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CZECH ECONOMY IN 2007 AND IN THE START OF 2008

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1. SUMMARY AND CONCLUSIONS

The year 2007 was a period of continued stable growth of the Czech economy, which was also reflected in the improvement of both internal and external imbalances. After two years of economic growth higher than 6 %, GDP in 2007 increased by 6.5 %, y/y, representing the highest growth dynamics in the Czech history. This was also 3.6 percentage points more than the average GDP growth in the EU 27, pointing to the ongoing process of real convergence. According to the estimations of the Czech statistical office, GDP per capita in PPS reached 82 % of the EU 27, which is significantly more than in the other Visegrad countries.

Domestic economic expansion was also supported by the continued economic recovery in the other European countries and raising foreign demand – the major effect can be attributed to the developments in Germany and Slovakia, the main trading partners. The other central European (Visegrad) countries registered above average pace of growth as well, with an exception of Hungary. Hungary faces problems with curbing the inflation and stabilizing both the growing internal and external imbalances. The economic growth in Slovakia reached a double-digit level and the economic performance of Poland was comparable to the Czech Republic.

Strong domestic demand remained the main factor driving the economic expansion in 2007. Consumers demand growth accelerated to 4.2 %, y/y and contributed to the overall economic growth by 2.9 percentage points. However, there was a slowdown of the dynamics in the course of the year. The main leading factor was the consumption of households, strengthened by their increasing purchasing power. This was improved mainly by the favourable situation on the labour market, low inflation (despite significant acceleration at the end of the year) and interest rates, providing for wide accessibility of credits. On the other hand, government consumption increased by 0.9 %, y/y only, this accounted for 0.2 percentage points in the overall GDP increase. Higher government expenditure was registered at the end of the year. Investment demand sustained the most rapidly growing component of the GDP. Expenditure on gross capital formation grew by 9.2 %, y/y, contributing to the overall economic growth by 2.5 percentage points. This was less than in 2006, but the dynamics was recovering throughout the year.

Foreign trade balance became a more important source of the GDP growth in a year on year comparison. Positive trade balance brought 1.1 percentage points to the overall GDP increase. The growth of exports accelerated to 15.3 %, y/y, and significantly exceeded the growth rate of imports, which accounted for 13.2 %, y/y, i.e. 2.1 percentage points less. The main favourable factors contributing to this development were the improvement in the terms of trade (increase by 2.3 %, y/y), and economic recovery in the main trading partners' economies. The large trade surplus led to a fall in the current account deficit and its share on GDP decreased to 2.5 % (from 3.1 % in 2006), despite deepening of the deficit of balance of incomes, which was record high in 2007. Worsening balance of incomes was a result of high FDI registered in the previous years. Large FDI net inflows remained the main factor underlying the high surplus on financial account in 2007. Its share in GDP decreased to 2.9 %, nevertheless, the surplus on financial account was more than covering deficit on the current account.

As for the supply side, economic performance of the industry was strong during the cyclical economic upswing in 2007. Industrial output rose by 8.2 %, y/y, but the dynamics slowed down compared to year 2006. Manufacturing, which accounts for the largest share of industrial output, registered an 8.9 % growth, y/y. As in previous years, transport equipment, electrical and optical equipment, rubber and plastics, and general machinery remained the main driving forces of the manufacturing production growth, altogether accounting for more than 50 % of total industrial sales.

After two years of economic growth higher than 6 %, GDP in 2007 increased by 6.5 %, y/y, representing the highest growth dynamics in the Czech history. This was also 3.6 percentage points more than the average GDP growth in the EU 27. GDP per capita in PPS reached 82 % of the EU 27, which is significantly more than in the other Visegrad countries.

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Transport equipment strengthened its position as the leader of the Czech industry, accounting for continuously growing share of its overall output (22 % in 2007). Employment in the industry increased by 1.8 %, y/y, real wages grew by 4.5 %, y/y, and labour productivity rise amounted to 6.6 %. Labour productivity growth thus still remains higher than the growth of real wages, but the gap has narrowed. Unit labour costs in the industry retained the decreasing trend from previous years; however, the decline registered a significant slowdown. This might negatively affect the competitiveness of the Czech exporters in the future.

Construction output rose by 6.7 % in 2007, which is a growth comparable to the previous year. The major driving force of the construction output increase was building construction, mainly in the area of new construction, reconstruction and modernization of buildings – i.e. new dwellings, assembly halls, shopping centres etc. The growth of contracted construction work in this field reached 10.9 %, y/y. Altogether, the share of building construction on the total construction output increased to almost 60 %. On the other hand, civil engineering recorded a decline of 2.6 %, y/y. Year 2007 registered a record-high growth of finished dwellings since 1991. The number of finished flats reached 41 650, which means a 38 % increase compared to 2006, and the dynamics was increasing in the course of the year, attaining almost 50 % year-over-year growth in the last quarter of 2007. Besides the favourable general economic conditions, the reason for such an expansion of finished dwellings might also be found in the expected changes of VAT rate for housing construction, and was supported by the developing mortgage market, growth of loans from construction savings and overall low interest rates.

Year 2007 registered a record-high growth of finished dwellings since 1991. The number of finished flats reached 41 650, which means a 38 % increase compared to 2006, and the dynamics was increasing in the course of the year, attaining almost 50 % year-over-year growth in the last quarter of 2007.

Strong domestic demand contributed to the acceleration of retail sales growth in 2007, strengthening the trend from previous years. Retail sales grew by 7.7 %, y/y, i.e. 1.2 percentage points more than in 2006. This was a record high growth since 1997. However, the growth registered a weakening trend in the course of the year, caused mainly by the expected hike in the VAT, leading to higher prices of foods and some other goods and services. Altogether, foods sales growth amounted for 2.8 %, y/y, only. The main driving force behind the retail sales growth was the non-food goods sales, with a year-over-year growth reaching to 9.7 %. In this segment, households' equipment, and clothing and footwear were increasing the most rapidly. The dynamics of sales in the automotive segment was even higher than in the retail trade sector; it reached 9.6 %, y/y, mainly due to the developments in sale, repair and maintenance of motor vehicles.

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Inflation registered an accelerating trend in the course of the year 2007. It continued to be low in the first quarter of 2007 (the y/y inflation at the end of Q/1 was 1.9 % only). However, from the spring 2007, it started to accelerate and at the end of 2007, it reached 5.4 %. In average, it amounted to 2.8 %, y/y in 2007. Prices in the Czech Republic increased more than did the EU average: harmonized index of consumer prices reached 2.1 %, y/y in the EU 27, while it amounted to 3.0 % in the CR. There were several reasons for this development. On the domestic side, strong economic activity driven by the domestic demand, and shortage of skilled labour accompanied by rising wage pressures resulted in strong growth of retail sales. Consequently, demand inflationary pressures emerged. However, external factors played a role as well, mainly the rise of prices of high raw materials, fuel, energy and foods.

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The increasing trend in producer prices continued in 2007 as well, and further strengthened in the course of the year. Among others, the factor behind the growth of producer prices is again the rise in prices of foods and fuels. Appreciation of koruna against the dollar could only partially compensate for this increase. The average industrial producer price index reached 4.1 %, y/y and it was even higher in the agriculture, where the index amounted to 16.5 %, y/y.

For the Czech koruna, year 2007 was again a year of appreciating trend. However, in the first quarter, appreciation against both the euro and the dollar stopped. The reason can be found in the prevailing markets sentiment toward most currencies in the region, rather than in fundamentals. However, this market sentiment faded away, and since the second half of March 2007, Czech currency started again to appreciate more moderately against the euro, more vigorously against the USD, and the appreciation accelerated in the last quarter of 2007. The average koruna exchange rate

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Increasing inflation led to tightening of the monetary policy several times in 2007. The 2W repo rate stood at 2.5 % until the end of May 2007. Then, the CNB Board raised the basic interest rates four times during 2007, by cumulative 100 basis points, leaving two-week repo rate at 3.50 %, at the end of 2007. Nevertheless, Czech interest rates remained the lowest among the EU 27 countries. At the same time, the differential between ECB and CNB basic interest rates narrowed. Strong competition among Czech banks keeped market interest rates at a low level, despite the high inflation.

The high growth of the Czech economy was reflected in the ongoing improvements of the labour market performance indicators in 2007. The unemployment rate had a decreasing tendency throughout the whole year 2007 and reached 6 % in December. There was also a significant improvement in the long-term unemployment in 2007. After previous years of gradual increases, the share of long-term unemployed significantly decreased bellow one half. The strong economic activity promoted also the supply of vacancies; it was record high in the Czech history in 2007. Along with declining unemployment, employment was continuously growing throughout the whole year. Nevertheless, labour force participation of 15-64 year-old has been gradually decreasing and for the first time in the Czech history, it declined bellow 70 %. Shrinking labour capacity may impair the future growth prospects of the whole economy. Relative competitiveness of the Czech economy might also be weakened by the trends in narrowing the gap between the real wage and labour productivity growth. It is mainly the recent cyclical economic upswing that affected the favourable developments of the Czech labour market. Still, there remain significant obstacles to the efficient functioning of the Czech labour market, represented mainly by the inappropriate institutional framework.

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Table 1: Main Macroeconomic Indicators

		2003	2004	2005	2006	2007	01/08	02/08	03/08	2008F
GDP	%, y/y	3.6	4.6	6.5	6.4	6.5	–	–	–	4.8
Inflation	%, y/y	1.0	2.8	2.2	1.7	5.4	7.5	7.5	7.1	5.5
Inflation	%, m/m	–	–	–	–	–	3.0	0.3	-0.1	–
Industrial prices	%, y/y	0.9	7.7	-0.3	2.6	5.3	6.0	5.6	5.3	3.0
Industrial prices	%, m/m	–	–	–	–	–	1.9	0.1	0.3	–
Unemployment rate*	%, eop.	10.3	9.5	8.9	7.7	6.0	6.1	5.9	5.6	5.0
Industrial production	%, real	5.5	9.6	6.7	9.7	8.2	9.1	11.3	...	7.5
Construction output	%, real	8.9	9.7	4.2	6.6	6.7	1.0	11.5	...	6.0
Retail sales	%, real	4.9	2.5	4.0	6.4	7.7	4.0	6.3	...	4.0
State budget	CZK bill.	-109.1	-93.5	-56.4	-97.3	-66.4	9.8	-5.0	-13.3	-70
Trade balance	CZK bill.	-69.8	-26.4	38.6	39.8	85.0	12.2	14.3	...	90
FOREX reserves	USD bill.	27.0	28.4	29.5	31.3	34.9	36.1	37.0	38.0	38.0
PRIBOR 3M	% average	2.3	2.4	2.0	2.3	3.1	4.0	3.9	4.1	4.2
CZK/EUR	Average	31.8	31.9	29.8	28.3	27.8	26.1	25.4	25.2	26.3
CZK/USD	Average	26.3	25.7	23.95	22.61	20.3	17.7	17.2	16.2	17.5

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

2. OUTLOOK FOR 2008

In 2008, we expect the consumer demand to register a slight slowdown due to higher inflation and slower growth of real incomes, and the investment demand to continue in dynamic growth. We expect full-year growth of the GDP at 4.8 %, y/y. We also expect some slowdown of foreign trade; the exports are expected to be slightly hit by the impact of strong EUR to eurozone activity. Nevertheless, weak USD will continue to compensate for expensive fuel and raw materials. As for domestic factors, the tight labour market is expected to limit the export activity. In 2008, the trade balance is expected to reach approximately the same result as in 2007.

The slowdown of economic growth in the eurozone forecasted for 2008 will hit the industrial output from the second quarter of 2008 (as indicated by the new orders in November 2007). In 2008, the growth of the industrial output will slow to 8 %, y/y. Construction will be promoted by infrastructure projects supported partially by the EU funds. The projects of foreign investors will be helpful, as well. Also the construction of new flats will grow rapidly, at least temporarily. Growth in construction in 2008 is expected to be around 6 %, y/y, which corresponds to production capacity of the Czech construction. On the other hand, high inflation will attenuate the real growth of retail sales in 2008. At the same time, tightening of monetary policy will limit the space for spending in households with mortgages. The 2008 growth in retail trade is expected around 4 %, y/y.

Price increases from the beginning of 2008 are in line with our expectations that in the coming months, inflation will be around 6 %, and will go down to 5 % bar only in the second half of the year. Despite the growing inflation, strong consumer demand will continue (albeit with declining force) to push prices up. The appreciating exchange rate will be able to attenuate the inflationary pressures only partially. In 2008, we expect the year over year CPI to be above 5 % at the end of the year. Average inflation will be above 6 %, y/y. The main drivers of PPI in 2007 – metal prices and oil – will remain expensive also in 2008, despite some decline due to lower demand in developed countries. Continuing spill-over of high raw materials prices into manufacturing industries must be expected, despite the attenuating effect of appreciating Czech currency. We expect PPI at 4 %, y/y at the end of 2008.

All indicators show increasing pressures on the labour market. In some regions – in Mladá Boleslav and Prague, where unemployment rate is 2.1 % – the labour market is very tight and close to full employment. The expected slowdown in vacancies due to weaker economic growth will not take place before the second half of 2008, easing the slowdown of the unemployment rate. At the end of 2008, we expect unemployment rate around 5 %. However, there is still a scope for increasing the labour force participation rate and

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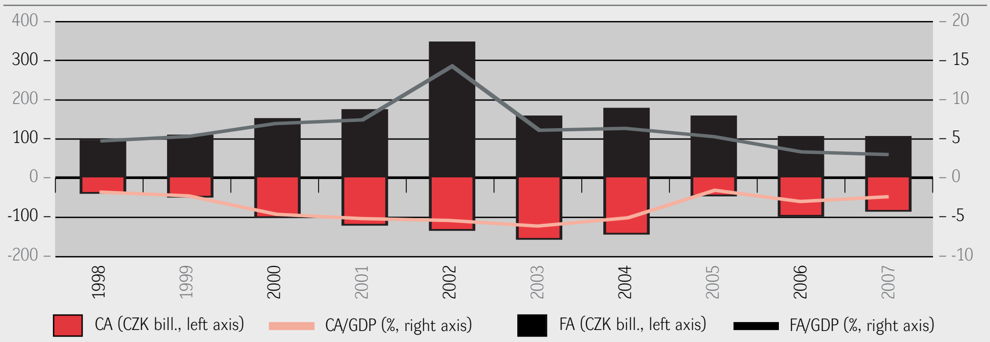
At the end of 2008, we expect unemployment rate around 5 %. However, there is still a scope for increasing the labour force participation rate and reducing the qualification mismatch, that could ease the tight conditions on the labour market and support the future economic growth.

Table 2: Balance of Payments, (CZK bill.)

	2001	2002	2003	2004	2005	2006	2007
Current account	-124.5	-136.4	-160.6	-147.5	-48.5	-100.8	-89.0
o.w. Foreign trade	-116.7	-71.3	-69.8	-13.4	59.4	65.1	117.5
Balance of services	58.0	21.9	13.2	16.6	36.5	42.2	55.4
Balance of incomes	-83.5	-115.6	-119.9	-156.6	-155.7	-201.3	-253.8
Transfers	17.8	28.7	15.8	6.0	11.3	-6.8	-8.1
Capital account	-0.3	-0.1	-0.1	-14.2	4.7	8.5	19.7
Financial account	172.8	347.8	157.1	177.3	154.8	104.9	104.5
o.w. Direct investments	208.3	270.9	53.5	101.8	279.6	102.8	158.2
Portfolio investments	34.9	-46.7	-35.7	53.0	-81.2	-26.9	-53.2
Financial der.	-3.2	-4.3	3.9	-3.2	-2.8	-6.2	1.8
Long-term capital	-2.9	31.6	27.5	57.0	32.7	62.6	-8.1
Short-term capital	-64.1	96.4	107.9	-31.3	-73.5	-27.3	5.8

Source: Czech National Bank

Figure 1: Current account and financial account balance



Source: Czech National Bank

reducing the qualification mismatch, that could ease the tight conditions on the labour market and support the future economic growth.

3. EXTERNAL BALANCE

Current account deficit registered a decline in 2007, compared to the 2006 level, as indicates Table 2. Financial account remained in surplus comparable to the previous year, more than covering the deficit on the current account. The main source of the current account deficit was the negative balance of incomes, exceeding the foreign trade surplus. The major driver of the financial account surplus remained foreign direct investment. The external balance of the economy improved – the share of current account deficit on GDP decreased to 2.5 %, given the drop of the deficit and also the significant rise of GDP. Financial account surplus as a share of GDP fell as well, amounting 2.9 % in 2007 (see Figure 1).

3.1 Current Account

The current account dynamics was mostly influenced by a significant deterioration of the balance of incomes. Another source of the current account deficit was the negative balance of transfers – the deficit, which was firstly recorded in 2006, deepened further. On the other hand, there was a significant rise in the surplus of the trade balance (increased by 80 %, y/y) and also there was a certain improvement in the balance of services. However, the volume of trade surplus was roughly half of the balance of incomes deficit, resulting in the overall current account deficit.

The foreign trade registered the best results in the Czech history and the Czech Republic became one of the most opened countries in the EU with the share of exports of goods and services on GDP reaching to 80 % of GDP in 2007. The trade balance continued in the improving trend from previous years, which further strengthened, and reached a surplus of CZK 117 bill., representing 3.3 % of GDP. The dynamics of exports and imports registered a double-digit growth in 2007. Contrary to the previous year, when the exports and imports rose in the same pace, the positive difference was registered in 2007. The exports growth accelerated to 15.3 %, y/y, while the dynamics of imports slowed down to 13.2 %, y/y. Imports were driven up by the strong domestic demand, appreciating currency and also by high prices of fuels. On the other hand, exporters took an advantage of the economic recovery in the major trading partners' countries (Germany and Slovakia mainly) and also of the positive developments in the terms of trade. The expansion of industrial production and strong inflow of foreign direct investment affected exports positively, as well.

Prices of exports rose by 1.3 %, y/y in 2007, contrary to the decline registered in the previous years. On the other hand, imports prices recorded a fall of 1 %, y/y. Terms of trade thus increased by 2.3 %, y/y, creating a favourable environment for the development of the foreign trade in 2007. However, in the course of the year there was a slowdown in the terms of trade growth. The main factors behind the changes of foreign trade prices were the exchange rate development and changes of the world prices.

The concentration of the foreign trade into three commodity groups was further intensified in 2007 – the main drivers of the volume of the trade remained machinery (including cars), fuels and chemistry. While the deficits in trade with chemistry

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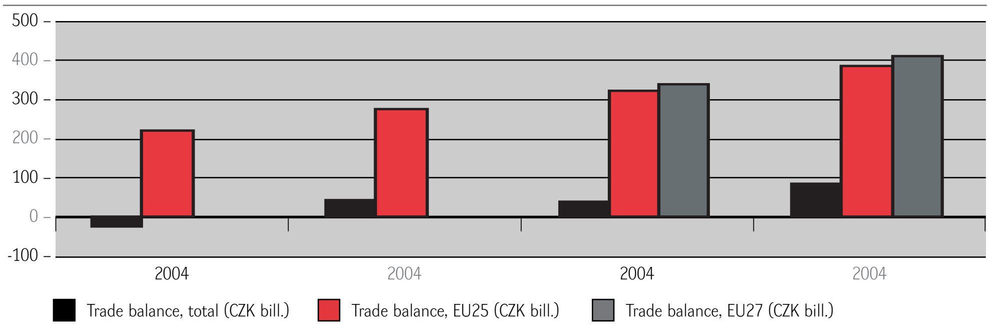
Figure 2: Trade Balance – Whole World, EU 27 and EU 25



Source: Eurostat

registered record high values in 2007, the long-term trend of increasing deficits in fuels has been stopped. Still, the deficits in these two fields reached more than CZK 200 bill. However, this amount was more than compensated by the developments in the trade with machinery and transport equipment (total surplus was higher than CZK 300 bill.). The automotive industry thus stayed the main driving force of exports, contributing by two thirds to the trade balance in the machinery and making up for 17 % of the total exports.

Territorial structure of the foreign trade didn't change much in 2007. The main trading partner continued to be the EU, with 85 % share of the exports and 70 % share of the imports. The surplus of trade with the EU countries further grew (increase of CZK 71.7 bill.) and compensated for the trade deficits with the non-EU countries, despite the significant deterioration of these deficits (increase of CZK 25.4 bill.). The highest surpluses were generated in the trade with Germany (CZK 98.2 bill.) and Slovakia (CZK 91.4 bill.). There was also the most significant increase of trade surplus with these countries in 2007; on the other hand, positive trade balance with Austria and Hungary declined. However, the main deterioration of the trade balance took place in case of China – the deficit increased by 40 %, y/y, amounting to CZK 171 bill. China thus keeps its position of the country generating the highest trade deficits, influenced mainly by the high Czech domestic demand. On the other hand, the trade position with the Russian Federation improved as the deficit decreased, year-over-year, and amounted CZK 67 bill.

Balance of services improved in 2007, as well. The surplus increased year-over-year and reached CZK 55.4 bill. The surplus in transport increased by 40 %, y/y, and amounted to CZK 28.7 bill., while the positive balance of tourism slightly decreased (amounted to CZK 60.3 bill.). On the other hand, the deficit of other services improved by 16 %, y/y, and declined to CZK 33.6 bill., caused both by increase of exports and fall of imports. Other services include such kinds of services as telecommunication, insurance, financial, legal, accounting and consulting services. The main effect on high imports of these can be attributed to the substantial foreign direct investment and increasing penetration of the companies under foreign control, which mostly demand these services from abroad. The positive effects of the large FDI inflows on the financial account are thus to some extent counterweighted by a negative effect on the balance of services, and, more importantly, on the balance of incomes.

Balance of incomes has been traditionally the major source of the current account deficit. The deficit deteriorated year-over-year by 26 % and reached CZK 253.8 bill. The structure of the balance of incomes is given by Table 3. It is clearly visible that the compensation of employees contributed to the overall deficit from roughly one fifth, while the deficit in investments incomes balance made up for the utmost part.

On the compensation of employees side, the deficit increased substantially compared to 2006 – it reached CZK 52.2 bill. in 2007. While the incomes from work abroad stayed on the same level, the expenditure on employment of foreign workers in the Czech republic grew by 32 %, y/y.

The main driver of the high deficit of investments incomes balance was the FDI-related expenditure. The high inflows of the foreign direct investment in the previous years and increasing profitability of foreign-controlled companies in the Czech Republic are causing a growing outflow of incomes. The expenditures connected with the

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Table 3: Balance of Incomes – Individual Balances (CZK bill.)

	1995	2000	2005	2006	2007
Balance of incomes: total	-2.8	-53.0	-155.7	-201.3	-253.8
Of which:					
Compensation of employees balance	2.3	-12.0	-23.5	-33.5	-52.2
Investments incomes balance	**-5.1**	**-41.0**	**-132.2**	**-167.9**	**-201.6**
Out of investments:					
Balance of FDI	**-1.2**	**-53.6**	**-147.7**	**-190.7**	**-233.4**
Balance of portfolio investments	-5.8	-7.5	6.3	4.3	9.2
Balance of other investments	**1.9**	**20.1**	**9.3**	**18.6**	**22.5**

Source: Czech National Bank

previous FDI inflows account for CZK 247.6 bill., i.e. 63 % of total expenditures of the balance of incomes. These expenditures consist of the reinvestments of profits, dividend payments, and interests from FDI loans. Unlike in 2006, the volume of reinvested profits substantially exceeded the volume of dividends (made up for 53 % and 44 % of total FDI-related expenditure in 2007, respectively). On the other hand, the balance of incomes connected with the previous portfolio investment is positive (surplus CZK 9.2 bill.), however, it is not large enough to compensate for the substantial deficits stemming from the large FDI-connected expenditure.

3.2 Financial account

Financial account in 2007 reported a net inflow of CZK 104.5 bill., an amount almost similar to year 2006. The main source of this surplus was FDI – the net FDI inflow reached CZK 158.2 bill., representing a year-over-year growth of 54 %. While the investments of Czech companies abroad fell, total FDI inflow to the Czech Republic increased to CZK 185.3 bill., (representing a year-over-year growth of 36 %) and reached 5.2 % of GDP (see Figure 3). Reinvestment of profits accounted for more than two thirds of the total FDI inflow (CZK 130.1 bill.) and the share of the inflow to basic capital increased to approximately 30 % (CZK 57.5 bill.). The total cumulative volume of FDI inflow to the Czech Republic between years 1993 and 2007 amounted to CZK 2 trill.

Portfolio investment remained in red numbers and recorded an increased deficit amounting to CZK 53.2 bill. (year-over-year growth of almost 100 %). As the inflow of the portfolio investment remained stable compared to 2006, the outflow growth was the main factor behind this dynamics, partly also because the persisting low interest rates in the Czech Republic. The strong activity of Czech investors abroad continued and their purchases of foreign portfolio investments reached CZK 94.7 bill. (year-over-year growth of 38 %). The overall net outflow of portfolio investment also positively affected the balance of incomes (reached a surplus of CZK 9.2 bill. in 2007). Net outflow was recorded in case of other investments, too, amounting to CZK 2.3 bill. The deficit was caused by the result of long-term capital flows – there was registered a net outflow of CZK 8.1 bill. On the other hand, short term capital recorded a net inflow of CZK 5.8 bill. The main driving force of these flows was the banking sector; on the other hand, the Government's influence was rather negligible.

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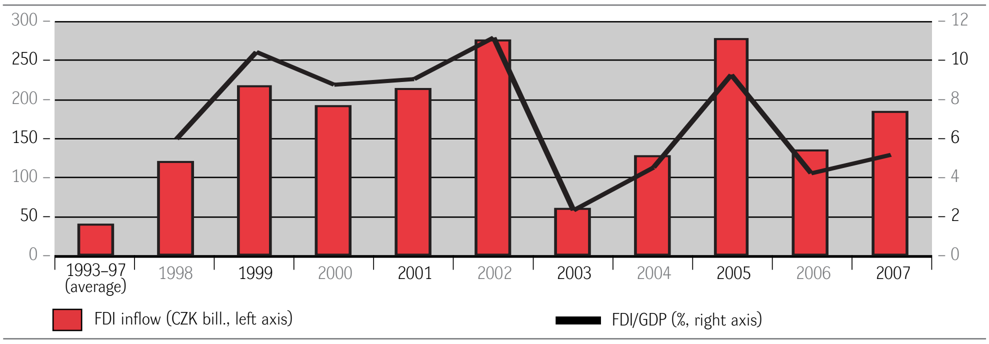
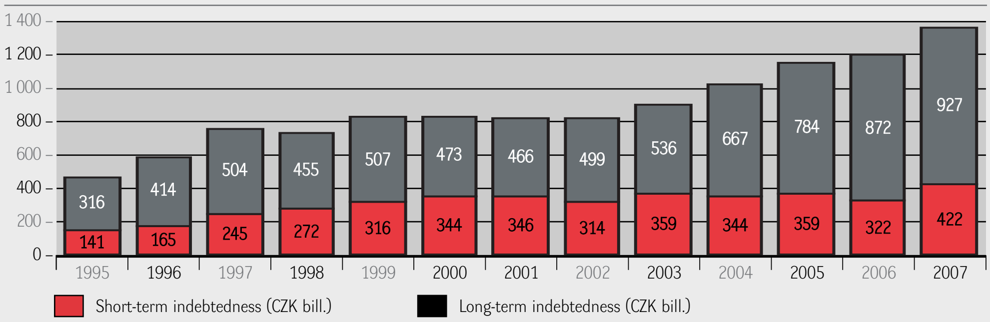
Overall foreign indebtedness amounted to CZK 1349 bill. at the end of 2007. This represents an increase of 13 %, y/y, which is a two-fold dynamics of growth compared to 2006.

Figure 3: The Inflow of FDI to the CR



Source: Czech National Bank

Figure 4: Foreign Indebtedness (CZK bill.)



Source: Czech National Bank

Economic performance of the industry was strong during the cyclical economic upswing in 2007. Industrial output rose by 8.2 %, y/y, but the dynamics slowed down compared to year 2006 and throughout the whole year.

As in previous years, transport equipment, electrical and optical equipment, rubber and plastics, and general machinery remained the main driving forces of the manufacturing production growth, altogether accounting for more than 50 % of total industrial sales.

Transport equipment strengthened its position as the leader of the Czech industry, accounting for continuously growing share of its overall output (22 % in 2007). Profiting from the boom in the automotive industry, the highest growth was recorded in manufacturing of rubber and plastics (19.7 %, y/y).

represents an increase of 13 %, y/y, which is a two-fold dynamics of growth compared to 2006. The share of the debt on GDP raised by 1 percentage point to 38 %. There was also a shift in the structure of the debt. Short-term indebtedness increased to 31 % of total volume of debt, while share of long-term indebtedness fell to 69 % (see Figure 4). The debt of the Government accounts for a rather small part of the total indebtedness and since 2005 has been stabilized at the level of 20 %. Further, 28 % share of the debt belongs to the commercial banks and remaining half represents the indebtedness of the other sectors.

4. DEVELOPMENTS IN THE SELECTED SECTORS OF THE ECONOMY

4.1 Industry

Economic performance of the industry was strong during the cyclical economic upswing in 2007. Favourable conditions were supported by positive economic developments in the main trading partners' economies and strong domestic demand. Industrial output rose by 8.2 %, y/y, but the dynamics slowed down compared to year 2006 and throughout the whole year. Similar trend was registered for industrial sales (the growth amounted for 9.3 %, y/y), although the difference compared to previous year wasn't so pronounced. While domestic sales showed a lower pace of growth, 8.4 %, y/y, export sales rose by 13.9 %, y/y, indicating large contribution of foreign demand to industrial output dynamics in 2007.

Manufacturing, which accounts for the largest share of industrial output, registered an 8.9 % growth, y/y. As in previous years, transport equipment, electrical and optical equipment, rubber and plastics, and general machinery remained the main driving forces of the manufacturing production growth, altogether accounting for more than 50 % of total industrial sales. On the other hand, mining and quarrying reported a decline of production (-0.7 %, y/y) and the output growth in electricity, gas and water supply was rather low (1.6 %, y/y).

Transport equipment strengthened its position as the leader of the Czech industry, accounting for continuously growing share of its overall output (22 % in 2007). However, the record high growth registered in previous years moderated and reached only 13.9 %, y/y in 2007 (compared to 20.6 %, y/y in 2006) and thus contributed by 2.8 percentage points to the total industrial output growth. Profiting from the boom in the automotive industry, the highest growth was recorded in manufacturing of rubber and plastics (19.7 %, y/y). However, this makes up for only 7.1 % share on total industrial production. Manufacturing of electrical and optical equipment, and general machinery also reported significant growth (16.1 and 17.7 %, y/y, respectively) and by representing a large share of the overall sales, these industries significantly contributed to the total industrial output growth (2.3 and 1.2 percentage points, respectively). On the other hand, manufacture of coke and refined petroleum products decreased by -4.3 %, y/y and manufacture of basic metals and fabricated metal products decreased by -0,6%, y/y.

The fastest growing industries share two similar characteristics: there is a high propensity to export and also a high penetration of foreign controlled companies. While the average share of export sales in the industry amounted 50 % in 2007, this number was substantially higher in transport equipment (73 %), and also electrical and optical equipment and general machinery (more than 60 %). The share of foreign controlled companies on total sales has been traditionally high, but the increasing trend evident in previous years stopped in 2007 on the same level as in 2006 (56 %). The share of exports on sales in this segment further increased to 74.2 %.

Employment in the leading sectors of the industry increased by more than 5 %, y/y, which significantly exceeds the average industrial employment growth of 1.8 %. On the other hand, change in the average nominal wages in these sectors didn't considerably differ from the industrial average value of 7.4 %. Real wages in the industry increased by 4.5 %, y/y; labour productivity rise in the industry slowed down compared to 2006 and amounted 6.6 %. Labour productivity growth thus still remains higher than the growth of real wages, but the gap has narrowed. Unit labour costs in the industry retained the decreasing trend from previous years; however, the decline registered a significant slowdown. This might negatively affect the competitiveness of the Czech exporters in the future.

The beginning of 2008 indicates a continuation of the trends from the previous years. The industrial production maintained a high growth dynamics and increased by 9.3 %, y/y, in January and 11.3 %, y/y, in February; the structure of growth staying unchanged. However, a deceleration of growth connected to an expected slowdown of the eurozone economies and domestic demand is expected. The increase of the value of new orders was only 1.1 % in January and 4.4 % in February (the average growth for 2007 reached 9.8 %); there was even a decline in case of foreign new orders.

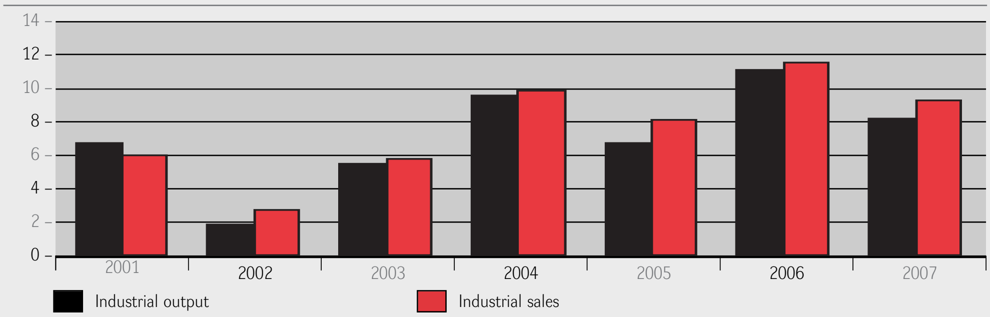
4.2. Construction

Construction output rose by 6.7 % in 2007, which is a growth comparable to the previous year. There was an increasing trend in the course of the year, followed by a considerable decline in December. Compared to 2006, the output increased in all the months of 2007 with the exceptions of June, July and September – this was mainly caused by the strong statistical bases in 2006. On the other hand, distinct increases were evident at the beginning of 2007 (average growth in the first quarter was almost 30 %, y/y), because of the mild winter and weak statistical bases in 2006.

The major driving force of the construction output increase was building construction, mainly in the area of new construction, reconstruction and modernization of buildings – i.e. new dwellings, assembly halls, shopping centres etc. The growth of contracted construction work in this field reached 10.9 %, y/y. Altogether, the share of building construction on the total construction output increased to almost 60 %. On the other hand, civil engineering recorded a decline of 2.6 %, y/y. Construction works abroad showed a substantial rise of 51.6 %, however, this accounts for a small fraction of the total output only.

Year 2007 registered a record-high growth of finished dwellings since 1991, although the number of dwellings started and under construction stayed roughly the same. The number of finished flats reached 41 650, which means a 38 % increase compared to 2006, and the dynamics was increasing in the course of the year, attaining almost 50 % year-over-year growth in the last quarter of 2007. Besides the favourable general economic conditions, the reason for such an expansion of finished dwellings might also be found in the expected changes of VAT rate for housing construction (effective as of January 2008) and was supported by the developing mortgage market, growth of loans from construction savings and overall low interest rates. The dynamics of new

Figure 5: Industrial Output and Industrial Sales (growth rates in %, y/y)



Source: Czech Statistical Office

Labour productivity growth still remains higher than the growth of real wages, but the gap has narrowed. Unit labour costs in the industry retained the decreasing trend from previous years; however, the decline registered a significant slowdown. This might negatively affect the competitiveness of the Czech exporters in the future.

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mortgages on housing remains very high despite a certain deceleration relative to 2006 – the growth declined to 24 %, y/y, with the volume of new mortgages amounting CZK 148 bill. (increase by 28 %, y/y). In December 2007, total volume of loans on housing assigned to households amounted to CZK 515 bill., representing 14.5 % of GDP.

Despite the growing construction output, number of new granted building permits decreased by 13.3 % in 2007, y/y. However, approximate total value of new granted buildings decreased by 0.9 %, y/y, only, making the average value of a new building higher than in 2006.

The trend of increasing value of new buildings continued in 2008 as well. The year-over-year growth in January slowed down to 1 %, caused mainly by very strong statistical basis from 2006, but the dynamics was recovered in February, when the output increased by 11.5 %, y/y. The growth was driven by civil engineering and big projects in infrastructure mainly. Also, there is a persisting growth trend in the area of dwellings construction, despite the hike in the VAT. The number of new granted construction permits on flats increased by 30.7 % and 13.3 %, y/y in January and February 2008, respectively. The main factors of this development are demographic trends, situation on the mortgage and loan markets, and also strong individuals' preferences of own housing.

4.3. Retail Trade and Trade Services

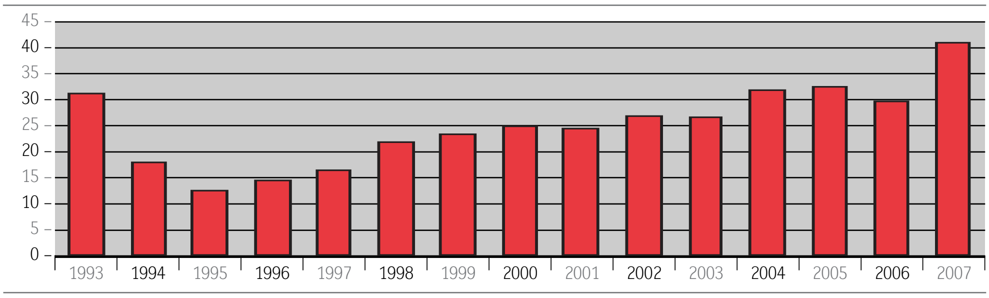
Strong domestic demand contributed to the acceleration of retail sales growth in 2007, strengthening the trend from previous years. Retail sales grew by 7.7 %, y/y, i.e. 1.2 percentage points more than in 2006. This was a record high growth since 1997. The highest dynamics was registered in the first quarter of 2007 (9.8 %, y/y), gradually slowing down in the course of the year and stabilizing at the level of 6.8 %, y/y, in the second half of the year. Among the different size groups of enterprises, the highest pace of growth was registered in the companies with 50-99 employees (14 %, y/y), followed by businesses with 20-49 employees (9.2 %, y/y).

There are more factors that have been favourable for this distinct growth in retail sales; mostly they are connected to the cyclical economic upswing. The most important were the strong economic activity and increasing purchasing power of consumers, caused by low unemployment, solid growth of real wages and a good accessibility of credits. Total volume of households' consumer credits granted by financial institutions amounted CZK 139 bill. at the end of 2007, representing an increase of 26 % compared to 2006. The importance of non-financial institutions for granting the credits to household was growing as well.

On the other hand, the weakening of the growth trend in retail sales, obvious at the end of 2007, can be attributed to another factor, which will be further influencing the retail trade sector in 2008. It is the expected increase in the VAT, leading to higher prices of foods and some other goods and services. The expected rise was partially incorporated into the prices already before the effectiveness of the law in January 2008, and thus influenced the retail sales of foods already at the end of 2007.

Altogether, foods sales growth amounted for 2.8 %, y/y, only, with a stagnation of sales in November and decline in December, caused by the increasing prices. On the other hand, the main driving force behind the retail sales growth were the non-food goods sales, with a year-over-year growth reaching to 9.7 %. In this segment, households' equipment, and clothing and footwear were increasing the most rapidly (14.5 % and

Figure 6: Completed Dwellings (in thousands)



Source: Czech Statistical Office

Strong domestic demand contributed to the acceleration of retail sales growth in 2007. Retail sales grew by 7.7 %, y/y, i.e. 1.2 percentage points more than in 2006. This was a record high growth since 1997.

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15.7 %, y/y, respectively). There was also a significant increase of sales registered by mail order houses (15.6 %, y/y), suggesting a growing importance of consumers' preferences shift towards e-shopping.

The dynamics of sales in the automotive segment was even higher than in the retail trade sector; it reached 9.6 %, y/y. The main driver of this growth was sale, repair and maintenance of motor vehicles (increased by 12.4 %, y/y). On the other hand, the contribution of the sale of automotive fuels remains rather low (rose by 4.9 %, y/y), partly also because of the high prices (there was an increasing trend in the automotive fuels prices throughout the year 2007).

The slowdown in retail sales growth registered in the end of 2007 has continued in the beginning of 2008, too. In January 2008, retail sales rose by 4 %, y/y only, mainly as an effect of increasing price level. Food sales continued in declining (-2.3 %, y/y) and slower growth pace was registered in non-food consumer goods and automotive segment, too. The growth dynamics was partially recovered in February (amounted to 6.3 %, y/y). There was registered a raise in sales of foods, despite the substantial price increase. Also, other segments of retail trade recorded an acceleration compared to January. However, the dynamics was lower compared to 2007. This development foresees the expected slowdown of retail sales in the whole year 2008, influenced by rising inflation and tightening of the monetary policy.

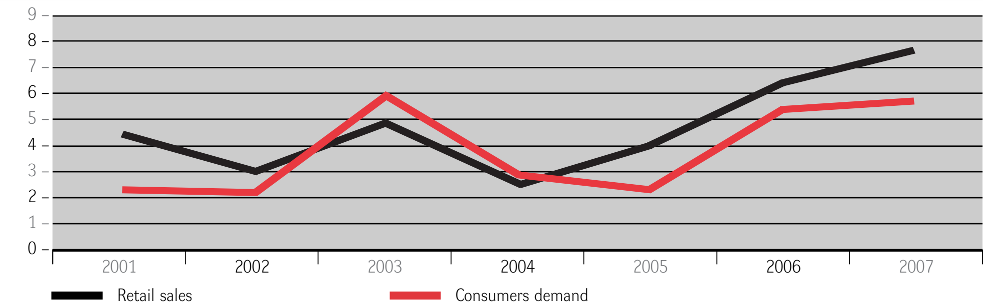
The segment of trade services also registered an unusually rapid growth in 2007 – the volume of sales increased by 5.8 %, which is 3.8 percentage points more than in 2006 and a record high value since 1997. The highest pace of growth was connected to the fields supporting the growth in other segments of the economy. This concerns mainly the labour recruitment and provision of personnel which was supplying work force to the expanding economy, and architectural and engineering activities which were related to the rise of construction and industrial output. However, a slow-down can be expected in this segment, too, as a result of the overall slowdown of the economic growth.

5. INFLATION

5.1 Consumer Prices

Inflation continued to be low in the first quarter of 2007. Although in January 2007

Figure 7: Retail Sales and Consumer Demand, (growth rates in %, y/y)



Source: Czech Statistical Office

Figure 8: Retail Sales – Total Sales, Consumer Goods, Foods, Cars, 2003–2007, (growth rates in %, y/y)

Source: Czech Statistical Office

The dynamics of sales in the automotive segment was even higher than in the retail trade sector; the main driver of this growth was sale, repair and maintenance of motor vehicles.

Table 4: CPI Inflation, Q1/2007 – Q1/2008 (in %, e.o.p.)

Q1/2007	Q2/2007	Q3/2007	Q4/2007	Q1/2008
1.9	2.5	2.8	5.4	7.1

Source: Czech Statistical Office

Table 5: PPI Inflation, Q1/2007 – Q1/2008 (in %, e.o.p.)

Q1/2007	Q2/2007	Q3/2007	Q4/2007	Q1/2008
3.6	4.6	4.0	5.3	5.3

Source: Czech Statistical Office

some regulated prices were increased, as well as some consumption taxes, the y/y inflation at the end of Q/1 was only 1.9 %. But from the spring 2007, inflation started to accelerate, and at the end of 2007, it reached 5.3 %. There were several factors behind this move:

- strong economic activity driven by domestic demand, shortage of skilled labour accompanied by rising wage pressures resulted in strong growth of retail sales (cf. above). As a consequence, demand inflationary pressures emerged;
- the pass-through from high raw materials, fuel and energy prices took place;
- global increase in food prices due to increasing world demand affected the domestic food prices that registered an upturn after two years of moderate growth.

At the beginning of 2008, the shift of VAT on some prices (food, services, energy, etc.) from 5 % to 9 % and introduction of regulation fees for health services pushed CPI to 7.1 % at the end of the first quarter of 2008. Moreover, inflation expectations of households increased; this fact could endanger the plan of the Czech National Bank to shift (from 2010) the medium-term inflation target from 3 % (± 1 %) to 2 % (± 1 %).

5.2. Producer Prices

After a sharp fall of producer prices in 2005, the first quarter of 2006 brought their stagnation – and, in the rest of 2006, producer price inflation increased. This increase of producer prices continued in 2007 and in the first quarter of 2008 (see Table 5).

The factors behind the growth of producer prices are following:

- oil prices grew from the level of 60 USD per barrel to (or even over) 100 USD per barrel;
- rapid economic growth in China, India and some other countries keeps the demand high for metals and metal products, with resulting high prices;
- high grain prices push the prices of food products up;
- CZK appreciation against the dollar could only partially compensate for the increase of prices of imported oil, raw materials and food products.

6. MONETARY POLICY AND EXCHANGE RATE

In the first quarter of 2007, appreciation of Czech koruna against both the euro and the dollar stopped. The reason can be seen in the prevailing markets sentiment toward most currencies in the region, rather than in fundamentals of the Czech economy (strong economic growth continued, inflation was under market expectations, trade balance was further improving) – or in political reasons (Czech Republic, at last, had government approved by the

Table 6: Exchange Rates, Q1/2007 – Q1/2008 (monthly averages, e.o.p.)

	Q1/2007	Q2/2007	Q3/2007	Q4/2007	Q1/2008
CZK/EUR	28.65	28.54	27.57	26.30	25.22
CZK/USD	21.19	21.22	19.87	18.042	16.25

Source: Czech National Bank

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Parliament, after more than six months). However, this market sentiment faded away, and since the second half of March 2007, Czech currency started again to appreciate more moderately against the euro, more vigorously against the USD (see Table 6).

The appreciation accelerated in the last quarter of 2007 and in the first quarter of 2008, both against EUR and USD. Again, the appreciation against USD was more robust: it was the combined effect of the independent appreciation of the Czech currency and indirect influence of the appreciation of the euro vis-à-vis the greenback.

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 two-week repo rate at 3.50 %, at the end of 2007. Unexpectedly high inflation at the beginning of 2008, 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 %. Nevertheless, even after these increases, the Czech interest rates remained the lowest among EU 27 countries. At the same time, the differential between ECB and CNB basic interest rates narrowed to 25 basis points and between 3M PRIBOR and 3M EURIBOR to 30 basis points, at the end of March 2008.

Till the end of the first half of 2007, the 3M PRIBOR was at a low level, 130 basis points under the 3M EURIBOR. From June 2007, market rates started to grow, following hikes of the 2W repo rate (see Table 7). The rise of 3M EURIBOR stopped in the last quarter of 2007.

Strong competition among Czech banks keeps market interest rates at a low level, despite high inflation. If CNB will keep repo rate unchanged, this situation will continue, at least for the near future.

7. LABOUR MARKET

The high growth of the Czech economy was reflected in the ongoing improvements of the labour market performance indicators in 2007. This trend developed further during the start of 2008, with the start of seasonal works. Still, there remain significant obstacles to the efficient functioning of the Czech labour market, represented mainly by the inappropriate institutional framework.

The unemployment rate had a decreasing tendency throughout the whole year 2007 and reached 6 % in December, which represents a decrease of 1.7 percentage points compared to the same period in 2006. Absolute number of unemployed at the end of the year declined to 355 thousands, about 80 % of previous year's level. The rate of unemployment decreased further to 5.6 % in March 2008. Despite this positive development, significant disparities remain in the structure of unemployed. Disabled make up almost 20 % of total number of unemployed, which is more than proportional to their share in the labour force. Also women amount for more than one half of total number of unemployed and given their lower labour force participation, female unemployment rate is more than 2 percentage points higher then male (6.9 % female, 4.6 % male).

There was a significant improvement in the long-term unemployment in 2007. After previous years of gradual increases, the share of long-term unemployed significantly decreased bellow one half (amounted for 48.6 % of the total unemployed in 4Q, compared to 54.5 % in 2006). Still, relatively high level of long-term unemployment remains an important negative phenomenon of the Czech labour market compared to other European countries. Also, there persist significant differences among the educational and age groups. The highest share of long-term unemployed is typical for the least educated and the least qualified workers (65 % in the case of basic education) and also older people. These are

Table 7: 3M PRIBOR, Q1/2007 – Q1/2008 (monthly averages, e.o.p.)

Q1/2007	Q2/2007	Q3/2007	Q4/2007	Q1/2008
2.56	2.93	3.46	4.05	4.04

Source: Czech National Bank

The appreciation of Czech koruna accelerated in the last quarter of 2007 and in the first quarter of 2008, both against EUR and USD. Again, the appreciation against USD was more robust: it was the combined effect of the independent appreciation of the Czech currency and indirect influence of the appreciation of the euro vis-à-vis the greenback.

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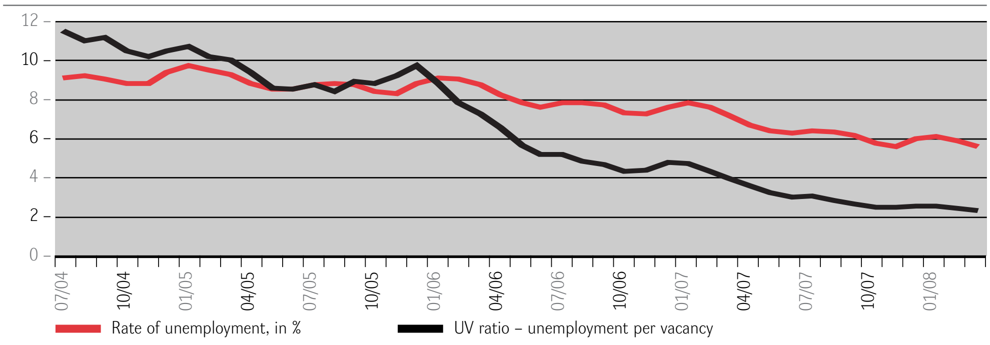
After previous years of gradual increases, the share of long-term unemployed significantly decreased bellow one half. Still, relatively high level of long-term unemployment remains an important negative phenomenon of the Czech labour market.

Figure 9: Rate of unemployment and the UV ratio



Source: Ministry of Labour and Social Affairs

also the groups facing the highest rates of unemployment.

The strong economic activity promoted also the supply of vacancies; it was record high in the Czech history in 2007. In December, there were 141 thousands vacancies, and the number of unemployed per vacancy (the UV ratio) fell to 2.5. In March 2008, the number of supplied vacancies exceeded the 150 thousands bar, resulting in the UV ratio 2.2. However, there is still a significant regional mismatch in the supply of labour and vacancies – there are regions, where the number of vacancies exceeded the number of unemployed, on the other hand, in some regions the UV ratio still amounted for double-digit levels.

Along with declining unemployment, employment was continuously growing throughout the whole year. The average employment rate amounted for 66.1 % in the age groups 15-64, which represents an increase of 0.8 percentage points compared to 2006. Despite favourable developments in the fields of employment and unemployment, labour force participation of 15-64 year-old has been gradually decreasing and for the first time in the Czech history it declined bellow 70 % (the average in 2007 was 69.8 %). Shrinking labour capacity may impair the future growth prospects of the whole economy.

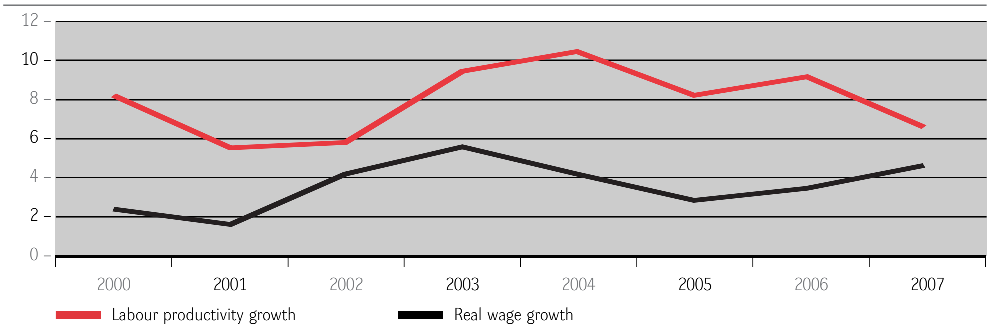
Relative competitiveness of the Czech economy might also be weakened by the trends in the real wage and labour productivity developments. Average nominal wage in the economy increased by 7.3 % to 21 692 CZK in 2007, which represents the real growth of 4.4 %. Average real wage growth in the industry reached 4.5 %, whereas labour productivity in the industry increased by 6.6 % (slow down from 9.2 % in 2006). The gap between the productivity and wage growth is thus declining. This worsens the relative labour cost advantage of the Czech economy (the appreciation of the Czech crown being another negative factor here).

On the other hand, changes in the minimum wage tariffs affected the competitiveness in the opposite direction. Minimum wage was raised only by 3 % in 2007 (compared to 8 % in 2006) and there has been no further growth in 2008. This has stopped the long-term trend of increasing the ratio of the minimum wage to the average wage and thus contributed to improvement of firms' incentives for employment of the least qualified, low-wage workers.

The strong economic activity promoted also the supply of vacancies; it was record high in the Czech history in 2007.

Despite favourable developments in the fields of employment and unemployment, labour force participation of 15-64 year-old has been gradually decreasing and for the first time in the Czech history it declined bellow 70 %. Shrinking labour capacity may impair the future growth prospects of the whole economy.

Figure 10: Labour productivity and real wage growth in industry (%)



Source: Czech Statistical Office

Table 8 : The Ratio of the Minimum Wage and the Average Wage, in %

1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
23.4	22.7	28.4	33.4	34.1	36.3	36.6	37.1	37.8	38.4	36.9

Source: Ministry of Labour and Social Affairs, Czech Statistical office

It is mainly the recent cyclical economic upswing that affected the favourable developments of the Czech labour market in the latest years. However, still there remain many challenges, mainly for improving the labour force participation and long-term unemployment. These are in particular the qualification structure of the labour force and the inappropriate institutional framework resulting in the low flexibility of the Czech labour market. The main unfavourable features involve: high tax wedge on wages (in particular for low-income groups), lack of motivation to work for the low-income groups caused by the relatively generous social system, increasing ratio of the minimum wage to the average wage, restrictive employment protection legislation (mainly the high costs on dismissing employees with permanent contract), low regional mobility, and inadequate regulations of temporary work and part-time employment. Part-time employment is very low in the Czech Republic and accounted only for 4.4 % of the total employment in the second quarter of 2007, while the EU-27 average reached 17.7 % and EU-15 even 20.4 %. There exists a scope for labour force participation growth in increasing the part-time employment.

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