Czech Republic

OUTLOOK

After expanding by more than 6 % in the past two years, we expect economic growth to slow to 5.9 % this year and further to 4.8 % in 2008. Whereas household consumption is set to post the highest growth rate in 11 years in 2007, the implementation of fiscal reforms affecting household purchasing power is likely to be at the heart of deceleration in growth next year. Still, the anticipated slowdown of consumption growth should not be large enough to prevent the CNB from further tightening its monetary policy. We expect the CNB to deliver one additional interest rate hike in Q4, followed by a cumulative 75 bp increases in 2008. On the fiscal side, the approval of economic reforms has substantially raised the chances that the country will meet the 3 % target for public sector deficit next year.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH LT FC RATING	SPREAD AVG (AUG) 35
A1/Positive	A–/Positive	A/Stable	EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2005	2006	2007f	2008f	2009f
Nominal GDP (EUR, bn)	101	114	126	137	148
Per capita GDP (EUR)	9,820	11,070	12,220	13,230	14,310
Real GDP, yoy (%)	6.5	6.4	5.9	4.8	4.5
Inflation (CPI), yoy, eop. (%)	2.2	1.7	3.6	4.5	2.7
Inflation (CPI), yoy, avg. (%)	1.9	2.5	2.6	4.4	2.8
Unemployment rate (%)	8.9	8.1	6.6	6.2	6.0
Exchange rate CZK/EUR, eop.	29.01	27.50	28.00	27.70	27.50
Exchange rate CZK/EUR, avg.	29.78	28.34	28.00	27.90	27.60
2-week repo rate, eop.	2.00	2.50	3.50	4.25	4.25
2-week repo rate, avg. of the year	1.95	2.17	2.90	3.80	4.25
1M Pribor, Dec avg.	2.05	2.52	3.55	4.30	4.30
1M Pribor, annual avg.	1.98	2.22	2.95	3.85	4.30
Current account balance/GDP (%)	–1.6	–3.1	–3.5	–3.3	–3.5
FDI/GDP (%)	9.3	4.2	4.2	5.0	3.8
Public debt/GDP (%) (ESA 95)	30.2	30.2	30.5	30.8	31.0
Budget balance/GDP (%) (ESA 95)	–3.5	–2.9	–3.5	–3.0	–2.7
Total external debt/GDP (%)	38.1	37.8	36.3	35.6	35.3

Sources: Czech National Bank, Czech Statistical Office, Labour and Social Affairs Ministry, Ministry of Finance, Živnostenska Banka Research – UniCredit New Europe Research Network.

MAIN TOPICS

- Q2 GDP growth reached 6.0 % yoy, dropping from 6.4 % yoy in Q1. The growth engine remained on the domestic side, with household spending making the largest contribution to the expansion.
- Inflation has so far shown no signs of demand-driven acceleration, remaining below the CNB's 3 % target (2.4 % yoy in August). Nevertheless, the CNB continued to tighten interest rates by a total of 50bp in July and August, pointing to increased inflation risks.
- The Czech koruna reversed a weakening trend from H1 and firmed sharply against the euro in the past three months. The unwinding of carry trades due to the increased risk aversion on global markets appeared to be the major driver behind the CZK's appreciation.
- The economic reforms consisting of changes to the tax system, healthcare financing and cuts in social benefits have been approved by parliament.

Strong growth driven by private spending

GDP growth slows moderately in Q2

Q2 GDP growth reached 6.0 % yoy, slowing from the revised figure of 6.4 % yoy in Q1. The figure was stronger than our forecast of 5.7 % yoy, but the extent of the slowdown from the previous three months was just in line with our expectations, as Q1 expansion was revised from its previous figure of 6.1 %. By contrast, the CNB predicted that growth would be slightly faster than it actually was (by 0.2 p.p.). The result underlined the healthy state of the economy, pulled by domestic demand. Although household spending, which is up 6.5 % yoy, failed to maintain its tremendous growth from Q1 (7.2 % yoy), the figure posted was still the second highest in almost four years. Private spending, driven by steep wage rises, increases in employment and generous social benefits, contributed the most to the GDP growth. On the other hand, investment growth strengthened mildly to 4.2 % yoy from 4.0 % yoy in Q1. In addition to this, the robust growth of inventories remained intact, with their contribution to growth being the second highest. Finally, the foreign trade surplus made a positive, though still marginal, contribution to the expansion (0.3 p.p.). On the supply side, manufacturing, trade and corporate services were the fastest growing sectors in the economy.

Full-year growth in 2007 set to slow less from 2006 than previously forecast

With due consideration of the stronger-than-expected growth in Q2 combined with the upward revision of the Q1 growth rate, we have raised our full-year growth forecast to 5.9 % yoy from the previous 5.6 % yoy. We expect household spending growth to accelerate to 6.4 % yoy this year from 4.4 % yoy in 2006, and the strong build-up of inventories to continue. On the other hand, investment growth is set to slow from last year, and spending by government institutions may even decline on a yoy basis. The growth dynamics of both exports and imports will highly likely remain in double-digit territory. However, we expect import growth to marginally exceed the growth of exports in full-year terms, resulting in a more or less neutral contribution of net exports to growth.

Slowdown still expected in 2008

With regard to 2008, we have not changed our GDP forecast for 4.8 % yoy growth. The implementation of fiscal reforms affecting household purchasing power is likely to be at the heart of this slower growth, compared to this year. A spike in inflation, cuts in social benefits and proposed wage slowdown in public sector are suspected to be the main factors which will weigh on household spending in 2008. Moreover, inventories are unlikely to repeat the robust increase we have seen in the past quarters.

Industry remains the engine of the economy despite losing some momentum

Industrial output, adjusted for the number of working days, slipped into single-digit growth rates in the May-July period, in line with our expectations that the spectacular expansion of the sector in the first months of this year would not prove to be sustainable. On an unadjusted basis, average output growth reached 8.3 % yoy in the past three months (versus 12.4 % yoy growth in Jan–Apr). Even though the output dynamics likely peaked in April (14.5 % yoy), manufacturing has remained the key sector supporting GDP growth. Growth in industrial sales, led by direct export sales, continued to outstrip output growth, up 9.6 % yoy on average for the May–July period. Car and machinery production, manufacturing of electrical and optical equipment were again the main drivers behind the industrial expansion. The weaker sector performance has not been reflected in employment figures yet. Employment growth reached 2.6 % yoy in July, up from 2.3 % yoy at the beginning of the year. Similarly, despite accelerating wage rises, growth in labour productivity continued to outpace growth in real wages, though the relation has deteriorated slightly. Going forward, we expect output to continue showing solid growth rates in the coming months, with some deceleration possibly in Q4 due to the unfavourable base effect. In addition, statistics on new orders also point to lower production growth in the future. While new orders surged 19.7 % yoy in 2006 on average, growth in first seven months of this year was much less pronounced (9.4 % yoy). For the year as a whole, we expect industrial output to expand by 9.0 % yoy, down from a hefty 11.2 % in 2006.

Short-term indicators

	Aug-06	Sep-06	Oct-06	Nov-06	Dec-06	Jan-07	Feb-07	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07
Real GDP, yoy (%)	–	6.3	–	–	6.1	–	–	6.4	–	–	6.0	–	–
Industrial production, yoy (%)	9.3	7.4	14.8	10.2	6.1	10.8	13.1	11.0	14.5	6.8	6.6	11.5	–
Inflation (CPI), yoy (%)	3.1	2.7	1.3	1.5	1.7	1.3	1.5	1.9	2.5	2.4	2.5	2.3	2.4
Unemployment rate (%)	7.9	7.8	7.4	7.3	7.7	7.9	7.7	7.3	6.8	6.4	6.3	6.4	6.4
Exchange rate/EUR, eop.	28.22	28.33	28.22	27.97	27.50	28.16	28.30	28.00	28.13	28.33	28.72	28.04	27.73
1M Pribor, avg.	2.28	2.36	2.53	2.52	2.52	2.53	2.54	2.54	2.54	2.61	2.81	2.90	3.07
Export, (EUR) yoy (%)	16.3	15.3	29.1	21.0	17.5	18.0	22.2	18.4	23.6	13.4	14.1	21.2	–
Import, (EUR) yoy (%)	13.7	14.4	28.8	19.7	17.0	21.2	17.0	15.5	19.0	11.0	14.4	19.2	–
Trade Balance, EUR mn	−39	260	136	177	−133	290	509	488	180	255	281	−26	–
Current account, EUR mn	−333	−353	−766	−390	−476	−86	220	387	−569	−502	−451	−310	–

Sources: Czech National Bank, Czech Statistical Office, Labour and Social Affairs Ministry, Živnostenska Banka Research.

Czech Republic

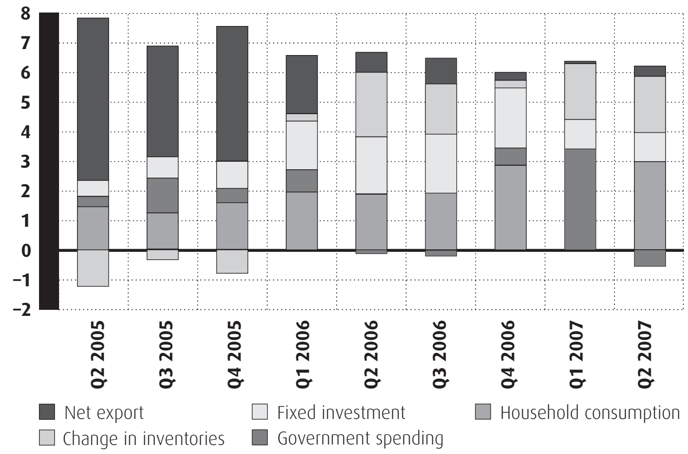
CNB steps up tightening

Despite strong economic growth, inflation has showed no signs of acceleration in the past three months. Following a pause in July, year-on-year CPI returned to the upward path in August, though amounting to the same level as in April (2.4 % yoy). The yoy inflation rate was mainly pulled by prices of tobacco products (following hikes in excise taxes required by the EU), food prices and housing rents. In the opposite direction, package holiday prices fell due mainly to a methodological change related to the implementation of the new consumer basket this year. Prices in telecommunications and transport also pushed down the yoy CPI in August. A mild pick-up in inflation in August seems the first step ahead of much steeper price acceleration in the final months of this year and in 2008. We assume that a low comparative base from late last year, coupled with further increases in food prices already pre-announced by sources from the agriculture sector, will help lift the inflation as high as 3.5 % in Q4. Furthermore, tax hikes resulting from economic reforms will push prices further upward at the beginning of 2008.

Pointing to the increased inflation risks, the CNB continued to tighten its monetary policy, raising interest rates by a total of 50bp in July and August. The August hike lifted the benchmark two-week repo rate to a five-year high of 3.25 %, narrowing its discount to the higher Eurozone equivalent to 75bp. Still, the repo rate remains the lowest in the European Union. The CNB justified this tightening by citing robust economic growth, which is hovering above potential, stronger household consumption and tighter labour market conditions, all suggesting that price growth may pick-up well above its inflation target of 3 % next year. Concerns over a steep rise in inflation in the future were also reflected in the bank's macroeconomic prognosis released in July. The prognosis envisaged faster economic growth and higher inflation for this year and next year, compared with the previous CNB's forecasts. The midpoint of the predicted interval for GDP growth is seen at 6.1 % yoy this year and 5.4 % yoy in 2008, up 0.4 and 0.1 p.p. respectively. Accordingly, the forecasted inflation corridor was shifted up to 3.5 %–4.9 % from 2.7 %–4.1 % for the end of next year. Looking ahead, we suppose that the recent steep advance of the koruna, the global market turbulence and a drop in core inflation, which excludes taxes and volatile food and fuel prices, have somewhat reduced the urgency of additional tightening. On the other hand, ongoing strong economic growth driven by domestic consumption, signs of wage growth acceleration and potential secondary impacts of regulated price hikes and tax increases planned for next year call for caution. On balance, we expect the CNB to deliver one additional 25-bp hike by the end of this year (we bet on October), which will be followed by further tightening for a total of 75bp in 2008.

Contribution to GDP growth

in %



Note: Statistical discrepancies are not considered in the chart.
Source: Statistical Office

The trend of weakening domestic currency, which started at the beginning of this year, turned around sharply in early July. Since then, the koruna has erased all of its losses suffered in H1, gaining around 5 % against the euro to touch new record highs. Unwinding carry trades due to increased risk aversion on global markets, which boost low-yielding currency units, proved the major driver behind koruna appreciation. We suppose, however, that the CZK rally was short-lived. The persistant interest rate disadvantage and the surging outflow of profits by foreign investors, which are pulling the current account down to a deep deficit, raise the prospects for a weakening of the koruna in the final months of this year. Next year, however, we believe that positive sentiment towards the domestic currency will prevail. Strong economic growth, a solid inflow of long-term capital and a gradual closing of interest rate gap versus euro rates should play a dominant role in the koruna's firming.

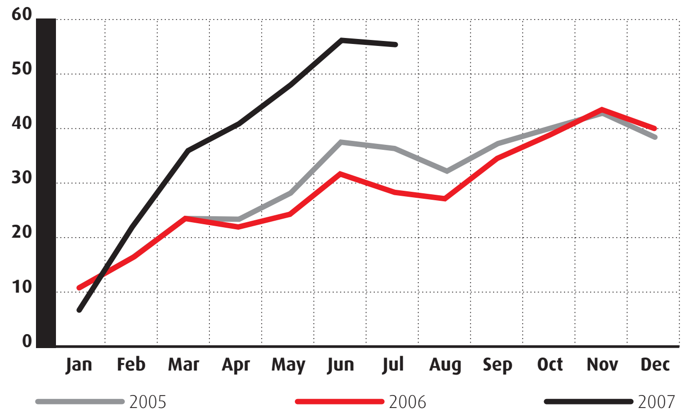
Foreign trade continues improving yoy

The foreign trade balance slipped to the red for the first time this year, posting a CZK 0.7 bn deficit in July. However, this negative figure did not surprise us, as the month of July is traditionally affected by a decline in export volumes, with many employees of large industrial companies taking holidays. Positively, when compared with July 2006, the deficit narrowed by CZK 2.7 bn. The cumulative surplus for the first seven months of 2007 reached CZK 55.7 bn. July's yoy dynamics of exports and imports accelerated from the previous month, amounting to 20.7 % and 18.7 %, respectively. Structurally, factors primarily contributing to the improvement have not changed for many months: a decline in imports of mineral fuels and the increasing surplus in trade with machinery and cars. Paradoxically, the key risk to be monitored is related to the export dynamics in the group of machinery and transport equipment, which lagged behind the pace of corresponding imports for the third month in a row in July. It seems that the demand boom has already peaked, which limits further growth in exports. For this reason, we assume that the trade improvement in the remainder of this year will not be as significant as it was in H1. Despite this, the trade balance is set to post a record full-year surplus this year, and we expect it to reach CZK 68 bn.

A broader current account showed a much lower-than-expected deficit of CZK 8.8 bn in July, shrinking from a CZK 12.9 bn gap a month earlier as mainly the outflow of profits dropped in month-on-month terms, due to a different distribution of dividend payouts over time. The deficit was also much lower than in July 2006, making the cumulative yoy deterioration less significant than in H1. The year-to-date current account deficit reached CZK 37.1 bn, exceeding by the level in the corresponding period last year only CZK 2.1 bn. Apparently, the marked rise in the foreign trade surplus was more than offset by a deepening deficit of the income balance and the balance of current transfers. For the whole of this year, we expect the current account gap to reach 3.5 % as a percentage of GDP, which would mean a worsening from 3.1 % in 2006. Despite the sizable net FDI inflows, the financial account surplus failed to cover the current account gap in year-to-date terms, reaching CZK 19 bn. Whereas we can observe a yoy increase of FDI flowing into the country this year, the balance of other investment turned to a deep deficit. We expect inward FDI to reach 4.2 % of GDP this year.

Foreign trade (cumulative)

CZK bn



Source: Statistical Office

Approved economic reforms allow budget deficit to shrink

The state budget posted a surplus of CZK 22.2 bn at the end of August, improving markedly from the CZK 6.4 bn deficit for the corresponding period last year. January-August revenues were up 9.9 % yoy, driven by tax collection (+9.5 % yoy). Boosting revenue side, the ministry released CZK 13.9 bn from the reserve fund in August. Growth in expenditures lagged behind, up 5.0 % yoy. Nevertheless, with most of expenditures traditionally realized in the final months of the year, we would not hope for having much lower deficit than budgeted for this year (CZK 91.3 bn). For the next year, the government proposes to cut the deficit to CZK 70.8 bn, which is also lower than suggested in the first draft (CZK 78.4 bn). Revenues are seen rising by 9.2 % yoy, helped by an assumed CZK 76.1 bn injection from EU budget, while expenditures are expected to grow by 6.4 % yoy. More importantly, the proposal is based on the economic reforms recently approved by the parliament. With the tax pillar of the reform set to be fiscally neutral, the fiscal restriction is allowed mainly by cuts in welfare spending. We regard tax changes as a long-term positive factor, as they shift the burden from direct to indirect taxes and make the taxation of individuals less complicated.

Entry date removed from euro adoption strategy despite brighter fiscal outlook

The Finance Ministry stated that the proposed 2008 state budget gap is consistent with the public budget deficit of 2.95 % of GDP, just below the 3 % target pre-agreed with the EU. The government has thus given a clear signal to the EU that the country remains on track to consolidate public finances. In 2009–2010 the deficit is now seen falling further to 2.6 % and 2.3 % of GDP, respectively. We are slightly more pessimistic, projecting fiscal gap ratios for 2008–2010 at 3.0 %, 2.7 % and 2.7 %.

Although the fiscal picture is now looking much brighter, Finance Minister Kalousek turned out to be in a minority with his plan for setting 2012 as the target date for joining the euro area. Prime Minister Topolanek and his right-wing Civic Democrats, who have long been opposed to setting any entry date, forced the date to be removed from a draft euro adoption strategy. The opponents of fixing the target at this point stressed that the country first needs to undertake the economic reforms including fiscal, healthcare, pension and labour market changes before it decides on the right timing. Furthermore, Topolanek won the backing of the CNB which is also against rushing into the Eurozone, pointing out that the Czechs need to allow prices and incomes to converge closer to average EU levels before switching their currency to the euro. Nevertheless, country's authorities have stated that regardless of abandoning the 2012 entry target proposal, the country could still theoretically join the euro area by this date.

Event	Date	Reading
MPC decisions on interest rates	Q4 2007	It remains to be seen whether the CNB will be more aggressive in tightening than we expect (+25 bp by year-end) or even will leave rates on hold in the wake of the global financial turbulence.