



PATRIA

Czech Republic - Update Who cares?

13th July, 2007

Last time we wrote about a hope that the fiscal policy could be finally reshaped and budgetary deficits diminished in years to come. Nothing is sure in economics, fiscal policy is not an exemption. First swift steps are followed with dimmed discussions inside the governing coalition.

The government proposal is too tight for some Christian Democrats and too loose for some members of ODS. First ones would like to moderate changes in healthcare policy. Second ones proposed a deeper tax cutting. Who cares about deficits? It is going to be tough task to find any compromise and to push it through the Parliament.

A hesitation led to another unpleasant letter from the European Commission and its experts are going to deliver proposal what to do. Further steps would be less gently. But, who cares?

In the meantime ministry of labor and social affairs introduced a timetable for the pension reform. The first phase includes raising retirement age from 63 to 65 year for both men and women, and some minor changes in the current PAYG system. The second stage should contain detachment PAYG from the central government budget, creation of a fund for pension reform and legislative changes for pension funds (separation of clients' savings and shareholders' property). The last part will introduce a new funded pillar of pension system with a possibility to opt-out from PAYG partially. It can be seen as widening of current two-pillar system, not fully-fledged three-pillar system that was introduced in almost all other central European countries. Discussion about reforming pensions in the Czech Republic lasts for a decade. It is time to move, not to write timetables. Again, who cares?

Fortunately, economy lives its own life in the short-term. GDP keeps annual speed over six percent and the country belongs to favorable targets for foreign investors. The Czech Republic is going to face ordinary problems like a mild increase in inflation and wage pressures stemming from a fall in unemployment. The central bank is likely to lift its repo rate once maybe twice by 25 bps until the end of the year. It is much harder to cope with long-term problems like a population ageing. So far, economists care, politicians not.

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Gross domestic product

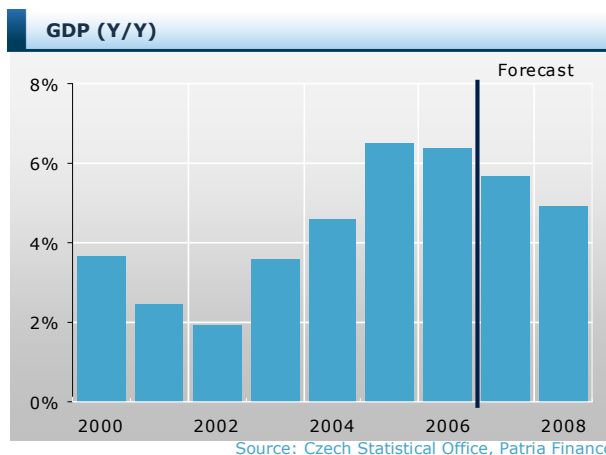
Czech GDP keeps growing fast. Its growth rate in real terms reached 6.1 percent in the first quarter 2007. Domestic demand is the main driver of growth. Household consumption rose by 6.7 percent boosted by growth of wages combined with decreasing unemployment.

On the other hand, investments growth was surprisingly low, at 1.5 percent, probably due to increasing stocks. Foreign trade negatively contributed to the GDP growth although its nominal balance is positive.

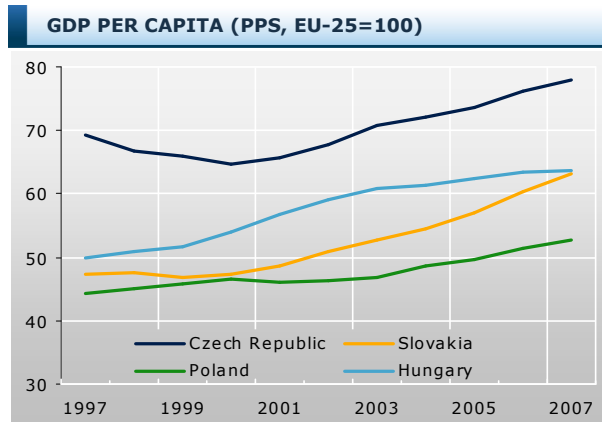
Besides the 1Q results, the Statistic office released revisions of GDP numbers in the last three years. The growth rates were revised up by 0.4 percentage point in 2004 and 2005 and by 0.3 percentage point in 2006.

The economic growth of the Czech economy is now above its non-inflationary potential growth by 0.7 to 1.1 percent. This supports the need of tightening monetary policy.

For the 2007, we forecast a mild slowdown of the economy. The GDP growth is expected to reach 5.7 pct after 6.4 pct in 2006.



In 2006, the Czech Republic reached 76 pct of the EU average in terms of per capita GDP. Therefore, the CR remains far ahead of other CEE countries.

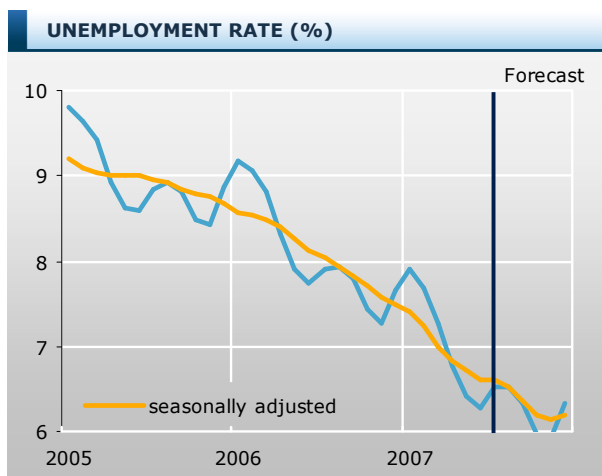


Labor market

The current unemployment level (6.3 percent) in the Czech economy is the lowest in the last 8 years. The fast growing economy creates jobs enabling the unemployment rate to decrease gradually during the first half of the year.

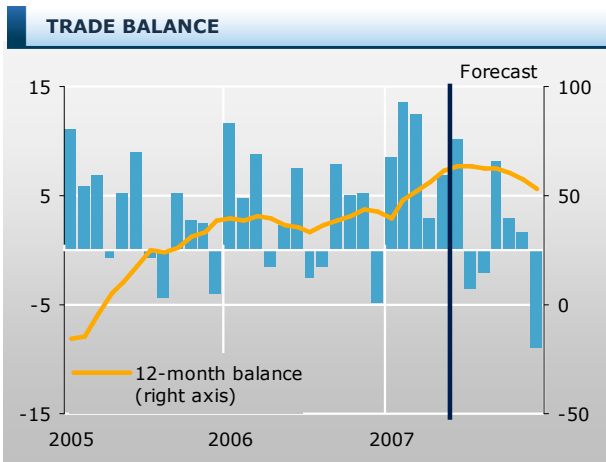
Creating jobs is quite fast and results in rising vacancies. In certain sectors, companies faces problems to find workers in needed professions. That is why the vacancies growth is higher than decrease of unemployment. Another reason for this is the low mobility of labor force.

Further decline in unemployment rate is expected towards the end of the year.



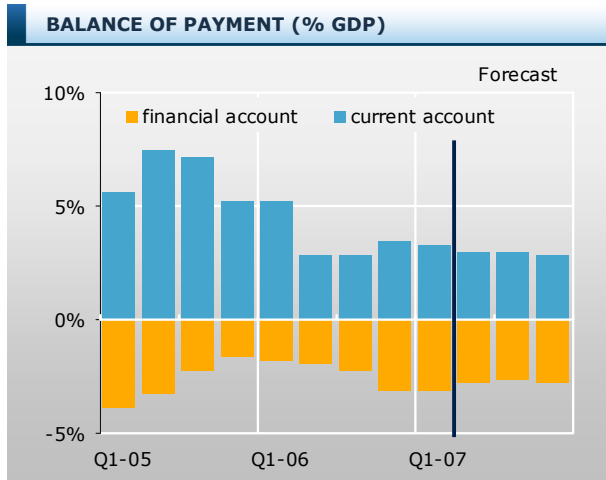
Current account / foreign trade

The trade balance posted a surplus in all three months in Q2. Czech economy can profit from high investment to its industry in recent years. The investment now drags the trade balance to positive numbers as it boosts exports. On the other hand, domestic demand pressures imports higher and worsened trade balance in real figures. However, decreasing import prices and rising export prices outweighed real factors and trade balance in nominal figures improved.



Source: Czech Statistical Office, Patria Finance

The trade balance should keep its increasing trend through the end of this year and a surplus for the whole year should be around CZK 87bn (EUR 3.1bn).



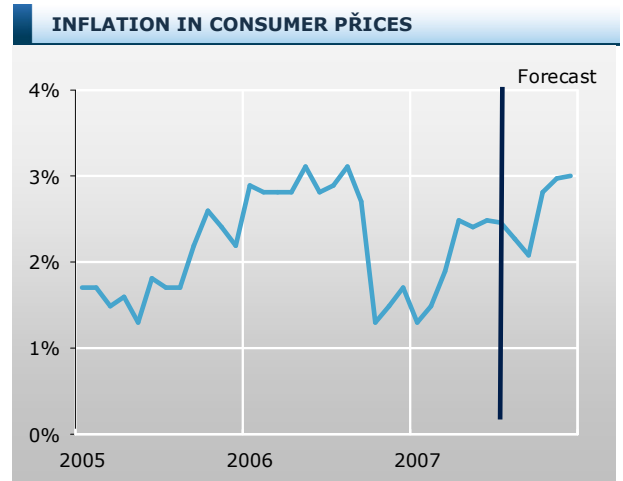
Source: Czech National Bank, Patria Finance

The current account deficit is burdened by costs of previous FDI inflow: dividend payments abroad and reinvested earnings. Unlike the trade balance, the current account is expected to show a deficit of about CZK 100bn (EUR 3.4bn). This deficit would be nearly the same as in the previous year. The deficit of 2.8 percent GDP does not represent any significant threat to the economy.

Inflation

The inflation rate further increased in the second quarter. Consumer prices rose by 2.5 percent in June. As the economy has got above its potential, it starts to generate mild inflationary pressures. But, the numbers in 2Q were more influenced by the increase in excise on tobacco and by growing fuel prices.

Also the currency has an inflationary impact. The Czech koruna weakened in the first half of the year, moving away from its long-term appreciation trajectory.



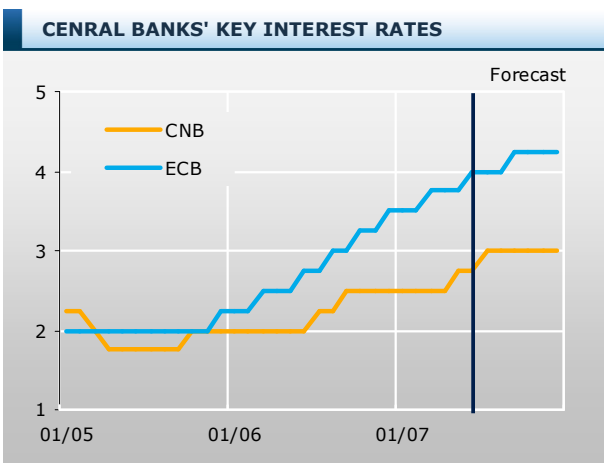
Source: Czech Statistical Office, Patria Finance

Inflation rate is expected to slightly speed up this year as oil prices in the world looks to be pretty volatile again and food prices are likely to reflected weak harvest last year. Annual inflation can surpass 3 pct at the end of the year.

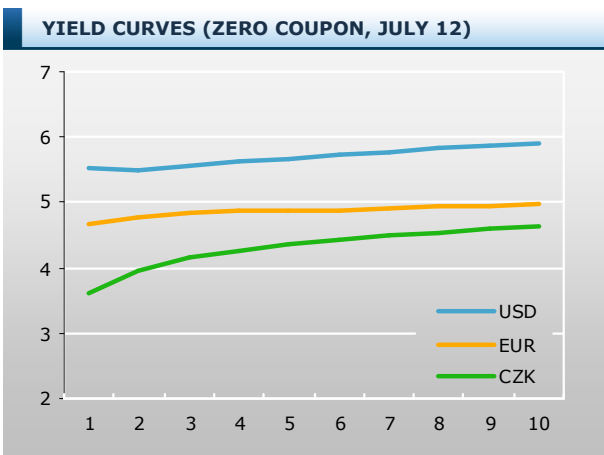
Monetary policy / interest rates

The Czech National Bank hiked its two-week repo rate by 25 basis points to 2.75 percent. This step was widely expected as the inflation deviated from the CNB's forecast in recent months.

Moreover, weak exchange rate, rising oil prices, accelerating wage growth and continuing quick GDP growth supported with the domestic demand push inflation forecasts still higher. Monetary belt should be tightened again. Mixing all relevant figures into the reaction function of the central bank we assume that the CNB will raise its rates by 25-50 basis points this year and possibly by another 50 basis points in 2008. Such a scenario is already priced in FRA rates and bond yield curves.

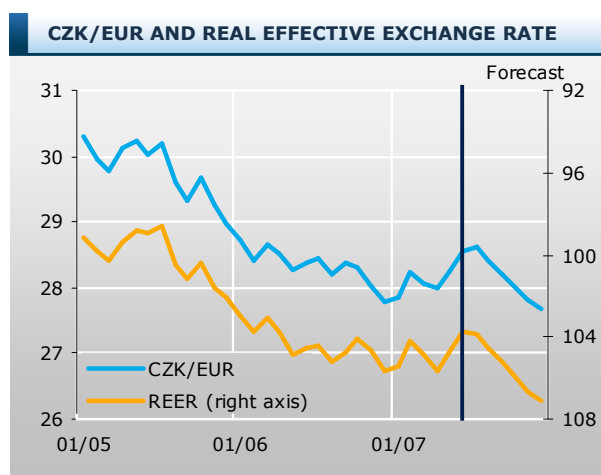


Source: CNB, ECB, Patria Finance



Exchange rate

The Czech koruna was weakening gradually during the second quarter. Main topic for the market was interest rates. The Czech central bank interest rates were very low, well below the ECB level. This negative rate differential combined with increasing global risk appetite resulted in building carry trades from the CZK to high-yielding assets. Moreover, also outflow of dividends weighed on the koruna, pushing it to weaker levels.



Source: CNB, Patria Finance

Early July, a shift in global risk aversion brought some canceling of speculative positions related to carry trades. This helped the koruna to firm significantly and approach to its long-term appreciation path.

The Czech currency is expected to firm further as we estimate its fair rate at 27,70 CZK/EUR by the end of this year. But, during the third quarter, still higher ECB rates and the outflow of company profits can still prevent the CZK from quicker move towards stronger levels.

CZECH REPUBLIC: KEY ECONOMIC DATA
Population: 10.2 mil.

GDP per capita (2006): 13.804 USD

%, y-to-y,

unless otherwise stated

	2001	2002	2003	2004	2005	2006	latest period	2007F	2008F	
GDP, CZKbn, current p.	2352	2464	2577	2817	2994	3220	816	Jan-Mar '07	3534	3794
GDP, USDbn, current p.	61,8	75,3	91,3	123,2	125,0	142,4	37,5	Jan-Mar '07	168,8	182,7
GDP, growth rate	2,5	1,9	3,6	4,6	6,5	6,4	6,1	Jan-Mar '07	5,7	4,9
Industrial output, growth rate	6,7	1,9	5,5	9,6	6,7	11,2	7,5	May '07	9,9	5,0
Construction output, growth rate	9,6	2,5	8,9	9,7	4,2	6,6	1,4	May '07	7,3	2,3
Retail sales, growth rate	4,5	3,0	4,9	2,5	4,0	6,4	8,1	Apr '07	7,5	4,4
Unemployment, % of labour force, eop *	8,9	9,8	10,3	9,5	8,9	7,7	6,3	Jun '07	6,3	6,4
Consumer prices, average	4,7	1,8	0,1	2,8	1,9	2,5	2,1	last 12M	2,3	2,7
Consumer prices, eop	4,1	0,6	1,0	2,8	2,2	1,7	2,5	Jun '07	3,0	2,8
Industrial producer prices, average	2,9	-0,5	-0,3	5,7	3,1	1,6	2,8	last 12M	4,1	4,0
Industrial producer prices, eop	0,8	-0,7	0,9	7,7	-0,3	2,6	4,1	May '07	4,9	3,7
Average national wage, growth rate	8,5	7,3	6,6	6,6	5,3	6,4	7,8	Jan-Mar '07	8,6	7,6
Current account balance, USDm	-3272	-4165	-5785	-5751	-1940	-4585	626	Jan-Mar '07	-4724	-6134
in % of GDP	-5,3	-5,5	-6,2	-5,2	-1,6	-3,1	-3,2	last 12M	-2,8	-3,4
Trade balance, USDm	-3077	-2248	-2530	-530	2522	2979	331	May '07	4136	3157
Service balance, USDm	1524	643	470	636	1532	1531	246	Jan-Mar '07	1623	1723
Financial account, USDm	4544	10624	5620	7041	6379	5072	-676	Jan-Mar '07	4820	6092
in % of GDP	7,3	14,1	6,1	6,3	5,2	3,5	3,3	last 12M	2,8	3,3
Foreign direct investment inflow, USDm	5641	8482	2022	4980	11600	6020	1415	Jan-Mar '07	8740	8410
in % of GDP	9,1	11,3	2,3	4,5	9,3	4,2	4,5	last 12M	5,2	4,6
Gross external debt, USDbn	22,4	27,0	34,9	45,2	46,5	58,3	58,9	Mar '07	64,0	70,0
in % of exports of goods and services	55	59	62	53	52	54	51	Mar '07	47	46
in % of GDP	35	33	35	36	38	38	38	Mar '07	38	38
Official convertible FX reserves, USDbn	14,5	23,7	27,0	28,4	29,5	32,0	31,2	Jun '06	33,0	35,0
in months of imports of goods&services	4,1	6,1	5,5	4,4	4,1	3,7	4,2	Jun '06	3,0	2,8
State budget bal., CZK bn, incl. pensions	-64,3	-45,5	-106,5	-69,0	-61,1	-97,3	1,3	Jun '07	-91,3	-125
General government budget**, in % of GDP	-5,7	-6,8	-6,6	-2,9	-3,5	-2,9	-2,9	Dec '06	-4,1	-5,3
Central government debt, CZK bn	345	396	493	593	691	803	812	Mar '07	903	1028
in % of GDP	14,7	16,1	19,1	21,0	23,1	24,9	24,9	Mar '07	25,5	27,1
Broad money, growth rate, eop	13,0	3,5	6,9	4,4	8,0	8,1	12,1	May '07	8,7	7,7
2-week repo rate, eop	4,75	2,75	2,00	2,50	2,00	2,50	2,75	Jun '07	3,00	3,50
3M PRIBOR, average	5,18	3,55	2,28	2,36	2,01	2,30	2,93	Jun '07	2,91	3,59
3M PRIBOR, eop	4,62	2,59	2,09	2,56	2,17	2,55	3,00	Jun '07	3,33	3,89
CZK/EUR, average	34,1	30,8	31,8	30,7	29,8	28,3	28,55	Jun '07	28,1	27,5
CZK/EUR, eop	32,0	31,6	32,4	30,5	29,0	28,0	28,72	Jun '07	27,7	27,3
CZK/USD, average	38,0	32,7	28,2	22,9	24,0	22,6	21,01	Jun '07	20,9	20,8
CZK/USD, eop	36,3	30,1	25,7	22,4	24,6	21,7	21,26	Jun '07	20,5	21,0

Source: Czech Statistical Office, Czech National Bank. Forecasts: Patria Finance.

* a new methodology applied from 2004

** excluding net lending and subsidies to transformation institutions

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