

## **The Czech economy dragging its feet**

The Czech economy has inherited a large industrial base; over the past few years, a sizeable segment of the industrial sector has been upgraded thanks to the massive involvement of foreign direct investors – and the process continues on. Seen from that angle, the economy is in good shape. It has the potential to expand rapidly in terms of both capacity and output. At present, however, capacity is not expanding; gross fixed investment has almost stagnated in 2002; and output expansion has switched to low speed. The restraining factor is sluggish foreign demand for want of dynamics in the EU and the western economies in general. In 2002, export revenues grew 9.1% in euro terms – much less than in the previous two years – but shrank by 1.4% in Czech koruna terms. Import growth followed roughly the same pattern, given the very high import content of Czech exports. The difference between the euro and CZK growth rates is the outcome of the nominal appreciation of the koruna vis-à-vis the euro: 3% in 2000, 4% in 2001 and 10% in 2002.

The country's accession negotiations with the EU came to a positive end in December 2002. The Czech Republic is scheduled to join the Union in May 2004, if its citizens give the go-ahead in a referendum to be held later this year (most probably mid-June). The economic ties between the Czech Republic and its EU neighbours are already very intense; direct investors from the EU are already massively involved; the larger part of the business community is enthusiastic about accession. On the political plane, the government with its clearly positive attitude towards the EU has yet to dispel some scepticism among the electorate.

The prospect of EU accession does not make the government's task any easier. It will be under strong pressure to bring the budget deficit into line with one of the Maastricht objectives. Major deficits in the public sector could well prevent the Czech Republic from joining the Economic and Monetary Union in the near future. To make matters worse, both EU pre-accession aid (viz. SAPARD) and several EU post-accession support funds currently available, such as the rural development fund within the EU agricultural budget and the EU structural fund, require some degree of co-financing from the national budget. At the same time, farmers are sure to insist on EU direct payments being topped up from national sources. Together with the government's annual transfers to Brussels, all these mandatory outlays will make for an extremely tight budgetary situation in the years to come.

Many business people, journalists and economists believe that a budget deficit always boosts inflation. Were this true, the Czechs should be grateful to their government for having built up a tidy budget deficit in 2002 which, solely on account of privatization revenues, remained restricted to 2.4% of GDP. Even given this deficit, the price indices fell rather than rose. In 2002 the consumer price index fell in all months except for three, and in January 2003 the index was 0.4% lower than the year before. We can thus speculate whether had there been a balanced budget, deflation might have been significant. Did the restrictive monetary policy actually offset the presumed inflationary impact of the budget deficit? Was it a heroic deed on the part of the National Bank that forced inflation down close to zero? No, quite the contrary! The interest rates under direct control of the National Bank were lower in the Czech Republic than anywhere else in Central Eastern Europe; for example, at the end of 2002 the discount rate was as low as 1.75%. The aim of this policy is to guard against nominal appreciation. As we can see, low interest rates, even if coupled to a significant public deficit, do not necessarily boost inflation.

As for the future of the public sector budget, in January 2003 the Czech finance minister Sobotka presented findings of a group of experts: Were the current budgetary rules to remain in force, so the experts, the overall public sector deficit, calculated according to the EU methodology, would peak in 2005 at close to 7% of GDP, whereas comparatively tough reforms could well bring the deficit down to slightly over 4% in 2005 and less than 4% in 2006.

One of the remarkable features of the Czech public sector hitherto has been that the social security system budget, based on the pay-as-you-go principle, has remained almost balanced. The deficit amounted to 0.2% of GDP in both 2001 and 2002. Within the system's budget, the funds collected for the financing of unemployment benefits displayed a surplus of around 1% of GDP; this more or less offset the pension system deficit. The health insurance budget was balanced. Overall the system's revenues amounted to less than 12% of GDP. Despite the system being in relatively good shape financially, we can already observe the all too familiar pressure building up in favour of a systemic change on the grounds that the public finances need to be consolidated. Admittedly, the increasing proportion of retired people will cause some headaches in future years, irrespective of the system applied. An ever smaller number of economically active people will have to generate income for the economically inactive. The debt-ridden hospitals also pose a pressing problem. That notwithstanding, for the time being the major problems besetting the public sector budget lie elsewhere, such as the deficit run up by the consolidation agency, an institution that in the past took over the bad loans accumulated by badly managed financial and non-financial corporations. Another problem is the low rate of efficiency in collecting taxes: a failing that at least in part is linked to corruption.

The Czech economy is doing relatively well in a difficult international environment. The GDP is likely to continue growing by about 3% throughout 2003 and 2004. Inflation will remain low; pressure will continue to build up in favour of nominal appreciation of the currency. The National Bank will continue to back a comparatively constant exchange rate – the degree to which it will manage to do so is difficult to say. It also depends on the future volume of foreign direct investment inflows.

The rate of unemployment measured as the share of those registered jobless in the total labour force is likely to exceed the 10% mark during the first half of 2003. It is the price to be paid for slow GDP growth. As soon as the most important trading partners and their economies re-enter the bullish mode, unemployment in the Czech Republic should decline somewhat.

Table CZ

## Czech Republic: Selected economic indicators

	1996	1997	1998	1999	2000	2001	2002 <sup>1)</sup>	2003	2004 forecast
Population, th pers., mid-year <sup>2)</sup>	10315.4	10303.6	10294.9	10282.8	10272.5	10224.2	10189.1	.	.
Gross domestic product, CZK bn, nom.	1567.0	1679.9	1839.1	1902.3	1984.8	2157.8	2250	2350	2475
annual change in % (real)	4.3	-0.8	-1.0	0.5	3.3	3.3	2.6	2.8	3.3
GDP/capita (USD at exchange rate)	5596	5142	5536	5347	5007	5548	5750	.	.
GDP/capita (USD at PPP - wiiw)	12990	13160	13320	13660	13800	15090	15560	.	.
Gross industrial production									
annual change in % (real)	2.0	4.5	1.6	-3.1	5.4	6.5	4.6	4.7	6
Gross agricultural production									
annual change in % (real)	-1.4	-5.1	0.7	0.6	-4.5	2.5	.	.	.
Goods transport, mn t-kms <sup>3)</sup>	32581	62460	53591	54620	57343	57777	45900 <sup>I-HX</sup>	.	.
annual change in %	-0.4	.	-14.2	1.9	5.0	0.8	7.0 <sup>I-HX</sup>	.	.
Gross fixed capital form., CZK bn, nom.	500.6	514.5	535.5	528.3	561.5	610.9	.	.	.
annual change in % (real)	8.2	-2.9	0.7	-1.0	5.4	7.2	0.9	2	5
Construction industry									
annual change in % (real)	5.3	-3.9	-7.0	-6.5	5.3	9.6	2.5	.	.
Dwellings completed, units	14482	16757	22183	23734	25207	24759	17376 <sup>I-HX</sup>	.	.
annual change in %	11.4	15.7	32.4	7.0	6.2	-1.8	12.1 <sup>I-HX</sup>	.	.
Employment total, th pers., average <sup>4)</sup>	4972.0	4936.5	4865.7	4764.1	4731.6	4750.2	4796.0	.	.
annual change in %	0.2	-0.7	-1.4	-2.1	-0.7	0.4	1.0	.	.
Employment in industry, th pers., average <sup>4)</sup>	1597.7	1550.4	1519.9	1468.7	1429.4	1470.6	1476.1 <sup>I-HX</sup>	.	.
annual change in %	-1.4	-3.0	-2.0	-3.4	-2.7	2.9	0.7 <sup>I-HX</sup>	.	.
Reg. unemployed, th pers., end of period	186.3	268.9	386.9	487.6	457.4	461.9	514.4	.	.
Reg. unemployment rate in %, end of period	3.5	5.2	7.5	9.4	8.8	8.9	9.8	10.3	9.8
LFS - unemployment rate in %, average	3.9	4.8	6.5	8.7	8.8	8.1	7.3	7.5	7.4
Average gross monthly wages, CZK <sup>5)</sup>	9676	10691	11693	12666	13499	14640	15172 <sup>I-HX</sup>	.	.
annual change in % (real, gross)	8.8	1.8	-1.2	6.1	2.6	3.6	5.2 <sup>I-HX</sup>	.	.
Retail trade turnover, CZK bn	.	.	.	.	.	.	.	.	.
annual change in % (real)	12.1	-0.4	-6.8	3.0	4.3	4.5	2.9 <sup>I-X</sup>	.	.
Consumer prices, % p.a.	8.8	8.5	10.7	2.1	3.9	4.7	1.8	1.6	2.0
Producer prices in industry, % p.a.	4.7	4.9	4.9	1.0	4.9	2.9	-0.5	0.5	1.0
Central government budget, CZK bn									
Revenues	482.8	509.0	537.4	567.3	586.2	626.2	705.0	.	.
Expenditures	484.4	524.7	566.7	596.9	632.3	693.9	750.8	.	.
Deficit (-) / surplus (+)	-1.6	-15.7	-29.3	-29.6	-46.1	-67.7	-45.7	.	.
Deficit (-) / surplus (+), % GDP	-0.1	-0.9	-1.6	-1.6	-2.3	-3.1	-2.0	.	.
Money supply, CZK bn, end of period									
M1, Money	447.1	418.9	404.0	447.8	497.7	583.6	669.8 <sup>Nov</sup>	.	.
M2, Money + quasi money	1078.1	1177.8	1241.4	1337.5	1412.3	1596.0	1646.6 <sup>Nov</sup>	.	.
Discount rate, % p.a., end of period	10.5	13.0	7.5	5.0	5.0	3.75	1.75	.	.
Current account, USD mn	-4121	-3564	-1255	-1462	-2718	-2625	-3200	-3500	-4000
Current account in % of GDP	-7.1	-6.7	-2.2	-2.7	-5.3	-4.6	-4.7	-4.3	-4.7
Gross reserves of NB incl. gold, USD mn	12435	9774	12617	12825	13139	14464	23717	.	.
Gross external debt, USD mn	21181	21617	24348	22861	21608	21696	23824 <sup>Sep</sup>	.	.
Exports total, fob, EUR mn <sup>6)</sup>	17691.3	19811.8	23070.4	24640.9	31482.7	37251.2	40629.8	42300	46800
annual change in %	7.2	12.0	16.4	6.8	27.8	18.3	9.1	4	11
Imports total, cif, EUR mn <sup>6)</sup>	22189.7	24014.3	25289.4	26387.4	34875.7	40674.8	43046.2	46000	51500
annual change in %	14.4	8.2	5.3	4.3	32.2	16.6	5.8	7	12
Average exchange rate CZK/USD	27.15	31.71	32.27	34.60	38.59	38.04	32.74	.	.
Average exchange rate CZK/EUR (ECU)	34.01	35.80	36.16	36.88	35.61	34.08	30.81	30.5	29
Purchasing power parity CZK/USD, wiiw	11.69	12.39	13.42	13.54	14.00	13.99	14.19	.	.
Purchasing power parity CZK/EUR, wiiw	12.68	13.39	14.62	14.75	14.51	14.93	14.88	.	.

Notes: 1) Preliminary. - 2) From 2001 based on census March 2001. - 3) In 1996 public transport only. - 4) Based on Labour Force Survey data. - 5) Enterprises with more than 100, from 1997 with 20 and more employees. - 6) Converted from the national currency to EUR at the official exchange rate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.