

CONTENTS

Czech Economy in Autumn 2006	2
World Economy: Short Term Prospects and Risks	6
FDI: From Reinvestments to Dividends	8

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CZECH ECONOMY IN AUTUMN 2006

Kamil Janáček, Eva Zamrazilová

1. ECONOMIC GROWTH

In the first half of 2006, GDP grew by 6.6 %, with a slight deceleration in the second quarter to 6.1 %, down from 7.1 %, y/y, in Q1 2006. Unlike in 2005, the domestic demand became the main driver of economic growth. The GDP growth in the second quarter was primarily fuelled by fixed capital investments, which increased by 5.3 %, y/y, and household consumption with growth of 3.8 %, y/y. In external trade, y/y increase in the exports of goods and services (10.2 %) was precisely the same as the growth of imports of goods and services (10.2 %), both figures in constant prices. The only declining component was government consumption, which registered decrease of 3.4 %, y/y.

The biggest contributor to GDP growth in the second quarter was manufacturing with record-high 18.6 % growth of value added. Out of services, trade and transport reported most dynamic growth of 4.9 %, y/y. Financial services increased by 2.1 %, y/y. After a long-term decline, the value added in construction increased by 1.1 %, y/y.

Industrial output has accelerated as of the beginning of 2006, the cumulative growth from January to August reached 11.3 %, y/y. The acceleration been driven in particular by the automotive industry with growth close to 30 %, y/y, and supported 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 penetration of companies under foreign control has been further increasing – their share on industrial sales reached almost 60 %, in July 2006.

Manufacturing keeps favourable proportion between growth of productivity and real wages. For the first seven months of 2006, the productivity increased by 10.8 %, y/y, real wage rose by 3.3 %, y/y. The pressures on costs keep the competitiveness of Czech producers on the foreign markets even under the strong currency. The producers are still able to press down costs due to productivity increase. Also for these reasons, hiring of new employees has been slowing down.

After weak results and strong volatility of the first four months, construction kept double-digit growth from May to July 2006. For the first eight months, the construction output rose by 5.7 %, y/y. The growth is driven predominantly by the public investments to infrastructure, supported by foreign investors and housing construction. Construction activity is continuously supported by low interest rates. Housing keeps rather dynamic growth. In the first half of 2006, the number of started dwellings rose by 14.2 %, y/y, while completed flats fell by 3.2 %, y/y. Dwellings started grew faster than the number of dwellings completed due to capacity limits of developers.

The main factors behind growth of housing construction remain the same: developing mortgage market, growth of loans from construction savings (both supported by low interest rates), demographic factor, expected changes in the VAT rate for housing construction. Mortgage market has kept dynamic growth between 40 and 50 %, y/y, in all the seven months of 2006.

Growth in construction is differentiated along with the size of company. According to the CZSO analysis, the biggest companies have been the most rapidly growing ones. The average growth in Q2 2006 was at 6.5 %, y/y. The biggest companies (over 500 employees) registered a growth of 14.4 %, y/y. These companies account for approximately 35 % of total output. Growth of mid-sized companies (above 50 employees) reached 8.3 %, y/y, with share of 20 % on total output. Small companies (up to 50 employees) registered a growth of 5.1 %, y/y, accounting for approximately half of the production.

During the whole 2006, the retail sales are growing significantly over longer-term path, increasing by 6.7 %, y/y, January to August. The major drivers of retail sales have been consumer goods, with highest sales of household equipment including electronics and clothes and footwear. The demand has been supported by relatively low prices (influenced by strong currency and high competition).

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Moreover, spending is promoted by a shift towards more expensive goods with higher quality, because of increasing living standard. This applies also for food products. While in the past the sales of foods rose by average of 3 % yearly, in 2006, a shift to higher trajectory around 5 % reflected the shift to more expensive, higher quality items. The demand for cars recovered in comparison with previous year. Consumer loans represent considerable support for spending – people are more and more willing to finance even short-term consumption by loans. Consumer loans were increasing by a stable pace over 30 %, y/y, since the beginning of the year.

The third quarter of 2006, experienced two increases of basic interest rates, each time by 25 basis points, from 2.0 % to 2.5 %. The main reason was the higher inflation risks in the second half of this year. In both cases the markets anticipated these steps of monetary policy: 3M PRIBOR increased in both cases before the CNB decision. Nevertheless, the repo rate is still by 75 basis points below the refi rate of ECB, and the differential between 3M PRIBOR and 3M EURIBOR is also high, amounting to 80 basis points in September. Czech Republic remains the country with lowest interest rates among all 25 EU members.

2. FOREIGN TRADE AND EXCHANGE RATE

For the first eight months of 2006, imports rose by 13.9 %, y/y, exports increased by 13.7 %, y/y. The exports continue to be driven by machinery exports (cars, telecommunications, computers), which rose by strongly above average 21.4 %, y/y. Trade surplus amounted to CZK 33.9 bill, which was a year over year improvement of CZK 1.7 bill. More rapid growth of imports was affected predominantly by high world fuel and gas prices and was supported also by accelerating domestic demand. The surplus in trade with machinery has further increased to CZK 170 bill., which was by CZK 45 bill. more than a year before. On the other hand, fuels produced a deficit of CZK 84 bill., which was CZK 30 bill. deterioration.

In 2006, the Czech currency has been appreciating. The path of appreciation stopped in July 2006, as a consequence of an unclear result of parliamentary elections and payments of dividends abroad. Nevertheless, in August, the CZK started to appreciate again, with only a slight weakening in September. In the first three quarters of 2006, the CZK appreciated by 5.5 % on average against the EUR and by 3.5 % with respect to USD, in comparison with the same period of the last year. Until now, the election results and difficult negotiations about the new government did not affect the Czech currency (the September average of 28.38 CZK/EUR was precisely the same as was the June average).

3. INFLATION

Consumer price increase in the first eight months of 2006 was mainly caused by the rise of administered prices of electricity (by 9 %), natural gas (24.6 %), and prices of housing (6.9 %) 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 as of May; 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 nine months of 2006, standing at 2.7 %, in September 2006.

After almost one and half year, the food prices started to grow as of June 2006; in September 2006 the food prices were by 2.6 % higher than a year before. This was an important upturn, since the food prices account for 20 % of the consumer price index. The food prices increase was caused by the second round effect of energy prices growth.

Producer prices stopped to fall in the first quarter of 2006, since the second quarter the growth accelerated. At the end of September, the PPI stood at 2.4 %, y/y. Prices of electricity, gas increased by 7.9 %, y/y and prices of basic metals by 3.9 %, y/y. Agricultural PPI grew by 4.2 %, y/y, in September 2006. With some time lag we will experience, the spill-over of agricultural producer prices to food products prices, and finally to consumer prices.

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4. UNEMPLOYMENT

The labour market continues to improve under strong economic activity, the numbers of unemployed keeping below the half-million bar in previous months. The unemployment rate for September stood at 7.8 %, which was by percentage point less than a year before. The effect of graduates this year was not very strong due to demographic factor and relatively tough measure providing the unemployment benefits only to graduates with working experience.

Strong economic activity supports the creation of new jobs - their September offer amounted to 97.5 thousands, which was by 75 % more than a year before. However, there is a structural mismatch between the vacancies and free labour force. The unemployed (especially long-term unemployed) are not qualified and educated enough to get better paid (and qualified) jobs. On the other hand, they are not willing to take low qualified (and bad paid) jobs. As a consequence, the share of long-term unemployment in the Czech Republic further increased to 55 %.

The harmonised rate of Czech unemployment published by the Eurostat (the latest data are disposable for July 2006) was at 7.1 %, this is below the EU 25 average of 7.7 %. The Czech unemployment rate was the lowest within Visegrad countries. In year over year comparison, economic activity was helpful for the labour market in majority of EU 25 countries. July

2006 unemployment rate in EU 25 declined to 7.7 %, down from 8.5 % in July 2005. This decline was more pronounced than in the CR, indicating again the importance of the structural Czech labour market weaknesses. The above average decline in the unemployment rate was observed in Germany (from 9.6 % to 8.4 %), Estonia (from 7.2 to 4.0 %) or Spain (from 9.3 % to 7.4 %). On the other hand, the unemployment rate registered y/y increase in Hungary, Belgium, Ireland and Great Britain.

5. OUTLOOK

In 2006, the GDP will continue to grow, albeit not at the level of the first half of the year. Due to deceleration of world output, high raw material prices 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 around 6 % or slightly below.

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 %. In the last quarter of 2006, the external demand will be most probably lower due to expected weakening of the economic activity in the major eurozone economies, therefore permanent double-digit growth rates are not expected. Nevertheless, the full-year 2006 growth in industry will be slightly above 10 %, which

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Table 1: Main Macroeconomic Indicators

		2001	2002	2003	2004	2005	06/06	07/06	08/06	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	2.9	3.1	3.0
Inflation	%, m/m	-	-	-	-	-	0.3	0.4	0.2	-
Industrial prices	%, y/y	0.8	-0.7	0.9	7.7	-0.3	1.8	2.4	2.7	3.0
Industrial prices	%, m/m	-	-	-	-	-	0.2	0.7	0.3	-
Unemployment rate*	%, eop.	8.9	9.8	10.3	9.5	8.9	7.7	7.9	7.9	7.9
Industrial production	%, real	6.7	1.9	5.5	9.6	6.7	10.0	12.2	7.4	10.5
Construction output	%, real	9.6	2.5	8.9	9.7	4.2	10.0	12.2	6.4	6.0
Retail sales	%, real	4.5	3.0	4.9	2.5	4.0	6.5	6.4	-	6.0
State budget	CZK bill.	-67.7	-45.7	-109.1	-93.5	-56.4	6.7	-0.4	-6.4	-85
Trade balance	CZK bill.	-117.4	-70.8	-69.8	-26.4	39.5	7.9	-1.2	-2.1	45
FOREX reserves	USD bill.	14.5	23.7	27.0	28.4	29.5	30.4	30.7	30.9	31.5
PRIBOR 3M	% average	5.2	3.6	2.3	2.4	2.0	2.16	2.29	2.36	2.3
CZK/EUR	Average	34.1	30.81	31.84	31.9	29.78	28.38	28.44	28.19	28.4
CZK/USD	Average	38.0	32.74	26.32	25.7	23.95	22.44	22.44	22.01	22.8

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

will be above the so far highest figure of 9.9 %, observed in 2004, and will be notably higher than the EU average.

Strong investment activity driven in particular by the public sector will support growth in construction in the rest of the year. Low interest rates will be helpful, too. The growth rates will be less volatile in the second half of the year. For the first eight months the growth of construction output was at 5.7 %, full-year growth is expected at 6 %.

The growth of retail sales will remain solid in the rest of the year, driven by stable dynamics of incomes, low inflationary environment, improving labour market conditions and rapid growth of credits to households. Positive impact of strong currency will be felt, as a significant part of retail goods is imported. We expect the full-year figure around 6 %. This will be a notable acceleration against 2005 (4 %, y/y) and higher than the so far best figure from 2003 (4.9 %, y/y). At the same time, it is obvious that consumer demand will play a more significant role in economic growth as confirmed by the GDP results for H1.

The exports will continue in solid growth, driven by the machinery exports, in particular by the automotive industry. However, the room for further improvement of the trade balance seems to be exhausted under present circumstances of high fuel prices. The year over year effect of expensive fuels will weaken as of September, promoted also by year over year appreciation of CZK against USD. The imports will, however, keep roughly the same growth as the exports due to strong domestic demand. We cut down the full-year forecast of the trade balance for 2006 to CZK 45 bill.

Even under slight improvement of the trade balance, the current account deficit will increase up to 3 % of GDP due to increasing deficits of the incomes balance. The expenditures of the balance of incomes register rapid growth as a consequence of increasing reinvestments and dividends

along with increasing profits of companies under foreign control.

In the rest of 2006, the inflation will move around 3 per cent bar. There is a spillover effect of increasing producer prices of fuels, other raw materials and foods; competition on retail market and appreciation of the Czech currency are able to dampen these second round effects only to some degree. We expect 2006 year-end CPI and PPI around 3.0 %. Average CPI will be also at 3 %, average PPI will reach approximately 2 %.

The CZK will keep the path of moderate appreciation until the end of the year. The average appreciation of the Czech currency in 2006 thus will be slightly below 5 %, i.e. lower than last year, with respect to both USD and EUR. The average 2006 exchange rate is expected at 28.4 CZK/EUR and 22.8 CZK/USD.

CNB continues to keep 75 basis points differential between its repo rate and refi rate of European Central Bank; this is not sustainable in the longer run. Therefore, we can await the increase of repo rate, with high probability during the last quarter of the year – either by 25 basis points in the case of strong CZK (or by 50 basis points in the case of weakening of the Czech currency).

Autumn months will register decline of the unemployment rate to approximately 7.5 %. In December, seasonal works will finish, as well as term labour contracts, which will cause regular growth of unemployment. At the end of 2006, we expect the unemployment rate at 7.9 % or 8.0 %. This will be by one percentage lower than a year before. However, the decline of the unemployment rate will be driven only by the decline of short-term unemployment. Long-term unemployment will continue to increase further, up to 56 % of total unemployment. At the same time, structural and regional problems of the Czech labour market as well as the reforms of the institutional framework continue to be the main challenges.

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The decline of the unemployment rate will be driven only by the decline of short-term unemployment. Long-term unemployment will continue to increase further, up to 56 % of total unemployment.

WORLD ECONOMY: SHORT-TERM PROSPECTS AND RISKS

Kamil Janáček

In the last four years, the world economy has shown the fastest growth, measured over more than three decades. As shown in Table 1, global economic growth will again speed up somewhat in 2006, from the 4.9 % achieved in the previous year. Rapid growth can be seen in all regions – even the Eurozone will in 2006 show growth at (or even above) its long-term growth potential. Japanese economy has definitely emerged from the long-term recession, Latin America is profiting from the boom of raw material prices, and India and China grow by rates enabling them to catch up quickly with other South-Asian countries.

Yet there are increasingly signs that the period of fast global growth can soon be over. Growing risks of high inflation, expensive raw materials, and an aging population in advanced European countries and Japan (as well, in future, in China) lead international institutions (IMF, World Bank, ECB) and analysts to the conclusion that in 2007 global growth will slow down – and that the slowdown can be worse than suggested by Table 1.

Increasing input prices, mainly prices of oil and some metals, are pushing up inflation – and central banks in USA, Eurozone, Japan and other countries have started to raise the interest rates. It is clear that the era of historically low interest rates, characteristic for the last four years, is over. Economic slowdown in USA, EU, or Japan will influence the whole world economy and global trade. The continuing strong dynamics of the Chinese economy, or of other East-Asian countries,

cannot compensate for the impact of the main economic powers.

From the point of view of Czech economy, so dependent on exports and hence on economic growth abroad (mainly in Eurozone), the future trends in economies of our main trade partners are crucial. The situation in 2006, and the outlook for 2007, is shown in Table 2.

All our main trade partners have to expect a relatively sizable growth slowdown. Reasons of the slowdown are multiple, both general and country-specific:

- Increase of ECB's interest rates, in the endeavor to push inflation under the 2 % target, will curb economic growth;
- Strong euro, together with the global slowdown, will lower the demand for eurozone exports;
- Fiscal consolidation in Germany, France and Italy will reduce government expenditures, with a short-term negative impact on the economy;
- Increased VAT in Germany by three percentage points will curb household consumption, which showed a revival in 2006 after a very slow growth in 2004-2005. In 2007, its rate of growth will again approach zero.

This outlook is not very favorable for the Czech economy. Germany has 34% share in Czech exports, Eurozone more than 60 %. Thus, it cannot be expected that Czech exports to these territories could grow as fast – in double digits – as in 2005 and to some extent also in the first half of 2006. Other rapidly growing

Table 1: Growth of the World Economy, 2005 – 2007

(GDP, in %)	2005	2006F	2007F
USA	3.5	3.4	2.6
Japan	2.6	3.0	2.7
Eurozone	1.4	2.4	1.7
Central and Eastern Europe	5.4	5.3	5.2
Latin America	4.4	4.5	3.8
India	8.5	8.2	7.5
China	10.2	10.0	10.0
World	4.9	5.0	4.6

Source: IMF, Société Générale, Komerční banka

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Table 2: GDP Growth of Czech Republic's Main Trading Partners

(in %)	2005	2006F	2007F
Germany	1.2	1.9	0.7
France	1.1	2.3	1.7
Austria	2.0	2.7	1.6
Italy	0.1	1.6	1.2
The Netherlands	1.1	2.4	1.7
Slovakia	6.1	6.5	5.5

Source: IMF, Société Générale, Deutsche Bank, Komerční banka

economies (India, China) cannot in the short time substitute the export opportunities missing in Western Europe. It is highly probable that the contribution of exports to net GDP growth will be lower compared to 2005 and

2006. This will be only partly compensated by the increase of domestic demand (investment, and household consumption). For these reasons, we expect that GDP growth in 2007 will slow to 5% (or, slightly below the 5% level).

It is highly probable that the contribution of exports to net GDP growth will be lower compared to 2005 and 2006. This will be only partly compensated by the increase of domestic demand.

FDI: FROM REINVESTMENTS TO DIVIDENDS

Eva Zamrazilová

There is a widespread consensus that foreign direct investments contributed to a high extent to present good shape of the Czech economy. FDI have many positive effects on the Czech economy, in particular in enforcing the market environment, restructuring of the business sector and increasing export efficiency. It is their merit that the Czech trade balance turned to the black in 2005 (as the only among new EU member states) and that the Czech economy was fully integrated to the EU Single market at the moment of our EU entry.

On the other hand, there are also some costs connected with the FDI inflows. Along with an increasing penetration of FDI into domestic economy, increasing part of profits has been generated by foreign controlled companies (e.g. they accounted for 73 % of manufacturing industry profit in 2004). These profits are either reinvested or paid to foreign owners, according to their decision. Recently a tendency from reinvestments of profits towards payments of dividends has been observed, in accordance with the theory of life-cycle of the investment.

The economic theory suggests that the investment goes through three different stages during its life cycle. In the first stage, the investment usually produces loss (with the exception of some privatisation investments). In the second stage, the efficiency increases and the investment start to produce profits. However, in this stage, major part of generated profit is reinvested with the aim of another enlargement and development of the company. After this reinvestment stage, increasing share of profits is paid to shareholders - payments of dividends takes place; dividends gradually exceed the reinvestments. According to previous experience of many FDI host countries, payments of dividends start to exceed the inflow of FDI.

This process partly differs along with type of the investment (acquisition or greenfield investment), individual industries and macroeconomic conditions of the host economy. Generally, greenfield investments need longer time before the company stabilizes and generates regular profits. In the Czech

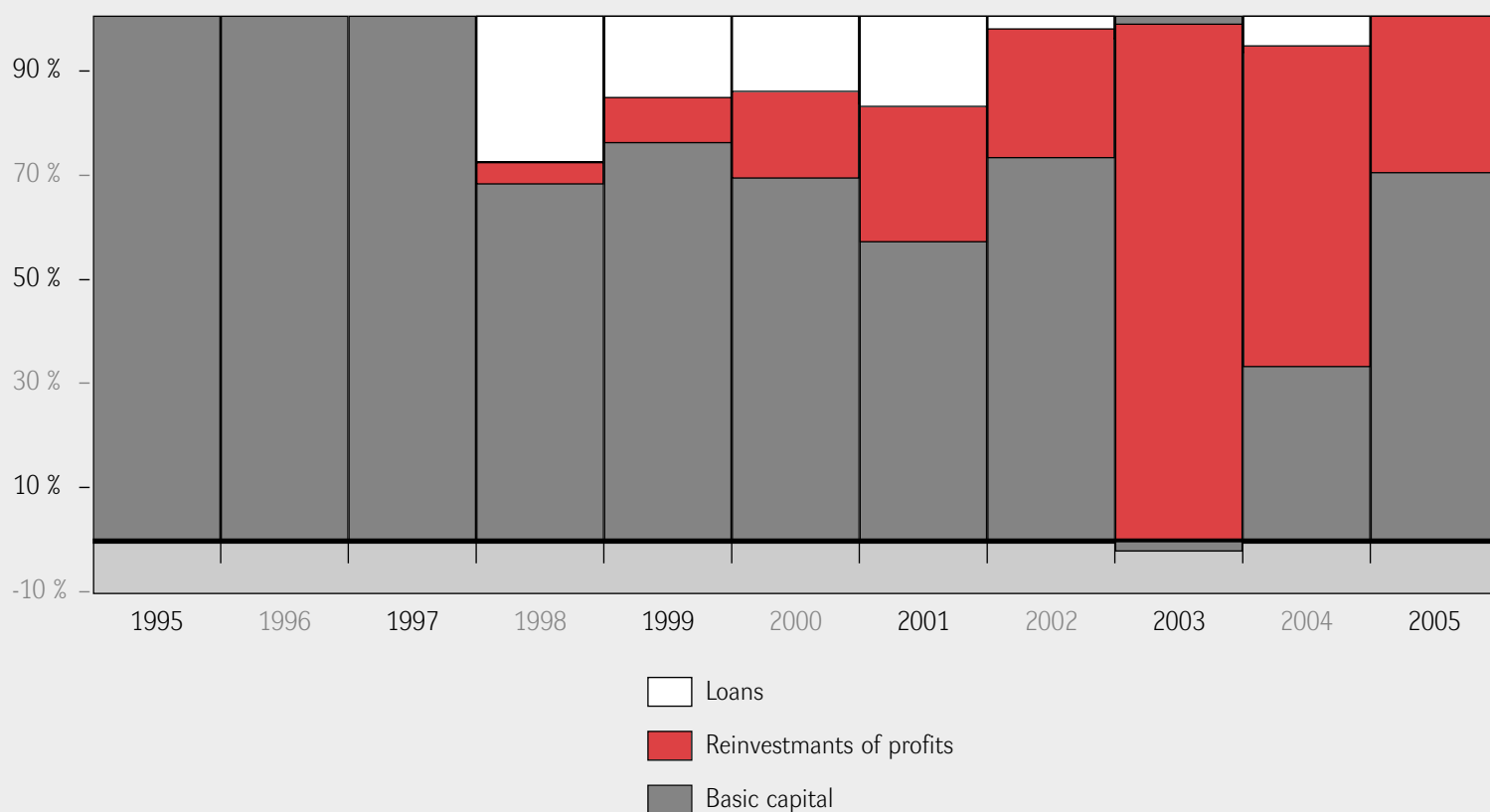
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Table 1: Inflows of FDI: Basic Capital, Reinvested Profits, FDI Loans, CZK bill.

	Basic capital	Reinvestments of profits	Loans	FDI total
1995	68	0	0	68.0
1996	38.8	0	0	38.8
1997	41.3	0	0	41.3
1998	81.9	5.8	32.2	120.0
1999	168.7	23.9	26.2	218.8
2000	134.9	36.9	20.6	192.4
2001	128.2	57.8	28.6	214.6
2002	205.7	64.3	7.6	277.7
2003	-1.5	60.9	0	59.3
2004	45.7	75.8	6.4	127.8
2005	184.6	78.2	0.4	263.2

Sources: CNB.

Figure 1: Structure of FDI Inflow



Source: CNB

Table 2: FDI stock: Basic Capital, Reinvestments, Loans

	Basic capital		Reinvestments		FDI Loans		FDI total
	CZK bill.	%	CZK bill.	%	CZK bill.	%	
1995	195.5	100	0		0		195.2
1996	234.3	100					234.3
1997	275.6	86.2	9.1	2.8	35.1	11.0	319.8
1998	349.9	81.5	14.9	3.5	64.4	15.0	429.2
1999	506.5	80.2	31.8	5.1	93.1	14.7	631.5
2000	641.4	78.4	60.8	7.4	116.2	14.2	818.4
2001	706.4	71.9	131.2	13.4	144.8	14.7	982.3
2002	798.1	68.5	215.0	18.4	152.4	13.1	1 165.8
2003	767.0	66.0	242.4	20.9	152.4	13.1	1 161.8
2004	800.6	62.5	321.3	25.1	158.8	12.4	1 280.6
2005	985.2	63.8	399.4	22.8	159.2	10.3	1 543.8

Sources: CNB.

Republic, friendly attitude towards privatisation via foreign capital lagged behind other Visegrád countries, which is nowadays reflected in later start of the third stage.

Reinvestments: Important Part of FDI Inflows and Stock

The reinvestments of profits have gradually become an important source of FDI inflow. Table 1 presents data of FDI inflows divided among basic capital, reinvestments and other capital (Figure 1 shows the corresponding structure). The profits started to be reinvested as of 1998, reinvestments being however low until 2000. They started to play a more important role as of 2001, along with the outlined theory of the investment life cycle. In 2003, the reinvestments were the only source of FDI inflow, in 2004 – 2005 representing an important part of it.

Table 2 shows the figures on FDI stock. It is obvious than until the end of 2005, the FDI amounted to CZK 1544 bill., out of which CZK 985 bill. (64 %) belonged to basic capital, CZK 399 bill. (23 %) represented reinvestments of profits. The reinvestments started to play an

important role as of 1999, their importance gradually increasing up to 2004. The rest of 10 % of total FDI stock represents other capital, i.e. loans granted by foreign mother companies to their daughters in host countries. Lets us note that FDI are usually considered as non-debt financing of the gap between domestic savings and investment and which is not fully correct. Table 3 presents the structure of foreign indebtedness indicating that the loans linked to the FDI started to be felt in the total foreign indebtedness as of 2000, along with higher intensity of FDI investment. Their share on total indebtedness was increasing up to 20 % in 2002, with some decline to 14 % in 2005. It is visible that the indebtedness of banks declines along with growth of indebtedness by FDI loans. In the Nineties, Czech banks borrowed money abroad, lending them later to domestic companies - the FDI loans thus partly replaced borrowing from banks.

Structure of FDI: Individual Industries

It is interesting to register the significant differences among individual industries as for the proportions between basic capital, reinvestments and loans – see Table 4.

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The loans linked to the FDI started to be felt in the total foreign indebtedness as of 2000, along with higher intensity of FDI investment. Their share on total indebtedness was increasing up to 20 % in 2002, with some decline to 14 % in 2005.

Table 3: Foreign Indebtedness, CZK bill.

	Total	Government	Business sector	Banks	CNB	FDI loans
1995	457.3	77.2	190.3	167.3	22.4	0
1996	578.9	58.6	251.4	257.6	11.2	0
1997	748.7	59.9	313.4	328.7	11.6	35.1
1998	726.9	42.0	282.9	326.7	11.0	64.4
1999	822.5	41.2	316.9	358.7	12.6	93.1
2000	817.1	40.8	337.9	322.0	0.2	116.2
2001	811.3	31.3	354.1	280.8	0.2	144.8
2002	813.3	48.5	354.7	257.5	0.2	152.4
2003	895.1	69.7	389.6	283.3	0.1	152.4
2004	1 011.8	151.1	448.2	252.8	0.9	158.8
2005	1 125.9	222.2	471.5	268.0	6.0	158.4

Sources: CNB.

Table 4: Basic Capital, Reinvestments, Loans: Individual Industries

	CZK bill.	Basic Capital	%	Reinvestments	%	FDI loans	%
FDI total	1 543.8	985.2	63.8	399.4	25.9	159.2	10.3
Industry	664.2	380.0	57.2	227.0	34.2	57.2	8.6
of which:							
Mining	17.6	10.8	61.4	5.4	30.7	1.4	7.9
Electricity, gas, water	89.0	48.8	54.8	39.2	44.0	1.0	1.1
Manufacturing	557.6	320.4	57.4	182.4	32.7	54.8	9.9
Of manufacturing:							
Food	58.6	33.8	57.7	19.7	33.6	5.1	8.7
Timber	44.8	27.7	61.8	14.6	32.6	2.5	5.6
Chemistry	38.5	22.5	58.5	12.6	32.7	3.4	8.8
Rubber and plastics	41.1	13.7	33.3	27.1	66.0	0.3	0.7
Metals	83.9	50.9	60.7	23.9	28.5	9.1	10.8
General machinery	33.1	21.7	65.6	1.8	5.4	9.6	29.0
Elektrotechnics	36.5	16.4	44.9	13.9	38.1	6.2	17.0
Automotive	105.7	65.9	62.3	40.6	38.4	-0.8	-0.7
Others	115.4	67.8	58.8	28.2	24.4	19.4	16.8
Construction	26.7	16.4	61.4	12.4	46.4	-2.1	-7.8
Services	850.4	586.5	69.0	159.8	18.8	104.1	12.2
Of services:							
Trade	180.5	129.6	71.8	23.3	12.9	27.6	15.3
Transport and communications	8.5						
Financial services	242.1	101.2	41.8	124.2	51.3	16.7	6.9
Rental and business services	191.1	130.5	68.3	1.7	0.9	58.9	30.8
Others	2.5	2.3	92.0	0.2	8.0	0.0	0.0

Sources: CNB.

Generally, the reinvestments play more important role in industry and construction than in services.

The FDI loans (loans granted from mothers to daughters) represent 10 % on average of total FDI stock.

Generally, the reinvestments play more important role in industry and construction than in services. The highest shares of reinvestments are observed in the rubber and plastic production and financial services, where the reinvestments even exceed the basic capital input. The share of reinvestments is close to 50 % in electricity, gas and water supply and in construction. In the automotive industry, the share of reinvestments is also above average, close to 40 %.

The FDI loans (loans granted from mothers to daughters) represent 10 % on average of total FDI stock. Contrary to this tendency, Czech

recipients of FDI in construction and car industry even granted loans abroad. In production of rubber and plastics, electricity, gas and water supply, the role of FDI loans was negligible. On the other hand, these loans accounted for strongly above-average share of 30 % of FDI stock in general machinery and rental services.

The interests paid from FDI loans belong to the debit side of the balance of incomes on the current account. The interests on FDI loans amounted annually to approximately CZK 7 bill., in the course of previous five years. The impact of FDI on balance of

Table 5: Volume of Incomes and Ratio of Incomes to FDI Stock

	2001		2002		2003		2004	
	CZK	%	CZK	%	CZK	%	CZK	%
	bill.		bill.		bill.		bill.	
Total	982	8.2	1 165	8.9	1 162	10.2	1 281	12.2
Manufacturing	369	11.0	414	9.6	487	10.9	513	13.2
Electricity, gas, water	60	7.2	80	8.6	84	10.7	85	10.0
Trade	148	6.4	139	6.5	143	5.0	165	9.3
Transport and telecommunications	102	2.2	158	6.1	69	13.3	80	12.6
Financial services	145	12.9	185	15.3	195	15.1	211	16.3
Rental and business services	112	2.1	108	4.6	104	3.9	145	7.6
Others	46	7.0	82	5.5	80	8.1	81	11.5

Sources: CNB.

incomes will be focused in a more detail in the last section.

From Reinvestments to Dividends

The ratio of incomes from FDI stock has been gradually increasing since 2000. The so far highest value was reached in 2004 (but the preliminary result 10.2% in 2005 is expected to be revised upwards, as was the case for 2004, along with the final upwards revision of dividends payments). The ratio of incomes is

different for individual industries – see Table 5. As expected, the highest ratio of incomes belongs to financial services. The position of key manufacturing industry is slightly above average; transport and telecommunications improved their ratio of income significantly during previous two years.

The industries with highest incomes exhibit naturally lower tendency to take loans. Correspondingly, the industries with lowest incomes draw above average loans from their mother companies.

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Table 6: Proportion between Reinvestments and Dividends: Individual Industries, in %

	2001		2002		2003		2004		2005	
	R	D	R	D	R	D	R	D	R	D
Total	78	22	66	34	54	56	51	49	55	45
Manufacturing	77	23	68	32	67	33	58	42	49	51
Electricity, gas, water	82	18	63	37	62	38	4	96	49	51
Trade	78	22	49	51	51	49	62	38	56	44
Transport and telecommunications	50	50	44	56	n.a.	n.a.	30	70	46	54
Financial services	55	45	75	25	67	33	35	65	66	34
Rental and business services	30	70	62	38	65	35	70	30	19	81
Others	76	24	85	15	88	12	89	11	86	14

Sources: CNB.

Table 7: Balance of Incomes: Total Expenditures and FDI Expenditures, CZK bill.

	Expenditures	FDI expenditures	Interests on FDI loans	Reinvestments	Dividends from FDI
1995	34.5	1.7			1.7
1996	51.4	2.1			2.1
1997	69.8	1.8			1.8
1998	90.1	11.2	0.0	5.8	5.4
1999	111.0	36.2	3.7	23.9	8.6
2000	128.4	36.9	5.5	36.9	10.8
2001	168.4	81.1	6.9	57.8	16.4
2002	182.4	103.3	6.3	64.3	32.7
2003	191.1	118.3	5.3	60.9	52.1
2004	244.8	156.6	7.3	75.8	73.5
2005	254.6	148.6	7.3	78.2	63.1

Sources: CNB.

The financial flows connected with FDI affect strongly the balance of incomes. Reinvestments of profits, dividends and interests from FDI loans represent total incomes for the foreign investor on the one side and total FDI payments abroad for domestic economy on the other one.

As a consequence of rapid growth of reinvestments and dividends, the share of total FDI costs on total expenditures of the balance of incomes steadily increases – as of 2002 the share of FDI payments has been exceeding one half.

The outflow of dividends means that a notable part of profit generated in the Czech economy is flowing out of the country – this amount represented approximately 2 % of GDP in previous two years. The potential of the outflow is much higher because bigger part of profits was reinvested up to now.

The tendency from reinvestments to dividends is clearly documented by Table 6. While in 2001 78 % of profits were reinvested on average, the share of reinvestments declined to 55 %, in 2005. Financial services show highest share of reinvestments (with the exception of 2004).

The Impact of FDI on the Balance of Incomes

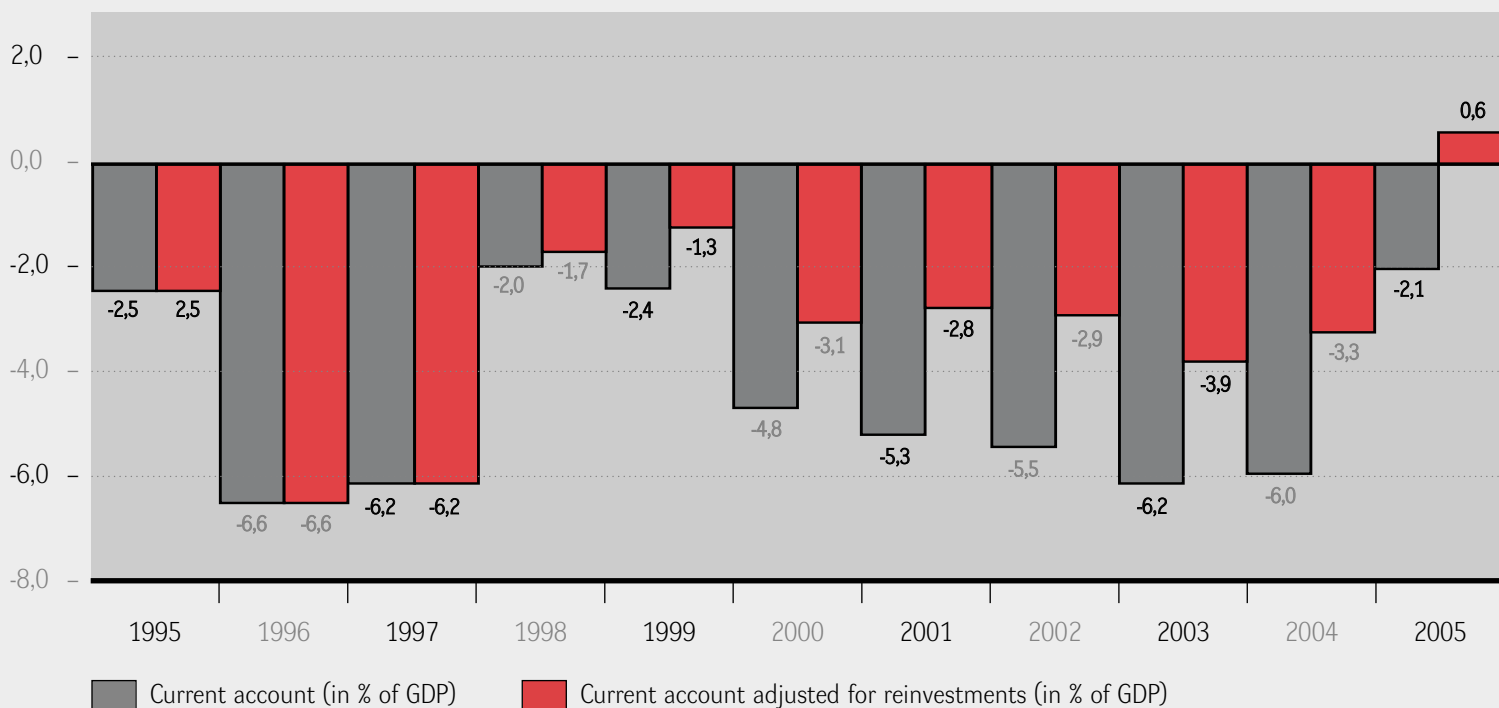
The financial flows connected with FDI affect strongly the balance of incomes – on of the four items of the current account of the balance of payments. The increasing profits from FDI represent a burden of the current account since they are registered on the debit side of the balance of incomes, either like reinvestments or dividends. Reinvestments of profits, dividends and interests from FDI loans represent total incomes for the foreign investor on the one side and total FDI payments abroad for domestic economy on the other one - see Table 7.

As a consequence of rapid growth of reinvestments and dividends, the share of total FDI costs on total expenditures of the balance of incomes steadily increases – as of 2002 the

share of FDI payments has been exceeding one half. The reinvestments do not represent pressures on foreign financing; therefore, this item is not risky for external stability of the country. Figure 2 shows the current account deficit after adjustment for reinvestments of profits – it is obvious that the difference is roughly 2.5 % of GDP. Current account adjusted for the reinvestments of profits would even turned to the black in 2005.

The dividends represent another, less favourable story. The outflow of dividends has been very progressive in previous three years, their share on total expenditures of the balance of incomes amounting to approximately one quarter. The payments of dividends represent the main adverse side of the generally very positive phenomenon of FDI. The outflow of dividends means that a notable part of profit generated in the Czech economy is flowing out of the country – this amount represented approximately 2 % of GDP in previous two years. The potential of the outflow is much higher because bigger part of profits was reinvested up to now. Based on foreign experience, it can be estimated that the amounts of dividends will exceed the value of FDI inflow in the future (after the end of privatisation).

Figure 2: Current Account: Adjustment for Reinvestments (in % of GDP)



Source: CNB

Figure 3: Current Account: Individual Balances, CZK bill.



Source: CNB

Reinvestments and dividends are the most rapidly growing items of the balance of incomes. Rapid growth of these items led to a significant change of structure of the balance of incomes. In the first half of the Nineties, the major part of expenditures on the balance of incomes belonged to interests payments, nevertheless these have stabilised around 40 CZK bill. since 1997. As mentioned above, the payments connected with FDI inflows have gained on importance since 2001, with a steady rise. The structural change of the balance of incomes reflects structural changes in the inflow of capital, from the foreign debt capital to FDI.

To sum up: foreign investors helped to consolidate the trade balance but also stand behind growing deficits on the balance of incomes. The changes of the individual

balances of the current account are well illustrated by Figure 3. It is a question, how progressive the improvement of the trade balance will be in the years to come. Anyway, at least half of the exports is generated by the companies under foreign control. In particular, the share of foreign control is above average in machinery industries that are the only ones able to produce trade surpluses. These profitable industries will generate outflow of dividends, so that it is most probable that the improving of the trade balance will go hand in hand with another growth of the deficit on the balance of incomes. This tendency will be partly compensated by future FDI of the Czech companies abroad. First signs of these have already appeared, but a more significant extent of getting back dividends is a question of the next two decades.

Foreign investors helped to consolidate the trade balance but also stand behind growing deficits on the balance of incomes.

The improving of the trade balance will go hand in hand with another growth of the deficit on the balance of incomes. This tendency will be partly compensated by future FDI of the Czech companies abroad.

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