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The Czech Republic: export-led expansion continues

The year 2004 marks a historical change in the recent economic history of the Czech Republic, not only on account of the country becoming an EU member. In 2004 a prolonged period of unimpressive growth performance following the 1996 currency crisis, with an average 1.5% GDP growth per year, seems to have come to an end. Simultaneously, the role of foreign trade in goods and non-factor services changed radically. In contrast to previous years, when foreign trade had been reducing the GDP growth (via the differential performance in real exports and imports), in 2004 foreign trade contributed +1.4 percentage points to the overall 4.7% growth.[1] The role of foreign trade was even more significant in 2005: trade contributed a rather unusually high 4.4 percentage points to the recorded 6.1% GDP growth. Provisional estimates for the first quarter of 2006 suggest that foreign trade continues to contribute positively to the buoyant overall GDP growth (7.4% in 1Q2006) – though its current contribution (about 1.9 p.p.) is much more moderate than in 1Q2005 (4.3 p.p.). The differential between the rates of real growth of exports and imports narrowed to 17% and 15.3% respectively (from 17.5% and 10.4% recorded a year earlier). Correspondingly, the importance of consumption (primarily private, but also public) and of gross fixed investment increased significantly. Moreover, in 1Q2006 there was a massive rise in inventories (accounting for some 36% of the nominal rise in GDP).

The change in the character of growth in 2004 does not seem to be directly related to the accession to the EU. For several years prior to the accession, Czech trade with the EU had already been practically liberalized (the then existing restrictions on trade in food and farm products essentially did not matter for the Czech Republic). The change in macroeconomic performance is related to the successful structural transformation of the economy which has been extended over a longer period. The structural transformation has had several elements. First, high inflows of foreign direct investment: the inward FDI stock as a percentage of GDP has risen from 23% in 1998 to over 51% in 2005. Moreover, over 40% of FDI has gone into manufacturing, predominantly in export-oriented activities. Second, gross fixed investment has been very high, ranging between 28% of the GDP at the beginning of the decade and 25.5% in 2005. Thus, the country's fixed productive assets are generally qualitatively and quantitatively superior to the assets at the disposal of firms in other Central European countries, where investment rates have been much lower.[2]

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1 Between 2001 and 2003 the average contribution of foreign trade to GDP growth equalled minus 1.3 percentage points.

2 The Czech Republic has outperformed Hungary and Poland in manufacturing exports to the EU-15. (See Overview Part A of this Report.)

Industry, which is the backbone of the Czech economy, performed very well in the first quarter of 2006. Its gross value added rose a phenomenal 18.5% in real terms (with the total GVA up about 7.8%). Industrial production grew by 15.4% in real terms. The production of consumer durables rose 38%, of capital goods by 31%. Direct industrial export sales (excluding exports performed by trade intermediaries) rose 16.3%. Sales of foreign-controlled firms expanded by 26.3%.[3] The volume of orders placed with industry increased by 22.7%, the volume of export orders by 19%. Both employment in industry and the average nominal industrial wage increased, by 2.4% and 6.1% respectively. But, as labour productivity rose by more than 13%, industrial unit labour costs fell by about 7%.

Preliminary data available for April and May suggest some slowdown in the growth of industrial production, sales, new orders and employment. Most probably this is a seasonal phenomenon. On the other hand, one must see this development in connection with the high rise in inventories reported by the national accounts statistics for the first quarter of 2006. Also, the latest data on foreign trade indicate that, while the trade surplus continues to increase (albeit at moderate speed), the growth rate of imports of goods has caught up with the growth rate of goods' exports (both items at current prices). An acceleration of growth of imports is a fairly natural consequence of rising incomes (the total wage bill in particular) and consumer demand – as well as of the strength of the Czech currency. This foretells a more balanced composition of aggregate demand, with an increasing role for the growth of private consumption as the major factor behind GDP growth. Trade may remain an important factor contributing to growth positively – but stand in a more reasonable proportion to other GDP components.[4]

Some acceleration of inflation observed in April and May can easily be blamed on hikes in prices of energy and administratively-controlled utilities. But prices of other goods have gone up too. Currently inflation appears higher than last year, and this is consistent with strengthening consumer demand. It remains to be seen whether the Czech National Bank perceives the present situation as requiring some action. Formally, the current inflation – running at about 2.8% – is still lower than the CNB's inflation target of 3% (more precisely the 2-4% range). In any case, eventual increases in the policy interest rates (which currently are very low) are highly likely to be insignificant, or harmful to investment or exchange rates.

The parliamentary elections held in June have produced a stalemate. The two largest parties: the Social Democrats (which presided over the country's successful transformation

[3] Direct export sales account for about 49% of all industry's sales. The share of foreign-controlled firms in total sales of industry is close to 59%.

[4] For example, Ireland's average GDP growth since 1999 (6.3%) has been the effect of rising domestic demand (4.4 p.p. contribution) and foreign trade (1.9 p.p. contribution). This is the opposite of the proportion observed in the Czech Republic in 2005.

over the past eight years) and the Civic Democrats (who led the country through the most turbulent initial years of the transition to a market economy) voiced – prior to the elections – radically different views on various essential economic policy questions. The Civic Democrats promised fast privatization of utilities (energy, post, railways, etc.), a three-pillar pension reform, a flat-tax with a 15% rate, and a speedy deregulation of housing rents. They did not state any fixed date for the introduction of the euro.[5] The Social Democrats promised not to privatize the utilities, not to change the tax system, and not to deregulate the rents quickly. Moreover, they were in favour of euro adoption by the year 2010.

Whichever party finally forms the government (a formal, or informal, coalition of the two is not unimaginable), it is likely that the pace of change in the tax and pension systems will be low, privatization of utilities token rather than real, and the deregulation of rents protracted. Given the fairly good state of the economy, there is little reason to wage major institutional or social experiments. True to its traditional style of conducting economic policy, the Czech authorities will be avoiding 'reform excesses', which plague some neighbouring countries.

Summing up, GDP growth is likely to remain strong, but perhaps less buoyant than last year. The revival of fixed investment and private consumption (the latter supported by rising wages and employment) will be combined with a stronger rise in imports. But exports are likely to remain strong as well, even if the Czech koruna continues its slow nominal appreciation. All in all, growth may be somewhat slower, but otherwise better balanced. It may also be added that the next government, whose political complexion is hard to predict now, is rather unlikely to start any radical experiments (such as the flat tax system) which could threaten the country's economic and social stability.

[5] The party was founded by the present State President, Václav Klaus, an exemplary 'Eurosceptic'.

Table CZ

Czech Republic: Selected economic indicators

	2001	2002	2003	2004	2005 [1]	2005	2006	2006	2007
						1st quarter		forecast	
Population, th pers., mid-year	10224.2	10200.8	10201.7	10206.9	10231.7	.	.	.	.
Gross domestic product, CZK bn, nom. [2]	2352.2	2464.4	2577.1	2781.1	2978.2	691.2	748.8	3230	3480
annual change in % (real) [2]	2.5	1.9	3.6	4.2	6.1	5.4	7.4	5.5	5
GDP/capita (EUR at exchange rate) [2]	6750	7841	7933	8540	9773	.	.	.	.
GDP/capita (EUR at PPP - wiiw) [2]	13730	14580	14860	16000	17360	.	.	.	.
Gross industrial production									
annual change in % (real) [3]	6.7	1.9	5.5	9.6	6.7	3.9	15.4	10	8
Gross agricultural production									
annual change in % (real)	2.5	-4.4	-7.6	14.9	.	.	.	.	.
Construction industry									
annual change in % (real)	9.6	2.5	8.9	9.7	4.2	-3.1	0.5	.	.
Consumption of households, CZK bn, nom. [2]	1206.9	1248.1	1317.4	1391.1	1449.0	335.1	356.0	.	.
annual change in % (real) [2]	2.3	2.2	6.0	2.5	2.4	1.8	3.4	3.5	4
Gross fixed capital form., CZK bn, nom. [2]	659.3	677.8	687.5	729.3	758.7	172.4	186.3	.	.
annual change in % (real) [2]	6.6	5.1	0.4	4.7	3.6	2.3	7.1	7	5
LFS - employed persons, th, avg. [4]	4750.2	4764.9	4733.2	4706.6	4764.0	4704.4	4785.2	.	.
annual change in %	0.4	0.8	-0.7	-0.6	1.2	0.6	1.7	.	.
LFS - employed pers. in industry, th, avg. [4]	1470.6	1463.1	1424.7	1409.0	1422.0	1400.9	1476.3	.	.
annual change in %	2.9	-0.1	-2.6	-1.1	0.9	0.2	5.4	.	.
LFS - unemployed, th pers., average	421.0	374.1	399.1	425.9	410.0	429.3	414.1	.	.
LFS - unemployment rate in %, average [4]	8.1	7.3	7.8	8.3	8.0	8.4	8.0	7.5	7.5
Reg. unemployment rate in %, end of period	8.9	9.8	10.3	9.5	8.9	9.4	8.8	8.5	8.5
Average gross monthly wages, CZK [5]	14793	15866	16917	18041	19024	17680	18903	.	.
annual change in % (real, gross)	3.8	5.4	6.5	3.7	3.4	4.0	4.0	.	.
Consumer prices, % p.a.	4.7	1.8	0.1	2.8	1.9	1.7	2.8	2.8	2.5
Producer prices in industry, % p.a.	2.8	-0.5	-0.4	5.7	3.0	6.9	0.3	3	2
General governm. budget, EU-def., % GDP [6]									
Revenues	38.7	39.9	40.7	41.4	41.1	.	.	40.8	40.4
Expenditures	44.5	46.7	47.3	44.3	43.7	.	.	44.1	43.9
Deficit (-) / surplus (+)	-5.9	-6.8	-6.6	-2.9	-2.6	.	.	-3.2	-3.4
Public debt, EU-def., in % of GDP [6]	25.3	28.8	30.0	30.6	30.5	.	.	31.5	32.4
Discount rate, % p.a., end of period	3.8	1.8	1.0	1.5	1.0	1.3	1.0	.	.
Current account, EUR mn	-3652	-4426	-5044	-5245	-2071	628	8	-2000	-2000
Current account in % of GDP	-5.3	-5.5	-6.2	-6.0	-2.1	2.7	0.0	-1.8	-1.7
Gross reserves of NB incl. gold, EUR mn	16400	22614	21340	20884	25054	21246	24570	.	.
Gross external debt, EUR mn	25368	25738	27624	33212	38818	34358	.	.	.
FDI inflow, EUR mn	6296	9012	1863	4007	8837	1101	793	.	.
FDI outflow, EUR mn	185	219	183	817	688	34	131	.	.
Exports of goods, BOP, EUR mn	37251	40711	43051	53995	62961	14582	17830	71000	78000
annual growth rate in %	18.3	9.3	5.7	25.4	16.6	27.2	22.3	12.4	10
Imports of goods, BOP, EUR mn	40675	43026	45243	54824	61606	13709	16938	69000	76000
annual growth rate in %	16.6	5.8	5.2	21.2	12.4	20.2	23.6	12.3	10
Exports of services, BOP, EUR mn	7913	7501	6882	7790	8662	1935	1983	9500	.
annual growth rate in %	6.4	-5.2	-8.3	13.2	11.2	20.3	2.5	10	.
Imports of services, BOP, EUR mn	6211	6792	6466	7397	8011	1819	1954	8800	.
annual growth rate in %	5.2	9.4	-4.8	14.4	8.3	17.1	7.4	10	.
Average exchange rate CZK/USD	38.04	32.74	28.23	25.70	23.95	22.90	23.79	.	.
Average exchange rate CZK/EUR (ECU)	34.08	30.81	31.84	31.90	29.78	30.02	28.59	29.4	29.0
Purchasing power parity CZK/USD	14.60	14.27	14.50	14.55	14.20	.	.	.	.
Purchasing power parity CZK/EUR	16.76	16.58	16.99	17.03	16.77	.	.	.	.

Notes: 1) Preliminary. - 2) According to ESA'95, real change based on constant prices of previous year. Revised data due to FISIM adjustment. 3) According to new calculation. - 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; Eurostat; wiiw forecasts and European Commission (Spring 2006).