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CZECH ECONOMY IN THE FIRST HALF OF 2006

Kamil Janáček, Eva Zamrazilová

1. ECONOMIC GROWTH

In the first quarter of 2006, GDP grew by 7.4 %, which was an acceleration from 6.9 % growth in the last quarter of 2005. Fixed capital investments (growth by 7.1 %), household consumption (3.4 %) and external trade primarily fuelled the GDP growth in Q1/2006, where y/y increase in the exports of goods and services (17 %) was by 1.7 percentage points higher than the growth of imports of goods and services (15.3 %). On the other hand, government consumption decreased by 1 %.

The biggest contributor to GDP growth in Q1/2006 was manufacturing (18.5 % growth of value added), financial services (8.3 %) and trade and transport (7 %). In construction, value added declined by 9.2 %. Growth of value added in agriculture was zero.

Industrial output has accelerated as of the beginning of 2006. Change in methodology had only a marginal positive effect, since the revised figures for 2005 increased the full year 2005 growth rate by only 1 percentage point. The growth in industry was between 10 and 20 %, y/y, in all the months of Q1 2006. Due to April slowdown, the cumulative figure for the first four months amounted to 12.2 %, y/y.

The acceleration in the first quarter has been driven by the automotive industry in the first place (witnessing growth above 30 %, y/y), accompanied by the accelerating growth in the electronics and renewed growth in metal industry. These three industries account for almost one third of total industrial sales.

The share of companies under foreign control continues to rise; in April 2006, their share on total industrial sales reached 55.8 %. These companies employ almost half-million people and represent major driving force of the Czech industrial output and exports.

The growth of construction in the first five months of 2006 was strongly volatile (-1.2 %, -8.2 %, +8.7%, -2.9 %, 11.0, y/y). The main reasons for this high and unusual volatility were bad weather conditions (tough winter and March floods) and the impact of fluctuations of statistical bases from 2004 and 2005. January to May 2006, construction output rose by 2.5 %, y/y.

At the beginning of 2006, the growth of employment in construction showed a slowdown: employment rose by 0.9 %, y/y, after a growth of 6 % observed in the last quarter of 2005. Moreover, new construction permits fell by 7.2 %, indicating that some signs of saturations have already appeared. The only

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Table 1: Main Macroeconomic Indicators

		2001	2002	2003	2004	2005	03/06	04/06	05/06	2006F
GDP	%, y/y	2.5	1.9	3.6	4.2	6.1	-	-	-	5.8
Inflation	%, y/y	4.1	0.6	1.0	2.8	1.9	2.8	2.8	3.1	2.8
Inflation	%, m/m	-	-	-	-	-	-0.1	0.1	0.5	-
Industrial prices	%, y/y	0.8	-0.7	0.9	7.7	-0.3	0.3	0.5	1.5	3.0
Industrial prices	%, m/m	-	-	-	-	-	0.1	0.3	0.3	-
Unemployment rate*	%, eop.	8.9	9.8	10.3	9.5	8.9	8.8	8.3	7.9	8.2
Industrial production	%, real	6.7	1.9	5.5	9.6	6.7	17.4	3.6	-	10.0
Construction output	%, real	9.6	2.5	8.9	9.7	4.2	8.7	-2.9	11.0	6.0
Retail sales	%, real	4.5	3.0	4.9	2.5	4.0	6.9	5.1	-	5.0
State budget	CZK bill.	-67.7	-45.7	-109.1	-93.5	-56.4	15.7	-20.0	-12.2	-75
Trade balance	CZK bill.	-117.4	-70.8	-69.8	-26.4	39.5	8.0	0.2	0.6	50
FOREX reserves	USD bill.	14.5	23.7	27.0	28.4	29.5	29.7	30.2	30.8	31.5
PRIBOR 3M	% average	5.2	3.6	2.3	2.4	2.0	2.08	2.11	2.12	2.4
CZK/EUR	Average	34.1	30.81	31.84	31.9	29.78	28.65	28.51	28.27	29.0
CZK/USD	Average	38.0	32.74	26.32	25.7	23.95	23.83	23.25	22.14	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

segment witnessing continuous growth has been the housing construction with +7.4 % of completed flats in Q1 2006.

In the first four months of 2006, retail sales increased by 6.6 %, y/y, driven in particular by strong demand for cars and consumer goods. The sales of cars registered quite solid results due to regular replacement cycle as expected. The best performing segments of the market with consumer goods were textiles, clothing and household equipment including electronics. In addition, the demand for foods shows signs of longer-term shift to higher growth trajectory, the January – April average growth amounting to 5.3 %, y/y, which is strongly above long-term average growth around 3 % observable in previous years. The retail sales have been strongly positively affected by appreciating currency, with the imported goods dominating on some segments of the market (e.g. with clothing and electronics).

In addition, there is a link between solid dynamics of household equipment and housing market, some mortgage products offering additional financing of household equipment. Therefore, the hypothesis about crowding out effect of mortgages on retail sales was not confirmed. Moreover, consumer loans further promote sales in this segment. At the end of Q1 2006, the credits to households amounted to CZK 433 bill, increasing their volume by one third, year over year. In addition, the growth of consumer loans accelerated at the beginning of 2006.

2. FOREIGN TRADE AND EXCHANGE RATE

General factors affecting foreign trade have remained the same like in the second half of 2005. The exports continued in solid growth, driven by the machinery exports, in particular by the car industry (the impact of new TPCA factory started to be felt). Nevertheless, only a slight improvement of the Eurozone's dynamics hinders further acceleration of the Czech exports. High oil and gas prices fuel rapid growth of imports. Therefore, the positive gap between the growth of exports and imports has been diminishing. January to May 2006, imports rose by 14.6 %, y/y, exports rose by 13.6 %, y/y.

Monthly trade surpluses are thus no more reaching impressive double-digit figures. In the first five months of 2006, the trade balance registered a surplus of CZK 26.2 bill., which was a negligible year over year deterioration. The major players of the trade balance remain machinery, fuels and chemistry. Machinery generated a surplus of CZK 120.7 bill., while fuels and chemistry produced deficits (CZK 59.7 bill. and CZK 36 bill., respectively). The trade balance with machinery improved by CZK 28.3 bill, y/y, major merit belonging to the car exports.

In 2006, the Czech currency has been appreciating, the appreciation accelerating in April and May. At the end of May 2006, in respect with the EUR, CZK reached an almost record level of 28.21 CZK/EUR, exchange rate CZK/USD stood at 21.91. Strong Czech currency has been attenuating adverse effects of high prices of oil, gas and some other raw materials and helps to keep inflation on low level.

The Czech National Bank is ostensibly happy with this situation. Keeping basic repo at rate at 2 %, i.e. 75 basis points under ECB's refi rate, it hinders the fastest appreciation of the Czech crown and can await the next steps of the European Central Bank. Due to this situation, PRIBOR is still very low; in May 2006, the average 3M PRIBOR was at 2.12 %, more than 60 basis points below 3M EURIBOR. Nevertheless, in the second half of June 2006, the CZK slightly depreciated to the level of 28.5 CZK/EUR, driven by the instability in the Central European region after the Czech and Slovak elections. Also PRIBOR rose to the level 2.3 % at the end of June; markets are expecting the rise in repo rate and reflecting the vulnerability of the recent political developments.

3. INFLATION

Consumer price increase in the first months 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

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dollar; the spillover of high oil prices into domestic prices of fuels thus ceased to be hindered by exchange-rate shifts. The year over year CPI was, however, still around the 3 % level, in the first half of 2006, standing at 2.8 %, in June 2006. The main reason of the CPI increase in April and May were fuel prices and prices of telecommunications. The gap between the price increases of goods and services is still visible – prices of goods went up by 2.5 %, prices of services by 3.2 %, y/y.

Producer prices stopped to fall in the first quarter of 2006; at the end of May, PPI stood at 1.5 %, y/y. Prices of coke and refinery products rose by 18.8 %, y/y. Prices of electricity, gas and water increased by 8.2 %, y/y. Also farm prices started to grow. Despite it, food industry prices were only partly influenced by the expensive energy; food industry products are still in the price deflation range (- 2.0 %, y/y, in May 2006).

4. UNEMPLOYMENT

In the first months of 2006, unemployment rate continued to decline in a year over year comparison. The regular spring decline of the unemployment was more intensive than in 2005. The rate of unemployment fell below the 8 % bar in May 2006, being by 0.7 percentage points lower than a year before.

The harmonised rate of Czech unemployment published by the Eurostat (April 2006) was at 7.5 %, this is below the EU 25 average of 8.2 %. For the first time, the Czech unemployment rate was lower than in Hungary (7.6 %). Therefore, in April 2006, the Czech unemployment rate was the lowest within Visegrad core countries, since the rate of unemployment is twice as high, in Poland and in Hungary.

Situation on the labour market thus has been improving; nevertheless, a moderate decline of the unemployment is not an excellent result under robust economic activity. Unemployment 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 next government policy.

5. OUTLOOK

In 2006, the GDP will continue in robust growth, though not at the level of the first quarter. Due to low growth in eurozone and strong CZK, the positive effect of exports on GDP dynamics will be lower than in 2005. We expect GDP growth for the whole year of 2006 in the interval 5.5 - 6 %.

In the rest of the year, industry will continue to be the main driving force of economic activity. Recovery in the eurozone, renewed demand for metal production and new capacities in the automotive industry will drive this year growth in industry above 10 %. Keeping the dynamics around 15 % seems to be too optimistic for the time being, however, the full-year figure slightly above 10 % is realistic.

Recent developments of construction permits accompanied by stagnation of the employment seem to indicate lower future growth trajectory than expected. In the rest of the year, positive growth rates are expected; nevertheless, we cut our full-year forecast of the construction output growth to 6 %.

The growth in retail trade will remain solid, driven by stable dynamics of incomes, low inflationary environment and rapid growth of credits to households. The full-year figure will be around 5 %.

The exports will continue in solid growth, driven by the machinery exports, in particular by the automotive industry. Appreciation of the CZK against the USD observed since April will lead to a slowdown of the increase of the deficit produced by fuels. The full-year trade surplus will reach approximately CZK 50 bill. As a consequence, current account deficit will decline below 2 % of GDP.

Appreciating currency (especially towards USD) and competitive environment on the market with consumer goods will help to keep inflation under control. In the second half of 2006, the inflation will continue to be below 3 %. We expect both the year-end and average rate of CPI in the interval 2.5 – 3.0 %. We can await faster growth of producer prices in the rest of 2006. At the end of 2006, the year over year growth of PPI will amount to approximately the same level as CPI, i.e. slightly under 3 %.

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Labour market in 2006 will continue in moderate improvement, the scope of which should be similar to that of 2005. Third quarter will register increase of the unemployment rate as a consequence of fresh school leavers entering the labour market. Nevertheless, even in the worst month (i.e. in August), the unemployment rate will not exceed the 8 % bar by more 0.1 – 0.2 percentage point. Regular autumn decline will be replaced by seasonal December increase due to finishing seasonal jobs and term

contracts. At the end of 2006, we expect the unemployment rate slightly above 8 %.

However, the decline of the unemployment rate will be driven merely by the decline of short-term unemployment. 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 challenge for the policy of the new government.

CENTRAL EUROPEAN NEW EU MEMBER STATES: TWO YEARS AFTER THE ENTRY¹

Kamil Janáček

Four Central-European countries (Poland, Hungary, Slovakia and Czech Republic) have accomplished two years of European Union membership. Politically, this period was very turbulent: first, the actual death of the European Constitution after the French and Dutch referenda. Then the new members got a practical – and very clear – lecture on real functioning of the decision-making process within the EU, in negotiations over the Union budget for 2007-2013, and over the new directive on services. They were shown how big is the split between “solidarity” rhetoric and the tough pursuit of national interests. The new countries also were taught that European Union is a club where all countries are equal, but the founding members are more equal than others.

Economic development of the new countries was less turbulent (as shown below). EU accession meant no external shock for the Central-European economies: prices did not jump up, exports into the EU-15 kept growing, FDI inflows continued without big fluctuations. This was due to the fact that, in practice, all four countries had been members of the Single Market since the end of the 1990s, and their preparedness for functioning within the EU was at a high level (with the notable exception of agriculture, as to CAP). On the other hand it also meant that the positive effects of EU membership had been consumed, to a large part, before actual accession – and no further positive impact can now be expected. Moreover, the new members must live with the fact that till the start of the next decade, they will be at disadvantage against the “old” EU members (common agricultural policy, limited movement of labour, etc.). Also the adoption of new

directives and new items of “acquis communautaire” will disproportionately burden the weaker economies of new members.

POLAND

After a weaker growth in 2005, economic revival can be expected in the current year, thanks to growing household demand (low interest rates have induced double-digit growth of consumer and mortgage credits to households) as well as fixed capital investment – supported by high corporate profits, and by the use of EU funds for the building of infrastructure.

Low inflation (permanently under the NBP 2.5 % target over the last year) has allowed the central bank to cut the basic interest rate repeatedly. The result was a credit boom, mainly in the household sector. Appreciation of the zloty compensated partly for the increase of oil prices; a good harvest pressed down the food prices. Strong retail competition and impact of cheap imports of consumer goods (mainly from China) keep inflation under control despite the risk of higher energy prices and more volatile exchange rate.

Precarious position of the minority government prevents any radical steps toward cutting the public finance deficits; the deficit of government budget has been frozen at the

¹Based on the paper prepared for International Conference of Commercial Bank Economists 2006 Annual Meeting, held in Milan, Italy, on June 21 – 24, 2006.

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Precarious position of the minority government prevents any radical steps toward cutting the public finance deficits; the deficit of government budget has been frozen at the volume of zloty 30.6 billion, at the price of permanently underfinanced local budgets. This brings the risk of further deficit growth in 2007, with possible expenditure cuts and reforms postponed till 2008.

Table 1: Poland – Main Economic Indicators, 2004 – 2006

	2004	2005	2006F
GDP (growth in %)	5.3	3.2	4.5
Inflation (average, in %)	3.5	2.1	1.5
Unemployment rate (average, in %)	18.0	17.6	16.5
Current Account (as % of GDP)	-3.8	-1.3	-1.6
WIBOR 3M (average)	6.1	–	–
PLN/EUR (average)	4.54	4.02	3.90
Public budgets (as % of GDP)	-5.7	-4.4	-5.0

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

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Entry of two small populist parties into the government (Samoobrona and LPR) reduces even further the scope for fiscal consolidation, and precludes any significant steps toward market-oriented structural reforms.

Privatization looks likely to continue, despite the opposition from the populist parties backing the government. In this year, privatization will take the form of sale of minority shares in several chemical firms, and in one publishing house. Privatization of electricity-generating companies and coal mines, however, has been postponed; dispute with Eureko, Dutch insurance group, over PZU, the largest insurance company in the region, continues. And, the government decided to buy back the 46% share in BOS (an environmental development bank) from SEB (Sweden) after rejecting SEB's offer to buy a majority stake.

The prospects for EMU entry, as well as the sentiment of financial markets, will largely depend on the character of economic policy under the influence of the two small populist parties. Conflicts with the EU (Unicredit) or with the central bank can bring short-time popularity for the government on the domestic scene. Yet the long-term costs can be sizable – if the external world concludes that there is no consensus on the necessity to uphold the results of polish economic transformation, especially with regard to low inflation and independent monetary policy.

HUNGARY

In the medium term, Hungary is fighting with a double deficit – of the current account, and

of public finance. Moreover, steps taken by the government in the election year (increased public expenditures for employee wages, and tax cuts) will burden the budget both in 2006 and 2007 - in spite of the fact that GDP growth above 4 % will bring additional budget incomes. The state of public finance makes Hungary the last candidate for the adoption of euro (on the time scale).

In spite of solid GDP growth and increasing commodity prices, inflation fell to one half in 2005, making it possible for the National bank to cut the basic rate in several steps. However, opinion splits within its rate-setting council forced the central bank to keep the basic rate at 6 %, in spite of a rapid fall of inflation in the recent period toward the lower limit of the target interval of 2.5 – 4.5 % (core inflation is around 1 %).

The governing central-left coalition has won a majority in the April parliamentary election, yet it will be very difficult to realize the reforms of health care, education, and public administration. The government decision to take over the debts of public railways, Budapest public transport, and other state-owned firms will result in a growth of public finance deficit in 2006 to almost 11 % of GDP. In this situation, it will hardly be possible to reduce the deficits by more than half percentage point per year. Instead of structural reforms, the new Hungarian government bets that tax cuts in the period of fast economic growth will lead to a fast growth of budget incomes – so that the deficit will gradually diminish.

Adverse trends in public finance have increased the public debt to roughly 70% of GDP at the end of 2006 (from 61 % in 2004). Debt service is growing and – with increased interest rates in world financial markets – starts to represent a large budget burden. Government foreign exchange borrowing will

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Table 2: Hungary – Main Economic Indicators, 2004 – 2006

	2004	2005	2006F
GDP (growth in %)	4.6	4.1	4.5
Inflation (average, in %)	6.7	3.7	6.8
Unemployment rate (average, in %)	6.3	7.0	6.8
Current Account (as % of GDP)	-8.3	-6.5	-6.5
HUF/EUR (average)	251.8	248	254
Public budgets (as % of GDP)	-6.5	-7.5	-10.8

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

grow in 2006. These factors increase the risks for the forint, with probable high volatility, or even depreciation. In such case, it is apparent that the central bank would be ready to raise the interest rates, to keep inflation within its medium-term target band.

The sluggish decrease of fiscal deficits, and the risk of a vulnerable and volatile forint, postpone the chance of EMU entry till (or even beyond) 2015.

SLOVAKIA

In the last three years, Slovakia has shown the fastest average GDP growth among the four Central-European new EU members. Massive inflows of foreign direct investment; reforms of the tax, social and pension systems; less complicated public administration – all this has created favourable conditions for the activities of domestic and foreign capital.

Reforms undertaken in 2002 – 2004 helped to stabilize the public finance. In spite of initial doubts, the introduction of a flat tax, and of a much less complicated tax system, did not push the overall tax incomes down. The contrary was true. The combination of fast economic growth with a sharp fall of tax evasion brought their fruits. And – what is even more important – the tax reform proved to be socially feasible. The poor and middle class did not lose - actually, the effect for them was mostly positive.

Dynamic fixed capital investment, combined with revived household consumption, led to GDP growth above 6 % in 2005 – in spite of a temporary slowdown of the car industry and of exports. Domestic demand compensated for the slowdown of foreign demand.

Slovakia has finished the basic structural reforms of public finance. Left to be done are only a reform of education, and a correction of the (reformed) system of health care financing. The government and the National Bank of Slovakia thus can pay their attention to more subtle problems – further fiscal stabilization, cutting inflation, and stabilization of the exchange rate of Slovak koruna. The aim is to adopt the euro in 2009. Medium-term goals of fiscal stabilization and of stable exchange rate are presently slightly intimidated by the coming election (on June 17), but it is not probable than even a different government coalition would radically turn the course of economic policy – so much so that the goal of euro adoption might be under threat.

Fast economic growth and rising energy prices have so far hindered the achievement of the 2.5 % inflation target (see Table 3). The Slovak koruna is also more volatile than, for example, the Czech currency, which is another factor making the Slovak inflation target harder to achieve. To overcome this difficulty – and to help to achieve the other Maastricht criteria as well - The National Bank of Slovakia has at the end of November 2005 decided to enter the ERM2 exchange rate mechanism. That meant that this step was taken several months earlier than required by the rules - and than expected by the markets. The monetary authorities hope that pegging the exchange rate (at 38.46 SKK/EUR) will stabilize the currency, with a positive effect on economic development. The last year has so far confirmed that expectation in principle.

However, some long-term problems persist. The rate of unemployment was reduced by social reforms, yet unemployment is still at a two-digit level, and has a strongly structural character. A persistent (economic but also social) problem is unemployment of the Roma

Table 3: Slovakia – Main Economic Indicators, 2004 – 2006

	2004	2005	2006F
GDP (growth in %)	5.5	6.1	6.5
Inflation (average, in %)	7.6	2.7	3.2
Unemployment rate (average, in %)	18.1	16.2	15.5
Current Account (as % of GDP)	-3.1	-6.1	-5.0
BRIBOR 3M (average)	4.2	3.0	3.6
SKK/EUR (average)	41.5	38.6	38.0
Public budgets (as % of GDP)	-3.1	-3.6	-3.3

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

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population, exceeding 80 % in some regions. Regional distribution of unemployment is very irregular, with unemployment rates increasing sharply from the west toward the east of the country.

To solve this problem, it will be necessary to reform the system of education, build new infrastructure in Central and Eastern Slovakia, and bring both domestic and foreign investors to those regions. Slovakia also expects positive effects from the European Union cohesion- and structural funds.

The overall economic outlook of Slovakia is positive. Foreign investment, especially in car production, will increase the exports. Domestic demand is also expected to grow fast, so that GDP growth in 2006 and 2007 can achieve 6 to 6.5 %. Improved trade balance will gradually bring the current account deficit down toward the 5% of GDP limit. Moderate appreciation of the currency, together with increased interest rates, will help to keep inflation under control. Slovakia is on the way to fulfill all required conditions for the adoption of euro in 2009.

CZECH REPUBLIC

Economic growth of the Czech Republic accelerated strongly during 2005. In the last quarter of 2005, GDP growth was 6.9 %, and in the first quarter of 2006, it reached 7.4 %. That is an important source of catching up with the more advanced EU countries. Czech economic growth was at the same level as in Slovakia, and much faster than in Poland and Hungary.

Exports were the main engine of growth in 2005. In contrast to a deficit of CZK 26.4 billion in 2004, the trade balance (for the first time in Czech Republic's history) showed a surplus of CZK 40.4 billion in 2005

– which means an improvement by CZK 66.8 billion. As a result, also the current account deficit decreased dramatically, from 6 % of GDP in 2004 to 1.9 % in 2005.

Improved external-trade balance results from the pro-export effects of FDI inflows that came over the last 10 years (CZK 1544 billion, i.e. USD 65 bill.) Czech Republic so far attracted by far the largest sum of foreign direct investment per head among the four Central-European countries; in FDI volume, the CR equals Poland – a country with four times larger population.

Manufacturing (and foreign-owned manufacturing firms) count most for the positive export results. In 2005, there were 1938 foreign-owned firms registered in Czech industry, employing 458 thousand people and having a 55 % share in total industrial sales. Given the limited capacity of Czech markets, foreign-owned firms, logically, are export-oriented. Direct exports represent 74 % of their sales. These firms are, and will remain, the main driving force of Czech industry and Czech exports. Also, the Czech Republic is among the very few European economies where the share of industry in GDP reaches 30 % (with, even, a slight increase of this share in the last two years). In this respect, it is structurally similar to German economy.

Appreciation of the Czech koruna, and strong competition of large chains in the retail market, helped to keep inflation at low levels, in the middle of the inflation target band of the Czech National Bank. Strong koruna also made it possible for the central bank to keep the basic repo rate in the second half of 2005 at the level of the ECB refi rate – and later, in the first half of 2006, even under the refi rate. At present, the CNB basic rate is 75 basis points under the ECB

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Table 4: Czech Republic – Main Economic Indicators, 2004 – 2006

	2004	2005	2006F
GDP (growth in %)	4.2	6.0	5.8
Inflation (average, in %)	2.8	1.9	2.5
Unemployment rate (average, in %)	9.5	8.9	8.0
Current Account (as % of GDP)	-6.0	-2.1	-1.5
PRIBOR 3M (average)	2.4	2.0	2.3
CZK/EUR (average)	31.90	29.78	29.00
Public budgets (as % of GDP)	-3.0	-2.7	-3.5

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

basic rate. Czech central bank keeps this differential as a tool against a fast appreciation of the koruna, after all other instruments failed to stop the appreciation. As a result, in the last three months, the 3M PRIBOR kept 60 basis points below 3M EURIBOR.

Robust economic growth and higher-than-predicted tax incomes brought the deficit of public finance down to the magic limit of 3 % (in 2004) and below (in 2005). However, fiscal policy of the government has been, and remains, very generous. In spite of fast growth, the government achieved no cuts of expenditures (to say nothing about a real reform of public finance), so that in 2004 and 2005 the government budget deficits again reached many tens of billion crowns.

Before the elections, the government pushed a number of new laws through the parliament - laws which will increase social expenditures, and lower some direct and indirect taxes, from the second half of 2006 (or start of 2007). As a result, public finance deficit will again jump above 3 % - and reach 3.5% of GDP in 2006, and 4.5% in 2007.

Such policies are in sharp conflict with the government's medium-term fiscal programme, to which the EU Commission gave the assent. The programme assumes public finance deficit of 3.3 % in 2007, and 2.8 % in 2008. Reaching these figures now seems difficult, or impossible. In the medium run, pressure on an increase of expenditures will grow, with the need to co-finance infrastructure projects from EU funds, and with growing inherent deficits of the health-care and pension systems. The courage to reform the lavish social system, or the system of health-care financing, is not on the horizon. Another complication is the situation after the June parliamentary election, which brought no clear winner. The hope that the necessary reforms will be done has again been postponed to some more distant future.

In the light of these facts, the original official plan of the government, and of the Czech National Bank, to adopt the euro in 2010, is melting. The central bank does not want to stay in the ERM2 system longer than the obligatory two years, to limit the danger

of speculative attacks on the currency (which will have to return to the regime of fixed exchange rate). As it cannot be expected that political situation in the autumn of 2006 will enable such a fundamental decision, the year 2011 becomes the nearest date for EMU entry.

Finally, let us discuss two themes of which one can bring potential problems in future, while the other represents a long-term weak point of the Czech economy. The first point: Czech industry and industrial exports are to a large part built on car production. Within two years, the country will produce one million cars, and Czech firms also are suppliers of car parts to most large European car producers. This brings one danger: larger volatility of the car industry would result in a larger volatility of the whole Czech manufacturing, and in larger fluctuations of GDP.

Another topic is unemployment. The problem of Czech unemployment lies in its mostly structural character. Robust economic growth does not lead to any sizable fall in unemployment. It reduces only the numbers of short-term unemployed, while long-term unemployment (representing more than 50 % of the total rate) remains untouched. Low flexibility of labour contracts, non-functioning market with rental flats, generous social system, and low labour mobility, are among the causes of this problem which remains unsolved over the last nearly ten years. Structural problems in the labour market thus may become a serious economic threat (lack of qualified labour for higher value-added services), and social threat (long-term unemployed living on social benefits, on the periphery of society).

EMU ENTRY

According to the Accession Agreement, new member countries are obliged to enter the European Monetary Union – some time in future, after they have fulfilled the so-called Maastricht Criteria of nominal convergence. There will be no opt-out clauses (as there were in the cases of Great Britain and Denmark). The Accession Agreement, however, states no compulsory date for the new members.

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It has to be said openly that in all four countries, there are proponents of an early EMU entry, as well as opponents of such a step. As shown above, presently only Slovakia fulfils the Maastricht criteria - so that it can hope for EMU entry in 2009.

Proponents of an early accession of new Central European member states to the European Monetary Union stress the following benefits:

- Eurozone entry will finalise their integration process, giving them the possibility to participate fully in forming and implementing the common monetary policy;
- Elimination of exchange rate risk will be beneficial for their firms trading with eurozone countries;
- Risk of monetary crises and turbulences will diminish;
- The new members will be able to profit from lower interest rates in the eurozone. (This factor - due to recent trends - is losing in importance. In all four countries after the accession, interest rates declined significantly toward the eurozone level; in the Czech Republic, since the beginning of 2005, they have been under eurozone level, now by 60 basis points.)
- Also the argument that obligation to fulfil the conditions of the Stability and Growth Pact would increase the public finance discipline has lost much of its value.

On the other hand, an early eurozone accession can bring considerable new risks and costs. In the nearest period, the costs would probably highly outweigh the above mentioned benefits. The new member states are characterised by a completely different economic level. They are in process of catching up with the EMU-12, and undergoing fundamental structural change. Their economic cycles are not synchronized with the cycles of the majority of eurozone countries; their response to exogenous shocks is not, and will not be, symmetric.

Giving up prematurely the option of country-specific monetary policy, and of exchange rate flexibility, would be

unreasonable and potentially harmful to long-term economic growth. The new members of European Union will need a maximum of flexibility for fostering growth and catch-up with the "old" members. The example of Ireland in the 1990s proves that intelligent use of country-specific monetary policy can support fast economic growth.

It would be naive to believe that the problems which some EMU countries have with ECB's "one size fits all" monetary policy would not apply, with much higher intensity, to the economically weaker and structurally more vulnerable new EU members from Central and Eastern Europe. These countries, in their catch-up process, will have an inherent tendency toward real appreciation, due to faster productivity increase. After eurozone entry, this tendency will manifest itself in a pressure for higher inflation rates (as the other channel of real appreciation, flexible exchange rate, will be lost). Such situation will pose additional problems for both for the newcomers and for the ECB, who will be forced to push some traditional low-inflation EMU members toward the brink of deflation.

There also exists another vital economic problem which has up to now lacked broader attention of both the academic circles, and the media. It is the problem of setting a correct central parity of the newcomers' currencies to the euro on entering the ERM II - and of fixing the exchange rate at a proper level on the moment of joining the eurozone. This really is a vital problem, with grave economic consequences - either beneficial or fatal.

As an example, let us consider the case of Czech Republic. This will not be the first time of having to establish the parity of the Czech currency toward a foreign one. Setting the exchange rate of then Czechoslovak koruna (CSK) toward the USD was a similar case - at the end of December 1990, at the very start of transition from command to market economy, before liberalisation of prices and of external trade, and before starting other reforms. At that time, the federal minister of finance (then legally responsible for exchange rate policy) did not yield to the populist proposals of some economists, and to pressures from part of

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the media and the public, to set the exchange rate of CSK at an unrealistic level of 10 or 14 CSK/USD. Setting the exchange rate at 28 CSK/USD has since then proved as correct – such exchange rate assessed realistically the position of the currency, and supported exports, without unduly impeding Czech imports. Best proof is the fact that after almost 15 years, the fluctuations of Czechoslovak and, later, Czech koruna have never exceeded $\pm 25\%$ toward the USD and $\pm 15\%$ toward the DEM or EUR. The long-term stabilising effect of the exchange rate supported economic growth and gradual catch-up with more advanced European countries.

At the moment of ERM II entry, and later, eurozone entry, the four Central-European countries will face the same problem – with the substantial difference that setting the exchange rate at eurozone entry will be irrevocable. There will be no possibility to correct a wrong decision. Actual exchange rates will be a poor guide to setting a rate viable in the long run (to say nothing of the fact that, at that very moment, they can be strongly biased by speculators). Moreover, this vital decision will have to result from a broad consensus among the country in respect, the ECB, and all the member states of eurozone. Economic interests of the involved parties could be different and conflicting.

Summing up the pros and contras for an early eurozone entry, we can conclude that following a “don’t hurry” policy for euro surely would be beneficial for a long-term catch-up process of the Central European new EU members. Exchange rate flexibility and the use of country-specific monetary policy is indispensable for real convergence – which is no less important, if not more important than nominal convergence.

The same “don’t hurry” attitude can be

observed also on the part of the ECB, and the EU Commission. The case of Lithuania has shown that both institutions 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:

Slovakia	2009-2010
Poland	2011-2012
Czech Republic	2011-2012
Hungary	2014-2016

One however should not underestimate one possible effect of longer waiting times before Eurozone entry. Some analyses 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.

Summing up the pros and contras for an early eurozone entry, we can conclude that following a “don’t hurry” policy for euro surely would be beneficial for a long-term catch-up process of the Central European new EU members. Exchange rate flexibility and the use of country-specific monetary policy is indispensable for real convergence – which is no less important, if not more important than nominal convergence.

RISKS OF THE INFLATIONARY PRESSURES AFTER THE EMU ENTRY

Eva Zamrazilová

After two years after the EU entry, the Czech Republic faces another crucial milestone – the EMU entry. The sine qua non for the EMU entry will naturally be the fulfilment of the Maastricht criteria. At the same time, the discussion among domestic economists has been more and more focused on the evaluation of costs and benefits of the adoption of the euro, on the timing of the entry and on the setting of the appropriate exchange rate level.

In the previous two years, the Czech economy was in a very good condition – accelerating economic growth under the low inflation and improving external balance. The year 2006 will most probably have the same label. There is a question, whether rapid economic growth and low inflation will persist after the eurozone entry. This paper is focused on the possible inflationary pressures that may follow after fixing of the currency (ERM II) and the EMU entry. The recent developments of inflation have put aside the fears from the inflationary pressures. But why is the inflation in the Czech Republic so low?

FACTORS OF LOW INFLATION

Strong competitive pressures, appreciating currency and sound monetary policy – these have been major factors preventing emerging demand inflationary pressures and enabling good absorption of cost inflationary pressures. High openness of the economy with steady increase of the share of imported goods on both consumption and production makes the role of the exchange rate increasingly important in taming the inflationary tendencies.

In 2005, import prices rose by mere 0.3 %, y/y, in spite of record high world prices of

fuels. According to the analyses carried out by the Czech Statistical Office, the increase of import prices would be much more significant, if it had not been for the exchange rate appreciation. Note that the CZK appreciated by 6.6 % on average with respect to the EUR and by 6.8 % against the USD. The import prices of foods declined by 0.8 %, y/y, import prices of machinery fell by 4 %, y/y, prices of consumer goods dropped by 7.3 %, y/y. The weakening of the Czech currency against the USD in the last quarter of 2005 was immediately seen in the inflation figures.

Strengthening competition and appreciating currency have thus been major factors behind the ability of the Czech Republic to fulfill the Maastricht inflation criterion in previous years. There is a question whether this will be the case after the fixing of the currency. Let us remind that the Maastricht criteria should be sustainable in the long-term horizon.

LOW RELATIVE PRICE LEVEL

The risks of inflationary pressures after the EMU entry are stemming not only from the fact that the appreciating currency prevents inflationary pressures but also from the fact that the Czech relative price level is very low. According to the Eurostat, the relative price level (of final consumption of households) is approximately at 55 % of the EU 25 average. This is one of the lowest price levels in the EU 25, similar to Poland, Latvia, and Slovakia (52 %, 55 %, 55 % of the EU 25 average, respectively). Low relative price level represents the most significant deviation within the framework of the real convergence to the eurozone. Even the less developed members of the eurozone did not have such a low relative price level at the moment of EMU entry – the lowest price level of 75 % of the EU average belonged to Portugal.

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Table 1: Maastricht Inflation Criterion and the Czech Reality

	2001	2002	2003	2004	2005
Maastricht inflation criterion	3.1	2.9	2.7	2.2	2.6
Czech Republic	4.5	1.4	-0.1	2.6	1.6

Source: Czech National Bank

Table 2: Czech GDP (PPP based) and Relative Price Level, EU 25=100

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
GDP (PPP based)	70.0	67.8	65.3	64.8	63.7	64.8	66.3	67.8	70.3	73.3
Price level	42.7	43.2	46.2	45.4	47.2	50.3	54.7	55.5	55.0	n.a.

Source: Eurostat

Anyway, this was by approximately 20 percentage points higher than the today's Czech reality.

Some economists may not consider the problem of low price level of so great importance, pointing to the fact that considerable differences between the price levels persist within the EMU itself. However, in the case of the Czech economy, the problem of low price level is accompanied by the discrepancy between the price level and the relative GDP level (level of economic development) – see Table 2. Some difference between GDP (in terms of PPP) and relative price level is typical for small and opened economies; relatively high differences being observed also for Belgium, the Netherlands, Austria, and Ireland. However, the relative price level in these economies is not lower than in EU 25. The relative price levels in Poland, Slovakia and Hungary are very close to the GDP (PPP based) level.

In the period 1999 – 2004, the Czech relative price level increased by 10 percentage points. The convergence of price levels may be based on two channels: inflation differential or nominal appreciation of the currency. Regarding the fact that in this period the average Czech inflation was roughly the same as in EU 25, the increase in relative price level was driven by the nominal appreciation of the currency. The importance of the exchange rate is thus stressed again. What will happen after the fixing of the exchange rate? The scenario of increased inflationary pressures will be highly probable.

KEY ROLE OF THE EXCHANGE RATE

To sum up, the importance of the exchange rate is stressed at least by two circumstances:

- appreciation of the currency prevents inflationary pressures,
- appreciation of the currency is the main channel of the convergence of the Czech price level to eurozone.

If the exchange rate is fixed too early, the channel of the price convergence via nominal appreciation of the currency will be closed and the threat of its spillover to the price channel will be imminent. The scenario of increasing inflation, weakening of economic activity and slowdown in the process of real convergence is realistic. At the same time, the convergence of the price level based on the nominal appreciation of the exchange rate is the best way because it does not threaten domestic price stability. Therefore, it is not reasonable to close the nominal appreciation channel too early.

Since 2001, the process of real convergence of the Czech economy accelerated – both the GDP (PPP based) level and the relative price levels have come significantly closer to the EU average. Czech economy followed the trajectory of acceleration economic growth under low inflation. Premature entry to the eurozone may change this picture dramatically. The case of the Irish economy may serve as an interesting example.

THE IRISH CASE

Although the Irish economy is much more developed than the Czech one, there have been some similar features as small size and high openness of the economy. In addition, the positive effects of foreign direct investments were the main driving force of strong economic growth in the nineties. Moreover, the exchange rate of the Irish pound has been appreciating in this period. Until 1998, that is until fixing the exchange rate, strong growth was accompanied by low inflation (lower than the EU average). However, this picture has changed after the EMU entry: inflation increased, followed by slowdown in economic growth. In recent two years, the inflation was pressed down by restrictive economic policy; nevertheless, the economic growth has also been considerably lower than in the nineties – see Table 3.

With respect to the developments of inflation in recent years and taking into account persisting existence of very low relative price

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Table 3: Ireland: Economic Growth and Inflation

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
HICP (in %)	2.2	1.2	2.1	2.5	5.3	4.0	4.7	4.0	2.3	2.2
GDP growth rates (in %)	8.3	11.7	8.5	10.7	9.2	6.2	6.1	4.4	4.5	4.7

Source: Eurostat

level, the most reasonable policy is to wait with the fixing of the exchange rate until the appreciation of the currency does not stop. The appreciation of the exchange rate has been connected with the real convergence of the Czech economy towards more developed market economies. If the exchange rate was fixed too early, the exchange rate channel of the price convergence would be closed.

Consequently, inflationary pressures would emerge, followed (with high probability) by slowdown of economic growth and slowdown of the real convergence processes. In addition, the increase of inflation may lead to exceeding the Maastricht inflationary criterion. This could lead to prolongation of the ERM II period, which is consensually considered to be highly dangerous for the Czech economy.

With respect to the developments of inflation in recent years and taking into account persisting existence of very low relative price level, the most reasonable policy is to wait with the fixing of the exchange rate until the appreciation of the currency does not stop.

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