

# CZECH ECONOMY IN 2001: CATCHING UP AGAIN?

## 1. Summary and Conclusions

In 2000, the revival of economic growth, observable since the second half of 1999, accelerated. While in 1999, the upturn of Czech economy was driven mainly by exports, in 2000 the gross capital formation and private consumption have taken over the role of main pro-growth factors. Faster growth in the European Union first helped to revive demand for Czech industrial goods; the resulting growth of Czech industry, with some delay, boosted domestic investment demand as well (see Table 1).

**Table 1: Main Macroeconomic Indicators**

		1995	1996	1997	1998	1999	2000	2001f
<b>GDP growth</b>	%, real	5.9	4.8	-1.0	-2.2	-0.2	<b>2.7</b>	<b>3.5</b>
<b>Industrial sales</b>	%, real	9.2	6.8	6.1	0.6	-0.5	8.4	<b>7.0</b>
<b>Industrial production</b>	%, real	n.a.	2.0	4.5	1.6	-3.1	5.8	<b>5.0</b>
<b>Construction output</b>	%, real	8.5	4.8	-3.9	-7.0	-6.5	5.6	<b>7.0</b>
<b>Retail sales</b>	%, real	4.8	11.4	1.9	-7.2	2.1	4.6	<b>4.5</b>
<b>Inflation</b>	%, average	9.1	8.8	8.5	10.7	2.1	3.9	<b>4.3</b>
<b>Inflation</b>	%, e.o.p.	7.9	8.6	10.0	6.8	2.5	4.0	<b>4.0</b>
<b>Net inflation*</b>	%, e.o.p.	7.3	6.6	6.8	1.7	1.5	3.0	<b>3.0</b>
<b>Industrial producer prices</b>	%, e.o.p.	7.2	4.4	5.7	2.2	3.4	5.0	<b>4.5</b>
<b>Nominal wages</b>	%, average	18.5	18.4	10.5	9.3	8.2	<b>6.0</b>	<b>8.0</b>
<b>Unemployment rate</b>	%, e.o.p.	2.9	3.5	5.2	7.5	9.4	8.8	<b>7.5</b>
<b>Exports</b>	%, nom.	23.5	6.6	20.0	17.7	9.2	23.3	<b>17.0</b>
<b>Imports</b>	%, nom.	33.7	13.0	15.3	7.5	7.5	28.2	<b>16.5</b>
<b>Trade balance</b>	CZK bill.	-105.9	-155.8	-151.2	-76.3	-69.9	-126.8	<b>-140.0</b>
<b>Current account</b>	USD bill.	-1.4	-4.3	-3.2	-1.0	-1.1	<b>-2.0</b>	<b>-2.4</b>
<b>Current account</b>	% of GDP	-2.6	-7.4	-6.1	-1.9	-2.0	<b>-4.2</b>	<b>-4.4</b>
<b>Financial account</b>	USD bill.	8.2	4.3	1.1	2.6	2.5	<b>2.0</b>	<b>2.4</b>
<b>Financial account</b>	% of GDP	16.5	7.4	2.1	4.8	4.7	<b>4.2</b>	<b>4.0</b>
<b>State budget</b>	% of GDP	0.5	-0.1	-1.0	-1.6	-1.6	<b>-2.4</b>	<b>-2.2</b>
<b>Gross foreign debt</b>	USD bill.	17.2	21.2	21.6	24.3	22.9	<b>20.0</b>	<b>20.0</b>
<b>Official FOREX reserves</b>	USD bill.	14.0	12.4	9.8	12.6	12.9	12.9	<b>14.0</b>
<b>M2 growth</b>	%, e.o.p.	19.8	9.2	10.1	5.2	8.1	<b>7.2</b>	<b>8.0</b>
<b>PRIBOR 3M</b>	%, average	10.95	12.02	16.00	14.33	6.85	5.4	<b>5.7</b>
<b>CZK/EUR**</b>	average	36.22	35.32	35.75	35.85	36.88	35.6	<b>35.5</b>
<b>CZK/USD</b>	average	26.55	27.14	31.71	32.27	34.60	38.6	<b>37.8</b>

Source: Czech National Bank (CNB), Czech Statistical Office, forecasts by Komerční banka (bold figures)

Note: \*) target indicator of the CNB; consumer price inflation net of administered prices; \*\*) until 1998 the

CZK/DEM exchange rate converted by 1 EUR = 1.95583 DEM; n.a. = not available

\*) till 1996 production of goods, since 1997 industrial sales

\*\*\*) till 1994 according to the old methodology

Gross capital formation was the main pro-growth factor in 2000. Restored growth of fixed capital investment (growth by 5.9 % during the first three quarters of 2000) was predominantly oriented on investment in machines and technological equipment. Since the third quarter, also building investment has revived, and as data for construction output for the second half of 2000 show, demand for building investments kept increasing over the rest of the year

GDP grew by 2.8 % in January-September 2000. Economic growth is thus more rapid than generally expected at the beginning of the year. Moreover, the economic recovery has been based on solid fundamental background of an economy which has been undergoing rapid restructuring.

Czech industry has been witnessing great progress in 2000. Rapid growth (5.8 %, January to November 2000) has been accompanied by ongoing restructuring. Continuing restructuring led to a significant productivity increase outpacing the growth of real wages four times, January to November 2000. This explains why Czech exporters succeed to compete on demanding foreign markets even under strong exchange rate of CZK. While the recovery in industry was supported by revival of machinery investments, demand for building investments, as mentioned, recovered with some delay.

The time lag of construction growth against GDP growth followed from the fact that the main sources of economic upturn rested in external demand and in foreign direct investment. Growth of fixed capital investment so far has been reflected mainly in the performance of large construction firms. Housing construction, being predominantly the field of smaller firms, on the other hand is decreasing.

A moderate speedup was observed in another part of domestic demand - that of household consumption. It grew by 2 % in the third quarter of 2000, and by 1.8 over the first three quarters of the same year. Household consumption was partly financed by a decrease of the savings rate (y/o/y decrease by 2 percentage points to 9.3 %). Households perceive the improvement of economic climate and use an increased volume of consumer credit. Household consumption thus supports economic growth. A slow growth of disposable real incomes is accompanied by a decreasing propensity to save, and increasing propensity to consume.

Optimism of households was partly caused by the development of unemployment: due to overall economic recovery and the massive inflow of foreign direct investments, rate of unemployment reached 8.8 % at the end of 2000, declining by 0.7 percentage points against the end of 1999. Acceleration of domestic demand helped to create new jobs. Number of vacancies reached 52.5 thousand in December 2000, which was a year-on-year growth of 40 %. At the same time, the growing economy started to absorb new labour: the number of job-seekers declined by 24 thousand against the end of 1999.

Growing openness of the Czech economy has increased the vulnerability of some macroeconomic parameters to external factors. Acceleration of inflation in 2000 (CPI inflation 4 % at the end of year) was caused not by domestic economic recovery but mostly by the world oil price hike. Despite this fact the growth of net inflation was 3.0 %, which again represented an undershooting of the Czech National Bank inflation target.

Although foreign demand was strong during the whole 2000 (exports grew by 23.3 %), the trade deficit reached almost CZK 127 bill. (and increase of 56.9 bill. against 1999). The imports increased even more rapidly (by 28.2 %)

especially due to world oil price hike. Major part of the trade deficit growth (more than three fifths) was caused by the growth of raw materials and fuel import prices, the rest was caused by increasing domestic demand. While the economy continues to grow, domestic supply has not been able to cope with the growing demand completely. This is most profound in the area of modern machinery and technologies, that must be imported from developed market economies.

### ***Outlook***

Factors that influenced GDP in the second half of 2000 will be in play in a longer perspective, too. A continuing dynamic growth of fixed capital investment can be expected, with foreign direct investment again representing the main part. The growth rate of private household consumption will be around 2 %. We do not expect any significant worsening of the business climate in European Union countries (a factor which could have a negative impact on Czech exports). As oil and some other commodity prices will calm down, and perhaps decrease slightly, the Terms of Trade will improve. We expect HDP growth in 2001 to reach roughly 3.5 % (after an expected growth of 2.6-2.8 % in 2000).

Industrial output will increase by 5 % in 2001 and we forecast a construction output growth of 7 %. We expect the same growth rate of inflation in 2001 as in 2000 (headline inflation 4,0 %, net inflation 3 %). Accelerating economic growth will affect the labour market favourably as well: unemployment rate will continue to decline under the eight percent level, reaching 7,5 % at the end of 2001.

Positive results of continued restructuring - which speeded up in the years of economic recession - allow a conclusion that economic revival can proceed without any strong internal disequilibrium tendencies. A different situation is with regard to the external disequilibrium. Disquieting is especially the fact that the economy generated trade deficits even in the period of deepest recession. A small open economy is prone to suck in imports whenever economic growth accelerates. A contributing factor is the high import intensity of Czech exports. This type of an economy is, moreover, highly sensitive to changes in the external environment such as in external demand, commodity prices, situation in financial markets, etc. Therefore we expect that the trade deficit will amount to CZK 140 bill. and the current account deficit will be about 4.4 % of GDP at the end of the year.

The inflow of foreign direct investment will continue in 2001 and can exceed USD 5 bill. We expect the average exchange rate of CZK to be at 35.5 CZK/EUR and at 37.8 CZK/USD.

## **2. External Environment**

Trends in the external environment - especially in the European Union context - have a strong impact on the Czech economy and its growth prospects. The combined visible exports and imports represent roughly 150 % of GDP. The share of European Union on Czech exports exceeds 70 %.

The forecasts of international institutions and independent analysts mostly predict a slight slowdown of global economic growth over 2001. In the U.S.,

the predicted slowdown is particularly pronounced. An acceleration of global growth is however expected in the second half of 2001 and in 2002. The expansion of world trade is set to decline in 2001 as well (see Table 2).

**Table 2: GDP Growth (% , y/y)**

	<b>2000</b>	<b>2001</b>	<b>2002</b>
<b>U.S.</b>	<b>5.1</b>	<b>2.8</b>	<b>3.8</b>
<b>Euro-zone</b>	<b>3.4</b>	<b>2.9</b>	<b>3.2</b>
<b>Japan</b>	<b>1.9</b>	<b>1.4</b>	<b>2.0</b>
<b>Central- and Eastern Europe</b>	<b>5.2</b>	<b>3.7</b>	<b>4.5</b>
<b>World</b>	<b>4.2</b>	<b>3.8</b>	<b>3.4</b>
<b>World Trade</b>	<b>11.0</b>	<b>7.0</b>	<b>8.0</b>

*Source: ABN-AMRO, Deutsche Bank Research, Komeční banka*

Table 2 shows that after a boom year in 2000 the world economy is expected to show a slightly weaker expansion in the next two years. The economy in Western Europe will also continue to slow in the first half of 2001, but less so than in the U.S., as macroeconomic imbalances are not so significant. Emerging economies will follow the cycle of the developed economies. Central and Eastern Europe will benefit somewhat from the relatively strong performance of the Euro-zone economy, and the anticipation of entry into the E.U., which supports investment imports and low inflation.

With high probability, the oil price will decline in 2001 to an average around USD 26/bbl, which is inside the OPEC target corridor. The probability of another oil price hike is relatively low, not exceeding 20 %. Prices for other

commodities, especially metals, are likely to recover on the back of continuing global growth.

Weaker economic growth and easing inflationary pressures pave the way for rate cuts in 2001. These cuts will probably be higher in the U.S. than in Europe: the real interest rates are lower in the Euro-zone, therefore the ECB is likely to cut rates only slightly and not in the first quarter of the year. The better growth performance in the European Union will lead to a further appreciation of the euro against the dollar.

Contrary to some opinions expressed, we are of the opinion that the significant slowdown of economic growth in the U.S. will have only limited impact on the European economy. The exports from the Euro-zone to the United States are less than 3 % of Euro-zone GDP, which limits the effect of U.S. cycle on Europe. Much more pronounced effects of U.S. slowdown are to be expected in Japan and in south-east Asian countries.

On the whole, the prospects of the world, and especially of the European Union economy, form a moderately favourable framework for Czech economic growth. According to forecasts, exports will remain the dynamic component of demand in the Euro-land, giving the Czech exporters the opportunity to take part in these dynamics. Exports Euro-land will grow by almost 10 % in 2001, surpassing growth in world trade (see Table 2). On the import side, the Czech economy will probably profit from the oil price remaining within reasonable limits, and from the weakening of the USD against the CZK. Another positive factor is the decreasing inflation in the Euro-land, with a favourable effect on prices of imported technologies.

After four years, the Czech economy can expect a year of catch-up in growth with European Union countries (though partly due to their slowdown). This can nevertheless bring a problem of sustainability of Czech GDP growth from the perspective of trade and current account balance, as discussed below.

### 3. External Balance

Even though the surplus on the financial account surpassed the current account deficit for Q1 – Q3, 2000, signs of deterioration have been visible as of second quarter on. After ten successful quarters, balance of payments ended in the red, in the third quarter of 2000. Nevertheless, foreign reserves showed the increase of USD 0.6 bill, January – September 2000.

**Table3: Balance of Payments (CZK bill.)**

	H1 1999	Q1-3 1999	Q1-4 1999	H1 2000	Q1-3 2000	Q1-4 2000f
<b>Current account</b>	-11.6	-12.2	-36.6		-47.0	-85.0
<b>o.w. Foreign trade</b>	-19.9	-29.0	-71.3	-43.4	-76.8	-127.0
<b>Balance of services</b>	12.4	26.3	42.5	19.5	32.5	45.0
<b>Balance of incomes</b>	-13.6	-23.4	-25.6	-9.9	-12.6	-15.0
<b>Transfers</b>	9.4	13.7	17.7	6.6	9.8	12.0
<b>Capital account</b>	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
<b>Financial account</b>	14.6	32.2	85.9	51.6	59.4	80.0
<b>o.w. Direct investments</b>	46.6	118.2	169.9	74.9	108.5	150.0
<b>Portfolio invest.</b>	8.5	9.1	-48.3	-24.4	-44.2	-
<b>Long-term capital</b>	4.8	4.8	-11.0	33.0	22.6	-
<b>Short-term capital</b>	-45.2	-100.0	-24.8	-29.5	-26.7	-

*Source: Czech National Bank*

#### 3.1 Current Account

Deterioration of the current account deepened during 2000. The deficit in the third quarter was the highest in 2000, totalling almost the same amount as the deficit in the first half of 2000. As usually, trade with goods was the main factor affecting developments on the current account.

### ***Trade with Goods***

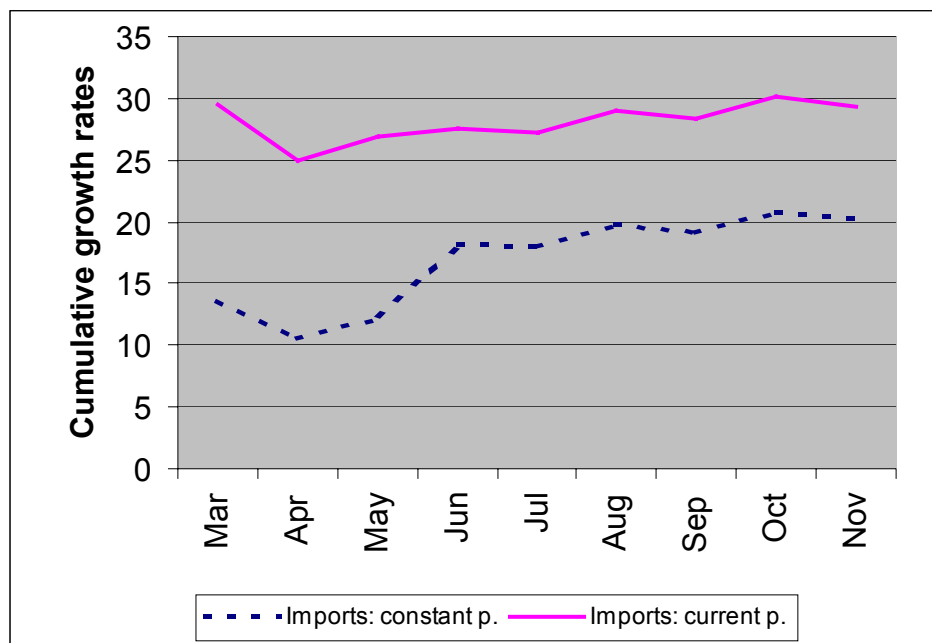
The trade deficit in 2000 amounted to CZK 126.8 bill., which means an increase of CZK 57 bill. against 1999. In the beginning of 2000, the most pessimistic expectations did not exceed CZK 90 bill. Results of foreign trade with goods were affected by several factors performing in both directions. Some of these factors were expected: economic recovery was speeding up, boosting the imports; moreover, import intensity of rapidly growing exports increased. On the other hand, the oil price hike which hit Czech trade balance notably was hardly predictable at the beginning of 2000.

The exports grew quickly in 2000, due to foreign demand. Growth rate of exports reached 22 %, January – September. Last quarter registered a small speeding-up against second and third quarter, exports growing by 23.3 % in 2000. The exports grew fast in spite of the developments of exchange rate against EUR, appreciating from 36 CZK /EUR in January 2000 to 34.8 CZK/EUR in December 2000. Exports were supported by competitive gains as restructuring boosted labour productivity and helped to keep wage growth moderate. Notable part of these achievements was enabled by new foreign owners.

At the same time, favourable development of exports caused an increase of domestic investment demand. Naturally, part of this demand could not be met by domestic supply, concerning especially new technologies, software and know-how. Czech industry is heavily dependent on raw material imports. Imports of consumption goods grew modestly, whereas imports of raw materials, intermediate goods and investment goods increased sharply. Strong dependence of export-oriented production on imported goods combined with stronger domestic demand and oil price hike resulted in rapid growth of imports.

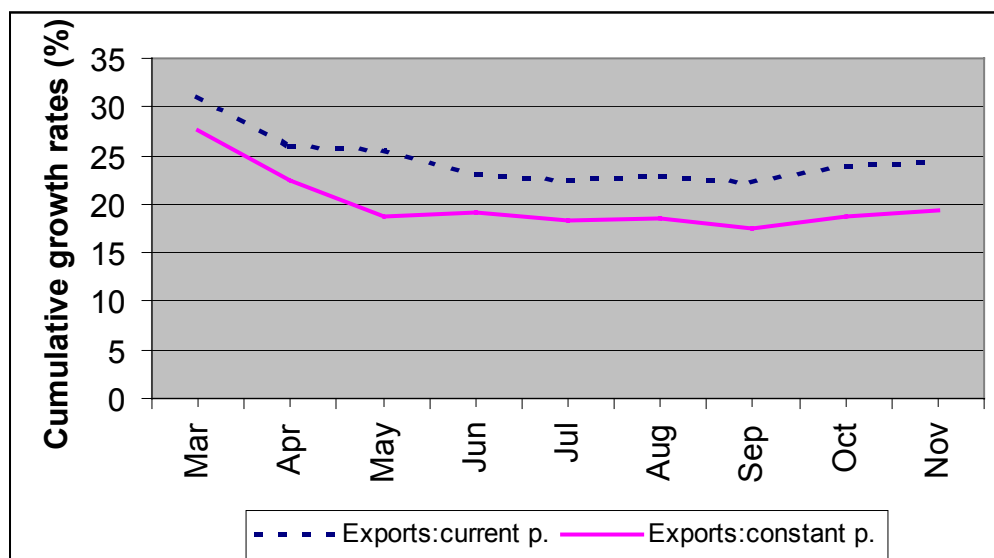
The imports grew more rapidly than exports in 2000, the growth rate of imports reaching 28.2 %. However, volume of imports increased by 20.2 %, only negligibly higher than volume of exports (19.3 %), January – November. The difference between development of growth rates in current prices and constant prices is illustrated in Figures 1 and 2.

**Figure 1: Imports: Real and Nominal Growth**



*Source: Czech Statistical Office*

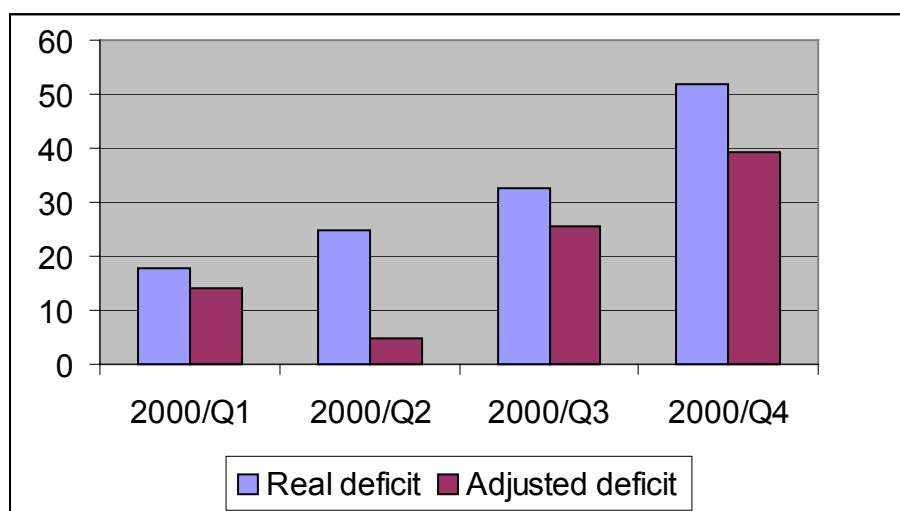
**Figure 2: Exports: Real and Nominal Growth**



*Source: Czech Statistical Office*

The difference between developments of current and constant prices was much more pronounced on the part of imports than that of exports. Terms of trade deteriorated by 3.9 %, January – November 2000, as a result of high world prices of raw materials, predominantly crude oil. Thus, if it had not been for the oil price hike, trade balance would end in a deficit close to prior expectations. Our estimates of the deficit adjusted for the impact of import prices developments shows Figure 3. Both Figures 1 and 3 indicate that the impact of import prices has been diminishing as of third quarter on.

**Figure 3: Real and Adjusted Trade Deficit (CZK bill.)**



*Source : Czech Statistical Office*

The increase of trade deficit was thus primarily a result of high oil prices, this factor accounting for almost 90 % of the yearly increase in trade deficit in the first half of 2000. The impact of continuing economic recovery has been gaining on importance since then. At the end of 2000, the impact of high oil prices accounts for roughly 70 % of the yearly increase of the trade deficit. This corresponds well with the shifts in the factors of economic growth: while foreign demand (and net exports) were the main pro-growth factor until second quarter of 2000, strong economic demand has been most important for the economic growth in second half of 2000.

### ***Services, Incomes, Transfers***

Trade with services was able to compensate for about 40 % of the trade with goods deficit. The surplus of services increased by 25 % year-on-year, January – September 2000. However, in the third quarter the surplus of the services stagnated. Both incomes and expenditures stagnated in the area of transport in the first three quarters of 2000. Tourism performed quite well: while incomes increased by more than CZK 4 bill., expenditures decreased by approximately the same amount, year-on-year. Some receipts due to IMF-

IBRD meetings can be expected to fall into last quarter results. Payments for other services (advertisement, legal, insurance, financial etc.) registered another jump (from CZK 30 bill. to CZK 47 bill.) in the third quarter of 2000. At the same time, other services receipts increased by 50 %, in the same period.

Improving prospects offers balance of incomes, an upturn coming in the second quarter of 2000. While in the first quarter of 2000 the deficit increased by 22 % year – on- year, it declined by 27 % in the first half of 2000 and by 46 %, January to September 2000. This item represents a sort of connection between current and financial account. While it had been quickly deteriorating during the period of massive inflow of other investments to Czech Republic, it has been slowly recovering since 1998.

Financial account in 2000 shows moderate inflow of long-term capital and an outflow of short-term other investments which resulted in a yearly stagnation of payments. On the other hand, receipts increased by more than 25 % year-on-year, January to September 2000 due to growing activities of Czech banks abroad.

## **3.2 Financial Account**

### ***Direct Investments***

Again, foreign direct investments were most important part of the capital inflow amounting to CZK 108.5 bill., January – September 2000. About 60 % of these investments were oriented to services, especially to retail trade. The rest were FDI to manufacturing industry, predominantly toward automotive manufacturing. According different surveys, foreign-owned firms perform better than those with only domestic owners. Exports have been growing fastest among foreign-owned companies.

### ***Portfolio investments***

The net outflow of portfolio investments increased during the third quarter of 2000 by another CZK 20 bill., net outflow amounting to CZK 44.2 bill., January – September. In the third quarter of 2000, foreign investors were not very keen to buy Czech equities, portfolio equity investments inflow amounting to CZK 17.8 bill., January to September. Moreover, this was more than offset by accelerated portfolio equity investment abroad, which rose to CZK 40 bill. in the same period. Residents sought to diversify into foreign shares and avoid low returns on domestic markets. Portfolio equity investments registered more than CZK 20 bill. net outflow, compared with a moderate net outflow of CZK 2 bill., January – September 1999.

Developments in other investment changed from a year earlier, net outflow amounting to CZK 4 bill., compared to net outflow of CZK 95 bill. in 1999. Other assets totalled CZK 8.5 bill., January –September 2000, compared to outflow of assets in 1999 amounting to CZK 120 bill., when banks lent heavily to foreign investors. Both short-term and long-term borrowing slightly increased.

### ***Long-term capital***

Net inflow of long-term investments totalled CZK 22.4 bill., January – September 2000, which is a decline against first half of 2000 (CZK 33 bill.). A withdrawal of Czech banking assets from abroad stopped during third quarter of 2000. On the other hand, borrowing by companies increased slightly during 2000. In the first half of 2000, net long-term borrowing of companies totalled CZK 25 bill., increasing by another CZK 4 bill. during the third quarter. The banking sector was responsible for net outflow of long-term capital reaching CZK 6 bill. There was visible decrease in deposits held by non-residents that were built-up in 1999 to pay for the acquisition of Czech companies.

### ***Short-term capital***

Short-term capital showed net outflow of CZK 26.7 bill., January to September 2000. Net short-term assets registered outflow of CZK 13 bill., January – September, against outflow of CZK 113 bill. last year. Reflows from Czech banks lendings abroad amounted to CZK 100 bill., January- September. Domestic banks drew down some CZK 27 bill. in assets abroad during March when CNB intervened to ease upward pressures on the koruna. Increased financing costs abroad also encouraged banks to reduce their borrowing in foreign currencies.

Foreign exchange reserves stood at USD 12.0 bill. at the end of December 2000, equivalent to 4.5 months' imports of goods, which is a difference against December 1999. Even though this is nominally the same amount of reserves as at the end of 1999, at that time it represented 5.5 months' imports.

### ***Outlook***

Developments in the trade with goods witness undoubtedly for strengthening of imbalances in the external sector, that are provoked by growing domestic demand. As of second quarter of 2000 on, the factors of economic recovery changed: decisive role of foreign demand and net exports was replaced by domestic investment demand which result in massive imports of machinery and technologies.

However, the possibility of economic policy to cope with rapidly increasing imports are very limited, the channel for financing imports not going through domestic monetary policy. Development on financial account shows that some Czech imports are financed from abroad, while Czech banks either place their money abroad and/or lend money to foreign investors. Most of Czech heavily importing companies use own finances for financing imports due to improving financial conditions.

Permanently high level of foreign direct investments somewhat eases adverse assessment of rapidly increasing current account deficit. Even though this deficit has been predominantly a result of imports of machinery and technologies and its financing seems to be more than covered by foreign direct investments inflow, level of the deficit should not exceed generally accepted limits. International financial markets do not tolerate deficits of any kind to surpass these levels: the 1997 lesson should not be forgotten.

In 2000, the current account deficit will reach approximately 3.5 % of GDP. Providing no external shocks similar to 2000 oil price hike, both trade balance and current account deficits should stabilise in 2001 reaching approximately the same levels like in 2000. Nevertheless, in mid-term horizon, the external imbalance could emerge as a threat, again.

#### **4. Gross Domestic Product**

While in the second half of 1999, the upturn of Czech economy was driven mainly by exports, in 2000 the gross capital formation and private consumption have taken over the role of main pro-growth factors (see Table 4). Faster growth in the European Union first helped to revive demand for Czech

industrial goods; the resulting growth of Czech industry, with some delay, boosted domestic investment demand as well.

Foreign direct investment played a substantial part in the recovery of Czech industry. In the Czech economy, the transmission mechanism redistributing financial means from the banking sector into the business sphere does not yet function normally. Hence foreign investment plays a key role in boosting investment activity. There is a big difference against the years 1994-1996 when foreign capital also used to play a key role in post-transformation revival of the Czech economy. Then, it was mainly debt capital (long-term credits for Czech firms from abroad), while now the inflow is mainly in direct foreign investment, i.e. capital which stays in the country over a longer run. Moreover, foreign owners are speeding up restructuring of their firms, so that the present economic growth builds on a much more solid base than in mid-1990s.

Restored growth of fixed capital investment (growth by 5.9 % during the first three quarters of 2000) is predominantly oriented on investment in machines and technological equipment. Since the third quarter, also investment in constructions has revived, and as data for construction output for the second half of 2000 show, demand for building investments kept increasing over the rest of the year.

The time lag of construction growth against GDP growth followed from the fact that the main sources of economic upturn rested in external demand and in foreign direct investment. Growth of fixed capital investment so far has been reflected mainly in the performance of large construction firms. Housing construction, being predominantly the field of smaller firms, on the other hand is decreasing. Government intentions to support housing construction and other

infrastructure projects, via extra-budget funds, so far remain unfulfilled; government outlays grew, during the first three quarters of 2000, only marginally (by CZK 0.7 bill.)

As different from 1999 and from the first quarter of 2000, in the rest of the year the deficit of visible trade has been deepening: net trade in goods made a negative contribution to GDP growth. This has been caused partly by trends in world oil prices and in the exchange rate of U.S. dollar, partly by the strong acceleration of fixed capital investment where imported goods form a predominant part. The positive balance in trade with machines and transport equipment turned into a deficit in the third quarter of 2000, and for the whole year, this commodity group showed a deficit of CZK 3.6 bill. (after a surplus of 2.1 bill. in 1999).

A moderate speedup was observed in another part of domestic demand - that of household consumption. It grew by 2 % in the third quarter of 2000, and by 1.8 over the first three quarters of the same year. Household consumption was partly financed by a decrease of the savings rate (y/o/y decrease by 2 percentage points, to 9.3 %). Households perceive the improvement of economic climate and use an increased volume of consumer credit. Household consumption thus supports economic growth. A slow growth of disposable real incomes is accompanied by a decreasing propensity to save, and increasing propensity to consume, as mentioned before. However, this trend has its limits as households will not reduce their savings under a certain level. Hence it cannot be expected that the share of household demand in GDP growth could grow significantly and reach the dimensions seen in the years 1994 to 1996. There are other reasons: wage growth is much more subdued now. Trade unions, in the light of the situation in the labour market, have reduced their excess requirements and are accepting, in wage bargaining, a closer tie between

wage growth and productivity increase, building also on more rational inflation expectations. At the post-transformation stage - in the first half of 1990s - households were equipping with new types of durable consumer goods, and this formed a special demand impulse. In future, household demand will evolve in standard renewal cycles, as expected by economic theory.

**Table 4: Absolute Increases of GDP Factors (CZK bill., constant prices)**

	GDP	Household consumption	Government consumption	Gross Fixed Capital	Net Exports of Goods	Net Exports of Services
<b>1999Q1</b>	-12.6	3.9	0.2	-6.1	-2.7	-5.3
<b>1999Q2</b>	-2.9	2.1	-0.4	-6.7	8.0	-12.7
<b>1999Q3</b>	1.4	-1.3	0.4	-4.8	10.7	-0.3
<b>1999Q4</b>	3.4	0.2	-0.4	-1.9	-2.7	-1.2
<b>2000Q1</b>	14.0	2.7	1.2	1.9	5.6	0.0
<b>2000Q2</b>	7.4	3.4	0.6	5.5	-6.8	4.2
<b>2000Q3</b>	8.2	3.8	-1.1	9.0	-17.5	0.8

*Source: Czech Statistical Office*

Factors that influenced GDP in the second half of 2000 will be in play in a longer perspective, too. A continuing dynamic growth of fixed capital investment can be expected, with foreign direct investment again representing the main part. The growth rate of private household consumption will be around 2 %. We do not expect any significant worsening of the business climate in European Union countries (a factor which could have a negative impact on Czech exports). As oil and some other commodity prices will calm down, and perhaps decrease slightly, the Terms of Trade will improve. We expect HDP growth in 2001 to reach roughly 3.5 % (after an expected growth of 2.6-2.8 % in 2000).

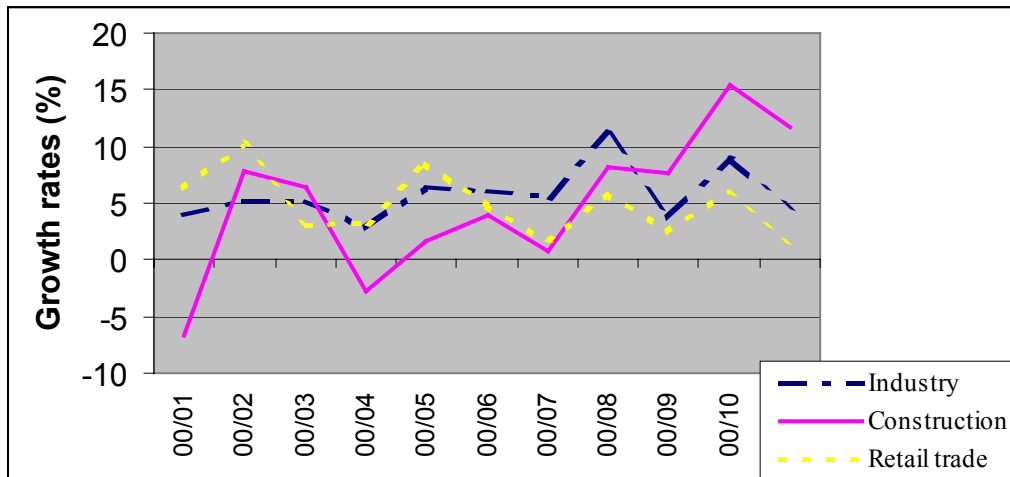
An open problem of economic revival in the Czech Republic is the question if, and to what extent, it will again lead to some economic imbalances. As to potential internal imbalance, trends in the second half of 2000 have eased the fears that increased demand will again face a supply barrier. Positive results of continued restructuring - which speeded up in the years of economic recession - allow a conclusion that economic revival can proceed without any strong internal disequilibrium tendencies.

A different situation is with regard to the external disequilibrium. Disquieting is especially the fact that the economy generated trade deficits even in the period of deepest recession. A small open economy is prone to suck in imports whenever economic growth accelerates. A contributing factor is the high import intensity of Czech exports. This type of an economy is, moreover, highly sensitive to changes in the external environment such as in external demand, commodity prices, situation in financial markets, etc. In the Czech economy this can be demonstrated by trends of the trade and current account deficits during the whole year 2000.

External parameters cannot be influenced by Czech economic policy-makers. The only way to protect the economy at least partly from their negative impacts lies in increasing the stability of the domestic economic system which would support the competitiveness of exported goods and services.

## **5. Industry, Construction and Retail Trade**

**Figure 4: Growth in Industry, Construction and Retail Trade**



*Source: Czech Statistical Office*

### **5.1. Industry**

Industrial production turned from decline to growth at the end of 1999, growth speeding up in the course of the whole 2000. The recovery in industry during 2000 was stronger than expected: at the beginning of 2000, the analysts forecasted 3 % of growth, while the reality doubled the forecast. In 2000, industrial production grew by 6 % year-on-year, while industrial sales increased by 8.5 % year-on-year.

Monthly figures show (see Figure 5) narrowing the gap between growth rates of industrial sales and industrial production in 2000. That is quite obvious; in the beginning of recovery, the companies are selling older stocks and only after experiencing the recovery is a lasting phenomenon, industrial production accelerate.

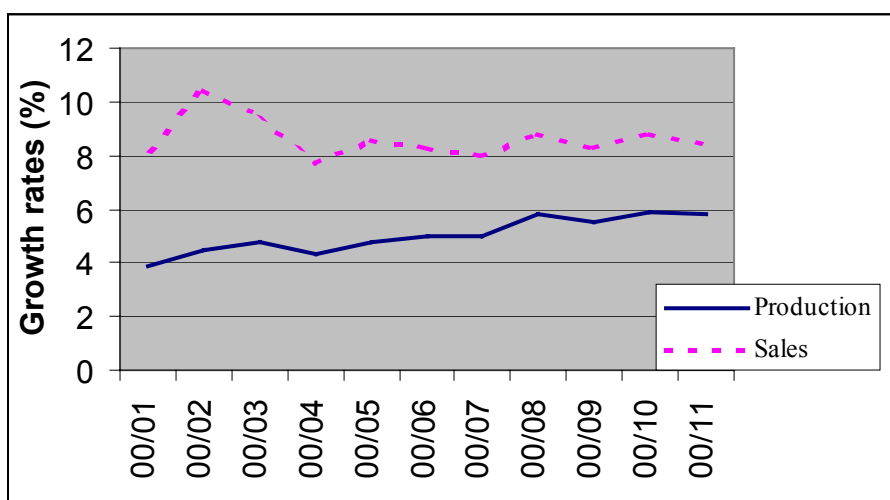
The recovery in industry has been primarily pulled by the exports, where machinery and manufactured goods have been dominating. Strong foreign demand succeeded to recover Czech industry to such an extent that –after eleven quarters- the investment machinery demand increased, in the second

quarter of 2000. Consumer demand was solid in 2000, its growth reaching 2 %, January to September 2000. Combination of these factors led to more rapid growth in industry than expected.

Mining and quarrying grew more rapidly than manufacturing industry, in 2000 (the respective growth rates being x % and y % year-on-year). As for manufacturing industries, production of transport equipment, rubber and plastic industry, wood industry and textile manufacturing were the most successful industries.

According to surveys of Ministry of Industry and Trade, small and medium-sized enterprises gained on importance notably. They account for about 60 % of employment at present, while it was only 10 % in 1992. Similarly, share of small and medium-sized enterprises account for about 40 % of GDP and exports, reaching similar proportions like developed European economies. Private companies under foreign control have been the ones growing most rapidly: their sales grew almost by 20 %, January – October (compared to overall figure of 8.8 %). Better economic conditions in industry were confirmed by increase of profits by more than CZK 30 bill. year-on-year, January to September 2000.

**Figure 5: Growth in Industry: Production and Sales**



Source: Czech Statistical Office

## 5.2. Construction

Recovery in construction lagged behind the revival of industry and retail trade, being visible first in February 2000. Since then, the growth in construction was very fragile and volatile. The picture has changed rapidly as of September, last quarter of 2000 registering rapid growth in construction. While in the first half of the year the growth of construction was the slowest among individual economic sectors, in second half of 2000 it was the highest – see Figure 4.

The above described developments correspond fully with the analysis of the factors of economic growth. While Czech industry had been pulled primarily by foreign demand, recovery in construction had to wait on recovery of domestic demand. Government investments seemed to be helpful for construction in the second half of 2000, as well.

At the same time, recovery in construction is not general, but has been concentrated predominantly to big construction, while small construction is still weak. Recovery of fixed capital investments helped predominantly to big construction companies. Since the construction of new flats does not seem to revive yet, small companies do not register notable improvements. The

difference between conditions of small and big construction will not diminish in the near future. In 2000.

### **5.3. Retail Trade**

Retail trade was the first economic sector registering economic recovery, retail sales beginning to grow as early as in last quarter of 1999. However, recovery was pulled predominantly by private domestic demand. This was a difference against industry and construction which were supported mostly by foreign demand, followed by domestic investment demand.

Retail sales grew by 4 % in 2000 which was speeding up against 1999. In 2000, behaviour of Czech households changed, their propensity to save decreasing due to better economic prospects (recovery of growth, decline in unemployment, increase of vacancies). Moreover, wider offer of consumer credits supported propensity to spend together with booming supermarket chains. All items of retail sales performed well with the only exception of fuels which were hit by oil price hike. As for another services, telecommunications are growing most rapidly, especially due to expansion of mobile –phones.

Sales of fuels registered notable differences in individual monthly growth rates, increasing by 1.3 % in 2000. According to our estimates, the oil price-hike made for approximately 5 % decline in fuels sales growth. Though this did not hamper the overall retail sales growth to considerable extent, a slowdown of about 0.5 percentage points can be attributed to this factor.

### ***Outlook***

We expect that contrary to previous years, construction will be the most rapidly growing industry in 2001. Industrial output will increase by 5 % in 2001 and we forecast a construction output growth of 7 %. No external factor similar to 2000 oil-price hike is probable to hamper retail trade. Moreover, low

statistical base will increase the growth rates of fuels sales, in 2000 which will be helpful for retail trade. Another growth of supermarkets chains will promote retail trade as well, in 2000. We expect that domestic consumer demand will continue to grow and retail sales will increase by 4.5 %, in 2001.

## **6. Inflation**

### ***Recent Developments***

After a very slow inflation in 1999 (average inflation rate was 2.1 %), inflation somewhat speeded in 2000. Developments of inflation in 2000 was conformed with general expectations, which was a difference against 1999. Inflation expectations at the beginning of 2000 varied around 4 % for CPI and 3.5 for PPI. Higher inflation should have been due to faster deregulations in the first half of 2000 in comparison with 1999 and increasing demand resulting from ongoing economic recovery. Lower level of PPI was based on assumption of continuing favourable development of world raw material prices including oil. The reality, however, was different. CPI inflation rate reached 4 % at the end of 2000, while PPI increased by 5 %, year-on-year.

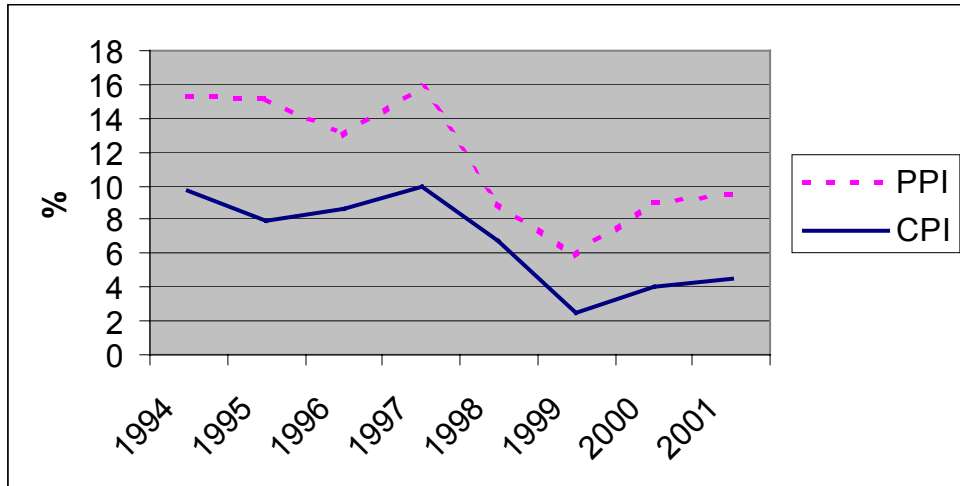
### **6.1 Consumer prices**

Even though the figures went along with expectations, the main factors behind this development differed significantly from those the original forecasts were based on. Economic recovery affected CPI in a very limited extent. Despite higher economic growth against initial assumptions, rapid growth in labour productivity outpacing growth of real wages almost three times protected Czech economy from cost-inflationary pressures. The strengthening of the CZK during 2000 was another anti-inflationary factor. Strong currency increased competitiveness of imports on domestic market and limited the tendency of Czech producers to increase their prices.

The developments of raw materials on world markets was the main factor affecting Czech inflation in 2000 differing strongly from initial assumptions. Main wave of oil shock hit the economy in June and July causing high month-

on-month inflation growth rates. The average yearly price of oil per barrel was by 10 USD higher than initial expectations. These let us to conclude that reality and forecast met only by accident.

**Figure 6: CPI and PPI, 1994 - 2001**



*Source: Czech Statistical Office*

## 6.2 Producer prices

Contrary to consumer prices, producer prices growth exceeded the original expectations by 1.5 percentage points, reaching 5 % year-on-year at the end of 2000. The acceleration of PPI growth was caused by high increase of imported raw material prices. The developments of prices in some industries almost copied developments on oil markets – of course with a time lag of several weeks. According to our analyses, this time lag is close to six weeks.

Unlike in manufacturing, where the growth of PPI did not show significant cost-inflationary pressures, prices in agriculture grew rapidly. However, growth of agricultural prices was rather a consequence of specific cycle in development of agricultural prices than a result of economic recovery.

For Czech agricultural prices is typical that relatively long period of stagnation or decrease is followed by a period of catching-up with the general level of prices in manufacturing. In 1999, we experienced the former period, while in 2000 we passed through the latter. Agriculture in 2000 was thus the only segment showing cost-inflationary pressures, these pressures being however compensated by growing competitiveness between Czech retail traders with foodstuffs.

Czech recovery led to slight increase in prices in construction. Nevertheless, final figure for 2000 (4 %, y-o-y) was lower against that for 1999 (4.8 %, y-o-y) when construction was in deep recession. Anyway, in the longer run, the threat of cost pushed inflation stemming from construction could emerge.

### ***Net inflation***

In 2000, the Czech National Bank again undershot its net inflation target. The range of the net inflation target was 4.5+/-1.0 % for the end of 2000, but net inflation reached 3.0 % year-on-year.

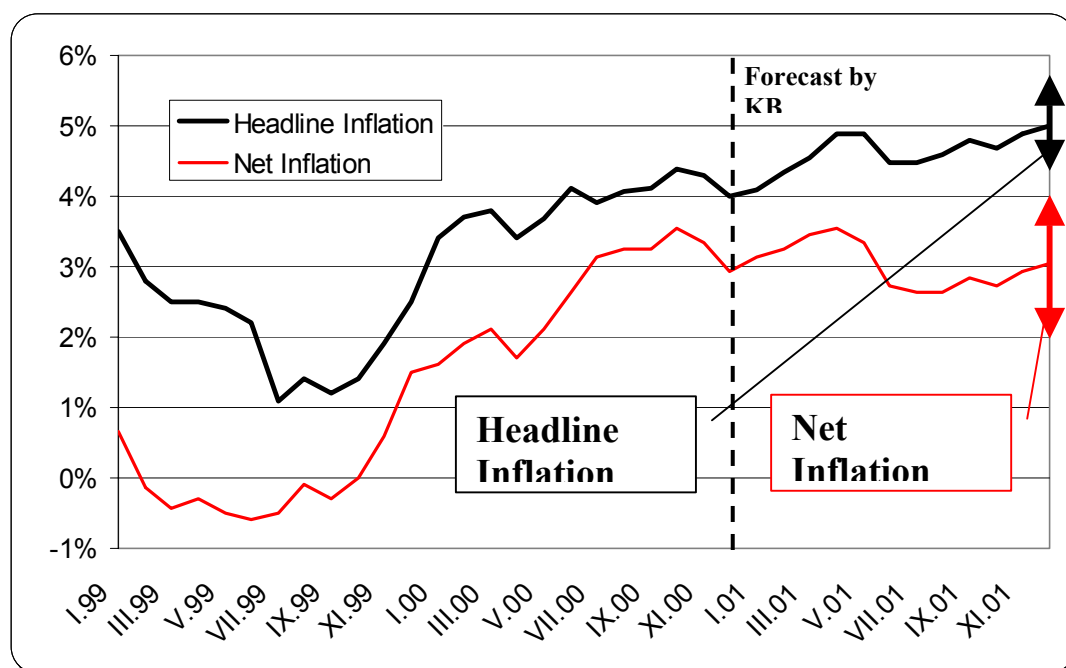
The problem of 2000 is not only the undershot inflation target but also the fact of wrong assumptions of the inflation target. The inflation target for 2000 was build on prognosis of continuing decline of Brent crude oil price from USD 23 per barrel in the first quarter 2000 to USD 19 per barrel in the fourth quarter 2000 (see CNB's Inflation Report, January 2000). In fact, in 2000, the average price of Brent crude oil was USD 28 per barrel, i.e. 30 % more than the CNB forecasted. So, if oil prices developed according to the Central Bank's expectations, the inflation target for December 2000 would have been undershot even more than it was. Based on this experience we consider to be desirable for the Czech National Bank to specify exactly the rules of exemptions.

## **7. Monetary Policy**

The undershot inflation target in 2000 again opened the discussion about the results of CNB monetary policy in 1998-2000. The CNB claimed to perform a neutral monetary policy, resp. modified expansionary monetary policy to back up the economic recovery in the Czech Republic. But we suppose that although in 1999 the Central Bank was several times cutting interest rates to 5.25 % and in 2000 the interest rates stayed stable, monetary policy could not be considered as an expansionary policy. A problem in an assessment of CNB monetary policy consists in the “deadlock” of credit transmission mechanism. The bad quality of credit portfolios in the majority of Czech commercial banks precluded reflecting the interest rate cut into recovery of credit emission. The high share of bad debts, creation of reserves and provisions and new evaluations of collaterals (especially real estate) did not permit commercial banks to increase their amount of new credits.

We expect that in 2001 this situation will change as a result of a deadline for the creation reserves on bad loans in the commercial banks. An increase in new credits is also expected as a result of new auction law, which provides the commercial banks to sell the collaterals for bad loans.

**Figure 7: Headline and Net Inflation**



*Source: Czech National Bank; forecast by Komerční banka*

### **7.1 Inflation Target for 2001**

Net inflation target for the end of 2001 was set as 3+/-1 %. For the first time CNB also published its target in headline inflation: if the Ministry of Finance adheres to the timetable of price deregulation, headline inflation will amount in December 2001 to 4.3-5.8 %. The Czech National Bank has stated that the inflation target had been consulted with the Ministry of Finance. Through the inflation target for 2001 the CNB confirmed that it would endeavour not to accelerate the low inflation in the CR. At the same time it confirmed that the CNB strategy was aiming to long-term net inflation target which had been set in the CNB's "Long-term Monetary Strategy" at 2.0+/-1.0 % in 2005. The "Long-term Monetary Strategy" document also includes a long-term target for headline inflation. It claims that in 2005 net and headline inflation should be almost the same. Given the differences in structure of domestic and foreign

relative prices, the inflation target for 2005 underestimates the problem of real convergence of the Czech economy towards the EU. We are afraid that the 2005 target of 2 % (mid-range) only reflects the expected world prices growth and does not respect the technical innovation and increasing quality of products in the country which is in the process of transformation.

The inflation target for 2001 is a short-term inflation target and for the first time it includes interval with range +/-1 %. Inflation target for 2000 was also set as interval with range +/-1 %, but this target was the medium-term target whereas the short-term targets used to be set in intervals with range +/-0.5 %. The setting of broader interval can be assessed positively, especially due to existing uncertainty of inflation development in 2001 (oil prices, foodstuffs prices and exchange rate development).

As a very positive step in the programme of inflation targeting we evaluate the announcement of headline inflation target. For the general public headline inflation is much more understandable. Now it could be supposed that inflation targeting will realize the main aim: to stabilise inflation expectations of economic agents, in other words, to be a nominal anchor for the economy. Headline inflation targeting is also technically easier to perform because in this broader indicator the weight of volatile items like foodstuffs is lower.

**Table 5: Inflation Targets of Czech National Bank**

	Target of December Net Inflation	Reality of December Net Inflation	Inflation (CPI, average)	Inflation (CPI, end of year)
1998	6.0+/-0.5	1.7	10.7	6.8
1999	4.5+/-0.5	1.5	2.1	2.5
2000	4.5+/-1.0	3.0	3.9	4.0
2001	3.0+/-1.0	3.0 <sup>*)</sup>	4.3 <sup>*)</sup>	4.0 <sup>*)</sup>
2005	2.0+/-1.0	2.3 <sup>*)</sup>	2.4 <sup>*)</sup>	2.5 <sup>*)</sup>

Notice: <sup>\*)</sup> forecast by Komerční banka.

Source: Czech National Bank and Czech Statistical Office

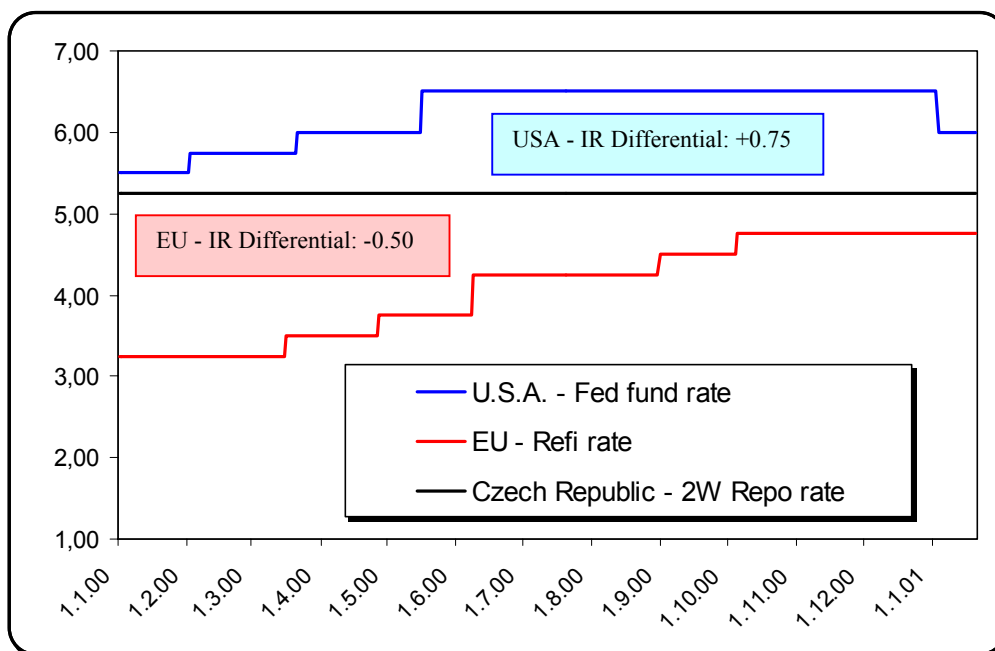
## **7.2 Monetary Policy in 2001**

The increasing foreign trade deficit is actually one of the most watched macroeconomic indicator in the Czech Republic. A key question for taking the next monetary decision is to estimate how the high world crude oil prices and how the economic recovery contribute to the increase in the foreign trade deficit. The fact is that the economic recovery in 2000 was two times higher than the Czech National Bank predicted at the beginning of 2000. In 2001, the Czech National Bank will have to watch the development of domestic demand and supply (gross domestic product) very carefully to eliminate possible inflation pressures.

We expect that CNB will keep its basic interest rate (two-week Repo rate) unchanged and that the probability of raising the Repo rate in the second half of 2001 (by 25 basic points) is low. Due to regular parliamentary election, held in June 2002, it is supposed that the Czech National Bank will be very cautious during the end of 2001 and Spring 2002.

The most important factors, which could lead to a moderate rate rise, are the following ones: increasing domestic demand, increasing foreign trade deficit, expansion of fiscal policy, increase in supply of government bonds and decrease in interest rate differential of CZK toward the main world currencies (see Figure 8).

**Figure 8: Basic Interest Rates in the CR, USA and the Euro-zone**



*Source: Reuters*

State budget deficit and development of public debt play a key role in the next development of the Czech monetary policy. In October 2000, the Ministry of Finance announced the schedule of government bonds issues on the year 2001 and from this schedule results that the amount of issued government bonds should increase from today's CZK 110 bln. to 148 bln. (see table 7). The supply of government bonds will exceed the demand for these bonds and this situation will result into decrease of their prices (it implicates the rate rise pressures, including the crowding out effect in private investment).

The Czech National Bank has to think about the interest rate changes because of avoiding the unstable macroeconomic situation that happened in 1996 and which in May 1997 resulted into financial crisis.

**Table 6: Factors Indicated Changes of Interest Rates**

<b>Factors favouring interest rate rise in one year perspective</b>	<b>Factors favouring interest rate cut in one year perspective</b>
<ul style="list-style-type: none"> <li>• Accelerating domestic demand and GDP growth</li> <li>• widening trade balance deficit</li> <li>• expansion of fiscal policy</li> <li>• new composition of consumer price index</li> <li>• growing supply of new bonds</li> </ul>	<ul style="list-style-type: none"> <li>• nominal appreciation of CZK with anti-inflationary impacts</li> <li>• positive relation between wage and productivity growth</li> <li>• anticipated decline of crude oil prices</li> <li>• non-accelerating inflation</li> <li>• continuing rescheduling of the Czech economy (positive impacts of FDI inflow)</li> </ul>

*Source: Komerční banka*

**Table 7: Schedule of the Medium and Long Term Government Bonds Issues in 2001**

	<i>Coupon (in %)</i>	<i>Date of Issues</i>	<i>Date of Maturity</i>	<i>Maturity Term in Years</i>	<i>Value of Issues (bln. CZK)</i>
Government Bond 2000-2003	6.90	12.1.2001	21.1.2003	3	4
Government Bond 2001-2016	n.a.	26.1.2001	26.1.2016	15	5
Government Bond 2000-2005	6.75	23.2.2001	18.2.2005	5	4
Government Bond 2000-2007	6.30	23.3.2001	17.3.2007	7	4
Government Bond 2000-2010	6.40	27.4.2001	14.4.2010	10	4
Government Bond 2000-2003	6.90	18.5.2001	21.1.2003	3	3
Government Bond 2001-2016	n.a.	1.6.2001	26.1.2016	15	2
Government Bond 2000-2005	6.75	22.6.2001	18.2.2005	5	3
Government Bond 2000-2007	6.30	20.7.2001	17.3.2007	7	4

Government Bond 2000-2010	6.40	24.8.2001	14.4.2010	10	4
Government Bond 2001-2004	n.a.	14.9.2001	14.9.2004	3	5
Government Bond 2001-2016	n.a.	5.10.2001	26.1.2016	15	2
Government Bond 2001-2006	n.a.	26.10.2001	26.10.2006	5	5
Government Bond 2001-2008	n.a.	16.11.2001	16.11.2008	7	4
Government Bond 2001-2011	n.a.	14.12.2001	14.12.2011	10	4

*Source: Ministry of Finance*

## **8. Exchange Rate**

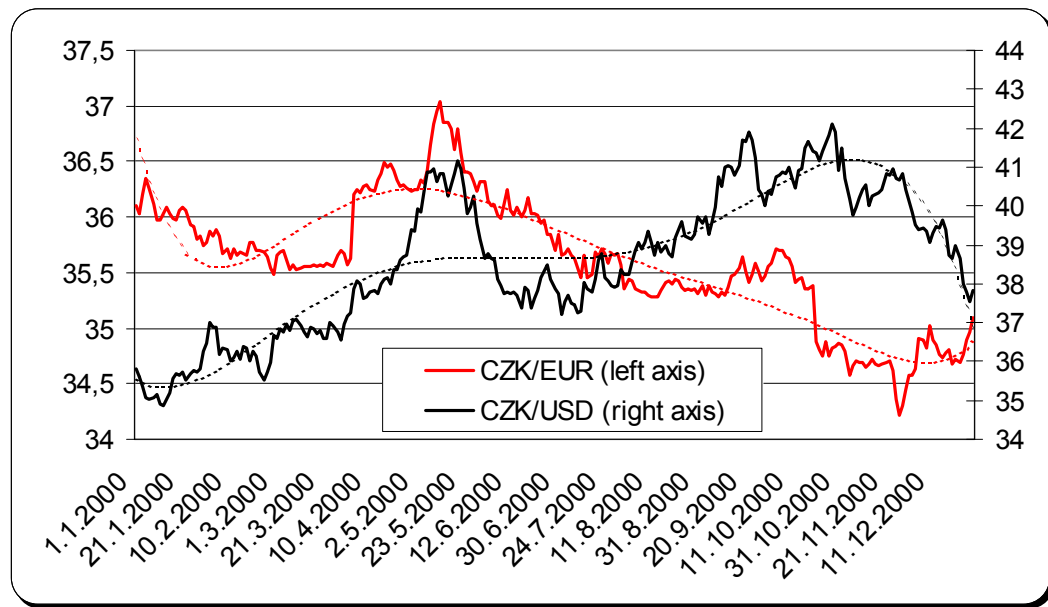
### **8.1 Exchange Rate in 2000**

In 2000, the exchange rate of Czech crown was influenced by the dollar's appreciation against the euro. As a result, the Czech crown depreciated from about 36 CZK/USD to 41 CZK/USD; it represented a year-on-year depreciation by more than 13 %. At the end of 2000, due to appreciating euro against the US dollar this development has been corrected and CZK/USD exchange rate started to appreciate. On average, the exchange rate reached 38.6 CZK/USD in 2000 (in 1999, it was 34.6 CZK/USD), representing a year-on-year depreciation by more than 11 %. This contributed - together with high crude oil prices - to an acceleration of import prices, as a majority of raw material imports to the Czech Republic is paid for in US dollars.

In the first quarter of 2000, the CZK/EUR exchange rate was slightly appreciating from 36.1 (December 1999) to 35.6 (average exchange rate in March 2000), but in the second quarter of 2000 due to CNB intervention it depreciated to 37.0 CZK/EUR (May 2000). This level was the minimum CZK/EUR exchange rate in 2000 and from this point the Czech crown was continually appreciating. In November, the Czech crown against euro was even

testing the historic maximum of CZK/EUR. On average, the exchange rate reached 35.6 CZK/EUR in 2000 (in 1999, it was 36.9 CZK/EUR), a year-on-year appreciation by more than 3.5 %.

**Figure 9: Exchange Rate**



*Source: Czech National Bank*

The major factor of the appreciation trend of the Czech crown against euro was a continuing high inflow of foreign direct investments to the Czech Republic. The appreciation of CZK/EUR exchange rate was also supported by favourable development of basic macroeconomic indicators: positive GDP growth, acceleration in industry production and retail sales, recovery in construction and still low inflation.

The CZK's reactions to the changes in interest rates in the Euro-zone and USA were in fact negligible: in 2000, Fed and ECB have risen the basic interest rates in several steps to 6.5 % in the U.S.A. and to 4.75 % in euro zone. The interest rate differential of Czech basic interest rate (Repo rate) decreased to only 50 basis points against European money market; this interest rate differential has even become negative against to American money market. It

shows that the major factor of the appreciation trend of CZK/EUR exchange rate was an inflow of long-term capital that does not react to changes in short-term interest rates.

## **8.2 Exchange Rate in 2001**

In 2001, the foreign direct investment inflow, which due to privatisation of strategic companies (České Radiokomunikace, Komerční banka, ČEZ, Unipetrol, etc.) is expected to reach more than USD 5 bill. (a maximum in the history of the Czech Republic), will remain to be the most important factor influencing exchange rate. An accelerating GDP growth and an expected modest rise of the official interest rates in the second half of 2001 will also support the exchange rate.

On the other hand, outlook for the Czech crown is not risk free. The sources of potential risk lie in the development of trade balance and fiscal policy expansion. Current account deficit is still covered by FDI inflow. But when the revenues from privatisation finish and the Czech trade balance do not improve, the current account deficit will push on depreciation of the Czech currency. We also warn of widening deficit of public finance that increases the excess of domestic demand over supply. This situation results into widening of trade balance deficit with pressure on depreciation of the Czech crown.

The main factors influencing developments of the exchange rates in four main Central and Eastern European countries in 2001 are summarised in Table 8. For appreciating of the Czech crown is only one factor - high FDI inflow; political situation and level of GDP growth are neutral and the remaining factors favour nominal depreciation of the Czech crown against euro in 2001.

**Table 8: Factor Influencing Change of Local Currency in the Czech Republic, Hungary, Poland and Slovakia in 2001**

	Czech crown (CZK)	Hungarian forint (HUF)	Polish zloty (PLN)	Slovak crown (SKK)
<b>Political situation</b>	0	+	-	-
<b>Level of:</b>				
GDP growth	0	+	+	-
CPI inflation	-	-	-	-
Interest rates	-	+	+	+
<b>Expected change in:</b>				
C/A deficit	-	0	0	+
FDI inflow	+	0	-	+
<b>Total</b>	-	+	-	0

Note 1: + indicates nominal appreciation; - indicates nominal depreciation, 0 indicates neutral development

Note 2: Level of indicator is compared with the level of the same macroeconomic indicator in the EU.

*Source: Komerční banka*

For 2001, we expect that the average exchange rate will be 35.5 CZK/EUR; at the end of 2001, we predict CZK/EUR exchange rate in interval 35.5-36.0. During the entire year 2001, the euro should gradually appreciate against the US dollar due to a slowing down of economic growth in the U.S.A. As a result, the Czech crown should appreciate against the dollar to 37.8 CZK/USD on average. At the end of 2001, we forecast the CZK/USD exchange rate in interval 37.5-37.0.

## **9. Stock Market**

In the first quarter of 2000, the Czech stock prices were growing. But at the end of March, when a growing trend of American technological stocks Nasdaq finished, the growing trend of the Czech stocks also disappeared. From April to November 2000, a gradually declining tendency of stock prices was prevailing. A new growing trend, enabled by a favourable sentiment in foreign

stock markets and published figures about positive GDP growth in the third quarter of 2000, begun in December 2000. The stock index of Prague Stock Exchange PX-50 decreased in year-on-year comparison by 5.6 %. But this result still looks very well in comparison with development of the stock indices abroad: American Nasdaq fell down by 35.7 % y/y, British Financial Times Stock Exchange FTSE 100 declined by 12.8 % y/y and German DAX Xetra weakened by 7.5 % y/y (for more details see Table 10).

This relatively favourable development of the Czech stocks cannot be overrated because the volumes of almost all stock deals are very low. Moreover, the Czech stock market indicates low liquidity. Only stocks of banks and telecommunication companies were favourable influenced in 2000 by government's steps leading towards the privatisation of these companies, associated in the case of large banks also with state financial aid (see Table 9).

The development in the Czech stock market was also affected by a lack of foreign investors' interest in portfolio purchases of the Czech stocks. According to financial account of the balance of payments for the first three quarters of 2000, the outflow of portfolio investment reached CZK 44 bill.

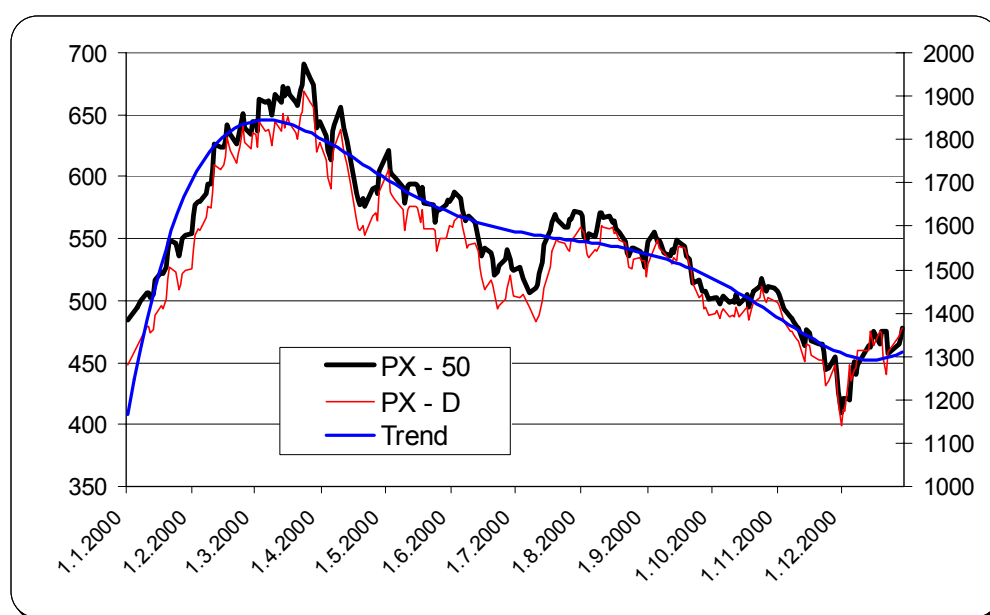
In 2001, the ongoing privatisation process and low stock and asset prices will create favourable conditions for a concentration of larger equity stakes, which will contribute to set in a bull trend in the Czech stock market. An acceleration of economic growth should also support the growing trend of the stock prices. On the other hand, the possibility of a rise domestic interest rates in the second half of 2001 will tend to lower the stock prices. Nevertheless, the actual rise in interest rates will be modest and should thus not change the overall growing trend of stock prices.

**Table 9: Prices of the Most Liquidity Stocks at the Prague Stock Exchange**

Stock	Price in CZK (December 29, 2000)	Year-on-year change (in %)
České Radiokomunikace	1 290.00	-2.0
Česká Spořitelna	234.40	41.3
Český Telecom	507.20	-12.0
ČEZ	101.10	14.1
Komerční banka	912.10	48.9
Tabák	5 751.00	-20.4
Unipetrol	62.20	21.6

*Source: Prague Stock Exchange*

**Figure 10: Development of Prague Stock Indexes (PX-50, PX-D)**



*Source: Prague Stock Exchange*

**Table 10: Development of Stock Indexes in 2000**

Index	Level (December 29, 2000)	Change in 2000 (in %)		Yearly Minimum	Yearly Maximum
		in local currency	in USD		
PX-50 (Prague)	478.5	-5.6	-11.0	409.9	691.1
BUX (Budapest)	7 849.75	-14.9	-24.5	6 684.74	10 471.90
WIG (Warsaw)	17 847.50	-3.2	-2.5	14 873.40	22 868.40
SAX (Bratislava)	92.65	22.7	11.3	70.19	98.74
Dow Jones IA	10 786.90	N/A	-4.8	9 796.03	11 723.00
Nasdaq Composite	2 470.52	N/A	-35.7	2 291.86	5 048.62
S&P 500	1 320.28	N/A	-8.3	1 264.74	1 527.46
FTSE 100	6 222.50	N/A	-12.8	5 994.60	6 798.10
DAX Xetra	6 433.61	N/A	-7.5	6 200.71	8 064.97
CAC 40	5 926.42	N/A	-4.6	5 450.11	6 922.33

*Source: Reuters*

## 10. Public Finance

### 10.1 State Budget

State budget does not offer a comprehensive picture about public finance, however it still remains their main item informing about current public revenue and expenditure. Though the economic revival accelerated, state budget experienced deepening deficit. State budget ended in a deficit of CZK 46.1 bill, what is by CZK 10 bill. more against initial assumptions. Though these figures are still preliminary and final GDP figures for 2000 are not released, it is obvious that 2000 deficit will be close to Maastricht criterion.

Higher deficit of the state budget against original assumptions was due to two main factors: lower revenue for indirect taxes and higher outlays for pensions. Revenue of state budget was hit by high petrol prices which limited consumption of petrol to some extent. This is evident from the lower revenue for indirect taxes. This factor made for about CZK 8 bill.

Contrary to previous year, the economic recovery affected favourably the social insurance revenues, which were exactly the same than assumed. As the pensionary outlays were by roughly CZK 4 bill. higher than planned, the real deficit of pensionary account reached CZK 17 bill. (original assumption was CZK 13 bill.). It is clear that pensions system must be changed; without either increasing the incomes of pensions budget (insurance fee or other sources), or increasing the retirement age or lowering level of pensions, the system is not sustainable in the long run.

**Table 11: State Budget 1999 and 2000**

	1999	2000		
	Outcome	Budget	Outcome	Growth rate (%)
<b>Revenue (CZK bill.)</b>	<b>567.3</b>	<b>592.2</b>	<b>586.2</b>	<b>103.3</b>
Value added tax	138.3	149.9	145.9	105.5

Excise tax	73.1	77.6	70.9	96.9
Corporate income tax	51.3	52.1	52.3	101.9
Personal income tax	35.1	36.6	34.7	98.9
Duty	12.1	11.2	13.6	113.0
Social insurance	210.9	221.6	222.2	105.4
<b>Expenditure (CZK bill.)</b>	<b>596.9</b>	<b>627.3</b>	<b>632.3</b>	105.9
Social expenditures	<b>238.0</b>	<b>253.7</b>	<b>256.4</b>	<b>107.7</b>
Wages in state adm.	70.3	71.6	70.3	100.0
Interest payments	17.5	18.3	19.9	113.3
Investments	20.0	21.3	24.1	120.7
<b>Deficit</b>	<b>-29.6</b>	<b>-35.2</b>	<b>-46.1</b>	<b>155.4</b>

*Source Ministry of Finance, Czech Statistical Office*

Latest figures show another increase of the structural deficit. This is confirmed by the fact that the budget deficit did not decline even under solid economic growth. The hypothesis that the deficiency of state finance has not been caused by economic recession only, was thus confirmed. Therefore, the problems of state budget shortfalls will not be solved automatically with the economic recovery and stronger growth.

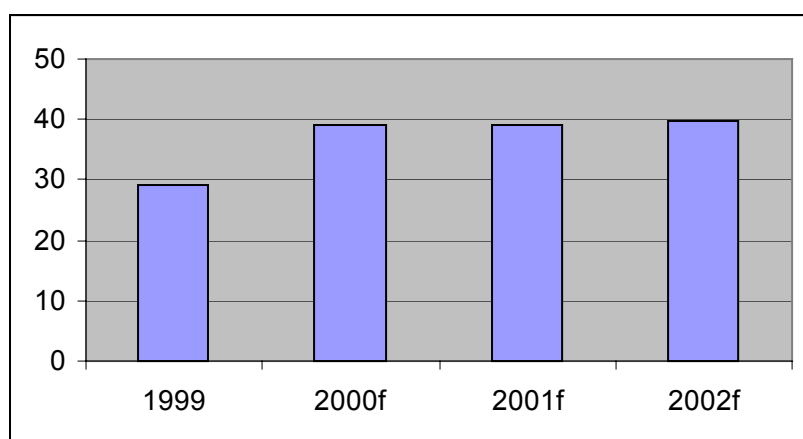
## **10.2 System of Public Finance**

Low transparency of public finance has been their most significant problem that has been criticised since 1998. Part of public finance not included in the framework of the state budget (extrabudgetary financing) has led to huge public debt. Governments avoided transparency of transfers between receipts from privatisation and the costs of restructuring or consolidation of enterprises and banking sector. Restructuring costs will rise further until the privatisation of big companies and banks is finished.

The real level of public debt is not precisely known, and remains subject to speculations. Ministry of Finance declares the official total public debt to 15 - 20 % of GDP at the end of 2000; the estimates of international institutions are

however by 15 - 20 percentage points higher. Non-transparency of public financing and unprecise reporting of the level of public debt has been widely criticised by the international institutions. Estimates of the Institut of International Finance for 2000 is at the level of almost 40 % of GDP in 2000, with no signs of improvements. It is worthmeaning that the level of debt jumped by more than 9 % of GDP during 2000. This means that spending spree by extrabudgetary institutions amounted to almost 7 % of GDP in 2000, mainly in the form of transfers to transformation institutions. These costs are connected with the way of privatisation chosen by present Government: revitalisation of companies with following sale to foreign investors.

**Figure 11: Government Debt Including Guarantees (% of GDP)**



*Source: Institute of International Finance, November 2000*

### **Outlook**

The 2001 budget , adopted by the Parliament at the end of 2000, proposes to leave fiscal policy broadly unchanged this year. The budget targets the deficit of the state budget to reach 2.2 % of GDP (against approximately 2.4 % of GDP in 2000). Macroeconomic background of the budget seems reasonable, probably not causing pressures on the revenue part of the budget. GDP growth is assumed to reach 3 %,headline inflation should reach 4.7 % at the end of

2001 and the rate of unemployment should amount to 9 %. We assume that macroeconomic fundamentals will be more favourable and that there are even some reserves on the revenue side of the budget.

Restructuring costs are expected to amount roughly the same level as in 2000. However, receipts from privatisation should almost cover these outlays, so that overall level of public debt should not increase by more than 3 percentage points in 2001. Anyway, even after the end of privatisation, the way of consolidation of public finance will be difficult. Public finance and increasing level of public debt will remain the most important macroeconomic bottleneck not only in 2001, but also in mid-term horizon.

## **11. Labour Market**

### **11.1 Unemployment**

Rate of unemployment showed a continuous decline from the second quarter of 2000 onwards. As a result, the developments of the unemployment were much more favourable than expected at the beginning of 2000. The unemployment rate amounted to 8.8 % in December 2000, which represents a decline of 0.6 percentage points compared to the 1999 year-end. Overall expectations for 2000 year-end moved around 11 %, so that the difference between initial forecast and final result amounts to about two percentage points, which shows the rapid change the labour market went through during 2000. The unemployment rate is nowadays at the same level as in the Euro-zone (8.8 % at November 2000).

The decline in the unemployment rate was predominantly a consequence of ongoing economic recovery. Economic growth is not only more rapid than expected but domestic investment demand has recovered strongly as of first quarter 2000. This was a difference against second half of 1999 when

moderate revival was pulled predominantly by foreign demand. Strong demand for Czech exports was able to recover Czech industry, causing after eleven quarters of continuous decline revival of demand for investments in Q1 2000. With a small time-lag, labour market witnessed an upturn, as well: strengthening domestic demand boosted vacancies and increased absorption capacity of the economy. This can be well illustrated by December labour markets data.

Number of vacancies amounted to approximately 52.5 thousands in December 2000, showing an increase by 40 % against December 1999. Growing economy started to absorb new labour force at the same time, number of job-seekers declining by almost 24 thousands persons compared to 1999 year-end. The ratio between number of unemployed falling upon one vacancy thus declined from 12.6 (December 1999) to 8.4 (December 2000).

Creation of new jobs has been supported by strong FDI inflow. Foreign direct investments played an important role in recovering of the Czech industry – partly also due to non-existing transmission channel from banks to business sector. Important part of FDI are the green-field investments and reinvestments of profit which show a direct impact to job creation.

FDI inflow helps to reduce the overall unemployment, however not being helpful for diminishing of regional differences. Regional differentiation of the unemployment rate has been one of the most notable characteristics since the beginning of transformation in the Czech Republic. Situation has been improving in the districts with high FDI inflows, while the situation continues to deteriorate in regions which are not attractive for foreign investors. Regional differences will thus diminish only very slightly in the coming years.

New foreign owners or partners have been speeding-up the restructuring inside the companies. Labour market was worst hit by restructuring in the second half of 1999 and first quarter of 2000, when lack of finances and

limited access to bank loans led to massive decline of employment in business sector.

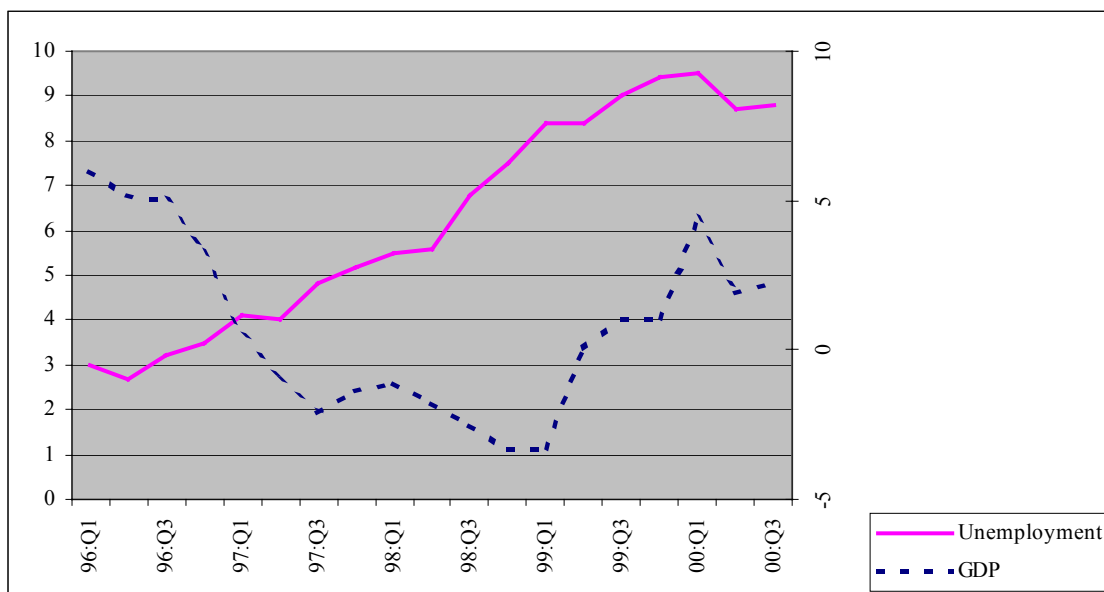
Recovery of economic growth accompanied with continuing restructuring leads to notable differences between developments of individual industries. Some industries – especially those which exports heavily (automotive industry, electrical appliances) - register increase in employment. Rapid growth of demand for labour force is obvious in some services (especially retail trade). On the other hand, employment declines in mining and quarrying, metallurgy and construction.

**Table 12: Rate of Unemployment, 2000, y-o-y and m-o-m changes**

	Unemployment rate (%)	Year-on year change (percentage points)	Month-on-month change (percentage points)
December 1999	9,4	2,1	0,4
January 2000	9,8	1,7	0,4
February 2000	9,7	1,4	-0,1
March 2000	9,5	1,1	-0,2
April 2000	9,0	0,8	-0,5
May 2000	8,7	0,6	-0,3
June 2000	8,7	0,3	0,0
July 2000	9,0	0,2	0,3
August 2000	9,0	0,0	0,0
September 2000	8,8	-0,2	-0,2
October 2000	8,5	-0,4	-0,3
November 2000	8,5	-0,5	-0,0
December 2000	8,8	-0,6	0,3

*Source: Ministry of Labour and Social Affairs*

**Figure 12: GDP Growth and the Unemployment Rate, 1994 - 2000**



*Source: Czech Statistical Office*

## 11.2 Wages

Restructuring affected not only the employment but wage developments as well. Since the labour markets prospects had not been favourable for 2000, the trade unions reduced their demands and accepted wages to go along with the developments of labour productivity. They were also willing to accept rational inflation expectations. One must not forget that these achievements were often connected with new foreign owners in many companies.

The development of wages did not accelerate during 2000: in the first quarter of 2000, nominal wages grew by 6.1 %, in the second quarter by 5.7 % and in the third quarter by 6.1 % year-on-year. Low inflation reduced the difference between nominal and real wages developments. The relationship between real wage and labour productivity in industry and construction improved, growth of productivity outpacing that of real wages.

Total expectation for nominal wage growth in 2000 amounts to 6 %. Nominal wage in public sector grew by 2.3 %. Different development was registered in business sector with nominal wage increasing by 7.6 %. This is

quite the opposite situation in comparison with 1999, when wages in public sector grew rapidly due to one-off increase in tariffs at the beginning of the year.

Slowdown of wage growth had no adverse effect on private consumption because the propensity to consume of Czech households began to grow. This was a difference against 1998 and 1999 when the households had to be careful due to uncertain prospects of the Czech economy. In 2000, the savings rate declined by 2 percentage points (to 9 %). Moreover, Czech consumers started to use consumer credits for boosting their outlays. At the same time, the moderate growth of wages kept the household demand in reasonable limits, not provoking demand inflationary pressures.

Reasonable wage developments resulted in an important macroeconomic achievement: growth in productivity of labour outpaced growth of real wage significantly. Productivity of labour increased by 5.7 %, January to September while real wage grew only by 2 %. Favourable development of this basic macroeconomic tendency can explain why economic growth has not yet provoked inflationary pressures.

Developments of wages has been differentiated within individual economic sectors, wage differentiation deepening. Highest wages were paid in banking and insurance again, average wage amounting to CZK 24 171, automotive industry (CZK 15 766). On the other hand, lower wages belonged to agriculture and textile industry, where the average wage only slightly exceeded CZK 10 thousands, January to September 2000. Differences between best and worst paid industries have thus continued to increase.

Growing differentiation has been visible also within individual industries depending upon financial conditions and wage policy in individual companies. According survey of Trexima company, wage differences may reach only hundreds of CZK in individual professions while even thousands of CZK in different ones.

**Table 13: Employment, Productivity and Real Wage**

	Employment y-o-y growth (%)		Productivity y-o-y growth (%)		Real Wage y-o-y growth (%)	
	3Q 2000	1-3Q2000	3Q2000	1-3Q2000	3Q2000	1-3Q2000
<b>Total economy</b>	-2,3	-3,2	4,7	5,7	2,0	2,5
Construction	-4,0	-4,8	10,2	8,9	0,7	-0,2
Industry	-3,2	-4,9	8,2	9,0	1,6	2,2
Mining and Quarrying	-8,4	-10,6	35,0	23,5	2,8	3,0
Manufacturing	-2,6	-4,5	5,7	7,3	1,7	2,5

*Source: Czech Statistical Office*

Differences have become much more significant also in ratios between wage and labour productivity growth in individual economic sectors. Productivity of labour in industry outpaced growth of real wage almost four times, January to November, productivity of labour increasing by 9 %, while real wage only by 2 %. Unit labour costs declined by 3 % as a consequence which helped to keep the competitiveness of Czech goods on world markets even under strong CZK. The differences between productivity and wages have differed in mining and manufacturing – see Table 11.

Productivity has been outpacing wages much more significantly in mining and quarrying than in manufacturing industries. In manufacturing the ratios between labour productivity and wages has been deteriorating in the course of 2000 (see Table 11). In September 2000, e.g. real wage increased by 1 % while productivity increased by 2.4 %. To sum up: the ratio between productivity and wage is much worse in manufacturing than in primary industries, however not being dangerous yet.

In construction, the differences between productivity and wages developments have been even more significant than in industry, productivity increasing by 10.4 and real wages by only 0.4 %, January to November. In recent months, due to revival of construction, growth of real wages

accelerated. But the growth of wages was outpaced by productivity growth (5.3 and 21 % y-on-y, respectively in November 2000).

### ***Outlook***

Unemployment reaching levels usual in the EU seems to remain a noncommittant feature of the Czech economy. Fundamental factors affecting the labour market will remain unchanged in 2001. Economic growth supported by domestic demand will continue with higher intensity. The inflow of foreign direct investment should be record-high due to finishing privatisation. Restructuring of the economy will no longer be so intensive to cause general increases of unemployment, though this may be the case in individual micro-regions or industries. Demographic factors are favourable. The pressures caused by strong cohorts from the Seventies have started to weaken since 1999. This will affect labour market not only in 2001, but in following years as well. We expect unemployment rate to reach 7.5 % at the end of 2001.

We assume that reasonable developments of wages will continue in 2001. Our estimate of nominal wage growth amounts to 8 %. Higher wage growth could provoke demand inflationary pressures as well as another increase of imports.

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