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The Czech Republic: after record trade surplus, growth to slow down

The impressive performance of the Czech economy has continued, with 5.8% GDP growth reported for the third quarter of 2006. However, this official estimate is likely to be eventually subject to a downward revision, which appears to be a regular practice of the Czech statistical office. In December 2006 the CZSO lowered its GDP growth estimates for the three preceding quarters, with the highest revision for the first quarter of 2006, substituting 6.4% for the proud 7.1% initially announced. Since the beginning of 2006 private consumption has been growing steadily at about 4%, definitely faster than in the recent past. Government consumption fell in both the second and third quarters of 2006. In part the decline in government consumption is a 'base effect' of high one-off purchases of weaponry for the army in 2005 (but possibly also on account of the prolonged formation of the new government). Private consumption has been contributing about 2 percentage points (p.p.) to overall GDP growth in the first three quarters of 2006. The nation-wide wage bill rose 4.4% (in real terms). However, the gross mixed income of the household sector (i.e. of the small family businesses) has been contracting in real terms. Growth in real disposable income of the entire household sector has been lagging behind the real growth in household consumption (since 2003). This tendency is accompanied by a progressively declining saving rate of the household sector. Very low interest rates on household deposits (about 1%) do not encourage saving while much higher interest rates on loans (above 5%) do not deter a sustained rise in lending to households. The ratio of bank debt to households' disposable income (close to 33%) is quite low by international standards. A further rise in lending (primarily supporting households' housing investment) is to be expected in the future.

Growth in the gross operating surplus of the corporate sector has been accelerating. In the first three quarters of 2006 the surplus rose over 8% nominally (close to an estimated 7% in real terms¹). The dynamics of gross operating surplus corresponds to the dynamics of gross fixed capital formation (investment), which rose in real terms by about 6.7% in the first three quarters of 2006. The contribution of rising fixed investment to GDP growth was moderate (estimated at about 1.7 p.p.).

Inventories have continued to rise for the fourth quarter running. Their impact on GDP growth recorded in the first three quarters of 2006 matches that of fixed investment (1.7 p.p.). The data available do not say anything on the composition of inventories.

¹ The price deflator for gross capital formation was about 1% in 2006. It may be worth noticing that in current euro terms the gross operating surplus of the corporate sector rose by 13.7%. (On average the Czech koruna strengthened, nominally, by 5.3% vs. the euro in 2006.)

However, some indirect evidence indicates that the share of 'work in progress' in the rising inventories may be rather low. The implication would be that rising inventories represent primarily accumulating stocks of finished products (but perhaps also of raw materials). Should the inventories become excessive, in due time they may require de-stocking which would then suppress overall GDP growth.

The contribution of foreign trade (goods and non-factor services) to GDP growth fell to about 0.9 p.p. in the first three quarters of 2006 (down from about 4.1 p.p. in the same period of 2005). This dramatic change in the role of foreign trade in generating overall growth happened quite abruptly. Throughout 2005 exports grew about 5 p.p. faster than imports (in real terms). But in the first quarter of 2006 that differential narrowed to about 2 p.p., followed by 1 p.p. in the third. Moreover, it should be remembered that in 2005 the one-off purchases of arms inflated the recorded imports (and of course lowered the size of the trade surplus that would have been recorded in absence of those purchases). In 2006 the dynamics of 'regular' imports (disregarding the effects of imports of arms) appears to be higher than the real growth of exports. Despite this, the trade surplus was record high in nominal terms.

It must be stressed that the change in the role of trade involves an acceleration of imports. There are no signs of a slowdown in the growth of exports, which continue to rise at double-digit rates. Such a speed of export growth is a sign of advanced structural change in the export sector, with a further rise in the share of medium-high-tech goods (such as machinery, and electrical and transport equipment, produced primarily by FDI firms). Of course, the ability of exports to expand at double-digit rates will depend on the presence of proper production capacities. At present the average level of capacity utilization is very high (close to 87%). This may limit growth of exports for a while. The completion of new FDI manufacturing projects (e.g. car factories) currently under way will add to export capacities in 2008 and beyond.

The ongoing improvements in labour productivity and falling unit labour costs, which seem to have been strongest in the export-oriented sectors, may be insufficient in the more traditional sectors supplying price-elastic, lower-tech products. The continuous nominal appreciation of the Czech koruna not only affects negatively exports of such products (e.g. textiles, food, beverages and tobacco), but also encourages their higher imports. While rising imports of competitively priced consumer goods will support further beneficial structural changes, at the same time they will be limiting the overall contribution of foreign trade to GDP growth, and GDP growth itself.

Employment has been growing steadily, if slowly, with the unemployment rate falling. In actual fact employment (and output) could have been higher provided more labour had been available. That the demand for labour in some segments of the economy already

exceeds its supply is confirmed by the fact that the registered employment of foreigners rose by about 18% within one year.² (Of course, the number of unregistered working foreigners has probably risen even faster.) Interestingly, emerging labour shortages do not seem to be strengthening growth in wages. Wages follow a rising trend, without outpacing labour productivity. In fact wages lag behind aggregate output: the share of employees' compensation in the GDP is falling consistently, if not very strongly. (In 2003 that share stood at 43.8%, in 2006 it probably reached 43%.) One possible reason why labour shortages do not translate into more pronounced wage hikes may have something to do with the presence of a reserve army of employable foreigners, who stand ready to displace native employees, should these demand too much. Besides, the constant pressure from low-price imports of standard goods may be disciplining both business and workers. The latter may believe that easy success in getting higher wages may come at a higher risk of unemployment in the near future. Even if such unemployment were to be reasonably temporary, it may nonetheless be considered too painful.

The reasons underlying the fairly slow drift in wages explain, to a large extent, also the relatively low inflation. Despite very high levels of capacity utilization, producer price inflation slowed down in 2006 (also on account of the nominal appreciation of the Czech koruna). Consumer price inflation was somewhat higher than in 2005. However, approximately one third of the current inflation is the direct effect of rising indirect taxes and regulated prices (utilities). Interestingly, higher oil prices did not seem to have secondary impacts.

In September 2006 the Czech National Bank responded to higher inflation by raising its interest rates by 0.5 p.p. Despite this interest rates are quite low, and unlikely to rise significantly either in 2007 or 2008. Yields on ten-year government bonds are lower than in the euro area. Despite this the Czech currency keeps strengthening nominally.

The political situation remains unstable. The new government installed in December 2006 does not have any solid parliamentary backing and is unlikely to serve the full term. This will certainly limit its ability to consolidate public finances. The general government deficit in 2007 will probably surpass the 4% of GDP mark, in violation of the 3.3% target set in the 2005 Convergence Programme. Increased social spending is mandated by new pieces of legislation. Besides, a part of the deficit seems to result from the old obligations incurred in the aftermath of the banking crisis of 1996. Despite high deficits, public debt remains quite low (less than 30% of the GDP). Given the low interest rates on the government debt and quite fast economic growth, the fiscal situation is not really bad. Nonetheless, it will take time before the Czech Republic can be admitted into the

² Compensation of foreign workers reported by the balance of payments amounted to 0.6% of the GDP in 2005 and (an estimated) 1% in 2006.

Exchange Rate Mechanism. (The Czech authorities are not in a hurry to join the eurozone anyway.)

Summing up, GDP growth is likely to slow down somewhat in 2007, primarily on account of a stronger rise in imports. Besides one can expect some adjustments following the very strong accumulation of inventories. Supply bottlenecks (labour shortages, very high levels of capacity utilization) may also restrict export growth, at least temporarily. But the 'fundamentals' remain solid: positive structural changes go on, labour productivity growth remains strong, wage hikes are moderate, and inflation and interest rates are very low. Moreover, despite continuing currency appreciation, foreign trade will continue to generate respectable surpluses. There is only one cloud overshadowing this otherwise rosy picture: the income of foreign investors, which is larger than the trade surpluses, is rising even faster than the latter.

Table CZ

Czech Republic: Selected Economic Indicators

	2000	2001	2002	2003	2004	2005	2006 ¹⁾	2007	2008
									forecast
Population, th pers., mid-year	10272.5	10224.2	10200.8	10201.7	10206.9	10234.1	10266	.	.
Gross domestic product, CZK bn, nom. ²⁾	2189.2	2352.2	2464.4	2577.1	2781.1	2970.3	3220	3470	3750
annual change in % (real) ²⁾	3.6	2.5	1.9	3.6	4.2	6.1	5.9	5	5
GDP/capita (EUR at exchange rate) ²⁾	5985	6750	7841	7933	8540	9745	11068	.	.
GDP/capita (EUR at PPP - wiiw) ²⁾	13020	13730	14580	15390	16380	17290	18790	.	.
Gross industrial production									
annual change in % (real) ³⁾	1.5	6.7	1.9	5.5	9.6	6.7	10	8	8
Gross agricultural production									
annual change in % (real)	-4.5	2.5	-4.4	-7.6	14.9	-4.8	.	.	.
Construction industry									
annual change in % (real)	5.3	9.6	2.5	8.9	9.7	4.2	6	.	.
Consumption of households, CZK bn, nom. ²⁾	1134.7	1206.9	1248.1	1317.4	1391.1	1454.4	.	.	.
annual change in % (real) ²⁾	1.3	2.3	2.2	6.0	2.5	2.8	4	4.5	4
Gross fixed capital form., CZK bn, nom. ²⁾	612.5	659.3	677.8	687.5	729.3	740.9	.	.	.
annual change in % (real) ²⁾	5.1	6.6	5.1	0.4	4.7	1.3	7	6	4
LFS - employed persons, th, avg. ⁴⁾	4731.6	4750.2	4764.9	4733.2	4706.6	4764.0	4810	.	.
annual change in %	-0.7	0.4	0.3	-0.7	-0.6	1.2	1	1	1
LFS - employed pers. in industry, th, avg. ⁴⁾	1429.4	1470.6	1463.1	1424.7	1409.0	1422.0	1490	.	.
annual change in %	-2.7	2.9	-0.1	-2.6	-1.1	0.9	5	.	.
LFS - unemployed, th pers., average	454.5	421.0	374.1	399.1	425.9	410.2	380	.	.
LFS - unemployment rate in %, average ⁴⁾	8.8	8.1	7.3	7.8	8.3	7.9	7.3	6.7	6.5
Reg. unemployment rate in %, end of period	8.8	8.9	9.8	10.3	9.5	8.9	7.7	7.5	7.5
Average gross monthly wages, CZK ⁵⁾	13614	14793	15866	16917	18041	19024	20200	.	.
annual change in % (real, gross)	2.4	3.8	5.4	6.5	3.7	3.4	3.6	3.6	3.6
Consumer prices, % p.a.	3.9	4.7	1.8	0.1	2.8	1.9	2.5	2.5	3
Producer prices in industry, % p.a.	4.9	2.8	-0.5	-0.4	5.7	3.0	1.6	2.5	2
General governm. budget, EU-def., % GDP ⁶⁾									
Revenues	38.1	38.7	39.5	40.7	41.5	40.4	40.1	40.2	40.5
Expenditures	41.8	44.5	46.3	47.3	44.4	44.1	43.6	43.8	43.8
Deficit (-) / surplus (+)	-3.7	-5.7	-6.8	-6.6	-2.9	-3.6	-3.5	-3.6	-3.2
Public debt, EU-def., in % of GDP ⁶⁾	18.2	26.3	28.5	30.1	30.7	30.4	30.9	30.8	31.0
Discount rate, % p.a., end of period	5.0	3.8	1.8	1.0	1.5	1.0	1.5	.	.
Current account, EUR mn	-2945	-3652	-4426	-5044	-5245	-2071	-5000	-5500	-5500
Current account in % of GDP	-4.8	-5.3	-5.5	-6.2	-6.0	-2.1	-4.4	-4.4	-4.0
Gross reserves of NB incl. gold, EUR mn	14159	16400	22614	21340	20884	25054	23755	.	.
Gross external debt, EUR mn	23285	25368	25738	27624	33212	38818	40995 ^{ix}	.	.
Gross external debt in % of GDP	37.9	36.8	32.2	34.1	38.1	38.9	.	.	.
FDI inflow, EUR mn	5404	6296	9012	1863	4007	8837	5100	.	.
FDI outflow, EUR mn	47	185	219	183	817	688	1300	.	.
Exports of goods, BOP, EUR mn	31483	37251	40711	43051	53995	62961	75600	85000	95000
annual growth rate in %	27.8	18.3	9.3	5.7	25.4	16.6	20	12	12
Imports of goods, BOP, EUR mn	34876	40675	43026	45243	54824	61606	73900	84000	95000
annual growth rate in %	32.0	16.6	5.8	5.2	21.2	12.4	20	13	13
Exports of services, BOP, EUR mn	7436	7913	7501	6882	7790	8662	9300	.	.
annual growth rate in %	12.5	6.4	-5.2	-8.3	13.2	11.2	7	.	.
Imports of services, BOP, EUR mn	5904	6211	6792	6466	7397	8011	8700	.	.
annual growth rate in %	7.6	5.2	9.4	-4.8	14.4	8.3	9	.	.
Average exchange rate CZK/USD	38.59	38.04	32.74	28.23	25.70	23.95	22.60	.	.
Average exchange rate CZK/EUR (ECU)	35.61	34.08	30.81	31.84	31.90	29.78	28.34	28.0	27.5
Purchasing power parity CZK/USD	14.37	14.57	14.27	13.89	14.03	14.08	14.02	.	.
Purchasing power parity CZK/EUR	16.37	16.76	16.57	16.41	16.63	16.79	16.69	.	.

Note: The term 'industry' refers to NACE classification C+D+E.

1) Preliminary. - 2) According to ESA'95 (FISIM-adjusted and real change based on previous year prices). - 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; European Commission (Autumn 2006); wiiw forecasts.