

Josef Pöschl

Czech Republic: international competitiveness strengthening

GDP growth, year-on-year at constant prices, was an impressive 3.4% in the third quarter of 2003. The seasonally adjusted growth rate was slightly lower, at 3.2%. A 7.3% rise in private household consumption was the main growth impetus; another boost came from an upsurge in gross fixed investment. Each of these two factors had a side effect on demand for imported goods: the balance of trade – including non-factor services, at constant prices – deteriorated correspondingly and affected GDP growth adversely.

2003 data for exports and imports of goods – in euro terms at current prices – confirm the continuation of a long-term trend towards an improvement of the trade balance. Starting from mid-2001, year-on-year quarterly data depicted a continuous decline of the trade deficit. Export revenues covered over 95% of import expenditures in 2003 compared to roughly 90% in 2000. In 2003, exports covered 112% of imports in trade with the EU-15 and 108% in that with Germany. The EU-15 absorbed 70% of Czech exports, Germany alone 37%. Over time, the deficit in the balance of goods may disappear. Given that the economy of the Czech Republic grew significantly faster than that of its main trading partners, the improving trade performance most likely reflects increasing international competitiveness of the tradable sector. In 2003, the year-on-year growth rates were 5.8% for exports and 5.3% for imports, and growth accelerated in the course of the year. Czech exports to the EU grew more than 11% in spite of the rather chilly EU business climate. The export share of machinery and transport equipment surpassed the 50% mark. It would be wrong to interpret the continuous deficit on the current account, which has always been close to 6% of GDP in recent years, as a sign of low international competitiveness of Czech producers of tradable goods.

The trade balance has improved in recent years, but the current account deficit has remained high. The reason was a shrinking surplus in the balance of services together with a widening gap in the balance of income. In the first quarter of 2003, the current account deficit amounted to EUR 3.3 billion as a result of a EUR 1.1 billion trade deficit, a 2.8 billion deficit in the balance of income and a 0.3 billion surplus in both services and transfers. In the same period of 2000 – and of 2001 as well – the trade deficit had been over EUR 2 billion, the surplus in services over 1 billion and the deficit in the income account 1 billion (2 billion in 2001). The high deficits in the balance of income reflect mainly the profits earned by foreign-owned Czech enterprises, which are to a large extent repatriated to the firms' mother companies; the remaining marginal part is reinvested within the country or abroad. The volume of those profits is relatively high, as the Czech Republic is the regional leader in terms of foreign direct investment per capita. Foreign-owned companies are the engine of the country's strong dedication to foreign trade.

In 2002, the improvement in the trade balance took place in spite of a 10% nominal currency appreciation against the euro. A close to 9% decline in export prices helped to avoid price increases of Czech products on international markets. In 2003, the Czech koruna depreciated by some 3% against the euro, whereas export prices remained roughly constant (-0.3%), so that on international markets the prices of Czech products tended to fall.

On the import side the Czech koruna's appreciation against the US dollar, by approximately 15% in both 2002 and 2003, played a major role. This was of particular relevance for imports of fuels and raw materials, whereas for imported semi-finished and finished goods mainly the exchange rate against the euro was of relevance. Import prices fell close to 7% in 2002 and rose slightly in 2003. In 2002 in particular, the change in the import price index was modest compared to the alteration of exchange rates.

The absence of significant price changes, especially in 2003, was not restricted to exports and imports alone. It was also observable for consumer prices and industrial producer prices. The average rate of consumer price inflation was only marginally above zero (0.1%) in 2003. This was the net outcome of stagnating non-regulated prices and of regulated prices rising by 0.6%. From another point of view, the price stability was a net outcome of a decline with regard to goods – especially food – and a rise with regard to services. Housing, health, financial services and insurance became significantly more expensive.

The stagnation or slight fall in the prices of consumer goods was predominantly cost induced. In December 2003, the industrial producer price index was exactly at the level it had reached at the beginning of 2002. The fluctuations in between were marginal. A moderate rise up until April 2002 was followed by a nearly continuous, slight decline, and only in the second half of 2003 did that trend reverse. The average rate of PPI inflation was negative in both 2002 and 2003 (-0.5% and -0.3% respectively). The background was a decline in unit labour costs thanks to an increase in industrial labour productivity in excess of the rise in gross nominal wages: In the period January to October 2003 labour productivity was 9.3% higher, whereas wages were only 5.4% higher as against the same period in 2002. The decline in unit labour costs in tandem with the stagnation or decline of import prices supported the fall or stability of producer prices.

As for future developments, the Czech koruna is not too likely to strengthen against the euro in the first half of 2004. In 1999, the Czech currency had entered an appreciation path, and with some time lag expectations had adapted. The Czech National Bank, at ease about the fulfilment of its inflation target, showed its willingness to fight appreciation and proved remarkably successful in this respect. The CNB-controlled interest rates are below ECB levels. The Czech koruna has become weaker, a fact that the authorities may welcome: entering the phase of exchange rate stabilization, as projected in the course of

EU accession, with an overvalued exchange rate would be a disadvantage for the real sector. The financial markets' expectations have adjusted to the depreciation tendency; a wait-and-see stance is feasible until EU accession has actually taken place. A renewed appreciation tendency may follow after EU accession and may continue in 2005.

Consumer prices will rise by up to 3.5% in 2004 – not pushed by market forces, but owing to higher VAT rates and increases in the limits for regulated prices. These measures are at least partly EU accession-related. In 2005, inflation will calm down again, to about 2%. Producer price inflation will remain modest.

The economy grew by about 2.9% in 2003 thanks to a strong increase in private consumption and construction expenditures. In 2004 it will grow by up to 3.5%. It could be more, but in 2003 private consumption rose mainly on account of an over 6% increase in gross monthly wages and a strong expansion of consumer credits. The latter cannot go on forever, and the rise of real wages will be dampened in 2004 by the hike in consumer prices. Investment growth will probably remain modest in the first half of 2004. It may accelerate in the second half of the year, when it has become clear that the EU accession has passed without trouble. Export growth should strengthen thanks to an improving business climate in the EU. In 2005, GDP growth may climb to 4%.

The question of the best date for introducing the euro has become a much-discussed topic in the Czech Republic as well. The main hindrance to a fast introduction of the euro is the budget deficit, no matter that fears expressed in advance usually exceed *ex post* reality in the Czech case. The somewhat higher rate of inflation in 2004 as well as accession-related tax hikes and higher GDP growth could ease the budget problems at least to a certain extent. In any case, the National Bank and the government share the opinion that the country should enter ERMII only when macroeconomic indicators meet the Maastricht requirements, and that the ERMII episode should be kept as short as possible. The population's confidence in the domestic currency is strong, and the degree of euroization is lower than in comparable countries. This may add to the cautious attitude towards euro introduction.

The coalition government has so far survived in spite of its tiny majority in parliament, and also in spite of its weak leadership that triggers a lot of avoidable discussions, such as those on the new VAT rates or the future Czech EU commissioner.

Table CZ

Czech Republic: Selected Economic Indicators

	1997	1998	1999	2000	2001	2002	2003 ¹⁾	2004	2005
	forecast								
Population, th pers., mid-year ²⁾	10303.6	10294.9	10282.8	10272.5	10224.2	10189.4	.	.	.
Gross domestic product, CZK bn, nom.	1679.9	1839.1	1902.3	1984.8	2175.2	2275.6	2340	2500	2650
annual change in % (real)	-0.8	-1.0	0.5	3.3	3.1	2.0	2.9	3.3	4
GDP/capita (EUR at exchange rate)	4554	4940	5016	5426	6242	7248	7220	.	.
GDP/capita (EUR at PPP - wiiw)	12260	12340	12700	12490	13250	14080	14210	.	.
Gross industrial production									
annual change in % (real)	4.5	1.6	-3.1	5.4	6.5	4.8	5.5	5.5	6
Gross agricultural production									
annual change in % (real)	-5.1	0.7	0.6	-4.5	2.5	-4.4	.	.	.
Goods transport, mn t-kms	62460	53591	54620	57343	57777	61350	46500 ^{I-HX}	.	.
annual change in %	.	-14.2	1.9	5.0	0.8	6.2	1.3 ^{I-HX}	.	.
Gross fixed capital form., CZK bn, nom.	514.5	535.5	528.3	561.5	603.3	599.3	.	.	.
annual change in % (real)	-2.9	0.7	-1.0	5.4	5.5	0.6	2.2	4	6
Construction industry									
annual change in % (real)	-3.9	-7.0	-6.5	5.3	9.6	2.5	9.0 ^{I-XI}	.	.
Dwellings completed, units	16757	22183	23734	25207	24759	27291	16853 ^{I-HX}	.	.
annual change in %	15.7	32.4	7.0	6.2	-1.8	10.2	-3.0 ^{I-HX}	.	.
Employed persons total - LFS, th, avg ³⁾	4936.5	4865.7	4764.1	4731.6	4750.2	4764.9	4733.2	.	.
annual change in % ³⁾	-0.7	-1.4	-2.1	-0.7	0.4	0.8	-0.7	.	.
Employed pers. in industry - LFS, th, avg ³⁾	1550.4	1519.9	1468.7	1429.4	1470.6	1463.1	1424.7	.	.
annual change in % ³⁾	-3.0	-2.0	-3.4	-2.7	2.9	-0.1	-2.6	.	.
Reg. unemployed, th pers, end of period	268.9	386.9	487.6	457.4	461.9	514.4	542.4	.	.
Reg. unemployment rate in %, end of period	5.2	7.5	9.4	8.8	8.9	9.8	10.3	10.2	10.1
LFS - unemployment rate in %, average ³⁾	4.8	6.5	8.7	8.8	8.1	7.3	8.1	8.2	8.0
Average gross monthly wages, CZK ⁴⁾	10802	11801	12797	13614	14793	15857	16321 ^{I-HX}	.	.
annual change in % (real, gross)	1.3	-1.4	6.2	2.4	3.8	5.3	6.9 ^{I-HX}	.	.
Retail trade turnover, CZK bn
annual change in % (real)	-0.4	-6.8	3.0	4.3	4.5	3.0	4.9 ^{I-XI}	.	.
Consumer prices, % p.a.	8.5	10.7	2.1	3.9	4.7	1.8	0.1	3.5	2.0
Producer prices in industry, % p.a.	4.9	4.9	1.0	4.9	2.9	-0.5	-0.3	1.1	0.5
Central government budget, CZK bn									
Revenues	509.0	537.4	567.3	586.2	626.2	705.0	699.6	.	.
Expenditures	524.7	566.7	596.9	632.3	693.9	750.8	808.7	.	.
Deficit (-) / surplus (+)	-15.7	-29.3	-29.6	-46.1	-67.7	-45.7	-109.1	.	.
Deficit (-) / surplus (+), % GDP	-0.9	-1.6	-1.6	-2.3	-3.1	-2.0	-4.7	.	.
Money supply, CZK bn, end of period									
M1, Money	418.9	404.0	447.8	497.7	583.6	692.3	782.7 ^{Nov}	.	.
M2, Money + quasi money	1177.8	1241.4	1337.5	1412.3	1596.0	1647.3	1723.0 ^{Nov}	.	.
Discount rate, % p.a., end of period	13.0	7.5	5.0	5.0	3.8	1.8	1.0	.	.
Current account, EUR mn	-3157	-1120	-1372	-2945	-3652	-4691	-4700	-4800	-5200
Current account in % of GDP	-6.7	-2.2	-2.7	-5.3	-5.7	-6.4	-6.4	-6.1	-6.1
Gross reserves of NB incl. gold, EUR mn	8857	10756	12771	14159	16400	22614	21341	.	.
Gross external debt, EUR mn	19588	20757	22765	23285	25368	25067	24367 ^{Sep}	.	.
Exports total, fob, EUR mn ⁵⁾	19811.2	23067.9	24639.6	31482.7	37251.2	40711.2	43067.7	46500	51500
annual change in %	12.0	16.4	6.8	27.8	18.3	9.3	5.8	8	11
Imports total, cif, EUR mn ⁵⁾	24013.6	25286.6	26386.0	34875.7	40674.8	43026.0	45303.3	48500	53400
annual change in %	8.2	5.3	4.3	32.2	16.6	5.8	5.3	7	10
Average exchange rate CZK/USD	31.71	32.27	34.60	38.59	38.04	32.74	28.21	.	.
Average exchange rate CZK/EUR (ECU)	35.80	36.16	36.88	35.61	34.08	30.81	31.84	32.0	31.0
Purchasing power parity CZK/USD, wiiw	12.61	13.78	14.08	14.14	14.32	14.77	14.55	.	.
Purchasing power parity CZK/EUR, wiiw	13.30	14.47	14.57	15.47	16.06	15.86	16.17	.	.

Notes: 1) Preliminary. - 2) From 2001 based on census March 2001. - 3) From 2002 weighted according to census 2001. - 4) Enterprises with more than 20 employees, from 1998 including part of the Ministry of Defence and the Ministry of the Interior. - 5) Converted from the national currency to EUR at the official exchange rate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.