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# CZECH ECONOMY AT THE START OF 2008

Kamil Janáček, Eva Zamrazilová

## 1. ECONOMIC GROWTH

In 2007, strong economic activity in the Czech economy continued, as well as the catch-up process towards developed market economies. The economic level measured by GDP per capita in real PPP terms was very close to 75 % of the eurozone average. However, some signs have appeared that the economy has already reached the peak of the business cycle. In the first three quarters, the growth of GDP amounted to 6.2 %, y/y, with growth slightly slowing down from 6.4 %, y/y, in Q1 to 6.0 %, y/y, in Q3 2007.

Domestic demand was the main driver of economic growth, with only marginal impact of external trade. Structure of domestic demand was balanced: consumption of households increased by 6.1 %, y/y, and investment demand rose by 5.5 %, y/y. Government consumption increased very slightly, by 0.4 %, y/y. Exports of goods and services rose by 14.6 %, imports increased by 14.2 %, y/y. Foreign trade thus ceased to be the driver of GDP growth, but predominantly 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 main leader of GDP growth on the supply side continued to be manufacturing industry, with the share on GDP around one quarter. The full year growth of industrial output amounted to 8.2 %, in 2007. Growth in industry was pulled predominantly by car industry, electronics and general machinery. The role of foreign companies in industry has been further increasing – they accounted for approximately one-half of industrial value added and their share on GDP exceeded one quarter. In addition, the export orientation of foreign-controlled companies has been increasing, with around three quarters of their production being exported.

Industry was driven predominantly by good result of the electronics with growth of 15.7 %, y/y, solid growth of the automotive industry (13.7 %, y/y) accompanied by rapid

growth in rubber and plastics (19.7 %, y/y) and very good result of general machinery (17.5 %, y/y). On the other hand, output of metal industry stagnated. Industry has been pulled by both foreign and domestic demand. Favourable foreign demand was behind growth of the export sales (13.0 %, y/y), which was strongly above total increase in sales (9.3 %, y/y).

In the second half of the year, the growth of employment in industry has been slowing down due to shortage of skilled labour force on the Czech labour market. Employment in industry increased by 1.8 %, in 2007; while the H1 registered growth around 2.5 %, in Q4 the employment rose by mere 1.2 %. The shortage of skilled labour has pushed up wages and leads to closing of the positive gap between the growth of labour productivity and real wages. Continuing of this tendency could undercut the competitiveness of the Czech exports and provoke the wage-driven inflation.

In 2007, construction output rose by 6.7 %, y/y, with notable fluctuations during the year. Construction registered extremely high growth at the beginning of 2007, with the output increasing by 25 %, y/y, January to April. However, this extremely strong construction activity was driven by favourable weather conditions and low basis for comparison. As of May 2007, the growth has been sluggish, as a consequence both of statistical and fundamental reasons. Similar to industry, the lack of qualified labour force represents the most serious barrier for future growth.

The full-year 2007 number of finished flats (41 650 flats) has reached a record high since 2001. At the same time, year over year increase in finished flats (38 %, y/y) was extremely high as well. The Q4 data for housing construction confirm the impact of VAT increase on the 2007 boom in housing. In Q4 2007 the number of completed flats increased by 48 %, y/y, while number of started flats and flats under construction rose by only 1 %, y/y.

In 2007, employment in construction fell by 1.5 %, y/y. This decline has several reasons. Firstly, some workers in construction are hired through labour

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agencies and these workers are not included in the sector of construction but in services. Secondly, the decline in employment has been partly caused by the shortage of labour. At the same time, the demand for construction workers is concentrated to selected regions, where the demand is below saturation. On the other hand, in some regions, the construction workers still cannot find appropriate job. And last but not least - shadow economy is more frequent in construction than in other sectors.

Consumer demand was strong in the course of the whole year. Therefore, the growth of retail sales was record-high amounting to 7.7 %, in 2007. Strong consumption was supported by higher wage gains, further strong expansion in borrowing, generally increasing propensity to spend and developments on the labour market.

Non-food consumer goods were the leader of the market, in 2007, boom in housing stood behind massive demand for housing-related durables. Car sales witnessed year of very solid growth of sales, that amounted to 12.4 %. Strong purchases of consumer goods and increasing food prices have had some adverse effect on demand for foods: food sales rose by 2.8 %, y/y, in 2007.

## 2. FOREIGN TRADE AND EXCHANGE RATE

In 2007, the exports increased by 15.0 %, y/y, the imports rose by 13.1 %, y/y. The full-year surplus of trade balance amounted to CZK 86.1 bill., which was more than double the 2006 surplus and the best result in history. The growth in foreign trade has been higher than the growth of GDP, so that the openness of the Czech economy is steadily on the rise. Czech economy is one of the most opened economies in EU 27; the share of trade turnover of goods and services estimated at 80 % by the European Commission, which is the sixth position among EU countries.

In 2007, machinery, fuels and chemistry continued to be the key items for the trade balance. Machinery produced a surplus of CZK 307 bill., which was an increase of CZK 36 bill. in comparison with 2006. Cars accounted for approximately two thirds of the machinery surplus (CZK 202 bill.).

Machinery exports thus performed well in spite of strong CZK. The year over year improvement was highly attributable to the developments in terms of trade that improved by 2.5 %, y/y. In the trade with machinery, the improvement in terms of trade was above average, indicating again that the effect of strong currency is more significant for imports than for the exports.

The impact of weak USD overweighed the effect of high world oil prices: the deficit with fuels declined to CZK 123 bill. (by CZK 16 bill., y/y). However, high fuel prices affected the trade balance indirectly, as the deficit with chemistry increased to CZK 102.7 bill. (by CZK 13.5 bill. y/y).

The trade with EU 27 ended in a surplus of CZK 421.5 bill. The highest surpluses were generated in the trade with Germany (CZK 98.1 bill.), followed by Slovakia (CZK 91.4 bill.). The highest deficits were produced by China (CZK 170.7 bill.), Japan (CZK 67 bill.) and Russia (CZK 55.3 bill.). Czech trade registered deterioration in trade with China and Japan due to increasing machinery imports. On the other hand, the deficit with Russia declined by CZK 28 bill., y/y, as the Czech machinery exports to Russia strongly increased.

Appreciation of the Czech currency, which was a very important factor preventing the inflationary pressures in recent two years, stopped to act in Q2 and Q3 of 2007, recovering, however with a strong intensity in the last four months of the year. The CZK depreciated from the January average 27.8 to 28.5 CZK/EUR in June 2007. As of August 2007, the CZK has started to appreciate again, and the average exchange rate of CZK amounted to 26.3 CZK/EUR and 18.0 CZK/USD. Strong appreciation towards the USD thus compensated for high world oil and some other raw materials prices. The average appreciation towards the EUR and USD amounted to 1.8 % and 10.1 %, respectively.

## 3. INFLATION AND MONETARY POLICY

Strong economic activity driven by domestic demand, shortage of labour accompanied by rising wage pressures resulted in emerging demand inflationary pressures. At the same time, the pass-through from high raw materials, fuel and

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Appreciation of the Czech currency, which was a very important factor preventing the inflationary pressures in recent two years, was temporarily interrupted, in H1 2007. The CZK depreciated from the January average 27.8 to 28.5 CZK/EUR in June 2007. As of August 2007, the CZK has started to appreciate again, and the average exchange rate of CZK amounted to 26.3 CZK/EUR and 18.0 CZK/USD.

energy prices to producer prices took place. Global increase in food prices due to increasing world demand, production of bio-fuel affected the domestic food prices that registered an upturn after two years of moderate growth. The growth of consumer price index amounted to 5.4 %, y/y, in December, average inflation was at 2.8 %, in 2007.

Increasing inflation led the Czech National Bank to tighten the monetary policy. The 2W repo rate stood at 2.5 % until the end of May 2007. The CNB Board raised the basic interest rates four times during 2007, by cumulative 100 basis points, leaving the key two-week repo rate at 3.50 %, at the end of 2007. Consequently, the 3M PRIBOR rose from initial January value of 2.6 % to 4.1 %,

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Table 1: Main Macroeconomic Indicators

		2003	2004	2005	2006	2007	10/07	11/07	12/07	2008F
GDP	%, y/y	3.6	4.6	6.4	6.4	6.1	-	-	-	4.8
Inflation	%, y/y	1.0	2.8	2.2	1.7	5.4	4.0	5.0	5.4	5.5
Inflation	%, m/m	-	-	-	-	-	0.6	0.9	0.5	-
Industrial prices	%, y/y	0.9	7.7	-0.3	2.6	5.3	4.4	5.4	5.3	3.0
Industrial prices	%, m/m	-	-	-	-	-	0.4	0.7	-0.1	-
Unemployment rate*	%, eop.	10.3	9.5	8.9	7.7	6.0	5.8	5.6	6.0	5.0
Industrial production	%, real	5.5	9.6	6.7	9.7	8.2	8.4	6.7	2.9	7.5
Construction output	%, real	8.9	9.7	4.2	6.6	6.7	3.2	7.1	5.6	6.0
Retail sales	%, real	4.9	2.5	4.0	6.4	7.7	9.4	5.9	5.4	4.0
State budget	CZK bill.	-109.1	-93.5	-56.4	-97.3	-66.4	27.2	12.8	-66.4	-70
Trade balance	CZK bill.	-69.8	-26.4	38.6	39.8	86.1	8.6	11.3	-1.1	90
FOREX reserves	USD bill.	27.0	28.4	29.5	31.3	34.9	33.3	34.5	34.9	38.0
PRIBOR 3M	% average	2.3	2.4	2.0	2.3	3.1	3.55	3.73	4.05	4.2
CZK/EUR	Average	31.84	31.90	29.78	28.34	27.76	27.34	26.73	26.30	26.30
CZK/USD	Average	26.32	25.70	23.95	22.61	20.31	19.22	18.21	18.04	17.50

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

in December, with the average 2007 value at 3.1 %. Nevertheless, even after four increases, the Czech interest rates remained the lowest in EU 27. The negative differential vis a vis the ECB's refi rate thus contracted to 50 basis points from 100 points at the start of 2007 and the differential between 3M PRIBOR and 3M EURIBOR narrowed to 80 basis points, in December 2007.

In January 2008, headline inflation increased by 3.0 %, month over month, and grew by 7.5 %, year over year. The average inflation in the last twelve months grew by 3.4 %. These figures were strongly above the expectations both of the experts and the Czech National Bank. January inflation increase by 3 %, m/m, was influenced almost exclusively (2.9 percentage points) by administrative measures, i.e. by the rise of VAT, regulated prices of energies and water and introduction of regulation fees for health services. Surprisingly, food prices rose only by 2.3 %, m/m, due to the fact that the expected VAT increase was already introduced to the food prices in the November and December 2007.

Unexpectedly high inflation, significantly exceeding the medium-term CNB target, led the Board of CNB to another increase of repo rate on February 7, 2008, to 3.75 %. This narrowed the differential between the ECB and CNB basic interest rates to 25 basis points.

#### 4. UNEMPLOYMENT

The decline in unemployment in 2007 was very significant, with the unemployment rate declining from 7.7 % in December 2006 to just 6.0 % at the end of 2007. The harmonised Czech unemployment rate published by the Eurostat was at 4.9 %, in December 2007, which was by more than 2 percentage points below the overall average for EU 27 (7.0 %). The rate of unemployment was the seventh lowest in EU. On the other hand, as for long-term unemployment, the Czech position is the fourth highest.

The main indicators of unemployment returned to the levels before the restructuring of the Czech economy, however, the macroeconomic background is different. While the over-employment stood behind favourable figures in the Nineties, current shortage of qualified

labour force represents an important barrier to future economic growth. Due to rigidities on labour market and still generous social system, record high number of vacancies cannot be saturated by domestic workers. There appears to be a contrast between more than 140 thousand vacancies, 355 thousand of Czech unemployed and almost 250 thousand of officially employed foreigners. Foreign workers are willing to work under worse conditions and for lower wages than Czech unemployed are. The real situation in the Czech economy is thus close to full employment.

The ratio between unemployment and vacancies is at 2.5, a record-low level in the last decade. However, in some professions (unqualified workers, shop assistants, low administration staff), this ratio is three times higher. Moreover, this qualification mismatch is strongly regionally differentiated. Low regional mobility is another serious problem of the Czech labour market.

Lack of some professions represents one of the most serious barriers for future economic growth. One of the sources for enlarging employment could be unemployed women. The women's unemployment (7.1 %) is permanently above the rate of unemployment for men (4.5 %). At the same time, the employment rate for Czech women (56.9 %) is lower than the rate of employment both of Czech men (74.1 %) and women in EU (58.8 %). According to the CZSO analyses, one of the important reasons behind this is extremely low share of part time jobs. In the CR, only 8 % of women work part time, while the respective share is around 40 % in old EU countries. This is another indicator of low flexibility of the Czech labour market.

#### 5. OUTLOOK

In 2008, real GDP will slow to 4.8 %, with slowdown being more pronounced in the second half of the year. There are several factors behind this slowdown: 1) Weaker foreign demand due to deterioration of the situation on the European markets and general slowdown in the eurozone. 2) Monetary tightening will lead to lower growth of credits both to corporate and households sectors. 3) VAT and price hikes will have the dampening effect on the

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growth of consumer demand. On the other hand, we do not expect strong weakening of the investment demand due to continuing infrastructure projects financed partly by the EU funds. In addition, a reduction in the corporate income tax rate should support private investments of companies controlled by both domestic and foreign owners.

Weaker foreign demand will also lead to some slowdown in manufacturing activity. As the second half of 2007 showed, the period of double-digit growth rates in industry is over. We expect that the industrial output will reach 7.5 %, in 2008, driven by the same manufacturing industries as in 2007, i.e. transport, electronics and general industry.

In 2008, construction will be promoted by infrastructure projects supported partially by EU funds. On the other hand, housing is expected to register a mild caldmdown. In any case, first quarter results will be very weak due to extremely high statistical basis from 2007, in H2 this drop is expected to be compensated for. The growth in construction in 2008 is expected to be around 6 %.

The record-high 7.7 % growth of retail sales achieved in 2007 represents unique result that will not be repeated. Some signs of weakening have already appeared in Q4 figures. Increasing inflation will attenuate the real growth of retail sales, in particular rising food prices and indirect tax increases will limit the spending of households. At the same time, tightening of monetary policy will limit the space for spending of households with mortgages. The 2008 growth in retail trade will be around 4 %.

In 2008, we expect some slowdown in foreign trade; the exports will be hit by the impact of strong EUR on the eurozone activity. Slowdown in trade has been already registered in November and December figures, the developments of foreign industrial orders showed the same picture. As for domestic factors, the tight labour market will also limit the export activity. Nevertheless, weak USD will continue to compensate – at least partially – for expensive fuel and raw materials. In 2008, the trade surplus will reach CZK 90 – 100 bill.

General framework of the current account remains unchanged: improvement of the

trade balance will be more than offset by the deterioration of the balance of incomes. However, rapid growth of GDP in nominal terms prevents the deficit of the current account to reach unsustainable levels. We expect the current account deficit to be around CZK 125 bill., in 2008. This means that the deficit of the current account will be slightly above 3 % of GDP, which is in tolerable limits. However, in the longer time horizon, the risks for external balance persist, stemming from expectations about increasing outflow of profit from FDI.

In the first half of 2008, inflation will be above 6 % and will go down to 5 % bar only in the last quarter of the year. It is unclear to what degree the second round effects of January VAT tax changes will take place. Nevertheless, it is obvious that the above-target inflation will force the Czech National Bank to tighten again the monetary policy, to keep adverse inflation expectations from fueling wage-price spiral. The first step is expected to take place as early as at the end of the Q1 of 2008, by another 25 basis points. This will set the Czech basic interest rate on the level of the basic rates of ECB, i.e. 4 %. For 2008, we expect the end of year CPI to be at 5.5 % and the average annual inflation to be above 6 %.

Risks arising from high inflation create a very complicated situation for the Czech National Bank. Central bank must act in a due time, to keep inflation expectations in tolerable limits and at the same time, not to undercut the economic growth by overtightening of monetary policy. Central bank has been facing this situation for the first time in the last decade.

In the course of 2008, the unemployment will continue to decline. However, this decline is expected not to be so intensive as it was in 2007, in particular in the second half of the year, when the effects of weaker economic activity will be felt. The decline of the unemployment will also probably encounter the structural barrier.

In the course of the year, we expect regular seasonal developments. Spring months will register declining unemployment rate due to seasonal jobs in construction, agriculture and some services. The unemployment rate will decline to or slightly below 5 % in June 2008. Third quarter will register increase of the unemployment rate as a consequence

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of fresh school leavers entering the labour market, which will be only moderate this year due to demographic factor. Regular autumn decline will be replaced by

seasonal December increase due to finishing seasonal jobs and term contracts. At the end of 2008, we expect the unemployment rate around 5 %.

# WORLD ECONOMY IN 2008

Kamil Janáček

## 1. WORLD ECONOMY

Never in this decade caused the forecast of basic macroeconomic indicators such headache as at the start of 2008. Expert opinions, as well as publications of renowned institutions, seem to point to two main variables that cause the frequent change of predictions: daily fluctuations of the dollar, and the oil prices.

Those two economic variables however are not mutually independent. The subprime crisis that led to hasty cuts of Fed rates has weakened the dollar. And between the oil price and the dollar the correlation is negative. That explains why oil prices are increasing – or staying high – in spite of growing concern about the growth of the U.S. economy (and others).

Yet the outlook of the world economy is not as gloomy as one might think when studying the comments in international economic press. Of course it is true that the subprime crisis will result in a fast slowdown of the U.S. economy, still representing almost a quarter of the global GDP. But, in spite of the weak U.S. economy in the first half of 2008, U.S. growth over the whole year will be in positive figures, though under the potential growth path. Weak dollar will support exports, lower growth will cut imports, and keep the deficits of the trade and current account balances within limits. Weaker U.S. demand for oil will help to keep the oil price within – or below – the level of USD 90/barrel. Of course, the risks of this scenario are on the downwards rather than upwards side, but one should not expect the

U.S. economy to fall into a deep crisis of the 1930s type.

Weaker U.S. demand will only moderately impair the fast-growing world economies: Chinese growth will be in double digits, Indian GDP will show only a light slowdown (see Table 1); Latin American countries will also grow over the average, seen from their past perspective. In Latin America, Mexico will be the country suffering most from the U.S. slowdown (due to the strong links with the U.S. economy), but even Mexico will grow by solid 3%.

The strong euro, together with some slowdown of the world economy, will be adverse for the Euro Area in the short run. In all probability, one cannot expect such growth of eurozone exports, as in 2006 and 2007. Demand in the world markets will be lower, and in some key manufacturing industries, Euro Area will also face growing competition by U.S. firms. It seems so far that consumer demand (and/or corporate investment) will not be able to compensate for lower European exports. Euro Area will have another year of lower-than-potential growth.

As to commodity prices, steel prices are expected to decrease (the completion of large capacities in China will curb the demand in world markets); prices of other metals will stay on, or decrease only moderately. Average oil price should oscillate around USD 85/barrel. Prices of agricultural commodities will remain high, not reflecting the slowdown of the world economy: predictions of next harvests are always very uncertain, and practically inconclusive.

Table 1: World Economic Development, 2005-2008 (GDP growth in %, constant prices)

	2006	2007p	2008f
USA	2.9	2.2	1.9
Japan	2.2	1.9	1.2
China	11.1	11.5	10.2
India	9.7	9.0	8.2
Latin America	5.3	5.4	4.5
Euro Area	2.9	2.6	1.7
World	5.4	5.2	4.5

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

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## 2. 4CE COUNTRIES

Economic growth in the four Central-European countries will slow down in 2008, but still it will remain well above the EU-27 average. Slowdown will mainly be caused by the weaker growth in Euro Area, higher inflation, and more risky climate in the world economy. In general, one can say that all four countries will – with different intensity – be hit by the slowdown of European growth, while the *direct* impact of financial turbulences in the U.S. and in Western Europe will be fairly limited. Of course, the situation differs from country to country.

In **Poland**, economic growth reached in 2007 was the highest in the last decade, mainly thanks to very strong domestic demand. Demand will be the engine of growth in 2008, too. Poland also should be least hit by the slowdown in world and European economy (see Table 2), as exports represent only one third of Poland's GDP (compared to two thirds in the Czech Republic and Hungary, and as much as three quarters in Slovakia).

Rapid growth, in situation of high prices of oil, foods and metals, has accelerated Polish inflation. At the end of 2007, inflation surpassed 4 %, but in foods it was double. Polish National Bank increased its basic rate several times, presently to 5.25%. It seems that inflation will be the Achilles' heel of Poland (as of the other Central-European countries) in fulfilment of the Maastricht criteria for euro adoption.

**Hungary** in 2007 had the second lowest economic growth among the 27 European Union countries. Government efforts to cut high public finance deficits will continue in 2008, so that growth will again be deep below the potential. Additional flaws of the Hungarian economy are the relatively large current account deficit, and the high rate of foreign exchange indebtedness of both households and the corporate sector. Credit squeeze will rapidly increase the borrowing

costs, with a dampening effect on Hungarian manufacturing industry.

The approaching parliamentary elections in 2010, and the resistance of the majority of citizen against the hitherto reform steps (fees in health care and at Universities) make the success of further reform efforts of the Government rather doubtful. Also the efforts to curb inflation have been weaker in the last months. Of all Central-European currencies, only for the forint can a weakening tendency be predicted with high probability (as opposite from zloty, and Slovak or Czech koruna).

**Slovakia** has been the "star performer" of Central Europe in the last two years. Fast growth, supported both by domestic and foreign demand, will continue in 2008, albeit at a somewhat lower level.

The government and the Slovak National Bank continued their concerted efforts to achieve euro adoption in 2009, the goal they pre-announced. Public finance deficit in 2007 was 2.8 % of GDP (in preliminary figures); inflation is closely below the level set by the Maastricht criteria. Slovak representatives have repeatedly expressed their conviction that in mid-2008, the decision of both the EU Commission, and the ECB, about Slovak accession to the Euro Area will be positive.

Stans at the other part, however, are not that optimistic. EU commissioner for economic and financial policy Joaquín Almunia, when assessing the convergence report, warned Slovakia that the country may not be able to keep inflation below the Maastricht criteria limit over a longer horizon. More and more, it is clear that the so-called long-run sustainability of both inflation, and of public finance deficits, will be the key to the "yes" or "no" decision by European institutions.

Especially the ECB shows at the examples of Lithuania (the country which was denied access to ERM-II due to a miniscule

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Table 2: Growth in CE-4 Countries, 2006-2008 (GDP growth in %, constant prices)

	2006	2007p	2008f
Poland	6.3	6.5	5.0
Hungary	3.9	1.5	2.2
Slovakia	8.3	10.2	7.3
Czech Republic	6.4	6.6	4.8

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

surpassing of the inflation criterion), and of Slovenia (which was accepted as EMU member on January 1, 2007), how important the question of long-run sustainability of low inflation is. Lithuania almost fulfilled the inflation criterion at a given moment. But, afterwards, inflation in Lithuania jumped to 6 to 8 %, where it stays till now.

The example of Slovenia is also seen as a warning for the new candidates of euro adoption. In 2006, inflation in Slovenia was at a very acceptable level of 1.6 %. But Euro Area entry closed the exchange rate channel through which part of the catch-up of Slovenian price level with the eurozone average had proceeded. The only channel left open was the inflation differential. And the effect came immediately: in the first year of EMU membership, inflation shot up to 5.7 % (top among eurozone countries), and Slovenia took over from Ireland the role of the highest-inflation member (Ireland had "only" 3.7 % while the eurozone inflation average was 3.1 %).

Going back to Slovakia, there remains one more open problem: how to set the central parity of Slovak koruna toward the euro at the moment of fixing it for the eurozone entry. The present parity is at SKK 35.44/EUR. The markets are anticipating – due to macroeconomic trends – the fixing at SKK 33.0/EUR, or another sizable appreciation. From the point of view of long-term prosperity of the Slovak economy, such step is very problematic.

**The Czech Economy** has grown above 6 % for the last 11 quarters, the current account deficit is low, the trade surplus grows in spite of appreciating CZK. However, inflation has shot up to 5 %, a level not seen in the last decade. The Czech National Bank increased the rates by 100 basis points in 2007, so far without effect on inflation. The question is whether appreciation of the koruna will continue, thus making the task of inflation control easier for the CNB.<sup>1</sup>

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<sup>1</sup> In more detail see Part One of this paper.

# WHY HAS THE INFLATION SURPRISED ON THE UPSIDE?

Eva Zamrazilová

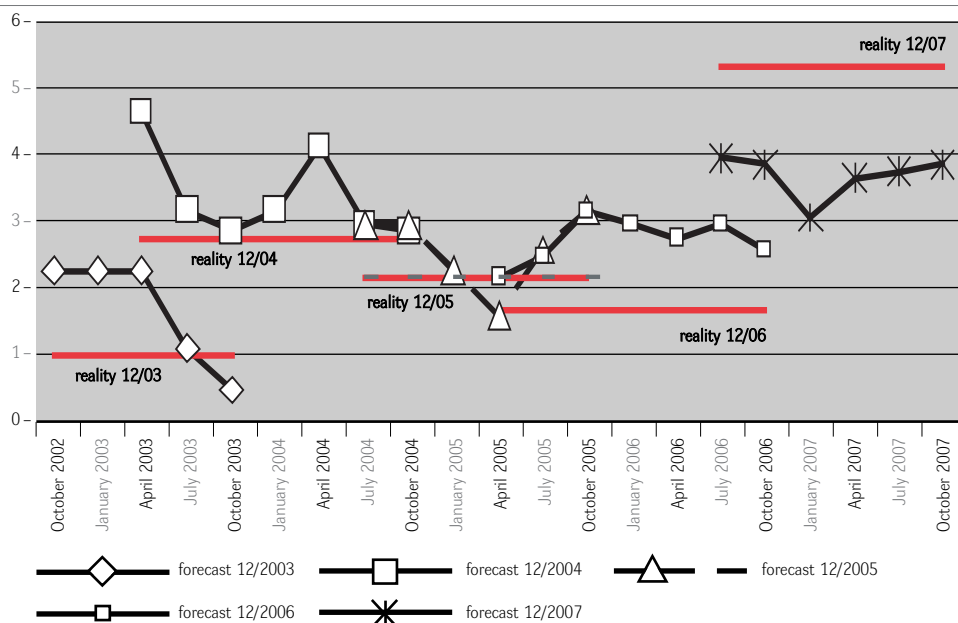
The Czech Republic has been entitled to the label of non-inflationary economy since 2001, with the average annual inflation in the previous five years (2002 – 2006) amounting to 1.8 %. This picture has, however, somewhat changed in the second half of 2007, with inflation accelerating above all forecasts and expectations. In mid-2007, the average forecast of 10 major financial institutions (including the Czech National Bank and Ministry of Finance) for December 2007 year over year CPI growth amounted to 3.4 %, the individual estimates ranging from 2.9 %, to 3.7 %, y/y. In the course of the third quarter, the forecasts were generally raised, in particular due to external factor of rising food prices. The average forecast from early November 2007 for December 2007 was raised to 4.4 %, y/y (the interval ranging from 2.9 % to 4.8 %, y/y).

The inflation, however, surprised strongly on the upside, year over year CPI amounting to 5.4 %, in December 2007. This was just by 1 percentage point above the average forecast and even above the upper band of the interval. The inflation has surpassed also the inflation forecast of the Czech National Bank, which regularly overshooted the

inflation reality in the previous five years. Which were the factors leading to unexpectedly high inflation and how long will they act?

The difference between the real December CPI and the inflation forecasts was attributable mostly to the unexpectedly high growth in food prices, which increased by 11.2 %, y/y. The factors behind price growth of food are not easily distinguishable because external factors were combined with the influence of the increase of VAT. The increase of VAT rate (from 5 % to 9 %) should have been effective not before January 2008, however, the traders most probably incorporated at least part of this 4 % increase earlier. The separation of the external and domestic influence may be based on the long-term relationship between the developments of food import prices and domestic food consumer prices. Figure 2 shows the correlation between these two types of prices and illustrates the passthrough of external prices to the domestic consumer prices. The developments in October and November significantly deviated from the long-term relationship. According to this simple model, the CPI of food would have increased by

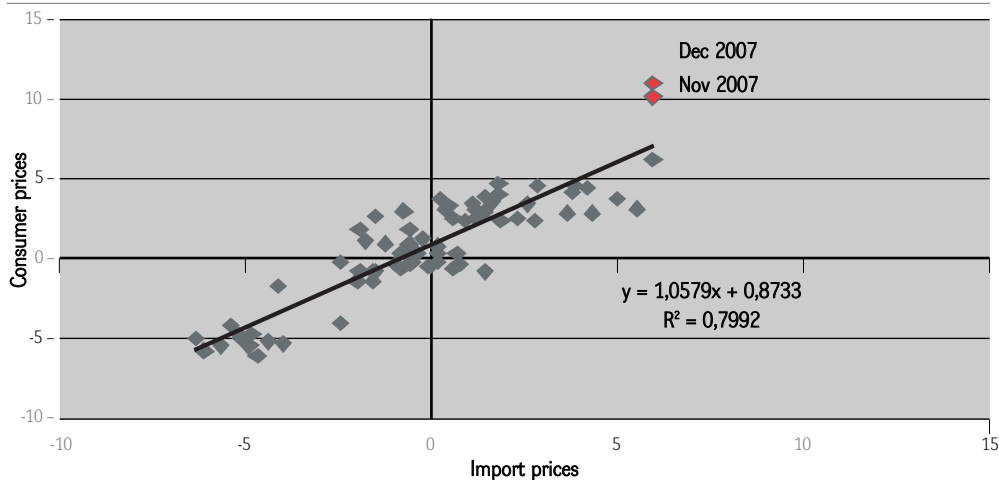
Figure 1: Inflation Forecast of the CNB and Real Inflation



Source: CNB

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Figure 2: Import Prices and Consumer Prices of Food



Source: Czech Statistical Office

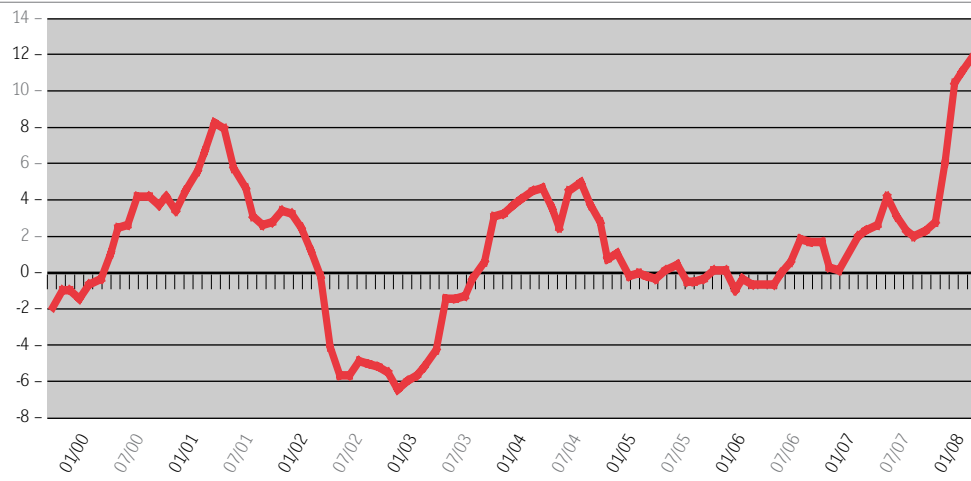
approximately 7 %, y/y, in December 2007, under normal circumstances (i.e., adjusted for the VAT driven increase). Under the 7 % growth of food prices, the total December CPI would have amounted to 4.4 %, y/y, corresponding exactly to the average Autumn forecast of the analysts.

Correspondingly, food prices rose by 2.3 %, m/m in January 2008 – which confirmed the hypothesis that part of increase of VAT was introduced before the real effectiveness of higher rate of tax. This view is supported by the fact that prices of some kinds of food surprisingly declined m/m in January 2008 in spite of the increase of the VAT tax rate. E.g. prices of butter dropped by 7.8 % and so did prices of rolls, baguettes and bread (by 3.0 % and 2.1 %, respectively). This indicates that the traders have tested the sustainable price level of some key food items at the end of 2007.

Anyway, further development in food prices is rather unclear. The most probable scenario is that the peak of the food price growth has been achieved and that a gradual calm-down will come. Figure 3 shows long-term developments in food prices (harmonized year over year index). It is obvious that previous sharp increase in food prices in 2001 was followed by even sharper fall in 2002. The current situation on global markets does not afford us to be so optimistic and to expect such a strong correction, however, some calm-down below 10 %, y/y, is probable.

As for total CPI, the month over month growth amounted to 3 %, m/m, in January 2008, predominantly due to administrative measures which contributed by 2.9 percentage points. Besides the increase in food prices, the regulated prices of housing were raised (including regulated rents,

Figure 3: Food Prices in CR, 2000–2007, harmonized year over year index



Source: Eurostat

The CPI of food would have increased by approximately 7 %, y/y, in December 2007, under normal circumstances (i.e., adjusted for the VAT driven increase). Under the 7 % growth of food prices, the total December CPI would have amounted to 4.4 %, y/y, corresponding exactly to the average Autumn forecast of the analysts.

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water, electricity, gas and other fuels) and fees for healthcare services were introduced. In housing, prices of electricity rose by 9.5 %, natural gas by 7.8 %, heat and hot water by 8.1 %, water supply by 3.8 % and sewerage collection by 3.9 %. Net actual rentals increased by 11.6 %, of which for dwellings with regulated rentals by 18.9 %, while for dwellings with market rentals by 0.5 %. The introduction of regulated fees showed markedly, with the effect of 0.5 percentage point on the month-on-month overall CPI increase.

The year over year inflation therefore increased sharply to 7.5 % in January 2008, up from 5.4 % in December 2007. The impact of price shocks (increase in regulated prices, VAT increase, introduction of healthcare fees) should start to evaporate gradually in the second half of the year. Tightening of monetary policy – basic interest rates were increased by 125 basis points in the course of previous nine months – will soon cool down strong consumer demand and will help to push down demand inflationary pressures. Record-strong CZK will continue to press down import prices that are rapidly translating into domestic consumer prices.

On the other hand, it is unclear whether some second-round effect will not take place. Another domestic risky factor is the wage policy: pressures stemming from the tight labour market may threaten balanced growth of wages. Czech labour market is close to the full employment, with 350 thousand of unemployed, 150 thousand of vacancies and 250 thousand of officially employed foreigners. Foreigners are willing to work for lower wages than domestic workers, which partly attenuates the wage inflationary pressures. It is however a question how long will this barrier work under a strong lack of working force on the labour market.

Even though it is clear that the January 2008 inflation hike has been driven mostly by administrative measures and represents a one-off fluctuation, the inflation outlook is biased with high degree of uncertainty. The new inflation forecast of the Czech National Bank expects the CPI to decline to 5.3 % y/y, in Q4 2008 and even below the inflation target (to 2.4 %, y/y) in Q1 2009. This roughly corresponds with our forecast, which expects the year over year CPI to decline to 5.5 % until the end of 2008.

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# DID EURO SPEED UP GROWTH?

Kamil Janáček

In the second half of the 1990s – before the eurozone was set up – several studies of prestigious research institutions, plus the EU Commission, concluded that forming the European monetary union will speed up the growth of its member countries by 0.5–1.0 percentage point. As the eight-year history of eurozone shows, this assumption has not proved correct. The average GDP growth rate of eurozone (EU-12) countries was 3.3% in the seventies, 2.4% in the eighties, 2.2% in the nineties, and 1.6% in the period 1999 – 2006. Optimistic predictions about a positive eurozone influence on economic dynamics still wait to become true.

Often it is said that for countries like Ireland or Finland, the adoption of euro has not slowed growth down – that, on the contrary, this step has upheld growth on strongly above-average levels, compared to eurozone average. From this point of view, it is interesting to compare Finland with Sweden, that is, with a country staying out of the eurozone, occupying a similar area and geographic room, having not much more inhabitants, and a very similar economic structure: The share of industry in GDP in 2005 was 23.4% in Sweden, 25.4% in Finland; the shares of services in GDP were 70.5% and 65.9%, respectively. Also the shares of high-tech products in exports are similar. Table 1 shows economic growth of Finland and Sweden in 1970 – 2006.

While in the two decades of 1970 – 1989, average growth in Finland was one-third higher than in Sweden, in the 1990s the growth of both countries was practically identical, and the adoption of euro by Finland did not change anything on this fact. At the same time, average yearly inflation in 1999 – 2006 was exactly the

same in both countries, at 1.6%. Both countries belong to low-inflation countries within the European Union, regardless of whether they do or do not have the euro. In the same period, both countries also have shown high average current account surpluses – Finland at 7.3% of GDP, Sweden at 5.8%. Relative economic level of Finland toward the eurozone average grew from 101.0% in 1999 to 105.6% in 2006. For Sweden, the figures were 109.8% and 112.2%. Hence Finland started from a lower level and did overcome the eurozone average somewhat faster. But both countries surpassed the eurozone average economic level, and are leaving it behind.

Basic macroeconomic data thus show that the adoption of euro failed to improve the position of Finland – compared to Sweden that kept the own currency. The conclusion is that the euro did not harm Finland – but it did not help, either. But, as Finland is not a catching-up country compared to eurozone average, one cannot draw much lesson for the Czech Republic from the fact that the euro did not hurt Finland.

In the Czech Republic, GDP per head is just below 75% of the average eurozone level. We are a typical catch-up country. Also, our relative price level in 2006 was only 59.1% of eurozone average – while it was 114.8% in Sweden, and 119.3 in Finland. Czech Republic is catching up with its advanced neighbours not only in economic level measured by GDP per head, but in the relative price level, too. And, here the gap toward eurozone average is even larger than in GDP. Hence the process of price level convergence may be even faster, than convergence of economic levels. There are only two channels of price level

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Table 1: GDP Growth of Finland and Sweden: 1970-2006

Period	GDP growth in %	
	Finland	Sweden
1970 – 1979	3,9	2,4
1980 – 1989	3,5	2,5
1990 – 1998	3,0	3,1
1999 – 2006	3,4	3,3

Source: OECD, Eurostat

convergence: nominal appreciation of the currency, and inflation differential.

After joining the eurozone, the currency appreciation channel would be shut for the Czech Republic. Price level convergence would proceed through inflation differentials. But from the point of view of both stability of economic growth, and of positive effects for households and firms, the currency channel is more favourable. In the last four years, the convergence of price levels proceeded almost exclusively through the currency channel in the Czech Republic; yet the nominal appreciation of koruna did

not undermine fast economic growth, and the trade balance surplus kept increasing.

Real convergence, that is, fast catch-up in economic level with eurozone average, is much more important than the so-called nominal convergence: the fulfillment of Maastricht criteria for euro adoption. A strong Czech economy will be much more resistant to asymmetric shocks. And for successful catch-up, autonomous monetary policy is very important – as shown, for example, by Ireland in the period before euro adoption, or by the catch-up process of Sweden.

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