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Czech Republic: increasing competitiveness, higher GDP growth

Industrial production increased by 9% in the first quarter of 2004. By Czech standards, this was exceptionally high. With a rise of 8%, exports contributed positively to this result. Output in the construction sector grew by over 16% in the first quarter, surging to over 62% in April 2004. Faced with a higher VAT rate from May 2004 on, most construction companies may well have pre-dated their invoices. All this contributed to the backdrop for accelerated GDP growth: 3.1% year-on-year according to preliminary estimates for the first quarter of 2004. The major driving force was a marked increase in gross fixed investment: up 9.5%, attributable mainly to construction activities. Household consumption grew by 3.9%; this is rather low given the high wage increases. In the first quarter of 2004, gross monthly wages grew by 8.8% in nominal terms (6.2% in real terms). Moreover, consumer credits expanded further. At the end of April 2004, the stock of loans granted to households amounted to some EUR 7.9 billion or 10% of the GDP in 2003. Foreign trade contributed negatively to GDP, at least at constant prices. At current prices, the trade balance improved (see below).

On the sales side, the corporate sector profited from an upswing in the global economy; this translated into a somewhat better business climate in the eurozone, the main recipient of Czech exports. On the input side, things also developed positively for the corporate sector. Unit labour costs, in euro terms, sank almost continuously from mid-2003 onwards, without showing the slightest sign of the trend reversing in 2004. In other words, labour productivity growth almost always outstripped wage growth in euro terms. The latter was supported by the depreciation of the Czech koruna against the euro in the order of 4% (first quarter 2004 over first quarter 2003 average). Appreciation against the US dollar of more than 10% kept the rise of energy costs within limits.

Compensation of employees is still relatively low: some EUR 700 per month if calculated via exchange rates or 28% of the EU-25 average in 2003. On the other hand, the price level is only half of the EU-25 average, thanks in particular to low prices for non-tradable goods and services. Low wages are comforting for employers from the standpoint of production costs at least, whereas low prices also make life easier for employees. All in all, the impression is that a significant number of Czech producers of tradable goods are highly competitive. Trade intensity is high, and exports of goods tend to grow faster than imports. This has even been the case over the past few years, despite being confronted with an adverse business climate in most of the eurozone. The Czech trade deficit has shrunk over time only to disappear completely in recent months. Developments in services have been less favourable. Over the past few years they have always recorded surpluses: these, however, have steadily declined and recently came close to zero.

A high deficit characterizes the Czech Republic's current account, notwithstanding balance of trade in goods and services. The main contributory factor here is the profits stemming from prior foreign investment. They figure negatively in the income account, regardless whether the recipients

repatriate them, invest them elsewhere or reinvest them in the Czech Republic. The stock of FDI in the Czech Republic amounts to EUR 37.6 billion (end-2003) or around 50% of the GDP. The profits generated by past foreign investment amount to about 6% of GDP and imply a gap of similar size between GDP and Gross National Income. In the first quarter of 2004, FDI amounted to about EUR 1 billion. The inflow of FDI for 2004 as a whole is likely to increase compared to 2003. Foreign capital is involved in large parts of the corporate sector, the major concentration being in the production of transport equipment and the associated industries.

The massive involvement of foreign investors has had an adverse impact on employment. Compared to domestically owned enterprises, foreign-owned enterprises economize on labour input. Labour productivity is correspondingly high and permits the payment of relatively high wages. Foreign-owned manufacturers have a relatively low share in overall employment, but a high share in exports. The number of registered jobless remains around 10% of the labour force; it fell slightly below this mark at the end of May. The unemployment rate calculated on the basis of Labour Force Survey data is somewhat lower.

As mentioned already, Czech prices are on average low compared to the EU-25 overall price level. None the less, no forces nudging prices upwards are to be seen. Inflation would hardly feature at all, were it not for government intervention. Average inflation for 2004 can be expected to climb up to around 3%; for the most part this will be the outcome of higher indirect taxes, an upward shift in the upper limits of regulated prices and higher energy costs. Because of the latter, producer prices, which are much less exposed to regulations, are on the rise (1.8%, year-on-year, first quarter 2004). The import price index for the first quarter of 2004 was unchanged compared to the same period in 2003, but the increase in certain sub-groups, especially materials, may have had an impact on producer prices. Export prices rose by 2.6%. In euro terms, Czech exports may have slightly declined in price as a result of the 4% devaluation of the Czech koruna (first quarter 2004 over first quarter 2003).

The policy adopted by the Czech National Bank (CNB) last year creates the impression of having been inspired by Alan Greenspan rather than by the European Central Bank. The CNB pioneered a policy of low interest rates; this has put an end to the appreciation pressure vis-à-vis the euro that emerged after 1999. Credits, for both households and enterprises, became cheaper: a fact that helped to overcome the stagnation tendencies arising in the late 1990s. Textbook knowledge would suggest that a policy of low interest rates fuels inflation. In the case of the Czech Republic this has not been borne out. On the contrary, the economy has come close to deflation. This experience deserves much closer attention on the part of economists than it has attracted so far.

The CNB-controlled interest rates may have bottomed out. Expectations of a rise are gaining ground in the context of the inflation hike expected for 2004. If this turns out to be true, some appreciation pressure could re-emerge. The nomination of Zdeněk Tuma as CNB governor, as well as other members of the present board of directors, was the personal choice of the former president, Václav

Havel. Most likely, the current president, Václav Klaus, will nominate persons of his choice for the next term. This could point to some change in CNB policy from 2005 onwards.

The deficit in the consolidated budget of the public sector was huge in 2003: 12.9% of GDP. The government debt leapt to around 40% of GDP. The reason, however, was not an immense gap between current revenues and expenditures. In addition to the normal expenditures for the year 2003, the finance ministry switched to the EU budget monitoring methodology and included the deficit of the consolidation agencies as well as the amount of credit guarantees that Czech governments had signed in the past, e.g. in the search for foreign strategic partnerships with Czech banks. Most of these items will not burden the budget for 2004 and the years thereafter. It is therefore quite realistic for the finance ministry to count on a budget deficit of around 6% of GDP in 2004 and an even lower ratio thereafter. Given increased GDP growth and higher inflation, the budget deficit in 2004 could well turn out even lower. Alternatively, the government might decide to stay with the higher deficit, thus granting themselves some budgetary breathing space for co-financing EU projects.

In 2005, interest rates will probably be higher than to date. In this context we can expect the Czech currency to appreciate somewhat against the euro. The government – a new one after the resignation of premier Špidla – will come under pressure to reduce its deficit. At the same time, however, it will have to make some budgetary funds available for the co-financing of EU projects, failing which the inflow of EU transfers will be meagre. Taken together, economic policy will barely contribute to the improvement of the business climate. Nevertheless, the latter is likely to remain friendly thanks to increasing private consumption, expanded construction activities, more corporate investment in machinery and widening export opportunities: all reasonable prospects as the competitiveness of the corporate sector is likely to remain unscathed.

Table CZ

Czech Republic: Selected Economic Indicators

	1999	2000	2001	2002	2003 ¹⁾	2003 1st quarter	2004	2004 forecast	2005
Population, th pers., mid-year ²⁾	10282.8	10272.5	10224.2	10200.8	10206.5	.	.	.	.
Gross domestic product, CZK bn, nom. ³⁾	1902.3	1984.8	2315.3	2414.7	2532.4	594.4	637.9	2700	2850
annual change in % (real) ³⁾	0.5	3.3	2.6	1.5	3.1	2.8	3.1	3.3	3.6
GDP/capita (EUR at exchange rate)	5016	5426	6644	7683	7792	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	12700	12490	14100	14920	15400	.	.	.	.
Gross industrial production									
annual change in % (real)	-3.1	5.4	6.5	4.8	5.8	6.2	9	7	7
Construction industry									
annual change in % (real)	-6.5	5.3	9.6	2.5	8.9	-0.8	16.2	.	.
Consumption of households, CZK bn, nom. ³⁾	1006.6	1059.6	1179.4	1220.6	1272.4	296.0	311.5	.	.
annual change in % (real) ³⁾	1.9	2.3	2.8	2.7	4.9	5.1	3.9	4	5
Gross fixed capital form., CZK bn, nom. ³⁾	528.3	561.5	638.6	643.3	676.9	150.3	161.9	.	.
annual change in % (real) ³⁾	-1.0	5.4	5.4	3.4	7.4	6.2	9.5	9	7
LFS - employed persons, th, avg. ⁴⁾	4764.1	4731.6	4750.2	4764.9	4733.2	4739.9	4671.0	.	.
annual change in %	-2.1	-0.7	0.4	0.3	-0.7	0.5	-1.5	.	.
LFS - employed pers. in industry, th, avg. ⁴⁾	1468.7	1429.4	1470.6	1463.1	1424.7	1426.4	1397.3	.	.
annual change in %	-3.4	-2.7	2.9	-0.1	-2.6	2.7	-2.0	.	.
LFS - unemployed persons, average	454.1	454.5	421.0	374.1	399.1	388.3	443.0	.	.
LFS - unemployment rate in %, average ⁴⁾	8.7	8.8	8.1	7.3	7.8	7.6	8.7	9	9
Reg. unemployment rate in %, end of period	9.4	8.8	8.9	9.8	10.3	10.0	10.7	11	11
Average gross monthly wages, CZK ⁵⁾	12797	13614	14793	15857	16917	15366	16722	.	.
annual change in % (real, gross)	6.2	2.4	3.8	5.3	6.7	7.6	6.4	.	.
Consumer prices, % p.a.	2.1	3.9	4.7	1.8	0.1	-0.4	2.3	3.2	2
Producer prices in industry, % p.a.	1.0	4.9	2.9	-0.5	-0.3	-0.6	1.8	3.5	2
General governm. budget, EU-def., % GDP ⁶⁾									
Revenues	46.5	42.8	44.1	45.6	45.0	.	.	.	.
Expenditures	50.1	47.3	50.6	52.0	57.9	.	.	.	.
Deficit (-) / surplus (+)	-3.7	-4.5	-6.4	-6.4	-12.9	.	.	-6	-5
Public debt, EU-def., in % of GDP ⁶⁾	14	18	25	29	38	.	.	41	42
Discount rate, % p.a., end of period	5.0	5.0	3.8	1.8	1.0	1.5	1.0	.	.
Current account, EUR mn	-1372	-2945	-3652	-4426	-4937	-254	-476	-5600	-6000
Current account in % of GDP	-2.7	-5.3	-5.4	-5.6	-6.2	.	.	-6.6	-6.5
Gross reserves of NB incl. gold, EUR mn	12771	14159	16400	22614	21341	22708	22076	.	.
Gross external debt, EUR mn	22765	23285	25368	25738	27599	24715	.	.	.
FDI inflow, EUR mn	5933	5404	6296	9012	2289	861	802	.	.
FDI outflow, EUR mn	84	47	185	219	206	1	37	.	.
Exports of goods, BOP, EUR mn	24640	31483	37251	40711	43079	10545	11380	47000	51000
annual growth rate in %	6.8	27.8	18.3	9.3	5.8	7.0	7.9	9	8.5
Imports of goods, BOP, EUR mn	26424	34876	40675	43026	45258	10678	11419	48500	51500
annual growth rate in %	4.1	32.0	16.6	5.8	5.2	5.3	6.9	7	6
Exports of services, BOP, EUR mn	6612	7436	7913	7501	6882	1516	1616	7300	7800
annual growth rate in %	-3.1	12.5	6.4	-5.2	-8.3	-18.7	6.6	6	7
Imports of services, BOP, EUR mn	5486	5904	6211	6792	6466	1415	1606	7300	8300
annual growth rate in %	7.4	7.6	5.2	9.4	-4.8	-10.3	13.5	13	14
Average exchange rate CZK/USD	34.60	38.59	38.04	32.74	28.23	29.47	26.28	.	.
Average exchange rate CZK/EUR (ECU)	36.88	35.61	34.08	30.81	31.84	31.63	32.85	32	31
Purchasing power parity CZK/USD, wiiw	14.08	14.14	14.32	14.77	14.85	.	.	.	.
Purchasing power parity CZK/EUR, wiiw	14.57	15.47	16.06	15.86	16.11	.	.	.	.

Notes: 1) Preliminary. - 2) From 2001 based on census March 2001. - 3) Methodological break 2000/2001 - from 2001 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.

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