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CZECH ECONOMY IN MID 2007

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1. ECONOMIC GROWTH

In Q1 2007, GDP increased by 6.1 %, y/y. At the same time, the data for Q4 2006 were revised upwards, from 5.8 % to 6.1 %. The GDP growth in Q1 2007 was thus the same like in Q4 2006. However, the main drivers of economic growth were different. The domestic demand continued to be the main driving factor. While consumer demand accelerated, investment demand weakened. The Czech GDP growth continued to be roughly double than the growth in EU 27.

The GDP growth was fuelled predominantly by the consumption of households, which registered rapid growth 6.7 %, y/y, after a growth of 4.6 % in 2006. Rapid growth of real incomes, benign inflation, booming consumer and mortgage credits and declining unemployment are supporting the propensity of the households to consume. Government spending rose by 0.4 %, y/y, in accordance with the longer-term trend (after 0.3 % growth in 2006).

Fixed capital investments increased by 1.5 %, y/y. This was a notable deceleration in comparison with growth of 7.3 %, y/y, in 2006. We must await the data for coming quarters and then assess if this development is a deviation or change in the trend.

Exports of goods and services rose by 14.6 %, y/y, imports by 16.5 %, y/y. Foreign trade ceased to be the driver of GDP growth, but due to statistical reasons: improving terms of trade have perverse effect on national accounts data on foreign trade: they are underestimating the growth of exports, while overestimating the data for imports.

The biggest contributor to GDP growth in the Q1 was manufacturing (accounting for 28 % of GDP) with growth of value added by almost 10 %. Construction reported very high growth of value added – 17.8 %, y/y. Out of services, trade reported most dynamic growth of 21 %, y/y, correspondingly to strong consumer demand. Financial services increased by 11.4 %, y/y.

Industrial output accelerated in the beginning of the year, with industrial output increasing by 11.2 %, y/y, in the first five months of 2007. Double-digit growth of industrial output was driven predominantly by good result of the electronics with growth of 21.0 %, y/y, very good result of general machinery (23.5 %, y/y), solid growth of the automotive industry (11.9 %, y/y) accompanied by rapid growth in rubber and plastics (25.2 %, y/y). Metal industry - second most important industry as for the share on total output – rose by moderate 2.5 %, y/y.

The growth in industry is more and more driven by foreign controlled companies: they accounted for one half of industrial value added. Car industry and electronics witnessed the highest shares of foreign capital on value added, amounting to 86 % and 57 %, respectively. The role of exports in segment of the foreign companies further increases, with 76 % of sales belonging to exports. The companies under foreign control account for approximately 90 % of direct export sales, while their share on purely domestic sales is much lower – approximately one quarter.

Industry continues to hire new employees – January to May, the employment rose by 2.3 %, y/y. In particular, electronics, rubber and plastics are the main drivers of rising employment. Nevertheless, further growth will probably encounter the barrier of shortage of qualified labour force, as indicated by signals from some regions and big companies. In spite of growing employment, the proportion between productivity and wages remains favourable in the Czech manufacturing. January to May 2007, productivity in industry rose by 8.3 %, y/y, and real wages by 6.0 %.

Construction registered extremely high growth at the beginning of 2007, with the output increasing by 18.1 %, y/y, January to May 2007. High growth was strongly influenced by favourable weather conditions; this factor acted strongly with respect to the fact that 2006 winter was quite tough (pushing down the 2006 basis for comparison), while 2007 winter was extremely mild. The effect of weather conditions was confirmed by at least two facts. Firstly, neighbouring countries (Poland, Germany, Slovakia) registered extremely high figures on growth in construction, as well.

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Secondly, the growth was concentrated to building construction (27.5 %, y/y) while civil engineering lagged behind (with decline of 1.2 %, y/y).

In housing construction, Q1 2007 reported particularly high growth of 20.3 %, y/y, with the number of finished flats amounting to 8.3 thousands, which was a record high figure for Q1 since 1996. The number of flats under construction rose by 7.8 %, y/y. On the other hand, the number of started flats rose by mere 0.5 %, y/y, indicating that the boom driven by the expectations of the VAT rate change will be soon over and that the housing construction will probably shift to lower long-term growth-path. As expected, the dynamics of the mortgage market slightly eased, to approximately 35 %. The volume of loans on housing amounted to almost CZK 502 bill., at the end of May 2007.

From the beginning of 2007, retail sales have accelerated along with strong consumer demand. Main factors behind strong consumer demand may be depicted as follows: decline in unemployment, rapid growth of wages, housing boom, high propensity to spend, wide disposability of various types of consumer credits granted by financial and non-financial institutions. The psychological factor is also important: consumers have lower propensity to save; on the other hand, they are more and more willing to finance their consumption by wide offer of various types of loans. This is partly connected with the demographic developments: strong vintages from the Seventies dispose with increasing incomes and their propensity to save is low.

In the first four months of 2007, retail sales increased by 9.0 %, y/y. The growth of sales was driven in particular by sales of cars and consumer goods with double-digit growth rates. Car sales increased by 11.6 %, y/y, consumer goods rose by 11.9 %, y/y. As for the segment of consumer goods, the sales continue to be pushed up by housing equipment (along with the boom in housing) and clothing including footwear.

2. FOREIGN TRADE AND EXCHANGE RATE

January to May 2007, the exports increased by 16.4 %, y/y, the imports rose by 14.7 %, y/y. The favourable trend of higher growth of exports in comparison with the imports led to notable year over year improvement of trade balance. The trade surplus amounted to CZK 44.4 bill., which was an improvement of CZK 18.3 bill. in comparison with the same period of 2006. At the same time, the five months surplus was higher than the full-year 2006 result (CZK 43 bill. after last revision). The surplus with EU 27 amounted to CZK 173 bill. Three major factors stood behind these favourable results: good performance of machinery exports, weaker imports of fuels due to more or less stabilized prices and mild winter, favourable developments of prices in foreign trade.

Machinery exports rose by above average 17.3 %, y/y, producing a surplus of CZK 135.6 bill., January to May 2007. Similar to previous year, cars accounted for approximately two thirds of the machinery surplus (CZK 86.1 bill.). Fuels and chemistry represented highest deficits of CZK 49.8 bill. and 42.2 bill., respectively. The deficit of fuels, however declined by CZK 10 bill., y/y, due to decline of imports by 10.5 %, y/y. The deficit of chemistry increased by CZK 6.3 bill., y/y.

The development of foreign trade prices was favourable in Q1 2007, with continuing improvement, which started to act in Q4 2006. The prices of exports rose by 1.9 %, y/y, in Q1 2007, while the prices of imports fell by 1.7 %, y/y. The terms of trade thus improved by 3.7 percentage points, which was helpful for the trade balance in current prices.

At the end of January 2007, the appreciation of the Czech currency stopped. The Czech crown depreciated from the January average 27.8 CZK/EUR to 28.5 in June 2007. There were two main reasons behind this upturn. First, the perception of Central European market became less optimistic and second, the continuing big interest rates differential between 3M PRIBOR and 3M EURIBOR, still close to 100 basis points.

At the end of May 2007, the Czech National Bank raised basic interest rate 2W repo by 25 basis points to 2.75 %. Nevertheless, the differential of refi rate of ECB and repo rate of CNB remains the same (i.e. 125 basis points), as the ECB raised the refi rate to 4.0 %, at the beginning of June 2007. At the same time, the Czech basic rates continue to be the lowest among EU 27 countries.

The decision of CNB was expected by the market and was caused by emerging inflationary signals. These pressures are

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driven by strong domestic demand, in particular the consumer one, which led to record high Q1 2007 retail sales figures. At the same time, the exchange rate stopped to appreciate for the moment, which means that important anti-inflationary factor weakened. Rapid growth of producer prices is another risky pro-inflationary factor.

3. INFLATION

At the first half of 2007, Czech inflation slightly accelerated due to several factors: strong consumer demand, which creates space for price increases, high oil and energy prices, and the consequences of the global increase of agricultural products. In addition, the exchange rates stopped to attenuate the inflationary pressures, as of the beginning of February. At the end of June 2007, the year over year increase of CPI amounted to 2.5 %, y/y. Growth of consumer prices was driven in particular by food and housing prices, which account for 41 % of the consumer basket. Food prices rose by 2.6 %, y/y, housing prices increased by 2.8 %, y/y.

The demand inflationary pressures have already emerged, which is indicated by the upturn of clothing and household equipment prices. Even though the prices of clothing were still at the same level as in June 2006, month over month growth has continued for nine consecutive months. The same applies for prices of housing equipment. In this segment of the market, the consumer demand has been the highest giving the traders space for price increases.

Producer prices continued to accelerate during the first five months of 2007. The year on year PPI amounted to 4.6 %, in June 2007. Producer prices in manufacturing (4.0 %, y/y) were below the overall growth. The main factor of PPI growth was expensive metals and energies. The pass-through of expensive metals is visible on increasing import prices of semi-manufactured production, which rose by 4.5 %, y/y, in May. Domestic producer prices of intermediate goods registered similar growth (5.9 %, y/y). Prices of energies increased by 6.9 %, y/y. The pass-through to producer prices of final production is still limited. The year over year growth of PPI of final production (investment goods, consumer goods) was significantly lower: 2.3 % and 2.2 %, respectively.

4. UNEMPLOYMENT

At the end of H1 2007, the rate of unemployment was at 6.4 %, almost by one and half percentage point lower than a year before. The number of unemployed reached a new record-low (370.8 thousands) declining by more than 80 thousands, y/y. At the same time, the offer of vacancies was record-high (123.3 thousands), with year on year growth of 44 %. As a consequence of the decline in unemployment combined with growing offer of vacancies, the UV ratio continues in improvement. The ratio between unemployment and vacancies declined to 3.0, while it was at 5.2 a year before.

It seems not to be difficult to find a job under present circumstances; however, it

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Table 1: Main Macroeconomic Indicators

		2002	2003	2004	2005	2006	03/07	04/07	05/07	2007F
GDP	%, y/y	1.9	3.6	4.6	6.5	6.4	–	–	–	5.8
Inflation	%, y/y	0.6	1.0	2.8	2.2	1.7	1.9	2.5	2.4	3.0
Inflation	%, m/m	–	–	–	–	–	0.3	0.7	0.4	–
Industrial prices	%, y/y	-0.7	0.9	7.7	-0.3	2.6	3.6	3.7	4.1	5.8
Industrial prices	%, m/m	–	–	–	–	–	0.5	0.6	0.6	–
Unemployment rate*	%, eop.	9.8	10.3	9.5	8.9	7.7	7.3	6.8	6.4	6.5
Industrial production	%, real	1.9	5.5	9.6	6.7	9.7	11.0	14.0	7.5	10.5
Construction output	%, real	2.5	8.9	9.7	4.2	6.6	26.4	17.6	1.4	12.0
Retail sales	%, real	3.0	4.9	2.5	4.0	6.4	10.5	8.1	–	7.0
State budget	CZK bill.	-45.7	-109.1	-93.5	-56.4	-97.3	11.3	-17.0	-26.0	-95
Trade balance	CZK bill.	-70.8	-69.8	-26.4	38.6		12.6	3.0	6.9	75
FOREX reserves	USD bill.	23.7	27.0	28.4	29.5	31.3	31.7	32.1	31.4	32.5
PRIBOR 3M	% average	3.6	2.3	2.4	2.0	2.3	2.56	2.60	2.77	2.9
CZK/EUR	Average	30.81	31.84	31.9	29.78	28.34	28.06	28.01	28.23	28.2
CZK/USD	Average	32.74	26.32	25.7	23.95	22.61	20.73	20.90	21.27	21.5

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

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

For the rest of 2007, we expect that the rapid dynamics of the Czech economy will continue. For 2007, the GDP growth will be close to 6 % and will continue to be driven by strong consumer demand.

The growth of industrial output will be even higher than in 2006, between 10 and 11 %. Therefore, also in 2007, industry will be the general leader of Czech economic growth.

The exports will continue in solid growth, driven by the machinery exports, in particular by the automotive industry, computers and other machinery.

The full-year trade surplus in 2007 is expected at CZK 70 – 80 bill. under two assumptions. Firstly, the improvement in the terms of trade persists and secondly, world oil price does not persist on present levels until Q4 2007.

does not apply for everybody. There is a general structural and regional mismatch between the offer of vacancies and structure of free labour force. The highest problems have the unemployed with no qualification and low administration staff. High number of vacancies indicates that relatively high taxation of wages and labour code is a less important barrier for the decline in unemployment that a generous social network – which regularly places the CR to the lowest position as for the scope of poverty, in the EU comparisons.

According to our analyses, the regions with above average stock of FDI dispose with above-average offer of vacancies. However, these regions do not have significantly lower unemployment rates. This reflects the fact that foreign investors often have not been able to find enough qualified and skilled domestic workers. Therefore, the decline of the unemployment has been driven by cyclical factors, structural problems of the labour market preserving.

5. OUTLOOK

For the rest of 2007, we expect that the rapid dynamics of the Czech economy will continue. For 2007, the GDP growth will be close to 6 % and will continue to be driven by strong consumer demand. As the Q1 data indicate, the growth of investment demand will be much weaker than in 2006, declining from roughly 7 % to approximately 4 %, in 2007. The impact of foreign trade will not depend only on the development of trade balance, but also on the developments of terms of trade, i.e. prices of exports and imports. Due to statistical reasons, improving terms of trade have perverse effect on national accounts data on foreign trade: they are understating the growth of exports, while overestating the data for imports. We thus expect marginal impact of net exports to GDP growth.

The growth in industry will continue to be driven by the sector of foreign controlled companies, the penetration of which gradually increases, with one half of value added in Czech manufacturing generated by these companies. As for individual industries, the main driving force will continue to be the automotive industry accompanied by rapid growth in rubber and plastics, electronics and general machinery. The growth of industrial output will be even higher than in 2006, between 10 and 11 %. Therefore, also in 2007, industry will be the general leader of Czech economic growth.

Fundamental factors behind growth in construction are the same like in previous two years: continuing projects in infrastructure, activities of foreign investors, boom in housing. However, the full-year 2007 figure will be affected by the extremely high activity from the beginning of the year due to favourable weather. The full-year forecast is thus exposed to high degree of uncertainty; for the time being the growth of construction in 2007 is expected slightly above 10 %.

Main factors behind strong consumer demand continue to be the same like in previous months: decline in unemployment, rapid growth of wages, housing boom, high propensity to spend, wide disposability of various types of consumer credits granted by financial and non-financial institutions. The psychological factor is also important: consumers have lower propensity to save; on the other hand, they are more and more willing to finance their consumption by wide offer of various types of loans. One of the reasons is demographic structure: strong cohorties from the Seventies dispose with increasing incomes and their propensity to save is low. In the rest of the year, 2007, the retail sales continue to be driven by industrial consumer goods and cars. The boom in housing will be peaking in the rest of the year pushing up the purchases of housing equipment. For the moment, the consumer boom does not seem to be cooling in the short-term horizon., so that the retail sales are expected to increase by 7 – 8 %, in 2007.

The exports will continue in solid growth, driven by the machinery exports, in particular by the automotive industry, computers and other machinery. At the same time, the exports will continue to be concentrated in the sector of foreign controlled companies. However, the improvement of the trade balance with machinery is expected to be slightly lower than in 2006, since the exports of the car industry is close to full capacity for the time being (before the new factory Hyundai is finished). The full-year trade surplus in 2007 is expected at CZK 70 – 80 bill. under two assumptions. Firstly, the improvement in the terms of trade persists and secondly, world oil price does not persist on present levels until Q4 2007.

Along with the improving trade balance, the current account deficit will slightly decline to

3 % of GDP. However, the increase of the deficit of the balance of incomes up to CZK 200 bill. creates some risky space for the external balance for the future. The share between reinvestments and dividends from FDI will be of high importance. In 2006, the volume of dividends exceeded the volume of reinvestments for the first time in history. Further shift to dividends payments would lower the coverage of the current account deficit by non-debt financing.

The data from the first half of 2007 confirmed that the inflation in the Czech economy starts to grow due to strong consumer demand. Moreover, the exchange rate stopped to attenuate the inflationary pressures as of February and the price of oil has been keeping over 70 USD per barrel as of May. We expect the year over year CPI to reach approximately 3 %, at the end of 2007. Average inflation will move around 2.5 %.

As for PPI, two key factors will play major role in 2007: world prices of oil and metals. The main driver of PPI – metal prices – will remain expensive due to high global demand driven in particular by strong economic activity in South-East Asia. In addition, some pass-through of expensive utilities into manufacturing industries must be expected. Part of cost inflationary pressures will be absorbed by strong competition; CZK stopped to appreciate against USD and EUR and ceased to contain the price increases. The year over year growth of producer prices will amount to 5.5 – 6.0 %.

The newest data about inflation, wages and retail sales are indicating that the Czech National Bank will increase the basic interest rate until the end of the year; the only question is whether two times by 25 basis points, or three times by 25 basis points. This will lessen the gap between 3M EURIBOR and 3M PRIBOR from 90 basis points to 30 – 50 basis points. This could also lead to a reversal of depreciating trend of CZK back to a slight appreciation attenuating the inflationary pressures of import prices. The average 2007 exchange rate is expected at 28.2 CZK/EUR and 21.5 CZK/USD.

Solid economic activity will continue to affect the unemployment positively; however, the more favourable part of the year is over. In July and August, the unemployment rate will increase back to the 6.5 % bar due to the fresh school leavers and women caring for children in the course of holidays. Regular autumn decline will be replaced by seasonal December increase due to finishing seasonal jobs and term contracts. At the end of 2007, we expect the unemployment rate at 6.5 %.

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FOUR CENTRAL EUROPEAN COUNTRIES: THREE YEARS AFTER (THE EU ENTRY)

Kamil Janáček

Three years ago, on May 1, 2004, Poland, Hungary, Slovakia and Czech Republic became (with 6 other countries) members of the European Union. What is the experience of these countries with EU membership? As usual, full membership has brought both benefits and costs. The main benefits and costs are discussed in this short paper.

1. POSITIVE EFFECTS OF EU MEMBERSHIP

EU membership, above all, had a great psychological and symbolic importance: it represented the culmination of fundamental systemic change and economic transformation, achieved by these countries over the preceding 15 years. It was a confirmation that they have been successfully converted into standard market economies, with solidly functioning democratic institutions.

Though all four countries practically were members of the Single Market since the start of the decade (when the tariff- and non-tariff obstacles to trade were removed), EU entry meant the lifting of last administrative barriers (customs proceedings at borders, etc.). The effect on trade between EU-15 and the CE-4 was pronounced. **Table 1** shows how EU entry accelerated exports form the four countries, especially into the "old" member countries. Poland, Hungary, Slovakia and Czech Republic started to make full use of their comparative advantage, both economic and geographic. Exports (where the share of EU is 75-80 %) grew by double-digit rates in the last three years. Two countries (Hungary and Czech Republic) have also notably improved their trade balances – in the case of Czech Republic, trade balance was in surplus in 2005 and 2006, for the first time in the country's history (i.e. since 1993).

Moreover, the year 2005 – a year of very feeble growth of the Euro Area countries - has proved that the new member countries are able to find empty spaces in the EU markets even in times of sluggish economic growth and weak demand.

EU entry has also induced a further increase of FDI inflows. As the main privatization waves practically (with some exceptions) ended at the start of the present decade, foreign investment now has the form of either acquisitions, or green-field investments. A large part is formed by re-invested profits of foreign companies.

However, EU membership has somewhat changed the structure of FDI inflows:

- First, South-Asian companies started to invest more massively into this region (from Japan, South Korea, Taiwan). For these "cautious" investors, we have become a safe territory only after the EU entry.
- Second, the profile of EU-15 investors has diversified strongly. Before our EU entry, mainly large companies (both financial and non-financial) invested into the Central-European region. Now, medium- and smaller-sized firms are coming, as they also see the region as standard and low-risk.

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Table 1: Exports and Trade Balance, 2004-2006

	2004	2005	2006
		Exports (growth in %)	
Poland	14.5	8.6	14.9
Hungary	19.2	11.0	16.1
Slovakia	4.0	0.7	19.0
Czech Republic	21.2	10.2	15.5
		Trade Balance (bill. USD)	
Poland	-5.6	-2.8	-5.1
Hungary	-3.0	-1.8	-0.7
Slovakia	-1.5	-2.4	-3.6
Czech Republic	-1.0	+1.7	+1.9

Source: National Statistical Offices, IIF

- And, third, firms from the CE-4 have also started to invest abroad, so that the previously one-way investment inflow starts to be more balanced, by FDI outflows.

2. COSTS AND NEGATIVE EFFECTS

The full EU membership, however, also brings some costs and problems. The biggest problem for all four countries is increased regulation of the economy, due to the adoption of "acquis communnautaire", and its transposition into national legislatures.

All four Central-European countries during their economic transformation in the 1990s deregulated their economies substantially, preferring the Anglo-Saxon, more liberal model, over the continental one. Preparations to enter the EU, and the first years of membership, on the contrary, represent a period of re-regulating all sides of economic activity – owing to the duty to apply EU directives and regulations in national legislatures. Moreover, the European Commission strictly requires a hundred-percent adherence to all the rules exactly from the new member countries. (Should the Commission be as strict toward France, as it is to the Czech Republic, half of Parisian restaurants would have to close, and two-thirds of French cheese producers would have to stop producing).

This is not the only example of the EU being a "two-class society". Almost half of the EU-15 countries still – irrationally – close their labour markets to the citizen of new member counties; Germany and Austria will continue to do so till 2011. Similar barriers are in place for companies from the new member countries that would like to be active in some of the "old" countries (in construction, or transport). Also, conditions for payments from the Common Agricultural Policy are far stricter for the new member countries, allowing them to get 60 %, at most, of the sums paid to farmers from the EU-15 countries. In the club of equals, some members are more equal than others...

There are other negative sides: the endeavour to harmonize taxes (naturally, toward the French or German level), to require so-called ecological or social standards, and to impose too many norms and regulations. All this would undermine the comparative advantage of producers from new member countries. The European Union tends to forget that dynamic growth is supported by diversity and competition, not by uniformity and harmonization administered from above.

3. EURO: WHEN AND HOW

After entering the EU, adapting to EU internal mechanisms, absorbing the Acqui, and becoming accustomed to the work of the Brussels institutions, the Central-European countries now face another serious step: euro adoption. The accession agreements state no fixed date for the adoption of euro as home currency. They require the fulfilment of nominal convergence criteria (the five Maastricht criteria), real criteria (a certain level of GDP per head, strength of market structures), and the so-called legal criteria of convergence (well-functioning justice, genuine adoption and application of EU legal norms in the national legislature).

The common currency will mean a substantial change for the individual countries. Their strategies for euro adoption ought to assess the costs and benefits of this operation, and find the right timing. At the same time, the requirement to fulfil the convergence criteria brings new problems and open issues.

First problem are the Maastricht criteria themselves, or, at least, some of them. Namely, the criterion for inflation, and the necessity to spend two years in the ERM II system.

Maastricht criteria were set in 1992 for a "club" of countries totally different from the CE-4 – with their economies transforming (or finishing the transformation) from a centrally commanded system to standard market economy. This process includes the transition from administered to market prices, and the correction of huge distortions of relative prices. At the same time, we speak of typical "catch-up economies", where the well-known Balassa-Samuelson effect is at work. Hence it is clear that over a longer period, inflation in these countries will tend to be higher than in "settled" market economies. In such situation, the criterion of average inflation in three lowest-inflation countries can harm and

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disfavour these candidates of euro area entry.[1] Even more so if, contrary to logic, not only euro area countries are taken into consideration, but all EU members. Not incidentally in the last two years, two of the three lowest-inflation countries were outsiders to the euro area.

The Central-European countries have suggested a modified interpretation of the inflation criterion:

– either to measure it only on euro area members
– or to take the ECB inflation target as etalon, and add a permitted diversion of 1.5 % (or, 1 %).

Such interpretation of the inflation criterion would give the post-communist candidates for EMU entry more room to realize the needed adaptation of prices, and at the same time would allow them to have monetary policy not slowing economic growth (and the catch-up process with more advanced neighbours). Under such an arrangement, the Lithuania's application for EMU entry would not have been rejected.

Unfortunately such proposals are being unanimously refused by European Commission (ECOFIN, DG Legal) and the European Central Bank. Keeping the formal interpretation of the Maastricht Treaty unaltered seems to weigh more than economic rationality.

Another open issue is the ERM-II. The requirement to fix the exchange rate of the national currency, and keep it in a given interval over 24 months, poses no problem for those countries that have a currency board with euro (the Baltic states, Bulgaria). For them, it even means a certain loosening of monetary policy.

Completely different is the situation of the four Central-European countries (or three, as Slovakia has entered the ERM-II in November 2005). The requirement to stay in ERM-II for two years requires a change from free float back to the system of fixed exchange rates, with all disadvantages that a fixed exchange rate has for small, open and catching-up countries.

Slovakia entered the ERM-II system in November 2005, that is, more than three years before the expected EMU entry. The reason why Slovakia decided to fix the exchange rate for more than the required two years was political: the central-right government coalition wanted to bind any future government, which would result from the spring-2006 election, to uphold the strategy of euro adoption in 2009. This policy, in the end, proved to be effective. Yet at the same time the clear disadvantages of staying in the ERM-II system became apparent. The central parity on entering the ERM-II was set at 38.45 SKK/EUR (+-15%, which means that the exchange rate could fluctuate between 32.69 and 44.22 SKK/EUR). Strong inflows of foreign direct investment, plus high GDP and exports growth rates, however pushed the Slovak koruna permanently toward the upper (appreciation) limit of the fluctuation band. A number of interventions by the National Bank of Slovakia failed to help. On March 19, 2007, the NBS (in agreement with the ECB) was forced to revalue the central parity by 8.5 % to 35.44 SKK/EUR. It is clear what this step can mean for Slovak exporters. Yet the problem persists: appreciation pressures continue, and some experts admit that Slovakia will again have to revalue the currency in 2007, or at the start of 2008, to keep it within the required band.

Currencies of the other three countries (zloty, forint and Czech koruna) will face the same danger, as soon as they enter the ERM-II system). The European Commission and ECB continuously refuse to loosen the requirement of a two-year stay in ERM-II system for the new member countries (for example, allowing them to avoid and official announcement of ERM-II entry, and, instead, examining and testifying ex post their two-year exchange-rate stability, within the +-15% interval).[2] It follows that for these countries, the only solution is a) shorten the stay in ERM-II to the necessary minimum of 24 months; b) set the central parity carefully on entry – with overvaluation better than undervaluation; c) undertake the change of central parity, if necessary, as a series of smaller steps, rather than one jump – an approach which however would first have to be approved by the ECB.

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[1] This has been proven clearly by the example of Lithuania.

[2] As it was the case – at least partially – of Greece before entering the EMU.

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As to the expected timing of euro adoption, the situation is as follows. Slovakia keeps her goal to join the euro area in 2009. Policies and forecasts of the National Bank of Slovakia give hope that the country can succeed to bring inflation below 3.5 % - and fulfil the last nominal criterion which it so far has been violating. The probability of euro adoption by Slovakia in 2009 can be assessed as 70 %, at least.

The other three countries have so far not announced their intentions officially, as to the timing of euro adoption. Expert evaluation of the situation in individual countries, regarding the fulfilment of Maastricht criteria, especially the deficit of public finance and inflation, leads to the following ranking: Poland and Czech Republic could adopt the euro in 2012-2013, Hungary in 2014-2015.

FDI IN THE CZECH REPUBLIC: SOME MACROECONOMIC IMPLICATIONS

Eva Zamrazilová

The inflow of foreign direct investments to the Czech Republic in the last decade was massive, filling the gap between the domestic investments and savings. Until the end of 2006, the total inflow amounted to approximately CZK 1817 bill. (USD 61 bill., EUR 56 bill.). The stock of FDI per capita amounted to EUR 5719 in 2006. The FDI stock exceeded one half of GDP amounting to 52 % of GDP in 2006. The final stock per capita and in % of GDP was the second highest among the Visegrad countries, with first position belonging to Hungary (see Table 1).

PENETRATION OF FOREIGN CONTROLLED COMPANIES IN THE CR

Massive inflow of FDI resulted in increasing penetration of foreign controlled companies (FCC) in the Czech Republic. The importance of FCC has been rapidly increasing since 2000: the share of FCC on gross value added in national economy (which approximately corresponds with GDP) amounted to 26 %, in 2005, up from 10 %, in 1999 (see Table 2). Even though the latest data on GDP in sectoral structure are available until 2005, it can be estimated that the FCC will soon generate 30 % of GDP. The penetration of foreign controlled companies has been above average in the segment of big and medium companies (above 20 employees) with 45 % of value added in 2006. At the same time, the penetration of FCC in the segment of non-financial companies (above 20 employees) was also very rapid, increasing from 31 % to 45 % in the course of last 5 years. Higher penetration in the segment of mid and big-sized companies corresponds with widely recognized fact that the multinationals are usually bigger than the average size of domestic company.

Increasing penetration of FCC has some important macroeconomic outcomes; this short information will shortly address some of them. Firstly, the effect of FCC on GDP growth and productivity will be briefly analysed, secondly the impact on external balance and thirdly the impact on GDP distribution will be focused.

FOREIGN CONTROLLED COMPANIES AND ECONOMIC GROWTH

Even though the impact of FCC to GDP growth cannot be precisely measured (due to the lack of data), some conclusions may be derived from sectoral data on GDP in current prices. Table 3 indicates that the share of FCC on volume increases of GDP (in current

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Table 1: Stock of FDI in CEE4, in 2006

	FDI stock per capita (in EUR)	FDI stock (in % of GDP)
Czech Republic	5719	52.0
Slovakia	3338	41.0
Hungary	6170	69.6
Poland	2361	33.4

Source: The Vienna Institute for International Economic Studies

Table 2: Shares of Foreign Controlled Companies on Gross Value Added (in %)

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Share on GVA, total economy (in %)	9.2	11.2	17.3	20.4	21.2	22.7	25.4	25.7	n.a.
Share on GVA, non- financial companies above 20 empl. (in %)	n.a.	n.a.	n.a.	31.2	35.7	38.5	41.5	42.8	44.7

Source: Czech Statistical Office

Table 3: Shares of Non-financial FCC on Gross Value Added and Its Increase (in %)

	The share of non-financial FCC on domestic value added (in %)	The share of non-financial FCC on the increase of domestic value added (in %)
1996	6.3	10.1
1997	7.9	32.1
1998	9.2	14.6
1999	11.2	80.7
2000	17.3	113.9
2001	20.4	41.8
2002	21.2	35.8
2003	22.7	42.4
2004	25.4	59.3
2005	25.7	31.7

Source: Czech Statistical Office

prices) is permanently higher than their share on GDP. This corresponds to their above average dynamics. Under the increasing penetration of FCC in the Czech economy, the sector of FCC became an important driver of economic growth. In 2005, the sector of FCC accounted for 26 % of GDP and for 32 % of its increase (in volume terms).

A special attention should be devoted to the key segment of the Czech economy – manufacturing. Czech manufacturing has been the industry with high importance for economic growth with more than one-quarter share on GDP. At the same time, the share of manufacturing on the increase of GDP is much higher – 59 % on average in the period 2004 – 2006. In the Czech manufacturing, the FCC accounted for one half of value added in 2006, indicating again the important role of FCC on strong economic activity in the CR.

The FCC in CR dispose also with higher productivity of labour: in the Czech non-financial companies, the labour productivity of FCC exceeds the productivity of domestic companies by 55 %. This corresponds with international experience (see EC, 2007)[1]. As FCC are usually bigger than their domestic counterparts, the productivity differential may be partly attributable to the economies of scale.

There is also a link to the developments of productivity in the Czech manufacturing, which reported particularly high growth of labour productivity: in 2004 – 2006, the productivity rose by 9.3 %, y/y, on average. The productivity in the FCC in the manufacturing industry exceeds the productivity in their private domestic counterparts by 85 %. At the same time, the industries reporting highest dynamics in the Czech manufacturing during previous 3 years were three industries: automotive industry, electronics and general industry. The cumulative share of these industries on total industrial output amounts to approximately 40 % and is even higher with respect to sales (almost one half). In the first two industries, the FCC clearly dominate (with 86 and 57 %

[1] The Impact of Foreign Controlled Companies in the EU. European Comission, 2007.

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Table 4: Czech Manufacturing: The Shares of FCC on Value Added and Growth in Labour Productivity

	The share of FCC on value added	Growth of Labour Productivity (average 2004 – 2006, in %)
Manufacturing, total	48.7	9.3
Out of which:		
Food and beverages	40.0	1.8
Textiles	23.5	7.1
Pulp and paper	34.8	3.5
Chemicals	50.3	6.6
Ruber and plastics	57.5	5.6
Metal industry	35.3	4.0
General machinery	35.0	14.0
Electronics	56.6	14.3
Automotive industry	85.6	13.1

Source: Ministry of Industry and Trade

Table 5: Balance with Goods and Services: Sector of Domestic Companies and FCC

	1999	2000	2001	2002	2003	2004	2005
Foreign controlled companies	-8.3	-34.4	18.0	7.6	44.9	56.2	129.4
Domestic companies	-15.9	-31.8	-76.7	-57.1	-101.4	-70.2	-70.5

Source: Czech National Bank

on value added generated by FCC). Having in mind that the penetration of FCC has been increasing and their productivity exceeds the productivity of domestic companies, it is clear that the growth of productivity in manufacturing has been driven particularly by FCC.

Increasing penetration of FCC accompanied by their higher productivity and efficiency has a consequence of increasing concentration of profits generated in the Czech economy into the sector of FCC. E.g., in manufacturing, (enterprises above 100 employees) the sector of FCC accounted for 77 % of generated profits, in 2006. This fact has at least two macroeconomic implications: firstly, there are effects on the external balance and, secondly, the proportion between formation and use of product on macroeconomic level is affected.

FDI AND EXTERNAL BALANCE

FDI now have been playing an important role in the area of external balance. The inflow of FDI has primarily brought a very positive effect on the balance with goods and services.

The effect of FDI on the area of trade is illustrated by the data in Table 5. The trade with goods and services in the sector of FCC has been in the surplus since 2001. The surplus has been rapidly increasing since then, amounting to CZK 129 bill., in 2005. On the other hand, the domestic sector continuously generates deficits in the trade with goods and services. While total trade with goods and services turned into a surplus in 2005, the sector of domestic companies produced a deficit of the same scope like a year earlier (see Table 5).

On the other hand, the effect of FDI on the balance of incomes – the main source of the current account defict and the major volume item of the current account in previous five years – may be estimated as well. The division of the balance of incomes (see Table 6) into more detailed segments illustrates that the main source of increasing deficits of the balance of incomes are the FDI. In 2006, the deficit of the balance of incomes amounted to CZK 183.4 bill., out of which the FDI accounted for CZK 171.1 bill. (5.3 % of GDP). This was only slightly lower amount than total deficit of the balance of incomes. The expenditures on FDI (reinvestments of profits, dividend payments and interest payments) amounted to CZK 180 bill. and made for 60 % of total expenditures of the balance of incomes. Growth of these payments has been attributable to increasing penetration of FCC and the increasing profitability of FDI which exceeded 10 % in previous 4 years.

Related and important issue is the structure of these payments: 90 % of them belongs to reinvestments and dividends, interest payments of FDI are relatively low (below CZK 10 bill.). Contrary to dividends, the reinvestments do not represent real outflow of money out of the country, nevertheless they also represent property not possessed by domestic owners. The tendency from reinvestments to dividends payments is evident (see Figure 1).

In 2006, for the first time, the volume of dividends (CZK 89.4 bill.) exceeded the volume of reinvestments (CZK 82 bill.). At the

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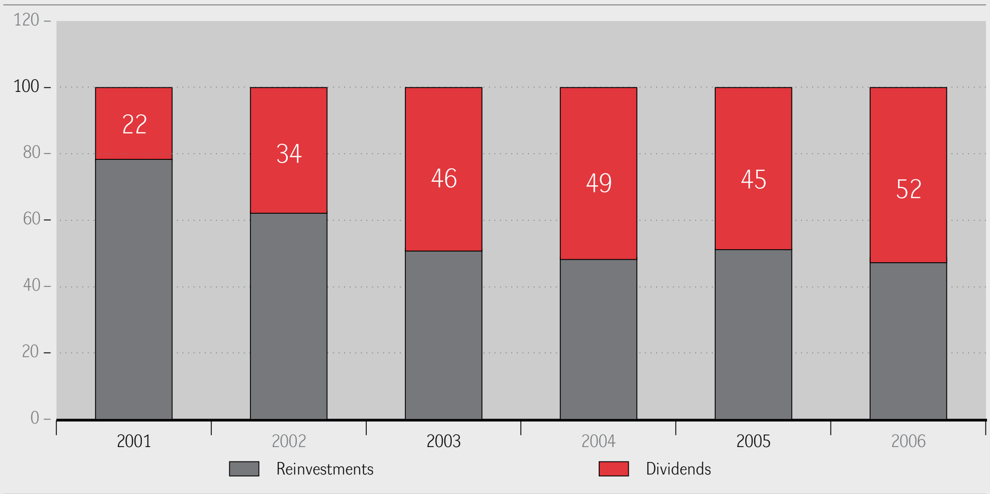
In 2006, for the first time, the volume of dividends (CZK 89.4 bill.) exceeded the volume of reinvestments (CZK 82 bill.). At the same time, the payments of dividends was much higher than the inflow of FDI to basic capital (CZK 36 bill.).

Table 6: Balance of Incomes: Individual Items (in CZK bill.)

	1995	2000	2005	2006
Balance of incomes	-2.8	-53.0	-155.7	-183.4
Out of which:				
Incomes on labour	2.3	-12.0	-23.5	-35.7
Incomes on investments	-5.1	-41.0	-132.2	-147.7
Out of investments:				
FDI	1.9	-53.6	-147.7	-171.1
Portfolio investments	-5.8	-7.5	6.2	4.3
Other investments	-1.2	20.1	9.3	19.1

Source: Czech National Bank

Figure 1: Profits on FDI – Reinvestments and Dividends (in %)



Source: Czech National Bank

same time, the payments of dividends was much higher than the inflow of FDI to basic capital (CZK 36 bill.). The tendency from reinvestments to dividends corresponds to the theoretical concept of the investment life cycle: first, the investment to the enterprise is made, later the consolidation of the company brings profits and the owner decides between reinvestment and repatriation. At the beginning of this stage, notable part of profit is reinvested, and then the repatriation (dividend payments) takes place. The share of dividends payments thus continuously increases; in the course of previous five years, the share of repatriated profits more than doubled from 22 % in 2001 to 52 %, in 2006.

According to the international experience, the tendency from reinvestments to dividends will proceed. In the period 1990 – 2004, the investors from developed countries (which prevail in the CR) repatriated 55 % of profits on average, with share oscillating between 50 – 60 % in individual years (see UNCTAD 2006)[2]. Therefore, similar proportion between reinvestments and dividends must be expected in the CR in the forthcoming years, too. The volume of dividends amounted to approximately 3 % of GDP in 2006, but the potential exceeded 5 % of GDP in previous 3 years.

The recent developments and external experience are important for the future of external balance in the CR (and other Central European Economies, as well). The developments of the current account deficit will be further strongly affected by the balance of incomes. The pressures on external financing of the current account deficit will be dependent on the proportion between reinvestments and dividends. At the same time, the reinvestments represent non-debt financing of the current account deficit. The FDI into basic capital are not expected to reach the levels of the previous decade which will be further emphasized by the enlargement of the EU and the move of the investors from central Europe further in the east- south direction. Moreover, this territorial shift may be another cause of further increase of dividends payments to use them for financing in other countries. Therefore, there are some risks as for the external balance of the CR; the risks will be actual in particular in the ERM II period when the monetary policy will have to do its best in keeping the exchange rate in the fluctuation band.

GROSS DOMESTIC PRODUCT AND GROSS NATIONAL INCOME: THE IMPACT OF FDI

Increasing penetration of FCC, higer productivity and efficiency of FCC in comparison with their domestic counterparts, increasing scope of profits generated by FCC affect also the proportion between the formation and use of the product in the domestic economy. The balance of incomes (in the balance of payments framework) basically corresponds with the saldo of primary incomes (in the national accounts framework). However, the economic

[2] World Investment Report. United Nations Conference on Trade and Development, United Nations, New York and Geneva, 2006.

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Table 7: Gross Domestic Product and Gross National Income

	1995	2000	2005	2006
GNI in % of GDP	99.8	97.7	95.6	94.3
Saldo of primary incomes, CZK bill.	-3.0	-49.5	-134.5	-182.6
Saldo of balance of incomes, CZK bill.	-2.8	-53.0	-155.7	-183.4

Source: Czech Statistical Office, Czech National Bank

interpretation is different, while the balance of incomes relates to the external equilibrium, primary incomes relate to the issue of distribution of product. With a slight simplification, saldo of the primary incomes represents the part of product that is produced in the domestic economy but does not belong to its residents. In the framework of the national accounts, the saldo of the primary incomes represents the diference between the gross domestic product (GDP) and gross national income (GNI). Table 7 shows that while the negative saldo of primary incomes (and the difference between the GDP and GNI) was negligible in the Nineties, it rose quite rapidly up to almost 6 % in 2006.

As the saldo of primary incomes basically corresponds with the saldo of balance of incomes, the analysis of the balance of incomes outlined above gives also the answer to the question what is the main cause of increasing negative saldo of primary incomes. Along with the division of balance of incomes, also the primary incomes consist primarily from incomes on labour and incomes on capital, which are further divided into FDI, portfolio investments and other investments. According to the analysis of the balance of incomes, the negative saldo of the primary incomes is caused predominantly by the negative saldo produced by the FDI.

Consequently, FDI are the main factor behind growing diference between the GDP and GNI. In other words, increasing penetration of FCC accompanied by their higher efficiency and productivity results in gradually growing volume of profits concentrated in the sector of FCC and thus not belonging to Czech residents. Almost 6 % of GDP is thus the amount of the diference between the volume of product generated in the CR by the production factors possessed by the

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Almost 6 % of GDP is thus the amount of the diference between the volume of product generated in the CR by the production factors possessed by the foreigners and product generated by Czech productive factors abroad.

Table 8 : Investment Position on FDI and the Difference between GDP and GNI, 2005

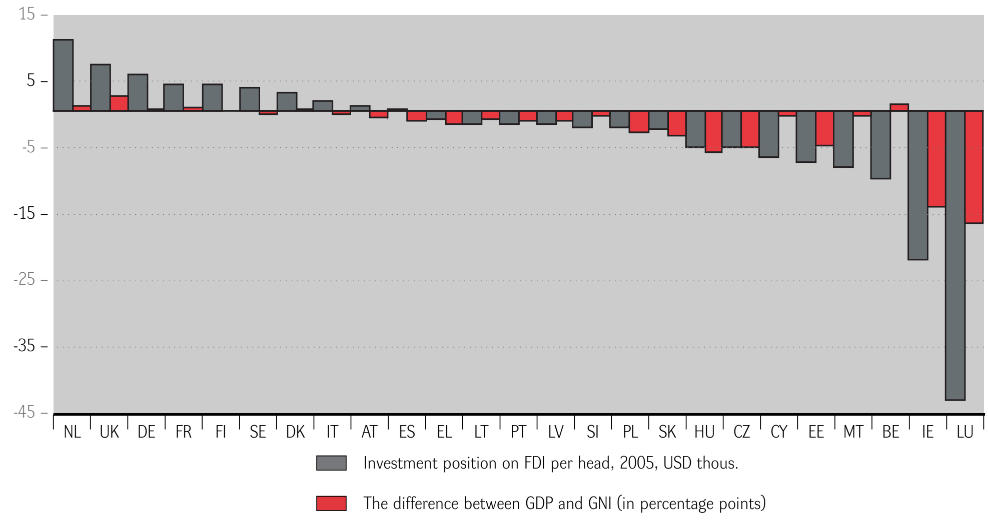
		Investment position on FDI (USD thous. per head)	GNI in % of GDP
Belgium	BE	-10,2	101,1
Germany	DE	5,6	100,2
Greece	EL	-1,4	98,2
Spain	ES	0,3	98,4
Francie	FR	4,2	100,5
Irleland	IE	-22,5	85,5
Italy	IT	1,3	99,7
Luxenbourg	LU	-43,5	83,1
The Netherlands	NL	10,9	100,9
Austria	AT	0,7	99
Portugal	PT	-1,9	98,4
Slovenia	SI	-2,3	99,4
Finland	FI	4,1	100
Denmark	DK	3,0	100,1
Estonia	EE	-7,7	94,8
Cyprus	CY	-6,9	99,2
Latvia	LV	-1,9	98,4
Lithuania	LT	-1,7	98,6
Hungary	HU	-5,4	93,6
Malta	MT	-8,3	99,4
Poland	PL	-2,3	96,7
Slovakia	SK	-2,7	96,4
Sweden	SE	3,5	99,7
United Kingdom	UK	7,1	102,4
Czech Republic	CZ	-5,4	94,6

Source: Eurostat

foreigners (the incomes from production factors of foreigners placed in the CR) and product generated by Czech productive factors abroad (the incomes – wages and profits – of Czech citizens earned abroad).

It is worthmentioning that there is a strong correlation between the GDP and GNI relation and the FDI investment position in the whole EU (see Table 8 and Figure 2). The countries with active investment position on FDI (countries where inward FDI is lower than outward FDI) have higher GDI than GDP. The only exception is Belgium. It is obvious (as mentioned above) that the diference between the GDP and GNI is determined not only by FDI but also by employment of citizens abroad and employment of foreigners in the national economy, and by incomes on portfolio and other investments. Therefore it is interesting that the impact of FDI investment position on the diference between the GNI and GDP was very strong. The correlation between the diference of GDP and GNI and the investment position of FDI amounted to 0.88 (0.93 adjusted for Belgium). Out of EU 27, the CR reported the seventh highest passive investment position and fourth highest diference between the GDP and GNI, in 2005.

Figure 2: Investment Position on FDI and the Difference between GDP and GNI, 2005



Source: Eurostat

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