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Czech Republic: revised data present a picture of sound development

The Czech Republic's statistical office is eagerly engaged in revising its methodology and data sets, driven by the objective of implementing the EU methodology. This leads to frequent revisions, even several years back. As the latest revised data for national accounts suggest, GDP growth had come close to 4% in 2000, but shrank in the two subsequent years, to 1.5% in 2002. A recovery, up to 3.7%, followed in 2003. A result quite similar to the one reported for 2003 can be expected for 2004; in 2005 and 2006 growth could slightly accelerate.

Meanwhile, a strong expansion of gross fixed investment acts as the main engine of growth. Money from Brussels, aimed at upgrading the country's infrastructure, has an accelerating effect, together with the companies' efforts to meet EU standards or to increase competitiveness. Private consumption, on the other hand, expands on a slow track, no matter that average wages (gross, monthly) are increasing year-on-year by about 7% in nominal and close to 4% in real terms and overall employment has remained nearly constant. Changes in indirect taxation, introduced in the context of EU accession, have adversely affected private consumption. Enlarged savings to finance investment in housing have played a similar role. Stimulated by the announcement of new regulations starting from the beginning of 2005, mortgage loans and borrowing from building societies increased by 47% and 33% respectively, so that at the end of 2004, relative to the GDP, mortgage loans added up to about 6%; loans from building societies totalled 4% whereas deposits in these societies almost doubled against 2003, climbing to 13% of GDP. The banking sector is in good shape and eager to expand lending to private households, which is good business without big risk. Commercial banks hold relatively high deposits with the Czech National Bank (CNB), but are cautious with respect to lending to non-financial enterprises, at least to those not governed by transnational companies. It is still difficult to recover loans that have become non-performing; the legal procedures are dragging and complicated. A new attempt to reform bankruptcy procedures is likely to become, once again, delayed indefinitely. With more banks lending to non-financial enterprises, last years' overall growth performance may have been better. This underlines the importance of legal reforms.

At present, the most dynamic element in the Czech economy is foreign trade. In euro terms, the export of goods increased nearly 25% in 2004, and imports rose close to 20%. In trade with the EU-25 countries, the Czech Republic may have reached a surplus of close to EUR 2 billion in 2004 – in particular with Germany (over 1 billion), Slovakia, Austria

and Belgium. The product group generating the highest surplus was machinery and transport equipment (close to EUR 2 billion). EU accession had a significant positive impact on foreign trade: In the last months prior to accession, i.e. from January to April 2004, exports in CZK terms had increased by 16.3% and imports by 15.8%, whereas thereafter, from May to November 2004, the growth rates were 28.6% and 23.0% respectively. Not surprisingly, the removal of all kinds of tariff and non-tariff barriers caused a boom in trade with unprocessed agricultural products as well as food.

Export prices rose by about 1.5% year-on-year in 2004, import prices by some 3.5%. At constant prices in CZK terms, exports of goods rose by 22%, imports by 15% in 2004, year-on-year. The 9% nominal appreciation against the US dollar helped to keep the rise in import prices within limits, as on the import side the dollar plays an important role (particularly in energy imports). On the other hand, the destination of exports is predominantly to the eurozone (86% of exports went to the EU-25 in 2004). Although in the course of the year 2004 an appreciation tendency vis-à-vis the euro became visible, the average nominal exchange rate against the euro was nearly identical in 2003 and 2004. In other words, Czech exporters profited from some real depreciation: in euro terms, Czech export prices rose less than the eurozone's consumer prices. The background was a growth of industrial labour productivity in excess of the increase in nominal wages (over 11% versus 7%) and a corresponding decline in unit labour costs.

In spite of improving foreign trade in goods – in 2004, export revenues covered nearly 100% of import expenditures – and a lasting surplus in services trade, the deficit on the current account has remained high, reflecting high and rising profits earned by foreign investors. Total income outflows, mainly related to previous foreign direct investment inflows, amounted to EUR 6.8 billion or 8% of GDP in 2003, and to approximately 8% of GDP in 2004. Income inflows were much lower and did not grow much (in both years they made up about 2.9% of GDP). Part of the profits earned by foreigners remained in the country and figured as capital inflow in the balance of payments. All in all, the CNB's international reserves fell from EUR 21.3 billion at the end of 2003 to 20.9 billion a year later, whereas the country's gross external debt increased from EUR 27.6 billion to 29.9 billion.

For financial investors, the ongoing gradual nominal appreciation strengthens the attractiveness of the Czech currency. A similar tendency had emerged in the first half of 1999; the exchange rate fell from peak values of over CZK 38 per euro to below 29 on 10 July 2002. The Czech National Bank had responded with a set of instruments, among them a reduction of repo and discount rates to levels that were low even compared to the eurozone. The CNB kept them that low up to the moment when in 2004 increases in VAT rates and in energy prices fuelled inflation. Inflation had been 0.5% in 2003, but jumped to 2.8% in 2004. When confronted with the renewed ongoing appreciation

tendency, on 27 January 2005 the CNB surprised the markets by reducing interest rates once again, down to 2.25% (2 weeks repo rate), 1.25% (discount rate) and 3.25% (Lombard rate). It has to be seen as an indicator of the CNB's willingness to keep the exchange rate above 30 CZK per euro for the time being. This policy was successful in the past, and this time again it is likely that the CNB will be able to decelerate nominal appreciation. On paper, the CNB's policy is inflation targeting and nothing else, but most of the time, inflation has remained below the targeted band. In 2005, this may easily happen again, with an inflation rate remaining below that of the eurozone.

With regard to inflation, interest rates and the exchange rate, the Czech economy gives the impression of being fit for the introduction of the euro. The main obstacle is the high deficit of the public sector. Figures related to government deficit differ depending on the measurement method, but in terms of the EU-relevant methodology (ESA 1995) the deficit fell from 12.6% of GDP in 2003 to between 4% and 4.5% in 2004. This unexpectedly good performance resulted from higher revenues thanks to relatively high GDP growth, slightly higher inflation and a higher average VAT rate. Budgetary pre-election populism – parliamentary elections are due in 2006 – may prevent the deficit from reaching the Maastricht limit of 3% of GDP already in 2006.

The clear merit of the ruling centre-left government is having guided the country to EU membership. In the economic sphere, the government has not made many mistakes so far, nor was it an assiduous reformer. Of course, introducing some kind of flat tax has now become a much-debated topic in Prague as well. Another lasting topic is reforming the pension system: this is not an urgent problem in the Czech case but, like everywhere else, politicians feel urged to care about long-term perspectives – which is a rare approach in many other fields. Reform alternatives in the healthcare system are also a topic, and the sector may face trouble after a EU-wide liberalization of labour markets. In any case, the Czech Republic is one of the lucky countries where political debates and even turmoil are not likely to disturb economic progress substantially. Things are a bit different on the political floor. Prime Minister Gross and the coalition government as a whole are in a wobbly position. Quite possibly, within a few months' time, i.e. long before the next regular election year (2006), the Civic Democratic Party (ODS), the leading opposition party, may come to power. Large parts of this party share the EU scepticism of President Klaus, and it may become interesting to see the ODS-led government's handling of the ratification of the EU constitutional treaty.

Table CZ

Czech Republic: Selected Economic Indicators

	1998	1999	2000	2001	2002	2003	2004 ¹⁾	2005	2006
									forecast
Population, th pers., mid-year ²⁾	10294.9	10282.8	10272.5	10224.2	10200.8	10201.7	10207.0	.	.
Gross domestic product, CZK bn, nom. ³⁾	1962.5	2041.4	2150.1	2315.3	2414.7	2550.8	2720	2880	3050
annual change in % (real) ³⁾	-1.1	1.2	3.9	2.6	1.5	3.7	3.8	3.9	4
GDP/capita (EUR at exchange rate)	5271	5383	5878	6644	7683	7852	8350	.	.
GDP/capita (EUR at PPP - wiiw)	11840	12170	12810	13530	14320	14690	15570	.	.
Gross industrial production									
annual change in % (real)	1.6	-3.1	5.4	6.5	4.8	5.8	10.0	9	9
Gross agricultural production									
annual change in % (real)	0.7	0.6	-4.5	2.5	-4.4	-7.6	.	.	.
Construction industry									
annual change in % (real)	-7.0	-6.5	5.3	9.6	2.5	8.9	10.4 ^{I-XI}	.	.
Consumption of households, CZK bn, nom. ³⁾	998.3	1046.3	1108.8	1179.4	1220.6	1283.1	.	.	.
annual change in % (real) ³⁾	-1.5	2.2	2.9	2.8	2.7	4.9	2.7	3.2	3.3
Gross fixed capital form., CZK bn, nom. ³⁾	554.6	550.6	594.9	638.6	643.3	678.0	.	.	.
annual change in % (real) ³⁾	-1.1	-3.6	4.9	5.4	3.4	4.8	10	8	7
LFS - employed persons, th, avg. ⁴⁾	4865.7	4764.1	4731.6	4750.2	4764.9	4733.2	4706.7	.	.
annual change in %	-1.4	-2.1	-0.7	0.4	0.8	-0.7	-0.6	.	.
LFS - employed pers. in industry, th, avg. ⁴⁾	1519.9	1468.7	1429.4	1470.6	1463.1	1424.7	1408.1 ^{I-IX}	.	.
annual change in %	-2.0	-3.4	-2.7	2.9	-0.1	-2.6	-1.4 ^{I-IX}	.	.
LFS - unemployed, th pers., average	335.7	454.1	454.5	421.0	374.1	399.1	425.9	.	.
LFS - unemployment rate in %, average ⁴⁾	6.5	8.7	8.8	8.1	7.3	7.8	8.3	8.7	9
Reg. unemployment rate in %, end of period	7.5	9.4	8.8	8.9	9.8	10.3	9.5	10	10
Average gross monthly wages, CZK ⁵⁾	11801	12797	13614	14793	15866	16920	17418 ^{I-IX}	.	.
annual change in % (real, gross)	-1.4	6.2	2.4	3.8	5.4	6.5	3.9 ^{I-IX}	.	.
Consumer prices, % p.a.	10.7	2.1	3.9	4.7	1.8	0.1	2.8	1.8	2.2
Producer prices in industry, % p.a.	4.9	1.0	4.9	2.8	-0.5	-0.3	5.7	4	2.5
General governm. budget, EU-def., % GDP ⁶⁾									
Revenues	38.8	39.2	38.5	39.1	40.2	41.9	42.4	.	.
Expenditures	43.7	42.8	42.1	45.0	46.8	54.5	46.7	.	.
Deficit (-) / surplus (+)	-5.0	-3.6	-3.7	-5.9	-6.7	-12.5	-4.3	-4.1	-3.8
Public debt, EU-def., in % of GDP ⁶⁾	15.0	16.0	18.2	25.3	28.8	37.8	37.8	39.4	40.6
Discount rate, % p.a., end of period	7.5	5.0	5.0	3.8	1.8	1.0	1.5	.	.
Current account, EUR mn	-1120	-1372	-2945	-3652	-4426	-4937	-4600	-4800	-5200
Current account in % of GDP	-2.1	-2.5	-4.9	-5.4	-5.6	-6.2	-5.4	-5.0	-4.9
Gross reserves of NB incl. gold, EUR mn	10756	12771	14159	16400	22614	21341	20885	.	.
Gross external debt, EUR mn	20757	22765	23285	25368	25738	27599	29882 ^{IX}	.	.
FDI inflow, EUR mn	3317	5933	5404	6296	9012	2289	3800 ⁷⁾	.	.
FDI outflow, EUR mn	114	84	47	185	219	206	200 ⁷⁾	.	.
Exports of goods, BOP, EUR mn	23068	24640	31483	37251	40711	43079	53200	62200	69000
annual growth rate in %	16.4	6.8	27.8	18.3	9.3	5.8	23.5	17	11
Imports of goods, BOP, EUR mn	25391	26424	34876	40675	43026	45258	54300	62200	68500
annual growth rate in %	5.2	4.1	32.0	16.6	5.8	5.2	20.0	15	10
Exports of services, BOP, EUR mn	6822	6612	7436	7913	7501	6882	7800	8900	10200
annual growth rate in %	7.5	-3.1	12.5	6.4	-5.2	-8.3	13.3	14	15
Imports of services, BOP, EUR mn	5109	5486	5904	6211	6792	6466	7300	8500	10000
annual growth rate in %	6.8	7.4	7.6	5.2	9.4	-4.8	12.9	16	18
Average exchange rate CZK/USD	32.27	34.60	38.59	38.04	32.74	28.23	25.70	.	.
Average exchange rate CZK/EUR (ECU)	36.16	36.88	35.61	34.08	30.81	31.84	31.90	30.2	29
Purchasing power parity CZK/USD, wiiw	13.97	14.26	14.36	14.60	14.27	14.51	14.58	.	.
Purchasing power parity CZK/EUR, wiiw	16.10	16.31	16.34	16.74	16.53	17.02	17.12	.	.

Notes: 1) Preliminary. - 2) From 2001 based on census March 2001. - 3) According to ESA 95. - 4) From 2002 weighted according to census 2001. - 5) Enterprises with more than 20 employees, including part of the Ministry of Defence and the Ministry of the Interior. - 6) According to ESA/95, excessive deficit procedure. - 7) wiiw estimate.

Source: wiiw Database incorporating national statistics; AMECO Database; wiiw forecasts.