

ECONOMIC TRENDS 29

CZECH ECONOMY IN MID 2001: A STRONG RECOVERY

1. Summary and Conclusions

Growth acceleration in the Czech economy, observed in the second half of 2000, continued in the first quarter of 2001. Gross Domestic Product grew, in the first quarter of 2001, by 3.8 % on a year-on-year basis, and by 1.1 % against the fourth quarter of 2000. (In the whole of 2000, GDP grew by 2.9 %, and in the fourth quarter by 3.8 %, y/y.)

All demand factors with the exception of net exports have pulled the growth of GDP. Another trend that started in the second half of 2000 also continued in the first quarter of 2001, namely that the main growth factors of the Czech economy have shifted from foreign demand to a decisive influence of domestic demand. Fixed capital formation again represented the main growth factor, increasing by 7.3 % (CZK 7.4 bill.), followed by household consumption that grew by 3.9 % (CZK 7 bill.). Government consumption, continuously, more or less stagnated (a decrease by 0.7 %). Exports of goods and services went up by 19.8 %, and imports by 21.8 %; the decrease of net exports by CZK 9.7 bill. represented a negative contribution to GDP growth.

Industry was the most important economic sector with the share of 37 % on GDP (manufacturing 29 %). Growth in industry was more robust than expected in the beginning of the year, industrial output increasing by 9.6 %, January to May 2001. At the same time, productivity of labour increased by 7.5 % and real wage by 2.9 %, declining unit labour costs thus enabled Czech

exporters to compete on EU markets even under the strong exchange rate of the CZK against the EUR.

After hesitating recovery in the first half of 2000, construction was the most rapidly growing industry in the last quarter of 2000 and first five months of 2001: growth of construction output amounted to 15.4 % year on year. Contrary to industry, where small and medium sized companies have been profiting out of overall conjuncture, there is a strong dividing line between performance of big and small construction companies. While some cost inflationary pressures emerged in construction in the second half of 2000, situation seems to be stabilised in the first half of 2001: productivity of labour outpaced the growth of real wages almost five times.

Generally, strong domestic demand has not been provoking significant inflationary pressures yet. As expected, in the first half of 2001, the gap between consumer prices and producer prices diminished: headline yearly inflation amounted to 5.5 % at the end of June 2001, while PPI grew only by 3.4 %. Net inflation went along with headline inflation and grew by 4.4 %.

The economic growth has – with some delay – changed the situation on the labour market: from the second quarter of 2000 the unemployment rate started to fall and in June 2001 declined to 8.1 %. While in 2000, the fall of unemployment was accompanied by a fall in employment (by 0.3 %), in 2001 total employment has turned to growth. Growing economy started to demand for new labour force.

Revived economic growth, and significant progress in restructuring the portfolios of privatised banks led to a moderate increase in the volume of new credits in the first months of 2001. But all the net increase in credits is in

the field of credits to households and small businesses, mainly due to a rapid growth of mortgages and consumer credits. At the same time, financial statistics suggest that improved cash-flow have somewhat eased the dependence of the corporate sector on the external financing. Ongoing inflow of FDI and favourable macroeconomic indicators supported a stronger exchange rate of CZK in spite of the deteriorating indicators of external equilibrium and of the deepening deficit of public budgets.

In the first quarter of 2001 the current account deficit amounted to CZK 26.7 bill. which represents 5.6 % of GDP. The main reason was deterioration of trade balance. The financial account showed a surplus of CZK 29.6 bill., FDI inflow making the major part of incomes (CZK 34.5 bill.).

Table 1: Main Macroeconomic Indicators

		1995	1996	1997	1998	1999	2000	2001f
GDP growth	%, real	5.9	4.3	-0.8	-1.2	-0.4	2.9	3.7
Industrial sales	%, real	9.2	6.8	6.1	0.6	-0.5	8.4	7.0
Industrial production	%, real	n.a.	2.0	4.5	1.6	-3.1	5.8	7.0
Construction output	%, real	8.5	4.8	-3.9	-7.0	-6.5	5.6	10.0
Retail sales	%, real	4.8	11.4	1.9	-7.2	2.1	4.6	4.5
Inflation	%, average	9.1	8.8	8.5	10.7	2.1	3.9	4.4
Inflation	%, e.o.p.	7.9	8.6	10.0	6.8	2.5	4.0	4.7
Net inflation*	%, e.o.p.	7.3	6.6	6.8	1.7	1.5	3.0	4.0
Industrial producer prices	%, e.o.p.	7.2	4.4	5.7	2.2	3.4	5.0	4.0
Nominal wages	%, average	18.5	18.4	10.5	9.3	8.2	6.6	8.0
Unemployment rate	%, e.o.p.	2.9	3.5	5.2	7.5	9.4	8.8	7.5
Exports	%, nom.	23.5	6.6	20.0	17.7	9.2	23.3	17.0
Imports	%, nom.	33.7	13.0	15.3	7.5	7.5	28.2	16.5
Trade balance	CZK bill.	-105.9	-155.8	-151.2	-76.3	-69.9	-126.8	-130.0
Current account	USD bill.	-1.4	-4.3	-3.2	-1.0	-1.1	-2.4	-2.4
Current account	% of GDP	-2.6	-7.4	-6.1	-1.9	-2.0	-4.8	-4.4
Financial account	USD bill.	8.2	4.3	1.1	2.6	2.5	3.4	2.4
Financial account	% of GDP	16.5	7.4	2.1	4.8	4.7	6.8	4.0
State budget	% of GDP	0.5	-0.1	-1.0	-1.6	-1.6	-2.4	-2.2
Gross foreign debt	USD bill.	17.2	21.2	21.6	24.3	22.9	21.5	21.0
Official FOREX reserves	USD bill.	14.0	12.4	9.8	12.6	12.9	13.1	14.0
M2 growth	%, e.o.p.	19.8	9.2	10.1	5.2	8.1	6.5	9.0
PRIBOR 3M	%, average	10.95	12.02	16.00	14.33	6.85	5.4	5.3
CZK/EUR**	Average	36.22	35.32	35.75	35.85	36.88	35.6	34.5
CZK/USD	Average	26.55	27.14	31.71	32.27	34.60	38.6	38.5

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

Outlook

In 2001, domestic demand will be the decisive driving factor of GDP growth, especially investment demand and household demand. Also government demand can be expected to revive slightly in the second half of 2001. The contribution of net exports of goods and services to GDP growth will remain negative, due to the business slowdown in EU countries. We expect GDP to grow by 3.7 % over the year 2001. We expect that industrial output will increase by 7 % in 2001 and construction output by 10.0 %.

Economic growth will support the increase of real incomes and keep a relatively high level of optimism of Czech consumers. One can reasonably expect a revival of demand for durable consumer goods, as well as more widespread purchases of flats and family houses. Such trends would revive small scaled construction whose several-year recession will with high probability be over.

Inflationary pressures emerging in some rapidly growing manufacturing industries are still attenuated as well as inflationary pressures in construction. 2001 will be the year of minimal difference between the growth of consumer and producer prices: at the end of 2001, the yearly increase both of CPI and PPI will be around 4.5 %.

As indicated earlier, the main macroeconomic bottleneck remains the problem of twin deficit. We cannot expect that current account deficit (due to lasting trade deficit) would fall under 4 % of GDP in the next two years. At the

same time, mid-term fiscal outlook does not seem very promising for consolidation of public finance in short-time horizon (with the probability of Government budget deficit being close to 5 % of GDP at the end of 2001).

2. External Environment

In the first half of 2001, the world economy suffered from an economic slowdown which, with varying intensity, hit all regions. Though some analysts even talk of a recession, the facts, rather, show that the year 2001 will be marked by a significant weakening of economic dynamics, as well as of world trade. This is especially true of the country that in the last five years showed faster than average growth, i.e. the United States. (See Table 2.)

Table 2: World Economic Growth by Regions

(GDP growth rates in %)

	2000	2001F	2002F
USA	5.0	1.6	3.0
Eurozone	3.4	2.3	2.8
Japan	1.5	0.7	1.0
Asia (excl. Japan)	7.3	5.0	6.2
Central and Eastern Europe	5.4	2.8	4.0
World	4.2	2.2	3.1
World trade (% growth)	11.0	6.0	8.5

Source: Deutsche Bank Research, ABN AMRO, KB

Table 2 also shows that the European Union or the Eurozone so far are not able to replace the U.S. as an „engine of growth“. Weaker growth performance in both dominant economic regions (the GDPs of the U.S. and the Eurozone are comparable) has a decisive impact on the deceleration of world economic growth.

On the other hand most economists assume that the cooling of the world economy is only temporary and that in 2002 one can expect a return to solid growth trajectories that reflect the long-term growth potential of individual economies. At the same time, an observable acceleration of world trade can be expected.

A great unknown, as usually, is the price of oil in the world markets. One has to ask whether the developments of 2000 could be repeated, when average price jumped by 60 %. Prestigious institutions do not expect a repetition of the 2000 scenario (compare Table 3) - they count on the instability of the OPEC cartel, on the eagerness of individual members to increase supplies to the world market (in contemporary price conditions it is efficient to revive drillings that had been conserved), and on the preparedness of the U.S. to use strategic reserves as a tool of intervention in the market. Up to now real developments - in spite of short-term fluctuations - more or less support this scenario.

Conflicting developments in the world markets can have contradictory impacts on the Czech economy. Economic slowdown in EU countries (that absorb almost 70 % of Czech exports) signals a strong danger of weaker demand for Czech exports, especially in Germany. So far this situation has not

come - one of the reasons being that due to the weak Eur/USD exchange rate, exports from the Eurozone have shown less of a slowdown than GDP. Assuming that Czech exporters mainly supply to West-European exporting firms, the impact of slowdown in the EU would be milder than if Czech exports were destined directly for EU markets. Which of these assumptions is valid will probably be shown in the second half of 2001.

Table 3 :Forecast of oil prices

(Brent, USD/barrel)

1999	17.85
2000	28.39
Q1 2001	25.88
Q2 2001	26.50
Q3 2001	24.00
Q4 2001	24.00
2001	25.20
2002	24.00

Source: Deutsche Bank Research, KB

The slowdown of economic growth in EU countries - if prolonged - could also have a positive effect for transition economies of Central Europe: they

would become more attractive for foreign capital and foreign direct investment. That could be an important factor in the future period when privatization will be finished in these countries. and with it one important source of attracting FDI will be gone.

3. External Balance

In the first quarter of 2001, the balance of payments showed a small surplus of CZK 2.9 bill. Nevertheless, current account deteriorated considerably, the deficit amounting to CZK 26.7 bill. which is an increase of CZK 14.5 bill. against first quarter of 2000. Current account deficit thus reached 5.6 % of GDP which should be regarded as a level very close to the edge of mid-term sustainability. However, the net inflow of investments on the financial account was only slightly lower against the same period of last year, reaching CZK 30 bill, mostly as a consequence of continuing massive inflow of foreign direct investments (CZK 34.5 bill.).

Table4: Balance of Payments (CZK bill.)

	Q1 2000	Q1-4 2000	Q1 2001	Q1-4 2001F
Current account	-12.2	-91.4	-26.7	-95
o.w. Foreign trade	-18.0	-126.8	-30.12	-130
Balance of services	8.0	53.9	8.0	60
Balance of incomes	-5.0	-30.0	-7.0	-35
Transfers	2.9	11.0	2.5	10
Capital account	-0.0	-0.1	-0.0	-0.1
Financial account	35.5	129.6	29.6	85
o.w. Direct investments	37.2	172.8	34.5	180
Portfolio invest.	-12.6	-68.2	9.5	-
Long-term capital	4.5	-4.9	-4.1	-
Short-term capital	8.4	31.7	-10.5	-

Source: Czech National Bank, forecast KB

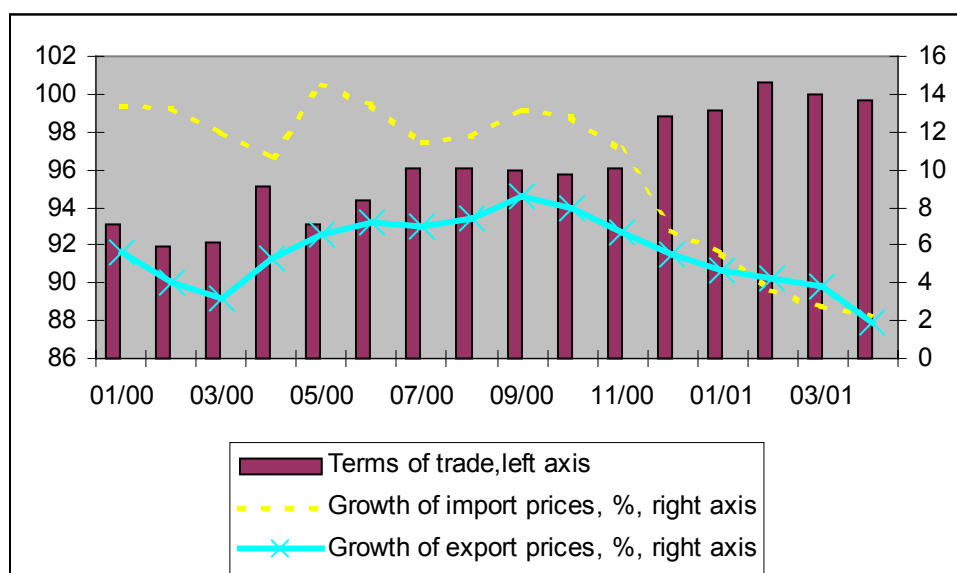
3.1 Current Account

As usually, trade with goods was the main factor affecting developments on the current account in the first quarter of 2001, the tendencies of trade balance deterioration continuing in April and May 2001, too.

Trade with Goods

Czech foreign trade has been affected by two major factors: level of foreign demand and world prices of raw materials. Compared to 2000, these factors showed different developments in the first half of 2001. While in 2000 the main factor of growing trade deficit were world oil prices (pushing upwards Czech import prices), in 2001 strong domestic demand supporting Czech imports combined with weakening conjuncture in the West Europe was the factor deteriorating Czech trade balance. Moreover, in April 2001 new wave of oil price increase started to rise Czech import prices again, though in a moderate extent.

Figure 1: Import Prices, Export Prices, Terms of Trade



Source: Czech Statistical Office

Table 5: Imports and Exports: Cumulative Growth Rates in %

	01/2001	01-02/2001	01-03/2001	01-04/2001	01-05/2001
Imports, total	35.5	27.7	26.6	27.1	23.9
Exports, Total	30.5	26.1	23.3	23.5	22.1
Balance, total	-9,3	-17.1	-30,1	-40,8	-48,1
Imports, Germany	25.5	25.3	32.2	31.9	28.9
Exports, Germany	12.0	14.0	15.5	15.1	13.2
Balance, Germany	5,1	9,5	8,9	11,1	12,7

Source: Czech Statistical Office

The trade deficit reached CZK 48.1 bill., January to May 2001, which is an increase of CZK 15.6 bill. against the same period of 2000. Growth rates both of imports and exports have been slowing down since the beginning of 2001. Imports grew by 13.2 % , exports by 15.3 % in May 2001, which is a notable slowdown indicating that weakening conjuncture in the EU countries has already begun to affect Czech foreign trade. This effect is most significant in the case of Czech major trading partner – Germany. In May 2001, the exports to Germany increased by 6 % only. This led to deterioration of the trade balance with Germany by CZK 18 bill, January to May 2000, the surplus still reaching CZK 12.7 bill in this period, but diminishing rapidly.

On the other hand, the slowdown of exports has been going hand in hand with slowdown of imports due to high import elasticity of Czech exports. Weakening conjuncture in the EU thus should not deteriorate Czech trade balance significantly.

Services, Incomes, Transfers

Services and transfers showed no change in tendency in the first quarter of 2001. Trade with services was able to compensate for 25 % of the trade deficit only. While transport and tourism performed quite well, with net profits of CZK 5 bill. and CZK 12 bill. respectively, other services ended in the red again. This item which has direct connection with strong FDI inflow seems to burden the current account permanently. Companies which invest in the Czech Republic often prefer to buy some of services included into this item (legal services, advertising, financial services, insurance) at home. Besides other factors this fact indicates also some weaknesses on the supply side of the Czech economy.

Balance of incomes does not offer very promising prospects. Developments on the incomes balance is tightly connected with the developments of overall investment position of the Czech Republic. After a short period of consolidation (IV Q of 1999 – III Q of 2000), a new wave of deterioration of incomes balance has been visible since the last quarter of 2000.

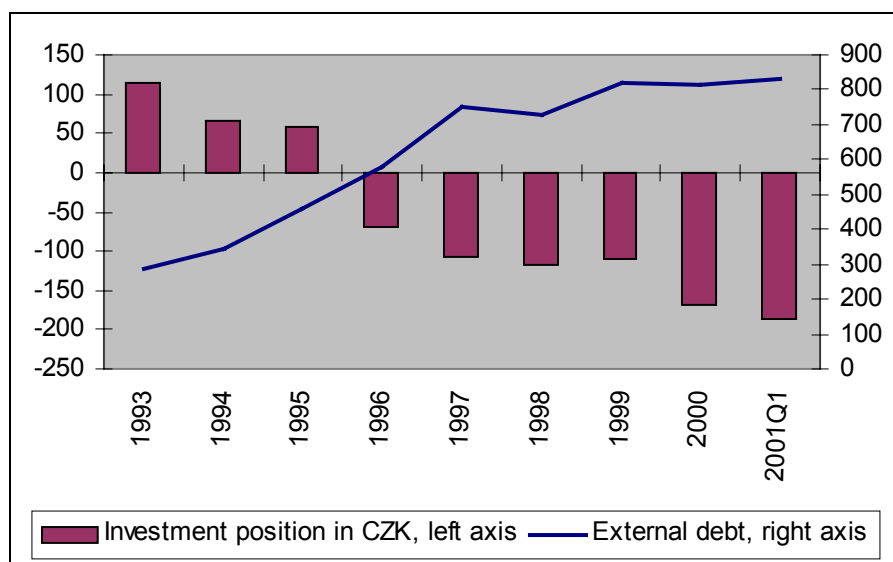
While during 1996 – 1998 the balance of incomes deteriorated mostly as a consequence of growing interest payments due to massive borrowing of Czech companies abroad, repatriation of profits seems to be the main factor of growing deficit of incomes recently. In the area of interests, the balance of

incomes was in the black in 2000 due to growing assets of Czech banks abroad. On the other hand, repatriation of profits will be another permanently growing burden of the Czech current account which will accelerate especially with growing green-field FDI. This is one of the adverse effects of massive inflow of foreign direct investments to transitive economies. While the surplus in services is very close to its mid-term potential, the deficit of the incomes balance must be expected to grow continuously.

3.2 Financial Account

Long-term developments on the financial account have been tightly connected with the developments of the investment position of the Czech Republic. Major part (almost 50 %) of the total liabilities of the investment position is nowadays represented by foreign direct investments.

Figure 2: External Debt and Investment Position of the Czech Republic



(CZK bill.)

Source: Czech National Bank

Direct Investments

Again, foreign direct investments were most important part of the capital inflow amounting to CZK 30 bill. in the first quarter of 2001 showing that rapid inflow of FDI is continuing. Foreign direct investments have been affecting also current account to a notable extent with a certain time lag. According to CNB 1999 surveys, industrial (and some other non-service companies) with foreign participation generated trade&services surplus of CZK 92 bill. On the other hand, companies from the area of services generated trade&services deficit amounting to CZK 95 bill.

In the short term horizon therefore applies that part of FDI either does not promote future exports or even support imports. This is given by the structure of FDI coming into the Czech Republic. Approximately one half of FDI belongs to manufacturing industries; these investments have positive direct effects on future exports with a certain time lag. The other half of FDI, however, belongs to services or non-exporting industries (electricity, gas, water supply etc) which have no direct positive effects on future exports. However, in the long run, the impact of FDI to restructuring and cultivation of entrepreneurial activities has been very precious.

Portfolio and Other Investments

Portfolio investments offered better picture in the beginning of 2001 than a year before: those investments amounted to a surplus of about CZK 10 bill. which seems to be a favourable upturn against last year developments.

The purchases of foreign investors went along with mid-term tendencies of 2000, not increasing considerably (CZK 11 bill.). On the other hand, purchases of foreign securities by Czech subjects was very low amounting to only CZK 2 bill., while those purchases reached CZK 20 bill. in average each quarter 2000. This was the reason for improving result of portfolio investments. One should also point out that while equity securities were the field of interest of foreign investors recently, in the first quarter of 2000, major inflow of portfolio investments was concentrated to debt securities.

Other investments changed also a bit from a year earlier, total inflow amounting to CZK 15 bill in the first quarter of 2001. Again, an opposite tendencies appeared in the area of long-term and short-term money.

While long term investments showed a moderate outflow, witnessing for ongoing tendencies from second half of 2001, short-term capital witnessed an outflow of CZK 10 bill. The main observable tendency was that Czech commercial banks started to place their money abroad, contrary to 2000. This applies for both long and short money, total net outflow of long-term and short-term capital due to activities of Czech banks abroad amounting to approximately CZK 23 bill.

Long-term borrowings of Czech companies abroad almost did not increase, partly probably due to methodical reasons: loans which have some connection with FDI are reported in FDI item. On the other hand, short-term loans of Czech companies abroad grew in the first quarter of 2001, which is a continuing tendency from second half of 2000.

Outlook

The extent to which the foreign demand will decelerate is still an open question. The exports from Germany and Eurozone have not been witnessing such a significant slowdown as the GDP in this area due to weak EUR against the USD. Czech exporters seem to be rather selling their production to West European exporting companies than placing Czech goods directly to West European markets. Validity of this hypothesis will be confirmed in the second half of 2001. Anyway, the trade balance should not deteriorate to a notable extent due to high import intensity of Czech exports even under weak West European demand for Czech exports. Terms of trade will perform better than in 2000. Therefore, the trade balance will end with a deficit of about CZK 130 bill. in 2001 and the current account deficit will amount to approximately CZK 95 bill., that is 4.5 % of GDP. This is not a very promising figure, however still in the interval of mid-term sustainability.

Rapid inflow of foreign direct investments will continue in 2001, full year figure reaching almost CZK 180 bill. Anyway, the problem of relatively high current account deficit should not be understated due to high inflow of direct investments. The main reason for cautious assessment is predominantly the twin deficit : the widening of fiscal deficit seems not to reach its top yet (see Chapter 8). If the financial markets do not get a signal of consolidation of public finance or/and consolidation of the trade deficit (trade deficit of CZK 100 bill. seems to be the limit for of long-term sustainability), deterioration of ratings can be expected in the near future as the world financial markets do not tolerate the indicators of macroeconomic stability to exceed acceptable limits.

4. Gross Domestic Product

Growth acceleration in the Czech economy, observed in the second half of 2000, continued in the first quarter of 2001. Gross Domestic Product grew, in the first quarter of 2001, by 3.8 % on a year-on-year basis, and by 1.1 % against the 4th quarter of 2000. (In the whole of 2000, GDP grew by 2.9 %, and in the 4th quarter by 3.8 %, y/y.)

Another trend that started in the second half of 2000 also continued in the first quarter of 2001, namely that the main growth factors of the Czech economy have shifted from foreign demand to a decisive influence of domestic demand. Fixed capital formation again represented the main growth factor, increasing by 7.3 % (CZK 7.4 bill.), followed by household consumption that grew by 3.9 % (CZK 7 bill.). Government consumption, continuously, more or less stagnated (a decrease by 0.7 %). Exports of goods and services went up by 19.8 %, and imports by 21.8 %; the decrease of net exports by CZK 9.7 bill. represented a negative contribution to GDP growth.

Table 6: Growth of GDP and Individual Factors (constant prices, growth rates in %)

	2000	2001Q1	2001F	2002F	2003F
GDP	2.9	3.8	3.7	4.2	4.5
Domestic Demand	1.1	2.8	6.5	6.8	7.0
Household Consumption	1.8	3.9	3.8	4.0	4.3
Government Consumption	-1.3	-0.7	1.2	1.5	1.0
Gross Investment	4.2	7.3	10.0	12.0	12.0

Exports of Goods and Services	18.7	19.8	15.5	16.0	16.0
Imports of Goods and Services	18.7	21.8	18.5	17.5	17.0

Source: Czech Statistical Office, Institute of International Finance, Komerční banka

Gross fixed capital formation increased mainly in the sphere of building investment (by 10.5 %), but also investment in machines and transport equipment grew fast (by 6.3 %). Positive impacts on investment came from continuing FDI inflows, from profit reinvestments by foreign companies, as well as from renewed investment activity of restructured Czech firms. The annual increase in gross value added was highest in industry (9.6 %), with manufacturing industries growing most rapidly. That is another indicator of the high dynamics of investment activity. Trends in the structure of inventories, where stocks of materials grow against those of finished products, suggest that companies count on a favourable business climate in the next quarters. This is confirmed by tests of business climate in companies.

Household consumption showed a significant revival, after relatively low increases in the preceding quarters. Two main factors were in play here: an accelerated growth of real incomes, and a further decrease of the propensity to save. Optimistic attitudes of households toward their own economic situation, as well as that of the whole economy, drive households to higher spending. (In the first quarter of 2001, mainly outlays for telecommunication services, health care, and education increased.) Optimism of households also reflects the fall of unemployment rate, and the revived growth of total numbers of employed (by 0.7 % in the first quarter of 2001, y/y).

Outlook

In 2001, domestic demand will be the decisive driving factor of GDP growth, especially investment demand and household demand. Also government demand can be expected to revive slightly in the second half of 2001. The contribution of net exports of goods and services to GDP growth will remain negative, due to the business slowdown in EU countries. We expect GDP to grow by 3.7 % over the year 2001.

Relatively robust growth (by European standards) will continue in 2002 and 2003 (see Table 6). Domestic demand, especially demand for investment and household demand, will remain the driving factor of growth. The final phase of privatization, and the continuing FDI, with investors reinvesting profits or undertaking „greenfield“ projects, will be accompanied and multiplied by „spillover effects“ of these investments on the sector of domestic firms. The election year 2002 - and the funds to come from the EU - will foster investments in public infrastructure (roads, railways, water purifiers). The investment wave will have a positive effect on growth in manufacturing and in large-scale construction.

Economic growth will support the increase of real incomes and keep a relatively high level of optimism of Czech consumers. One can reasonably expect a revival of demand for durable consumer goods, as well as more widespread purchases of flats and family houses, with substantially increased use of mortgage credit. Such trends would, in turn, revive small-scale construction, whose several-year recession will with high probability be over.

As shown in Table 6, the contribution of net exports to GDP growth will continue to be negative, in spite of the expected revival of growth in EU countries, and resurgence of world trade. This is mainly given by the high import intensity of Czech exports.

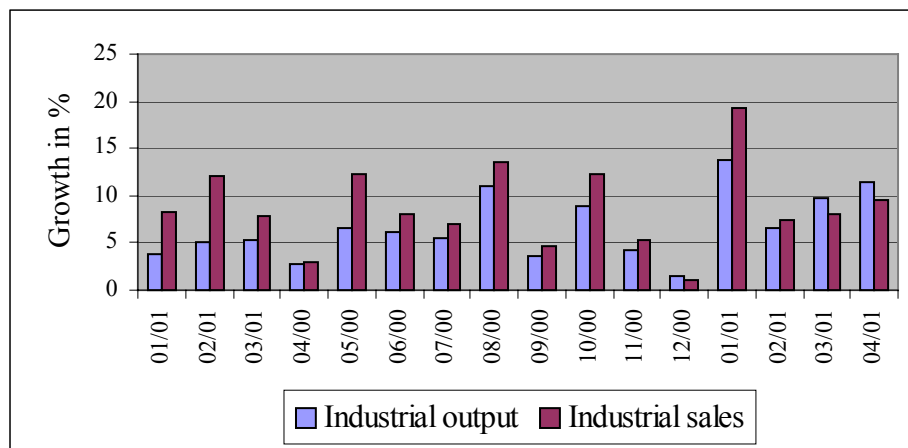
After four years, the Czech economy has restarted the catch-up process in relation to EU countries. For continued catch-up, Czech economic growth has to remain in the interval of 4 to 5 % yearly, over a longer horizon. Sustainability of such growth rates will depend on a favourable external economic environment, especially on the business climate in EU countries; on accession of Czech Republic to the EU in 2004-2005 (a later date would have a negative effect, both politically and economically); and, last but not least, on the ability to solve the problem of so-called twin deficits within the next two to three years, or to decrease both deficits substantially in this time horizon.

5. Domestic Demand

5.1 Industry

Industry is still the most important economic sector, accounting for 37.2 % of GDP in the first quarter of 2001. Growth in industry accelerated in the beginning of 2001: industrial output grew by 9.6 % and industrial sales increased by 9.0 %, January to May 2001. Growth in industry was thus more robust against expectations from the beginning of the year. As expected, the difference between growth rates of output and sales diminished, old stocks being exhausted. Companies with foreign participation were the best performing ones, their growth of sales being approximately double than the average.

Figure 3: Industrial Production and Sales (Growth in %)



Source: Czech Statistical Office

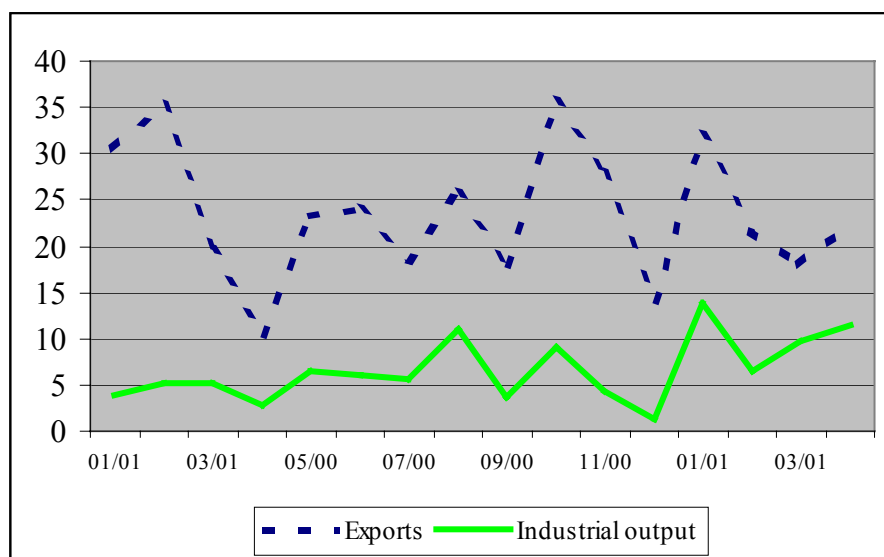
Contrary to first half of 2000, when industrial output was pulled predominantly by primary industries, manufacturing industry grew most rapidly in the first four months of 2001. While mining and quarrying stagnated January to May 2001, manufacturing grew rapidly, growing by 11.1 % year on year. The industries with high value added grew most rapidly, especially manufacture of machinery, equipment, electrical and optical appliances. Manufacture of rubber and plastic products performed well, too, being however very sensitive to world oil prices.

The development of employment in industry went hand in hand with this outline: employment in manufacturing increased by 2.3 % year on year, January to May 2001, while employment in mining and quarrying declined by 5.1 %. Rapidly growing industries thus demanded new labour force.

Productivity of labour increased by 7.5 % year on year, January to May 2001. At the same time, real wage grew by 2.9 % only. Decline in unit labour costs enabled Czech exporters to compete on demanding West European countries even under the strong exchange rate of CZK against the EUR.

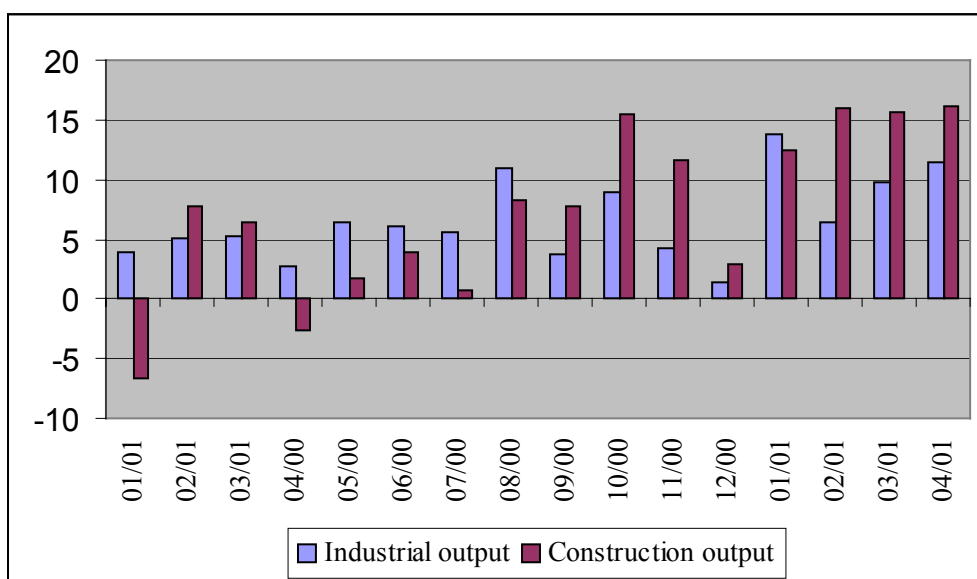
Moreover, the ratio between labour productivity and real wage growth remains more favourable in manufacturing industries, where real wage grew by 3.1 % and labour productivity increased by 8.0 % y/y. Again, this is a favourable difference against last quarter of 2000 when some rapidly growing manufacturing industries showed slowdown in productivity.

Figure 4: Growth of Exports and Industrial Output



Source: Czech Statistical Office

Figure 5: Growth in Industry and Construction



Source: Czech Statistical Office

5.2. Construction

After hesitating recovery in the first half of 2000, construction was the most rapidly growing industry in the last quarter of 2000 and first five months of 2001: growth of construction output amounted to 15.4 % year on year.

Growth in construction has been driven mostly by large commercial construction, housing still waiting for recovery. Therefore, there is a strong dividing line between the performance of big and small construction companies. Speeding of construction observable in previous six months was concentrated to largest construction companies (over 1000 employees). In April 2001 the output in this construction sector (over 1000 employees) accounting for about one fifth of total construction amounted to 28.6 %. Small companies (to 20 employees) are still badly hit by recession. This is a difference against the industry where small and medium firms have been profiting from overall conjuncture.

Nevertheless, in April 2001 the number of newly admitted flats increased (by moderate 1.3 % year on year), which is a first sign of possible recovery in housing and small construction. Anyway, to confirm that an upturn really happened after a long-term stagnation, one shall wait at least two or three months.

The main factor of boom in construction has been the continuing inflow of foreign direct investments, where greenfield investments or re-investments of profits started to gain on importance in final stage of privatisation. Again, these foreign investments are helpful for big companies, as well as state orders which were the second promoting factor in construction.

Productivity of labour increased by 15.4 %, January to May 2001, which was much higher than in industry. Real wage in construction increased by 2.8 % year on year (which is exactly the same figure like in industry), unit labour costs thus significantly decreasing. This shows that inflationary pressures which seemed to be threatening in this sector in last months of 2000 diminished and do not represent an actual threat for domestic price developments.

5.3. Services

Retail trade, transport and communications account for more than 20 % of Czech GDP. While the developments of retail trade are determined by domestic consumer demand, sales in transport go along with the overall economic growth. Retail sales increased by 3.7 %, January to May 2001, consumer demand grew by 3.9 % in the first quarter of 2001. Speeding up of consumer demand against the previous quarters was due to both moderate acceleration of real wages and continuing decline in savings rate. Consumers

sentiment has been keeping positive concerning both own situation and general economic outlook.

Rapid growth of international trade chains still lasts: significant part of permanently massive inflow of foreign direct investments being oriented towards trade. Moreover, similar to 2000, wider offer of consumer credits has been supporting propensity to spend of Czech consumers. On the other hand permanently high prices of petrol made the sales of petrol to decline by 1.6 % year on year, January to April 2001, first signs of recovery appearing in May. Domestic prices of petrol show very low downward price elasticity: while they are very sensitive for world market upward movements they react slowly when world raw material prices go down.

Sales in transport performed well in the first four months of 2001 due to continuing economic growth. Transport sales grew by 10.8 %, January to April 2001. Telecommunications were the most rapidly growing part of services, mostly as a consequence of mobile phones boom. Communication sales grew by 17.8 % year on year, telecommunication ones growing by 19.5 %. It is however a question how long can this boom last before the market is absorbed.

Outlook

Growth of export-oriented production pulled the industrial output to a great extent: e.g. growth of export sales in April amounted to 19 % y/y. Tight connection between exports and industrial production is well illustrated in Figure 4. An open question remains how the weakening West European demand will affect Czech industrial production. Export-oriented production was the part of industrial output growing most rapidly (see the April export

sales). Anyway, if the hypothesis outlined in Chapters 2 and 3 indicating that Czech exports are oriented mostly for reexports or semi-manufactured goods for West European exports, which have not been showing such a strong deceleration as West European industrial output, the impact on Czech industrial output will be relatively low. This will be cleared out in the next few months.

Anyway, the growth in industry is more rapid than expected in the beginning of the year, so we expect both the industrial output and industrial sales to grow by 7 % in 2001.

Similar to industry, boom in construction is more rapid than generally expected in the beginning of 2001. Up to September the bases for comparison will be favourable for 2001 monthly growth rates. Last quarter will probably show a slight slowdown in growth figures due to this statistical factor. Anyway, we expect that construction will be the leader of domestic demand for the whole of 2001 : the full-year growth will amount to 10 % in 2001.

Economic growth will support the increase of real incomes and keep a relatively high level of optimism of Czech households. Also the development of disposable incomes of households seem promising, reaching 4.2 % in the Q1 2001. We therefore expect that domestic consumer demand will continue to grow and retail sales will increase by 4.5 % in 2001.

6. Inflation

As expected, the gap between consumer price index and producer price index diminished in the first quarter of 2001. In March 2001 the two indices

amounted to exactly the same level of 4.1 %, year on year. During the second quarter an upturn occurred, the CPI growing more quickly than PPI. In the first half of 2001 thus the CPI increased to 5.5 % y/y, while PPI grew only by 3.4 % y/y. This indicates that domestic economic growth does not still provoke inflationary pressures in the main economic sectors. Net inflation went along with headline inflation speeding up to 4.4 %, year on year, in June 2001.

6.1 Consumer prices

The CPI growth in the first quarter of 2001 was moderate corresponding to overall expectations. January deregulations were (in size) similar to 2000 deregulations not thus increasing year on year headline inflation to a notable extent. In February and March 2001 the CPI almost stagnated mostly as a consequence of decline in food prices due to foot-and-mouth epidemic and favourable developments of fuels prices.

The picture somewhat changed in April 2001, when both major price items – fuels and foods speeded up. The same factors affected unexpected jump of the inflation rate in May 2001, when the biggest growth in consumer prices since December 1998 occurred. Final level of CPI at the end of June 2001 – 5.5 %, year on year - is thus higher than expected in the beginning of the year.

Anyway, the main factor of speeding up in consumer prices is the speeding up of world petrol prices again. Even though the growth of petrol prices in Spring 2001 was not of the magnitude of last year oil price shock, the Czech inflation showed a very sensitive reaction. Moreover (as noted above), while Czech petrol prices show high upward elasticity to world oil prices movements, their downward elasticity is negligible.

Despite the fact that economic growth was higher against initial assumptions, strong domestic demand affected the headline inflation to a limited extent only. Rapid growth in labour productivity outpacing growth of real wages kept the protection of the Czech economy from cost-inflationary pressures. Anyway, some indications of inflationary pressures already can be identified in rapidly growing Czech economy as will be discussed below. The strengthening of the CZK during 2001 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.

6.2 Producer prices

Contrary to 2000 when producer prices growth exceeded the original expectations by 1.5 percentage points, the first half of 2001 saw a continuous decline in industrial producer prices. The PPI (3.4 % y/y) was lower than the CPI (5.5 % y/y) in June 2001. Prices in mining and quarrying in fact stagnated in the first half of 2001, prices in manufacturing going along with the overall PPI (3.3 % year on year). Prices in gas, electricity and water supply were the most rapidly growing part of industrial prices, increasing to 5.8 % year on year in June 2001. Productivity of labour in this industry grew only by 2.8 % year on year, real wages increasing more rapidly than in the total industry.

Prices in manufacturing were affected by volatility of oil products on world markets to a great extent. In January 2001, prices of oil products declined by 10 % m/m, causing the low level of January PPI. An adverse movement occurred in February 2001, when prices in petrochemical industry increased by 2.5 %, which again had a strong impact on PPI figure. In March

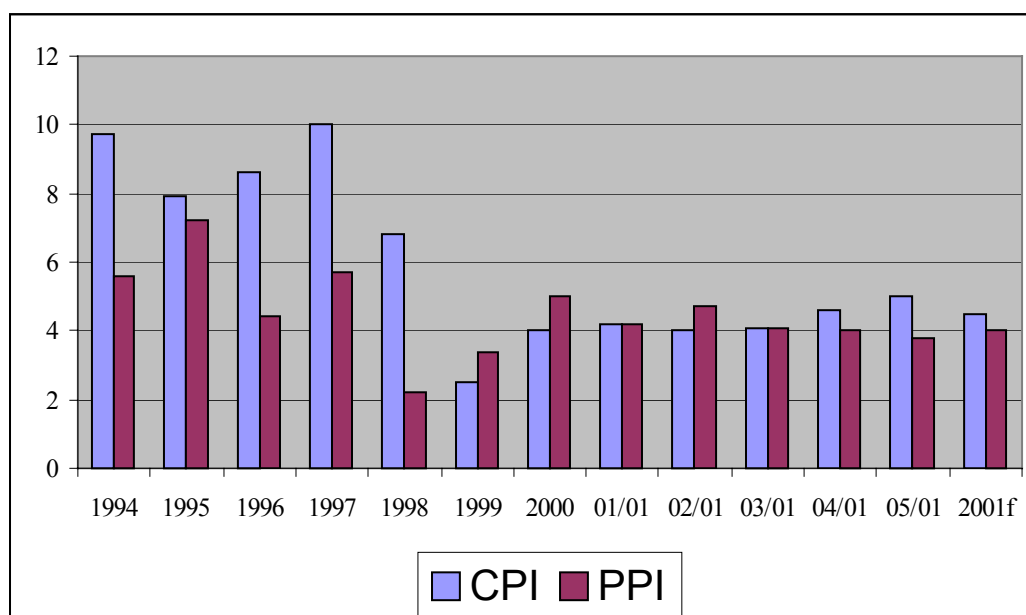
2001, petrochemical prices declined for the last time so far, prices of oil products increasing since April 2001, again.

Unlike in manufacturing, where the growth of PPI did not show significant cost-inflationary pressures, prices in agriculture grew rapidly amounting to 16.5 % year on year in June 2001. Anyway, growth of agricultural prices was rather a consequence of specific cycle in development of agricultural prices than a result of economic growth.

While some cost inflationary risks emerged in construction in second half of 2000, the situation seems to be stabilised in the first half of 2001. Productivity of labour in construction has been outpacing the growth of wages almost five times. Also, prices in construction are monopolised to a great extent because the construction boom is concentrated to low number of biggest companies. Prices in construction grew by similar pace as prices in industry their increase reaching 4.2 % year on year in the first half of 2001.

A less favourable picture has been offered by services. Prices in services increased by 5.5 % year on year in the first half of 2001. Prices in transport are witnessing reasonable growth of 3.3 %, prices in communications even declining a bit. Financial intermediation was the industry showing most rapid growth of prices, the yearly increase amounting to 18.8 %.

Figure 6: CPI and PPI



Source: Czech Statistical Office

Outlook

The development of CPI in the second half of 2001 will be determined by food and fuels developments, again. We expect that during the third quarter the growth of prices in these two items will almost stop. In the second half of 2001 also a slight appreciation of the EUR against the USD can be expected which would affect favourably the oil import prices. We expect the full year headline year-end inflation to amount to 4.7 % in 2001. Net inflation will thus increase by 4 %.

Inflationary pressures emerging in some rapidly growing manufacturing industries are still attenuated, as well as inflationary pressures in construction. 2001 will be the year of minimal difference between the PPI and CPI. Contrary to 2000, the growth of producer prices will be slower than the growth of consumer prices. At the end of 2001, the yearly increase of producer prices will be under the headline inflation, that is about 4.0 %.

7. Monetary Policy and Financial Markets

7.1. Monetary and Exchange Rate Policies

Relatively low inflation, and a strong CZK, led the Czech National Bank to some moderate interest rates easing. At the start of March, the CNB lowered the repo rate from 5.25% to 5.0%. At the same time, the discount rate was cut from 5% to 4%, and the lombard rate from 7.5% to 6%. This step was somewhat surprising for the financial markets: the new bank board members, including the new governor, who at the end of 2000 hinted at a possible increase of rates in the light of a speedup in economic growth, in reality did the opposite. One may conclude that the new CNB bank board will follow a more accommodative monetary policy, and will be less doctrinally concentrated on the inflation target only.

Pragmatism of the new bank board is shown also by the change from targeting net inflation to headline inflation (CPI) starting from 2000. That will make CNB policy more communicative to the general public. The target is set for December 2000 within the interval of 3-5%, and the CNB has also set a long-term target for December 2005 in the interval of 2-4%.

Revived economic growth, and significant progress in restructuring the portfolios of privatized banks, led to a moderate increase (after several years of decline or stagnation) in the volume of new credits in the first months of 2001. But all the net increase in credit is in the field of credits to households and small businesses, mainly due to a rapid growth of mortgage credit and consumer credit. Financial statistics at the same time suggest that improved cash-flow, and the ongoing inflow of foreign direct investment, have somewhat

eased the dependence of the corporate sector on external financing, so that its demand for credit has not increased.

Three-month Pribor went down in June 2001 to 5%, from the level of 5.4% at the end of 2000 (and one-year Pribor to 5.4% from 5.9%, respectively). Average interest rates on deposits decreased at the end of May 2001 to 2.9 % (from 3.4% in December 2000). Average interest rate on credit was at 6.8 % at the end of May 2001, rates on new credits approached 6.2%. Lower interest rates and higher inflation reduced the attractiveness of bank deposits. Households, rather, invested in non-bank investment funds, or consumed more. The household savings rate kept decreasing somewhat.

The Czech koruna (CZK) was getting moderately stronger, in the absence of intervention from the Czech National Bank. Ongoing inflow of FDI, and favourable macroeconomic indicators, supported a stronger exchange rate of CZK, in spite of the deteriorating indicators of external equilibrium, and of the deepening deficit of public budgets (see Table 7).

Table 7 : CZK Exchange Rates (monthly averages)

	CZK/USD	CZK/EUR
1998/12	30.1	35.3
1999/12	35.6	36.0

2000/3	36.8	35.6
/6	38.0	36.0
/9	40.7	35.4
/12	38.9	34.8
2001/1	37.4	35.1
/2	37.6	34.6
/3	38.0	34.6
/4	38.8	34.6
/5	39.3	34.4
/6	39.8	34.0
2001f	37.5	34.5
2002f	36.0	34.0

Source: CNB, forecast Komerční banka

Outlook

Inflows of foreign investment, and continued dynamic growth (together with the expected strengthening of EUR/USD) will induce further moderate strengthening of koruna vis-a-vis EUR, as well as a more significant strengthening of CZK vis-a-vis USD, with a positive impact on the trade balance and on the costs of importing oil and other raw materials.

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.

7.2. Financial Markets

In spite of low interest rates, equity prices showed a downward trend, mainly due to a general „bear“ mood in the world financial markets, and due to delays in privatization of some key Czech firms. (For detail, see Table 8)

Table 8 : Trends in Financial Markets

	INDEX PX 50 (END OF 1966=100)	T-BILLS (13-WEEK) YIELDS
1998/12	73.1	9.9
1999/12	90.8	5.4

2000/3	119.4	5.3
/6	97.3	5.3
/9	93.0	5.3
/12	88.7	5.4
2001/1	93.0	5.3
/2	84.2	5.3
/3	78.9	5.0
/4	76.9	5.0
/5	81.1	5.0
/6	82.4	5.0

Source: Datastream

It cannot be expected that a successful privatization of Komerční banka, or of České Radiokomunikace, could reverse this trend - it being primarily given by the mood of European financial markets, and by the (low) relative importance of capital markets of the transition economies of Central Europe.

Outflow of portfolio investment from the Czech Republic stopped in the first quarter of 2001 due to lower purchases of foreign securities by domestic investors (it amounted to USD 1.3 bill. in 1999, USD 0.5 bill. in 2000). The inflow amounted to USD 0,2 bill., January to March 2001. In 1999 the outflow was due to the financial crises of 1997 and 1998, and hit most of the emerging economies. In 2000 and 2001, the reasons are different. Czech subjects (companies as well as private persons) are more and more investing in foreign markets. The aim is to diversify the portfolios - on the part of important

investors (e.g., insurance companies), and - mainly - to achieve higher returns, compared to possibilities in the domestic financial markets. In the first three quarters of 2000 Czech investors preferred foreign equities, while in the fourth quarter - owing to the fall of stock prices in world markets - they re-oriented their preference toward bonds. The resulting proportion between investment in equities and bonds over the whole 2000 was about 50 : 50. In 2001, the preference of bonds to equities continues, as they ensure a stable return that is so far higher than that of either foreign equities or domestic bank products.

Outlook

In the second half of 2001, the trends in financial markets will be mainly given by the mood of world markets; the expected and realized privatization projects can only bring a short-term revival, not a substantial turn in trends.

8. Public Finance

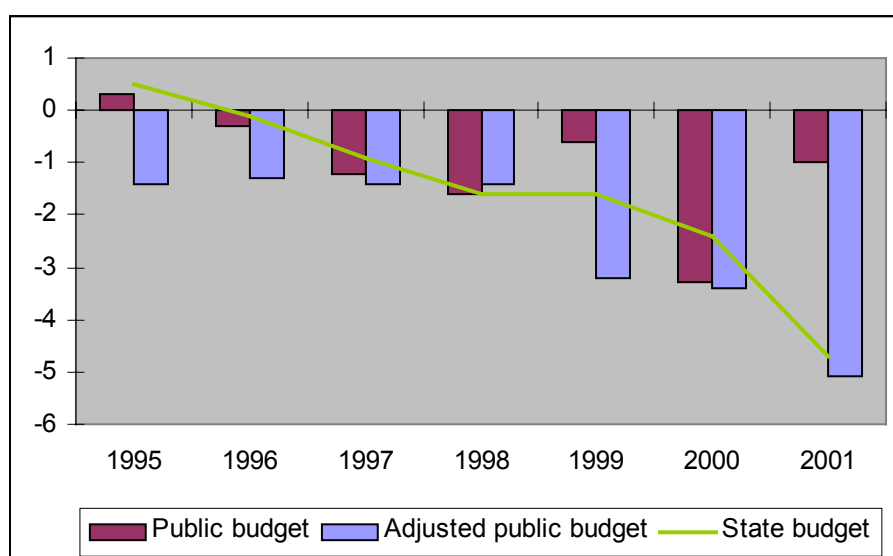
8.1 Trends in Public Budgets

Recently, a slow but visible progress has been done in the transparency of public finance. Government has established a modern budget process which is fairly stable and predictable, with reliable estimates of revenues and expenditures. State budget however does not offer a comprehensive picture about public finance. Quite a comprehensive picture can be obtained when state budget figures are put together with state financial assets, state funds, privatisation institutions, health care system and local budgets.

Anyway, these figures are biased by receipts from privatisation and by losses of transformation institutions. These two items can be regarded as one-off factors which do not ameliorate basic tendencies of public finance.

Therefore, adjusted public budgets seem useful to be specified to show differences between public finance including extraordinary items (privatisation ones) and public finance including them (see Figure 7 for comparison). One can see that in some years the difference is really significant and that general Government balance excluding extraordinary items really offers a better outline of real tendencies.

Figure 7: State budget, Public Budget and Adjusted Public Budget (in % of GDP)



Source: Ministry of Finance

The channels of current state budget and the other part of public finance (current financing and privatisation) is however partly mixed together due to losses of Konsolidační Banka which are included with a time-lag into the state budget. Therefore public deficits have been pushed by three major factors: transformation costs, structural factors and cyclical ones. Anyway, structural part of the deficit seems to be the most serious one: it is increasing according to all disposable estimates. This structural part is being widely discussed in recent years. One should however note again, that structural deficit has two major reasons: pensionary system and growing interests from public debt. Pensionary scheme has been also widely discussed and it became 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.

8.2 Public Debt

However, little attention has been so far paid to rapidly growing interest paid from public debt. While in principal - even though with problems – it is possible to do something with pensionary system and other social expenditures – the interests of public debt will decrease only along with the decline of public debt. These interests amounted to almost CZK 20 bill. in 2000, which was higher than pensionary account deficit (CZK 17 bill.) At the same time, these interests grew extremely rapidly (by 13 %) while so often criticised social expenditures rose by 7.7 % only. Therefore public debt and ways of its consolidation should be focused special priority. At the same time, it is evident that the price for growing indebtedness of the state is even higher than the price for improperly set-up pensionary scheme.

Structural bottlenecks of public debts together with extrabudgetary financing has led to huge public debt. 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 about 20 % of GDP at the end of 2001; the estimates of international institutions are however by 15 - 20 percentage points higher.

Although the level of public debt is not extremely high (let us remind that appropriate Maastricht criterion represents 60 % of GDP), at least three major points seem to be embarrassing:

- the tendency to growth with no signs of consolidation in the near future,
- the above mentioned fast growth of interests payments burdening public budgets,
- limits of financing the growth of public debt.

While the first two points were already discussed, the last one seems to be the worst macroeconomic recent news. The state bonds with 15 year maturity term totalling CZK 4 bill. issued in May were not sold completely – 10 % being unsold. According to previous schedule, only CZK 2 bill. should have been issued at that time. This shows both that the capacity of domestic investors to finance public debt is limited and that the confidence of domestic investors is beginning to weaken.

Therefore, Ministry of finance is considering to issue international bonds, which seems a sort of breakthrough in the area of public finance. This is most unfavourable also having in mind that under the conditions of twin deficits (current account and public finance) one must expect rising prices of external borrowing. At the same time, foreign lending would be probably necessary for covering the current account deficits after the privatisation is over and the FDI inflow does not reach record-hights from 2000 and 2001. Then the vicious circle may accelerate with huge interests payments attenuating domestic economic growth.

Outlook

In 2001, both the deficits of state budget and adjusted public finance (except from extraordinary items) will be close to 5 % of GDP with no clear sign of consolidation in coming years.

The exact sum of public liabilities included in transformation institutions is not precisely known. The rough estimate amounts to about 15 % of GDP. Loss of these institutions will be unevenly distributed in years to come. The estimates of profits resulting from the rest of privatisation are even more unclear. Anyway, it is obvious that the transformation institutions will burden public budgets in mid-term horizon as well as growing public debt. Until some structural bottlenecks of state budget are not solved, also the structural factor will go on to increase public debt. The necessary condition for consolidation of public finance is broader political consensus – if this will not be achieved, the perspectives of macroeconomic stability are uncertain in the mid-term horizon and the Maastricht criterion seems to be lost for at least a decade.

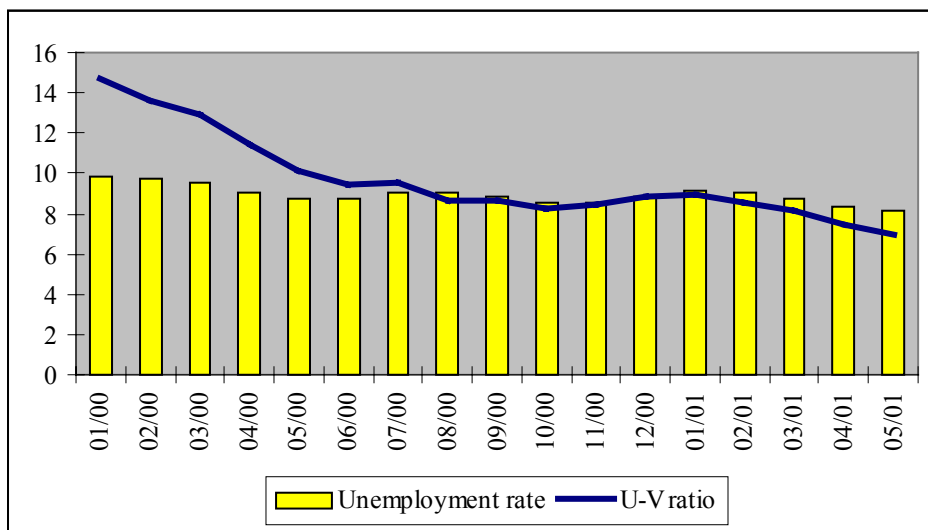
9. Labour Market

Revival of the economy has, with some delay, changed the situation in the labour market: from the second quarter of 2000, the unemployment rate started to fall, slowly but steadily. In May 2001 unemployment fell to 8.1%, thus being 1.7 percentage points lower than its historical maximum of January 2000, and 0.6 p.p. lower against May 2000. While in 2000, the fall of unemployment was accompanied by a fall of employment (by 0.3%), mainly due to retirements (often premature), in 2001 total employment has again started to grow. For example, in industry it rose in April 2001 by 1.4% on a y/y basis, in manufacturing by 2.2%, respectively. That signifies that the fast-growing segments of the Czech economy (mainly, manufacturing and some services)

have started to create new jobs. As foreign-owned firms show fastest output growth, it can be assumed that they also have created a great part of the new jobs.

The above trends are reflected in the relation of job seekers to the number of vacancies, which again improved in May 2001: there are only 7 job seekers per vacancy, the lowest number in the last three years (see also Figure 8). But this ratio is much more differentiated regionally, than the unemployment rate. For example, in the districts Karviná, Teplice and Most, there are more than 40 job seekers per vacancy.

Figure 8: Unemployment and Vacancies



Source: Czech Statistical Office

U-V ratio: number of unemployed falling upon one vacancy

Significant regional differences remain, although there are signs of improvement even in the most problematic districts. However, the combined effect of economic growth and restructuring leads to growing differences in employment trends among industries and regions. This is further strengthened

by a differentiated inflow of foreign direct investment. Over a medium term, alleviation of the regional differences cannot be expected.

This fact is of key significance for some intended steps of government policy, aimed at making the problem regions more attractive for foreign capital. Creating an industrial zone, for example, in Most, will in itself bring no foreign capital. Foreign investors seek locations that have not only good industrial and transport infrastructure, but also a sufficient pool of qualified labour. And that is the weakest point of the most problematic regions and micro-regions in Northern Bohemia and Northern Moravia. Without active employment policy, or without attracting qualified labour to these regions, technical and economic preconditions themselves will not suffice to attract foreign investment.

Past economic recession led to a fast growth of long-term unemployment (above one year). By the end of 1999, the share of such unemployment in total was 29.7%, in 2000 it grew to 38.4%, and presently this share has exceeded two-thirds of total unemployment. Long-term unemployment is a serious economic, but also social and socio-psychological problem. As European experience shows, seeking solutions, especially for the so-called hard core of long-term unemployment is a very difficult task.

As shown in Table 9, in 2000 labour productivity has again started to grow faster than real wages, which results in the fall of unit labour costs. That is an important factor, especially in view of the present real and nominal appreciation of CZK (see Table 7 in Chapter 7).

Table 9 :Labour Productivity and Average Wage in Industry, 1996-2001 (growth rates in %)

	1996	1997	1998	1999	2000	1-4 2001
Average Real Wage	8.2	3.1	0.0	4.6	3.1	3.2

Labour Productivity	14.2	3.4	0.3	-1.2	9.9	8.3
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Source: Czech Statistical Office

Czech exporters are thus competitive in spite of the strong koruna. In the rest of the year, fast output growth, especially in manufacturing, will probably bring the growth rates of real wages closer to those of productivity, but productivity will continue to grow faster.

Outlook

Fundamental factors influencing the labour market will remain unchanged till the end of the year. The relatively strongly growing economy will be able to create more new jobs than will be lost in companies due to restructuring. Hence we expect that, after five years, in 2001 total employment will increase, though moderately.

In summer months, however, one has to account for the seasonal factor - fresh leavers of secondary schools and universities will enter the labour market. That can push the unemployment rate up but this increase will be small, roughly about 0.2 to 0.3 percentage points. For 2001 as a whole, we expect a fall of the unemployment rate under 8%.

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