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CZECH ECONOMY AT THE BEGINNING OF 2006: STRONG GROWTH CONTINUES

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CZECH ECONOMY AT THE BEGINNING OF 2006: A PERIOD OF STRONG GROWTH

Kamil Janáček, Eva Zamrazilová

1. SUMMARY AND CONCLUSIONS

In 2005, the Czech GDP increased by 6 %, which was the highest growth in the history of the Czech Republic. This was acceleration against 2004 (4.7 %). The growth accelerated in the course of the whole year, last quarter of 2005 registering record-high figure of 6.9 %, y/y. The growth of GDP was impressive in comparison with the EU average GDP growth (1.6 %), and was at the same level as in neighbouring Slovakia, being above growth figures in Hungary and Poland.

Regarding high GDP growth figure, the domestic demand showed rather a slow growth, in 2005. Both consumer and investment demand registered a slowdown, in comparison with previous year – to 2.6 % and 3.7 %, respectively. Therefore, the exports took over the position of major growth factor – the Czech economy became an export driven one.

Foreign trade was another area reporting historically best figure – the trade balance registered first surplus since 1993. The exports increased by 8.6 %, y/y, the imports rose by 4.6 %, y/y. The trade surplus

amounted to CZK 40.4 bill., which was year over year improvement of CZK 66.8 bill. The pace of improvement of the trade balance, however, registered a slowdown in the second half of the year due to high world oil and gas prices. Foreign trade has improved in particular due to the pro-export effects of foreign direct investments, the inflow of which was massive during the last decade, amounting to CZK 1544 bill. up to the end of 2005. At the same time, the Czech Republic was the only one out of new EU members, which reported a trade surplus, in 2005.

The external balance significantly improved in 2005 – the current account deficit declined to 2.1 % of GDP, down from 6 % in 2004. The main reason was good performance of the trade balance, however also the balance of incomes – main troublemaker of the current account – registered a favourable upturn, after ten years of continuous deterioration. The deficit of the balance of incomes reached CZK 142 bill., down from 158 bill., in 2004. Financial account revealed a strong inflow of FDI inflows amounting to CZK 243 bill., due to privatisation sales and continuing reinvestments of profits, which accounted for approximately 30 % of the FDI inflow.

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Foreign trade was another area reporting historically best figure – the trade balance registered first surplus since 1993. The exports increased by 8.6 %, y/y, the imports rose by 4.6 %, y/y. The trade surplus amounted to CZK 40.4 bill., which was year over year improvement of CZK 66.8 bill.

The external balance significantly improved in 2005 - the current account deficit declined to 2.1 % of GDP, down from 6 % in 2004. The main reason was good performance of the trade balance, however also the balance of incomes - main troublemaker of the current account - registered a favourable upturn, after ten years of continuous deterioration.

Table 1: Main Macroeconomic Indicators

		2000	2001	2002	2003	2004	2005	2006f
GDP growth	%, real	3.9	2.6	1.5	3.2	4.7	6.0	5.0
Industrial production	%, real	5.8	6.7	1.9	5.5	9.6	6.7	8.0
Construction output	%, real	5.6	9.6	2.5	8.9	9.7	4.2	8.0
Retail sales	%, real	4.6	4.3	2.7	5.0	2.5	3.8	4.5
Inflation	%, average	3.9	4.7	1.8	0.1	2.8	1.9	2.5
Inflation	%, e.o.p.	3.9	4.1	0.6	1.0	2.8	2.2	2.5
Industrial producer prices	%, e.o.p.	5.0	0.8	-0.7	0.9	7.7	-0.3	2.5
Unemployment rate	%, e.o.p.	8.8	8.9	9.8	10.3	9.5*	8.9	8.2
Trade balance	CZK bill.	-126.8	-116.7	-71.3	-69.8	-26.4	40.4	60
Current account	USD bill.	-2.7	-3.3	-4.2	-5.7	-6.5	-2.6	-1.8
Current account	% of GDP	-4.9	-5.4	-5.6	-6.3	-6.0	-2.1	-1.5
Financial account	USD bill.	3.8	4.5	10.6	5.6	7.2	5.8	5.0
Financial account	% of GDP	6.9	7.5	14.4	6.1	6.6	4.7	4.0
State budget	% of GDP	-2.4	-2.9	-1.9	-4.3	-3.4	-1.9	-2.4
Official FOREX reserves	USD bill.	13.1	14.5	23.7	27.0	28.4	29.5	29.5
M2 growth	%, e.o.p.	6.5	12.4	3.2	7.0	4.4	8.2	8.0
PRIBOR 3M	%, average	5.4	5.2	3.6	2.3	2.4	2.0	2.4
CZK/EUR**	Average	35.6	34.1	30.8	31.8	31.9	29.8	29.0
CZK/USD	Average	38.6	38.0	32.7	28.2	25.7	24.0	24.0

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

*as of 2004, according to the new methodology

Although the growth in industry was not that record-high as in 2004, the dynamics of 6.7 % remains very solid, in particular in the European context. Moderate slowdown of industrial output was provoked by weak economic activity in the eurozone and overall slowdown of demand for metal production. Car industry was the most rapidly growing one, with growth above 20 %. The new capacities of TPCA, as well as growing production of automotive parts, helped to increase the automotive production. Regarding the key importance of automotive industry for Czech industry and foreign trade, risks for the whole economy stemming from the cyclical character of demand in this industry seem indisputable.

Statistical data on construction in 2005 were still affected by 2004 VAT change – rather low growth of output (4.2 %, y/y), was caused predominantly by the statistical effects. As in previous years, the construction was driven mostly by infrastructure projects and activities of foreign investors focused on business and commercial centres. Housing construction continued in growth, supported primarily by the mortgage market. The volume of mortgages rose by more than 40 %, their share on GDP (around 8 %) being, however, still low in the European context. Free space for further increase of the mortgage market in the Czech economy still exists.

Retail sales registered acceleration of growth to 3.8 %, up from 2.5 % in 2004. The main reason was the recovery in the automotive segment and a strong demand for non-food consumer goods. The advantageous offers have been widening due to activity of international retail chains. The purchasing power of the consumers has been supported by consumer credits which increased by 37 %, in 2005.

Record high growth of the Czech economy was accompanied by low inflation, fundamental inflation pressures in the economy remaining weak. In spite of high world oil and gas prices, inflation only moderately increased over the year 2005. The highest monthly rise was in October 2005 (2.6 %, y/y), when regulated prices of natural gas were increased. After that, however, inflation returned to its longer-term path. Average inflation thus reached 1.9 %, down from 2.8 %, in 2004.

Czech Republic has been showing the features of a low-inflation economy for a longer time, due to the following main factors: first, continuously appreciating

exchange rate of the Czech koruna and second, high degree of openness, and a competitive internal market both in relation. Due to these reasons, administered prices (electricity, natural gas, centrally-supplied heat, and water) accounted in 2005 for almost two thirds (63.6 %) of the yearly increase of consumer prices.

In 2005, Czech economy witnessed a genuine fall of producer prices – the producer price index went from +7.2 %, y/y, in January, to -0.3 % y/y in December. Main factors of the price fall were: decreasing prices of metals, strong koruna and strong competition in both the world and the Czech markets, resulting in a price decrease of engineering products (both imported and home-made). Producer prices stopped to fall in the first quarter of 2006. As one can see on EU markets, world economy entered a new period of faster growing producer prices, primarily due to strong world growth and shortages of some important raw materials (oil, precious metals).

In 2005, the appreciation of the Czech currency continued, driven by good macroeconomic performance (strong GDP growth, foreign trade improvement and continuing inflow of foreign direct investment). In average, the Czech currency appreciated by 6.6 % against the EUR and by 6.8 % towards the USD. The strong Czech currency attenuated the influence of high oil and gas prices on the Czech economy. Appreciation against the USD however stopped at the end of January 2006; since then, the dollar oscillates slightly below 24 CZK/USD, and it no more plays the role of a compensating factor for the growing prices of oil and some non-ferrous metals.

In the first four months of 2005, Czech National Bank cut the basic repo rate three times – each time by 25 basis points – from initial level of 2.5 % to 1.75 % at the end of April. From May to October, 2005, CNB basic rate was 25 basis points under the ECB refi rate. At the end of October, CNB raised the repo rate by 25 basis points to the level of ECB rate (2.0 %). After the December 2005 and March 2006 increases of ECB's refi rate to 2.25 % and 2.50 %, respectively, repo rate is again – and, for the time being, by 50 basis points – below the basic eurozone rate.

In 2005, labour market registered a decline of the unemployment rate as a consequence of strong economic activity, the year-end unemployment rate amounting to 8.9 %, down from 9.5 %, in December 2004. Employment

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has been increasing in successful manufacturing industries, construction and some services (in particular trade). However, strong economic activity does not address structural problems, as the decline of the overall unemployment rate has been driven predominantly by the decline of short-term unemployment. Strong regional disparities have been preserving and the scope of long-term unemployment continually increases. In the last quarter of 2005, the share of long-term unemployment amounted to 53.4 %.

Outlook

We expect 2006 to be another year of strong growth and relatively low inflation. Low inflation will allow the CNB to let the interest rate at low levels and wait for the next moves of the European Central Bank. GDP will continue to be driven by the net exports; private consumption and the investment demand will grow at approximately the same pace as in 2005. For the whole year 2006, we expect GDP growth at (or slightly above) 5 %.

Despite approaching election and growing uncertainty about the future government, the Czech currency will continue to appreciate with a temporary weakening in the second quarter (due to repatriation of profits and parliamentary elections). Strong currency will be one of the factors, keeping the inflation at low level. The cost inflationary pressures stemming from high raw world material prices (oil, gas, metals, etc.) will push producer prices up. External shocks excluded, PPI will move in the range between 2 and 3 % in the second half of 2006.

Demand inflationary pressures will not emerge yet, in particular due to strong competition on the domestic market. Nevertheless, higher producer prices will push CPI slightly over the 2005 level. We expect both the average and year-end CPI at 2.5 %.

The trade balance will be again in black figures, in 2006. Rapid growth of machinery exports driven by the automotive industry will improve the trade balance, while the high fuel prices will have the adverse effect. Under the assumption of stabilized world oil prices at current levels, the full-year trade surplus will reach approximately CZK 60 bill. As a consequence of further improvement of the trade balance, the deficit of the current account will further decrease. Under the assumption of GDP growth around 5 % and average inflation around 2.5 %, the ratio of the

current deficit to GDP would decline to 1.5 %.

In 2006, industry will continue to be the main driving force of economic activity. Moderate recovery of the activity in the eurozone has started to be felt as of the beginning of the year, both industrial output and sales registering an acceleration above 10 %. In addition, new capacities in the automotive industry have already started to affect positively the industrial output data. We expect that the recovery of the activity in the eurozone combined with the impact of new automotive capacities will push up the full year growth in industry close to the 10 % level.

Construction has still further potential for growth. New projects on business and administrative centres carried out predominantly by foreign investors as well as the investments to infrastructure will continue. Housing construction will grow by a pace similar to previous year, driven by the boom of the mortgage market. In particular, the demand for big flats will be pushed up by expected price increase (as of the beginning of 2008). The growth in 2006 will continue by a pace similar to that in the second half of 2005 – that is around 8 %.

The growth in retail trade in 2006 will be solid, as a consequence of stable dynamics of incomes and low inflationary environment. Consumer loans will continue to support the retail sales – the growth of consumer loans accelerated at the beginning of 2006, as well as the retail sales. The growth of retail sales will amount to approximately 4 - 5 %, in 2006.

Strong economic activity will help to improve slightly the situation of the labour market; in the first place, the short-term unemployment will continue to decline. At the end of 2006, we expect the unemployment rate slightly above 8 %. At the same time, rigidities of the labour market will represent one of the major challenges for the next Government: low flexibility of labour contracts, non-performing market with rental housing and low activity of the unemployed fuelled by still generous social policy are the main issues to be addressed.

2. EXTERNAL ENVIRONMENT

2.1 World Economy

In the first quarter of 2006, world economy continues to grow rapidly, as was typical for

In 2005, labour market registered a decline of the unemployment rate as a consequence of strong economic activity, the year-end unemployment rate amounting to 8.9 %, down from 9.5 %, in December 2004. However, strong economic activity does not address structural problems, as the decline of the overall unemployment rate has been driven predominantly by the decline of short-term unemployment.

We expect 2006 to be another year of strong growth and relatively low inflation. GDP will continue to be driven by the net exports; private consumption and the investment demand will grow at approximately the same pace as in 2005. For the whole year 2006, we expect GDP growth at (or slightly above) 5 %.

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Rigidities of the labour market will represent one of the major challenges for the next Government: low flexibility of labour contracts, non-performing market with rental housing and low activity of the unemployed fuelled by still generous social policy are the main issues to be addressed.

the past three years. Growth is clearly above the 30-years long-term trend. American economy – after a moderate weakening in the fourth quarter of 2005 – is speeding up; most probably, 2006 growth will be roughly the same as in 2005. The Fed raises the interest rates gradually, so that inflation is and will remain under control. Employment grows above the long-term trend, and the U.S. economy has unemployment under 5 %, i.e. below the estimated NAIRU. The prevailing view still is that the twin deficits pose no serious threat, so that a "hard landing" of the U.S. economy is not expected.

Japanese economy will continue to grow above the 3 % line. Faster growth of wages – supported by rapid productivity increase – will foster private demand. Closing of the output gap will provoke a moderate price increase (roughly 0.5 % growth of CPI) so that the Japanese economy will come out of the deflation period.

China and India will slow by approximately one percentage point in 2006 - with growth figures of 9 % and 7.3 %, respectively, still remaining very impressive. Demand of these two countries for oil will continue to be an important factor keeping oil prices at high levels. Also, high prices of commodities will promote growth in Latin America, where current account surpluses are expected to continue for another year. Comfortable financial position will enable some countries (Brazil, Venezuela, and Mexico) to pay up part of their external debt. On the other side, it may make governments less willing to do the necessary (but unpopular) economic reforms.

Eurozone growth will somewhat improve in 2006, but will remain around the 2 % level. Investment will be the main growth factor, supported by low interest rates and high corporate profits. Unemployment will show only a slow decrease, and inflation will remain above 2 %. Nevertheless, it is expected that private consumption will also revive

moderately, contributing to GDP growth. Depreciation of the euro in the second half of 2005 has renewed Eurozone's price competitiveness, so that exports will continue to foster GDP growth (thanks also to the robust world demand). Yet in global comparison, Eurozone will remain the slowest-growing region (see Table 2). As political elites are incapable to do the reforms necessary for removing rigidities and making the economies more flexible – and the citizen are unwilling to accept such reforms – Europe remains condemned to lagging behind the leaders of global economic development.

Strong growth of the world economy will keep oil prices over USD 60 per barrel for the prevailing part of the year. Demand for oil is expected to increase by roughly 1.5 million barrels per day, to 85 millions barrels of daily demand. Oil production will also increase, by almost two million barrels, yet free reserves and stocks will only grow minimally, to 1.2 million barrels of daily output. That means that the OPEC countries will keep control over oil prices, and will not let them go under USD 55/barrel. In 2007, as global growth and global demand will be gradually decreasing (to approx. 4%), it may however be expected that the price of oil will also diminish, to or below the USD 55/barrel level.

2.2 Central Europe

In two out of the four Central-European new EU members, growth speeded up in 2005 (see Table 3). In 2006 as well, these countries will grow 2 to 3 % faster than the Eurozone. Exports, strong investment activity, and a solid increase of household consumption are the main factors of economic dynamics.

Other facts however are less gratifying. With the exception of Slovakia, these countries are incapable to keep, over a longer period, public finance deficits under the 3 % "magic line" required by the Maastricht criteria. This is in

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Table 2: World Economic Development, 2004-2006 (GDP growth in %, constant prices)

	2004	2005	2006F
USA	4.2	3.5	3.3
Japan	2.3	2.8	3.2
China	10.1	9.9	9.5
India	7.5	8.0	7.3
Eurozone	1.8	1.4	2.0
Latin America	4.5	4.2	4.3
World	5.1	4.5	4.6

Source: Société Générale, Deutsche Bank, forecast by Komerční banka.

Table 3: Growth in CE-4 Countries, 2004-2006 (GDP growth in %)

	2004	2005	2006F
Poland	5.3	3.2	4.6
Hungary	4.6	4.1	4.1
Slovakia	5.5	6.0	5.8
Czech Republic	4.7	6.0	5.0

Source: National Statistical Offices, forecast by Komerční banka

spite of the robust (in European context) economic growth. The main reason lies in the lack of courage on the part of governments (Hungarian, Polish, and Czech) to carry out the necessary reforms of public finance. Mainly, changes in the pension systems, in financing the health care, and in some social benefits.

This situation will to a large extent determine the timing of possible entry of Central-European countries into the European Monetary Union. Together with inflation, fiscal deficits are the most important among the five Maastricht criteria. The European Central Bank clearly states the intention to insist on a strict fulfilment of all the Maastricht criteria - in their strictest possible interpretation. After the practical collapse of the Stability and Growth Pact, the ECB has problems with persistent deficits of public finance in Germany, Italy, France, Portugal, or Greece. A premature widening of the Eurozone, letting in further countries fighting with the fiscal criterion of membership, would make her task even more difficult for the ECB. Moreover, the newcomers this time would be much more different (and with significantly lower economic levels), which would make the "one-size-fits-all" monetary policy even more problematic. It is not by chance that the leading representatives of ECB, along with the requirement of strict fulfilment of the Maastricht Criteria, more and more stress also the importance of the so-called real criteria of convergence (i.e. economic level measured by GDP per head, harmonization of the cycle, structural convergence, etc.).

All this plays a key role in estimating the probable date of entry into the EMU for

individual countries. With a realistic view of the capability to master all the Maastricht criteria in their undiluted interpretation, we come to the following (hypothetical) timing – see Table 4.

One however should not underestimate one possible effect of longer waiting times before Eurozone entry. Some analyses¹ indicate that part of the Central-European countries might adopt the "Swedish model", that is, declare formally their will to adopt the euro, but apply a "no-need-to-hurry" policy, thus keeping access to their independent monetary policy.

3. GROSS DOMESTIC PRODUCT

In 2005, the Czech GDP increased by 6 %, which represents a considerable acceleration against 2004 (4.7 %). At the same time, this was the highest GDP growth in the history of the Czech Republic. The growth of GDP accelerated in the course of the year, last quarter registering record-high figure of 6.9 %, y/y. The growth of GDP was impressive in comparison with the EU average GDP growth (1.6 %), and was at the same level as in neighbouring Slovakia, being above growth figures in Hungary and Poland. Strong economic growth in last two years resulted in improvement of relative position of the Czech Republic in the international framework. The GDP per capita in USD (PPP based) is

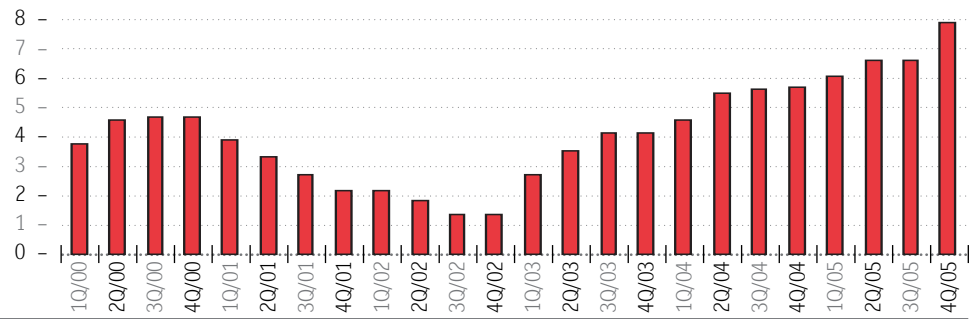
1) Cf. For example "Will CEE ever Join EMU?", New European Market Analyst 06/06, Goldman Sachs, March 16, 2006.

Table 4: Expected Dates of the Eurozone Entry

Slovakia	2009 - 2010
Poland	2010 - 2011
Czech Republic	2010 - 2011
Hungary	2012 - 2014

Source: National Authorities

Figure 1: GDP Growth (quarterly growth rates in %, y/y)



Source: Czech Statistical Office

Figure 2: Gross Domestic Product and Gross Domestic Income, growth rates in %



Source: Czech Statistical Office

Both consumer and investment demand registered a slowdown, in comparison with previous year. The exports took over the position of major growth factor.

Favourable picture of the net exports as the engine of GDP growth was strongly influenced by the developments of terms of trade.

If the terms of trade did not change, the volume impact of net exports would deteriorate by CZK 48 bill. The macroeconomic indicator, which accounts for the gain or loss from the change of terms of trade, is the Gross Domestic Income (GDI).

estimated at USD 20 100, amounting to 73 % of the EU 25 average, for 2005.

The absolute increase of GDP (in constant prices) amounted to CZK 164.8 bill. – see Table 5. It is obvious that the main growth factors differ as to its impact to GDP growth in terms of volume and in terms of growth rates. Regarding high GDP growth figure, the domestic demand showed rather a slow growth, in 2005. Both consumer and investment demand registered a slowdown, in comparison with previous year. On the other hand, the exports took over the position of major growth factor. The exports of goods increased by 12.4 %, y/y, while the imports rose by 5.9 %, y/y, therefore the net exports of goods contributed to GDP growth by CZK 110. bill., which was a significant improvement in comparison with 2004. The Czech economy thus became an export driven one.

However, favourable picture of the net exports as the engine of GDP growth was strongly influenced by the developments of terms of trade. The terms of trade deteriorated by 2.2 %, in 2005 (specified according to the deflators of overall imports and exports as parts of GDP), after a long-term continuous

improvement – see Table 6. If the terms of trade did not change, the volume impact of net exports would deteriorate by CZK 48 bill. The macroeconomic indicator, which accounts for the gain or loss from the change of terms of trade, is the Gross Domestic Income (GDI), which has started to be regularly published by the Czech Statistical Office, in the framework of National Accounts. In 2005, the GDI grew by mere 4.2 %, indicating slower growth than the GDP.

Figure 2 shows the differences between the growth of GDP and GDI in 1996–2005. When the terms of trade improve – that is, prices of exports grow more rapidly than the prices of imports do, – the GDI increases more rapidly than the GDP. The case of 2005 was the opposite one – GDP grew more rapidly than the GDI. The consequence of the deterioration in terms of trade results in lost of some part of its income or – in other words – some part of domestic demand. Therefore, in 2005, the growth of consumer demand and investment demand was rather low under strong GDP growth.

The deterioration of terms of trade was thus the factor which increased the GDP growth by

Table 5: GDP Growth, Individual Demand Items

	2004		2005	
	Absolute increase (CZK bill.)	Rate of growth (% , y/y)	Absolute increase (CZK bill.)	Rate of growth (% , y/y)
GDP	119.9	4.7	164.8	6.0
Consumption of households	42.4	3.3	35.9	2.6
Consumption of government	-16.1	-2.7	4.9	0.8
Gross capital formation	36.4	5.3	27.6	3.7
Net exports of goods	31.8	n.a.	110.1	n.a.
Net exports of services	5.2	n.a.	12.9	n.a.

Source: Czech Statistical Office

Note: This table presents only the most important demand items, some marginal items have been omitted (change in inventories, net acquisition of valuables and NPISH), therefore the sum of individual absolute increases does not correspond to overall GDP.

Table 6: Deflators of Exports and Imports, Terms of Trade (in methodology of National Accounts)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Deflator of Exports (%)	104.7	105.6	103.9	101.1	103.2	99.6	94.5	99.6	102.2	97.4
Deflator of Imports (%)	101.8	105.2	98.1	101.6	106.1	97.4	91.6	99.4	101.8	99.6
Terms of trade (perc. points)	2.8	0.4	5.9	-0.5	-2.7	2.3	3.2	0.2	0.4	-2.2

Source: Czech Statistical Office

1.8 percentage point, by increasing the volume of net exports in constant prices. The logic of an economist does not correspond with the logic of national accounts – it is clear that the deterioration of the terms of trade does not mean anything positive for the economy. The deterioration in terms of trade was thus the dark side of the generally impressive picture of Czech economic growth in 2005. At the same time, an upturn observable in terms of trade since the beginning of 2006 will have adverse effect on GDP in 2006. We must expect a slowdown of GDP to approximately 5 %.

As for individual sectors, manufacturing industry continued to be the main driving force of GDP. In 2005, gross value added in manufacturing industry rose by 10.9 %, which was strongly above the growth of 3.6 % in 2004. Manufacturing industry accounted for

27 % of GDP. The total share of industry on GDP (including mining industries and production of electricity, gas and water), however, still exceeds 32 %, which is quite high in the context of developed EU economies. Gross value added in services rose by 5.3 %. The share of services on total GDP amounted to 61 %. The growth in services was strongly differentiated. The highest growth registered finance and insurance with growth of gross value added amounting to 11 %, followed by trade industries (10.6 %). Anyway, there still exists a wide space for further development of the sector of services, in the Czech economy.

4. EXTERNAL BALANCE

In 2005, Czech balance of payments ended

Table 7: Balance of Payments, (CZK bill.)

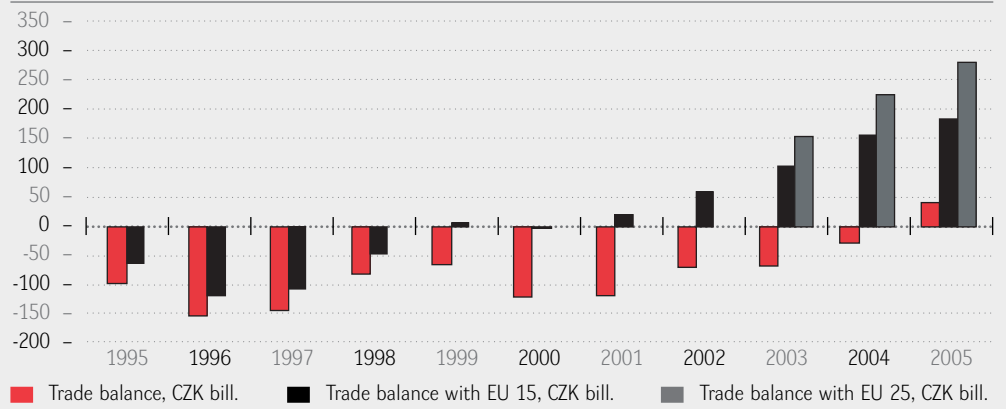
	2003	2004	2005
Current account	-160.6	-167.3	-61.7
o.w. Foreign trade	-69.8	-26.4	40.4
Balance of services	13.2	12.5	19.4
Balance of incomes	-119.9	-157.8	-142.3
Transfers	15.8	4.3	20.9
Capital account	-0.1	-14.0	5.1
Financial account	157.1	183.7	137.9
o.w. Direct investments	53.5	100.8	242.7
Portfolio investments.	-35.7	59.4	-72.0
Financial der.	3.9	-3.2	-2.8
Long-term capital	27.5	57.0	33.8
Short-term capital	107.9	-31.2	-63.8

Source: Source: Czech National Bank

In 2005, the GDI grew by mere 4.2 %, indicating slower growth than the GDP. Therefore, in 2005, the growth of consumer demand and investment demand was rather low under strong GDP growth.

The deterioration in terms of trade was thus the dark side of the generally impressive picture of Czech economic growth in 2005.

Figure 3: History of the Trade Balance



Source: Czech Statistical Office

in a surplus: current account deficit amounted to CZK 61.7 bill., the surplus on financial account reached CZK 137.9 bill. The current account deficit declined by more than CZK 100 bill, down from 167.3 bill, in 2004. Current account deficit thus reached mere 2.1 % of GDP, which was a strong improvement against 6.0 % in 2004. Financial account revealed a strong inflow of FDI inflows, due to privatisation sales and continuing reinvestments of profits.

4.1 Current Account

Trade Balance

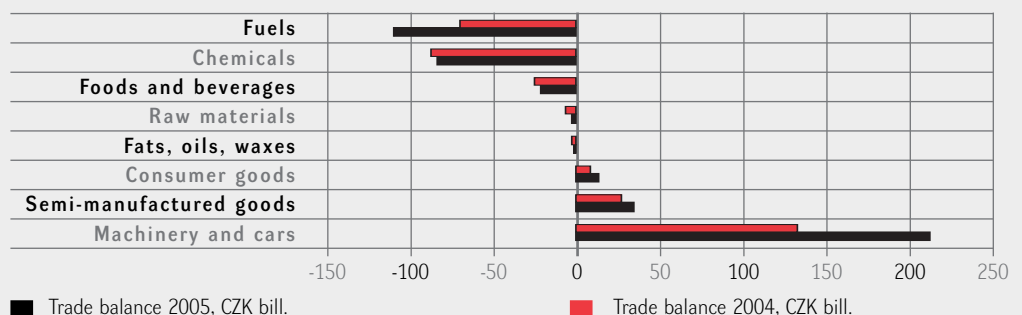
The turnover of foreign trade rose more rapidly than the GDP in current prices (6.6 %, y/y and 5.9 %, y/y) – the openness of the Czech economy measured by the ratio between the turnover of foreign trade and GDP thus further increased. The turnover of foreign trade exceeded the volume of GDP by 30 %, in 2005.

Figure 4: Trade Balance with Selected Countries



Source: Czech Statistical Office

Figure 5: Trade Balance: Commodity Structure



Source: Czech Statistical Office

The turnover of foreign trade exceeded the volume of GDP by 30 %, in 2005.

In 2005, the exports increased by 8.6 %, y/y, the imports rose by 4.6 %, y/y. The trade surplus amounted to CZK 40.4 bill., which was an improvement of CZK 66.8 bill. in comparison with 2004. This was the best result in the history of the Czech Republic. At the same time, the Czech Republic was the only one out of new EU members, which reported a trade surplus, in 2005. The pace of improvement of the trade balance, however, registered a slowdown in the second half of the year due to high world oil and gas prices.

Major part of foreign trade has been carried out with the EU, the share of EU 25 on exports amounting to 85 %, the share on imports is somewhat lower – 70 %. This shows extremely high level of trade cooperation with other EU members. The trade with EU 25 ended in a surplus of CZK 281.2 bill. (year over year improvement of CZK 56.8 bill.). The rapid increase of the trade surplus with both the "old" EU 15 and the "new" EU 25 is illustrated by Figure 3.

The highest surpluses were produced 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 significant (by CZK 22.4 bill.), due to high share (80 %) of fuels on total imports from Russia.

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. Automotive industry accounted for approximately two thirds of the machinery surplus. Machinery accounted for approximately 51 % of total exports, automotive production accounted for 16 %. 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 (by CZK 5.3 bill.), the trade with fuels deteriorated by another CZK 40.2 bill. (due to high prices of oil and gas).

As mentioned in the Section 3, terms of trade registered an unfavourable upturn, in 2005. The import prices rose by 0.3 % on average, the export prices declined by 1.4 %. Terms of trade thus deteriorated - by 1.7 percentage point. If the prices remained at the average level of 2004, the trade balance would have reached even higher surplus of CZK 73.5 bill. A very important factor behind the development of export and import prices was the appreciation of the exchange rate, which was in particular an important factor pressing down the export prices. The appreciation of the CZK thus contributed to the deterioration of terms of trade.

Balance of Incomes and Services

In 2005, balance of incomes was the only part of the current account ending in a deficit. However, even this main troublemaker

Table 8: FDI Inflow, 1993-2005

	CZK bill.	Share in %
FDI – total	1543.8	100
Manufacturing industry	557.6	36.1
- automotive industry	98.8	6.4
Services	602.0	55.1
- trade	162.6	11.7
- banking sector	208.2	15.7

Source: Czech National Bank

Major part of foreign trade has been carried out with the EU, the share of EU 25 on exports amounting to 85 %, the share on imports is somewhat lower - 70 %. This shows extremely high level of trade cooperation with other EU members.

Table 9: Portfolio Investments in CZK bill.

	2004	2005
Portfolio investments, net inflow	59.4	-72.0
Assets	-63.9	-72.9
- Equity securities	-30.1	-26.0
- Debt securities	-33.8	-46.8
Liabilities	123.3	0.9
- Equity securities	19.6	-36.4
- Debt securities	103.7	37.3

Source: Czech National Bank

In 2005, machinery, fuels and chemistry were the key items for the trade balance. Machinery produced a surplus of CZK 218.5 bill. Automotive industry accounted for approximately two thirds of the machinery surplus.

of the current account registered a favourable upturn – after ten years of continuous deterioration. The deficit of the balance of incomes reached CZK 142 bill, down from 158 bill., in 2004. The reason was that the revenue grew more rapidly than the expenditure, in particular due to the interest rate differential.

The services performed slightly better than a year before, too. The surplus of this balance amounted to 19.4 bill. The tourism and transport produced surpluses of CZK 53 bill. and 36 CZK bill., respectively, both figures being a slight year over year improvement. The deficit of other services slightly declined to CZK 69 bill., as a consequence of lower purchases of special services abroad.

4.2 Financial Account

The surplus of the financial account amounted to CZK 137.9 bill. in 2005, i.e. below the surplus of CZK 183.7 bill. in 2004. High surplus of the financial account was driven by massive inflow of foreign direct investments during 2005, net FDI amounting to CZK 242.7 bill, out of which approximately one third were the reinvestments of profits. In 2005, the major investor was Spain (CZK 117.6 bill. - the Telecom sale), followed by the Netherlands (47.5 bill.) and Germany (CZK 26.7 bill.). The cumulative inflow of FDI in 1993 – 2005 amounted to CZK 1544 bill, basic structure of the total inflow see in Table 8. More than half of the investments belonged to the sector of services, mainly to the trade, communications and financial services.

Portfolio investments reported net outflow of CZK 72.0 bill. The purchases of foreign portfolio investments made by Czech investors (Czech assets abroad) further increased to CZK 73 bill. On the other hand, the activities of foreign investors were much weaker than a

year before – see Table 9. In 2005, foreign investors were interested merely in debt securities.

Net outflow of other investments reached CZK 30 bill. The main reason for that was short-term capital, the net outflow of which amounted to CZK 64 bill. In particular, domestic banks increased their short-term positions abroad, the net outflow of short money due to commercial banks amounted to CZK 72.3 bill. On the other hand, long-term borrowings increased by CZK 34 bill. Similarly to 2004, long-term capital continued to inflow due to increasing loans of domestic business companies and Government activities.

Outlook

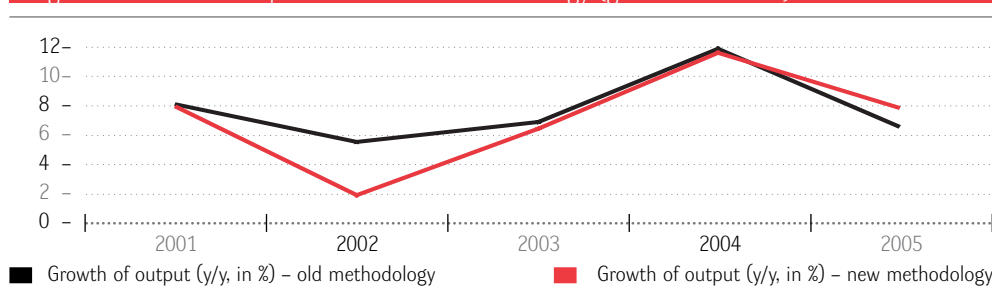
The current account will continue in improvement, in 2006, however, its scope will be lower than in 2005. The trade balance will be affected by two major factors: rapid growth of machinery exports, driven by the export-oriented companies under foreign control will improve the trade balance, while the high fuel prices will have the adverse effect. Machinery exports will continue to be driven by automotive industry. The new TPCA, which is strongly export oriented, reached its full capacity and will further improve the trade balance. Under the assumption of stabilized world oil prices at current levels, the full-year trade surplus will reach approximately CZK 60 bill.

Balance of services may improve to CZK 25 bill. The main question is the balance of incomes – for the time being, we expect stagnation at the level of 2005. The current account deficit would thus further decline to approximately CZK 30-45 bill. Under the assumption of GDP growth around 5 % and average inflation around 2.5 %, the ratio of the current deficit to GDP would decline to 1.5 %.

The current account will continue in improvement, in 2006, however, its scope will be lower than in 2005. Under the assumption of stabilized world oil prices at current levels, the full-year trade surplus will reach approximately CZK 60 bill.

Under the assumption of GDP growth around 4.5 % and average inflation around 2.5 %, the ratio of the current deficit to GDP would decline to 1.5 %.

Figure 6: Industrial Output: Old and New Methodology (growth rates in %)



Source: Czech Statistical Office

5. DOMESTIC DEMAND

5.1 Industry

As of February 2006, the Czech Statistical Office introduced new methodology in reporting the statistics of industrial output. The aim of this change was in particular diminishing the gaps between the growth rates of industrial production and sales, which had been quite significant in some months, with an unclear interpretation. Therefore, the final 2005 full-year growth figure of the industrial output was revised upwards, to 6.7 %, up from 5.7 %, previously reported. The figure for 2004 was slightly downwards revised (to 9.6 %, down from 9.9 %), therefore, the scope of 2005 slowdown was lower than it had previously appeared. The new and old time series presents Figure 6. Industrial sales registered slightly higher growth than the output, increasing by 8.1 %.

Growth in industry in 2005 was concentrated to manufacturing industries, which rose by 7.5 %, while mining increased by 0.5 % and electricity, gas and water supply declined by 1.2 %. The picture has changed in comparison with 2004 – out of three major industrial leaders from 2004, which had been cars, electrotechnics and metals, only the automotive industry kept strong growth. The automotive industry increased by record high 23 %, accounting for approximately 15 % of total industrial output. Metal industry declined by 0.9 %, recovering, however, as of September 2005, due to renewed world demand for metals. Production of electrical appliances reported a slowdown, too (to 5 %, down from 15 %, a year before). Rubber and plastic products, as well as manufacture of coke and refined oil products rose by 12.6 %.

In 2005, industry continued to be driven in

particular by the exports. The direct export sales rose by 10.2 %, their share on total industrial sales reaching 48.5 %. A slowdown in export sales (to 10.2 %, down from 19.6 %, in 2004) was caused primarily by organizational changes – producers increased their exports via trading export companies.

Both total sales and direct export sales continued to grow more rapidly in the segment of foreign-controlled companies – total sales rose by 14.9 %, export sales rose by 11.6 %. In 2005, 1938 companies under foreign control were registered in the Czech industry, with employment amounting to 458 thousands people. The share of foreign controlled companies further increased to 54.8 % of industrial sales. The companies under foreign control are primarily export oriented – direct export sales accounted for 73 % of their total sales. Foreign controlled companies continue to be the major driving force of the Czech industrial output and exports.

The growth of productivity continued to outpace the growth of real wages: in 2005, productivity in manufacturing rose by 7.7 %, real wage increased by 2.6 %. The decline of unit labour costs enables to keep the competitiveness of Czech industrial exporters on foreign markets even under appreciating currency. Strong CZK has been hitting the exporters and slowing down the exports, however, not to a very significant extent.

In 2005, the employment in industry stagnated. Mining, electricity, gas and water supply continued to dismiss workers, while manufacturing hired new employees. The employment in manufacturing rose by 0.7 %. However, fastest growing industries reported high growth of employment. Employment rose most rapidly in the automotive industry and manufacture of rubber and plastics

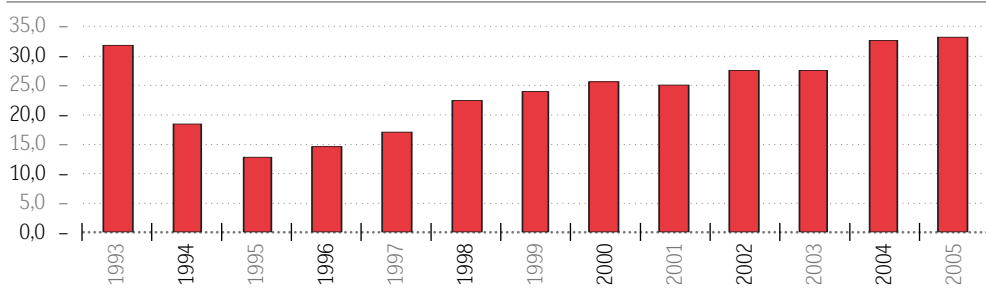
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The picture has changed in comparison with 2004 – out of three major industrial leaders from 2004, which had been cars, electrotechnics and metals, only the automotive industry kept strong growth, in 2005.

The share of foreign controlled companies further increased to 54.8 % of industrial sales. The companies under foreign control are primarily export oriented – direct export sales accounted for 73 % of their total sales. Foreign controlled companies continue to be the major driving force of the Czech industrial output and exports.

The decline of unit labour costs enables to keep the competitiveness of Czech industrial exporters on foreign markets even under appreciating currency.

Figure 7: Completed Flats (in thousands)



Source: Czech Statistical Office

(7 % growth). The growth of employment in manufacturing – by approximately 7 thousands people on average is not very high, but is still important as a change in tendency.

5.2 Construction

The full-year growth in construction was at 4.2 %, y/y. Slowdown in growth in comparison with 2004 (9.7 %, y/y) was caused by the statistical effects of May 2004 VAT change. High bases for comparison strongly affected the H1 2005 figures. In Q1 2005, construction output declined by 3.2 %, y/y, followed by stagnation in Q2 2005. Third and fourth quarters of the year already witnessed growth figures of 7.3 %, y/y, and 9.7 %, y/y, respectively. The employment in construction rose by 4.9 %, y/y, its growth accelerating in the last quarter of the year.

Similar to previous years, construction was driven primarily by infrastructure projects and activities of foreign investors focused on business and commercial centres. Housing construction continued in growth, supported by the mortgage market. The number of finished flats amounted to 32.9 thousands, increasing by 1.8 %, y/y. At the same time, this

was the highest figure in the history of the Czech Republic. At the end of 2005, the volume of mortgages amounted to CZK 236.5 bill., increasing by 44 %, y/y. However, the share of mortgages on GDP (around 8 %) has been still low in the European context. Free space for further increase of the mortgage market in the Czech economy still exists.

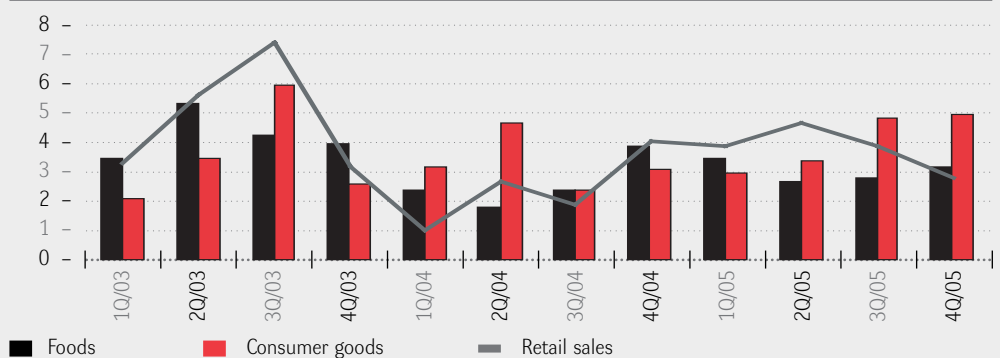
5.3 Retail Trade

In 2005, retail sales rose by 3.8 %, up from 2.5 %, y/y, in 2004. The dynamics weakened in the last quarter of the year (2.8 %, y/y), after a growth of 3.9 %, 4.7 % and 3.9 %, y/y, in Q1, Q2 and Q3 of the year. Weak results of the last quarter were caused by the stagnation in the automotive segment, which accounts for approximately one third of retail sales volume,

Sales in the automotive segment rose by 4.1 %, in 2005. Car sales rose by 4.7 %, y/y, fuel sales increased by 3 %, y/y. Fuels sales dropped by 3.4 %, y/y, in the last quarter due to high fuel prices, after a growth of 5.5 %, in Q1 – Q3 2005. Car sales performed better in H1 2005 than in H2, too. In H1 2005, car sales rose by 7.6 %, y/y, slowing down to 2.1 %, in H2 2005.

Food sales went along with the long-term

Figure 8: Retail Sales: Total Sales versus Foods and Consumer Goods (growth rates in %)



Source: Czech Statistical Office

Figure 9: Retail Sales: Total Sales versus Cars and Fuels (growth rates in %)



Source: Czech Statistical Office

Similar to previous years, construction was driven primarily by infrastructure projects and activities of foreign investors focused on business and commercial centres. Housing construction continued in growth, supported by the mortgage market.

growth path of 3 % (3.1 %, y/y, in 2005), registering the lowest fluctuations from all the retail segments. Consumer goods sales rose by 4.1 %, y/y, registering a slight acceleration in comparison with 2004. Clothing and footwear performed best, with growth of 11.8 %. Household equipment (including electronics) rose by 4.5 %. Household equipment sales are supported by consumer credits, which accelerated in the second half of 2005. At the end of 2005, the volume of consumer credits amounted to CZK 95.5 bill., increasing by 38.9 %, y/y. Consumer credits account for almost 25 % of total credits granted to the Czech households.

Consumers prefer more and more big retail chains, which are able to compete not only by price policy but also by wider assortment. The main tendency, observable recently has been signs of saturation in the case of hypermarkets and growing preferences of discount stores, that are targeted mainly at the most price-sensitive customers. The expansion stage is still far from over, as new projects are either under construction or planned. Shopping centres have been more and more penetrating inside big cities and sales will be concentrated more and more in multi-functional complexes.

Outlook

In 2006, industry will continue to be the main driving force of economic activity. Moderate recovery of the activity in the eurozone has started to be felt as of the beginning of the year, both Czech industrial output and sales registering an acceleration. In addition, new capacities in the automotive industry have already started to affect positively the industrial output data – the output of the automotive industry rose by almost 30 %, y/y, at the beginning of the year. We expect that higher activity in the eurozone combined with the impact of new

automotive capacities will push up the full year growth in industry close to the 10 % level.

Fundamental factors of construction potential remain the same like in previous years. Increasing employment in construction registered in the last quarter of 2005 confirms positive expectations of construction companies. New projects on business and administrative centres have been carried out as well as the investments to infrastructure. Housing construction will continue in solid growth, driven by the boom of the mortgage market. In particular, the demand for big flats will be fuelled by expected price increase (as of the beginning of 2008). However, the first months of 2006 were unfavourable for the construction activity due to bad weather conditions (tough winter and March floods). Anyway, we expect, that the second and third quarter should compensate for weak first quarter results. The growth in 2006 will continue by a pace similar to that in the second half of 2005 – that is around 8 %.

The growth in retail trade in 2006 will be solid, as a consequence of stable dynamics of incomes and low inflationary environment. Consumer loans will continue to support the retail sales – the growth of consumer loans accelerated at the beginning of 2006, as well as the retail sales. The growth of retail sales will amount to approximately 4 - 5 %, in 2006.

6. INFLATION

6.1 Consumer Prices

In spite of the dynamic growth of Czech economy, fundamental inflation pressures in the economy remain weak. As shown in Table 10, despite growing prices of oil and oil

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Table 10: CPI Inflation, Q1/2005 to Q1/2006 (in %, y/y, e.o.p.)

Q1/2005	Q2/2005	Q3/2005	Q4/2005	Q1/2006
1.5	1.8	2.2	2.2	2.8

Source: Czech Statistical Office

Table 11: PPI Inflation, Q1/2005 - Q1/2006 (in %, y/y, e.o.p.)

Q1/2005	Q2/2005	Q3/2005	Q4/2005	Q1/2006
6.4	2.7	1.0	-0.3	0.3

Source: Czech Statistical Office

products, inflation only moderately increased over the year 2005. The highest monthly rise was in October 2005 (2.6 %, y/y), when regulated prices of natural gas were increased. After that, however, inflation returned to its longer-term path.

Czech Republic has been showing the features of a low-inflation economy for a longer time, due to the following main factors:

- Continuously appreciating exchange rate of the Czech koruna, both in relation to USD and EUR. During 2005, koruna appreciated by 6.8 % (yearly average) against the dollar, and by 6.6 % against the euro. As the country pays in dollars for oil and raw materials, appreciation of the koruna was able to compensate for half to two-thirds of the price increases (of oil and some other commodities, namely, non-ferrous metals) in world markets;
- High degree of openness, and a competitive internal market. Competition among the trade chains, and easy access of foreign suppliers to the Czech market, keep prices low. Hence it is understandable that prices of goods grew by 1.3 % in 2005, while prices of services increased by 3.6 %. In services, competition is substantially weaker, and the share of administered prices relatively high; imperfections of the market allow for a faster price increase. Administered prices (electricity, natural gas, centrally-supplied heat, and water) accounted in 2005 for almost two thirds (63.6 %) of the yearly increase of consumer prices.

Consumer price increase in the first quarter

of 2006 was mainly caused by the rise of administered prices of electricity (by 9 %), natural gas (4.8 %), heat and hot water (6.3 %) as of January 2006. Again, administered prices accounted for two thirds of consumer price inflation. Another factor behind the price increases was the fact that Czech koruna ceased to appreciate against the dollar; the spillover of high oil prices into domestic prices of fuels thus ceased to be hindered by exchange-rate shifts.

6.2 Producer Prices

In 2005, Czech economy witnessed a genuine fall of producer prices – the producer price index went from +7.2 %, y/y, in January, to –0.3 % y/y in December. The fast fall of producer price inflation (see Table 11) was to some extent caused by the statistical effect of the record height of producer prices in 2004 – but main factors of the price fall were as follows:

- decreasing prices of metals;
- strong koruna;
- strong competition in both the world and the Czech markets, resulting in a price decrease of engineering products (both imported and home-made).

The fall of producer prices also influenced the average yearly figure for PPI inflation: it went down from 5.7 % in 2004 to 3 % in 2005. At the end of 2005, prices in most manufacturing industries were in the deflation range. Producer prices in steel industry were, in December 2005, lower by 5.5 % than a year ago; in car industry, by 1.4 %, in food industry by 3.5 %, respectively. Prices of electronic goods stagnated. The only industries where prices grew over 2005 were

Czech Republic has been showing the features of a low-inflation economy for a longer time, due to the following main factors: 1) Continuously appreciating exchange rate of the Czech koruna, both in relation to USD and EUR; 2) High degree of openness, and a competitive internal market.

Table 12: Exchange Rates Q1/2005 – Q1/2006 (monthly averages, e.o.p.)

	Q1/2005	Q2/2005	Q3/2005	Q4/2005	Q1/2006
CZK/EUR	29.78	30.03	29.30	28.98	28.65
CZK/USD	22.58	24.63	23.90	24.45	23.83

Source: Czech National Bank

Table 13: 3M PRIBOR, Q1/2005 – Q1/2006 (monthly averages, e.o.p.)

	Q1/2005	Q2/2005	Q3/2005	Q4/2005	Q1/2006
	2.08	1.75	1.80	2.17	2.08

Source: Czech National Bank

oil refining and coke production – due to the oil price increases.

Producer prices stopped to fall in the first quarter of 2006; at the end of March, PPI stood at 0.3 %, y/y. Prices of coke and refinery products rose by 14.3 %, y/y. Also farm prices started to grow (0.3 % y/y). Despite it, food industry prices were only partly influenced by the expensive energy; food industry products are still in the price deflation range (- 0.3 %, y/y, at the end of the first quarter of 2006). Nevertheless, we can await faster growth of producer prices in the rest of 2006.

7. MONETARY POLICY AND EXCHANGE RATE

In 2005, the appreciation of the Czech currency continued, driven by good macroeconomic performance (strong GDP growth, foreign trade improvement and continuing inflow of foreign direct investment). In average, the Czech currency appreciated by 6.6 % against the EUR and by 6.8 % towards the USD.

The appreciation trend towards euro was registered mainly in the fourth quarter of 2005, while the appreciation towards the USD had a more volatile course – strong appreciation in Q1 and Q3/2005, followed by depreciation in the second and fourth quarter (Table 12). As indicated above, the strong Czech currency attenuated the influence of high oil and gas prices on the Czech economy.

Over the last four years, Czech Koruna has been appreciating, both against the EUR and

the USD (see Table 12). In relation to USD, appreciation was fast and continuous. Toward the euro, it was different: the CZK became almost 10 % stronger during 2002, and kept near the 2002 level in the following two years (with some fluctuations, of course). Stability of nominal exchange rate toward the euro was one of the factors behind the revival of Czech exports, seen since the end of 2003.

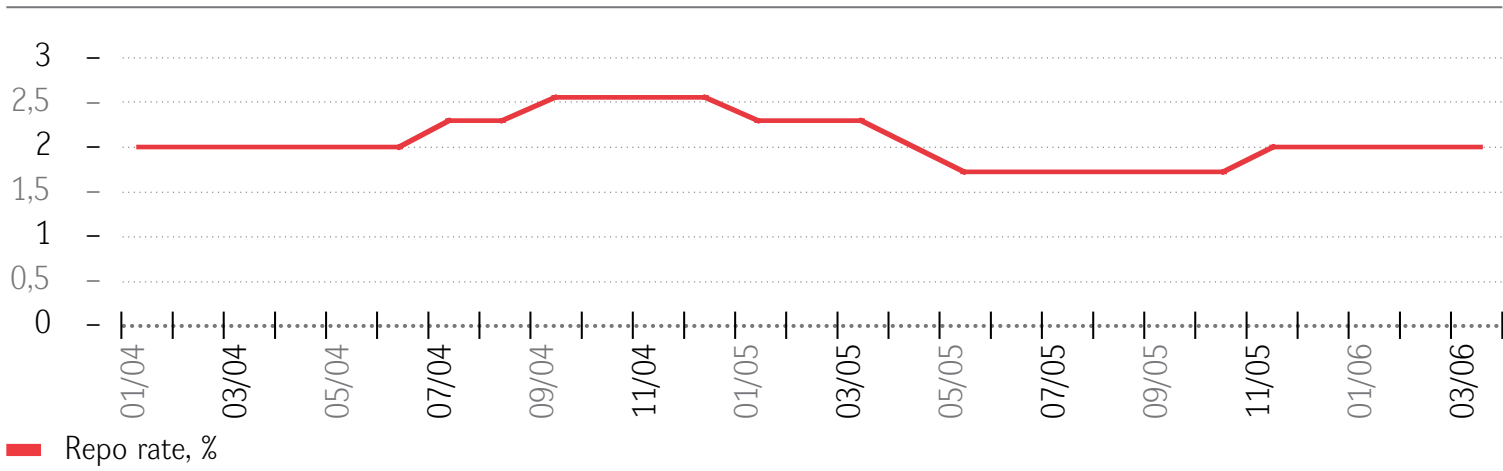
Appreciation against the USD however stopped at the end of January 2006; since then, the dollar oscillates slightly below CZK 24/USD, and it no more plays the role of a compensating factor for the growing prices of oil and some non-ferrous metals.

As shown in Table 13, since the end of the second quarter of 2005, the 3M PRIBOR has kept 20 to 30 basis points below the level of 3M EURIBOR. The last four quarters represent the period of historically lowest interest rates in the Czech economy. Low inflation, ample liquidity in Czech banks, and highly competitive bank and financial markets are the main causes of this state of affairs, very favourable for entrepreneurial activities.

In the first four months of 2005, Czech National Bank cut the basic repo rate three times – each time by 25 basis points. From May to October, 2005, CNB basic rate was 25 basis points under the ECB refi rate. At the end of October, CNB raised the repo rate by 25 basis points to the level of ECB rate (cf Figure 9). After the December 2005 and March 2006 increases of ECB's refi rate to 2.25 % and 2.50 %, respectively, repo rate is again – and, for the time being, by 50 basis points – below the basic eurozone rate.

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Figure 10: Development of REPO rate, 2004 - 2006



Source: Czech National Bank

Table 14: Short-term and Long-term Unemployment Rates (in %)

	1998	1999	2000	2001	2002	2003	2004	2005
Short-term unemployment	4.6	5.6	4.7	3.9	3.6	4.0	4.1	3.7
Long-term unemployment	1.9	3.1	4.1	4.2	3.7	3.8	4.2	4.2

Source: Czech Statistical Office

Czech National Bank makes use of the fact that the differential between the Czech basic rates and the basic rates in the Eurozone helps to slow down the appreciation of Czech koruna. As empirical evidence of the last several years shows, this is the only instrument by which a too strong appreciation of the koruna can be effectively hindered.

8. LABOUR MARKET

In 2005, labour market registered a decline of the unemployment rate as a consequence of strong economic activity. Employment has been increasing in successful manufacturing industries, construction and some services (in particular trade). At the end of 2005, the unemployment rate stood at 8.9 %, which was a decline of 0.6 percentage point in comparison with the year-end 2004.

However, strong economic activity does not address structural problems. Strong regional disparities have been preserving and the scope of long-term unemployment continually increases. In the last quarter of 2005, the share of long-term unemployment amounted to 53.4 %. The decline of the overall unemployment rate is driven by the decline of short-term unemployment – see Table 14.

The unemployment rate for women is quite notably above the unemployment rate for men. The total unemployment rate stood at 8.9 %, in December 2005: the unemployment rate for men was at 7.6 %, while the rate for women was at 10.5 %. According to the

surveys carried out by the Czech Statistical Office, only men experienced the decline of the unemployment during 2005, while the unemployment of women increased (the exception being women aged 20 – 29 and 60 – 64). One of many aspects of generally low flexibility of the Czech labour market is low frequency of part time jobs. According to the international comparisons, the frequency of women employed on part time jobs is at 8 % in the Czech Republic, while the EU 25 average is at 30 %. The reason for this situation is the low flexibility of the employers.

Another key factor is the education. Major part of all unemployed (72 %) disposes with only primary education or unfinished secondary one. Within these unemployed, the rate of long-term unemployment is above – average. Almost 70 % of the unemployed with basic or unfinished secondary education is unemployed over 1 year. The specific rates of unemployment significantly differ as for the level of education. General unemployment rate (according the ILO methodology) amounted to 7.5 %, in the last quarter of 2005 – specific rates for educational levels shows Table 15.

The position of the Czech Republic in international comparison is not unfavourable. The Eurostat methodology sets the Czech unemployment rate to slightly lower level than the domestic method. The final figure for the unemployment rate in 2005 was at 7.8 % (which was also an improvement in comparison with 8.7 %, reported for December 2004), i.e. below the EU 25 average of 8.4 %. Within the Visegrad countries, Hungary (7.2 %) still keeps the best position.

In 2005, labour market registered a decline of the unemployment rate as a consequence of strong economic activity. At the end of 2005, the unemployment rate stood at 8.9 %, which was a decline of 0.6 percentage point in comparison with the year-end 2004.

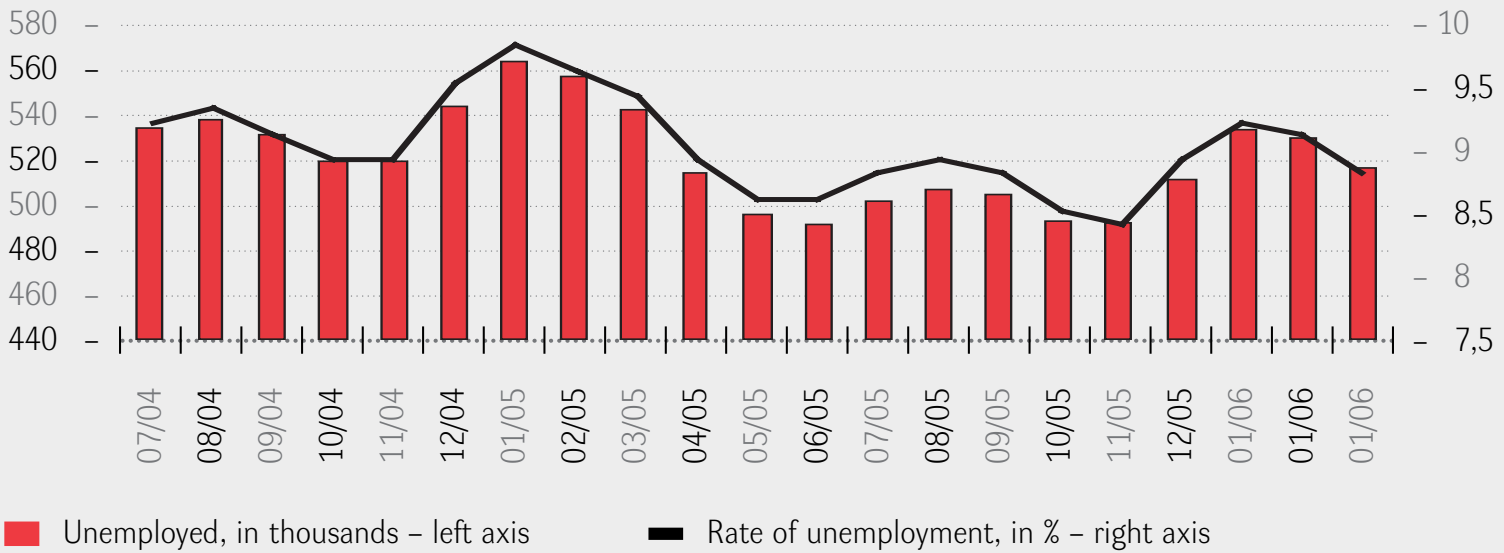
However, strong economic activity does not address structural problems. Strong regional disparities have been preserving and the scope of long-term unemployment continually increases. In the last quarter of 2005, the share of long-term unemployment amounted to 53.4 %.

Table 15: Unemployment Rates for Different Levels of Education

Education	Rate of unemployment, %
Basic	26.5
Secondary unfinished (incl. vocational)	8.7
Secondary finished	5.1
University	2.6
Total (average)	7.5

Source: Czech Statistical Office

Figure 11: Unemployment



Source: Ministry of Labour and Social Affairs

However, the unemployment rate in Poland and Slovakia was roughly double than the Czech one (16.9 % and 16.3 %, respectively).

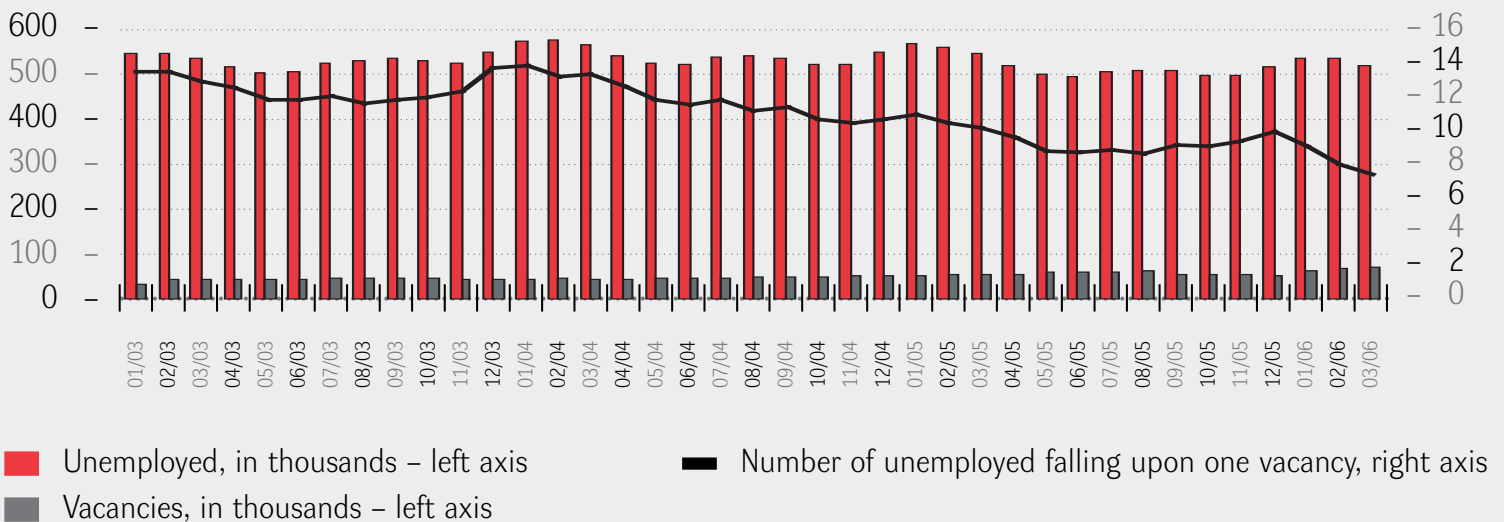
Nominal wages increased by 5.5 % in 2005, which was lower figure than in 2004 (6.6 %). Lower average inflation in 2005 (1.9 %) than in 2004 (2.8 %), however, caused that the real wages grew by almost the same pace than a year before (3.5 %). Average gross wage amounted to CZK 19 030. The growth of

wages was more rapid in the public sector (6.7 %) than in the business one (5.2 %). In spite of relatively low growth of real wage, retail sales performed better than in 2004. Spending has been more and more driven by an easy access to consumer loans.

Outlook

In the first months of 2006, unemployment

Figure 12: Unemployed, Vacancies, UV Ratio



Source: Ministry of Labour and Social Affairs
 Unemployed and Vacancies: in thousands
 U-V ratio: number of unemployed falling upon one vacancy

rate continued to decline in a year over year comparison. Strong economic activity promoted rather a rapid growth of vacancies. In 2006, we expect further improvement, the scope of which should be similar to 2005. The spring decline (which has already started) will proceed to the 8 % bar, where the unemployment rate will stand in May and June 2006. Third quarter will register increase of the unemployment rate as a consequence of fresh school leavers entering the labour market. Due to demographic developments, the new wave of graduates entering the labour market should not be very strong, in 2006. Regular autumn decline will be replaced by seasonal December increase

due to finishing seasonal jobs and other term contracts. At the end of 2006, we expect the unemployment rate slightly above 8 %.

At the same time, rigidities of the labour market will continue to be one of the major challenges for the next Government. For the time being, the analyses made by the Czech National Bank consider the low flexibility of the labour market as one of the most important obstacles to the eurozone entry. Low flexibility of labour contracts, non-performing market with rental housing and weak activity of the unemployed fuelled by generous social policy are the main issues to be addressed.

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