

The Czech Republic: falling prices, rising output

The Czech economy continues to grow at an annual rate of some 2% despite the country's close ties to its western neighbours' stagnating economies. This success is attributable to the continued strengthening of the country's industrial sector as manifest in the relatively good foreign trade results. Under the given difficult conditions, exports grew more than 6% in euro terms outstripping imports by almost one percentage point. In this context, the massive inflow of foreign direct investment in recent years has played a key role. Foreign-controlled companies now account for about half of the industrial sector's revenues and generate some 70% of total exports. Industrial output grew by over 6% in the first quarter of 2003, driven mainly by growth in the manufacture of rubber and plastic goods (+19%) as well as transport equipment (+17%). Matched by a decrease in employment, the rise in industrial output implied a gain in labour productivity of close to 9%. Nominal wages increased at a lesser rate (around 5%), thus enabling companies to enjoy a decline in unit labour costs. Compared to the year before, the average exchange rate vis-à-vis the euro remained almost unchanged and the import price index was some 2% lower in the first quarter of 2003. Decreasing unit costs made for a slight year-on-year decrease in industrial producer prices.

From the final use point of view, GDP growth in the first quarter of 2003 was primarily the outcome of increased private consumption. Increases in both public consumption and inventories also exerted a positive impact on growth, whereas the net effect of foreign trade, comprising both goods and services, was negative owing to a switch from surplus to deficit in the balance of services, as emerging in the calculation at constant prices. Investment into fixed capital declined and thus influenced GDP growth adversely.

In May 2003 the consumer price index stood at exactly the same level as the year previous; it would have been lower, were it not for the hike in gas prices in April. The government will increase taxes on alcohol and tobacco products in October, prior to EU accession. This could well become the main reason for a positive rate of inflation for 2003 as a whole, ranging between 0 and 1%. This year it is unlikely that the country will experience the almost customary major increase in housing rents in July or yet another hike in energy prices. Non-regulated prices have tended to drop in recent months, thus confounding the received wisdom that budget deficits – in 2003 possibly one hovering above 6% of GDP – and low interest rates feed inflation.

Both the absence of inflation and the meagre GDP growth have had a negative impact on the development of revenues in the public sector. Given the sector's low indebtedness, less than 20% of GDP in 2002, there is still room for high deficits for some time to come.

However, the pressure in favour of budget consolidation is high – emanating from financial markets and the EU side and fuelled by domestic fears of failing to meet the criteria for entry into the Monetary Union. The government is preparing a package of measures encompassing both revenue and expenditure: an increase in indirect taxation combined with lower corporate income tax, accompanied by cuts in expenditures for social security, research and defence. The reform should reduce the deficit to less than 4% of GDP by 2006. Certain items in the package, however, will also dent the government's popularity: for example, the increase in value added tax on most services – from 5% to 22%. The latter will be one of the reasons for relatively high inflation in 2004, estimated to range between 3% and 4%. The increase in tobacco and alcohol prices scheduled for October 2003 will also be felt in 2004, as it means a permanent upward shift in the consumer price index.

Higher inflation is likely to alarm the monetary authorities. In 2004, the period of very low interest rates may come to an end. In that case it will become more difficult to maintain a constant exchange rate vis-à-vis the euro. Over the past months, the exchange rate has fluctuated within a narrow band, thus dispelling expectations of significant nominal appreciation. In this respect, the EU commissioner for Monetary Issues, Pedro Solbes, is trying to push through tough conditions: before adopting the euro, the exchange rate fluctuations should remain in the range of $\pm 2.25\%$ for two years.

In June, 55% of the electorate participated in the EU referendum, 77% of whom agreed to entry, more than expected by most observers. Now, not much time is left to prepare for membership. Smooth integration into EU structures is the main challenge now facing the government, the National Bank and the corporate sector. The Ministry of Finance hopes that in the period 2004-2006, contributions to the EU budget totalling EUR 2.4 billion will be more than compensated by an inflow of EU funds totalling 3.4 billion. Attaining a surplus of this order could prove difficult since a large portion of the inflow will depend on the rate at which domestic projects are accepted by the EU. As for direct payment to farmers in the same period, the authorities will have to rely on the simplified allocation scheme. The administrative prerequisites for implementing the full scheme are too complex.

In 2003, GDP growth will be between 2.0% and 2.5%. There would appear to be nothing that could nudge it further upwards. The first quarter's preliminary results gave rise to some optimism, but that may prove premature. In 2004, higher growth, in the order of 2.5% to 3.0%, may come about should the business climate in Western Europe improve. Both budgetary and monetary policies are likely to keep the upswing modest. Unemployment will not change much, hovering around 7% and 8% (according to the Labour Force Survey methodology). All in all, the Czech economy will not yield exciting results, but its performance will be quite satisfactory given the current circumstances.

Table CZ

Czech Republic: Selected Economic Indicators

	1998	1999	2000	2001	2002 ¹⁾	2002 1st quarter	2003 1st quarter	2003 forecast	2004 forecast
Population, th pers., mid-year ²⁾	10294.9	10282.8	10272.5	10224.2	10189.4	.	.	.	.
Gross domestic product, CZK bn, nom.	1839.1	1902.3	1984.8	2175.2	2275.6	534.0	550.6	2340	2490
annual change in % (real)	-1.0	0.5	3.3	3.1	2.0	2.6	2.2	2.3	2.7
GDP/capita (USD at exchange rate)	5536	5347	5007	5593	6822	.	.	.	.
GDP/capita (USD at PPP - wiiw)	13320	13660	13800	15210	15740	.	.	.	.
Gross industrial production									
annual change in % (real)	1.6	-3.1	5.4	6.5	4.8	4.2	6.2	5	6
Gross agricultural production									
annual change in % (real)	0.7	0.6	-4.5	2.5	-4.4	.	.	.	.
Goods transport, mn t-kms	53591	54620	57343	57777	61400	.	.	.	.
annual change in %	-14.2	1.9	5.0	0.8	6.3	.	.	.	.
Gross fixed capital form., CZK bn, nom.	535.5	528.3	561.5	603.3	599.3	128.1	125.8	.	.
annual change in % (real)	0.7	-1.0	5.4	5.5	0.6	2.3	-2.5	0	5
Construction industry									
annual change in % (real)	-7.0	-6.5	5.3	9.6	2.5	3.7	-0.7	.	.
Dwellings completed, units	22183	23734	25207	24759	27291	6531	5017	.	.
annual change in %	32.4	7.0	6.2	-1.8	10.2	29.7	-23.2	.	.
Employment total, th pers., average ³⁾	4865.7	4764.1	4731.6	4750.2	4796.0	4718.7	4739.9	.	.
annual change in %	-1.4	-2.1	-0.7	0.4	1.0	0.5	0.5	.	.
Employment in industry, th pers., average ³⁾	1519.9	1468.7	1429.4	1470.6	1472.3	1465.9	1426.4	.	.
annual change in %	-2.0	-3.4	-2.7	2.9	0.1	2.0	2.7	.	.
Reg. unemployed, th pers., end of period	386.9	487.6	457.4	461.9	514.4	471.7	528.2	.	.
Reg. unemployment rate in %, end of period	7.5	9.4	8.8	8.9	9.8	9.1	10.0	10.3	9.8
LFS - unemployment rate in %, average	6.5	8.7	8.8	8.1	7.3	7.7	7.6	7.6	7.5
Average gross monthly wages, CZK ⁴⁾	11693	12666	13499	14640	15707	14339	15407	.	.
annual change in % (real, gross)	-1.2	6.1	2.6	3.6	5.4	4.2	7.8	.	.
Retail trade turnover, CZK bn	.	.	.	.	.	.	.	.	.
annual change in % (real)	-6.8	3.0	4.3	4.5	2.7	4.2	3.3	.	.
Consumer prices, % p.a.	10.7	2.1	3.9	4.7	1.8	3.7	-0.4	0.7	3.5
Producer prices in industry, % p.a.	4.9	1.0	4.9	2.9	-0.5	0.1	-0.6	-0.5	1.0
Central government budget, CZK bn									
Revenues	537.4	567.3	586.2	626.2	705.0	148.8	158.4	.	.
Expenditures	566.7	596.9	632.3	693.9	750.8	164.5	190.2	.	.
Deficit (-) / surplus (+)	-29.3	-29.6	-46.1	-67.7	-45.7	-15.7	-31.8	.	.
Deficit (-) / surplus (+), % GDP	-1.6	-1.6	-2.3	-3.1	-2.0	-2.9	-5.8	.	.
Money supply, CZK bn, end of period									
M1, Money	404.0	447.8	497.7	583.6	692.3	568.8	683.6	.	.
M2, Money + quasi money	1241.4	1337.5	1412.3	1596.0	1647.3	1581.6	1621.8	.	.
Discount rate, % p.a., end of period	7.5	5.0	5.0	3.8	1.8	3.3	1.5	.	.
Current account, USD mn	-1255	-1462	-2718	-3273	-4523	-778	-553	-5200	-5800
Current account in % of GDP	-2.2	-2.7	-5.3	-5.7	-6.5	-5.3	-3.0	-6.3	-6.4
Gross reserves of NB incl. gold, USD mn	12617	12825	13139	14464	23709	14760	24744	.	.
Gross external debt, USD mn	24348	22861	21608	22374	26281	21566	26021	.	.
Exports total, fob, EUR mn ⁵⁾	23067.9	24639.6	31482.7	37251.2	40582.9	9859.1	10541.4	43800	48200
annual change in %	16.4	6.8	27.8	18.3	8.9	7.6	6.9	8	10
Imports total, cif, EUR mn ⁵⁾	25286.6	26386.0	34875.7	40674.8	43011.8	10145.7	10684.2	46200	50900
annual change in %	5.3	4.3	32.2	16.6	5.7	2.3	5.3	7	10
Average exchange rate CZK/USD	32.27	34.60	38.59	38.04	32.74	36.24	29.47	28.4	27.5
Average exchange rate CZK/EUR (ECU)	36.16	36.88	35.61	34.08	30.81	31.75	31.63	31	30
Purchasing power parity CZK/USD, wiiw	13.42	13.54	14.00	13.99	14.19	.	.	.	.
Purchasing power parity CZK/EUR, wiiw	14.53	14.75	14.67	15.24	15.26	.	.	.	.

Notes: 1) Preliminary. - 2) From 2001 based on census March 2001. - 3) Based on Labour Force Survey data. - 4) Enterprises with more than 20 employees. - 5) Converted from the national currency to EUR at the official exchange rate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.