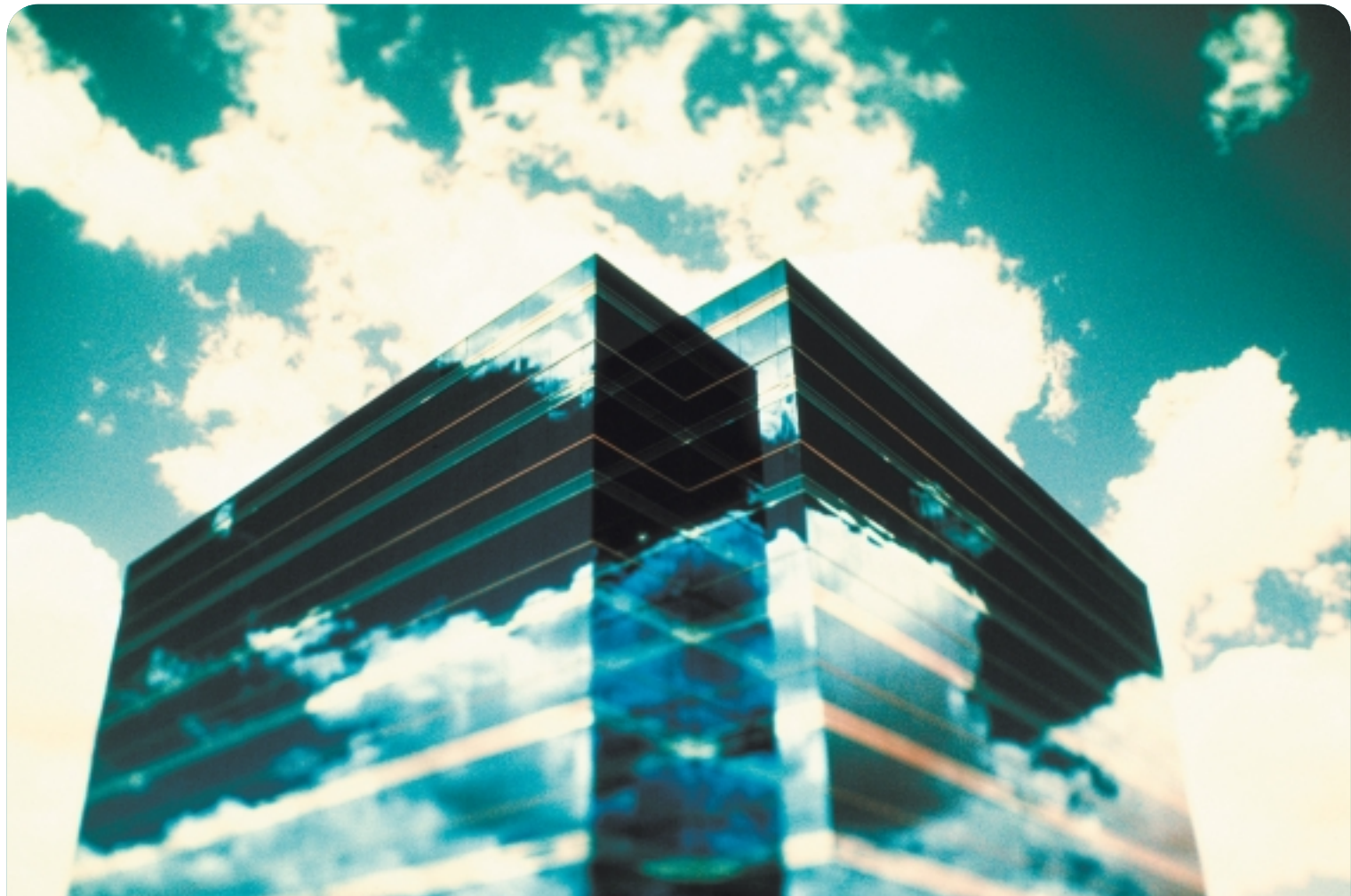


the world is changing so are we





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CZECH ECONOMY IN 2002: GROWTH UNDER THE STRONG CURRENCY

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Private consumption demand remained strong at the beginning of 2002. Consumption of households seems to become the most dynamic and stable factor of the Czech economic growth.

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CZECH ECONOMY IN 2002: GROWTH UNDER THE STRONG CURRENCY

1. Summary and Conclusions

Gross Domestic Product continued to grow in the first half of 2002, albeit at a slower pace than in 2001. GDP grew by 2.5 % in the first quarter of 2002. As in 2001, investment in fixed capital was the main driving force (increase by 8.1 %), followed by private consumption (4.1 %).

The contribution of the external sector was again negative, but, after a long period of aggravating negative impacts of net exports on GDP, this impact is now subsiding. Government consumption - after a year of stagnation or decline - increased by 0.4 %.

The mix of strong exchange rate, weak foreign demand and relatively low raw material prices led to decline both of imports and exports. The decline of imports was more significant than the decline of exports, perhaps also due to the fact that the effect of strong exchange rate is more intensive on the part of imports. The trade deficit thus declined considerably in the first five months of 2002 and consequently the current account deficit declined to 3 % of GDP.

Industry registered a solid growth rate in the first half of 2002, the industrial output increasing by 5.1 %, January to May 2002. The growth in industry has been predominantly pulled by foreign-controlled companies, this sector represents the most dynamic part of the Czech industry. The share of foreign-controlled companies on industrial sales amounted to 47.3 % in April 2002 and these companies have kept the competitiveness of the Czech exports. Productivity of labour is by 50 % and return on assets by 70 % higher in foreign-controlled companies than in the companies under control of domestic capital.

The weak foreign demand hit also the construction, however, only to some extent. The construction output increased by 4.5 %, January - May 2002. The most significant tendency in construction in recent months is the recovery of housing, helped by sinking interest rates on mortgages. This factor will continue to perform in the longer run, so the recovery of housing would probably last and support the construction output.

Private consumption demand remained strong at the beginning of 2002. Retail sales increased by 4.2 %, January to April 2002. Consumption of households seems to become the most dynamic and stable factor of the Czech economic growth.

In the first half of 2002, the price development registered a significant slowdown, due to relative low world raw material prices, strong exchange rate and weakening of both foreign and domestic demand. At the end of June 2002, CPI stood at 1.2 % and PPI at -0.8 %.

Despite the continuing economic growth, the unemployment rate is declining very slowly and reluctantly. The problem of the Czech unemployment is not cyclical, but structural one, and cutting the unemployment rate to the level of 5 % will be a longer task, depending on scope and successfulness of active employment policy.

In 2002, nominal appreciation of the Czech currency accelerated. On July 4, the exchange rate of CZK stood at 29.4 CZK/EUR, representing an appreciation of 7.2 % vis-à-vis the beginning of 2002. Although one can characterise the developments at the start of 2002 as a sort of bubble, it was only a divergence from the medium-term trend of gradual nominal appreciation of the Czech Koruna.

Public budgets have been characterised by increasing deficits in the first half of 2002, as it was the case in recent years. For the whole year 2002, the deficit of public budgets will be around 6 % of GDP, with no immediate prospects for improvement.

Outlook

In 2002, household consumption will grow further, supported by a fast increase of real incomes, as well as by optimistic perception by the majority of the Czech households of their economic future. Investment demand will be slightly weaker than in 2001, but it will also grow by approximately 5 %.

Czech GDP will also be dependent on the speed of economic recovery in EU countries, being our main trading partners. A lasting and visible revival in EU countries is not to be expected before the fourth quarter of 2002, so that its positive effects can be fully reflected in Czech economic growth only in 2003. Therefore, our estimate of GDP growth over 2002 is about 3 %.

The factors affecting Czech industry are not expected to change dramatically in the course of 2002: the exchange rate will remain strong and the influence of the world economic recovery very mild. The growth in industry in 2002 will reach 4 %. The general slowdown both of foreign and domestic demand will slow the growth in construction to approximately 6 % for the whole year.

The consumer sentiment and demand will remain solid in 2002. Low inflation and favourable conditions on consumer credits will support spending of households, nominal wages growing at a similar pace as in 2001. In 2002, retail sales will grow by 4.5 %.

We expect the yearly inflation rates to decline until the last quarter with slight acceleration at the end of the year. The CPI will reach 2.8 % in December 2002, while the growth of PPI will be very modest, i.e. 0.2 %. Unemployment rate will continue to be high: 8.8 % at the end of the year.

For 2002, our forecast is that CZK will appreciate by 10 % against the EUR (compared to the average CZK/EUR rate of 2001). In following years, the appreciation trend will probably slow down, as the pressure from inflowing FDIs will diminish somewhat.

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Low inflation and favourable conditions on consumer credits will support spending of households. In 2002, retail sales will grow by 4.5 %.

Table 1: Main Macroeconomic Indicators

		1996	1997	1998	1999	2000	2001	2002f
GDP growth	%, real	4.3	-0.8	-1.2	0.5	3.3	3.3	3.0
Industrial sales	%, real	6.8	6.1	0.6	-0.5	8.4	5.5	5.0
Industrial production	%, real	2.0	4.5	1.6	-3.1	5.8	6.8	4.0
Construction output	%, real	4.8	-3.9	-7.0	-6.5	5.6	9.6	6.0
Retail sales	%, real	11.4	1.9	-7.2	2.1	4.6	4.3	4.5
Inflation	%, average	8.8	8.5	10.7	2.1	3.9	4.7	2.5
Inflation	%, e.o.p.	8.6	10.0	6.8	2.5	3.9	4.1	2.8
Industrial producer prices	%, e.o.p.	4.4	5.7	2.2	3.4	5.0	0.8	0.2
Nominal wages	%, average	18.4	10.5	9.3	8.2	6.6	8.5	7.5
Unemployment rate	%, e.o.p.	3.5	5.2	7.5	9.4	8.8	8.9	8.8
Exports	%, nom.	6.6	20.0	17.7	9.2	23.3	13.1	2.0
Imports	%, nom.	13.0	15.3	7.5	7.5	28.2	11.7	-1.0
Trade balance	CZK bill.	-155.8	-151.2	-76.3	-69.9	-126.8	-119.0	-80.0
Current account	USD bill.	-4.3	-3.2	-1.0	-1.1	-2.4	-2.4	-2.2
Current account	% of GDP	-7.4	-6.1	-1.9	-2.0	-4.8	-4.3	3.1
Financial account	USD bill.	4.3	1.1	2.6	2.5	3.4	3.2	3.5
Financial account	% of GDP	7.4	2.1	4.8	4.7	6.8	5.7	5.0
State budget	% of GDP	-0.1	-1.0	-1.6	-1.6	-2.4	-3.3	-2.6
Gross foreign debt	USD bill.	21.2	21.6	24.3	22.9	21.5	22.0	21.0
Official FOREX reserves	USD bill.	12.4	9.8	12.6	12.9	13.1	14.5	20.0
M2 growth	%, e.o.p.	9.2	10.1	5.2	8.1	6.5	12.4	10.0
PRIBOR 3M	%, average	12.02	16.00	14.33	6.85	5.4	5.2	4.0
CZK/EUR*	Average	35.32	35.75	35.85	36.88	35.6	34.1	30.5
CZK/USD	Average	27.14	31.71	32.27	34.60	38.6	38.0	32.0

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

Note: *) until 1998 the CZK/DEM exchange rate converted by 1 EUR = 1.95583 DEM

Data on the world economy give a mixed picture in the first half of 2002.

Gradual recovery of the world economy is expected to spur world trade, bringing it out of the 2001 stagnation. Exporters in Western Europe will be providing stimulating effects for other sectors of their home economies.

Due to the fight against terrorism, and the continuing unstable situation in the Middle East, oil prices show a higher volatility, making predictions of inflation tricky and bringing problems and dilemmas for macroeconomic, especially monetary, policy.

2. External Environment

Data on the world economy give a mixed picture in the first half of 2002. On the one hand, numerous leading indicators suggest that the economy is coming out of the woods. On the other, there is also evidence that the upswing is not yet self-sustaining and that separated setbacks are likely to occur.

The United States so far shows most signs of having passed the trough of the cycle, with the economy now reviving. The evidence is supported by the stance of the Federal Reserve System which has changed the policy from expansive to neutral. There is a broad consensus among economists that, after the sluggish second quarter of 2002, economic growth will speed up in the U.S. in the third and, namely, fourth quarter. Over the whole year, growth is expected to reach 2.5 %, and to speed up to 4 % in 2003.

Economic revival, however, is still fragile in the eurozone countries. The economy of the EMU-12 will not achieve lasting growth before the fourth quarter of 2002. The eurozone so far is not in position to overcome the recession on its own. The fact that positive effects of U.S. economic revival will reach Europe with some delay supports the conclusion that a definite revival is only to be expected by the end of the year (see Table 2). Positive for the eurozone is the fact that thanks to a still favourable EUR/USD exchange rate, it can profit disproportionately from the revival of U.S. economy.

Gradual recovery of the world economy is expected to spur world trade, bringing it out of the 2001 stagnation. Exporters in Western Europe will be providing stimulating effects for other sectors of their home economies. Their revival can, in turn, spill over to some Central-European candidate countries (Hungary, Czech Republic, Poland) whose exports are strongly oriented toward the European Union.

The euro has overcome its lowest point in relation to the dollar (USD/EUR exchange rate was 0.856 on February 1, 2002) and has started to appreciate moderately, its rate by the end of June fluctuating between 0.97 – 0.99 USD/EUR. There is some room for further strengthening of the euro, but economic recovery in the U.S. which is faster and profounder compared to the eurozone can, in the second half of 2002, push the euro down again. Probability that the euro will be significantly above the parity with the dollar at the end of 2002 – start of 2003 is, therefore, rather low.

The Price of Oil: Is There a Danger of Another Oil Shock?

Due to the fight against terrorism, and the continuing unstable situation in the Middle East, oil prices show a higher volatility, making predictions of inflation tricky and bringing problems and dilemmas for macroeconomic, especially monetary, policy. Should the conflict in the Middle East escalate further, oil prices might rise dramatically, with a negative impact on inflation and economic growth mainly in the emerging markets, including the Czech Republic.

Since the start of 2002 oil prices have increased by more than one third, reflecting the growing Middle East tensions, in spite of growing stocks of oil in the main consumer countries. Experts work with the following three scenarios of possible further development:

1. Basic scenario: The price of oil will reflect macroeconomic fundamentals. If peace negotiations proceed between Israel and the Palestinians, the danger of curbed supply will be visibly reduced. Oil prices will, over the next 12 months, stabilise at USD 22 per barrel.

2. Scenario of continuous uncertainty: In this case, price is not determined by economic fundamentals but by uncertainty about future Middle East situation. In this scenario, oil price would further move in the interval of USD 25-30 per barrel till the end of 2002. Average oil price in the next 12 months would thus be USD 27 per barrel.

3. Scenario of "supply disarray": Further sharpening of the conflicts within the region would lead to lower oil supply but also to frequent disturbances in oil shipments. In this scenario, the price of oil would in the next 12 months be, on average, USD 33 per barrel.

Under the first scenario, CPI inflation in the Czech Republic can be expected to decrease (thanks to lower petrol prices) by 0.25 percentage points, and the PPI index to decrease by 0.1 percentage points. The scenario of continuous uncertainty would increase CPI inflation by 0.4 percentage points, and PPI inflation by 0.2 percentage points. And, finally, the scenario of disarray of oil supply would increase consumer prices by 1.1 percentage points and PPI inflation by 0.5 percentage points. It is evident that in case of the second or third scenarios, monetary policy would be tightened and basic interest rates would increase, with negative impacts on growth.

Table 2: Main Indicators for the Eurozone (growth rates in %)

	Q1	Q2	2002F	Q3	Q4	2002F	2003F
Industrial output	3.1	-1.8		0.0	1.0	-1.0	2.2
GDP	0.3	0.7		1.0	1.9	1.0	2.3
Inflation (CPI)	2.5	2.0		2.5	2.6	2.4	2.6

Source: Bayerische Landesbank

Table 3: Balance of Payments
(CZK bill.)

	Q 12001	Q 1-4 2001	Q 12002	Q 1-4 2002 F
Current account	-24	-101	-16	-70
o.w. Foreign trade	-26	-119	-9	-80
Balance of services	10	54	9	50
Balance of incomes	-11	-48	-18	-50
Transfers	4	12.5	2	10
Capital account		0	45	0
Financial account	33	153	45	110
o.w. Direct investments	38	183	22	190
Portfolio invest.	9.5	35	8	n.a
Long-term capital	-4	3	9	n.a
Short-term capital	-11	-65	7	n.a

Source: Czech National Bank, forecast KB

The mix of strong exchange rate, weak foreign demand and relatively low raw material prices led to decline both of imports and exports.

3. External Balance

In the first quarter of 2002, the balance of payments showed a solid surplus, again. Current account improved, the deficit amounting to CZK 16 bill., down from CZK 24 bill. in first quarter 2001. Current account deficit thus declined to 3.0 % of GDP.

3.1 Current Account

Trade with Goods

Most important part of the current account – foreign trade – showed an improvement against previous year. In the first quarter of 2002, two major factors have continued to affect Czech foreign trade, again: level of foreign demand and world raw material prices. The exchange rate of CZK further appreciated by 5 % against euro and by 5.5 % against USD. The mix of strong exchange rate, weak foreign demand and relatively low raw material prices led to decline both of imports and exports.

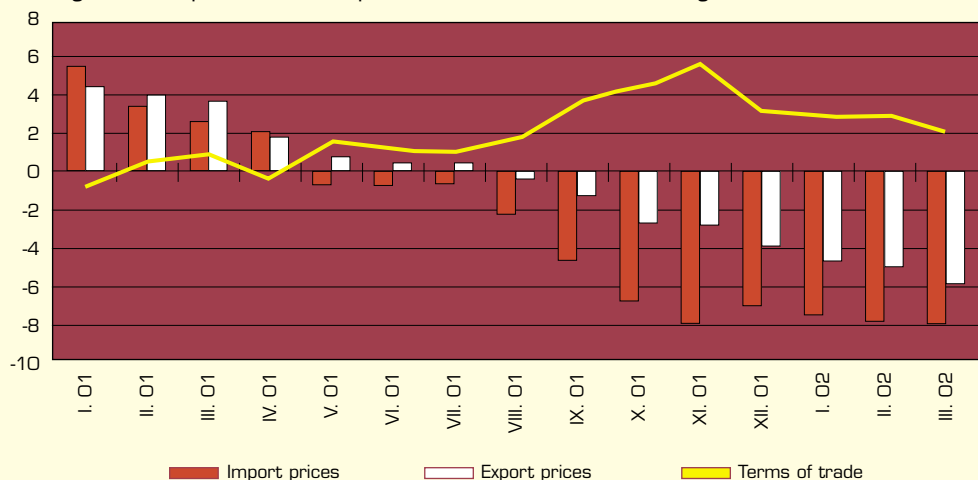
The decline of imports was more significant than the decline of exports, perhaps also due to the fact that the effect of strong exchange rate is more intensive on the part of imports. January to May 2002, the imports

declined by 5.3 % y/y and the exports fell by only 1.1 % y/y. The outpace of exports has been a long term tendency: the imports increased by 3.9 % y/y while the exports rose by 6.8 % y/y during last 12 months. May figures signalled further decline of exports (by 7.8 %), mostly due to decline of machinery exports, one month fluctuation however cannot be sufficient for judgements about long-term changes in trend.

More favourable developments of exports against the imports caused the yearly improvement of trade balance. January to May 2002, the trade deficit amounted to CZK 21.5 bill. which is a decline of CZK 24.9 bill. against the same period of 2001. The decline in trade deficit was both due to the decline of the deficit in the trade with raw materials and chemicals and the increase of the surplus in the trade with machinery and transport equipment.

To sum up: the weakening of demand in Western Europe did not deteriorate Czech trade balance. The exports to the EU declined only negligibly in the first quarter of 2002 (by 2 % y/y) while the imports fell by 10 % y/y. The trade balance with the EU thus improved by CZK 14 bill. in the first quarter of 2002, the trade surplus amounting to CZK 21.6 bill. The improvement was mostly due to growth of surplus in the trade with machinery and transport equipment, again. The most profound decline registered the trade with Germany, Czech main trading partner. Both the imports and exports declined by more than 10 % y/y in the first quarter of 2002. Czech exporters have been able to offset the weak German demand by succeeding to find new trading partners in other West European countries, especially in France, the Netherlands, Great Britain and Scandinavian countries.

Figure 1: Import Prices, Export Prices, Terms of Trade, (growth rates in %.)



Source: Czech Statistical Office

The weakening of demand in Western Europe did not deteriorate Czech trade balance.

The territorial structure of FDI inflow in recent years strongly correlates with territorial increases in exports.

Structure of foreign direct investments in last two years confirms that the inflow of FDI may register a slowdown but will not stop after the end of privatisation in the Czech Republic.

While equity securities were the field of interest of foreign investors recently, in the first quarter of 2002, inflow of portfolio investments was concentrated to debt securities.

The recovery in Western Europe seems to be only reluctant and hesitating. So that the demand for Czech exports cannot be expected to recover before the end of the year.

The full-year trade deficit in 2002 should be slightly lower than the 2001 deficit, most probably not exceeding CZK 80 bill.

Under the conditions of permanent CZK appreciation, the competitiveness of Czech exports on world markets can last only when both productivity of labour and quality of production is rising. Growth in productivity and quality are the two factors standing behind solid Czech exports to West European countries. Export ability of Czech producers has been improving especially due to strong inflow of foreign direct investments the pro-export effects of which is undeniable. At the same time, the territorial structure of FDI inflow in recent years strongly correlates with territorial increases in exports mentioned above.

Services, Incomes, Transfers

Services showed minor changes in the first quarter of 2002. Transport and tourism registered net profits of CZK 5 bill. and CZK 14 bill. respectively, other services being in the red again. However, the net income in tourism declined by CZK 1.5 bill. due to lower revenue, which seems to be hit by strong CZK exchange rate. Other services showed a small growth both on the parts of incomes and expenditures.

Balance of incomes deteriorated by almost CZK 7.5 bill. to a deficit of CZK 18.3 bill. Developments on the incomes balance is tightly connected with the developments of overall investment position of the Czech Republic, again especially due to FDI inflows. Repatriation of profits and payments of dividends have been the main factors of growing deficit of incomes. This is one of the adverse sides of massive inflow of foreign direct investments. Moreover, the payments of interests declined especially as a result of low foreign interest rates. On the part of expenditures, predominantly the interest yields from domestic debt securities increased due to growing activity of foreign investors.

3.2 Financial Account

Direct Investments

Foreign direct investments were – again – the major part of the capital inflow amounting to CZK 22.3 bill. in the first quarter of 2002. Even though a slowdown of FDI inflow was registered (38 bill. in Q1 2001), this result has not been alarming since no privatisation deals were accomplished in Q1 2002. The inflow has been usually the lowest in the first quarter of the year, due to seasonal reasons. Anyway, weaker FDI inflow is most probably a consequence of overall world economic slowdown.

Structure of foreign direct investments in last two years confirms that the inflow of FDI may register a slowdown but will not stop after the end of privatisation in the Czech Republic. Moreover, emerging markets in Central Europe are considered to be a relatively safe place for investments. The inflow of FDI in 2002 can be expected to be even higher than in 2001, amounting to (or exceeding) USD 6 bill.

Major part of FDI's were oriented towards services (approximately 55 %). Anyway the share of investments coming into the developments of production capacities was higher than in previous years amounting to almost 50 %. Almost 90 % of FDI was from the European Union (especially Germany, the Netherlands and Belgium).

Portfolio and Other Investments

Portfolio investments showed slightly lower net inflow than in Q1 2001. Higher purchases of foreign debt securities made by Czech investors were registered (amounting to CZK 10 bill.). This tendency will probably continue in the coming quarters. While equity securities were the field of interest of foreign investors recently, in the first quarter of 2002, inflow of portfolio investments was concentrated to debt securities (purchases amounting to CZK 22 bill.).

Other investments changed also a bit from a year earlier, total inflow amounting to CZK 15 bill. Both long-term and short-term investments registered net inflow (of CZK 9 bill. and CZK 6 bill. respectively). The most important factor affecting this segment of investments was the decline of short-term deposits made by the Czech banks abroad and the government income from the payment of Russian debt.

Outlook

The favourable impact of low raw material prices will diminish in the months to come. However, the imports will continue to be affected by strong exchange rate of CZK. At the same time, strong exchange rate will hit the Czech exporters. Czech National Bank continued to fight with strong currency in April 2002 by two series of interventions accompanied by rate cuts. These rate cuts placed the Czech basis rates to historical lows. Nevertheless, the changes in interest rates have only minor effects on the exchange rate in the longer run.

The recovery in Western Europe seems to be only reluctant and hesitating. More visible recovery is probable to come not before the last quarter of 2002. Well known structural problems, low flexibility of labour market and limited fiscal stimuli are the main factors behind slow West European recovery.

Last estimates indicate that German GDP will slightly increase in the third quarter of 2002, full-year growth being close to 1 %. The recovery of German industrial production (which is the key indicator affecting Czech exports) will be even slower and less intensive. The industrial output will stop to decline only in the last quarter of 2002, so that the demand for Czech export cannot be expected to recover before the end of the year.

Gradual recovery of Czech exports in the last quarter of 2002 will lead to higher growth rates of exports, however not exceeding 2 % for the whole year. The growth of exports will promote also Czech imports due to high import intensity of Czech exports, so that the improvement of trade balance will weaken in the second half of 2002. The full-year trade deficit in 2002 should be slightly lower than the 2001 deficit, most probably not exceeding CZK 80 bill. Balance of services will not show any significant improvement, tourism being slightly hit by strong exchange rate of CZK. The current account deficit will therefore amount approximately to CZK 70 bill. in 2002 (USD 2.2 bill.). Under the assumption of 3 % growth of GDP, the share of the current account deficit on GDP will decline to 3.0 %, which is quite a safe and sustainable level. Expecting the inflow of FDI at least USD 6 bill., external balance should not show any risks.

4. Gross Domestic Product

Gross Domestic Product continued to grow in the first quarter of 2002, increasing by 2.5 %. This growth however was slower than in 2001 or 2000 (see Table 3).

Table 3: GDP growth, 1996 – 2002, (growth rates in %, constant prices)

1996	1997	1998	1999	2000	2001	2002:Q1
4.3	-0.8	-1.2	0.5	3.3	3.3	2.5

Source: Czech Statistical Office

As in 2001, investment in fixed capital (increase by 8.1 %) was the main driving force of economic growth, followed by private (household) consumption (4.1 %). In volumes, GDP was driven mainly by the growth of household consumption. Total GDP increase equalled to CZK 8.9 bill., of which 8.1 bill. was household consumption, and 1.5 bill. fixed capital investment. The contribution of the external sector was again negative (-CZK 0.7 bill.), but, after a long period of aggravating negative impact of net exports on GDP, this impact is now subsiding. (In the first quarter of 2002, net exports grew by 3.1 %, imports by 3 %). Government consumption – after a year of stagnation or decline – increased by 0.4 %, as was to be expected before elections (so, in the Czech Republic as well, government consumption follows the laws of the political business cycle).

Value added increased mainly in services: transport and communications, trade, and business services all grew fast. The increasing share of services in GDP is bringing the structure of the Czech economy ever closer to advanced market economies.

Household consumption is growing at a steady pace (in the last four quarters, its growth rates were within the interval of 4.0 – 4.3 %). It is being fostered both by the increase of real incomes and by the low propensity to save (measured by Czech conditions and the history of the last decade). Presently, households use consumer credit as well as the rapidly growing mortgage credit market.

Outlook

Relatively solid growth (by EU standards) will continue in 2002. Due to low dynamics in EU economy and declining foreign demand, we estimate Czech GDP growth in 2002 to be at (or slightly above) 3%. The driving force behind this output dynamic will be domestic demand, especially household consumption and fixed capital investment. Fiscal easing will boost government spending, what is normal in election year, due to well known rules of political business cycle.

The contribution of net exports to GDP growth will continue to be negative, in spite of the expected revival of economic growth in EU countries in the second half of 2002, and following resurgence of world trade.

Despite all uncertainties emerging primarily from external environment, the Czech economy will continue to catch-up with EU countries. It is almost certain that in the next two or three years, Czech GDP growth will exceed the average EU growth rate by 1 to 1.5 percentage points.

5. Domestic Demand

5.1 Industry

Industry continued in solid growth in the first half of 2002, the industrial output increasing by 5.1 %, January to May 2002. The growth of industrial sales was lower, the growth amounting to 3.0 %. Czech exporters have been able to keep export performance even under sluggish foreign demand, direct sales from exports increasing by 13.7 %, January to May. The competitiveness of Czech exports has been kept mostly by foreign controlled companies.

The growth in industry has been pulled predominantly by foreign controlled companies – this sector represents the most dynamic part of the Czech industry. The share of foreign controlled companies on industrial sales amounted to 46.3 % in May 2002, their growth of sales being considerably higher than the growth of total industrial sales (e.g. in May 2002, the industrial sales increased by 2.6 %, while the foreign controlled companies realised the growth of sales by 9.9 %).

According to the analysis of Czech Ministry of Industry and Trade the companies under foreign control account for two thirds of total Czech exports and for more than 40 % of value added in the whole industry which indicates that this sector has been gradually gaining on importance in the Czech economy. Higher efficiency of foreign controlled companies is well illustrated on Figure 2: foreign controlled companies account for higher shares on value added and profits that would correspond their shares on capital factors (employment, assets etc.).

At the same time, relative indicators of foreign controlled companies are more favourable than those of companies under domestic control. Productivity of labour is by 50 % higher in foreign controlled companies, return on assets is by 70 % higher, and the return on equity is by more than 100 % higher. On the other hand, the average wage is only 25 % higher. Domestic private industrial sector has been still characterised by stagnation of value added, growth of personal costs and moreover by sluggish investment activity indicated by stagnation both of long-term assets and depreciation.

Productivity of labour increased by 5.2 % year on year, January to May 2002, which is the same growth as in 2001. At the same time, real wage grew by 3.2 %, which is an acceleration against previous year, nevertheless, slow decline in unit labour costs continued. The ratio between labour productivity and real wage growth remained more favourable in manufacturing industries, where real wage grew by 3.1 % and labour productivity increased by 5.8 % y/y. Due to appreciation of the Czech currency, the industrial prices have been continuously declining, while the output keeps quite solid growth. Weaker investment demand represents another factor pushing down the industrial producer prices (for more detail see Chapter 6). Manufacturing industries continued in above average

Under the assumption of 3 % growth of GDP, the share of the current account deficit on GDP will decline to 3.0 %, which is quite a safe and sustainable level.

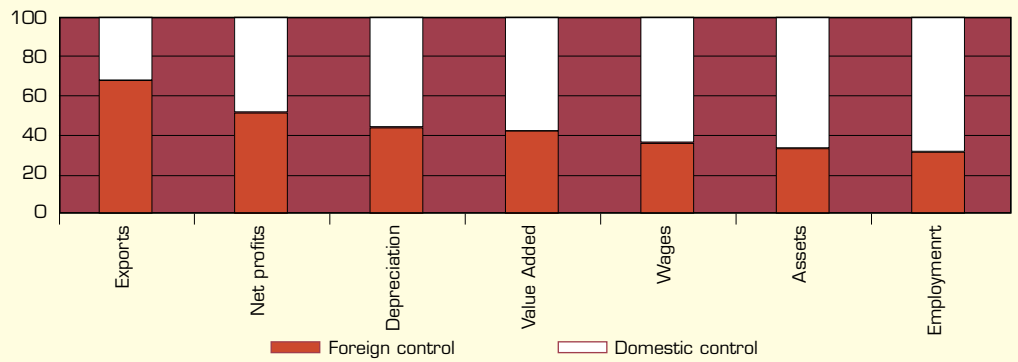
In volumes, GDP was driven mainly by the growth of household consumption. Total GDP increase equalled to CZK 8.9 bill., of which 8.1 bill. was household consumption, and 1.5 bill. fixed capital investment.

Despite all uncertainties emerging primarily from external environment, the Czech economy will continue to catch-up with EU countries.

Foreign controlled companies account for higher shares on value added and profits that would correspond their shares on capital factors (employment, assets etc.).

Due to appreciation of the Czech currency, the industrial prices have been continuously declining, while the output keeps quite solid growth.

Figure 2: Share of Foreign and Domestic Controlled Companies: Selected Indicators, (in %)

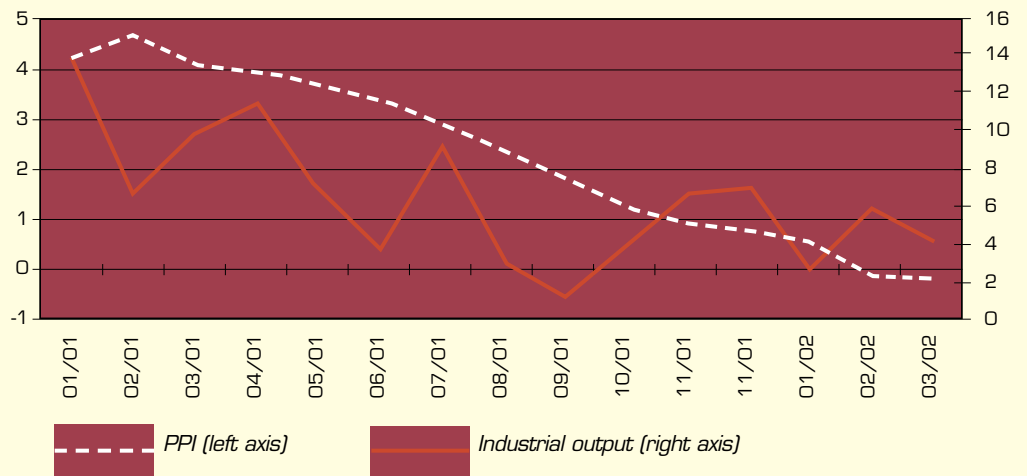


Source: Czech Ministry of Industry and Trade

growth: while mining and quarrying grew only 0.7 %, January – May 2002, manufacturing grew more rapidly, growing by 6.0 %, year on year. Manufacturing thus grew exactly at the same pace as in the second half of 2001 (6.0 %). Manufacture of electrical and optical appliances

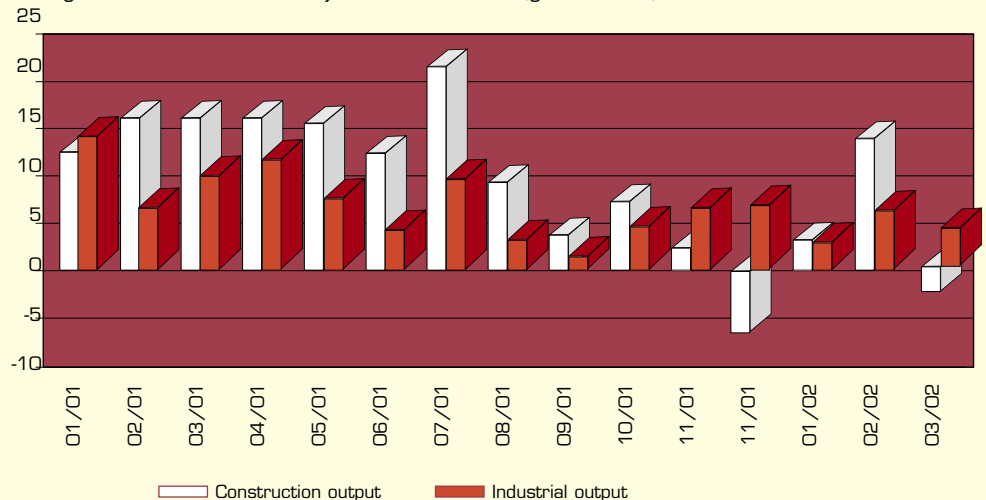
performed best with the growth of 31.0 %, January to May 2002. Manufacture of rubber and plastic products and manufacture of coke as well as manufacture of wood and wood products belonged to the industries with above average growth.

Figure 3: Industry: Growth of Output and Decline in Prices, (in %)



Source: Czech Statistical Office

Figure 4: Growth in Industry and Construction (growth in %)



Source: Czech Statistical Office

5.2. Construction

Construction has been showing strongly volatile monthly results since the end of 2001, the trend of slowdown being however evident. Statistical bases for comparison from 2001 were high, pushing the growth rates down. Nevertheless the partial impact of weak foreign demand seems to be felt also in this sector, visible as of last quarter of 2001. Naturally, the effect of sluggish demand is less significant than in the Czech industry; however, some indirect effects reached also the construction. Data on capital inflow indicated that in the first quarter of 2002 the inflow of FDI weakened most probably due to overall world economic slowdown which had affected the construction of assembly halls and other big construction projects. Construction output increased by 4.5 %, January to May 2002. The construction output grew in all types of construction activities: new construction, repairs and maintenance, both in building and civil engineering.

The most favourable tendency which appeared in Czech construction is the recovery of housing which had been going through long term recession. First signs of recovery of housing have appeared as early as in February 2002. The number of construction permissions on flats increased by 6.1 %, while the number of new flats increased by 25 %, January to May 2002. The demand in construction has thus shifted from shopping centres to housing construction. The important factor which helped to revive housing are – with high probability – more favourable conditions on mortgages. This factor will continue to perform in the longer run, so that recovery of housing would probably last and support the construction output. Also, housing recovery should be helpful for small construction companies which were not profiting from construction boom in previous two years.

In the first five months of 2002, employment in construction increased by 2.7 %, contrary to industry which has been experiencing long-term decline in employment. Labour productivity increased by only 1.4 %, while real wage grew by 3.6 %. This unfavourable relation has been preserving since February 2002 and may represent a risky factor for inflationary pressures which could be transferred to other sectors of the Czech economy.

5.3. Retail Trade

Private consumer demand remained strong in the first months of 2002. In the first quarter of 2002, private consumer demand increased by 4.1 %. At the same time, retail sales increased by 4.2 %, January to April 2002. Consumption of households seems to become the most dynamic and stable factor of the Czech economic growth. Strong consumer demand has not been provoking any inflationary pressures and thus seems to be sustainable in the long run.

The propensity of the Czech households to spend has been continuing, supported by solid growth of real incomes, overall optimism about their future economic situation and also by low interest rates on deposits and very soft conditions on consumer loans and mortgages. The real growth of wages amounted to 3.2 % in the first quarter of 2002. At the same time, the interest rate on term-deposits broke the 3 % level in April 2002 which does not support the households' propensity to save.

The growth of retail sales has been oscillating around the long-term trend with only minor deviations in the course of the first four months of 2002. All the sortiment groups registered growth of sales. Sales of food and non-food items continue to be supported by similar factors as in the past months: growth of hypermarkets, wide offer of consumer credits and the above quoted factors. Fuel sales grew rapidly in 2002 (by 12.6 % January to April 2002) being supported both by relatively favourable developments of fuel prices and by low statistical bases from the previous year. The world oil prices have not reached their 2001 levels, prices of fuels thus have been lower in year on year comparison. At present, the fuel prices are approximately by 10 % lower than in 2001.

Outlook

The data for the first quarter of 2002 proved that the Czech industry has been able to keep the growth approximately at the level of the second half of 2001 even under weak foreign demand and weaker domestic investment demand. Exporters have been able to export to new territories especially due to economic and trade relations created by inflow of FDI. The factors affecting Czech industry are not expected to change dramatically in the course of the 2002: the exchange rate will most probably remain strong and the general economic recovery of world economy which should promote Czech exports cannot be expected before last quarter of 2002. Therefore, in 2002, the growth in industry is most probable to be the same as in the second half of 2001 and the beginning of 2002: the growth in industry will reach approximately 4 % in 2002.

The general slowdown both of foreign and domestic demand will slow the growth in construction, too. Non - privatisation related FDI inflow continues, however at a slower pace than in 2001. Big construction will thus continue to grow, although not so robustly as in 2001. Housing will recover definitely, supporting the growth of construction output. The growth rates will be negatively affected by high bases for comparison from 2001, especially until August. The full-year figure of output growth in construction will therefore amount to approximately 6 %.

We expect the consumer demand and sentiment to remain strong in the rest of the year. Low inflation will support spending of household, real wages growing more quickly than in 2001. Favourable conditions on mortgages will be additional factor pushing the households spending up. However, in the longer run, an crowding out effect might appear, slowing somewhat the food and non-food items sales. Sales of fuels will continue to grow due to lower prices of petrol; on the other hand, since May 2002, the factor of low comparative basis will be diminishing. Retail sales will increase by 4.5 % in 2002.

The demand in construction has shifted from shopping centres to housing construction.

Consumption of households seems to become the most dynamic and stable factor of the Czech economic growth.

The growth of retail sales has been oscillating around the long-term trend with only minor deviations in the course of the first four months of 2002.

The world oil prices have not reached their 2001 levels, prices of fuels thus have been lower in year on year comparison. At present, the fuel prices are approximately by 10 % lower than in 2001.

In 2002, the growth in industry is most probable to be the same as in the second half of 2001 and the beginning of 2002 and will reach approximately 4 %.

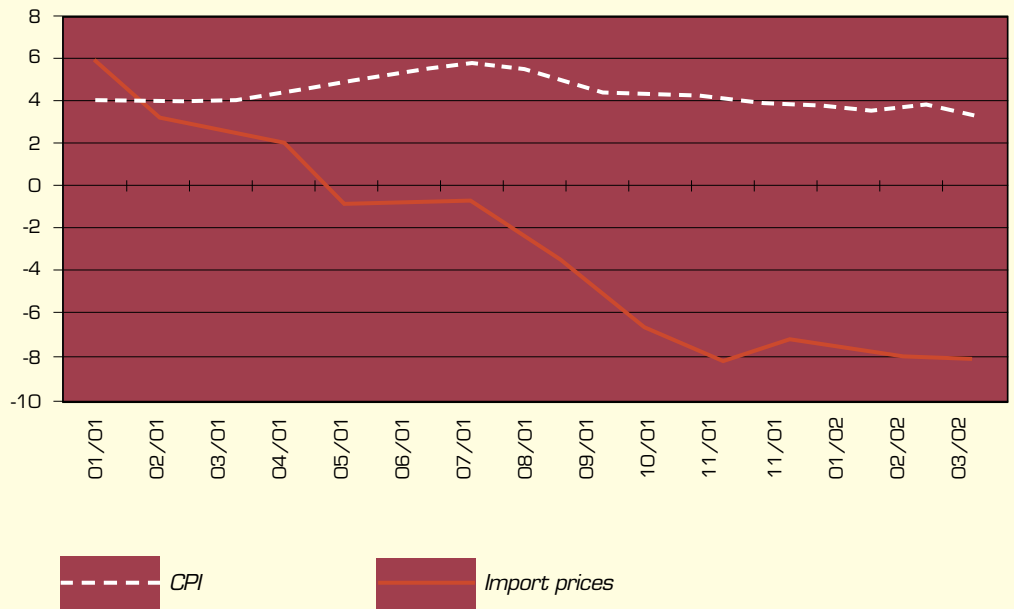
The first half of 2002 registered a significant slowdown in most components of the price movement, including both consumer and producer prices.

The low inflation in the first half of 2002 is a consequence of low world raw material prices combined with strong exchange rate of CZK and weakening both foreign and domestic demand.

The inflation rate got under the inflation target corridor set by the Czech National Bank.

Industrial producer prices turned to deflation in the first half of 2002.

Figure 5: Consumer Prices and Import Prices, (growth in %)



Source: Czech Statistical Office

6. Inflation

The first half of 2002 registered a significant slowdown in most components of the price movement, including both consumer and producer prices. The decline in producer prices was even sharper in the first quarter of 2002, the gap between CPI and PPI reaching approximately 4 percentage points. During the second quarter, the CPI declined more quickly than PPI the gap narrowing to 2.0 percentage points in June 2002. In the first half of 2001 thus the CPI reached 1.2 % y/y, while PPI turned even to deflation, falling by 0.8 % y/y.

The low inflation in the first half of 2002 is a consequence of low world raw material prices combined with strong exchange rate of CZK and weakening both foreign and domestic demand. In May 2002 e.g., world prices declined by 21 % y/y, prices of oil being by 10 % y/y lower, prices of gas by 40 % y/y lower. The combination of relatively low world material prices and strong exchange rate caused the decline in import prices affecting strongly both the Czech CPI and PPI (see Figure 5). Weakening domestic demand not provoking inflationary pressures helps to keep inflation on low levels, too.

6.1 Consumer Prices

Consumer prices were falling during the whole first half of 2002. Month-on-month indexes of consumer prices have been negative since March 2002. The year on year decrease in inflation was very strong: the inflation rate fell from 4.4 % in January 2002 to 1.2 % in June 2002. The year on year rates of CPI have been declining since July 2001 (the month of record-high inflation since the end of 1998) when the CPI amounted to 5.9 % y/y.

In June 2002, the yearly inflation rate was thus the lowest since September 1999 – a period of deep recession in the Czech economy. The inflation rate got under the

inflation target corridor set by the Czech National Bank and is by approximately 2 percentage points lower than expected by most analysts and institutions at the beginning of 2002.

Since 2001, the developments of CPI have been determined especially by two price items: food and fuels. In mid-2002, the prices of food items which represent 20 % of total consumer basket showed a year on year stagnation. The prices of transport which are most sensitive to world oil prices movements fell by 3.7 %. There was only one-off increase in fuel prices in April 2002, followed by decline in May, again due to consolidation on the world oil market. Also the prices of some non-food items, like clothing and equipment of households registered favourable developments (stagnation or even year on year decline of prices). Regulated prices registered a first drop since 1999 in April 2002 when gas prices were decreased as a consequence of strong decline of this price on world markets.

Favourable developments were supported also by domestic factors. Growth of labour productivity outpacing real wages in industry prevented the economy from cost inflationary pressures. At the same time, solid growth of consumer demand is not so strong to cause demand inflationary pressures.

6.2 Producer Prices

Industrial producer prices turned to deflation in the first half of 2002, the yearly PPI declined to – 0.8 % y/y in June 2002. The yearly PPI has been continuously declining since February 2001. The second quarter levels of yearly PPI are the lowest in the history of the Czech Republic. Again, the favourable developments on world raw material prices combined with strong CZK are the major factors behind the PPI developments.

The PPI decline is most pronounced in manufacture of petrol products and in chemical industry. The prices

of petrol products in mid 2002 are by almost 20 % lower than in the same period of 2001, especially due to USD depreciation and stabilisation on world oil markets. The only industry pushing the PPI up has been the sector of utilities (electricity, gas and water) where a yearly growth of PPI by approximately 6 % occurred.

In June 2002, prices in construction offer less favourable picture than in industry. Cost inflationary risks have emerged in construction as of first months of 2002. Prices in construction increased by 2.6 % year

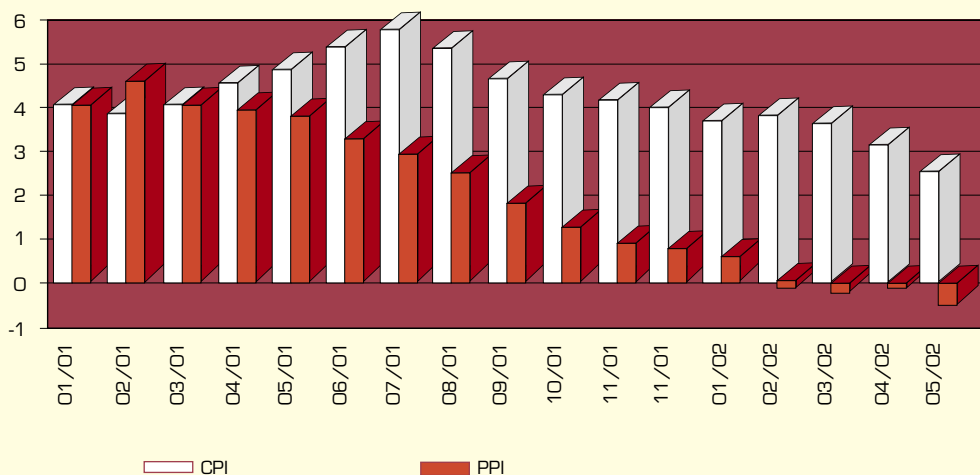
on year, in June 2002. Favourable relation between labour productivity and real wages keeping construction prices under control was broken in the beginning of 2002 due to slowdown in labour productivity. In the longer run, the threat of cost pushed inflation stemming from construction could emerge.

In May 2002, a first year on year decline in producer prices since February 2002 was registered in agriculture. In mid-2002, the agricultural prices declined by 16 % year on year.

Favourable developments of producer prices in industry and agriculture represent favourable factor for consumer prices: at least till the third quarter of 2002, the consumer prices will not be pushed up by producer prices.

We expect the yearly inflation rates to decline until the last quarter with slight acceleration at the end of the year. The yearly increase in consumer prices should reach 2.8 % in December 2002.

Figure 6: CPI and PPI, (growth in %, monthly figures)



Source: Czech Statistical Office

Outlook

Producer prices in industry will reflect the developments of world raw material prices, especially oil prices. The oil prices affect the domestic producer prices with a time lag of 3 to 6 months. The oil prices would push the Czech PPI up only being above the level of 26 USD per barrel (average level of 2001) which does not seem probable for the third quarter and could occur only in the last quarter of 2002. PPI will be kept low also by productivity of labour outpacing the growth of real wages in industry as well as weaker domestic investment demand. The exchange rate of CZK will remain strong, continuing to make the imports cheaper. Therefore we expect the PPI to stand at 0.2 % year on year at the end of 2002.

Favourable developments of producer prices in industry and agriculture represent favourable factor for consumer prices: at least till the third quarter of 2002, the consumer prices will not be pushed up by producer prices, even though some risks have appeared in construction. Unlike in summer 2001 when short-time speeding up of inflation emerged due to higher prices of recreation (especially foreign trips) strong CZK will eliminate this factor for summer 2002. We expect the yearly inflation rates to decline until the last quarter with slight acceleration at the end of the year. The yearly increase in consumer prices should reach 2.8 % in December 2002.

7. Monetary and Fiscal Policies

Monetary Policy

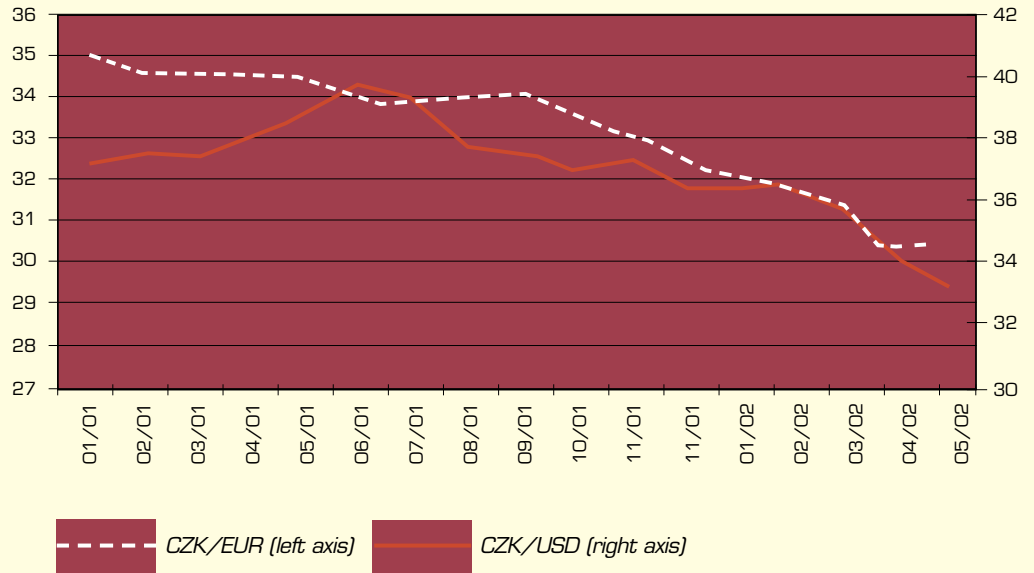
In 2002, nominal appreciation of the CZK accelerated in the first four months. In mid-April, the Koruna was 5.1 % above the beginning of January level. Several open market interventions by CNB were unable to stop the appreciation, and only the surprise cut of the repo rate on April 25, 2002, reversed the trend. On July 4, the exchange rate of CZK stood at 29.4 CZK/EUR, representing an appreciation of 7.2 % vis-à-vis the beginning of 2002.

Although one can characterise the developments at the start of 2002 as a sort of bubble, it was only a divergence from the medium-term trend of gradual nominal appreciation of the Czech Koruna. Reasons for the medium-term trend of nominal appreciation are as follows:

- Even after privatisation incomes dry out in 2003 (with the privatisation of remaining state-owned companies being accomplished), continuing inflow of FDIs can be expected, in the volume of roughly USD 3 bill. per year. This, incidentally, was the volume of the part of FDIs not connected with privatisation in 2000 and 2001 - i.e. greenfield investments, direct equity investments and re-investments of profits.

For 2002, our forecast is that the CZK will appreciate by 10 % against the EUR (compared to the average CZK/EUR rate of 2001). In following years, the appreciation trend will probably slow down, as the pressures from inflowing FDIs will diminish somewhat.

Figure 7: Developments of CZK Exchange Rate



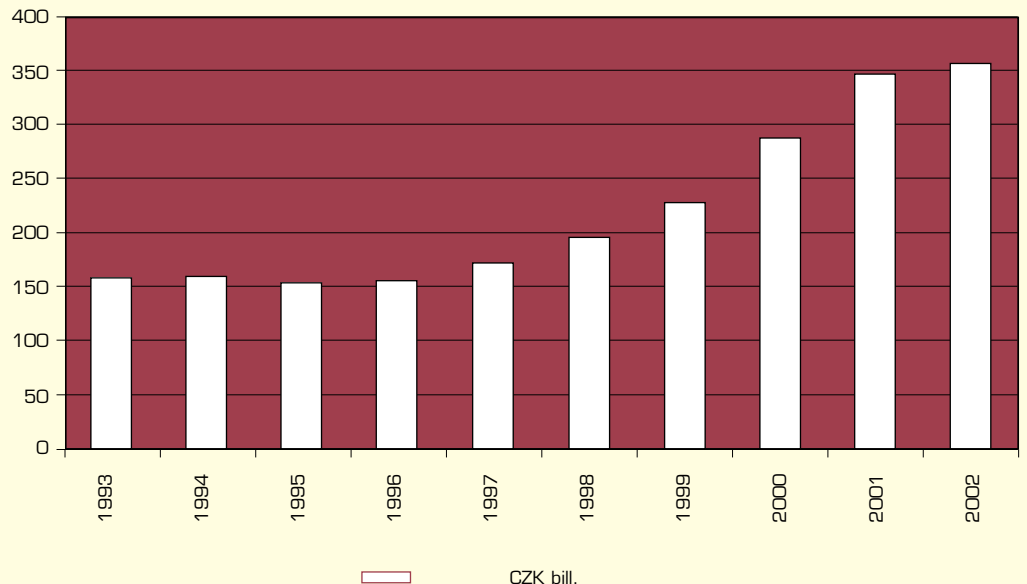
Source: Czech National Bank

- Investors will further see the territory of the Czech Republic as a favourable investment site: NATO membership provided for the CR a safety umbrella, and European Union membership will give it the advantage of participating in a large economic and political entity.
 - As in the case of Ireland, Portugal or Spain before EU accession, Czech currency is now going through a period of a speed-up of nominal appreciation.

For 2002, our forecast is that the CZK will appreciate by 10 % against the EUR (compared to the average CZK/EUR rate of 2001). In following years, the appreciation trend will probably slow down, as the pressures from inflowing FDIs will diminish somewhat; even so, one can expect an average yearly appreciation of 3-4 % in 2003 to 2005.

Low inflation (see Part 6 above) has allowed the CNB to cut interest rates to a lowest level in the history of the Czech Republic. There is also a historically lowest differential between the basic ECB rate (3.25 %) and the CNB repo rate (3.75 %). Though inflation will continue to decrease in June and July, giving some room for further rate cuts (roughly by 50 basic points), the Czech National Bank with all probability will leave the rates at the present level. Further rate changes can be expected at the end of the third quarter, at the earliest, depending on inflation development and on interest rates in the eurozone.

Figure 8: Government Debt in the Czech Republic, (CZK bill.)



Source: Ministry of Finance of the Czech Republic

Fiscal Policy

Fiscal policy in recent years has been characterised by increasing deficits and declining transparency, due to the creation of several extra-budget funds. Government budget in January – May 2002 ended with a deficit of CZK 32.4 bill. During the first quarter, government debt grew from CZK 345 bill. to CZK 358.4 bill. (see Figure 8). At the end of 2002, the government budget deficit will be CZK55 – 60 bill., i.e. roughly 2.5 % of GDP. The deficit of public budgets will reach, in our estimate, CZK 200 bill., i.e. more than 9 % of GDP. With privatisation incomes included, deficit of the public budgets will be just below 6 %, i.e. high above the level required by the Maastricht criteria.

The reason for the large and increasing difference between the government budget and public budgets figures is the use of extrabudgetary funds with significant expenditures. This implies that the monthly government budget figures have limited value and do not reflect the growing deficits correctly.

The new coalition government likely to be formed after June elections will hardly be a catalyst for major fiscal reforms. The election program of the Social Democrats includes items requiring substantial additional expenditures, while the determination to reform the public finance, especially the pension system, is low. Hence it can be expected that public debt will further grow, and the deficit of public finance will only be lowered after the accession of the Czech Republic to the European Union. This highly probable scenario has direct implications for the estimated date when the Czech Republic is to become member of the eurozone – as fiscal consolidation will be slow.

On the other hand, lasting and growing public budget deficits are good news for the securities markets. The government will finance the deficit by

bond emissions, probably in the Czech as well as in foreign markets, which will further strengthen this (today the only normally functioning one) part of the Czech capital market.

8. Labour Market

As of the last quarter of 2001, the impact of cooling West European conjuncture started to be visible also on the Czech labour market. The rate of unemployment followed usual seasonal developments in the first months of 2002. Spring months are usually favourable for developments of unemployment, agriculture and construction offering seasonal jobs. However, in 2002, the decline in unemployment observable from January to May was lower than in 2001 and 2000, declining by only 0.8 percentage point. Weaker both foreign and domestic demand did not allow domestic companies to hire additional labour force and create new vacancies.

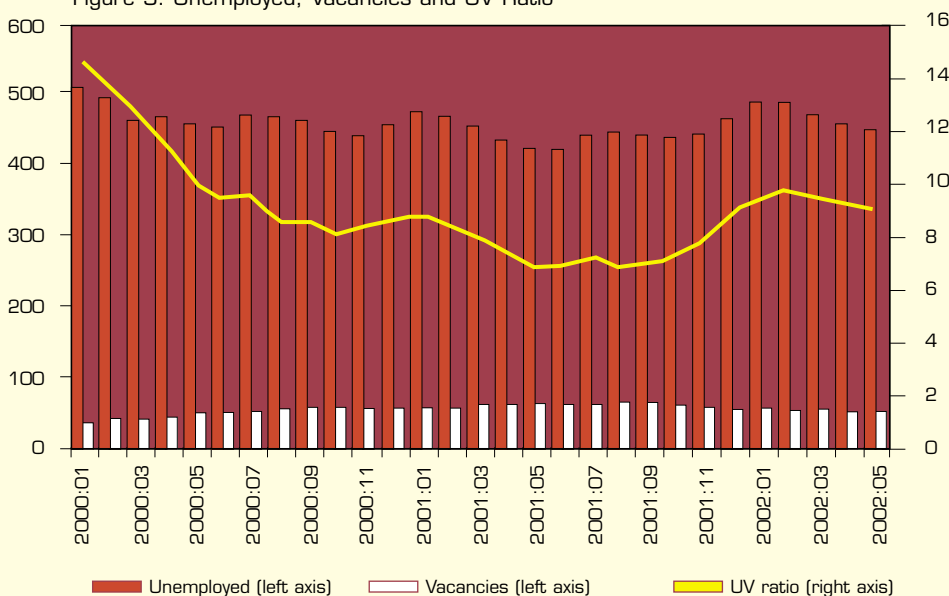
December 2001 was the first month with year on year decline in vacancies, after 22 months of continuous yearly growth. At the same time, in December 2001 the year on year growth in job-seekers increased after 14 months of continuous decline. Following months proved both these changed tendencies. As a consequence of developments of unemployed and vacancies, the ratio between unemployed and vacancies showed a deterioration since September 2001 after year and a half of improvement. In September this ratio amounted to 6.9, first quarter 2002 data indicating stabilisation around the level of 9-10 people falling upon one vacancy.

In April and May first signs of improvement appeared: while the deterioration of all the yearly indicators continued, month on month developments improved. This means that in May 2002 the number of unemployed increased against May 2001 (by 27 thousands of people) but a decline by almost 10 thousands persons was observed in comparison with

The new coalition government likely to be formed after June elections will hardly be a catalyst for major fiscal reforms. The election program of the Social Democrats includes items requiring substantial additional expenditures, while the determination to reform the public finance is low.

As of the last quarter of 2001, the impact of cooling West European conjuncture started to be visible also on the Czech labour market.

Figure 9: Unemployed, Vacancies and UV Ratio



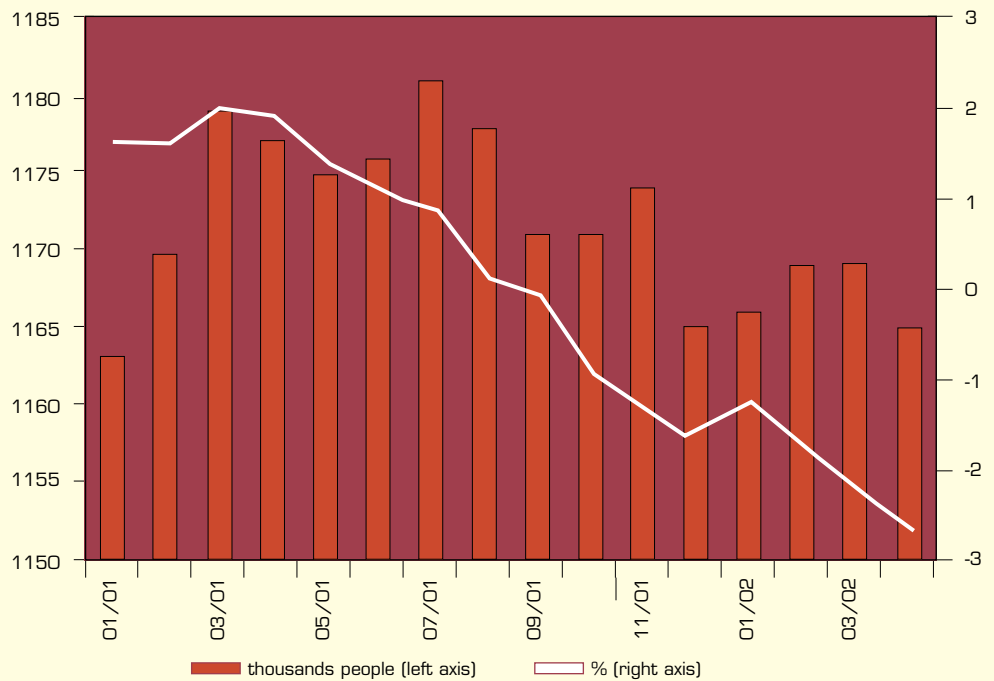
Source: Czech Ministry of Labour and Social Affairs
 Unemployed and Vacancies: in thousands
 U-V ratio: number of unemployed falling upon one vacancy

Growing pressures on the Czech labour market strongly correlate with the slowdown in the Czech industry experienced as of third quarter of 2001.

The decline in employment in the whole economy amounted to approximately 1 %. The only industries registering increase of employment were construction and some services, especially trade, hotels and restaurants.

Weak foreign demand combined with weakening domestic demand will not soften the labour market pressures.

Figure 10: Employment in Industry (thousands people, growth in %)



Source: Czech Statistical Office

April 2002. The same applies for vacancies: in May 2002 the decline of more than 10 thousands vacancies was registered in comparison with May 2001, free jobs however slightly increasing against April 2002 (by moderate 700 jobs). The UV ratio thus slightly declined in May to 9 unemployed falling upon one vacancy.

Growing pressures on the Czech labour market strongly correlate with the slowdown in the Czech industry experienced as of third quarter of 2001. Since then, the unemployment in industry has been continuously declining. It fell by 2 % in the first half of 2002. In primary industries, the employment fell by 6 %, while in manufacturing ones the decline was less profound (by 1.6 %). The decline in employment in the whole economy was lower amounted to approximately 1 %. The only industries registering increase of employment were construction and some services, especially trade, hotels and restaurants.

While wage growth seemed to be one of the risky factors for macroeconomic stability in 2001, the final growth of wages was not extreme, average wage increasing by 8.5 %. In the first quarter of 2002 the wages showed a slight slowdown to 7 %. Under the growth of consumer prices by 3.7 %, the growth of real wage amounted to 3.2 %. At the same time, the wages grew more quickly in the business sector (7.2 % y/y) than in the public one (6.5 % y/y). The wages grew most rapidly in the industries with highest wage level which means that wage differentiation has deepened. From macroeconomic point of view, the wages thus do not represent any risky factor for 2002.

Outlook

Weak foreign demand combined with weakening domestic demand will not soften the labour market pressures. The vacancies will grow only very slightly in the second half of 2002. The unemployment rate will follow usual seasonal trends in the months to come, reaching the similar year end level as in 2001, in December 2002. Wages will go in a slightly slower pace than in 2001, the full year growth rate of average wage amounting to 7.5 %. Under the low inflation expected in 2002 (the average inflation rate of 2.5%), real wages will increase by approximately 5 %.

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