sales increased by solid 10.2 %, 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 54.8 %.

The full-year 2005 growth of construction output was at 4.2 %. However, this figure was still affected by the statistical effects due to 2004 VAT change. January – July 2005, the construction output stagnated due to high reference base for comparison (January to July 2004, the construction output rose by 13 %). The 2004 change in VAT stopped to affect the construction output figures as of August, which was the first month when the data were meaningful. As of August, the dynamics of construction returned on the longer term growth path, with growth of 9 %.

The highest dynamics registered the civil engineering and infrastructure projects. Also, business and commercial centres continued in growth. Housing construction rose by approximately 5 % (latest figures are for Q1 – Q3 2005). Rapid growth of mortgage market continues: at the end of 2005, total volume of mortgages amounted to CZK 236.5 bill, out of which CZK 182.3 bill. was granted to the Czech households. The year over year growth of total mortgages thus amounted to 44 % (CZK 72.2 bill.).

Retail sales registered acceleration of growth to 3.8 %, up from 2.5 % in 2004. The main

In the first three quarters of 2005, GDP grew by 5.0 %. The economic growth was primarily fuelled by net exports.

The automotive industry was – by far – the most successful industrial sector in 2005, with annual growth approaching to 20 %.

Another positive fact is that the import input of car production has been decreasing in recent years; more and more automotive parts are produced by the Czech-based companies.

Rapid growth of mortgage market continues: at the end of 2005, total volume of mortgages amounted to CZK 236.5 bill, out of which CZK 182.3 bill. was granted to the Czech households. The year over year growth of total mortgages thus amounted to 44 % (CZK 72.2 bill.).

reason was the recovery in the automotive segment. After weak results in 2004, the sales and repairs of automobiles grew by 6 %, in 2005. Food sales, the fluctuations of which have been the lowest, kept the long-term path of approximately 3 %. Consumer goods performed better than in 2004, driven particularly by the sales of textiles, footwear, electronics and other domestic appliances. The competition in this segment of market is very strong and traders support sales of these commodities by low prices and special offers.

Consumers are more and more attracted by price policy of big retail chains. With newly opened hypermarkets in 2005, this segment of market is beginning to show a high degree of saturation. The main recent tendency is the growing popularity of discount stores, which are targeted mainly at the most price-sensitive customers. The expansion of hypermarkets is not, however, over, many projects being either in construction or planned; the sales are and will be more and more concentrated in multi-functional complexes.

## 2. FOREIGN TRADE AND EXCHANGE RATE

In 2005, the exports increased by 8.6 %, y/y, the imports rose by 4.6 %, y/y. The trade surplus amounted to CZK 41.9 bill., the best result in the history of the Czech Republic. Nevertheless, the pace of the trade balance improvement registered a slowdown in the second half of the year due to high world oil and gas prices.

In 2005, machinery, fuels and chemistry were the key items for the trade balance. Machinery produced a surplus of CZK 218.5 bill., which was an increase of CZK 82.3 bill. against 2004. Cars accounted for approximately two thirds of the machinery surplus. Fuels represented the highest burden for the trade balance, producing a deficit of CZK 112.4 bill, followed by chemistry (deficit of CZK 85.6 bill.). While the trade with chemistry improved year over year (by CZK 5.3 bill.), the trade with fuels deteriorated by another CZK 40.2 bill. (due to high prices of oil and gas).

The trade with EU 25 ended in a surplus of CZK 281.2 bill (year over year improvement of CZK 56.8 bill.). The highest surpluses were achieved in the trade with Germany (CZK 73.6 bill.) and Slovakia (CZK 63.9 bill.). The highest deficits were registered in the trade

with China (CZK 87.4 bill.) and Russia (CZK 69.1 bill.). While the deficit with China increased only to a small extent (by CZK 3.4 bill.), the deterioration of deficit with Russia was huge (by CZK 22.4 bill.), due to high share (80 %) of fuels on total imports from Russia.

Along with the improvement in trade balance, also the current account improved. In 2005, the Czech current account ended in a deficit close to CZK 80 bill., i.e. slightly below 3 % of GDP (down from 5.2 % in 2004). The current account is driven only by the balance of incomes (the deficit of which is expected at CZK 160 bill.). The Czech economy thus is another proof that the huge inflow of FDI leads to an improvement of the trade balance but – on the other hand – to a deterioration of the balance of incomes. The inflow of foreign direct investments continued in 2005, amounting to approximately CZK 240 bill.

In 2005, the appreciation of Czech currency accelerated, driven by good macroeconomic performance, in particular by the foreign trade improvement and continuing inflow of the foreign direct investments. In average, the Czech currency appreciated by 6.6 % against the EUR, the full-year average CZK/EUR being at 28.98. The appreciation towards the USD was in a similar extent, CZK strengthening by 6.8 %. The full-year 2005 average of CZK/USD stood at 24.45.

The appreciation trend was registered mainly in the fourth quarter of 2005. The appreciation of the CZK against the EUR continued also in January 2006; at the end of this month, the CZK/EUR stood at 28.5. The appreciation trend towards USD continued as well, CZK/USD being at 23.7 at the end of January 2006. The strong Czech currency attenuated the influence of high oil and gas prices on the Czech economy.

## 3. INFLATION

Fundamental inflationary pressures in the Czech economy are still weak. Consumer inflation moved below 2 % in major part of the year. Average inflation rate amounted to 1.9 %, down from 2.8 %, in 2004. The only factor pushing the prices up, was the autumn oil price increase: in October 2005, the CPI amounted to its highest 2005 level of 2.6 %, due to the spill-over of high fuel prices into transport and housing prices. The year-end figure stood at 2.2 %.

In 2005, the exports increased by 8.6 %, y/y, the imports rose by 4.6 %, y/y. The trade surplus amounted to CZK 41.9 bill., the best result in the history of the Czech Republic.

In 2005, the appreciation of Czech currency accelerated, driven by good macroeconomic performance. In average, the Czech currency appreciated by 6.6 % against the EUR. The appreciation towards the USD was in a similar extent, CZK strengthening by 6.8 %.

The domestic competition as well as the openness of the economy attenuates the increases in prices of goods with higher intensity than the prices of services. Imperfect markets and their oligopolistic structures still prevail in the service sector. Therefore, the space for higher price increase exists in the area of services, the prices of which have grown at a more rapid pace than the prices of goods. At the end of 2005, the prices of goods increased by 1.3 %, y/y, while the prices of services rose by 3.6 %, y/y. Increase of administrative prices (public transport, electricity, gas and heating for households) represented almost 64 % of CPI increase.

Rapid decline of producer prices in the course of 2005 (from initial level of 7.2 %, y/y, to final -0.3 %, y/y) was partly a consequence of statistical effect compensating for extremely high figures from 2004, strongly supported by strong currency and high competitive pressures. The effects of globalisation and increasing competitive pressures act with very high intensity, in the small and opened Czech economy. Due to this fact, the decline of PPI registered only a slight slowdown after September oil crisis. Average PPI was at 3 %, in 2005, which was also a notable decline in comparison with 5.7 % in 2004. PPI in majority of manufacturing industries were moving in the deflation range, at the end of 2005.

Czech producer prices thus do not go along with EU tendencies. According to the Eurostat figures, EU-25 PPI in November amounted to 5.5 %, y/y. Also the consumer

prices growth is under the EU 25 average: November year-on-year increase in the average harmonized index of consumer prices (HICP) in the EU-25 was at 2.2%, while the Czech one stood at 1.9 %.

2005 was the year of record-low interest rates. During the first four months, the Czech National Bank made the three repo rate cuts, to the historically lowest level of 1.75 %. Until the end of October, the repo rate was thus by 25 basic points under the basic ECB refi rate. At the end of October, CNB raised the repo rate by 25 basis points to the level of ECB rate. After December 2005 increase of ECB refi rate to 2.25 %, repo rate is again 25 basis points below the basic Eurozone rate. Consequently, the 3M PRIBOR has been persistently by approximately 20 – 30 basis points under the 3M EURIBOR.

#### 4. UNEMPLOYMENT

At the end of 2005, the unemployment rate amounted to 8.9 %, which was by 0.6 percentage point lower than at the end of 2004. This was the first year over year decline of the year-end final unemployment rate since 2000. The ratio between the unemployment and vacancies slightly improved in the course of 2005: at the end of 2005, this ratio declined to 9.8, down from 10.6 at the end of 2004. The number of unemployed persons declined by approximately 30 thousands, to 510.4 thousands people. However, the number of vacancies increased only moderately, to 52.2 thousands (i.e. by 1 thousand).

The domestic competition as well as the openness of the economy attenuates the increases in prices of goods with higher intensity than the prices of services. Imperfect markets and their oligopolistic structures still prevail in the service sector. Therefore, the space for higher price increase exists in the area of services, the prices of which have grown at a more rapid pace than the prices of goods. At the end of 2005, the prices of goods increased by 1.3 %, y/y, while the prices of services rose by 3.6 %, y/y.

2005 was the year of record-low interest rates. During the first four months, the Czech National Bank made the three repo rate cuts, to the historically lowest level of 1.75 %. Until the end of October, the repo rate was thus by 25 basic points under the basic ECB refi rate. At the end of October, CNB raised the repo rate by 25 basis points to the level of ECB rate. Consequently, the 3M PRIBOR has been persistently by approximately 20 – 30 basis points under the 3M EURIBOR.

Table 1: Main Macroeconomic Indicators

		2001	2002	2003	2004	2005	10/05	11/05	12/05	2006F
GDP	%, y/y	2.6	1.5	3.2	4.7	4.8	-	-	-	4.5
Inflation	%, y/y	4.1	0.6	1.0	2.8	2.2	2.6	2.4	2.2	2.5
Inflation	%, m/m	-	-	-	-	-	0.9	-0.3	-0.1	-
Industrial prices	%, y/y	0.8	-0.7	0.9	7.7	-0.3	0.3	0.0	-0.3	2.0
Industrial prices	%, m/m	-	-	-	-	-	0.4	-0.3	-0.6	-
Unemployment rate*	%, eop.	8.9	9.8	10.3	9.5	8.9	8.5	8.4	8.9	8.2
Industrial production	%, real	6.8	4.8	5.8	9.9	5.7	6.3	7.2	7.1	7.0
Construction output	%, real	9.6	2.5	8.9	9.7	4.2	13.8	6.6	8.6	8.0
Retail sales	%, real	4.3	2.7	5.0	2.5	3.8	2.8	3.3	2.1	4.0
State budget	CZK bill.	-67.7	-45.7	-109.1	-93.5	-56.4	15.2	0.2	-56.4	-75
Trade balance	CZK bill.	-119	-71.3	-69.8	-26.4	41.9	1.8	1.7	3.9	60
FOREX reserves	USD bill.	14.8	23.7	27.0	28.4	29.5	29.6	29.4	29.5	29.5
PRIBOR 3M	% average	5.2	3.55	2.3	2.4	2.0	1.91	2.024	2.17	2.4
CZK/EUR	Average	34.1	30.81	31.84	31.9	29.78	29.68	29.26	28.98	29.0
CZK/USD	Average	38.0	32.74	28.23	25.7	23.95	24.72	24.82	24.45	24.0

Source: Czech National Bank, Czech Statistical Office, forecasts by Komerční banka

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

Situation on the labour market thus slightly improved during 2005; nevertheless, a moderate decline of the unemployment along with only a slow increase of vacancies was not an excellent result under robust economic activity. Unemployment thus continues to be one of the main Czech macroeconomic problems. High share of long-term unemployment, regional disparities and low flexibility of the labour market represent the strong challenge for the Government policy.

## 5. OUTLOOK

After a growth of 4.8 %, expected for the full-year 2005, the GDP growth will moderately ease in 2006, to approximately 4.5 %. The main driving force will remain net exports of goods, followed by the investment demand. Private consumption will continue in growth around 3 %.

Growth of exports will keep above the growth of imports, therefore the improvement of trade balance will continue. In 2006, the improvement of trade balance will continue by a pace similar to that in the second half of 2005. The developments of Czech trade balance in 2006 will crucially depend on the world prices of oil and gas. Under the assumption of stabilised world oil prices at current levels, trade balance will improve by another CZK 20 bill., - we expect a full-year 2006 trade surplus around CZK 60 bill. The current account deficit will therefore continue in improvement, declining slightly below 2.5 % of GDP.

Gradual recovery in the eurozone will be felt from the second quarter of 2006. In addition the TPCA will reach its full capacity, i.e. 300 000 vehicles. For these reasons, we expect slight acceleration of the industrial output growth to 7 %, in 2006.

The growth of construction output in 2006, should continue by a pace similar to that in the second half of 2005. Government expenditure for infrastructure projects will not ease until the elections. New projects on business and administrative centres have started. Prospects of housing construction are quite favourable and increasing employment in construction confirms positive expectations of big construction companies. Construction output will increase by approximately 8 %, in 2006.

The growth in retail trade in 2006 will be roughly the same as in 2005, as a consequence of stable dynamics of incomes

and low inflationary environment. The sales of cars will register quite solid results due to regular replacement cycle. Food sales will keep the long-term growth path of approximately 3 %. Consumer durables sales will be slightly above the average growth rate, supported by the consumer credits. The full-year 2006 growth of retail sales will amount approximately to 4 %.

In 2006, the inflation will continue to grow modestly. The increase in the beginning of the year (to 3 %), will be followed by the decline back to the 2 % level. We expect year-end 2006 CPI at 2.5 % and average inflation also around 2.5 %. The most important driving force of the CPI will be again the increase of administrative prices. PPI will continue to move in the deflation range (or around zero) in the first half of 2006. Strong competition and appreciating currency will continue to act. Excluding longer lasting strong external shocks on the world raw material markets (predominantly with oil and gas), PPI will increase by approximately 2 %, y/y, at the end of 2006.

Labour market in 2006 will continue in moderate improvement, the scope of which should be similar to that of 2005. In the course of the year, we expect regular seasonal developments. Spring months will register declining unemployment rate slightly below the 8 % bar in June 2006, followed by summer increase (the attack of graduates) and autumn decline. In December, the unemployment rate will increase due to the end of seasonal jobs and expired term contracts; therefore, at the end of 2006, we expect the unemployment rate slightly above 8 %. However, long-term unemployment will continue to increase, up to 55 % of total unemployment. At the same time, structural and regional problems of the Czech labour market continue to be the main weak point of the Czech economy.

Situation on the labour market slightly improved during 2005; nevertheless, a moderate decline of the unemployment along with only a slow increase of vacancies was not an excellent result under robust economic activity.

After a growth of 4.8 %, expected for the full-year 2005, the GDP growth will moderately ease in 2006, to approximately 4.5 %. The main driving force will remain net exports of goods, followed by the investment demand. Private consumption will continue in growth around 3 %.

In 2006, the inflation will continue to grow modestly. The increase in the beginning of the year (to 3 %), will be followed by the decline back to the 2 % level. We expect year-end 2006 CPI at 2.5 % and average inflation also around 2.5 %.

# SLOVAKIA ON THE ROAD TO EURO

Kamil Janáček

## 1. MACROECONOMIC PERFORMANCE

The Slovak economy continued to grow rapidly in 2005. Over the first three quarters, GDP increased by 5.5 %, and the same growth rate is expected for 2005 as a whole. Foreign demand which increased by 16.1 % was the main source of the fast growth. Inflows of foreign direct investment in the first half of this decade have been reflected in increased exports. Domestic demand grew by 3.5 % in the first three quarters of 2005 – household consumption by 6.2 % and fixed capital formation by 16.5 %. This figure again reflects the activity of foreign investors.

Fast economic growth, and massive inflows of FDI, led to a decline of unemployment (see Table 1), and to growth of total employment by more than 1 %. This was an important factor: over the long run, unemployment is a big social and economic problem in Slovakia.

Successful reform of public finance, as well as an undeniable success of the flat tax, led to a decrease of public finance deficit. With high probability, Slovakia will reach the "magic" limit of 3 % in 2006, thus achieving a further step toward eurozone entry in 2009.

Stability of public finance, activity of foreign investors, and improved rating of the Slovak Republic, resulted in a continuous appreciation of Slovak koruna (see Table 2).

National Bank of Slovakia intervened several times during 2005, to slow down the fast appreciation. However, data on good results in exports suggest that Slovak exporters are able to live with appreciating currency without losing their competitiveness in European markets.

Inflation was very low in the second and third quarters of 2005, partly thanks to the appreciating currency. In the fourth quarter, inflation started to increase over 3 % due to growing prices of gas, energy and fuels. Inflation will further grow in the first half of 2006 (over the 4 % line), and it will not get back to the 3 % level before the fourth quarter of the current year.

The very good overall characteristics of economic growth in Slovakia, however, mask one problem: the continuing very uneven regional structure of growth.

As almost all FDIs have flown to the west of Slovakia (Bratislava, and the stretch between Žilina and Bratislava), that area is growing fast, has low unemployment, and attracts qualified labour from other regions. Other parts - in the middle and east of the country (with the exception of Košice, and a few other towns) - are lagging behind in economic growth, have double-digit unemployment, and suffer from underdeveloped infrastructure. Overcoming this dual character of Slovak economy remains the main challenge for government economic policy in the next years.

Table 1: Main Macroeconomic Indicators, 2002 – 2006

	2002	2003	2004	2005	2006F
GDP (growth in %, c.p.)	4.6	4.5	5.5	5.5	6.0
Industry (growth in %)	6.4	5.1	4.0	4.0	7.5
Inflation (average, in %)	3.3	8.5	7.5	2.8	3.5
Unemployment (average)	18.5	17.4	18.1	16.5	15.5
Current Account (as % of GDP)	-7.9	-0.8	-3.5	-4.8	-4.2

Source: Slovak Statistical Office, forecast by Komerční banka.

Table 2: Main Financial Indicators, 2002 – 2006

	2002	2003	2004	2005	2006F
BRIBOR 3M (average)	7.8	6.2	4.7	3.0	3.5
SKK/EUR (average)	42.7	41.5	40.0	38.6	37.8
Public Budget Deficit (as % of GDP)	-5.7	-3.7	-3.3	-3.2	-3.0
Public Debt (as % of GDP)	43.3	42.6	43.6	44.5	46.0

Source: Slovak Statistical Office, forecast by Komerční banka.

Fast economic growth, and massive inflows of FDI, led to a decline of unemployment and to growth of total employment by more than 1 %. This was an important factor: over the long run, unemployment is a big social and economic problem in Slovakia.

## 2. ERM II ENTRY

On November 25, 2005 Slovakia and the European Central Bank announced that Slovak koruna has entered the ERM II system. In this system, the exchange rate of the SKK is a “common concern”, which means that the National Bank of Slovakia (with possible but not guaranteed help from the ECB) would be obliged to defend the currency if it went to the edge of the  $\pm 15\%$  fluctuation limit. Central parity of the Slovak koruna was set at 38.455 SKK/EUR; thus, interventions should keep the exchange rate between 44.22 and 32.69 EUR. It can be expected that the National Bank of Slovakia will to keep to the stronger end of the fluctuation band, to fulfil the Maastricht criterion for inflation more easily.

Slovakia wants to accept the common European currency on January 1, 2009. As this requires a minimum of two-years stay in the ERM II, markets generally expected Slovakia to enter ERM II some time around mid-2006. ERM II entry almost a whole year earlier was a big surprise. Slovak government and the NBS were motivated by several goals:

- To isolate (at least partly) Slovak koruna from the influence of regional pressures;
- To increase the credibility of the plan for eurozone entry in 2009, and to limit the scope for the new government to abandon this goal after the June 2006 election;
- To underpin a broader political consensus on further reforms required before EMU entry.

Over the medium term till 2009, further appreciation of the Slovak currency can be expected. One cannot even exclude that the NBS would increase the central parity (the conversion exchange rate to the EUR). This would not be a first example: the same step was taken by Ireland at the end of the 1990s.

## 3. EXPERIENCE WITH THE FLAT TAX

In 2004, Slovakia undertook a substantial tax reform, introducing the so-called flat tax. The reform was aimed at:

- introducing a single tax rate (19 %), common for income tax, corporate tax, and value-added tax;

- simplifying the tax system immensely, by abolishing all exceptions and special regimes, leaving only a minimum number of deductible items.

The aims of the Slovak tax reform were often ridiculed (especially by some economic and political subjects in the Czech Republic). Hypothesis was expressed that the reform will result in a massive fall of government budget incomes, and in a collapse of public finance. However, nothing of the kind came true; Slovakia is (together with the Baltic countries) another EU country that proves that the flat-tax system can function successfully also in a relatively developed market economy.

### What, then, were the results of 2004?

- 1) The tax burden on the economy decreased by 0.5 % of GDP, which was positively reflected in acceleration of economic growth.
- 2) Contrary to expectations, tax incomes of the government budget grew by SKK 6.1 billion, thanks partly to faster economic growth, partly to better tax collection.
- 3) Tax discipline improved – lower tax rates do not discourage from tax payment, and the simplified and transparent tax system makes tax evasion more difficult.
- 4) The system is socially just: for a great majority of households, tax burden decreased; the progressiveness of taxation did not go down as many expected (on the contrary, it even increased somewhat – so that the flat tax was not introduced to help the rich, as the critics kept saying). Taking into account the changes in both direct and indirect taxation, most households did not experience any decrease of their real net incomes.
- 5) Successful tax reform has strongly improved Slovakia’s “marketing” picture. Attractiveness of Slovakia for foreign investors increased.

The results for 2005, and the forecasts for 2006, indicate a positive impact of the tax reform on economic growth (and employment) also in the medium term. No wonder that some neighbours (Poland, and, especially, Hungary) are considering ways to follow the Slovak example in their tax systems.

On November 25, 2005 Slovakia and the European Central Bank announced that Slovak koruna has entered the ERM II system. Central parity of the Slovak koruna was set at 38.455 SKK/EUR; thus, interventions should keep the exchange rate between 44.22 and 32.69 EUR. It can be expected that the National Bank of Slovakia will to keep to the stronger end of the fluctuation band, to fulfil the Maastricht criterion for inflation more easily.

The aims of the Slovak tax reform were often ridiculed. Hypothesis was expressed that the reform will result in a massive fall of government budget incomes, and in a collapse of public finance. However, nothing of the kind came true; Slovakia is (together with the Baltic countries) another EU country that proves that the flat-tax system can function successfully also in a relatively developed market economy.

The results for 2005, and the forecasts for 2006, indicate a positive impact of the tax reform on economic growth (and employment) also in the medium term. No wonder that some neighbours (Poland, and, especially, Hungary) are considering ways to follow the Slovak example in their tax systems.

# CREDITS IN THE CZECH ECONOMY: RECENT TRENDS

Kamil Janáček, Eva Zamrazilová

## 1. TRENDS IN CREDITS, 1997-2005

The analysis of trends in credits over the last decade shows interesting, though quite ambiguous picture. After rapid, two digit rate of growth from 1993 till 1997, the next five years experienced a significant drop of total credits granted by Czech banks. In Czech economic history, this period is known as a credit crunch period.

The main reasons of the credit crunch were following:

- recession of the Czech economy, and deteriorated financial situation of the Czech business sector;
- tougher rules on non-performing companies and their collateral, introduced by the Czech National Bank;
- over-restrictive monetary policy of the CNB, expressed in a huge increase of basic interest rates, followed by respective increases of basic rates of all Czech banks;
- starting cleaning of portfolios in the big Czech banks awaiting privatisation, followed by the end of generous credit policy.

The majority of bad loans was transferred to the Consolidation Bank - later transformed into the Czech Consolidation Agency. The four biggest Czech banks underwent privatisation in 1998–2001. The new foreign owners continued cleaning the portfolios of privatised banks, and started to introduce standard risk procedures in the credit process. Only after completing the necessary reshuffle, the banks renewed their credit emission. The growth of credits was also supported by the acceleration of economic activity as of 2003 – as indicated by Table 1.

Due to the trends described above, the share of loans on GDP fell from 64 % in 1997 below 40 % in 2002, with only a slight increase in 2005. This is very different from the situation in old EU-15 countries, where the share of credits on GDP varies between 100 and 130 %. At the same time, the still low share of credits on Czech GDP indicates an ample room for rapid growth of all types of loans in the Czech economy.

## 2. CREDITS TO THE CORPORATE SECTOR

The majority of the loan contraction in the Czech economy occurred in the non-financial

The majority of the loan contraction in the Czech economy occurred in the non-financial sector. The share of credits to non-financial corporates on total credits fell from 80 % in 1997 to 43 % in 2003. The non-financial sector was the biggest victim of the credit crunch.

Table 1: Total Credits, 1997-2005

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Credits, total, CZK bill.	1141.5	1152.7	1120.5	1092.8	994.5	941.6	997.3	1054.7	1215.4
Rate of Growth, in %	27.5	1.0	-2.8	-2.5	-9.0	-5.3	5.9	5.8	15.2
In % of GDP	63.9	58.7	54.9	50.8	43.0	39.0	39.0	38.1	41.7

Source: Czech National Bank

Table 2: Credits to Non-financial Corporates, 1997-2005

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Credits to Corporates, CZK bill.	919.7	866.0	804.7	726.6	531.5	434.5	428.8	460.0	525.9
Rate of Growth, in %	23.2	-5.8	-7.1	-9.7	-26.9	-18.3	-1.3	7.3	14.3
In % of Total Credits	80.4	75.1	71.8	66.5	53.4	46.1	43.0	43.6	43.3

Source: Czech National Bank

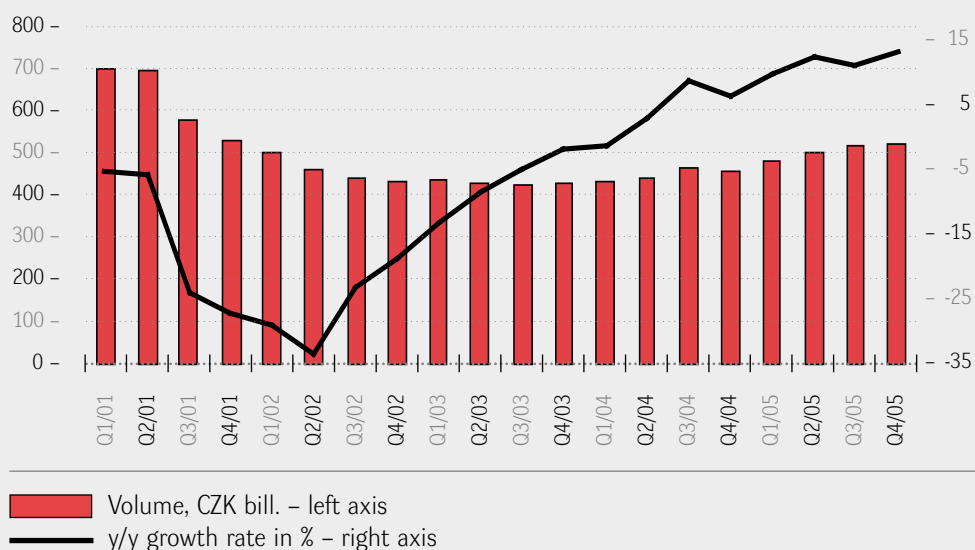
sector. As Table 2 indicates, the share of credits to non-financial corporates on total credits fell from 80 % in 1997 to 43 % in 2003. The non-financial sector was the biggest victim of the credit crunch described above. In addition, the companies in the Nineties were undercapitalised, with lack of own financial resources, and thus highly dependent on bank loans. They went through the necessary restructuring and their situation was aggravated by the abrupt decrease of loans.

Nevertheless, this difficult situation accelerated the restructuring process within many companies, and speeded up takeovers, mergers and acquisitions (mostly by foreign capital). Financial conditions of the Czech business sector, especially in manufacturing, thus significantly improved. These companies started to be viable clients for the banks.

However, the small and medium-sized companies were hit hard. These companies emerged during the Nineties, as a consequence of economic transformation, with all the weaknesses and problems of the start-ups. Many were forced to close down, or to limit their activities strongly. This is one of the reasons for this sector being still underdeveloped in the Czech economy - compared with similar countries, as Austria, the Netherlands or Denmark. Only in the last two years, the situation changed and this sector is now assessed as the most promising.

In 2004 and 2005, the banks increased credit emission, and loans to non-financial corporates grew by the same pace as total credits. However, the share of non-financial corporates on total credits

Figure 1: Credits to the Corporate Sector



In 2004 and 2005, the banks increased credit emission, and loans to non-financial corporates grew by the same pace as total credits. However, the share of non-financial corporates on total credits increases very slowly, and is still considerably below 50 %.

Acceleration of credits to households started in 2002, with the growth exceeding 30 % in the last three years. At the end of 2005, the ratio of loans granted by banks - and other financial institutions under the supervision of the CNB - amounted to 14 % of GDP. The total credits granted to the households not only by banks but also by non-financial institutions reached 26 % of GDP.

Source: Czech National Bank

Table 3: Credits to Households

	2000	2001	2002	2003	2004	2005f
Credits to households, in CZK bill.	122.6	139.3	178.7	235.7	312.0	413.0
Year over year growth in %	9.2	13.6	28.3	31.9	32.4	32.4
In % of GDP	5.7	6.0	7.4	9.2	11.3	14.0
Of which:						
- Mortgages, in CZK bill.	25.5	36.9	53.4	81.1	123.3	182.3
Year over year growth in %	44.1	44.7	44.7	51.9	52.0	47.9
- Consumer credits, in CZK bill.	19.9	27.9	51.9	61.1	69.2	95.5
Year over year growth in %	-11.9	40.2	86.0	17.7	13.3	38.0

Source: Czech National Bank

increases very slowly, and is still considerably below 50 %.

### 3. CREDITS TO HOUSEHOLDS

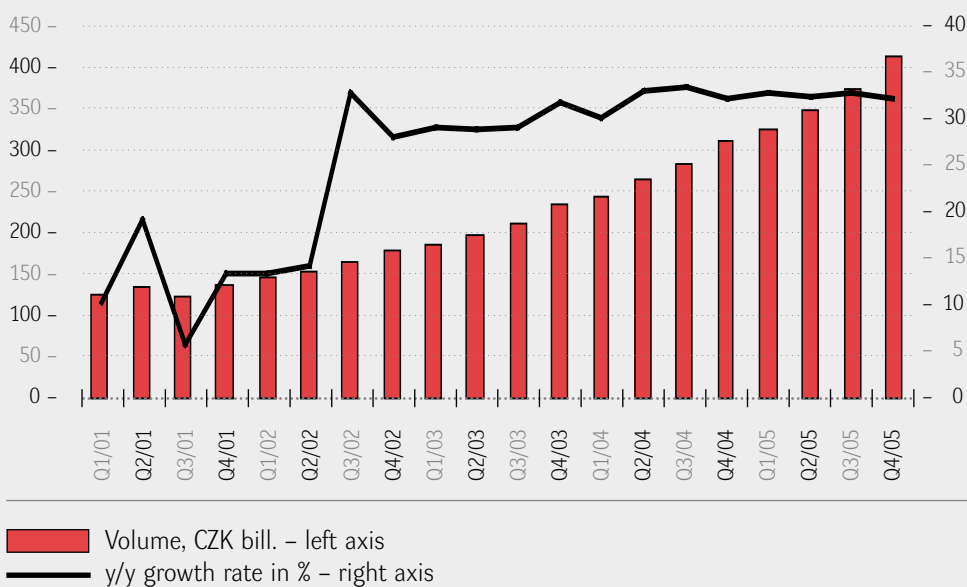
Acceleration of credits to households started in 2002, with the growth exceeding 30 % in the last three years. At the end of 2005, the ratio of loans granted by banks – and other financial institutions under the supervision of the CNB - amounted to 14 % of GDP (see Table 3). The total credits granted to the households not only by banks but also by non-financial institutions (e.g. leasing companies, big retail chains, Multiservis, Home Credit, Provident Financial, etc) reached – according to the official estimate of CNB – 26 % of GDP. This means that the banks

accounted for 55 % of total loans granted to the Czech households, while about CZK 350 bill. were granted by other institutions.

Mortgages represent approximately 45 % of total credits granted to the Czech households by the banking sector (banks account for almost 80 % of total mortgages). The growth of mortgage credits is very dynamic with growth rate around 50 % in the last three years. Czech households have been profiting from the historically low level of interest rates in 2005, as the average interest rate on new housing loans fell to 4.4 % and was similar to that in the euro area.

At the same time, the share of classified and non-performing mortgage loans is at a level comparable to the core EU countries, that is around 2 %. This is due to the fact that

Figure 2: Credits to Households



Source: Czech National Bank

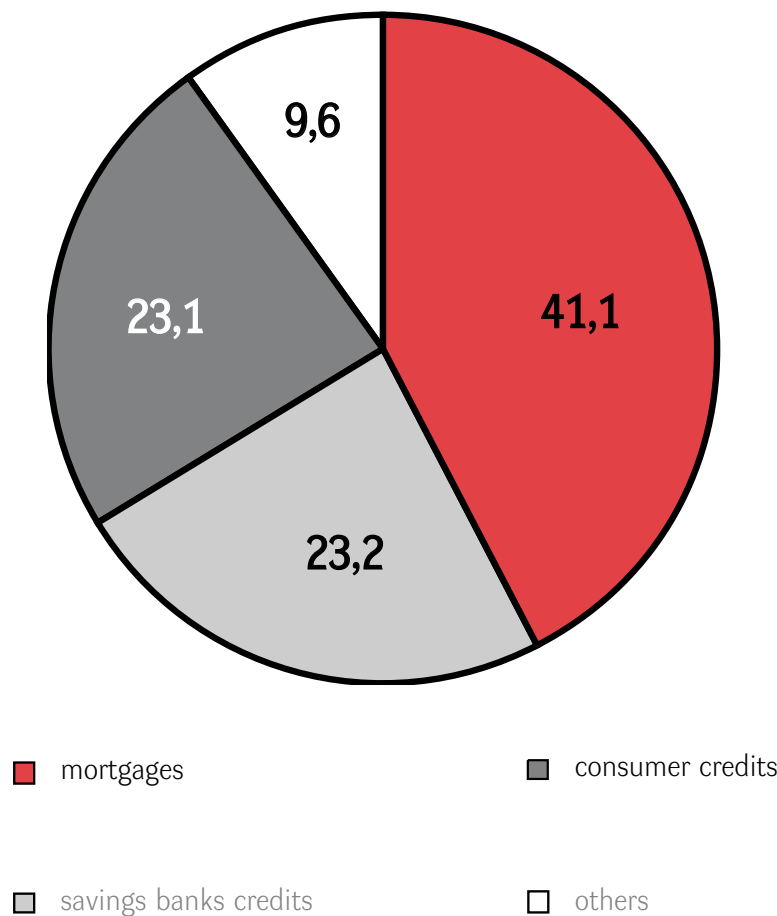
Table 4: Share of Loans to Households on GDP (2004, in %)

Eurozone	56
EU -15	70
United Kingdom	110
Germany	54
France	51
Portugal	49
Greece	31
Czech Republic	26

Source: European Central Bank, national statistics, Czech National Bank

Mortgages represent approximately 45 % of total credits granted to the Czech households by the banking sector. The growth of mortgage credits is very dynamic with growth rate around 50 % in the last three years. Czech households have been profiting from the historically low level of interest rates in 2005, as the average interest rate on new housing loans fell to 4.4 % and was similar to that in the euro area.

Figure 3: Structure of Credits to Households, in %, December 2005



Source: Czech National Bank

mortgage loans have been provided to households with higher incomes, and are covered by collateral in the form of real estate. According to the CNB, mortgage loans do not represent any risky factor for both stability of the banking sector, and financial stability of the households.

After an extremely rapid growth observed in 2002 due to very low base (CZK 28 bill.), consumer credits granted by the banking sector grew by approximately 15 % in the following two years. Further acceleration in 2005 (see Table 3) was provoked by favourable growth of real incomes and historically low interest rates. In addition, opinion polls have witnessed for a growing optimism about economic future by the majority of Czech households. Moreover, younger households do not share the conservative attitudes towards loans of the older generation. Their behaviour is closer

and closer to the behaviour of their West European counterparts.

Although the interest rates reached historically low levels in 2005, interest rates on new consumer credit have in the Czech Republic stayed above those in the Euro area, due to a risk surcharge. This surcharge is around 11 – 13 percentage points in the Czech Republic, compared to about 6-7 percentage points in the Euro area.

Consumer credit remains the most risky, as it was probably drawn mostly by lower income households. The share of non-performing consumer loans is slightly under 10 %, i.e. in principle on Euro area average. This means that around 10 % of households with consumer loans have smaller or bigger problems with their repayments. As the situation in big Czech banks indicates, the debt collection of non-performing consumer

loans is outsourced to specialized companies.

In the share indicated in Table 4, the Czech Republic lagged behind not only the most developed West-European countries, but also those EU-15 countries which are close in economic levels (for 2005, the Czech Republic surpassed Portugal in GDP per capita). This means that there is still free space for an increase of credit granting to

the Czech households. Two factors may play an important role – the trends in real disposable incomes, and the development of interest rates. Regarding the fact that at least CZK 100 bill. is estimated as the amount granted to households by non-financial institutions, there is a challenge for the banking sector to compete, and to crowd out these institutions – of course good risk management in this field is of vital importance.

The Czech Republic lagged behind not only the most developed West-European countries, but also those EU-15 countries which are close in economic levels. This means that there is still free space for an increase of credit granting to the Czech households.

# SOME QUESTIONS ABOUT THE INFLATION FORECASTS OF THE CZECH NATIONAL BANK

Eva Zamrazilová

Monetary policy of the Czech National Bank is a subject to frequent criticism focused on the movements of basic interest rates. The changes of basic rates have been really quite frequent: in the course of previous three years, the basic repo rate registered nine changes, each of them by 25 basis points: six cuts and three increases. The longest period of stable interest rate was August 2003 – June 2004, when repo rate stood at 2 %. At the same time, the ECB kept its basic refi rate at 2 % from June 2003 to December 2005, that is two and half years. Making its monetary policy decisions, the Czech bank board usually regards recent inflation developments and latest inflation forecast. The movements in basic rates also roughly corresponded to the changes of inflation forecasts, which had changed more often downwards than upwards (see Figure 1).

## Fluctuations of the Forecasts: Reasons and Consequences

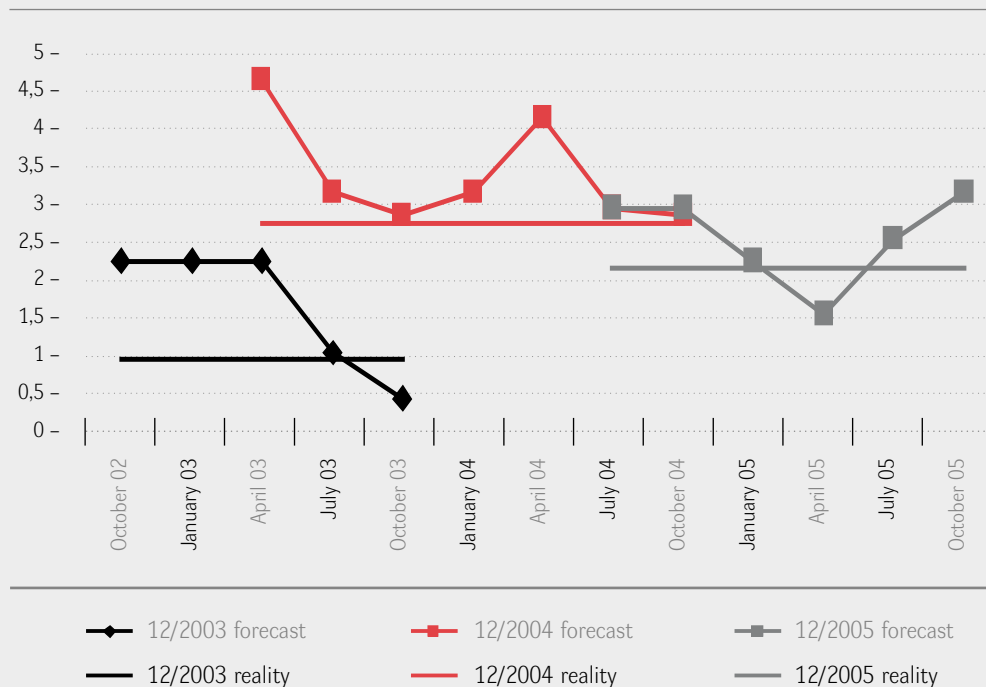
Figure 1 shows the developments of the inflation forecasts since October 2002 to

October 2005. Since the CNB does not explicitly publish the average full-year inflation forecast, only the year-end figures may be analysed. The fluctuation of the inflation forecasts was considerable.

**In December 2003, the CPI stood at 1 %.** After the overestimation of the year-end figure in the first half of 2003, the July 2003 forecast corresponded almost exactly to the reality. However, following October cut of the forecast further below caused final underestimation of December 2003 CPI. According to the respective Inflation Report, the forecast for the end of 2003 was downscaled due to recent inflation outturns, slower pass-through of certain inflationary pressures and strengthened effect of the negative output gap.

**At the end of 2004, the CPI amounted to 2.8 %.** The CNB inflation forecast was very close to the reality from July 2003 to January 2004. However, in April 2004, the inflation forecast for the year-end was raised to 4.2 % – to be gradually cut to 2.9 % in October 2004. April and July overstatement of the

Figure 1: CNB Forecast and Reality, CPI, year over year growth in %



The changes of basic rates have been quite frequent: in the course of previous three years, the basic repo rate registered nine changes, each of them by 25 basis points: six cuts and three increases.

The fluctuation of the inflation forecasts was considerable.

Source: Czech Statistical Office, Czech National Bank

forecast also corresponded with two increases of the basic interest rates (in July and August 2004) up to 2.5 %. The reasons of raising (and overvaluation) of the inflation forecast in April 2004 (that is before the EU entry) was the increase in expected impact of indirect tax changes and transitory speed-up of food prices due to the developments of agricultural producer prices. On the other hand, the developments of agricultural prices after the good 2004 harvest was the reason behind October 2004 cut of the forecast.

**At the end of 2005, the CPI amounted to 2.2 %.** The forecast was gradually cut down (from 3 % in October 2004) to 1.6 % in April 2005. The deferred emergence of the demand-pull inflationary pressures (together with the downward shift in the import prices and food prices expectations) led to the downscaling of the inflation forecast over the entire forecast horizon. At the same time, the April 2005 forecast was the most underestimated one in the course of previous three years and was followed by two repo rates cuts to the historically lowest level of 1.75 %.

The next forecast published in July 2005 reported the increase of the inflation forecast for December 2005 to 2.6 % as a consequence of increased prediction of import prices, regulated prices and fuels. Another increase of the inflation forecast to 3.2 % (for the year-end 2005) occurred in October due to expected cost inflationary shock and change in prediction of regulated prices. The increase of the forecast was followed by the basic rates increase. However, the economy rapidly absorbed the September oil shock and the December 2005 inflation rate ended one percentage point below the October forecast.

The second-row effects of the autumn oil price shock were clearly overstated, similar to previous overstatement of short-term fluctuations of food prices or the impacts of changes in indirect taxes. E.g. the estimate of Ministry of Finance, which is another very important institution publishing macroeconomic forecasts, increased its summer (and perfectly precise – at 2.2 %) inflation prediction by only 0.3 percentage points, due to the September oil shock.

For the end-year of 2006, the inflation forecast moved over the trajectory 3.1% → 2.7 % → 2.5 % → 3.2 % → 3.1% (mid points of the intervals of the forecast) since October 2004 to January 2006. It is most probable that the

reality will be again below this figure and will be close to the lower band of the wide interval of the forecast (2.4 – 3.8 %).

The fluctuations of the forecasts are probably caused by the over-shot reaction on short-term effects, the impact of which is over before the horizon of the forecast is reached. The discrimination between short-term effect and a longer-term change of tendency is one of the most complicated issues of the forecasting activities, which is far beyond the ability of any macroeconomic model. In addition, there is another problem about the inflation forecasts. In the course of previous three years, the inflation forecast was below the reality only in two cases (in October 2003 for the year-end 2003 and in April 2005 for the year-end 2005), in all other cases the inflation forecast overestimated the reality.

The inflation forecasts thus are systematically upper-biased. This was the case also in the period of net inflation targeting. Even the July 2002 transition towards the unconditioned forecast, which includes the possible change in basic interest rates, did not improve the quality of the forecast. Inflation forecast thus continues to be closer to the inflation target rather to the real inflation figures. The fluctuations of the forecasts may be caused by the overvaluation of transitory and short-term factors but what are the reasons behind permanent upper-bias?

### **Demand Inflationary Pressures and the Output Gap**

A wide range of factors has been taken into account in the framework of the CNB macroeconomic forecast – the assumptions about the developments of external environment, expected autonomous effect of fiscal policy, the trajectory of the equilibrium values of key macroeconomic variables and current position of the economy within the business cycle. The factor, which may have caused systemic overstatement of the inflation forecast, is relatively wide space that was devoted to the evaluation of the current position of the economy in the cycle. This factor was specified by the estimate of the output gap, which should mirror the overall demand inflationary pressures (the overall impact of the demand environment on inflation).

In the inflation forecasts of the Czech National Bank, the emergence of demand inflationary pressures stemming from the closure of the output gap was stressed, in the

The economy rapidly absorbed the September oil shock and the December 2005 inflation rate ended one percentage point below the October forecast. The second-row effects of the autumn oil price shock were clearly overstated, similar to previous overstatement of short-term fluctuations of food prices or the impacts of changes in indirect taxes.

The fluctuations of the forecasts are probably caused by the over-shot reaction on short-term effects, the impact of which is over before the horizon of the forecast is reached.

In the course of previous three years, the inflation forecast was below the reality only in two cases (in October 2003 for the year-end 2003 and in April 2005 for the year-end 2005), in all other cases the inflation forecast overestimated the reality.

In the inflation forecasts of the Czech National Bank, the emergence of demand inflationary pressures stemming from the closure of the output gap was stressed, in the previous three years.

previous three years. According to the Inflation Reports from April, July and October 2004, the demand inflationary pressures should have been the major driving force of the inflation in the future and the average inflation in the second half of 2005 should have amounted to 3 %. With every new inflation forecast, the emergence of demand inflationary pressures was postponed (in January 2005, the demand inflationary pressures were expected to push up inflation in 2006). Finally, in October 2005, the statements about the output gap changed: the output gap will remain to be opened, in 2006 and 2007.

It is necessary to remind that the estimates of the output gap and the specification of the current position of the economy within the business cycle were strongly complicated by numerous and significant revisions of the National Accounts. Nevertheless, it is obvious that the demand inflationary pressures in the Czech economy have not appeared and will not appear in the mid-term horizon.

The estimate of the output gap is generally a subject to wide discussion not only in the economic literature but i.a. also in ECB documents<sup>1)</sup>. The estimate of the output gap is a subject to a high degree of bias and uncertainty, and has only a limited message for the monetary policy. According to ECB, the differences between the estimates of the output gap (for individual years) based on preliminary data and final data (for individual year) are significant, sometimes even higher than the output gap itself and sometimes even with the opposite sign.

One must be afraid that the arguments of the CNB - low inflation in previous years was stemming from the fact that the economy was below its potential - indicates rather the fact that the concept of potential product and the output gap does not contribute sufficiently to the explanation of the low inflation reality in the Czech economy. Under the economic growth close to 5 %, no signs of demand inflationary pressures appear. Moreover, the economy was able to absorb the autumn oil price hike with no second round effect and only a limited and short-term increase in consumer inflation, while producer prices fell even to the deflation range, at the end of 2005.

The question is why the demand inflationary pressures have not appeared and do not threaten in the mid-term horizon. The extremely strong structural changes on the supply side of the economy have caused the outpace of the dynamics of the potential product against the real one. The effects of globalisation, increasing competitive pressures among both producers and traders act with an extremely high intensity in the case of small and opened Czech economy. It is a question, whether these dynamic processes may be mirrored within the framework of macroeconomic modelling.

### Why to Increase the Stability of the Inflation Forecast?

The aim of these comments is not to criticise the monetary policy decisions of the CNB's board. In its decisions, the bank board must follow standard procedures. If the real inflation goes beyond the range of the inflation forecasts, or the downside or the upside risks are significant, the bank board has to think over the basic rate change. At the same time, the bank board must consider the inflation forecast as reliable and credible and coordinate its steps with the changes of the forecast. Otherwise, the system of monetary policy should not make sense. The aim of this article is thus only to stress the need of stable and credible inflation forecasts.

It is also a fact that the basic interest rate changes were frequent but not very dramatic during the last three years. The repo rate oscillated in a relatively narrow range of 1.75 - 2.75 %, therefore the mistakes in the forecasts followed by monetary policy decisions in fact could not hamper the real economy to a very substantial extent. On the other hand, fluctuating forecast followed by flexible monetary policy most probably leads to the weakening of transmission mechanism and to the weakening of the monetary policy itself.

More robust inflation forecasts, less affected by short-term factors, would be beneficial not only to monetary policy decision making. The Czech National Bank is the superior Czech financial institution with

According to ECB, the differences between the estimates of the output gap (for individual years) based on preliminary data and final data (for individual years) are significant, sometimes even higher than the output gap itself and sometimes even with the opposite sign.

The effects of globalisation, increasing competitive pressures among both producers and traders act with an extremely high intensity in the case of small and opened Czech economy.

Fluctuating forecast followed by flexible monetary policy most probably leads to the weakening of transmission mechanism and to the weakening of the monetary policy itself.

More robust inflation forecasts, less affected by short-term factors, would be beneficial not only to monetary policy decision making.

<sup>1)</sup> Note e.g. ECB Monthly Bulletins, October 2000, February 2005. Orphanides, A-Van Norden.S.: The Unreliability of Output-gap Estimates in Real Time. The Review of Economics and Statistics, November 2002, No.4, pp.569-583. McCallum, B.T.: Should Monetary Policy Respond Strongly to Output Gaps? AEA Papers and Proceedings, May 2001, pp.258-262.

the best both personal and technical background. Czech economic public always awaits impatiently the new inflation forecast. For this reason, it would be highly appreciated, if the forecast could be generally considered as reliable and credible. Frequent changes of the inflation forecasts confuse the analysts, who must decide whether to change their own forecasts or not. Inflation is the key indicator for all economic subjects,

especially for the financial institutions; it is the background for their strategic decisions. In addition, the inflation figure is the basic tool for the wage bargaining and the overestimated inflation forecasts is a very dangerous weapon for the overstated wage demands. These are only some of the reasons speaking for the improved quality of the inflationary forecasts of the Czech National Bank.

---

<b>Authors:</b>	Kamil Janáček Chief Economist Eva Zamrazilová Senior Analyst	+420-224 214 666 kamil_janacek@kb.cz +420-222 436 633 eva_zamrazilova@kb.cz FAX +420-224 222 839
<b>Assistance:</b>	Radka Maděrová Assistant	+420-222 436 632 radka_maderova@kb.cz

---