

**CZECH UNIVERSITY OF AGRICULTURE IN  
PRAGUE**

**Faculty of Economics and Management**

**Department of Economics**



**Bachelor Thesis**

**The Balance of Payments, case study of the Czech  
Republic**

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### **Declaration**

I declare that the thesis "The Balance of Payments, case study of the Czech Republic" has been completed by me, without any other outside help and only the defined sources, and study aids were used; they are cited in the thesis and provided at the end of the thesis.

Prague, the 27<sup>th</sup> April 2009

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Barbora Sýkorová

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**The Balance of Payments, case study of the Czech  
Republic**

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**Platební bilance, případová studie České Republiky**

**Summary:**

The bachelor thesis deals with the analysis of the balance of payments of the CR in the period of 2000 to 2007. The conceptual framework, including principal economic characteristics, comes before the own analysis. It concerns the explanation of the term 'the balance of payments' itself, its structure, methodology of its construction and last but not least the overall balance of the balance of payments. The aim of the thesis was to consider how the entrance of the CR to the EU (in 2004) has influenced the balance of payments. In order to show the changes in development of international economic relations after the EU acquisition, it was necessary to analyse the balance of payments in a preceding period. Therefore, the analysis of the balance of payments is divided in two periods, 2000-2004 and 2005-2007. Attention is paid mainly to those factors, which significantly affected economic transactions with abroad in each observation period. Last part contains ideas about possible changes in the balance of payments after the entrance of the CR to the Euro-zone.

**Key words:**

Account of exchange reserves, balance of payments, balance of payments identity, current account, demand of exchange, exchange rate, foreign direct investment, portfolio investments, securities (stocks and bonds), and supply of exchange.

**Souhrn:**

Předložená práce se zabývá analýzou platební bilance České republiky v období 2000-2007. Vlastní analýze předchází pasáží obsahující charakteristiku základních ekonomických kategorií vztahujících se k danému tématu. Jde o vysvětlení samotného pojmu platební bilance, její struktury, metodiky jejího sestavování a v neposlední řadě vymezení salda platební bilance. Cílem práce bylo posoudit, zda a jakým způsobem se do platební bilance promítl vstup ČR do EU v roce 2004. Aby bylo možné ukázat na změny ve vývoji vnějších ekonomických vztahů po našem vstupu do EU, bylo nutné nejprve analyzovat platební bilanci za období, která tomuto kroku předcházela. Proto je analýza platební bilance za sledované období rozdělena do dvou etap 2000-2004 a 2005-2007. Pozornost je tu věnována především faktorům, které v jednotlivých etapách výrazným způsobem ovlivnily ekonomické transakce se zahraničím. Poslední kapitola obsahuje úvahy o možných změnách v platební bilanci po vstupu ČR do Eurozóny.

**Klíčová slova:**

Účet devizových rezerv, platební bilance, rovnováha platební bilance, běžný účet, devizová poptávka, směnný kurz, přímé zahraniční investice, portfoliové investice, cenné papíry (akcie a dluhopisy), devizová nabídka.

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## **1. Introduction**

In the last twenty years, Czech (Czechoslovak) economy went through the transformation process from the centrally planned economy to the entrance to the European Union, with the perspective on the entrance to the Euro area, or called the Euro-zone. One of the key pillars of the economic transformation was external economic relations. Decisions accepted by the government (after the agreement of the Central National Bank) in the area of external economic relations were tested by the external environment, i.e. foreign investors. The extent and character of foreign trade activities of a country is recorded in the balance of payments. The development of the balance of payments in each period was directly proportional to the openness of Czech economy and to the reached level of liberalization of transactions in the current and financial account of the balance of payments.

The balance of payments has been stimulating changes of Czech economy since 1989 and it has been reflecting back the results of changes in the internal economic environment. Therefore, the balance of payments is the important feedback of previous macroeconomic decisions of politicians and economists and its development influences decisions directed to the future.

Whole range of decisions of practical industrial politicians, not only at the macroeconomic level, but also at the level of each single economic subject, requires information, which is consisted in the balance of payments. In many cases, it would not be even possible to make any decision without that information. The analysis of the balance of payments does not allow only characteristics of external economic relations in a given country, but also makes possible to understand the development of international monetary system and its functional mechanism, as well as to judge and mainly compare monetary, fiscal and exchange policies of given countries. The development of items in the balance of payments may also considerably indicate future development of the exchange rate.

With regard to this reality, I consider studying development tendencies of the balance of payments and factors, having either positive or negative impacts on economic transactions with abroad, very challenging and useful, because these tendencies and factors influence decisions of economic subjects at both macroeconomic and microeconomic level in a given country.

## **1. Objectives of thesis and methodology**

The objective of my bachelor thesis is to analyse the balance of payments of the Czech Republic after the entrance to the EU in 2004. In order to point out the changes, which have occurred in the area of external economic relations after the entrance to the EU, it is necessary to analyse the development of the balance of payments in the previous period and that is from 2000 to 2004. In the conclusion, the attention will be



paid to possible changes in external economic relations, which are expected to happen after the introduction of Euro currency.

Before the own analysis of the balance of payments of the CR, it is necessary to understand what the balance of payments really is. The balance of payments conceptual framework is covered in the third part of the thesis. This part consists of the definition of the balance of payments, classifying balance of payments transactions, methodology and construction, the balance of payments accounts, the reserve assets, the balance of payments identity, the exchange rate and the relationship between the current account and domestic national income.

Following two parts include own analysis of the balance of payments of the CR. First of all, attention is paid to the development of external economic relations in the period preceding the entrance to the EU, i.e. from 2000 to 2004. The fifth part is the analysis of the balance of payments after the accession to EU, i.e. from 2005 to 2007. The main aim is to show main factors, which affected the extent and character of individual transactions in the observation periods.

Last part of the thesis contains reflections about possible changes in the balance of payments after the Czech entrance to the Euro-zone. It is obvious that this part will be rather hypothetic. It consists of reflections of possible impacts of Euro currency on the position of our economy compared to abroad.

Research methodologies are chosen according to the objective of the thesis. In the thesis, the method of quantitative analysis is used mainly. This type of method will serve to explain the development of individual transactions of the balance of payments. On the principle of used methodology, it will be possible to compare factors, which would have had influence on the development of external economic relations in the observation periods. Performed analysis and comparisons will make then possible to accomplish the final synthesis and abstraction, which will be included in the conclusion.

## **2. Literature overview**

### **2.1. The balance of payments conceptual framework**

The balance of payments might be defined as a systematic statement of economic activities between the residents of a (home) country and the rest of the world in a given period, usually one year. This very general definition needs to be explained and concretized, starting with the definition of the balance of payments as the systematic statement.

The balance of payments is considered the systematic statement, because it is set up on the basis of certain classification and grouping of economic transactions. *It is the record of country's transactions in goods, services, and assets with the rest of the world; also the record of a country's sources (supply) and uses (demand) for foreign*

*exchangeö*<sup>1</sup>. When we buy something from another country, we use the currency of that country to make the transaction. Foreign exchange consists of all currencies other than the domestic currency of a given country. The purpose of the balance of payments is to achieve the fast and illustrative information about the large amount of different transactions. It is structured on the basis of agreed methodology. While speaking about the classification and methodology, long-term endeavour is to achieve the standardization at wide international level. This tendency has been supporting by the International Monetary Fund (IMF) since its functioning. It may be possible to say that this intention was most partly achieved in all member countries.

## **2.2. Classifying balance of payments transactions**

A country's balance of payments does not record only its international trading, borrowing and lending, it is actually a very wide statement; it records all transactions between countries and these transactions affect the supply of or the demand for a currency in the foreign exchange markets.

### ***Economic transactions include:***

- a) Receipt of payments from foreigners and payments to foreigners, related to the movement of goods and services (i.e. export and import of goods and services)
- b) Receipt of payments from foreigners and payments to foreigners, related to the movement of financial funds (i.e. receiving of deposits from abroad and saving of deposits abroad, or export and import of capital)
- c) Receipt of payments from foreigners and payments to foreigners, which are not related to the movement of goods and services or financial funds between countries (for example foreign aids and gifts)
- d) Changes (increase or decrease) in foreign receivables and payables, which are not accompanied by exchange payments and refunds (such as for example export and import of goods on credit, usage of credits from abroad by domestic residents, issuing credits to foreign residents).

From the paragraph mentioned above, it results that the term 'the balance of payments' does not completely respond to the content, which is actually hidden behind it. Therefore, the more exact term for the balance of payments would be for example 'the balance of economic transactions'. However, it was not accepted.

The balance of payments records all economic transactions, which are realized between domestic and foreign economic subjects. These subjects are called residents or non-residents of a given country. The conception of the residence status is arranged by the corresponding exchange law of each country<sup>2</sup>. Residents include individuals, corporations, government entities, and financial institutions. Other corporations or

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<sup>1</sup> MAITAH, M.: Macroeconomics, ZU - PEF, 2009

<sup>2</sup>Zákon . 219/1995 Sb., Devizový zákon; translated by Barbora Sýkorová

financial institutions that have branch abroad or affiliate, are then considered non-residents. However, the existence of different definitions of resident and non-resident is obvious; each country may have different limitations. It includes mainly foreign workers, diplomats, military attaché, branch offices of domestic enterprises abroad and foreign enterprises in the CR etc. These enterprises may be considered to be a resident in some country while in other a non-resident.

The balance of payments is usually prepared annually for reporting purposes. However, it is generally computed for shorter periods, i.e. quarterly or even monthly. The balance of payments is the statement, which is set up by central national banks in the most countries.

### 2.3. Methodology, construction and transactions of the balance of payments

The basic methodological principle, which effects the construction of the balance of payments, is *the system of double-entry bookkeeping* of each economic transaction. It means that each transaction is represented by two entries with equal values. Once, it is recorded as a credit item (with a sign +) and once as a debit item (with a sign -). Each transaction is recorded as a credit or debit item according to if a given transaction influences supply of exchange or demand for exchange in the internal exchange market. Credit transactions are those transactions, which influence a supply of foreign exchange, respectively it leads to decrease of our foreign receivables, eventually increase of our foreign payables. On the contrary, debit transactions are those transactions, which influence a demand for foreign exchange in the internal exchange market, respectively it results in increase of our foreign receivables, eventually decrease of our foreign payables.

*Receipt transactions*, i.e. supply of exchange, include exports of goods and services, import of income, transfers and capital inflows. The Central National Bank may also affect supply of exchange in the reason, when it sells foreign currency from its own exchange reserves in the exchange market. Oppositely, *payments transactions*, i.e. demand for exchange include imports of goods and services, exports of incomes, transfers and capital. As before, the Central National Bank may affect demand for exchange by buying foreign currency in the exchange market. Credits give rise to payments inward to the country and debits give rise to payments outward from the country.

*Transactions of the balance of payments*, recorded as credit or debit items, see the table below:

Credits	Debits
Export of goods	Import of goods
Export of services	Import of services

Import of incomes	Export of incomes
Import of transfers	Export of transfers
Import of capital	Export of capital
Decrease of exchange reserves	Increase of exchange reserves

The construction of the balance of payments is also influenced by the resources, movement and processing of information for its composition. The balance of payments is composed on the basis of information, which all economic subjects transfer to the Central National Bank, when they enter in any foreign trade relations. These economic subjects are mainly importing and exporting firms, commercial banks, other financial non-bank institutions, travel offices, hotels etc. In some cases, only estimations are taken into account, for example data about revenues and expenses from tourist trade, revenues and expenses related to working camps of our habitants abroad and foreigners employed in the CR.

The way of recording economic transactions of a given country compared to abroad can be different. Each country has got its own methodology of construction of the balance of payments, which is always subordinated to the purpose, for which this statement stands. If it is supposed to serve for analytical purposes, the balance of payments is composed in more detailed structure. These types of balances can have even more than 100 items and serve as a basis for macroeconomic decisions at the government and ministration level. If it is supposed to serve for informative purposes, then transactions are aggregated into larger groups and this type of balance usually consists of less than 20 items.

All member countries of the International Monetary Fund (IMF) compose the balance of payments according to the same methodology. This procedure enables to compare balances of payments in time as well as between countries. Even though the unified methodology is used, some differences in the balance of payments may appear, it depends on a given country and it usually reflects specificities of a country.

## 2.4. The balance of payments accounts

In spite of existence of different methodologies of compositions of the balance of payments, the structure is always the same and consists of the current account, the capital account, the financial account and the official account (change in exchange reserves). The basic scheme of the structure of the balance of payments is shown in the following table.

### *The balance of payments accounts*

	Credit (+)	Debit (-)

<b>A. Current Account</b>		
<i>I. Trade balance</i> (exports - imports)		
<i>II. Balance of services</i> (transports, tourism, other services...)		
<i>III. Income balance</i> (dividends, interest, royalties, coupon, profits...)		
<i>IV. Current transfers</i> (legacy, donations, alimony, international aid, remittances...)		
<b>B. Capital Account</b> (transfer of capital due to migration, debt pardons...)		
<b>C. Financial account</b>		
<i>I. Foreign direct investment</i> (above 30% of ownership)		
<i>II. Portfolio investment</i> (less than 30% of ownership)		
<i>III. Financial derivatives</i>		
<i>III. Other investments</i>		
<b>D. Net errors and omissions</b>		
<b>E. Official Account Change in exchange reserves</b> (the sign minus is an increase)		

$$A + B + C + D + E = 0$$

**The current account** has got four parts. It includes trade balance, balance of services, income balance and current transfers.

*The trade balance* records movement of goods, which is divided according to the commodity groups. In developed industrial countries, four traditional groups are distinguished, i.e. raw materials, industrial consumer goods, agricultural products and means of production. From time point of view, movement of goods can be recorded in the balance of payments in the time of its frontier crossing or on the day, when exporter transfers its property to importer. From cost point of view, it is necessary to avoid any rise of statistical duplicities in the form of double recording of services in cost of goods and in the item of services at the same time. This problem touches mainly traffic services, storage and insurance expenses. As a result, costs of supplier customs frontier are used, these costs do not cover expenses mentioned above, which are related to movement of goods abroad.

*The balance of services* records various services of trade or non-trade character. It includes mainly traffic, insurance, banking services, tourist trade and also revenues and expenses connected with diplomatic and military representation.

*The income balance* records transactions, which most often react on previous long or short-term movement of capital, which is recorded in the financial account. Import of incomes consists of income interests, dividends, rents and profits earned from foreign direct investment. On the contrary, export of incomes represents adequate expenses related to foreign investment in domestic economy. Besides this, profits connected with the arbitrary operations of exchange and gold are also recorded in the income balance. Also incomes of our citizens working abroad and foreigners working in our country are found in the income balance.

Last part of the current account record *the current transfers*. These transfers are one-way payments to or from abroad, which do not lead to creation of foreign receivables and payables of a given country. They are private (gifts, legacy, alimony, and dues from private means to foreign organizations and institutions and others) or government (pensions, dues from the state budget to international organizations, foreign aids and others).

According to new methodology of the International Monetary Fund from 1993<sup>3</sup>, transfers of capital character were set off from the current transfers. Capital transfers are then recorded in a separate part of the balance of payments, which is called **the capital account**. Besides capital transfers related to migration of habitants, debt pardons and proprietary laws to basic means, the capital account also includes transfers of non-productive non-financial tangible assets (i.e. lands for administration offices, underground wealth) and intangible laws (patents, authorship rights and so on).

Other part of the balance of payments is **the financial account**, offering more detailed information about capital flows. The financial account records movement of

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<sup>3</sup> In 1993, the methodology of the balance of payments of the IMF was specified, in order to correspond to the methodology of the System of national accounts. In practice, it has been used since 1995.

foreign direct investment, portfolio investment, financial derivatives and other investments. The financial account also tells us, whether a country is a *borrower/lender, or a creditor/debtor nation*. A country that is borrowing more from the rest of the world than it is lending to it is called a net borrower. A net lender is a country lending more to the rest of the world than it is borrowing from it. A debtor nation is a country that has borrowed more than it has lent to the rest of the world during its entire history. While a creditor nation is a country that during its entire history has invested more in the rest of the world than it has been invested in that country by other countries.

The criterion for submission of capital flows into *foreign direct investment* is certain level of ownership control of the enterprise, which would reflect the interest of the owner in long-term active directing of the enterprise. In theory, it should be at least 51 % of ownership. In reality, required portion of ownership is far lower, usually above 30% of ownership, but it may differ from country to country. In the case of the CR, only 10% of ownership is required according to the valid exchange law. It can concern purchase of stocks, real investment, or reinvestment of profit<sup>4</sup>.

Movement of *portfolio investment* is also recorded in the financial account. Portfolio investment includes purchase of all bonds and those stocks, which do not satisfy condition for submission in foreign direct investment; it is usually less than 30% of ownership. From economic point of view, its movement is motivated by completely different factors than it is in the case of foreign direct investment. The effort of these investors is to gain profit from movement of costs of securities and movement of exchange rates.

In the 70's and 80's of last century, thanks to the instability of financial markets, caused by increase of volatility in interest rates, rates of stocks and bonds and exchange rates, risks for all subjects of financial markets significantly increased. The result of an effort of searching possibilities, how to prevent increased risks was high development of new instruments, for which the term of *financial derivatives* was introduced. These trades, realized with foreign subjects, are recorded in the financial account.

Movement of long-term (over one year) and short-term (less than one year) capital is recorded in the item of *other investment*. Government credits and long-term private trade credits are included in the long-term capital. There are also recorded some capital transactions of Central National Banks, which are not recorded in the item of exchange reserves. Short-term capital is moving from one country to another usually in the form of private capital, and that is mainly private banking capital in the form of saving and withdrawing of deposits, purchase and sale of short-term securities, purchase and sale of exchange, offering and paying loans while exporting and importing of goods and services and so on.

The last part of the balance of payments is created by **the account of exchange reserves**. Exchange reserves include exchange assets in the form of free exchangeable

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<sup>4</sup> Zákon . 219/1995 Sb., Devizový zákon, § 1 odstavec k.; translated by Barbora Sýkorová

foreign currencies and reserves of gold, which are in holding of the Central National Bank. Exchange assets are usually in the form of deposits in the current and time accounts in first-class foreign banks, and then include high liquid government foreign bonds, which are widely traded in World markets, and reserves of foreign currencies. While speaking about the performance of objectives of the Central National Bank in the area of ensuring external exchange stability, exchange assets are the most important and also quantitatively most significant item of the exchange reserves. Usage of gold for payment of foreign payables is very complicated, mainly because of significant fluctuation of costs of gold in World markets.

Operations with exchange reserves create the compensative item, whose aim is to make the balance of payments in balance. The change of exchange reserves usually responds to the surplus (or the deficit) from transactions in the current and capital account. The surplus results in its increase and on the contrary the deficit in its decrease. In the balance of payments, increase of reserves appears with the sign minus so that in the debit side and decrease of reserves has the sign plus and is recorded in the credit side. In the first case, increase of reserves, the Central National Bank influences demand for exchange in the exchange market. In the second case, decrease of reserves, the Central National Bank influences supply of exchange.

The last part of the balance of payments is **the account of errors and omissions**. This item is closely related to the method of construction of the balance of payments and reflects the reality, that not all transactions are properly recorded. Problems are placed mainly in the methodology of calculating amounts of transactions, then in öleakagesö of less important transactions and the time discrepancy in entry of certain transaction in the credit and debit side of the balance of payments.

The account of errors and omissions is understood as the balance item, because it enables to prevent occurrence of certain methodological shortcomings in construction of the balance of payments and achieve the formal balance in the way, that the sum of debit items equals the sum of credit items. In this sense, the balance of payments is always balanced. However, this formal equality does not say anything about by which way the balance was achieved and which consequences it will have for other internal economic development of a country and for development of its foreign relations.

## 2.5. The balance of payments identity

When the balance of payments accounts are recorded correctly then the combined balance of the current account (CA), the financial account (FA), and the reserves account (RA) must be zero. It means that  $CA + FA + RA = 0$ . The balance of payments identity (BOPI) must always hold. Therefore, the BOPI equation indicates that a country can run the balance of payments surplus or deficit by increasing or decreasing its official reserves. To make it clear, I will use an example. Under *the fixed exchange rate regime*, countries maintain official reserves, i.e. central national banks may intervene, when it is needed. For example, when a country runs a deficit on the overall balance, i.e. when  $CA + FA$  is negative; the central bank of a country can supply foreign exchanges out of its reserve holding to cover the deficit in the overall balance. If



the exchange rate is fixed, and there is the balance of payments deficit, outflows are greater than inflows and supply of CZK is greater than demand for CZK. But the problem is, if the deficit persists, the central national bank will eventually run out of its reserves. Under *the pure flexible exchange rate regime*, central national banks will not intervene in the foreign exchange markets; they do not maintain official reserves. As a result, the overall balance must necessarily balance, i.e.  $CA = -FA$ .

I consider very important to point out, that the balance of payments must be always formally balanced and that is ensured by the change of exchange reserves. So when it is talked about balances of the balance of payments, it is necessary to specify, which type of transaction is recorded in order to find out an appropriate balance. By the *surplus* respectively *deficit* in the overall balance, it is usually understood the sum of the CA and the FA without balancing by exchange reserves. In this context, it is convenient to introduce other two terms – the balance and the equilibrium of the balance of payments. In the case, when the overall balance shows zero, it means, that there was not any change in exchange reserves in a given period, the balance of payments is balanced. In the case, when the overall balance converges to zero in a given period, the balance of payments is in equilibrium.

## 2.6. The foreign exchange rate, exchange regimes and the real exchange rate

*The foreign exchange rate* is the price at which one currency exchanges for another. The market in which the currency of one country is exchanged for the currency of another is called *the foreign exchange market*. Thanks to movements of exchange rates, currency can either depreciate or appreciate. Currency depreciation is the fall in the value of the currency in terms of another currency. On the contrary, currency appreciation is the rise in value of the currency in terms of another currency.

Three foreign exchange rate regimes are distinguished. Fixed exchange rate regime and flexible exchange rate regime were already explained (in the previous part 3.5.). The last one is called *floating, or market-determined, exchange rate regime*. Floating exchange rates are exchange rates determined by the unregulated forces of supply and demand. Its movements have significant impacts on imports, exports, and movement of capital between countries.

*The real exchange rate* can be defined as a given basket of goods, which can be bought for a certain price abroad, in proportion to a basket of goods, which can be bought for the same price in the CR. Real exchange rate is:  $R = E \cdot PF/P$ , where E is nominal exchange rate, P is price level of domestic good and PF is price level of foreign good. The lower the real exchange rate, the less expensive are domestic goods relative to foreign goods. Decrease in R means currency appreciation. On the basis of the law of one price, *the Purchasing Power Parity* was introduced to the international market. PPP holds that prices of identical goods should be the same in all countries, differing only by the cost of transportation and any import duties.

## 2.7. Direct relationship between the current account and domestic national income

As it was already mentioned, the current account provides information on the balance of consumption, saving, investment and government taxes and spending. If the current account shows surplus, it means, that a given country purchase less than it earns. Therefore, it means that there is a direct relationship between the current account and domestic national income. It is necessary to recognize *the basic macroeconomic equality*:  $GDP = Y = C + I + G + X - M$ , where Y is national income, C is consumption spending, I is investment spending on plant, equipment, G is government spending on goods and services, X represents exports (credit items in the CA), and M represents imports (debit items in the CA). We can get an equation:  $Y - (C + I + G) = (X - M)$ , where the left side represents national income less spending and the right side is the CA balance.

Other approach to show the relationship is that national income can be written as:  $Y = C + S + T$ , where S is private saving and T represents taxes. So that we can obtain the equation:  $C + I + G + (X - M) = C + S + T$  and then we can rearrange it to other equation:  $(X - M) = S + (T - G) - I$ , where S is private savings and (T - G) is public savings. This equation shows that the CA depends on private and public saving. The CA can be either positive or negative depending on how much a country saves compared to how much it invest. By now, the theory of the balance of payments should be understood and the practical part follows.

## 3. The analysis of the Czech Republic balance of payments

### 3.1. The analysis of the CR balance of payments in 2000 - 2004

#### 3.1.1. Development of external economic relations in 2000 - 2004

The period of the end of 90's is characterized by the stabilization of external economic relations. Deficit of trade balance decreased in consequence of temporary monetary and partially budgetary restrictions, decrease of economic activity and falling of domestic, mainly consumption, demand. The rate of export growth was higher than the rate of import growth. Massive inflow of foreign investment was directed into the trade networks in the CR, service investment (insurance companies, communications, distributive channels, and distribution of water, gas and power) and the area of real properties. Enormous inflow of investment was accompanied by temporary upset of trade balance in 2000 and 2001, caused mainly by increase in trade imports (needed for investment and personal consumption), related to first investments in supra-national companies (including trade networks).

The privatization of banking sector and the entrance of foreign investors in distribution and telecommunication channels were very important in light of exchange

revenues. The admission of law of investment incentives along with the liberalization of economic environment was important for inflow of direct investment in the manufacturing industry. After the introduction of new production capacities, dynamics of export started to increase and deficit of trade balance started to decrease. Since 2000, the trade balance was getting better and when the CR entered to the EU, the trade balance was almost in balance.

In the financial account, the liberalization of exchange regime together with the introduction of system of investment incentives stimulated inflow of foreign direct investment. Logical liberal end of capital flows was gradual release of items of outflows abroad. In the area of portfolio investment, investments to foreign securities were possible only for banking sector. Since 1999, it has been also possible for non-banking subjects without exchange permission<sup>5</sup>. Stabilization of the balance of payments and significant increase of exchange reserves in the Central National Bank enabled to accept liberal precaution. While by the end of 1998 non-banking subjects invested almost CZK 20 milliards in foreign securities, by the end of 2002 it was almost CZK 120 milliards. The extent of investment in foreign securities for banking and non-banking subjects was directed only by rules of wary business stated by regulatory institutions according to international customs and own investment strategy of each subjects.

The Central National Bank activity was gradually decreasing in the inter-banking exchange market and the Czech National Bank (CNB) intervened only in the case of excessive development of exchange rate. The Czech National Bank and Czech government agreed that extraordinary revenues from privatization will be saved in the government accounts in the Czech National Bank. The aim of agreement was to eliminate extraordinary pushes on exchange rates of Czech currency in the system of controlled floating. The current and financial account recorded positive development, which increased exchange reserves in the Central Bank. Liberalization of capital flows, gradual decrease of Czech crown interest rate, together with other institutional steps resulted in creation of the standard environment in the financial and exchange market. The Czech National Bank finished up the process of modification from usage of administrative devices to standard instruments influencing financial and exchange market, which are usual in developed market economies. Involvement of the CNB was also decreasing in the inter-banking exchange market and it practically ended in 2002. Exchange rate of Czech crown started to move freely and had tendency (with some fluctuations) of continual strengthening of Czech crown.

Development of the current account in the balance of payments in 2000-2004 noted changes in the structure. Decrease of deficit in the trade balance was significant. It is worth to mention that decrease in the balance of services was a result of increase in export of other services and decrease of surplus in tourist trade. Growth in import of other services was caused by increasing demand of supra-national enterprises and habitants for import of services, which were not demanded until now, for example telecommunication services (development of mobile network and internet), financial and insurance services, auditor services, software services, and commercial services. In

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<sup>5</sup> The regulation was abolished by the government regulation no. 129/1998.

the tourist trade, certain stagnation of incomes happened after the tourist boom and massive frontier trade from mid-nineties, which was suppressed mainly after the expansion of hypermarket networks in Eastern European countries. In the side of expenses, expenses started to increase in relation with increasing standard of living and diversification of consumption behaviour according to income groups of population.

A crucial item, which increased total deficit in the current account, was the balance of incomes. Main factors, participating in increase of this deficit, were paid off dividends from direct investments and the amount of reinvested profit. In the case of reinvested profit, it is only the "accounting record", which records the amount of received profit, which is left by foreign investor in companies in the Czech Republic. The same item with the sign plus is included in the financial account, actually in the item of foreign investment in the Czech Republic.

Reinvested profit can be used for expansion of production or for distribution of dividends in the future. In the financial account, foreign direct investment was dominant. After liberalization of capital outflows, increase of outflow of portfolio investment, enabled through surplus funds of commercial banks, insurance companies, pension funds and investment companies was obvious. Service of portfolio administration for enterprises and population (custody service) got a higher importance, purchases of non-residential securities (bonds, stocks) were offered there. Thanks to liberalization of exchange regime, the item of other investment was changed, enterprises and commercial banks had higher discretion while working with exchange means.

The balance of payments ended up with the active balance in the end of each year in this period, this was reflected in increase of exchange reserves (a sing minus). The exchange reserves were increasing during whole observation period thanks to influences of purchase of interventions (till 2002) and deposition of government incomes from privatization in the accounts of the Czech National Bank. Incomes coming from administration of exchange reserves also participated in increase of exchange reserves. Slowing down of increase in exchange reserves of Czech National bank in the end of observation period was related to payments of early accepted government loans, or other government expenses (for example lost international arbitraries). Data about the development of the balance of payments in 2000-2004 are provided in the "Supplement 1".

### **3.1.2. Factors affecting investments in the CR**

In the second half of nineties, there were several factors affecting investment in the CR; investors in the CR were stimulated by following factors:

- a) Improving of rating
- b) Liberalization of exchange regime
- c) Entrance of the CR to the OECD and perspective of membership in the EU
- d) Legislative changes (international agreements, bankruptcy and compensation law, commercial law, privatization, law of investment incentives)

### *a) Improving of rating*

Rating of the Czech Republic is an assessment of its credibility on foreign markets. The rating is a synthetic expression of the quality of the Czech state as a debtor and of its economic capability to comply with its own issued obligations and to pay off the interests and the principal of the sum owing in time and in total quantity<sup>6</sup>. The importance of such rating lies in the fact that the debtor must pay to its creditors. The difference between the best rating assessments (e.g., AAA), i.e., reference rating, and its worse rating (e.g., A- of the Czech Republic), called credit surcharge in issuing new issues, which takes into account the worse quality of the debtor. The rating of the CR was changing since the nineties. The first rating was given to the former Czechoslovak National Bank by the agency Moody's in January 1992. The rating level was Ba1. In March 1993, the same agency pushed up its rating up to Baa3, thereby the CR became the first post-communist country, which got (the lowest) investment level. In May 1994, the CNB reached again better rating assessment, i.e. Baa2, and in August 1995 it was Baa1. This level of rating was not anyhow threatened by monetary fluctuations in 1997. Co-operation with the agency Standard & the Poor's meant other better rating assessment; in July 1993, the CR was given the investment level BBB. In June 1994, this agency improved its rating up to BBB+. In 1995, the agency even skipped one level of its rating assessment and admitted A level. First decrease down to A- level was recorded in November 1998, i.e. after more than one year since monetary fluctuations. The main reason was insufficient progress in reformation of the banking sector and many other enterprises. Since then, the rating did not change until 2004, with exception in 2002 when the agency Moody's raised our rating up to A1.

### *b) Liberalization of exchange regime*

Liberalization of exchange regime in the CR started in 1990 by abolishment of central planning, monopoly of foreign trade and exchange monopoly. Since 2000 liberalization started to continue again. Internal currency convertibility was introduced already in 1991. This enabled free access to exchange for entrepreneurial subjects within the framework of current payments and created legal and perpetual assumptions for capital inflow from abroad.

In the beginning of 1995, the CR became a member of the European Community. Thanks to the signature of the European treaty, the CR committed to harmonization of its law system with law of the European Community and to gradual liberalization of exchange regime. European treaty ensured free movement of capital in the area of direct investment to and from countries of European Community. In 1995, new exchange law was introduced, external convertibility of Czech currency was introduced on its basis, i.e. complete liberalization of payments and transfers in the area of international current transactions (for corporations and individuals) including abolishment of duty of offer and removal of limits for purchase of foreign currency for inhabitants, and almost complete liberalization on the side of capital inflow. According

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<sup>6</sup> [http://www.mfcr.cz/cps/rde/xchg/mfcr/hs.xsl/state\\_debt\\_13264.html](http://www.mfcr.cz/cps/rde/xchg/mfcr/hs.xsl/state_debt_13264.html)

to the exchange law, other liberal amendments were introduced in the form of government decisions. In 2001 on the basis of amendment to exchange law, remaining restrictions of capital flows were abolished. There was only one exception of restrictions related to purchase of domestic assets by non-residents, where the CR asked the EU for temporary period.

*c) Entrance of the CR to the OECD and perspective of membership in the EU*

Membership of the CR in the OECD since 1995, signature of treaty of affiliation to the EC (European Community), and later preparation and entrance of the CR to the EU, were important signals for foreign investors from the EU countries and overseas. Possibility to establish new enterprises in the territory of future EU member was very attractive for foreign investors from Europe and Asia. Massive investments were made mainly in car, electronic and electro-technical industry.

*d) Legislative changes*

Regulatory range for investments was generally very liberal and found the principle of national manipulation and put emphasis on the purpose of direct investments during the country transformation to market economy. Entrepreneurial activities of foreigners in the CR is lead by the commercial law, which sets, that foreigners can carry business in the Czech territory under the same conditions and in the same extent as Czech individuals, it means that the principle of national manipulation is used. License of foreign individual to carry business in the territory of the CR occurs, when its name is signed up in the Commercial Register. According to the EU norms, duty to sign up in the Commercial Register does not refer to persons, who have their residence in some of the EU member countries or in other European industrial country (the amendment is valid since 1.2. 2001). The CR signed international agreements about protection and support of investments with many countries. These agreements enable to offer more advantageous conditions than national law. In the case of change of national rules, they serve as a guarantee for foreign investors.

Tax, as well as customs law rules of the CR set the same duties for foreign direct investors as for Czech persons. As a member of the GATT (General Agreement on Tariffs and Trade), the CR applied customs duties on imports according to valid and international generally accepted custom tariff. The CR signed agreements of abolition of double taxation with many countries. These agreements created wider range of observing tax duties for non-residents. Since May 2004 the CR has adapted customs tariffs and rules of the EU.

In the beginning of privatization process, a general idea to create a collection of amendments for incentives to foreign investors, in order to strengthen their long-term investment interest in the CR, was considered useless. Cheap and qualified labour force and good geographic situation was considered sufficient enough for the CR. Therefore, while other countries applied incentives, the CR was losing in attracting foreign investors.

Law of investment incentives<sup>7</sup> was introduced in 2000, May 1. This law finished up the process of creating legislative base for offering privileges to foreign investors. The law enables to use investment incentives for foreign investors under the same conditions as well as for Czech investors and their allocation is dependent on performance of given criteria. This law was novelized secondly in 2004<sup>8</sup>. The amendment came into existence, when the CR entered to the EU. Changes in the system of investment incentives are maintained by the amendment; these changes were induced by the entrance of the CR to the EU and are essential with the view of transformation of competencies in the area of public support from the Office for protection of industrial competition on the EU commission.

The system of investment incentives contributed to higher inflow of investments, mainly in the industrial sector. It cannot ensure long-term success of investment though. Examples include the end of production of TVs Philips in Moravia, or departure of the enterprise Electronics from Brno. Crucial amount of inflow of direct investment was not related to offering of investment incentives and was motivated by different factors (such as geographic situation, cost of labour force).

### **3.1.3. Foreign direct investment**

The key role in the process of stabilization of the balance of payments, with the view of financial flows and later fundamental changes in the development of trade balance and income balance, had foreign direct investment. Its massive inflow started already in the second half of nineties. Direct investments include direct and non-direct owned affiliations, which are divided according to investor portion (%) in the basic capital or voting laws. So that, the division is as follows: subsidiary company (more than 50%), associated company (10-50%) and affiliates (100% owned long-term representation or offices of direct investor, land and buildings directly owned by non-resident; moveable devices operating in economy more than one year). Reinvested profit and other capital, including credit relations with direct investor, are also considered parts of foreign direct investment.

Inflow of foreign direct investment in the CR was differently intensive in each year related to possibility of gaining portion in large national enterprises with perspective production of goods or services. Foreign investors had requirements for clean-up from environmental stress or were interested only in specific parts in enterprise, when they entered selected enterprises.

First entry of foreign direct investors to enterprises was realized already in the beginning of economic transformation (for example car company T<sup>TM</sup>Koda Mladá Boleslav, Sklo Union Teplice). Some privatization projects were not successful at the first attempt and after the agreement with foreign investor it led back to the compensation with our country (for example Czech airlines). Some enterprises were privatized in stages (for example český Telecom). Some investments finished up in

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<sup>7</sup> Zákon o investičních pobídkách . 72/2000 Sb.; translated by Barbora Sýkorová

<sup>8</sup> Novela zákona o investičních pobídkách . 19/2004 Sb.; translated by Barbora Sýkorová

international arbitrary (for example TV NOVA) in consequence of foreign investor action, because our country did not meet the agreement on protection of foreign investment.

Massive inflow of foreign direct investment was significant in the second half of nineties. It was related to the privatization of commercial banks and introduction of building of foreign commercial networks in the CR. Inflow of foreign direct investment influenced not only the structure of the balance of payments but also led to changes in the structure of economy and influenced the development of many macroeconomic aggregates (prices, investments, production and personal consumption, development of consumer lending, revenues and expenses of budget).

From the macroeconomic point of view, inflow of foreign direct investment in the CR was actually positive reality, which led to speeding up of structural changes in our economy. Thanks to privatization of country property, our country gained indispensable means. Increase in profits of enterprises with foreign participation in the territory of the CR led to the improving of macroeconomic aggregates of the CR on one side (increase of export and transition of negative trade balance to positive trade balance), but on the other side payment of dividends abroad decreased the extent of usage of produced GDP. In 1999, incomes from direct investments amounted CZK 36 milliards and in 2006 it was CZK 180 milliards. At the macroeconomic level, GDP decreases by this amount while conversion to GNP in a given year, i.e. amount of created pensions from work and capital in a given year cleaned up of transfers in relation to abroad.

### **3.2. The analysis of the Czech Republic balance of payments after 2004**

Entrance of the CR to the EU was the formal end of transformation process from the centrally planned economy to the market economy. The CR agreed that the country will follow standards build up by the European integration for several decades and will struggle for introduction of Euro currency in the shortest period as possible. Integrated processes were not one-way directed in the EU countries; they also included periods, when it was inevitable to give up previous proclaimed aims, because of different economic and political reasons. This also touches the process of introduction of single European currency. New member countries of the EU have different economic level and partial macroeconomic imbalances in the beginning, which have to be solved. Schemes of monetary policy and exchange regimes are also different. Therefore, nominal and real convergence proceeds in different channels. Accomplishments of given Maastricht criteria, which are necessary condition for entrance to the Euro-zone, are becoming hardly achievable in some EU countries, mainly thanks to the high speed economic growth rate.

#### **3.2.1. External economic relations of the CR after the entrance to the EU**



Entrance of the CR to the EU was related to abolishment of rest customs and administrative barriers including import quotas. Customs duties and quotas of the EU have been implicated in face of third countries since 1. May 2004. Norms of the EU have become part of the CR law and began to influence some items in the balance of payments. Also investments in the territory of the CR, carried out earlier, brought its effects. Export of machines and equipment, and export of cars have been the most significant factors in improving the balance of payments.

The growth of production in manufacturing industry is the result of foreign direct investment, mainly in car industry and electro-technical industry. In some cases, components needed to finish the engineering product are produced most often in the CR (car industry), while some components are imported (mainly from Asia) and final product is completed in the CR (production of computers and consumer electronics). The growth of export is related to growth of import (components) and surplus of trade balance is created by the value added by the manufacturing in our territory. Chemicals and fuels also play very important role in import.

After 2005, turnover of foreign trade increased and trade balance became active. Turnover of foreign trade increased for many other reasons, such as building of logistic parks in the CR. Cost effective rent of storage areas in the CR (lower than in the Western Europe) and opening borders for free movement of goods after the entrance to the EU (while having relatively good frontage roads) also led to increase in foreign trade turnover. The growth in foreign trade turnover was then related not only to the cooperation in the area of production, but also in the area of logistic (storage) services in the CR after opening the EU borders.

Adoption of new laws (amendment of VAT law) enables to foreign enterprises to be registered as a payer of VAT in the CR. These enterprises, which are usually connected to enterprises in our territory, accomplish larger and larger import and export and participate in growth of surplus in trade balance. Payments of VAT and due claims to refund VAT influence the balance of transfers according to time disharmony.

Transactions between the CR and the budget of the EU are recorded in the balance of current transfers and in the capital account. New item recorded in the capital account is trade with emission permits. Emission permits are given by the EU and it relates to laws to emit greenhouse gases CO<sub>2</sub>.

In the balance of payments of the CR, besides improving of trade balance, the balance of services was also improved after the entrance of the CR to the EU. In the balance of other services, improvement was seen in those transactions, which showed passive balance in the previous period. Enterprises with foreign participation, focused

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<sup>9</sup> One emission enables to release one ton of greenhouse gases. Enterprises in whole Europe made reserves of emissions, which exceeded their needs. Energetic enterprise CEZ gained more than CZK 3 milliards on sale of permits in 2006, because its estimations, concerning the development on the market of emissions, were correct. CEZ sold its emission permits at price of about EUR 20. First emission of permits was for years 2005-2007 and then their validity ends. For following period 2008-2012, the European Commission will put higher restrictions in allocation of permits and it is possible to expect that their price will go up.

on audit, accounting, development and sale of software, logistics, and commercials and so on, started to open its subsidiaries in the CR and offer its services not only to domestic firms, but also to firms with their official seat abroad.

Passive growth in the balance of transfers is still continuing. In 2007, deficit of income balance increased to CZK 253, 8 milliards (in 2000, it was only CZK 52, 9 milliards). Higher revenues from property investments for foreign investors and growth in incomes of foreign workers employed in the Czech Republic were seen in growth of expenses. Year-on-year increase of incomes was connected on the contrary with encashment of interests from bonds.

Compared to 2006, the number of foreigners employed in the CR increased almost by a quarter; according to the CSO estimations the number exceeded 256, 5 thousands of foreign employees. Increasing number of foreign employees, employed in local enterprises, led to increase of income expenses including deductions needed for social insurance by 20 %. Income of Czech habitants from work abroad remained at the same level in the observation period. In spite of gradual opening labour market in the EU, the number of Czechs employed abroad did not change very much and according to CSO information, their number reached only 27, 6 thousands in the end of 2007.

Dividends flowing to domestic investors from their investments abroad slightly increased in the observation period; the majority of them are for portfolio investors. The amount of dividends paid out from industrial results of foreign direct investment abroad is not increasing significantly. Thanks to favourable industrial results of domestic enterprises, the total amount of dividends for foreign owners of domestic enterprises increased. Higher dividends were given mainly to direct investors, while profit from portfolio investors decreased. Expected amount of profit left by foreign investors for other development of enterprises with their portion is still increasing in the CR. On the contrary, the amount of profit reinvested abroad has slightly decreased.

Holding of foreign bonds has brought higher revenues to domestic portfolio investors, as well as to foreign investors from bonds of domestic enterprises. In principle, all interest revenues come from holding of long-term bonds. Banking sphere have had significant influence on improving of interest balance from other financial actives and passives. From achieved growth of interest revenues, more than 70% fall to revenues from exchange reserves of Czech National Bank (CNB). Higher interests paid abroad were proved by government sector. Besides interests calculated from the value of contract related to rent of air-fighters from Sweden, almost all interest payments were related to credits received from the European Investment Bank. Interest revenues from government loans abroad, issued earlier, were minor.

The balance of current transfers has shown passive balance since 2006. On the side of incomes, transfers of government sector and expenses of private sector dominated. The balance of government transfers were influenced mainly by higher tax deductions from incomes and subsidies of social insurance as a result of growing number of foreigners employed in the CR. Other results recorded an increase in VAT refunded to non-residents, slight increase in subsidies paid to international organizations and pensions paid out abroad. Passive balance of private transfers was affected by

increased outflow of means in the form of gifts and heritage, decrease of remittances (payments to the CR from abroad) and other transfers of households. On the other hand, tax deductions from incomes and social insurance of Czech citizens working abroad decreased.

The capital account has shown surplus since 2004. Development in the capital account has been affected mainly by incomes from structural funds of the EU (CZK 19, 6 milliards).

Since 2004, the financial account has shown surplus with tendency of slight decrease (from CZK 177, 3 to 104, 5 milliards in 2007). Active balance of the financial account was influenced by direct investments mainly (CZK 185, 3 milliards in 2007). Growth of reinvested profit (CZK 130, 6 milliards) contributed to it very much. In 2005, privatization of Czech Telecom and Unipetrol dramatically increased inflow of direct investments (up to CZK 279, 6 milliards), which was then seen in increase of exchange reserves (up to CZK 92, 9 milliards). Because government exchange revenues from privatization were saved in the CNB.

Outflow of capital abroad, in the form of direct investment, was continuously increasing. This outflow of capital was not connected only with CEZ acquisitions abroad, enabled by achieved level of liberalization in outflow of capital, but also by a new possibility to use the status of European company<sup>10</sup>.

On the side of portfolio investment inflows, in time of restructuralization of financing government loans, emissions of government bonds abroad were seen. Also national (for example Czech export bank, CEZ) and private enterprises (for example leasing enterprises) have become to use emissions of bonds abroad for its financing. On the contrary, investments in Czech stocks have decreased. But, interests of Czech investors in foreign assets and loan instruments have increased.

Development of portfolio investments, while speaking about securities, has been also affected by interest differential of Czech currency according to foreign currencies. Market of portfolio investment has been affected by many domestic and foreign economic factors. Outbreak of crisis in the market of American mortgages in the middle of 2007 was among the most serious events.

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<sup>10</sup> The European company (Societas Europaea; SE) is the capital commercial enterprise, established by the European Council. It is arranged by the Council Regulation no. ES/2157/2001 on the Statute of a European company and Council directive 2001/86/ES, which also complements the statute of European company with the view of employees' involvement. In the case of the CR, the European arrangement is followed up with implementing law no. 627/2004 about European company. SE can be registered in any member state of the European Union, and the registration can be easily transferred to another member state. There is no EU-wide register of SEs (SE is registered on the national register of the member state in which it has its head office), but each registration is to be published in the Official Journal of the European Union. Base capital is EUR 120000 and taxes are paid in all EU countries, where SE functions. In 2007, company Koh-I-Noor became the European joint-stock company with its head office in Luxembourg. Outflow of portfolio investment was the result of diversification of structure of actives of banking and non-banking subjects.

The item of other investment showed up outflow of banking sector sources abroad, especially in the form of short-term deposits in foreign banks, and issuing of long-term loans to foreign entities. In active operations, increases of Czech deposits in international institutions were seen. Debit side of other investment was influenced mainly by loan draw-downs from European Investment Bank at the central and regional level for building of infrastructure. The largest inflow of capital was reached in business sector, which draw sources abroad.

The change of exchange reserves was influenced by revenues coming from administration of exchange reserves abroad, government exchange revenues from privatization of assets saved according to agreements between government and Czech National Bank in its accounts and operations for its clients. In 2006, Czech National Bank was selling a part of its revenues from exchange reserves from previous period, which resulted in decrease of reserves from CZK 92, 9 milliards in 2005 to CZK 2, 1 milliards. Data about the development of the balance of payments in the CR in 2005 ó 2007 are provided in the õSupplement 2ö.

### **3.2.2. Impacts of the EU membership on the balance of payments of the CR**

By the date of the CR entrance to the EU, it accepted to be a part of customs union in the EU. In relation to third countries, i.e. non-member countries of the EU, the CR gave up its sovereignty while creating foreign trade policies and become to use common trade policies of the EU. The common trade policies, besides associated and developing policies, is the most important item of external economic relations. Its importance consists in united regulations of exports and imports of member countries and in their common representation in trade questions towards third countries. This also enables to enforce interests of the EU in the international trade easier.

The position of the EU in the world market (the largest world exporter and second largest importer) ensures the quality and success of common trade policy. The EU ensures advantageous access of member countries to third markets by all possible instruments. And on the contrary, it opens its market for goods coming from third countries, whereas it controls very strictly, if international rules of trade are followed. In the case of their violation, it applies actions to protect its interests.

Before the entrance to the EU, the CR had different trade political regimes against the EU in majority of commercial partners and tradable items, which corresponded to its own commercial interests.

The EU has preferential contract relations with many of non-member countries. Preferential agreement, i.e. agreement of creating free trade or customs union, which ensures more advantageous conditions for exchange of goods between trade partners; it is actually more convenient than usage of endorsement of highest advantages. Preferential trade agreements cover about 40% of trade between the EU and third countries, non-preferential agreements cover about 49% of trade. In the case of the CR,

the portion of trade on the basis of preferential agreements covered almost 60%, while non-preferential agreements covered about 20% before the entrance to the EU11.

By the entrance to the EU, the Czech Republic then accepts agreements concerning also trade with countries, which the CR has never had any preferential relations with in previous period. Agreements of the EU have wider extent of preferences and wider territorial coverage. Therefore, in the case of some Czech regions, the CR noted great improvement thanks to the entrance to the EU. It touches for example bilateral agreements with countries of Latin America or Mediterranean, where the EU has very wide contractual base. Before the entrance to the EU, the CR had only several bilateral non-preferential trade agreements with those countries. Thanks to these agreements, trade between the CR and mentioned countries runs according to preferential customs duties, that means it is cheaper. On the other side, Czech market opened more to new preferential partners.

The only change in non-preferential relations is that after the entrance to the EU the CR cannot use any advantages coming from application of General system of preferences. This system allowed duty-free export of chosen products to markets of developed partnership countries, mainly the U.S., Canada and Japan. According to analysis of Czech Ministry of industry and trade, finishing up of the application of General system of preferences should not have any crucial impacts on the structure of Czech export but it is possible to predict that some of Czech exporters will not be able to stay in these markets because of required increase of customs duties in the final price of product, others will switch to products of given export categories with lower customs duties. On top of this, the application of the General system of preferences concerning import from countries of OECD is a certain exception and cannot have long-term character.

In relation to transforming countries, or countries with state economy, trade political regime of the CR did not changed very much, only extending and forcing of platforms for interrelated industrial relations is happening. Also any radical changes should not be made in political trade relations to developing countries. The CR will offer, as well as all other EU member countries, preferential care to African countries, Caribbean area and Mediterranean (i.e. a group of countries ACP) and to other developing countries. Impacts on Czech imports should not be, according to low trade with those countries, important.

Obligatory adaption of common trade policy of the EU is not viewed as a principle problem, because our country focuses just on the EU in foreign market for a long-term period. *õHandover of sovereignties in the areas of external trade policies to the hands of the EU does not mean practically any real damage, because in consequence of accepted obligations (WTO, European agreements) the CR has very limited or even minimal political territorial possibilities. Compared with more*

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<sup>11</sup> The highest portion of preferential agreements was covered by trade with CEFTA countries and other European countries with free trade. PLCHOVÁ, B.: Dopady zm n v zahrani n obchodní politice na eskou ekonomiku po na-em vstupu do EU, In: Acta Oeconomica Pragensia, 3/2004, p. 140-141. Translated by Barbora Sýkorová

*powerful partners, the CR must always conduct according to expected good morals, because it cannot really participate in any trade wars with them*<sup>12</sup>.

At the time of entrance debates, one of the engagements of the CR towards the EU and OECD was liberalization of movement of capital. Compared to the EU countries, which liberated the flow of capital for almost 50 years, the process of liberalization of capital flows was really short (15 years) in the CR. However, it is impossible to compare completely different periods of time. The CR started to communicate with developed market economies in the beginning of the nineties; it was the time of globalization of financial markets and liquidation of control of capital movement. Free movement of capital is one of the main policies of the EU, in which the CR wanted to integrate and therefore, it was necessary to accept the rules of the game of larger entity.

Thanks to Czech accession to the EU, assumptions for full connection to the budget of the EU in revenues and expenses were created. Government transfers are recorded in the current transfers of the current account and transfers from the Cohesion Fund and structural funds are recorded in the capital account, which also created the base for industrial policy and social cohesion in the EU.

Before 2004, the CR relied only on chosen union funds in form of pre-entrance programs. After complicated meetings, the final proposition of clear position of the CR in 2004-2006 was ratified in amount of EUR 778 milliards. On top of this, direct compensations to the budget were enforced; it eliminated the possibility that the CR would be clear contributor to the budget of the EU in first six years of its membership.

The amount of means supplied to the EU budget is derived from the amount of gross national product (gross domestic product minus the balance of transfers to abroad, i.e. for example dividends) and its supplies are obligatory. On the side of incomes, means are entitled and its utilization depends on preparation of national projects. National means for co-financing must be declared at the same time with national projects. Means from the budget can be used in period of T+2 since introducing of entitlement. Means given to the CR for the period 2004-2006 was then possible to use to the year 2008.

The statistics of the balance of payments observes transactions in the accounts connected with transfers of means between institutions of the EU, the Commission budget and institutions in the CR. Means from the European Funds are transferred in favour of National Fund of Ministry of Finance, which is the payment agency for implementation of structural operations. Payments for agricultural politics are incomes of special created account of Ministry of Agriculture. Incomes are realized in EUR and are converted by the exchange rate used for a given transaction.

Clear position of the CR according to the EU budget, calculated as difference of total incomes from the budget and supplies to the EU budget, reached positive balance

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<sup>12</sup> FOLTÝN, J., HÁČEK, J.: Návrh ekonomické dimenze zahraniční politiky ČR, Praha: Ústav mezinárodních vztahů, Studijní sešity, 3/2001, s. 30; translated by Barbora Sýkorová

in the period of 2004-2007 and the CR received 9, 5 milliard CZK from the EU institutions. In the balance of payments, interrelated transfers are recorded in the current account in the item of government transfers.

Payment of capital and reserves of the European Investment Bank is included in the financial account and represents passive balance in the amount of 0, 8 milliard CZK. In 2006, the financial perspective of the EU (i.e. the financial frame of the EU) was agreed after complicated meetings. It was accepted in the form of Inter-institutional agreement, i.e. agreement between the European Commission, the European Parliament and the Council of the EU. The object of agreement is principle budget priorities of the EU and setting of expense constrains for each of these priorities.

Financial perspective is arranged for the period of five to seven years. Financial form of financial perspective for the period of 2007-2013 was finished after two year meeting, opened in February 2004. The result is the Inter-institutional agreement between all three key European institutions. The final amount of financial perspective for seven year period amounts EUR 864, 3 milliards. It is about 1% higher than the amount of gross national product of all EU countries. Significant part of the budget is created by expenses for common agricultural policy (EUR 293 milliards), followed by expenses for structural funds and the Cohesion Fund. The budget plan for the period of 2007-2013 opens the possibility to use means in the amount of CZK 90 milliards annually. It depends on capability of the CR to absorb those means.

National financial participation is necessary, when decisions of project entitlements are made (from 15 to 30% value of a project). Since financial means (mainly agricultural donations) are very often refunded, quite high requirements are put on the budgets of public finance, and in the case of the CR also on structural changes of the budget and reform of budgetary policy. With the view of already created financial usage and experience of other European member countries, full usage of allocated supports stated for the CR in the period of 2007-2013 is not really probable. In spite of this, it is spoken about quite high financial means, which will influence the balance of payments and expense side of state budget and will become an important impulse for Czech economy.

### **3.3. Expected changes in the balance of payments after introduction of Euro currency**

After introduction of Euro currency in the CR, national concept of the balance of payments will be more open. The base for the monetary policy of European Central Bank (ECB) will be the macroeconomic aggregate of the Euro-zone. Specific problem is money in circulation, which is actually ðnationalö money in circulation, and inflows to and outflows from the country in relation to transactions connected with the activity of institutions and individuals (tourist trade, activities of commercial banks with money in circulation). Therefore, central national banks monitor cross-border movement of money in circulation, which are realized by commercial banks.

If we dealt with changes in the development of individual items in the balance of payments of the CR after introduction of Euro, we would rather move in the

hypothetical level. On the basis of experiences from other comparable countries, such as Austria, we would come to conclusion that the changes in the current as well as in the capital account should not be really significant after introduction of Euro. The development in the balance of payments is and will be based on the fundamental factors of economy, connected with the environmental world, mainly by relations of enterprises with foreign capital participation and structures of the EU (EU budget).

Changes in the item of services are expected after introduction of Euro. The reduction of the balance of financial services will probably happen, because the necessity to close insurance operations against risk from the movement of exchange rate and exchange measures will be dropped out. Payments for realization of foreign purchase connection will decrease at the same time. Already nowadays, the regulation of the EC no. 2560/2001 about cross-border payments in Euro is valid. Already in the beginning of 2004, unification of payments for cross-border payments in Euro and domestic payments become to be required for all banks. First payments in Euro were up to EUR 12 500, and then the limit was increased up to EUR 50 000 in January 2006.

Introduction of the system SEPA (Single Euro Payments Area) in 2010 should completely eliminate the difference of payments for domestic and foreign payment relations. As a result, bank profits from international transactions will decrease significantly, while assuring payment relations and introduction of Euro and assuring operations in countries of the Euro-zone.

The item of cross-border financial services of Czech commercial bank within the balance of payments will be developed in the same direction. Elimination of interest differential in Euro-zone may also influence flows of portfolio investment, mainly trades with securities.

Monitoring of money in circulation will become a specific part of the balance of payments. Until now, purchase and sale of liquid money against abroad is realized by sponsorship of each bank. Central bank cares only for distribution of Czech money in circulation. After introduction of Euro, paper money in circulation will be national currency and then central bank will have to care of their circulation. Countries having active tourist trade, for example Austria (and then also the CR in the future), solve a specific problem of inflow of Euro in circulation from other countries. They have to draw down this money from circulation and then create the balance in the area of the Euro-zone. New member countries, such as Cyprus and Malta (also important tourist destinations) face to a similar problem. It touches a specific view of the item of tourist trade in the balance of payments after having Euro currency.

In the area of capital flows, it is not possible to except an increased activity of institutions established on specific purpose (i.e. special purpose entities). It concerns institutions with high inflows/outflows of capital. In consequence, they increase the balance in the financial account. These activities are very important for countries, such as Luxembourg, Netherland, but it is possible to see these transactions, of course in smaller extent, already today in the CR.



Specific situation will happen in the area of exchange reserves of the CR, because a part of exchange reserves will be transferred to the European Central bank. According to the status of the ECB, its amount is derived from the portion (of a given country) of total number of habitants and total GDP of the EU. The portion of the CR in GDP of the EU is moving in decimal percentage points. Estimated sum of the CR, created by gold and exchange, is about EUR 1, 5 milliards. The portion of exchange must be in different currency than Euro. The exchange reserves will create interest receivable of the Czech National Bank against the European Central Bank. The rest of reserves, denominated in other currency than Euro and detonated out of the area of the Euro-zone, will stay at the national level in holding of Czech National Bank and will be repaired according to rules stated by the ECB as the part of exchange reserves of the European System of Central Banks (ESCB). Central national bank might be asked by ECB to repair also the part of exchange reserves, which was transferred in agreement with the status of ECB and ESCB. National central banks of the Euro-zone participate in administration of ECB exchange reserves in agreement with general rules for administration of portfolios stated by the ECB.

Euro deposits will not be included in the category of exchange reserves and will be transferred into the payment system called TARGET (Trans-European Automated Real-Time Gross settlement Express Transfer). It concerns the system of payment settlements at real time operated by the Euro system. It is used for operation settlements of central banks for inter-banking high transfers in Euro and for other payments in Euro.

TARGET has been functioning since the beginning of the monetary union, i.e. since January 1999 and was created for purposes of safe and reliable mechanism to settle payments in Euro, and then to increase the affectivity of foreign payments in Euro, ensure functioning of the ECB monetary policy and support integration of the Euro monetary market. Euro-system creates other generation of system called TARGET2, which will be the base for functioning SEPA (Single European Payments Area) of united standard of banking payments in the Euro-zone.

One of the steps of CNB, according to the EU acquisition, was to set a part of national portion in the ECB capital already at day of the entrance to the EU, i.e. May 2004. Czech National Bank became a member of the ESCB and its employees participate in meetings of working groups and 12 committees acting in the ECB. Some meetings are hold within the presentation of all countries, while others concern only countries of the Euro-zone.

After acquisition of Euro currency, the basis for decision sphere is the balance of payments of countries of Euro-zone as a whole. National central banks of the ESCB monitor transactions in and out of the Euro-zone and participate in creation of the Euro-zone balance of payments. However, national balance of payments will be still part of economic information for directing sphere of Czech economic performance compared to abroad. Customizing mechanisms in the form of movement of exchange rate of national currency will not be possible though. After loose of national currency, the importance of stating aggregate of national balance of payments of the CR will decrease.

Statistics of the balance of payments of the Euro-zone countries should be in agreement with requirements and norms of the EU and the ECB. Countries, which accepted Euro, offer data (of the current account in national balance of payments) to the EUROSTAT in division according to territories, which enables to construct an aggregate on behalf of the EU with exception of the inter-union trade. Then the ECB requires data of the balance of payments and investment position of member countries and countries entering to the Euro-zone, compared to abroad in several varieties:

STEP 1: it records data at the national level.

STEP 2: a given country is a member of the Euro-zone and is compared to the rest of the World, out of the Euro-zone.

STEP 3: a given country is a member of the Euro-zone and is compared to chosen large partner countries, out of the Euro-zone (the U.S., Japan, Great Britain, and countries called šBRICůó Brazil, Russia, India and China).

From data of the Euro-zone members, the ECB constructs the balance of payments of the Euro-zone for needs of monetary analysis of the ECB. Since 2008, the CR provides data at the level STEP 2, i.e. as the CR would be a member of the Euro-zone. At the time of entrance to the Euro-zone, it will be necessary to provide national data of the balance of payments at the level STEP 2 in backward time series since 2004 (year of entrance to the EU). Conversion of Czech currency to Euro will be probably done by implementing the rate respectively the rate for conversion of CZK/EUR, which will be stated in the last stage of Czech participation in exchange mechanism ERM II<sup>13</sup>. While constructing the balance of payments at the level STEP 2, different restrictions of terms for resident and non-resident will be implemented in the area of national statistics of the balance of payments. Institutions of the EU, such as the European Commission and the European investment bank, are considered non-residents of the Euro-zone till the time of introduction of Euro in all countries of the EU<sup>14</sup>.

Inter-connection of Czech economy with countries of the Euro-zone is very high already today. In 2007, the proportion of the Euro-zone in the total balance of trade and services in the CR was about 55%, mainly by influence of foreign direct investment. The proportion of the Euro-zone countries in direct investment in the CR was about 82% in the end of 2007<sup>15</sup>.

Dependence of Czech economy on conjuncture of the Euro-zone countries, as the main territory of distribution of products produced in our country, is significant. Reasons for realization of direct investment in the CR are connected with cheap and qualified labour force compared to countries of the Euro-zone.

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<sup>13</sup> Membership in the exchange mechanism ERMII is one of the Maastricht criteria, by which the entrance to the Euro-zone is conditioned; the membership must last at least two years before the entrance to the Euro-zone.

<sup>14</sup> <http://www.ecb.eu/ecb/html/index.cs.html>

<sup>15</sup> [http://www.cnb.cz/cs/statistika/platebni\\_bilance\\_stat/publikace\\_pb/index.html](http://www.cnb.cz/cs/statistika/platebni_bilance_stat/publikace_pb/index.html), data about the territorial structure of the current account and foreign direct investment.

The Czech Republic is among the most developed new member countries of the EU (after Slovenia and Cyprus) since its acquisition. The gap between the EU countries and the CR is significant, if we express the economic level by the help of the ratio GDP/habitant, converted by the purchasing power parity of currency. According to this calculation, the CR reached about 73, 2% of economic level of the EU in 2007. Higher economic levels were achieved by 14 original EU countries in 2007, but the CR is already in advance compared to Portugal. Decrease of difference in pensions and assurance of convergence of economic level of the CR according to the EU will depend on difference between the ratio of product growth of the CR and the EU. It is predicted, that similarly as Ireland, which entered to the EU with the low economic level, the CR will need many years to decrease this difference. Nominal convergence to countries of the Euro-zone will decrease concurrence-ability related to costs of labour force. Success of foreign trade relations, based on values added by manufacturing, should continue also even after entrance to the Euro-zone. Other comparative advantages of Czech economy will also gain higher importance.

## **4. Conclusion**

The balance of payments is the statement, which reflects the position of our economy and is the aggregate, which evidences influences of external environment on our internal economy. The balance of payments offers much valuable information, which is necessary for practical decisions both at the macroeconomic level and at the level of individual enterprises.

By the day of entrance to the EU, the CR accepted the rules of unified internal market of the EU in the area of free movement of goods, services, citizens and capital. This has an impact on the economic area, but it is also reflected in the balance of payments.

The entrance to the EU also meant that the CR joined the customs union in the territory of the EU. It resulted in abolition of existing customs and administrative barriers, including import quotas. At the same time, the CR had to give up its own sovereignty in creating foreign trade policy in relation to third countries and started to use common trade policy of the EU. Its importance lies in the unified modification of export and import to member countries and their common representation in trade questions according to third countries. Before the entrance to the EU, the CR had different trade political regimes compared to the EU with many trade partners and other tradable items, these trade regimes responded to its own trade interests.

The application of the European common trade policy in the CR brought two important issues. On the one side, the CR was required to make convenient steps to remove obligations coming from its international agreements with third countries. On the other side, it opens a possibility to enter both new and already existing markets under better conditions.

Not all principal freedoms of the EU were applied symmetrically to new member countries of the EU, but selectively on the basis of national interests of different countries of the EU. It was the most visible in implicated rules for free movement of individuals and in extent of agricultural donations. Schengen agreement has been valid in the CR since December 2007 and liberalization of movement of labour force in the EU is being removed by individual "original" countries of the EU. Free movement of individuals and labour force is shown in the item of tourist trade and the balance of incomes.

In the items of current transfers, in the capital account and in the exchange reserves connection to the EU budget should be seen. The CR has got the possibility to use these financial resources from the EU budget. However, their liberation depends on readiness of the Czech economy to use these resources. Till now, the CR was not really successful; our economy was not able to use the total amount of provided resources.

Liberalization of capital movement is seen in the financial account; liberalization become in the beginning of nineties. It resulted in inflows of foreign capital in the form of direct and portfolio investment, and consequently it helped to speed up the process of transformation of our economy and to increase desirable competitive environment mainly in the market of financial services. In some cases, inflow of foreign capital also brought some negative impacts, such as restructuralization of our economy and closing of many operations, which were the backbone of export (glass industry) in past. It also resulted in increase of unemployment. This type of capital inflow has its reflection in the balance of incomes in the form of profit outflow and interests outflow from these investments, which is not possible to evaluate positively.

The importance of national balance of payments and possibility of its influence will decrease right after the introduction of Euro currency. The introduction of Euro should not have any essential impact on the development of the balance of payments, because it is the reflection of fundamentals factors, which acquisition of Euro cannot influence significantly. From experiences of other small EU countries " members of the Euro-zone, it is possible to expect changes in the area of financial services (reduction of costs needed for payment relations and assurance operations), movement of money in circulation across Czech borders (influence of tourist trade). Administration of exchange reserves in the Euro-zone is regulated by obligatory regulations and operations with them are possible only with an agreement of the ECB. Customizing mechanisms in the form of movement of exchange rate of national currency will not be possible as well. After loss of national currency, the importance of predicative aggregate of national balance of payments will decrease.

In spite of significant decrease in importance of national conception of the balance of payments, this statement will be one of the most important indicators for construction of national accounts. The balance of payments shows competitive abilities and the economic position of a given country compared to the rest of the World. National balance of payments will be still part of economic information for directing sphere to consider the performance of Czech economy compared to abroad.

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**Note:**

Quotations used in the thesis were translated by Barbora Sýkorová.

## **7. Supplements**

**Supplement 1: The development of the balance of payments in the Czech Republic in 2000-2004**

**Supplement 2: The development of the balance of payments in the Czech Republic in 2005-2007**

## Supplement 1

### The development of the balance of payments in the Czech Republic in 2000-2004 (in CZK milliard)

	2000	2001	2002	2003	2004
<b>A. Current account</b>	-104,9	-124,5	-136,4	-160,6	-147,5
<i>Trade balance</i>	-120,8	-116,7	-71,3	-69,8	-13,4
Total export	1 121,1	1 269,6	1 254,4	1 370,9	1 722,7
Total import	1 241,9	1 386,3	1 325,7	1 440,7	1 736,1
<i>Balance of services</i>	54,6	57,9	21,9	13,2	16,6
Revenues	264,8	269,7	231,1	219,2	247,1
Expenses	210,2	211,7	209,3	205,9	230,5
<i>Income balance</i>	-52,9	-83,5	-115,6	-119,9	-156,6
<i>Current transfers</i>	14,4	17,8	28,7	15,8	6
<b>B. Capital account</b>	-0,2	-0,3	-0,1	-0,1	-14,2
<b>C. Financial account</b>	148	172,8	347,8	157,1	177,3
Direct investment	190,8	208,3	270,9	53,5	101,8
Portfolio investment	-68,2	34,9	-46,7	-35,7	53
Financial derivatives	-1,4	-3,2	-4,3	3,9	-3,2
Other investment	26,9	-67,1	96,4	107,9	-31,7
<b>D. Errors and omissions</b>	-11,4	19,1	5,6	16,5	-8,9
<b>Overall balance</b>	31,6	67,2	216,9	12,9	6,8



<b>E. Change in exchange reserves</b>	-31,6	-67,2	-216,9	-12,9	-6,8
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Source: NB

[http://www.cnb.cz/m2export/sites/www.cnb.cz/en/statistics/bop\\_stat/bop/BOP\\_EN.XLS](http://www.cnb.cz/m2export/sites/www.cnb.cz/en/statistics/bop_stat/bop/BOP_EN.XLS)

## Supplement 2

### The development of the balance of payments in the Czech Republic in 2005-2007 (in CZK milliard)

	2005	2006	2007
<b>A. Current account</b>	-48,5	-100,3	-89
<i>Trade balance</i>	-13,4	68,2	117,5
Total export	1 868,6	2 144,0	2 472,4
Total import	1 809,2	2 075,8	2 354,9
<i>Balance of services</i>	36,5	34,6	55,4
Revenues	282,0	300,4	341,5
Expenses	245,5	265,8	286,1
<i>Income balance</i>	-155,7	-183,4	-253,8
<i>Current transfers</i>	11,3	-19,7	-8,1
<b>B. Capital account</b>	4,7	8,5	19,7
<b>C. Financial account</b>	154,8	111,6	104,5
Direct investment	279,6	104,3	158,2
Portfolio investment	-81,2	-26,9	-53,2
Financial derivatives	-2,8	-6,3	1,8
Other investment	-40,8	40,5	-2,3
<b>D. Errors and omissions</b>	-18,1	-17,1	-19,5
<b>Overall balance</b>	92,9	2,1	15,7

<b>E. Change in exchange reserves</b>	-92,9	-2,1	-15,7
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Source: NB

[http://www.cnb.cz/m2export/sites/www.cnb.cz/en/statistics/bop\\_stat/bop/BOP\\_EN.XLS](http://www.cnb.cz/m2export/sites/www.cnb.cz/en/statistics/bop_stat/bop/BOP_EN.XLS)