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CZECH ECONOMY AT THE TIME OF EU ENTRY

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CZECH ECONOMY AT THE TIME OF EU ENTRY

1. SUMMARY AND CONCLUSIONS

In the course of 2003, the Czech economic growth accelerated. GDP grew by 2.9 %. The main factor of this acceleration was massive household consumption accompanied by the

revival of fixed capital formation observable as of second quarter of 2003. The consumer demand increased by 5.5 %, while investment demand grew by 3.7 %. Gradual narrowing of the gap between consumer and investment demand was one of major achievements of 2003, supporting the long-term sustainability of Czech economic growth.

Table 1: Main Macroeconomic Indicators

| | | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004f |
|----------------------------|------------|-------|-------|--------|--------|-------|-------|-------------|
| GDP growth | %, real | -1.2 | 0.5 | 3.3 | 3.3 | 2.0 | 2.9 | 3.3 |
| Industrial production | %, real | 1.6 | -3.1 | 5.8 | 6.8 | 4.8 | 5.8 | 5.5 |
| Construction output | %, real | -7.0 | -6.5 | 5.6 | 9.6 | 2.5 | 8.9 | 6.0 |
| Retail sales | %, real | -7.2 | 2.1 | 4.6 | 4.3 | 2.7 | 5.0 | 3.0 |
| Inflation | %, average | 10.7 | 2.1 | 3.9 | 4.7 | 1.8 | 0.1 | 3.0 |
| Inflation | %, e.o.p. | 6.8 | 2.5 | 3.9 | 4.1 | 0.6 | 1.0 | 3.0 |
| Industrial producer prices | %, e.o.p. | 2.2 | 3.4 | 5.0 | 0.8 | -0.7 | 0.9 | 2.5 |
| Unemployment rate | %, e.o.p. | 7.5 | 9.4 | 8.8 | 8.9 | 9.8 | 10.3 | 10.5 |
| Trade balance | CZK bill. | -76.3 | -69.9 | -126.8 | -116.7 | -71.3 | -69.4 | -60 |
| Current account | USD bill. | -1.3 | -1.5 | -2.7 | -3.3 | -4.2 | -5.6 | -5.7 |
| Current account | % of GDP | -2.2 | -2.7 | -5.3 | -5.7 | -6.0 | -6.5 | -5.9 |
| Financial account | USD bill. | 2.9 | 3.1 | 3.8 | 4.5 | 10.6 | 5.8 | 5.7 |
| Financial account | % of GDP | 5.1 | 5.6 | 7.5 | 7.9 | 15.3 | 6.8 | 5.9 |
| State budget | % of GDP | -1.6 | -1.6 | -2.4 | -3.3 | -2.0 | -2.7 | -5.1 |
| Official FOREX reserves | USD bill. | 12.6 | 12.9 | 13.1 | 14.5 | 23.7 | 27.0 | 27.0 |
| M2 growth | %, e.o.p. | 5.2 | 8.1 | 6.5 | 12.4 | 3.2 | 7.0 | 8.0 |
| PRIBOR 3M | %, average | 14.33 | 6.85 | 5.4 | 5.2 | 3.6 | 2.3 | 2.3 |
| CZK/EUR | Average | 35.85 | 36.88 | 35.6 | 34.1 | 30.8 | 31.8 | 32.5 |
| CZK/USD | Average | 32.27 | 34.60 | 38.6 | 38.0 | 32.7 | 28.2 | 26.5 |

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

Consumer demand continued to be supported by low inflation, rapid growth of disposable incomes combined with double digit growth of consumer credits. The high use of consumer credits was supported by historical low of interest rates. Nevertheless, the growth of consumer demand slightly decelerated to 4.6 % in the last quarter of 2003; this trend will continue also in 2004. In 2003, government consumption stagnated. During the year, gross fixed capital formation recovered significantly, as of the second quarter. Construction investment grew by 5.8 %, while investment in machines and equipment increased by 2.6 %.

The contribution of external sector was again negative. The negative impact of net exports deepened (by 3.5 bill. CZK against 2002). While the trade balance improved by CZK 5.1 bill., the balance of services deteriorated by CZK 8.6 bill. In 2003, current account deficit amounted to CZK -157.2 bill. (USD 5.57 bill.), financial account showed a surplus of CZK 163.8 bill. (USD 5.8 bill.). The revised inflow of FDI reached CZK 69.4 bill. The reason for continuously high current account deficit is growing deficit of income balance and declining surplus of service balance. In 2003, the current account deficit represented 6.5 % of GDP. Strong consumer demand led to an acceleration

In the course of 2003, the Czech economic growth accelerated. GDP grew by 2.9 %. The main factor of this acceleration was massive household consumption accompanied by the revival of fixed capital formation.

The reason for continuously high current account deficit is growing deficit of income balance and declining surplus of service balance. In 2003, the current account deficit represented 6.5 % of GDP.

Industry continued in solid growth without significant fluctuations, the industrial output increasing by 5.8 % in 2003.

Rapid growth of housing driven by low interest rates combined with easy access to mortgages and housing loans was behind the fast increase of output in construction.

In the first half of 2003, Czech economy experienced a period of technical deflation. After a slight weakening of deflation tendencies in the third quarter of the year, last quarter confirmed a resurgence of inflation, the year on year headline inflation standing at 1 % at the end of 2003.

In 2004, the economic growth will continue and will be more balanced than in 2003. The economic dynamics will be pulled not only by private consumption, but also by investment demand and to a higher degree by exports.

in retail trade. The growth of retail sales reached 5 %. Extremely high growth rates observable in the second and third quarter of the year were most significantly affected by boom in automotive segment in Summer months. Along with weakening of consumer demand in the last quarter of the year, also retail trade reported a slowdown at the end of the year.

Industry continued in solid growth without significant fluctuations, the industrial output increasing by 5.8 % in 2003. Anew, the growth in industry has been pulled predominantly by foreign-controlled companies, the share of which on industrial sales increased to 52 % (up from 46 % at the end of 2002). The decisive importance of foreign owners in Czech manufacturing is a consequence of the massive FDI inflows over the last decade.

After a stagnation in the first half of the year, construction has shown double digit growth rates of output since June 2003, the full year growth of construction output amounting to 8.9 %. Boom in construction was also supported by expected increase of VAT (effective as of May 2004) which speeded large business and infrastructure projects. Also, rapid growth of housing driven by low interest rates combined with easy access to mortgages and housing loans was behind the fast increase of output in construction. Rapid growth in construction continued in the first two months of 2004, construction output increasing by 12.0 %.

In 2003, both imports and exports accelerated, increasing by 8.8 % and 9.3 %, respectively. The full-year 2003 trade deficit remained at the same level as in 2002, amounting to CZK 69.4 bill. Considering acceleration of Czech economic growth in 2003, stagnating level of trade deficit is favourable. In 2003, the average exchange rate of CZK against EUR amounted to 31.84 CZK/EUR. Compared to 2002, the average exchange rate weakened by 3.3 %. The developments of the CZK to the USD were quite the opposite. CZK appreciated on average by 14 % against the USD, and yearly average stood at

28.23 CZK/USD. In the first quarter of 2004, the slight depreciation trend of CZK against EUR continued and the appreciation against the USD stopped.

In the first half of 2003, Czech economy experienced a period of technical deflation. After a slight weakening of deflation tendencies in the third quarter of the year, last quarter confirmed a resurgence of inflation, the year on year headline inflation standing at 1 % at the end of 2003. The average index of consumer prices was only slightly above zero, amounting to 0.1 %. Producer prices were in deflation range until the last quarter of the year, and the year on year producer price index stood at 0.9 %, in December 2003 (almost at the same level as CPI). The twelve-months average declined by 0.3 % against the 2002 PPI average.

In the first quarter of 2004, the revival of inflation was confirmed. Tax increases, the growth of agriculture and food prices as well as world prices of some commodities pushed producer and consumer prices up. At the end of March 2004, CPI stood at 2.5 % y/y and PPI at 2.1 %.

In December 2003, the unemployment rate reached 10.3 %. In the course of 2003, the unemployment rate thus increased by half percentage point (up from 9.8 % in December 2002). The rate of unemployment is by 1.5 percentage points above the unemployment rate in the Eurozone. Level of unemployment is high predominantly due to structural factors, especially by differences between structure of vacancies and skills of the unemployed.

Outlook

In 2004, the economic growth will continue and will be more balanced than in 2003. The economic dynamics will be pulled not only by private consumption, but also by investment demand and to a higher degree by exports. The growth of the Czech economy will be supported by the slight revival of the European Union economy and a rather robust growth of the world

trade. We expect the 2004 GDP growth to be at 3.3 %.

The economic recovery in the Eurozone combined with weaker CZK would promote Czech exports, while weak USD will affect favourably the prices of raw material imports. In 2004, we expect slight decline of the trade deficit to CZK 60 bill. Balance of services will probably not show any significant improvement. The current account deficit will thus amount approximately to USD 5.5 bill., in 2004 and the ratio of the current account deficit on GDP should decline to 5.5 %. Though, these figure still seem to be high, the deficit of the current account in the last two years was not provoked by growing imports (as in the Nineties), but has been predominantly the price for the massive FDI inflows in the past decade. For this reason, it does not represent the threat to the external stability of the Czech economy.

Growth in industry will continue – without significant fluctuations – also during 2004. The revival of economy in major eurozone countries will support the exports, as indicated by the double-digit growth of new orders at the beginning of the year. For 2004, we expect the growth of industrial output around 5.5 %. Also, the growth in construction will continue in 2004 due to new infrastructure projects and ongoing demand for new flats. Furthermore, new projects by foreign investors are already underway. The growth will be lower as of June both for statistical reasons and due to the expected increase in VAT. In 2004, the growth in construction output will be approximately 6 %.

As for retail trade, 2003 was the year of exceptional growth, which will not be repeated in 2004 due to lower growth of disposable incomes and higher inflation. We expect the growth in retail trade to reach approximately 3 % in 2004.

Acceleration of domestic investment demand combined with recovery of world economy will push the producer prices up. Moreover, continuing increase of raw material prices on

world markets will support the upward trend as indicated by the data of last quarter of 2003 and first quarter of 2004. We expect that year on year growth of PPI will reach 2.5 % in December 2004. The growth of consumer prices will be above the producer ones. Tax increases in January and May 2004, combined with growing prices of some imported goods and domestic food prices will push the CPI up. We expect both the year-end headline inflation and average inflation to be around 3 %, in 2004.

In the coming months, the CNB will mainly guard inflation levels and GDP growth; some moderate rate increase might come at the end of the second quarter of 2004, or, more probably, in the second half of the year. At the end of 2004, we expect the repo rate to be within the interval of 2.50 – 2.75 %.

Unemployment became one of the main macroeconomic bottlenecks of the Czech economy. Structural character of Czech unemployment was confirmed by the developments of the unemployment under the acceleration of economic growth in the second half of 2003. In the course of 2004, we expect regular seasonal developments which will lead to a 10.5% unemployment rate in December 2004.

We expect the 2004 GDP growth to be at 3.3 %.

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2. EXTERNAL ENVIRONMENT

2.1. Outlook of the World Economy

The global recovery consolidated its strength in the first months of 2004. The US economy is

Table 2: World Economic Growth 2003 – 2005 (GDP growth, in %)

| | 2003 | 2004F | 2005F |
|---------------|------|-------|-------|
| USA | 3.1 | 4.8 | 4.5 |
| Euroland | 0.4 | 1.6 | 2.1 |
| Japan | 2.7 | 3.1 | 1.0 |
| China | 9.1 | 8.5 | 8.0 |
| India | 7.1 | 7.4 | 7.0 |
| Latin America | 1.3 | 4.0 | 3.5 |
| Russia | 7.3 | 5.5 | 4.5 |
| World | 3.6 | 4.5 | 4.2 |

Source: Société Générale, Komerční banka

In Latin America, we are witnessing a rapid economic recovery, pulled by growing US demand, higher commodity prices and depreciated real exchange rates. Euroland continues to fall behind, constrained by weak domestic demand and a strong currency. Eurozone's economic climate will only improve gradually, as both investment and consumer demand revives in the second half of 2004 – which will have a positive impact on economic growth in 2005.

As to monetary policy, both the Fed and the ECB are, more or less, letting things to take their course. In the US, growth so far has resulted neither in higher inflation, nor in a visible decline of unemployment. The Fed will tighten monetary policy only under a palpable growth of employment, so that one can expect the basic rate within the interval of 1,5 – 1,75 % by the end of 2004.

The ECB is under growing pressure to lower the rates, in order to foster the very slow economic recovery and balance the impact of the strong euro. The ECB will however, in all probability, resist these pressures, and leave the basic refi-rate unchanged (at 2 %) till the end of 2004.

2.2. Commodities

Prices of minerals, metals and oil increased

continuing in its expansion, and economic growth is accelerating in Japan, after five years of contraction. Economic growth in Asia remains impressive, with mainly China showing very fast growth rates.

substantially in 2003: at the end of 2003, prices of minerals and metals stood 43.6 % higher than a year ago; in the same period, oil prices increased by 7.9 %. This trend has continued in the first quarter of 2004: minerals and metals went up by 58.5 % y/y, oil by 22.6 % y/y.¹¹

Price increase of metals and minerals is mainly connected with the high demand from China, India and other Asian countries. One can expect that the higher price level will prevail over the next two years.

The growth of oil prices is of a longer-term character, and due to several factors. While in 1990-1999, the average price of oil was USD 18.4 per barrel of Brent, in the following four years the average increased to USD 26.9 per barrel. The continuing increase of oil prices is mainly caused by the combination of the following factors:

- The weakening dollar. Under lower dollar exchange rates, the oil exporting countries, mainly the OPEC members, try to keep their incomes stable by increasing the nominal price of oil.
- Higher geopolitical risk after the 11th

¹¹ According to The Economist indices.

September, 2001. This was due to increase the price of such a strategic commodity as oil. Even the rapid end of Iraq war, and the gradual restart of Iraq oil supplies to world markets, could not dampen the increase of oil prices in world markets.

- Sudden weather extremes (hard winters, hot summers) that led to a higher-than-normal consumption of oil (heating, air conditioning).

- The first synchronic revival of the world economy after more than 20 years resulted, in 2003 and 2004, in a co-ordinated increase of demand for oil in all world regions.

For all these reasons, it is to be expected that although oil prices tend to be volatile, the high price level will prevail over the medium term.

2.3. Developments in Core Visegrád Countries

The Czech Republic, Poland, Hungary and Slovakia face similar macroeconomic challenges, mainly:

- to keep and accelerate economic growth, so that their catching-up with more advanced EU countries could continue;

- to solve the persistent problem of public finance deficits, without hampering economic growth and undermining the social (and political) stability of the country.

Table 3: GDP and Inflation in Poland, Hungary and Slovakia (in %)

| | GDP | | Inflation (average, y/y) | |
|----------|------|------------|--------------------------|------------|
| | 2003 | 2004F | 2003 | 2004F |
| Poland | 3.7 | 4.5 | 0.8 | 2.5 |
| Hungary | 2.9 | 3.3 | 4.7 | 6.7 |
| Slovakia | 4.2 | 4.0 | 8.5 | 8.0 |

Source: Komerční banka

In 2003, Slovakia went the furthest along this road, starting a fundamental reform of the tax system, first steps of pension system reform, as well as reform of medical care. Slovakia enjoys a strong FDI inflow, with positive effects on economic growth. The started reforms give hope that the public finance deficit could sink below 3

of GDP in 2006 at the latest. If inflation also can be successfully controlled, Slovakia would be the first Visegrád country ready to join the EMU.

The main weakness of Slovakia's development is a growing territorial imbalance. The territory absorbing most FDI (Bratislava and Western Slovakia) is rapidly coming apart, in economic level, from the rest of the country. Thus, Slovakia is getting into a situation similar to that typical for Hungary (a deep economic split between Budapest, plus the territory from Budapest to Austrian border, on the one hand, and the larger rest of the country on the other).

Polish economy is again characterised by a relatively robust growth, with only moderate inflation. But the structural problems of Polish economy prevail: inefficient agriculture, unemployment approaching 20 %, privatisation brought to a stop, and the breakdown of the minority government, with almost sure early elections before the end of 2004. Under such situation, monetary policy of the National Bank of Poland will most probably remain on the restrictive side. The central bank will try to lower the volatility of the Polish currency, and to dampen the danger of speculative attacks. Hardly any steps to limit the public finance deficit can be expected. Economic circles and political elites will wait for the results of early parliamentary elections.

In Hungary, at the start of 2004, the government at last adopted a restrictive program prepared by the new Finance Minister T. Draskovics, which is to result in a gradual reduction of the public finance deficits. The aim is to achieve the 3 % Maastricht limit in 2007, at the latest. After two strong speculative attacks in 2003, the volatility of the Hungarian currency could hamper the smooth path of public finance deficits reduction. Hungary, in the last year, gives a warning how vulnerable the currencies of new member states can be after ERM II entry, and how difficult it may be for monetary policy to keep them within the prescribed interval.

The Czech Republic, Poland, Hungary and Slovakia face similar macroeconomic challenges, mainly:

- to keep and accelerate economic growth,
- to solve the persistent problem of public finance deficits.

3. EXTERNAL BALANCE

In 2003, Czech balance of payments was roughly balanced. Current account deficit amounted to CZK 157.9 bill., up from CZK 136.4 bill. in 2002. A moderate increase in current account deficit was caused predominantly by continuing decline in

surplus in trade with services. Financial account reached a surplus of CZK 163.8 bill., down from 347.8 bill., a year before. Financial account revealed a strong decline in FDI inflows on the one hand, and a massive inflow of short-term capital on the other one.

Table 4: Balance of Payments (CZK bill.)

| | 2002 | 2003 | 2004 F |
|-------------------------|--------|--------|-------------|
| Current account | -136.4 | -157.2 | -150 |
| o.w. Foreign trade | -71.3 | -69.4 | -60 |
| Balance of services | 21.9 | 13.2 | 20 |
| Balance of incomes | -115.6 | -116.6 | -120 |
| Transfers | 28.7 | 15.6 | 15 |
| Capital account | -0.1 | -0.1 | 0 |
| Financial account | 347.8 | 163.8 | 150 |
| o.w. Direct investments | 270.9 | 66.4 | 100 |
| Portfolio investments | -46.7 | -37.7 | n.a. |
| Financial derivatives | -4.3 | 3.9 | n.a. |
| Long-term capital | 31.5 | 22.5 | n.a. |
| Short-term capital | 96.4 | 108.9 | n.a. |

Source: Czech National Bank, forecast KB

3.1 Current Account

Trade with Goods

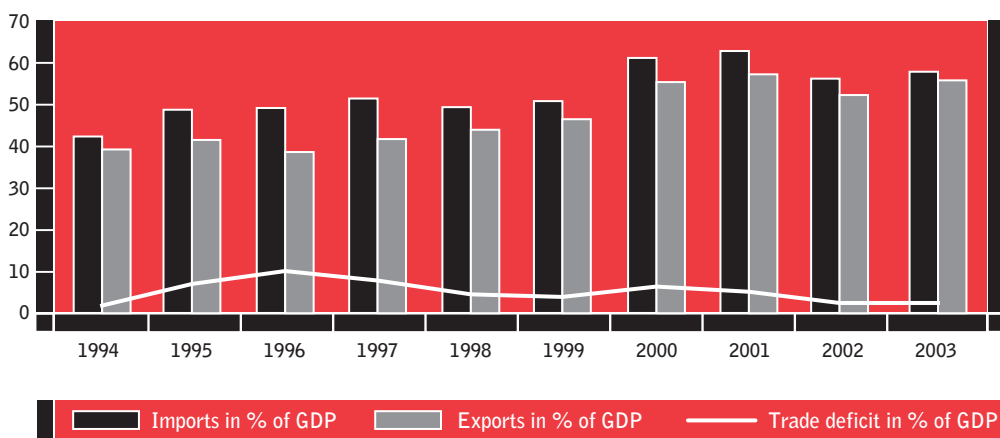
The full-year figure of trade deficit in 2003 (CZK 69.4 bill.) was almost the same as in 2002 (CZK 71.3 bill.). Considering speeding-up of Czech economic growth in 2003, driven by strong domestic demand, the stagnation of the deficit can be assessed as a success.

A slight decline in trade deficit occurred under the acceleration both of exports and imports to 9.3 % and 8.8 %, respectively. The growth rate of exports thus exceeded the growth rate of imports by half of percentage point. Also, the ratio between exports and imports in 2003

increased to 95.1 %, up from 94.6 % in 2002. High import intensity of Czech exports and Czech economic growth has thus been slowly declining.

A positive impact of foreign trade prices on Czech trade balance weakened – see Figure 2. The change both of import and export prices was more flat than in 2002. In 2003, the import prices declined by 0.3 % on average, the export ones rose by 0.9 %. The main reason for the developments of prices in foreign trade was the depreciation of the Czech currency against the EUR by 3.2 %.

Figure 1: Imports, Exports, Trade Balance (in % of GDP)



Source: Czech Statistical Office

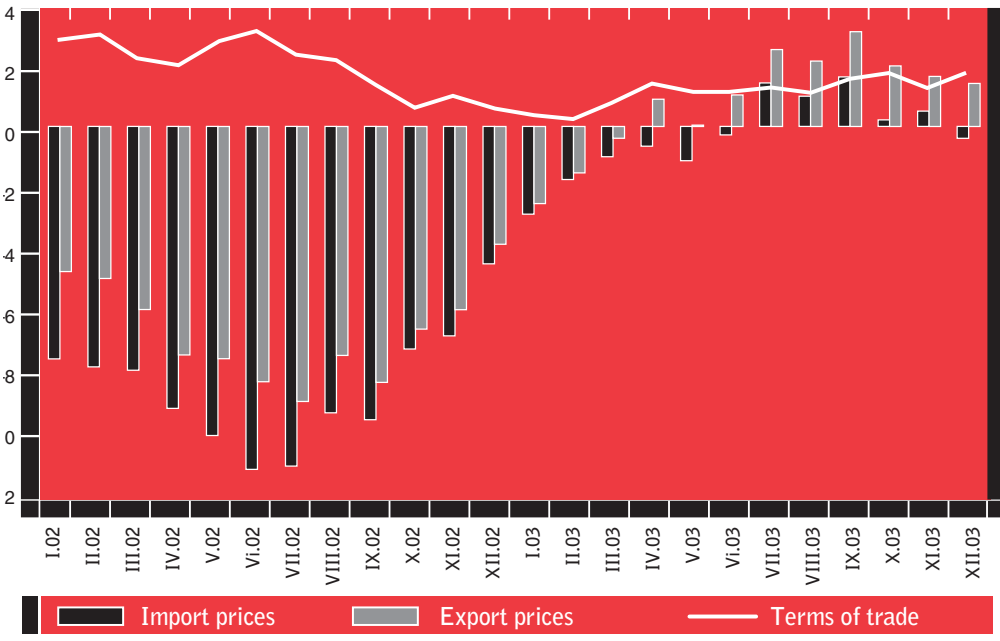
Growth of imports was driven by strong domestic consumer demand combined with gradual strengthening of investment demand. The acceleration of exports was achieved in spite of sluggish West-European demand. In particular, machinery exports grew by above average pace accounting for more than half of total Czech exports. The trade deficit in 2003 was concentrated to chemicals (CZK - 84 bill.) and raw materials (CZK -72 bill.), compensated for partly by surpluses in machinery and transport equipment (CZK 70 bill.) and semi-factured products (approximately CZK 30 bill.).

from CZK 60 bill. a year before. The exports to the EU have been pulled predominantly by activities of foreign controlled companies as a consequence of strong inflow of FDI in the past years. Companies under foreign control account for about one half of Czech industrial exports. Increasing surplus with the EU countries combined with high degree of trade integration (70 % of exports, 60 % of imports) has been supporting our expectations that no shocks should follow the May 2004 EU accession.

The trade deficit was concentrated to former Soviet Union countries and China (deficits amounting to around CZK -60 bill. with each of them), negative balance produced in the trade with Japan (CZK - 25 bill.) being also quite important.

In 2003, the growth of exports to the EU was above average amounting to 11.6 %. The surplus in the trade with the EU reached CZK 103.3 bill., up

Figure 2: Import Prices, Export Prices, Terms of Trade (growth rates in %.)



Source: Czech Statistical Office

In 2003, the growth of exports to the EU was above average amounting to 11.6 %. The surplus in the trade with the EU reached CZK 103.3 bill., up from CZK 60 bill. a year before. The exports to the EU have been pulled predominantly by activities of foreign controlled companies as a consequence of strong inflow of FDI in the past years.

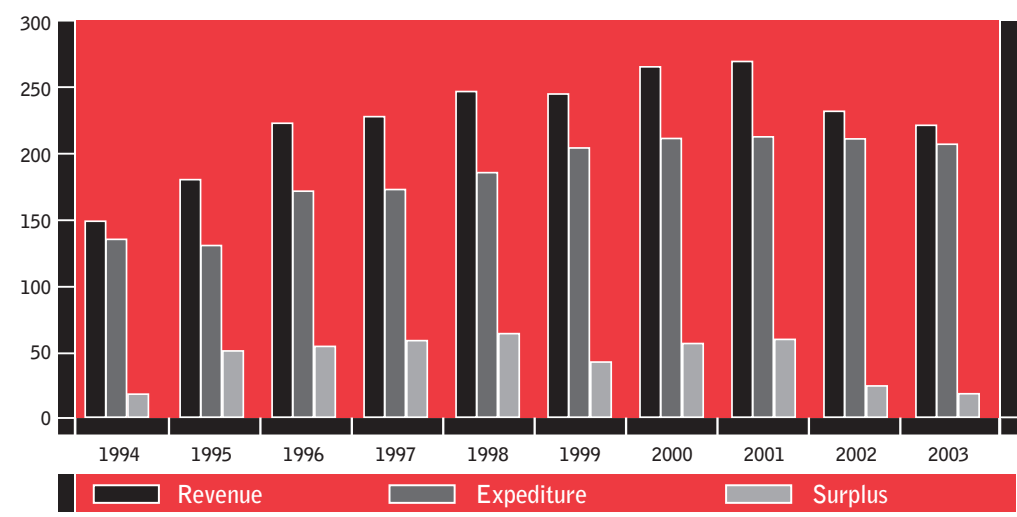
Balance of incomes registered almost the same deficit as a year before (CZK 116.6 bill.), remaining the main source of the whole current account deficit. Repatriation of profits and payments of dividends have been the main factors of deficit of the incomes balance.

Services, Incomes, Transfers

Balance of services has been continuously deteriorated in 2003. The net surplus declined to CZK 13.2 bill. which was a contraction of CZK 8.7 bill. against 2002. Incomes from services dropped by CZK 12 bill. (5 %), predominantly as a consequence of decline in other services

revenue. Transport and tourism showed quite stable developments. The 2003 figures therefore revealed clearly that deterioration in services in 2002 were affected by the floods to a limited extent only, and that the deterioration in the performance of services is a deeper and long-term problem.

Figure 3: Balance of Services (in CZK bill.)

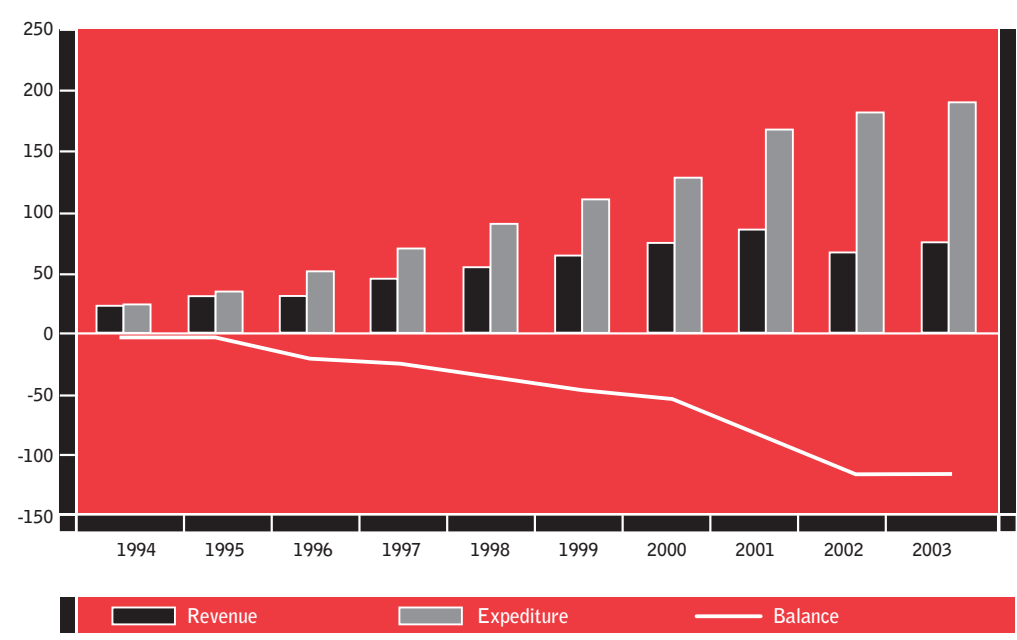


Source: Czech National Bank

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the incomes balance. This is the adverse side of massive inflow of foreign direct investments from the past decade. The balance of incomes has continued to be a strong and permanent burden for the current account as of 2001. The balance of

Figure 4: Balance of Incomes (in CZK bill.)



Source: Czech National Bank

incomes represents a sort of feedback between current and financial account. Reinvestments of profits as well as payments of dividends driven by previous massive inflows of FDI has been gaining on importance since 1998 or 1999. During the past decade, the revenue on the incomes balance increased approximately three times while the expenditure rose more than eight times – see Figure 4.

3.2 Financial Account

The surplus of the financial account amounted to CZK 163.9 bill. in 2003, down from 347.8 in 2002. The surplus of financial account declined due to weaker inflow of foreign direct investments. Portfolio investments showed a moderately lower net outflow than a year before. The net inflow of other investments was roughly the same as in 2002, their structure, however, changing.

In 2003, foreign direct investments showed a net inflow of CZK 66.4 bill., which was the weakest result since 1997. For the first time in the history of the Czech Republic, a net outflow of foreign direct investments amounting to CZK 16.4 bill. was registered in the last quarter of the year due to Český Telecom's purchase of 49% of Eurotel's shares from foreign owners. Subsequently, TelSource sold 27% of Český Telecom's shares, mostly to foreign institutional investors.

The net outflow of portfolio investments (CZK 37.7 bill.) was moderately lower than a net outflow in 2002 (CZK 46.7 bill.). A quite significant increase was recorded in foreign demand for Czech equities. Overall, the inflow of liability portfolio investment reached CZK 48.2 bill., a much higher figure than in 2002 (CZK 28.9 bill.). The purchases of Czech investors in foreign portfolio investments amounted to CZK 85 bill., concentrated especially to debt securities (purchases of 91.5 bill.). The demand of Czech portfolio investors for foreign bonds weakened in the last quarter of the year. Trading with financial derivatives recorded a net capital inflow of CZK 3.9 billion.

Other investments showed quite similar net inflow like a year before (CZK 131.4 bill., in

2003 and CZK 127.9 bill. in 2002), with a moderately higher share of short-term capital. The net inflow of long-term capital amounted to CZK 22.4 bill. due to activities both of Czech Government and companies. The net inflow of short-term capital amounted to CZK 108.9 bill. Czech banks accounted for major part (CZK 82.8 bill.) of this massive inflow.

Outlook

The foreign trade figures from the first two months of 2004 seem quite favourable for the trade balance prospects. January – February 2004, the trade balance registered a surplus of CZK 3.6 bill., an improvement of CZK 6 bill. against the same period of 2003. The massive inflow of FDI from the past decade has brought growing export performance, while the ongoing restructuring of the supply side of the economy leads to slow but continuing decline of the import intensity of the Czech exports.

The economic recovery in the Eurozone combined with weaker CZK would promote Czech exports, while weak USD will affect favourably the prices of raw material imports. Also, higher domestic consumer prices should weaken the demand for imports of foods and other consumer goods. In 2004, we expect slight decline of the trade deficit to CZK 60 bill. Balance of services will probably not show any significant improvement. At the same time, the incomes balance should also more or less stagnate. The current account deficit will thus amount approximately to CZK 150 bill. in 2004 (USD 5.5 bill.). Under the assumption of approximately 3 % growth of GDP, the ratio of the current account deficit on GDP would decline to 5.5 %.

Though, at first sight, the figures of current account deficits do not look favourable, one must have in mind that the deficit of the current account in the last two years was not provoked by growing imports (as in the Nineties), but has been predominantly the price for the massive FDI inflows in the past decade and therefore does not represent a threat to the external stability of the country.

In 2004, we expect slight decline of the trade deficit to CZK 60 bill. Balance of services will probably not show any significant improvement.

Against the American dollar, Czech currency appreciated over 2003, when the average CZK/USD rate strengthened by 14 %. This was already a medium-term trend: in 2001, koruna appreciated by 1.6 % against the dollar, in 2002 by 13.8 %.

Monetary policy of the CNB can be characterised as more-or-less neutral: after the last repo-rate cut at the start of August 2003, the policy can be characterised as "wait and see".

4. MONETARY POLICY

The Czech National Bank during 2003 cut the basic repo-rate three times (on January 31st, June 26 th and August 1st). Since August 1, 2003 the repo rate has been at its historically lowest

level of 2 %. The CNB has so reflected the level of inflation (being at the average of 0.1 % during 2003), and has also tried to prevent further strengthening of the koruna, which appreciated over 2002 and in the first months of 2003.

Table 5: CZK Exchange Rates, Q4 2003-Q1 2004

| | 10/2003 | 11/2003 | 12/2003 | 1/2004 | 2/2004 | 3/2004 |
|-------------------|---------|---------|---------|--------|--------|--------|
| CZK/EUR (average) | 31.98 | 31.97 | 32.31 | 32.72 | 32.86 | 32.95 |
| CZK/USD (average) | 27.35 | 27.34 | 26.32 | 25.95 | 25.98 | 26.90 |

Source: Czech National Bank

Thanks to this monetary policy, and to a surplus of liquidity at most Czech banks, interest rates in the interbank market kept decreasing. The average 3M Pribor reached 2.28 % in 2003; its fall continued in the first quarter of 2004, so that in March, the average 3M Pribor was at 2.05 %.

Exchange rate appreciation against the EUR, which characterised the whole of 2002, continued in the first quarter of 2003. Then, the CZK started to weaken. The average exchange rate in 2003 was 31.84 CZK/EUR, so that depreciation reached 3.2 %. As Table 5 shows, gradual weakening continued in 2004. In the last months, the exchange rate has been favourable for exporters, strengthening competitiveness of the economy.

Against the American dollar, Czech currency appreciated over 2003, when the average CZK/USD rate strengthened by 14 %. This was already a medium-term trend: in 2001, koruna appreciated by 1.6 % against the dollar, in 2002 by 13.8 %. The decisive factor in 2003 was the dollar's weakening against the euro. That trend stopped in the first quarter of 2004, and the dollar appreciated moderately. As shown in Table 5, the koruna followed, also weakening slightly against the dollar.

Monetary policy of the CNB can be characterised as more-or-less neutral: after the last repo-rate cut at the start of August 2003, the policy can be characterised as "wait and see". That might imply that the koruna exchange rate in the interval of 31.50 to 33.50 CZK/EUR is seen (presently) as equilibrium and no direct or indirect intervention is considered necessary. That is important, as keeping the exchange rate within some implicit interval probably does not lack importance in the eyes of the CNB.

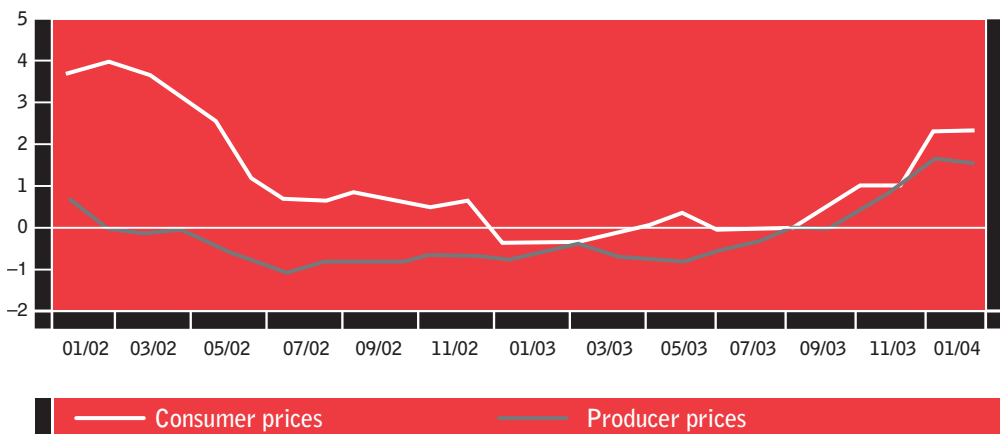
In the coming months, the CNB will mainly guard inflation levels and GDP growth; some moderate rate increase might come at the end of the second quarter of 2004, or, more probably, in the second half of the year. At the end of 2004, we expect the repo rate to be within the interval of 2.50 – 2.75 %.

5. INFLATION

After a strong disinflation in the Czech economy observed in 2002 and the first three quarters of 2003, an upturn occurred in the last quarter of

2003, followed by more visible price increases at the beginning of 2004. The gap between consumer and producer prices continued narrowing in the course of 2003.

Figure 5: CPI and PPI (growth in %)



Source: Czech Statistical Office

5.1 Consumer Prices

The average inflation rate in 2003 amounted to 0.1 % (down from 1.8 % in 2002), its historically lowest level since 1990, i.e. from the beginning of the transformation in the Czech Republic. The movements of the yearly consumer price index in 2003 was quite flat: it rose from -0.4 % at the beginning of the year to 1.0 % in December 2003. Acceleration of economic growth in the second half of the year did not provoke any inflationary pressures which is another proof of functioning market economy.

The price developments in 2003 were thus considerably less dramatic than in 2002 (when a decrease from initial 4.4 % in January 2002 to 0.6 % in December 2002 was observed). A slight upturn in yearly consumer price indexes (see Figure 5) was affected predominantly by the increase in food prices (accounting for 20 % of total consumer basket) in the last quarter of the year. The yearly index of food prices rose from

-6.3 % in January 2003 to 3.5 % in December. In spite of high end-year figure, the food prices declined by 2.2 % on average, pressing thus the average inflation rate down. The main source of slight CPI average increase were therefore the prices of housing (including water, energy and fuels). Yearly price indices of housing were above zero during the whole year, with the average growth of 2 %. Prices of transport stagnated (average growth of 0.1 %) in spite of higher fuel prices (by 1.4 %).

According to the Czech Statistical Office, prices of goods declined by 1.4 % on average, while the prices of services rose by 2.9 %. The decline in prices of goods was highly supported by strong domestic competition with quite significant impact of great retail chains. Average prices of clothing and footwear declined by 5 % and household equipment prices fell by 1.6 %.

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Acceleration of domestic investment demand combined with recovery of world economy and increase of world raw material prices support our expectations that Czech producer prices will grow in the course of 2004.

Table 6: Development of Consumer Prices (in %)

| | 2002 | 2003 |
|----------------------------------|------|------|
| Total | 1.8 | 0.1 |
| Food and non-alcoholic beverages | -1.9 | -2.2 |
| Alcohol, tobacco | 1.9 | 0.9 |
| Clothing and footwear | -2.6 | -5.0 |
| Housing, water, energy, fuels | 6.1 | 2.0 |
| Furniture, household equipment | -0.1 | -1.6 |
| Health | 4.7 | 4.0 |
| Transport | -1.9 | 0.1 |
| Posts, telecommunications | 3.3 | -2.0 |
| Recreation, culture | 2.0 | -0.3 |
| Education | 3.6 | 3.0 |
| Restaurants, hotels | 3.5 | 1.8 |
| Others | 4.0 | 2.9 |

Source: Czech Statistical Office

5.2 Producer Prices

The yearly indices of industrial producer prices have been moving in the deflation range until November 2003 when an upturn occurred. The Czech PPI was thus continuously declining from February 2002 to November 2003. In the last quarter of 2003, the PPI increased by 0.4 %. The yearly average decline of PPI amounted to 0.3 %, after a drop of 0.5 % in 2002. The year over year PPI stood at 0.9 % at the end of 2003.

In 2003, the developments of PPI were strongly affected by the developments in food industry with average decline of 1.1 %. The prices in food industry have been sensitive to the prices of agricultural producers and the import prices of foods. Agricultural prices registered year over year declines in the first half of the year (as of May 2002), followed by increases as of July 2003 as a consequence of bad harvest. Year on year index of agricultural prices stood at 8.0 % at the end of 2003 (- 15.6 % y/y in December 2002). In addition, food import prices stopped to push down the domestic food industry prices as of August 2003.

In 2003, also prices of electricity, gas and water supply declined by 0.7 % due to prices of electricity which were by 3.1 % lower than in 2002. The decline (due to January reduction of

tariffs) in electricity prices was observed for the first time in the last 12 years. Prices in car industry recorded a decline (of 0.3 % on average) for the first time since 1991.

Outlook

Price developments in the first quarter of 2004 definitely confirmed that the period of strong disinflation is over. In March 2004, yearly CPI stood at 2.5 %, while PPI was at 2.1 %.

Acceleration of domestic investment demand combined with recovery of world economy and increase of world raw material prices support our expectations that Czech producer prices will grow in the course of 2004. On the other hand, increasing productivity of labour in industry acts in the opposite direction and prevents the raw material price pressures to be fully reflected in producer prices. We expect that year on year growth of PPI will reach 2.5 % at the end of 2004. The growth of consumer prices will be above the producer ones. Tax increases in January and May 2004, combined with growing prices of some imported goods and domestic food prices will push the CPI up. We expect both the year-end headline inflation and average inflation to be around 3 %, in 2004.

6. FISCAL POLICY AND PUBLIC DEBT

The recent period has been characterised by growing deficits of public finance, and an increasing government debt. The government budget in 2003 ended with a deficit of

CZK109.1 bill., the budget approved by the parliament for 2004 has a deficit of CZK 115 bill. The first estimates for 2005 work with a CZK 140 bill. deficit. This trend means that the first stage of reform of public finance has not brought any turn in the gradual increase of public finance deficits in time.

Table 7: Public Finance Deficit and Government Debt (in % of GDP)

| | 2000 | 2001 | 2002 | 2003 |
|--------------------------------|------|------|------|-------|
| Czech Republic | | | | |
| public finance surplus/deficit | -4,5 | -6,4 | -6,4 | -12,9 |
| government debt | 18,2 | 25,2 | 28,9 | 37,6 |
| Slovakia | | | | |
| public finance surplus/deficit | -2,3 | -6,0 | -5,7 | -3,6 |
| government debt | 49,9 | 48,7 | 43,3 | 42,8 |
| Poland | | | | |
| public finance surplus/deficit | -1,8 | -3,5 | -3,6 | -4,1 |
| government debt | 36,6 | 36,7 | 41,2 | 45,4 |
| Hungary | | | | |
| public finance surplus/deficit | -3,0 | -4,4 | -9,3 | -5,9 |
| government debt | 55,4 | 53,5 | 57,1 | 59,0 |
| Eurozone | | | | |
| public finance surplus/deficit | +0,2 | -1,6 | -2,3 | -2,7 |
| government debt | 69,7 | 69,4 | 69,2 | 70,4 |

Source: Czech National Bank

The data also document that the hitherto steps of the so-called reform (changes in VAT, increase of consumer taxes, and some marginal changes in the system of social and health care insurance) have not brought a decline in the government budget deficits, either – they have only slowed down their rate of increase. The reform has not yet touched the substance, it has not addressed the structural causes of the inherent deficits, the chief being:

- a too generous and all-including social safety net;
- the oversized apparatus of public institutions;
- lack of readiness (or incapability) to reform the pension system and the financing of health care.

The government has practically postponed any substantial steps in the solving of the above problems to the time after the next parliamentary

elections (scheduled for June 2006). The government is unable (and unwilling) to bring the reform bills through the parliament where it has a fragile majority – and to explain their indispensability to the public. The public (as elsewhere in Europe) has been accepting any reform steps with indignation and resistance.

As Table 7 shows, the public deficits and government debt are disquieting even in the Central-European context. While in Hungary, Poland and Slovakia, governments try keep public finance deficits at level (Poland) or cut them (Hungary, Slovakia), the same cannot be expected in the Czech Republic. And, as economic trends only turn gradually, the state and perspective of public finance postpone the possible date of European Monetary Union entry for the Czech Republic beyond 2010.²¹

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Again, companies under foreign control registered above average growth both of total and export sales.

Foreign controlled companies account for one half of total industrial sales and represent the major driving force of the Czech industrial output and exports.

7. DOMESTIC DEMAND

7.1 Industry

In 2003, growth in industry output slightly accelerated against previous year, the industrial output increasing by 5.8 %, up from 4.8 % in 2002. The growth in industry did not register any significant fluctuations in the course of the year. Industrial sales grew by 5.4 % - almost by the same pace as the output which has been confirming the sustainability of the growth in industry.

In 2003, GDP in industry rose by 2.5 %. While mining industries registered a decline in GDP by 0.9 %, GDP in manufacturing increased by 2.9 %. Manufacturing has been remaining the most important GDP contributor, with its share amounting to 30 % of Czech GDP.

In spite of weak foreign demand, the growth of industry continued to be pulled by the exports. While industrial sales increased by 5.4 %, direct export sales increased by 8.8 %. Nevertheless, the difference between domestic and export sales strongly diminished against 2002 due to recovery of domestic investment demand. The share of export sales amounted to 46.3 % of total industrial sales.

Again, companies under foreign control registered above average growth both of total and export sales. Total industrial sales of foreign controlled companies rose by 7.1 % and their export sales increased by 10.3 % - which is almost twice as high as the total growth of industrial sales. The companies under foreign control are primarily export oriented - direct export sales accounted for 70 % of their total sales. Foreign controlled companies account for one half of total industrial sales and represent the major driving force of the Czech industrial output and exports.

Similar to 2002, manufacturing industries were the source of growth in industry, with output growing by 5.8 %. Mining and quarrying

stagnated while electricity, gas and water supply registered a growth of 8.9 %. Manufacturing was pulled by rubber and plastic products, and car industry (growth rates of 14 % and 12.5 %, y/y, respectively). While in 2002, car industry showed rather volatile results both of sales and output, both the growth of output and sales were more balanced in 2003.

As for direct export sales, rubber and plastic products, metal industry, electrical and optical equipment as well as other machinery were the best performing ones. The direct export sales in car industry increased by slightly under-average 8 % which indicates that car industry in 2003 was driven to a great extent by boom in domestic car sales during the second and third quarter of the year.

Table 8: Growth of Sales in 2003 (growth in %)

| | All industrial companies | Companies under foreign control |
|------------------------|--------------------------|---------------------------------|
| Total industrial sales | 5.4 | 7.1 |
| Direct export sales | 8.8 | 10.3 |

Source: Czech Statistical Office

Growth of industrial output was accompanied by continuing decline in industrial employment which had begun as early as in the last quarter of 2001. The employment in industry declined by 3.3 % in 2003. The decline in employment was more profound in mining and quarrying, with employment declining by 6.5 %. In manufacturing, the release of labour force was more moderate (-3.1 %). The only industries witnessing increase in employment were rubber and plastic industry (+3 %) and electrical and optical industry (+ 1.3 %). Contrary to 2002, also car industry showed decline of employees by 2 %. The number of 38 thousands people dismissed from the Czech industry in 2003 considerably affect the pressures on the Czech labour market. Productivity of labour in industry outpaced the growth of real wage (8.9 % and 5.7 %, respectively).

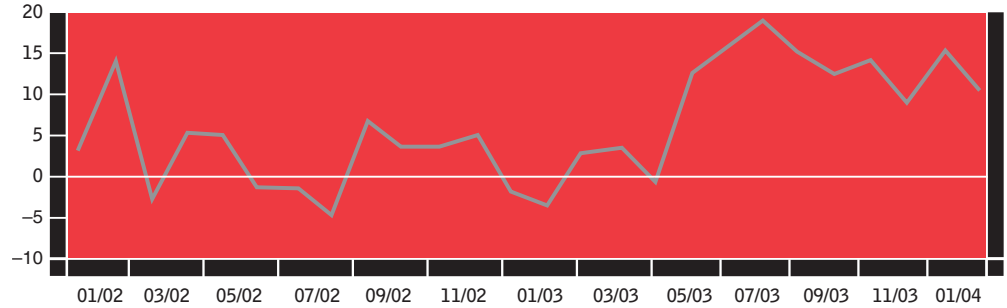
²¹ For more detail, see Czech Republic and the EMU Entry: Some Reflections, Economic Trends No. 39, Komerční banka, February 2004.

7.2. Construction

The developments in construction were significantly different in the first and second half of the year. Due to generally weak investment demand, construction stagnated until May. In June, there was an upturn, with construction showing double-digit growth rates in the second half of the year. While the overall estimates of full-year growth did not exceed 4 % in the first

half of the year, the boom in construction in the second half of 2003 increased the full year growth to 8.9 %. This was not only a significant acceleration against 2002, but it represents also the second best result since 1993. The growth rates in construction output reached record highs, especially in the third quarter of the year, with the average growth in Q3 2003 reaching 16.3 %.

Figure 6: Construction Output (growth in %)



Source: Czech Statistical Office

Rapid growth in construction in the second half of 2003 was in particular driven by large building and civil engineering projects (highways, railway corridors, the Prague metro and tram lines, business centres etc.). A very important factor in encouraging investors to continue as quickly as possible was the expected change in VAT, effective as of May 2004. Construction works will be subject to the basic VAT rate of 19 %, instead of the reduced rate of 5 %. The exception will be housing which will remain under the reduced VAT rate till 2007. This change should have been valid since the beginning of 2004.

reduce the demand for mortgages. In 2003, the number of new mortgages increased by one half, and in volume by 57 %.

While construction output grew in previous years, GDP in construction was in steady decline. In 2003 – after a long decline of GDP in construction – there was an upturn and GDP in construction increased by a moderate 0.2 %. The ratio between productivity and wage growth was kept within acceptable limits in 2003. Productivity of labour increased by 7.8 %, while real wages rose by 6 %.

Housing has become a more and more important segment of construction. In 2003, construction of 39 thousand new flats was approved, representing an increase of 11 % on the previous year and the highest figure since 1993. The average value of new flat was CZK 2.1 bill. The rapid growth in housing construction has been prompted by low interest rates and easier access to mortgages. Mortgages were used to pay for approximately one half of new flats. The abolition of state support for new housing in 2003 did not

In contrast to industry, where the numbers of employees have been in decline as a consequence of restructuring, construction continues to hire new workers. In 2003, employment in construction increased by 1.2 %. Developments here depend on the size of company. While large companies (with over 1000 workers) laid off 3 % of their employees, and companies with 500 – 1000 workers reduced employment by 0.6 %, small companies hired new staff. The smallest companies (with up to 25 employees) registered

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Extremely high growth rates observable in the second and third quarter of the year were most significantly affected by rapid growth in automotive segment in June – September 2003.

an increase of 4.7 % in employment, while the numbers of workers in medium-sized companies roughly stagnated.

7.3. Retail Trade

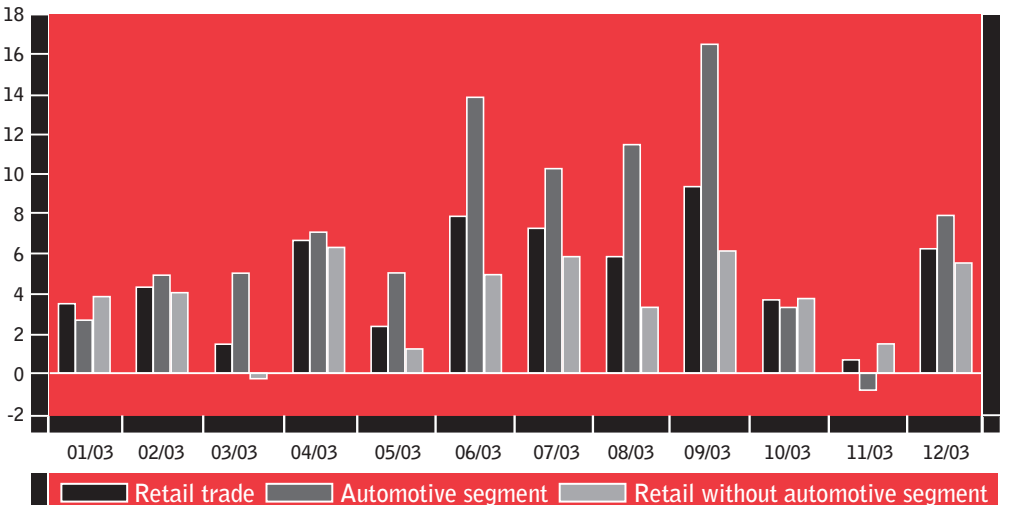
In 2003, retail sales increased by 5 %, up from 2.7 % in 2002. Consumer demand registered a strong acceleration in second and third quarter, retail sales increasing by 5.5 % and 7.5 %, respectively after a growth of 3.1 % in the first quarter. Extremely high growth rates observable in the second and third quarter of the year were most significantly affected by rapid growth in automotive segment in June – September 2003 – see Figure 7.

While fuel sales were growing quite rapidly in the course of the whole year, car sales registered a strong boom in Summer months. In September 2003, car sales increased by more than 20 %. Boom in car sales might be affected by change in the depreciation regime valid as of the beginning of 2004. In the last quarter of 2003, a slowdown in retail sales to 3.4 % was observed. Again, correlation with car sales has been evident: car sales dropped by 0.7 % in the last quarter of the year, after a massive growth of 5.7 % and 12.5 %, in the second and third quarter (see Figure 8).

The whole automotive segment accounts for approximately one third of retail sales, and the share of car sales is around 20 %. On average, automotive segment increased by 7.2 % in 2003, car sales increasing by 4.7 %, and fuel sales by 11.5 %.

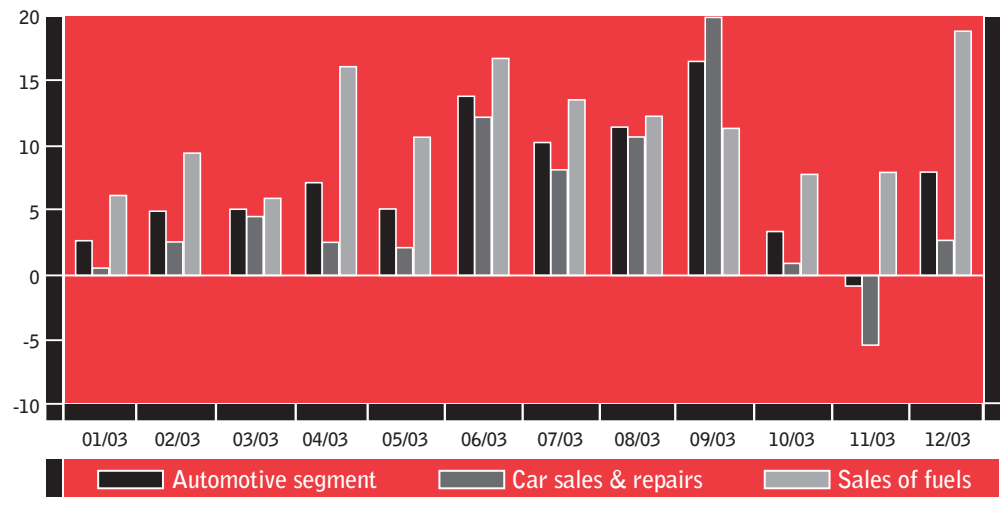
Retail trade without an automotive segment showed a growth of 4 % in 2003. Sales of food increased by 4.2 %, sales of non-food consumer goods rose by 3.8 %. Non-food consumer goods is the segment for which consumer loans are most often used. The total volume of consumer loans granted to Czech households amounted to CZK 61 bill. at the end of 2003. This volume rose by CZK 9 bill. (18 %) against year-end of 2002.

Figure 7: Growth of Retail Sales (in %)



Source: Czech Statistical Office

Figure 8: Retail Sales: Growth in Automotive Segment (in %)



Source: Czech Statistical Office

Outlook

Industry continued in solid growth in the first two months of 2004. The growth of industrial output amounted to 5.4 %. Companies under foreign control further increased their share of direct export sales on their total sales (to 72.8 %) and also the share of their sales on total Czech industrial sales (to 53.3 %). The revival of economy in major Eurozone countries will support the Czech industrial exports, as indicated by the double-digit growth of new foreign orders in the beginning of the year. For 2004, we expect the growth of industrial output around 5.5 %.

Construction output continued in growth in the first two months of 2004, with the output increasing by 12.7 %. The growth in construction will continue in 2004 due to new infrastructure projects and ongoing demand for new flats. Furthermore, new projects by foreign investors are already underway. Rates of growth will be favourably affected by low bases for comparison until June 2004 (construction output stagnated until June 2003). The growth will be lower as of June both for statistical reasons and due to the above mentioned increase in VAT. In 2004, the growth in construction output will reach approximately 6 %.

As for retail trade, 2003 was the year of exceptional growth, which will not be repeated in 2004 – due to lower growth of disposable incomes

and higher inflation. We expect the growth in retail trade to reach approximately 3 % in 2004.

8. LABOUR MARKET

In 2003, the developments on the Czech labour market confirmed the predominantly structural character of the Czech unemployment. In spite of acceleration of economic growth in the second half of the year, the unemployment increased to 10.3 % at the end of 2003, up from 9.8 in December 2002. The unemployment rate continued to grow in the first two months of 2004, reaching 10.9 % in February 2004 – a new record high level in the history of the Czech Republic. At the end of first quarter, a slight decline to 10.7 % was observed due to seasonal factors. The unemployment rate is thus by almost two percentage points above the unemployment rate in the Eurozone.

The number of unemployed amounted to 560 thousands at the end of March 2004, an increase of 32 thousands from a year earlier. In the course of March 2004, 52 thousands of unemployed were newly registered which is by almost 5 thousands people more than a year before. This increase is most probably also a consequence of tightening tax and social contributions regime for self-employed (valid as of the beginning of the year). The measures which were targeted to increase public revenue have thus appeared as contraproductive ones.

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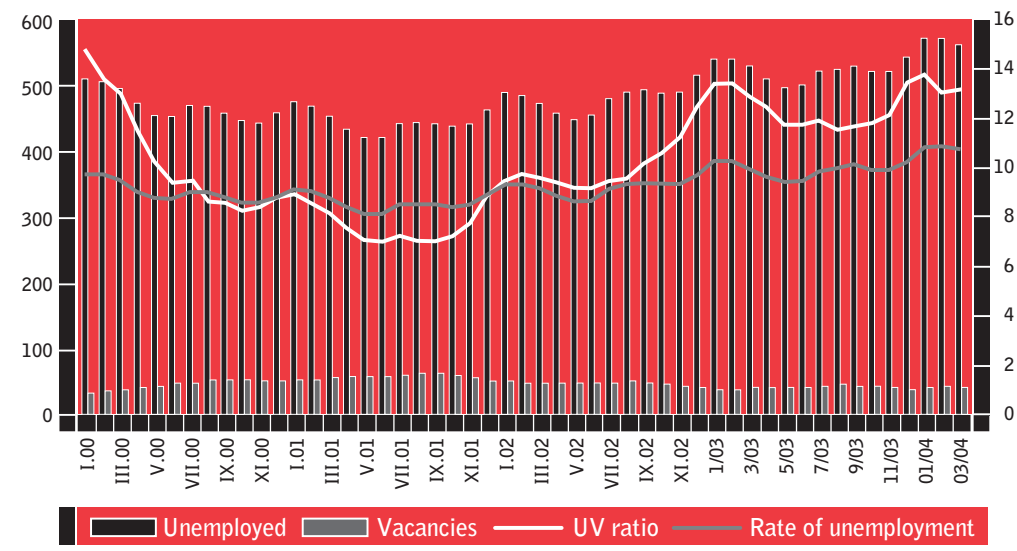
Restructuring of industry has been the main factor behind increasing long-term unemployment which accounts for almost one half of Czech unemployment.

While the developments in vacancies seemed to be rather promissive at the beginning of 2004, the new offer of jobs has been increasing only very reluctantly and hesitantly. At the end of March 2004, the number of vacancies amounted to 43 thousands which is by one thousand more than a year before. The ratio between unemployed and vacancies changed a little, with approximately 13 unemployed falling upon one vacancy. In 2003 and at the beginning of 2004, labour market continued to be strongly affected by ongoing restructuring of the Czech industry. Employment in industry started to decline in the last quarter of 2001, falling by almost 100 thousands of workers until the end of 2003.

However, it seems, that the dismissals from industry were less intensive in 2003, the industrial employment falling by 38 thousands persons while more than 50 thousands were laid off in 2002.

Restructuring of industry has been also the main factor behind increasing long-term unemployment which accounts for about one half of unemployed. Part of workers released from industry cannot find a new job due to low qualification and generally low flexibility. This corresponds well to the fact that two thirds of long-term unemployed dispose only with primary education.

Figure 9: Unemployed, Vacancies, Unemployment Rate and UV Ratio



Source: Czech Statistical Office
Unemployed and Vacancies: in thousands
U-V ratio: number of unemployed falling upon one vacancy

Nominal wages increased by 6.8 % in 2003, which was a slowdown against 2002 when the average wage had increased by 7.2 %. Due to low inflation, real wages grew almost by the same pace (6.7 %) as the nominal ones. Therefore, the growth of real wage was more rapid than a year before (in 2002 the real wage increased by 5.3 %). The effects of the price developments on the developments of wages are indicated in Table 9. Average wage before taxation amounted to CZK 16 917. The growth

of wages was more rapid in the public sector (9.8 %) than in the business one (6.0 %).

Growth of real wages was one of the most important factors of economic growth in 2002 and 2003. The growth of real wages combined with low interest rates on mortgages and consumer loans boosted private spending. Due to overall low inflation, rapid growth of real wages did not represent risky factor for macroeconomic stability.

**Table 9: Growth of Nominal and Real Wages
(growth in %)**

| | 2001 | 2002 | 2003 |
|---------------|------|------|------|
| Nominal wages | 8.7 | 7.2 | 6.8 |
| Real wages | 3.8 | 5.3 | 6.7 |

Outlook

In 2004, we expect regular seasonal developments: slight decline of the unemployment rate in Spring, increase in Summer months (as a consequence of school-leavers entering the labour market) and following slight Autumn decline. The rate of unemployment will amount to 10.5 % at the end of 2003.

The labour market continues to be (along with the public finance) the main weak point of the Czech economy. The chance to form active employment policy as a preventive programme was completely wasted. The scope of long-term unemployment and marginalised labour force has been continuously increasing. Flexibility of the labour market is low and the improvement may come only in longer-term horizon. In this respect, comprehensive measures focused on human factor is the only way how to increase the flexibility of labour force. Employment policy and the system of education should force people to be active in permanent improvements or changes in skills and qualification during the whole period of economic activity. At the same time, functioning market with housing (in particular the rental one) is a sine qua non for increasing labour mobility and thus flexibility of the labour market.

The labour market continues to be (along with the public finance) the main weak point of the Czech economy.

Employment policy and the system of education should force people to be active in permanent improvements or changes in skills and qualification during the whole period of economic activity.

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