

Leon Podkaminer

The Czech Republic: an export-led expansion

The high GDP growth which started already in the second quarter of 2004 has been continuing. In the third and probably fourth quarters of 2005 GDP rose by 4.9%, thus somewhat less than earlier in the year. Nonetheless, at an about 5% yearly growth rate, the current performance of the Czech economy is the best so far. What is quite noteworthy about the current situation is that growth, sustained over quite a long period now, has not produced any visible symptoms of 'overheating'.

First, one does not observe the usual signs of impending inflationary acceleration. In actual fact both the consumer and producer price inflation indices are much lower than in 2004, and that despite high energy prices, large increases in administered prices and indirect taxes. Moreover, the industrial producer price index has actually been falling throughout 2005.

Second, faster growth has not produced any tensions in foreign trade. To the contrary, the trade and current account balances have been improving. A sizeable trade (goods and services) surplus, equivalent to about 1.7% of the GDP, is expected for the whole year 2005 – the first such development in a decade. The current account deficit has roughly halved compared with 2004 (with investment income earned on inward foreign investment continuing to increase quite strongly).

Foreign trade contributed decisively to the overall GDP growth, with exports performing very strongly. The (negative) contribution of imports was much smaller. The relatively weak growth of imports¹ reflects the weakness of domestic demand, which rose only about 0.7%. Households' real disposable incomes rose somewhat faster than in 2004, but at a low pace all the same (by about 2%). This is consistent with a rather modest rise in private consumption (by about 2.6%) which was supported by expanding bank lending.

The low (and falling) share of labour income in GDP (about 42.6% in 2005), and hence a relatively high (and rising) share of corporate profits/mixed income, prove conducive to moderate growth of fixed capital formation (about 3%). However, part of the rise in fixed capital formation can be attributed to a fast rise in residential housing investment financed by expanding credits, and to rising government investment. There are good grounds to believe that fixed investment in the corporate sector may have stagnated in 2005.

¹ During the first three quarters of 2005 exports rose by 11.5% in real terms while imports by only 5.3%.

The fact that the relatively low (and generally not expanding) unemployment rate coexists with very moderate wage hikes indicates the presence of commendable moderation on the part of the Czech labour. On the other hand, also the Czech economic authorities seem to be doing a fairly good job. The consolidation of public finances has proceeded without undue haste. Fashionable – and controversial – reforms of the tax system (e.g. flat tax) have not yet been experimented with in the Czech Republic (though they figure on the programme of the opposition Civic Democratic Party) and cuts in social spending have been much more moderate and gradual than elsewhere in the region. Nonetheless the fiscal deficit in 2005 is provisionally estimated at about 3% of the GDP.² Still, in view of the parliamentary elections (scheduled for June) the deficit may rise temporarily in 2006 – only to be reined in later on.

The Czech National Bank has been maintaining very low interest rates (actually lower than the ECB's). This is consistent with very low 'core inflation'. Additionally, the CNB's policy is certainly motivated by a concern over an undesirable excessive strengthening of the domestic currency. The inflation target for 2006 (and beyond) is 3% (actually a 2-4% range). There is little doubt that inflation will fall into that range. However, as a consequence of the liberalization of housing rents and other administrative interventions, inflation in 2006 is likely to be temporarily somewhat higher than in 2005. But the risk of the CNB engaging in any exaggerated actions over increased inflation is minimal. Nonetheless, the steady nominal appreciation of the Czech koruna vs. the euro is quite certain to continue. Falling current account deficits coupled with steady capital inflows (dominated by foreign direct investments³) and rising transfers from the EU will continue to exert some appreciation pressure.

The general character of growth in 2006 and 2007 will not be radically different from that observed recently. Low inflation – which is relatively easy to control given the nominal appreciation of the domestic currency, maintained wage moderation and rather disciplined social spending – will allow for maintaining low interest rates. This in itself will not be provoking an excessive appreciation of the Czech koruna. Then, further gains in labour productivity and relative unit costs (low pace of wage increases) will be consolidating the country's external competitive position, despite some nominal (and thus quite remarkable real) appreciation.

Of course, some changes in the composition of growth are quite likely. First, domestic demand will probably accelerate gradually. Improved profitability and the overall financial

² The fiscal balance was positively affected by privatization revenues earned on two large privatization deals (sale of Czech Telecom and the petrochemicals firm Unipetrol) – and negatively by large one-off expenses on military hardware.

³ The FDI inflow in 2005 was over EUR 9 billion, almost twice the 2004 level. The two large privatization deals are certainly responsible for the results achieved in 2005. Nonetheless most of the FDI inflows are not related to privatization, and about one third of them consist of reinvested profits.

position of the corporate sector achieved in 2005 may be expected to induce a revival in its fixed investment. Growth in private consumption is also likely to be higher than in 2005, primarily on account of gradually improving real disposable incomes (rising – though moderately – employment, wages and social benefits). Continuing availability of cheap credit will continue to be conducive to higher household consumption and residential investment.

The expansion of Czech exports is likely to carry on, not only because of their maintained external price (and cost) competitiveness, but – first of all – because of their fast improving qualitative characteristics (high levels of FDI in the export-oriented activities). However, under sustained growth of exports and accelerating domestic demand, imports are unlikely to remain as anaemic as in 2005. Assuming that exports of goods and services will continue to rise at some 10% per annum in real terms, and domestic demand will rise at a moderate 3.5%, one would have to count with at least 8-9% real growth in imports. Net exports would then continue to add to overall growth, but their role would cease to be as dominant as in 2005.⁴

Under the scenario just outlined, eventual GDP growth would be about 4-4.5% in both 2006 and 2007. Growth rates of that order, though not quite as impressive as e.g. the performance of neighbouring Slovakia, would still be much higher than in the old EU. Moreover, they would stipulate rising trade surpluses and a stabilization of the current account deficits. On the other hand, as at the same time the level of the Czech gross national income will be lower by some 6% than its GDP, this otherwise realistic scenario is not quite perfect.

⁴ In the first three quarters of 2005 the Czech GDP rose by 5%, out of which 4.4% were due to net exports.

Table CZ

Czech Republic: Selected Economic Indicators

	1999	2000	2001	2002	2003	2004	2005 ¹⁾	2006	2007
	forecast								
Population, th pers., mid-year ²⁾	10282.8	10272.5	10224.2	10200.8	10201.7	10206.9	10231.7	.	.
Gross domestic product, CZK bn, nom. ³⁾	2041.4	2150.1	2315.3	2414.7	2555.8	2767.7	2960	3180	3410
annual change in % (real) ³⁾	1.2	3.9	2.6	1.5	3.2	4.7	5.0	4.5	4.7
GDP/capita (EUR at exchange rate)	5383	5878	6644	7683	7867	8499	9710	.	.
GDP/capita (EUR at PPP - wiiw)	12190	12810	13510	14280	14740	15920	16840	.	.
Gross industrial production									
annual change in % (real)	-3.1	1.5	10.6	4.8	5.8	9.9	5.7	6	6
Gross agricultural production									
annual change in % (real)	0.6	-4.5	2.5	-4.4	-7.6	14.9	.	.	.
Construction industry									
annual change in % (real)	-6.5	5.3	9.6	2.5	8.9	9.7	3.8 ^{I-XI}	.	.
Consumption of households, CZK bn, nom. ³⁾	1046.3	1108.8	1179.4	1220.6	1300.5	1372.4	.	.	.
annual change in % (real) ³⁾	2.2	2.9	2.8	2.7	4.6	3.3	3	3.3	4
Gross fixed capital form., CZK bn, nom. ³⁾	550.6	594.9	638.6	643.3	685.6	743.8	.	.	.
annual change in % (real) ³⁾	-3.6	4.9	5.4	3.4	4.7	5.3	3	5	5
LFS - employed persons, th, avg. ⁴⁾	4764.1	4731.6	4750.2	4764.9	4733.2	4706.6	4764.0	.	.
annual change in %	-2.1	-0.7	0.4	0.8	-0.7	-0.6	1.2	.	.
LFS - employed pers. in industry, th, avg. ⁴⁾	1468.7	1429.4	1470.6	1463.1	1424.7	1409.0	1414.3 ^{I-X}	.	.
annual change in %	-3.4	-2.7	2.9	-0.1	-2.6	-1.1	0.4 ^{I-X}	.	.
LFS - unemployed, th pers., average	454.1	454.5	421.0	374.1	399.1	425.9	410.2	.	.
LFS - unemployment rate in %, average ⁴⁾	8.7	8.8	8.1	7.3	7.8	8.3	8.0	7.5	7.5
Reg. unemployment rate in %, end of period	9.4	8.8	8.9	9.8	10.3	9.5	8.9	8.5	8.5
Average gross monthly wages, CZK ⁵⁾	12797	13614	14793	15866	16917	18035	19100	.	.
annual change in % (real, gross)	6.2	2.4	3.8	5.4	6.5	3.7	4	.	.
Consumer prices, % p.a.	2.1	3.9	4.7	1.8	0.1	2.8	1.9	2.8	2.5
Producer prices in industry, % p.a.	1.0	4.9	2.8	-0.5	-0.4	5.7	3.0	3	2
General governm. budget, EU-def., % GDP ⁶⁾									
Revenues	39.2	38.5	39.1	40.2	41.0	41.6	41.8	41.5	41.4
Expenditures	42.9	42.1	45.0	46.9	53.5	44.7	45.0	45.2	44.7
Deficit (-) / surplus (+)	-3.6	-3.7	-5.9	-6.8	-12.5	-3.0	-3.2	-3.7	-3.3
Public debt, EU-def., in % of GDP ⁶⁾	13.3	18.2	26.3	29.8	36.8	36.8	36.2	36.6	36.9
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	-5044	-4490	-2500	-3000	-2600
Current account in % of GDP	-2.5	-4.9	-5.4	-5.6	-6.3	-5.2	-2.5	-2.8	-2.2
Gross reserves of NB incl. gold, EUR mn	12771	14159	16400	22614	21340	20884	25003	.	.
Gross external debt, EUR mn	22765	23285	25368	25738	27624	33258	37779 ^{I-X}	.	.
FDI inflow, EUR mn	5933	5404	6296	9012	1863	3596	9000	.	.
FDI outflow, EUR mn	84	47	185	219	183	440	700	.	.
Exports of goods, BOP, EUR mn	24640	31483	37251	40711	43051	53714	63400	73000	82000
annual growth rate in %	6.8	27.8	18.3	9.3	5.7	24.8	18	15	12
Imports of goods, BOP, EUR mn	26424	34876	40675	43026	45243	54414	61500	69000	77000
annual growth rate in %	4.1	32.0	16.6	5.8	5.2	20.3	13	12	12
Exports of services, BOP, EUR mn	6612	7436	7913	7501	6882	7787	8600	9500	.
annual growth rate in %	-3.1	12.5	6.4	-5.2	-8.3	13.2	10	10	.
Imports of services, BOP, EUR mn	5486	5904	6211	6792	6466	7396	8100	8900	.
annual growth rate in %	7.4	7.6	5.2	9.4	-4.8	14.4	10	10	.
Average exchange rate CZK/USD	34.60	38.59	38.04	32.74	28.23	25.70	23.95	.	.
Average exchange rate CZK/EUR (ECU)	36.88	35.61	34.08	30.81	31.84	31.90	29.78	29.4	29.0
Purchasing power parity CZK/USD	14.26	14.38	14.60	14.27	14.50	14.55	14.42	.	.
Purchasing power parity CZK/EUR	16.29	16.34	16.76	16.58	16.99	17.03	17.18	.	.

Notes: 1) Preliminary. - 2) From 2001 based on census March 2001. - 3) According to ESA 95, real change based on constant prices of previous year. - 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 Database; wiiw forecasts.