

## CZECH ECONOMY AT THE BEGINNING OF 2002: UNCERTAIN PROSPECTS

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### Abstract:

Domestic demand, especially private household consumption and fixed capital investment was the main engine of continuing economic growth. At the same time, strong domestic demand did not provoke regular inflationary pressures. Inflation has stopped to be a threat of macroeconomic stability since the last quarter of 2001. Therefore, the Czech monetary policy could follow the overall world trend in basic rate cuts, the appreciating Czech currency being, however, very reluctant to monetary policy steps.

The slowdown in Western Europe was felt predominantly in the Czech industry, which was very sensitive especially to the decline of demand for Czech industrial exports to Germany. The scope of external imbalance was approximately the same as in previous year – low level of import prices helped to offset the negative impact of weakening foreign demand. The current account deficit was comfortably offset by ongoing inflow of FDI.

**Keywords:** Czech economy, monetary policy, world economic growth, labour market, external balance

**JEL Classification:** 0110, 0520

### 1. Summary

Accelerated GDP growth observed since the second half of 2000 continued during 2001. In 2001, GDP grew by 3.6 %.

Domestic demand, namely private household consumption and fixed capital investment, were the main engine of GDP growth. Government consumption decreased slightly and the decrease of net exports represented – again – a negative contribution to GDP growth in 2001.

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Strong domestic demand has not induced significant inflationary pressures so far. The gap between developments of consumer and producer prices was in the opposite direction than in 2000. At the end of 2001, the producer price index was

Table 1  
Main Macroeconomic Indicators

		1996	1997	1998	1999	2000	2001	2002f
GDP growth	%, real	4.3	-0.8	-1.2	-0.4	2.9	3.6	<b>3.0</b>
Industrial sales	%, real	6.8	6.1	0.6	-0.5	8.4	5.5	<b>5.0</b>
Industrial production	%, real	2.0	4.5	1.6	-3.1	5.8	6.8	<b>4.0</b>
Construction output	%, real	4.8	-3.9	-7.0	-6.5	5.6	9.6	<b>7.0</b>
Retail sales	%, real	11.4	1.9	-7.2	2.1	4.6	4.3	<b>4.5</b>
Inflation	%, average	8.8	8.5	10.7	2.1	3.9	4.7	<b>4.4</b>
Inflation	%, e.o.p.	8.6	10.0	6.8	2.5	3.9	4.1	<b>3.8</b>
Net inflation <sup>1)</sup>	%, e.o.p.	6.6	6.8	1.7	1.5	3.0	2.4	-
Industrial producer prices	%, e.o.p.	4.4	5.7	2.2	3.4	5.0	0.8	<b>2.0</b>
Nominal wages	%, average	18.4	10.5	9.3	8.2	6.6	8.5	<b>8.0</b>
Unemployment rate	%, e.o.p.	3.5	5.2	7.5	9.4	8.8	8.9	<b>8.5</b>
Exports	%, nom.	6.6	20.0	17.7	9.2	23.3	13.1	<b>12.0</b>
Imports	%, nom.	13.0	15.3	7.5	7.5	28.2	11.7	<b>10.0</b>
Trade balance	CZK bill.	-155.8	-151.2	-76.3	-69.9	-126.8	-119	<b>-100</b>
Current account	USD bill.	-4.3	-3.2	-1.0	-1.1	-2.4	-2,6	<b>-2.2</b>
Current account	% of GDP	-7.4	-6.1	-1.9	-2.0	-4.8	-4.7	<b>-3.5</b>
Financial account	USD bill.	4.3	1.1	2.6	2.5	3.4	4.0	<b>3.5</b>
Financial account	% of GDP	7.4	2.1	4.8	4.7	6.8	7.2	<b>5.3</b>
State budget	% of GDP	-0.1	-1.0	-1.6	-1.6	-2.4	-3.3	<b>-2.2</b>
Gross foreign debt	USD bill.	21.2	21.6	24.3	22.9	21.5	22.0	<b>21.0</b>
Official FOREX reserves	USD bill.	12.4	9.8	12.6	12.9	13.1	14.5	<b>18.0</b>
M2 growth	%, e.o.p	9.2	10.1	5.2	8.1	6.5	12.4	<b>10.0</b>
PRIBOR 3M	%, average	12.02	16.00	14.33	6.85	5.40	5.20	<b>5.00</b>
CZK/EUR <sup>2)</sup>	average	35.32	35.75	35.85	36.88	35.60	34.10	<b>31.50</b>
CZK/USD	average	27.14	31.71	32.27	34.60	38.60	38.00	<b>36.00</b>

1) Target indicator of the CNB; consumer price inflation net of administered prices.

2) Until 1998 the CZK/DEM exchange rate converted by 1 EUR = 1.9583 DEM.

Source: Czech National Bank, Czech Statistical Office, forecasts by Komerční banka (bold figures).

more than 3 percentage points lower than the consumer price index (0.8 % y/y and 4.1 % y/y, respectively). The developments of world raw material prices, especially the prices of oil, were the main reason behind the low growth of producer prices in 2001. Also the strengthening CZK pushed the import prices down, acting as another significant antiinflationary factor (see Table 1).

Industrial output grew strongly in the first half of 2001. From June onwards, a slowdown in industrial growth is visible as a consequence of weakening foreign demand. The recession in the EU hit the construction in the last quarter of 2001, too. Cost inflationary pressures both in industry and construction were attenuated by more rapid growth of labour productivity, which outpaced the real wage growth more than three times.

The developments both of imports and exports showed a strong volatility during the whole year 2001. Slowdown in West European economy started to affect Czech foreign trade as the second quarter of 2001. The decline of German demand hit the Czech trade balance worst. Weakening exports to EU countries combined with declining world raw material prices led to a slowdown of imports (as a consequence of high import intensity of Czech exports). As a result, the trade balance ended with a deficit of CZK 119.0 bill. (CZK 2 bill. less than in 2000).

The rate of unemployment went through two distinct phases: in the first half of 2001, unemployment rate fell by 1 percentage point (from 9.1 % in January to 8.1 % in July); afterwards, it started to grow, reaching 8.9 % by the end of the year. Data on Czech unemployment show that it is more and more of a structural character, as significant dynamics of the economy have only resulted in small fluctuations in the unemployment rate.

In 2001, we have witnessed a continuing, rather strong inflow of foreign direct investment. The volume of FDI inflow to reached USD 4.9 bill. Around 60 % of FDI were either greenfield investments or reinvestment of profits, the rest is FDI connected with privatization.

Strong inflow of FDI and solid macroeconomic fundamentals (vis-à-vis the EU average) are the main factors behind the strengthening of Czech currency. In 2001, CZK appreciated by 4.2 % against the EUR and by 1.6 % against the USD (yearly averages).

### *Outlook for 2002*

Relatively solid economic growth will continue in 2002. Due to low dynamics in the EU economy and declining foreign demand, we estimate Czech GDP growth in 2002 to be at – or slightly above – 3 %. Again, the driving force behind this output dynamic will be domestic demand, especially household consumption and fixed capital investment. Fiscal easing will boost government spending, what is typical for an election year.

We expect that the investment demand will register a slowdown; this – with weak external demand – will hit industry: industrial output will increase by 4 %. Construction output will slow down, to 7 % growth. This will be lower growth than in 2001, but a good result in the European context.

Weakening demand will affect also the Czech labour market. Domestic companies will be very reluctant about hiring additional labour. The unemployment rate will not show any significant changes and will be around 8.5 % at the end of 2002.

Future developments both of consumer and producer prices will again depend primarily on world prices of raw materials. Czech economy will continue to be protected from domestic cost-inflationary pressures by labour productivity growth out-

pace that of real wages in key industries. In December 2002, headline inflation will reach 3.8 %, year on year.

Weak foreign demand will keep the growth of exports around 10 %. On the other hand, the high import intensity of exports, combined with low raw material prices and a strong currency will keep the growth rate of imports under that of exports. The trade deficit will thus decrease to approximately CZK 100 bill.

Nominal appreciation of the CZK, caused by massive inflows of foreign capital (our estimate for 2002 is USD 6 bill.), as well as by better fundamentals of the Czech economy compared to main trade partners in the EU, will continue. We expect an appreciation of CZK to 31-32 CZK/EUR and around 36 CZK/USD. The current account deficit will be around or slightly under 4 %, which is a figure within the safe interval.

## 2. External Environment

Trends in the Czech Economy in 2002 will be strongly determined by the timing of economic revival in the USA and Western Europe. The time dimension of their revival will – via exports into the EU – influence the prospects of growth in the Czech Republic.

In the USA, 2001 was the year of oncoming recession (which started before the September terrorist attacks), and the year of the rate cut. The US recession was not provoked by declining consumption, but, rather, by the fall of fixed capital investment. Consumer demand cared for a mild character and short duration of the recession. At the beginning of 2002, a large amount of Fed easing is already in place. The U.S. economy is showing signs of bottoming out. Leading economic indicators – though sometimes still contradictory – signal a revival between the first and second quarters of 2002. Other industrial economies may be lagging a bit behind the USA; consequently, there is more scope for – and likelihood of – further monetary policy easing outside the USA in early 2002.

Table 2

**Growth of Gross Domestic Product** (constant prices, in %)

	2000	2001f	2002f	2003f
USA	4.1	1.0	2.0	4.5
Japan	2.4	-0.2	-1.8	0.5
Euroland	3.4	1.4	1.5	2.9
Asia (excl. Japan)	7.2	5.2	6.3	6.8
Central and Eastern Europe	5.7	3.1	3.4	4.5
Latin America	4.2	0.7	1.4	3.6
World	4.7	1.3	1.5	4.2
World Trade	11.2	1.2	2.5	5.0

Source: DB Research, Komerční banka.

As Table 2 shows, the growth in 2002 for the USA and Euroland is very modest. But the annual figures are masking the quarterly profile that goes from mild recession

sion around the turn of 2001 to a mild recovery in the mid-year to about 3 – 4% growth at the end of the year. And we can await a notable acceleration of economic growth in North America and Western Europe in 2003, close to peak years for these regions in the 1980s and 1990s.

What is less certain is whether the Euroland economy will enter the recovery phase at the same time as the USA. The German economy continues to perform weakly, while in addition France no longer seems to be able to protect the euro area from low growth.

In general, lower oil prices, together with negative output gaps, mean central banks have little to fear on the inflation front in the first half of 2002. By the second half of the year, with accelerating growth and labour markets tightening again (and with rising oil prices), central banks are likely to begin to re-adjust interest rates higher (see Table 3).

Table 3  
**Interest Rates Forecast** (% , end of period)

	2001	2002		
		Q1	Q2	Q4
USA	1.75	1.75	2.00	2.25
Japan	0.00	0.00	0.00	0.00
Euroland	3.25	3.25	3.25	3.50

Source: DB Research, Komerční banka.

When the EU reacts promptly to the revival of American economy one can also expect that Czech exports could follow and revive in the second half of 2002, with all the positive effects on industrial growth and fixed capital investment.

There is, however, another, pessimistic scenario. The EU economy might react with a delay and revive only in the second half of 2002. The well-known structural rigidities, elections in the two largest countries (Germany, France), and the inability – due to the Stability Pact – to use similar fiscal stimulus as now in the USA, can lead to a slow, hesitant revival that will actually be felt only toward the end of the year. Under this scenario, loss of Czech exports to the EU could lead to a slowdown of GDP growth by approximately half a percentage point.

Even under that unfavourable situation, however, the prospects for the three Central European candidate countries are, in some aspects, positive. It seems that they will not be hit by the contagion from Argentina (as they were not hit by the Turkish crisis in 2001). The perspective of an oncoming EU membership will further foster the inflow of direct foreign investment, so urgently needed to modernize the economies and close the gap in productivity levels. And low interest rates in the world markets will help to ease the costs of debt servicing, as well as to acquire additional (and cheaper) resources from these markets.

### 3. External Balance

In 2001, the balance of payments showed a solid surplus of CZK 52 bill. The current account slightly improved, the deficit amounting to CZK 101 bill. which is a decline of CZK 8.7 bill. in comparison with 2000. Current account deficit thus rea-

ched 4.7 % of GDP which should be regarded as a safe level. The net inflow of investments on the financial account reached CZK 153 bill., mostly as a consequence of continuing massive inflow of foreign direct investments (CZK 183 bill.).

Table 4

**Balance of Payments (CZK bill.)**

	2000		2001	
	Q1 – 3	Q1 – 4	Q1 – 3	Q1 – 4
Current account	-40.4	-87.7	-57.0	-101
of which: Foreign trade	-73.3	-120.8	-80.7	-119
Balance of services	35.9	51.1	38.2	54.0
Balance of incomes	-12.7	-51.4	-22.1	-48.4
Transfers	9.7	11.0	7.6	12.5
Capital account	0.0	-0.1	0.0	-0.1
Financial account	60.1	148.1	74.6	153.5
of which: Direct investments	121.2	190.8	106.8	183.3
Portfolio investment	-44.2	-68.2	19.0	34.9
Long-term capital	13.4	-4.9	-3.1	3.2
Short-term capital	-28.8	31.7	-47.2	-65.0

Source: Czech National Bank, forecast by Komerční banka.

### 3. 1 *Current Account*

#### *Trade with Goods*

As usually, trade with goods was the main factor affecting developments on the current account in 2001. Growth rates both of imports and exports have been slowing down since the beginning of 2001. At the same time, the developments both of imports and exports showed a strong volatility during the whole year 2001 as well as the trade deficits in individual months. The full year growth rates amounted to 11.7 % for imports and 13.1 % for exports in 2001. The trade deficit reached CZK 119 bill. in 2001, which was negligibly lower than the deficit in 2000 (CZK 120.8 bill.).

Again, Czech foreign trade has been affected by two major factors: level of foreign demand and world prices of raw materials. Combination of principal factors affecting Czech foreign trade in 2001 was quite the opposite than last year. In 2000, the exports were promoted by strong foreign demand, especially by the German one. On the other hand, the importers were hit by high world raw material prices. In 2001, the oil prices were by approximately 15 % lower than in 2000 but foreign demand for Czech exports started to weaken as of second quarter.

The import prices declined by 1 % year on year, January – November 2001, export prices increasing by 0.8 % year on year. The terms of trade thus improved by 5.7 percentage points, January to November 2001. The decline of oil prices in autumn 2001 were quite surprising for most analysts who expected another oil price

hike after the US terrorist attacks. However, the reality was quite different. Note that the commodity group of mineral fuels registered growth of import prices by 85 % in 2000, year on year, while in 2001 these prices showed an average decline of 1.9 % year on year, January to November.

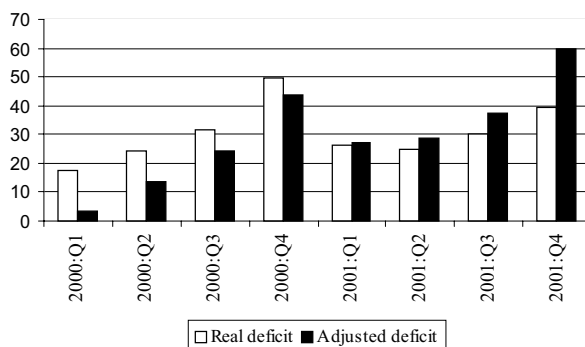
Table 5  
**Import Prices, Export Prices, Terms of Trade** (growth in %, year on year)

	I: 01	II: 01	III: 01	IV: 01	V: 01	VI: 01	VII: 01	VIII: 01	IX: 01	X: 01	XI: 01
IP	5.6	3.6	2.8	2.2	-0.7	-0.7	-0.6	-2.2	-4.7	-6.9	-8.0
EP	4.7	4.2	3.8	1.9	0.9	0.5	0.4	-0.4	-1.1	-2.7	-2.8
TT	-0.9	0.6	1.0	-0.3	1.6	1.2	1.0	1.8	3.8	4.5	5.7

Source: Czech Statistical Office.

Developments of import and export prices affected Czech trade balance favourably in 2001, which was exactly the opposite situation than in 2000. While the trade deficit in constant prices would amount to only CZK 90 bill. in 2000, the trade deficit in constant prices would amount to approximately CZK 150 bill. in 2001. The developments of prices in foreign trade thus helped to offset the impact of weakening foreign demand. The differences between real trade deficits and trade deficits adjusted for the impact of export and import prices (trade deficits in constant prices) are well illustrated by Figure 1.

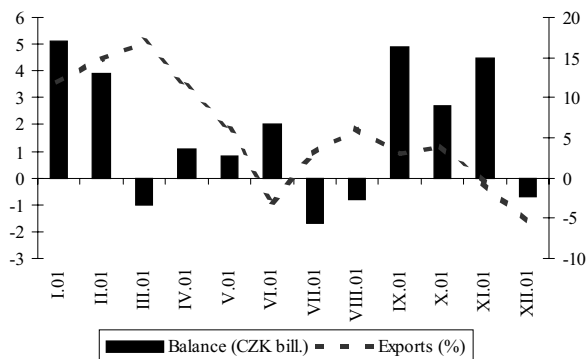
Figure 1  
**Adjusted and Real Trade Deficit** (CZK bill.)



Source: Czech Statistical Office, Komerční banka.

Slowdown of West European conjuncture has started to affect the Czech foreign trade as of second 2001 quarter. The decline of German demand hit the Czech trade balance worst. The exports to Germany increased by 6.4 % year-on-year only, the 2001 surplus (26.5 bill.) reaching to only half of the surplus in 2000. Trade with other important West European trading partners (France, Austria, United Kingdom, Italy, Belgium) has remained intensive, however, these countries accounted approximately for only one quarter of Czech exports. Also the trade with neighbouring Slovakia and Poland did not registered any slowdown, these two countries accounting for almost 15 % of Czech exports.

Figure 2  
Czech Foreign Trade with Germany



Source: Czech Statistical Office.

### *Services, Incomes, Transfers*

Services showed minor changes in 2001. Transport and tourism registered net profits, other services ending in the red numbers again. Other services showed an improvement as a consequence of declining demand of residents. This item which has direct connection with strong FDI inflow seems to burden the current account permanently. Companies which invest in the Czech Republic often prefer to buy some of services included into this item (legal services, advertising, financial services, insurance) in the countries of their origin. Decline in demand for these services could also indicate that the weaknesses on the supply side of the Czech economy in this area have been gradually improving.

Developments on the incomes balance is tightly connected with the developments of overall investment position of the Czech Republic, again especially due to FDI inflows. After a short period of consolidation (1999: Q4 – 2000: Q3), a new wave of the deterioration of incomes balance has been visible since the last quarter of 2000. Repatriation of profits and payments of dividends have been the main factor of growing deficit of incomes. This is one of the dark sides of massive inflow of foreign direct investments. Transfers showed an improvement of CZK 1.5 bill., the surplus in the first three quarters amounting to CZK 7.6 bill. Developments in the third quarter showed a slight improvement which will continue until the end of the year due to payments to Czech citizens as a compensation for imprisonments or the forced labour in Germany during the second world war.

While the surplus in services and transfers corresponds to their mid-term potential, the deficit of the incomes balance will grow continuously. This may be a serious problem for the total Czech current account in the year to come. Regarding the scope of all its items, one should stress again, that trade deficit up to 5 % of GDP seems to be safe as for mid term sustainability.



### 3. 2 *Financial Account*

#### *Direct Investments*

Foreign direct investments were – again – the major part of the capital inflow amounting to CZK 183 bill. in 2001. Foreign direct investments in 2001 were realised predominantly in the form of purchasing companies, or increasing their assets, however, green-field investments grew as well. Sales of Radiomobil, Vodovody and kanalizace Prague and Komerční banka represented major investments as well as investment of Philips display components or the entry of American investors into Chemistry Works at Prague.

Similar to recent years, major part of FDI was oriented towards services (approximately two thirds). In the short time horizon, these investments have no direct effects on future exports and often they even invoke imports. However, in the long run, the impact of FDI to restructuring and cultivation of entrepreneurial activities has been very important – as already mentioned above.

#### *Portfolio and Other Investments*

Portfolio investments offered better picture in 2001 than a year before as seen well in Table 4. The tendencies in this area of investment changed as of the beginning of the year. While the net outflow amounted to CZK 68 bill. in 2000, the net inflow in 2001 reached CZK 35 bill. The main reason of improvement was the decline in demand of Czech subjects for foreign portfolio investments. This tendency will continue as a consequence of the strong volatility and decline on the world capital markets due to September terrorist attacks and recession in the USA. One should also point out that while equity securities were the field of interest of foreign investors recently, in 2001, the inflow of portfolio investments was concentrated both to equity and debt securities.

Other investments changed also a bit from a year earlier, total outflow amounting to CZK 62 bill. in 2001. Adverse tendencies appeared in the area of long-term and short-term money. Long term investments showed a moderate inflow of CZK 3 bill. Short-term capital developments were affected predominantly by banking sector: contrary to 2000, Czech banks invested strongly abroad.

#### *Outlook for 2002*

The important ratio between current account deficit and the GDP amounted to 4.7 % in 2001. External imbalance thus did not deteriorate in 2001. The deficit was comfortably covered by continuing strong inflow of foreign direct investments. The volume of FDI inflow amounted to almost USD 3 bill., January to September 2001, and reached approximately USD 5 bill. in 2001.

External sector will be influenced by couple of contradictory factors. Weak foreign demand will keep the growth of exports around 10 %. On the other hand, high import intensity of the exports combined with low raw material prices and strong exchange rate will keep the growth of imports under the growth of exports. The trade deficit will thus decrease to approximately CZK 100 bill. in 2002. Another appreciation of the CZK both against the USD and the EUR is expected up to the level of 31 – 32 CZK/EUR and around 36 CZK/USD.

In 2002, the current account deficit will reach approximately 3.5 % of GDP. Structure of foreign direct investments in last two years confirms that the inflow of FDI

may register a slowdown but will not stop after the end of privatization in the Czech Republic. Rate cuts made by the Fed, ECB and other central banks widened the interest rates differential between the Czech Republic and foreign financial markets. Moreover, emerging markets in Central Europe are considered to be a relatively safe place for investments. The inflow of FDI in 2002 can be expected to be even higher than in 2001 amounting to or exceeding USD 6 bill. External balance thus should not show any deterioration.

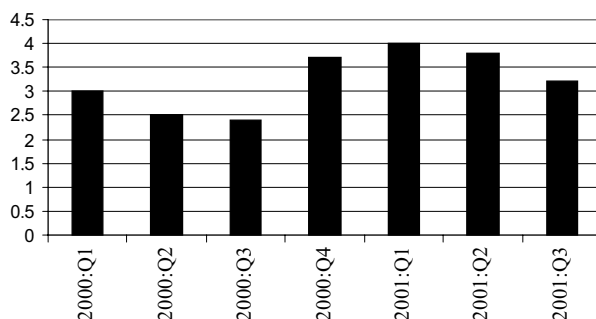
#### 4. Gross Domestic Product

Accelerated GDP growth observed since the second half of 2000 continued during 2001 (see Figure 3). In 2001, GDP grew by 3.6 %. In the fourth quarter, however, the growth slowed down somewhat (to 3.2 %). Slower GDP growth in the fourth quarter of 2001 reflected slower industrial growth, and also a decline in the dynamics of value-added in agriculture and construction. The data so far do not warrant a definite conclusion whether the slowdown in Czech industry and construction has been due to lower demand for net exports – resulting from the recession in European Union countries – though this explanation seems most likely.

In 2001, same trend was observed as in 2000: domestic demand, namely private household consumption and fixed capital investment, as the main engine of GDP growth. Household consumption and fixed capital investment led to an increase in domestic demand by 5.6 % in 2001. Government consumption, by contrast, fell 1.0 % during the same period, partly due to the fact that increases in government spending reflected larger transfers to households. Exports of goods and services went up by 12.0 %, and imports by 13.7 %; the decrease of net exports by CZK 35 bill. representing a negative contribution to GDP growth.

Figure 3

**Growth of Gross Domestic Product (in %)**



Source: Czech Statistical Office.

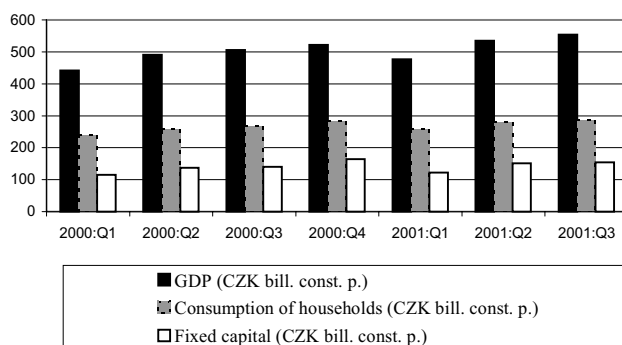
Stronger growth in real household incomes helped to strengthen growth in private consumption to 3.7 % in 2001 (for comparison: in 2000, private consumption grew by 1.7 %). Household incomes have been supported by stronger increases in real average wages and pensions. Nominal wages grew by 8.5 %, and due to relatively moderate inflation, real wages increased strongly by 4.2 %. Including pensions, property incomes and other receipts we estimate the rise of real household incomes by approximately 3 % in 2001. With slowly decreasing propensity to save,

the propensity to consume continued to rise. Moreover, the optimism of households toward their own economic situation drove households to higher spending, too.

Strong inflows of foreign direct investment and improved corporate liquidity helped to increase growth in fixed capital investment to 7.0 % in 2001. Partly, investment was also supported by a slight increase in credit from domestic banks to the corporate sector, after several years of continuing decline in credit granted to non-government borrowers. For the whole year 2001 GDP grew by 3.5 %.

Figure 4

**Gross Domestic Product: Major Factors** (CZK bill., const. prices)



Source: Czech Statistical Office.

### *Outlook for 2002*

Relatively solid growth (by EU standards) will continue in 2002. Due to low dynamics in EU economy and declining foreign demand, we estimate Czech GDP growth in 2002 to be at (or slightly above) 3 %. The driving force behind this output dynamic will be domestic demand, especially household consumption and fixed capital investment. Fiscal easing will boost government spending, what is normal in election year, due to well known rules of political business cycle.

The contribution of net exports to GDP growth will continue to be negative, in spite of the expected revival of economic growth in EU countries in the second half of 2002, and following resurgence of world trade.

Despite all uncertainties emerging primarily from external environment, the Czech economy will continue to catch-up with EU countries. It is almost certain that in the next two or three years, Czech GDP growth will exceed the average EU growth rate by 1 to 1.5 percentage points.

## 5. Domestic Demand

### 5.1 Industry

Industry experienced hardly expectable up- and down-swings in 2001 as a consequence of strong dependency on foreign demand. In the first half of 2001, the growth in industry was more robust than the expectations from the beginning of the year. Later on, a slowdown in industrial output has occurred since June, the growth rates in individual months not reaching high figures from the first half of the year. The full-year growth of industrial output amounted to 6.8 % in 2001, which is lower against the expectations from the beginning of the year; nevertheless it still represents a solid result in the general European context.

The slowdown in the Czech industry in the second half of 2001 was caused predominantly by the weakening of foreign demand followed by a slight slowdown of domestic investment demand. Czech industry was the economic sector hit worst by the economic slowdown in Western Europe. The most significant factor of deterioration was the slowdown of demand in Germany, which is major Czech trading partner: sluggish German demand affected the demand for Czech industrial exports. Economic slowdown in Western Europe slowed the growth in Czech industry by approximately 2 percentage points against the expectations from spring 2001.

Significant part of Czech exports has been oriented mostly for reexports or semi-manufactured goods for West European exports, which have not been showing such a strong deceleration as West European industrial output. This is a part of explanation why the Czech producers are able to compete even under weakening demand and strengthening exchange rate of CZK.

Nevertheless, Czech producers are able to export also due to ongoing restructuring and modernisation in the Czech industry. New technologies and new management are only two of positive outcomes of massive inflow of foreign direct investments into the Czech economy in recent years. More skilled management in most of Czech companies has been seeking for cost reductions in all areas supported by new technologies that are less cost demanding. The wages are not allowed to increase beyond growth of labour productivity in majority of industrial companies. Almost half of the industrial sales were controlled by foreign-owned companies in 2001. At the same time, companies with foreign participation were the best performing ones, their growth of sales being approximately double than the average. Domestic producers then have no other way than to adapt to these new methods if they want to survive.

Table 6

**Labour Productivity and Average Wage in Industry** (growth rates in %)

	1996	1997	1998	1999	2000	2001
Average Real Wage	8.2	3.1	0.0	4.6	3.1	1.4
Labour Productivity	14.2	3.4	0.3	-1.2	9.9	5.0

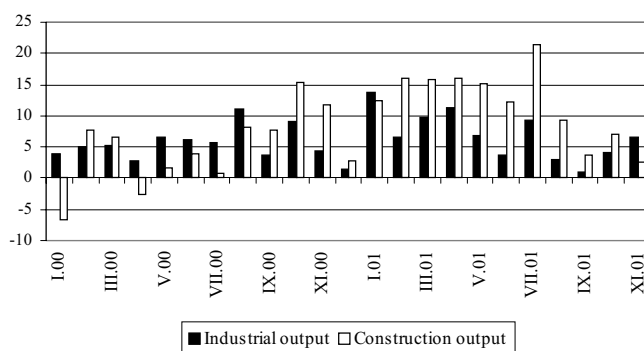
Source: Czech Statistical Office.

Productivity of labour increased by 5.0 % year on year, in 2001. At the same time, real wage grew by 1.4 % only. Decline in unit labour costs enabled Czech exporters to compete on demanding West European countries. Moreover, the ratio between labour productivity and real wage growth remained more favourable in manufactu-

ring industries, where real wage grew by 1.5 % and labour productivity increased by 5.4 % y/y.

Contrary to 2000, when industrial output was supported also by primary industries, manufacturing industry pulled the industrial output in 2001. While mining and quarrying grew only moderately (by 1.9 %) in 2001, manufacturing grew more rapidly, growing by 7.8 %, year on year. Manufacture of oil products performed best (20.2 %) being, however, very sensitive to world oil prices and vulnerable for external shocks. Some manufacturing industries with high value added grew most rapidly, especially manufacture of machinery, equipment, electrical and optical appliances. A notable slowdown in manufacture of transport equipment is experienced as of February 2001. Since the exports of this commodity group registered a solid growth (17 %), the main reason behind the slowdown of car industry is the decline of domestic demand for transport equipment.

Figure 5  
Growth in Industry and Construction (in %)



Source: Czech Statistical Office.

## 5.2 Construction

After hesitant recovery in the first half of 2000, construction was the most rapidly growing industry in the last quarter of 2000 and during the whole year 2001. In 2001 growth of construction output amounted to 9.6 % year on year.

Until September 2001, construction seemed not to be affected by the general slowdown. Nevertheless, last quarter data showed that the slowdown of domestic demand – with a certain time lag – hit also the Czech construction. The causality and the time lag is similar to the timing in the period of recovery. In spring 2000, industry started to grow first pulled primarily by strong foreign demand. There was a time lag of approximately four months before construction started to grow. In 2001, first signs of slowdown appeared in industry in May followed by construction with a time lag of four months, again. However, lower growth rates in the last four months of 2001 were partly caused also by statistical factor: the bases for comparison were extremely high as of August 2000.

Growth in construction has been driven mostly by large commercial construction (assembly halls, hypermarkets) pulled by the foreign direct investments inflow. This is another evidence that the inflow of foreign investments was not only due to Czech privatization – greenfield investments gradually increased. Also, big transport

projects contributed to the growth of construction output, while housing has been experiencing long-term stagnation.

Therefore, there was a strong dividing line between the performance of big and small construction companies. Growth in construction was concentrated to largest construction companies (over 1000 employees). Small companies (to 20 employees) registered only moderate growth. This has been a difference against the industry where small and medium firms were profiting from general economic growth.

Productivity of labour increased by 8.5 % in 2001, which was much higher than in industry. Real wage in construction increased by 2.2 % year on year, unit labour costs thus significantly decreasing. This shows that inflationary pressures which seemed to be threatening in this sector in last months of 2000 diminished and do not represent an actual threat for domestic price developments.

### 5.3 *Services*

Retail trade, transport and communications account for more than 20% of Czech GDP. Retail sales increased by 4.3 % in 2001 supported by strong consumer demand which had increased by 3.6 % in the first three quarters of 2001. The growth of retail sales thus was almost exactly the same as in 2000. Speeding up of consumer demand against the previous year was predominantly a consequence of rapid growth of wages.

Retail sales both of food and non-food items are supported by boom of hypermarkets. Rapid growth of international trade chains still lasts: significant part of permanently massive inflow of foreign direct investments has been oriented towards trade. Moreover, as in 2000, wider offer of consumer credits has been supporting propensity to spend of Czech consumers. As of 2000, the behaviour of Czech households changed, their propensity to spend and get indebted increasing. Most respondents of the opinion poll taken among consumers on the development of economy and their financial situation in January 2002 expect improvement or stagnation of both total economic situation and their financial situation in next twelve months.

Decline of petrol prices supported the sales of petrol, which have started to grow in May. Low statistical bases for comparison were helpful, too. In 2001, the sales of fuels increased by 7 %. It represents a significant recovery in comparison with 2000 when fuel sales grew by only 1.3 %. This confirmed again our estimate that the oil price hike in 2000 made for a slowdown of approximately 5 percentage points in the fuel sales growth.

Sales in transport performed well in the first half of 2001. Since this economic sector is strongly dependent on intensity both of domestic and foreign demand, a notable slowdown occurred in second half of 2001. Last quarter registered a drop of 0.9 % year on year. The full-year figure of transport sales amounted to 4.1 % in 2001.

Telecommunications were the most rapidly growing part of services, again, mostly as a consequence of mobile phones boom. Communication sales grew by 16.9 % year on year, telecommunication ones growing by 19.0 % in 2001 without no significant fluctuations during the year.

### *Outlook for 2002*

Last quarter data proved that Czech producers are able to export even under weak foreign demand and strong CZK. The general economic recovery of world economy cannot be expected before second half of 2001. Therefore, in 2002, the

growth in industry is most probable to be the same as in the second half of 2001. The growth in industry will reach approximately 4 % in 2002.

The general slowdown both of foreign and domestic demand will slow the growth in construction, too. Statistical bases are extremely high until August. Nevertheless, we believe that construction will be able to keep growth of approximately 7 % in 2002 especially due to continuing massive inflow of foreign direct investments.

The consumer sentiment and demand will remain solid in 2002. Low inflation will support spending of households, wages growing at a similar pace as in 2001. Growth of retail sales will be 4.5 %, again, in 2002.

## **6. Inflation**

Relations between producer and consumer prices were exactly the opposite than in 2000. As expected, the gap between consumer price index and producer price index diminished in the first quarter of 2001. During the second quarter, an upturn occurred, the CPI growing more quickly than PPI. In the first half of 2001 thus the CPI reached 5.5 % y/y, while PPI grew only by 3.4 % y/y. In the second half of the year the declining world raw material prices pushed down the import prices which resulted both in decline of consumer and producer prices. However, the gap between PPI and CPI widened. In December 2001, the year-end headline inflation amounted to 4.1 % y/y, the year-end rate of PPI falling to 0.8 % year on year only. The year-end rate of producer inflation was thus by more than 3 percentage points lower than the year-end rate of headline inflation. This indicates that domestic economic growth does not provoke inflationary pressures in the main economic sectors.<sup>1)</sup> Inflation has thus stopped to be a threat of macroeconomic development since the last quarter of 2001.

### **6. 1 Consumer Prices**

The developments of CPI was determined especially by two price items in 2001: food and fuels. The CPI growth in the first quarter of 2001 was moderate corresponding to overall expectations. Regular January deregulations were (in size) similar to 2000 deregulations. In February and March 2001 the CPI almost stagnated mostly as a consequence of decline in food prices due to foot-and-mouth epidemic and favourable developments of fuels prices.

The picture somewhat changed in the second quarter 2001, when both major price items – fuels and foods speeded up. Final level of CPI at the end of June 2001 (5.5 %, year on year) was thus higher than expected in the beginning of the year. Even though some fears appeared about possible demand-inflationary pressures in the Czech economy, third quarter proved, that speeding-up of inflation observable since May to August was provoked by one-off and random factors, especially prices of foreign trips and seasonal increases of agricultural products.

Developments of consumer prices in the last quarter was very favourable mostly as a consequence of declining world oil prices. CPI thus returned to the trajectory outlined by most forecasts in the beginning of 2001. The year-end headline inflation was thus only negligibly higher – by 0.2 percentage points – than in December 2000.

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1) Both the PPI and CPI have been computed on the new basis of revised scheme of new weights (based on 1999 expenditures and sales) in 2001. System of weights, price representatives and respondents choice were revised corresponding better to actual conditions.

Net inflation went along with headline inflation with the exception of months with deregulations. The end-year net inflation amounted to 2.4 % y/y which was by 0.6 percentage points lower than in 2000. The gap between headline and net inflation was thus wider in 2001 than in 2000. After three years of troubles with net inflation target, the CNB succeeded to shoot the inflation target, the corridor being from 2.0 to 4.0 %.

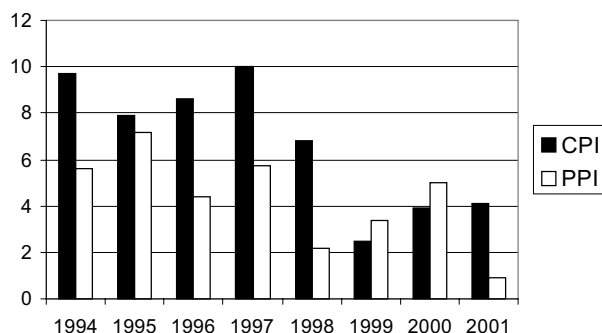
Favourable developments were not based only on decline of world oil prices in the second half of the year, but were also supported by domestic factors. Rapid growth of labour productivity outpacing real wages in key economic sectors prevented the economy from demand inflationary pressures. At the same time, solid growth of consumer demand was not strong enough to cause demand inflationary pressures, even though the growth of wages in 2001 seems to be on the edge of mid-term sustainability.

## 6.2 Producer Prices

Developments of industrial producer prices were probably the biggest macro-economic surprise in 2001: the industrial producer prices have been rapidly declining since March. The year-end rate of producer prices (0.8 %) growth was the lowest since July 1999.

The main factor affecting movements of producer prices were definitely the world oil prices. In 2001, the oil prices were by 15.2 % lower than in 2000, which influenced the import prices favourably. The world oil prices in 2001 did not reach the level of USD 30 per barrel – the level over which they were moving for several months in 2000. According to our estimates the increase of the oil price by USD 1 per barrel causes an increase of PPI by 0.3 – 0.4 percentage point. The sensitivity of producer prices to world oil prices is well illustrated by Figure 7 and is also confirmed by econometric computations (coefficient of determination of the respective model amounted to 0.84).

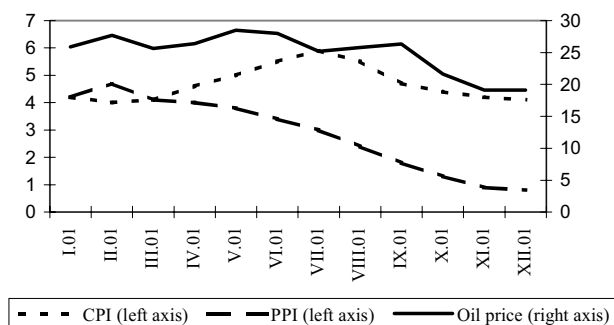
Figure 6  
CPI and PPI (yearly figures)



Source: Czech Statistical Office.



Figure 7  
CPI and PPI (monthly figures)



Source: Czech Statistical Office.

However, there are also deeper macroeconomic and institutional fundamentals than world oil prices behind low growth of PPI in 2001. Restructuring and strong inflow of FDI combined with strong exchange rate of CZK and weakening foreign demand supported the competition and did not allow Czech producers to increase prices. Labour productivity therefore outpaced the growth of real wage during the whole year 2001.

While some cost inflationary risks emerged in construction in second half of 2000, the situation was stabilised in 2001. Prices construction were decreasing steadily, though their deceleration was milder in comparison with the industry, year on year growth standing at 3.4 % in December 2001. Productivity of labour in construction has been outpacing the growth of real wages almost four times. Moreover, prices in construction are affected by all the above factors specified for the case of industry, moreover, prices in construction are monopolised to a great extent because the recent construction boom was concentrated to low number of biggest companies.

Prices of market services accelerated in the first half of 2001 increasing by 5.5 % year on year in the first half of 2001. Prices of services decelerated their growth irregularly in the second half of the year. The year-end rate amounted to 1.7 %. The most dramatic development was observed in prices of agricultural producers: following the sharp growth up to June, their growth rates were falling even sharper in the second half of the year. In 2001, agricultural producer prices grew most of all producer prices on average (by 8.4%), the year-end rate falling to 1.1 %.

### *Outlook for 2002*

The developments both of consumer and producer prices in the second half of 2001 confirmed that no inflationary pressures seem to be emerging in the Czech economy which will continue to be protected from domestic cost-inflationary pressures by productivity of labour outpacing the growth of real wages in key economic sectors. The gap between industrial producer prices and consumer prices is higher than would correspond to the scope of deregulations. This seems to be promising for developments of consumer prices in next months.

Future developments both of consumer and producer prices will be strongly affected by the developments of raw material prices, again. The oil prices are expected

ted to be in 2002 at the same level as in 2001 which is giving bright prospects both for Czech PPI and CPI.

In 2002 another appreciation of the CZK both against the USD and the EUR which would rise the competition further. Similar effects will have weakening domestic investment demand. At the end of 2002, the yearly increase of producer prices will be approximately 1.5 – 2 % year on year. Headline inflation will amount to 3.8 % year on year in December 2002.

## **7. Monetary and Exchange Rate Policies**

During 2001, a gradual and significant appreciation of CZK was to be seen: CZK appreciated against the EUR by 4.2 %, compared to the average 2000 exchange rate. Comparing the average CZK rate in January 2001 with that of December 2001, the appreciation amounts to 7.1 %. The respective figures for the appreciation of CZK against the USD are 1.6 % and 2.5 %. Czech currency thus differentiated notably from the majority of world currencies which registered depreciation against the USD during 2001.

Factors behind the nominal appreciation of CZK are as follows:

- continuing strong inflows of foreign capital, mainly in the form of foreign direct investment. In 2001 the flow of FDI reached USD 4.9 billion;

- better macroeconomic data of the Czech economy, compared to most EU countries, especially those of the Euroland. This is particularly significant with regard to our biggest trade partners (Germany, Austria). While in the Czech Republic economic growth in 2001 reached 3.6 %, in Germany it was 0.6 %. This situation can be expected to last over 2002, and probably in 2003, as well;

- financial investors are permanently interested in trading with the CZK and with CZK-denominated products. New emissions of Eurobonds are an example. Attraction of CZK is not predominantly for speculative capital, as nominal interest rates in the CR are much lower than in Hungary or Poland (in 2001, nominal interest rate in the CR was around 6 %, in Hungary over 10 %, and in Poland around 16 %, respectively). Similar differences were in real rates;

- the approaching date of European Union accession increases the attractiveness of most prominent candidates. Investors correctly assume that the trend of real appreciation, linked to the catch-up with present EU countries, will increasingly proceed via the nominal appreciation of Czech currency.

The trend of permanently appreciating CZK is criticised by Czech exporters who have repeatedly requested the Czech National Bank to intervene. But the scope for CNB to stop this trend is minimal, if not negligible. In November 2001, the CNB cut the repo rate by 50 basic points to 4.75 %. Moreover, the central bank intervened heavily in October and again in late November in exchange markets. Both interventions and the October cut in interest rates failed to weaken the currency, however. The same situation occurred after the last rate cuts, two times by 25 basis points (to 4.25 %) in January and early February 2002: the Czech currency is reluctant to weaken after either rate cuts or direct intervention in the markets.

Under the trend of appreciating currency, the only way of preserving competitiveness of Czech exporters is productivity increase, faster in the Czech economy than in countries of main trade partners – of course, together with product innovation and improved quality of exported goods and services, which increase non-price competitiveness.

The main question is whether in the medium run the Czech economy is able to achieve this goal. In seeking the answer we can regard the past experience. According to Eurostat data, labour productivity in the Czech economy grew, in 1995 –

2000, by an average of 2.8 % annually and in Czech manufacturing by 7.7 %. The increase of manufacturing productivity was more than three times faster than in EU countries. Continuing inflows of FDI, and the ongoing microeconomic restructuring, will with high probability lead to a similar productivity differential in the next five years, so that the gap between productivity levels in the CR and the EU will be gradually narrowed. Eurostat indicates that the relative level of labour productivity in Czech manufacturing was 46 % of EU average in 1995, and increased to 56 % in 2000.

### *Exchange Rate Outlook for 2002*

While in the second half of the 1990s the real appreciation of CZK went mainly through inflation differentials against EU countries, and by a minor part through nominal appreciation, in the next five years the weight of these two factors will be inverted. Due to the medium-term policy of the Czech National Bank, inflation differentials against EU countries will gradually decrease, while – as stated above – the trend of nominal appreciation of the CZK exchange rate will continue.

The impact on the economy of both channels of real appreciation is different. Real appreciation going mainly via inflation differentials (as in the past) facilitates relative price changes within the economy. The result is a higher price adaptability, which is vital for the catch-up before, as well as after the EU accession. The inflation channel of real appreciation can also be more selective, avoiding the over-all pressure on competitiveness which is typical for the nominal appreciation of currency. However, an emphasis on the inflation channel of real appreciation would be in conflict with the declared and realised medium-term monetary policy of the CNB, which aims to depress inflation gradually toward levels close to the EU average.

The CNB has little power to prevent the nominal appreciation of CZK caused by massive inflows of foreign capital, as well as by better fundamentals of the Czech economy compared to main trade partners in the EU. As experience of the last decade has shown, the scope for sterilization of capital inflows is very limited. The use of special government accounts with the CNB, with gradual exchange of privatization incomes, can ease the risk of abrupt jumps in nominal appreciation of CZK, but it cannot turn the overall trend. As the end of 2001 and January 2002 have shown, measures such as lower interest rates or open market operations also have only limited and short-time effect. Hence it can be expected that nominal appreciation of CZK against the EUR will in 2002 continue. The average exchange rate CZK/EUR will amount to 31 – 32 CZK/EUR which will represent 8 % against the average exchange rate in 2001 (34.1 CZK/EUR).

## **8. Public Finance**

The government budget in 2001 ended with a deficit of CZK 67.7 bill. (approx. 3.3 % of GDP) which was lower than expected by most analysts and also below the Ministry of Finance own prognosis from October 2001. While the expenditures were slightly overrun, incomes were lower than the approved budget by roughly CZK 10 bill.

On the income side, while tax and insurance incomes were higher than planned on the whole, the collected value added tax fell unexpectedly by 11 %. This gap partly could have been expected as the budget was built on unrealistic assumptions about the collection of VAT arrears from past periods. On the other hand, a higher than planned increase in the volume of income taxes by legal persons (by 30 %) signifies a relative good business climate which – typically – is characterised by an increased share of profits in output.

On the whole, however, the government budget suffers from a chronic tendency toward permanent deficits. As the years 2000 and 2001 have shown, the problem of Czech budget is not cyclical but structural. A speedup of economic growth has not resulted in lower deficits – on the contrary, the deficit deepened. Within the legislative period of the present government, none – not even partial – reforms steps in the system of public budgets were undertaken, so that the budget problem remains unsolved.

The 2002 government budget, approved in December 2001, expects revenues of CZK 690.4 bill. and expenditures of CZK 736.6 bill. The deficit of CZK 46.2 bill. should practically entirely be covered by government bonds to be issued (CZK 44 bill, with the rest to be financed from government financial assets). However, even this budget is very fragile as it is based on following assumptions: GDP growth of 3.8 %, inflation rate 4.6 %, unemployment rate 8 %. As other parts of our analysis show, both GDP growth and inflation will be (with probability approaching certainty) lower than figures used by the Ministry of Finance in constructing the budget. Hence the planned revenues are overestimated, while on the other hand some expenditures (wages in the government sector, social transfers) are underestimated. One can reasonably expect that the approved budget will be overrun.

In themselves, budget deficits which in one or two years exceed 3 % of GDP are nothing tragic. However, the fact that they are chronic and persist even during economic upturns, and the inability, or lack of willingness, of the current government to take decisive steps to solve them, put the whole situation into a different light. Moreover, 2002 is an election year, so that no conceptual reform of public finance comes into question. If one starts with reform steps in 2003 (and following years), a turn in the trends of growing public debt and chronic deficits of government (and public) budgets can only be expected after 2005. There is also a danger that the massive privatisation incomes in 2002 and 2003 can postpone the solution of this serious structural and systemic problem of the Czech economy to an even more distant time horizon.

## **9. Labour Market**

Year 2001 was less favourable for the Czech labour market than previous year: while during 2000 the rate of unemployment dropped by one percentage point (from 9.8 % in January to 8.8 % in December), the decline during 2001 was less significant (from 9.1 % in January to 8.9 % in December).

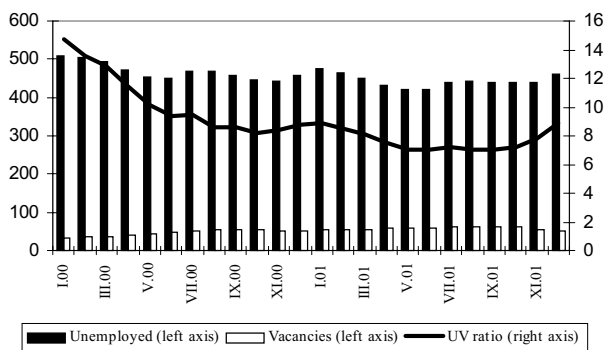
The developments on labour market differed in the first and second half of 2001. In the first half of 2001, along with strong economic growth, the unemployment rate fell by 1 percentage point (from 9.1 % in January to 8.1 % in July). Rapidly growing industries demanded new labour force, especially in manufacturing. Afterwards, the rate of unemployment started to grow, reaching 8.9 % by the end of the year. General slowdown thus affected also the Czech labour market in the second half of 2001.

In the first half of 2001, the number of unemployed declined from 475 thousands to 420 thousands, growing by 40 thousands by the end of the year. Number of vacancies registered adverse movements. In the first half of 2001, fast-growing segments of the Czech economy (mainly manufacturing and some services) have started to create new jobs. Last quarter showed strong drop of vacancies. The above trends are reflected in the relation of unemployed to the number of vacancies. The so-called UV ratio (number of unemployed falling upon one vacancy) has been improving from 8.9 in January to 7.0 in May 2001, followed by stagnation until September. Then a strong deterioration occurred in the last quarter, up to 8.9 in the end of 2001.

Significant regional differences have prevailed, which have been further strengthened by a differentiated inflow of foreign direct investment. The deterioration in the end of 2001 seems to be most visible in the districts with enduring problems, more than 50 unemployed falling upon one vacancy in the regions Karviná and Most.

Figure 8

**Unemployed, Vacancies (in thousands) and UV Ratio (in %)**



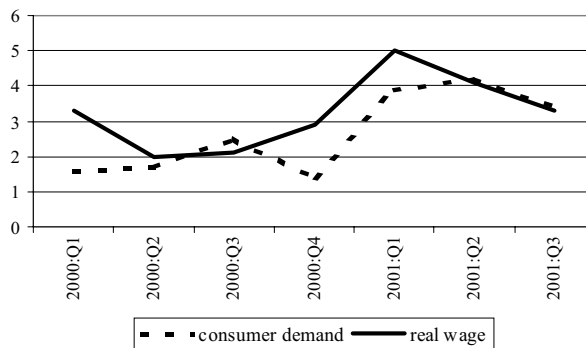
Source: Czech Statistical Office.

Growing pressures on the Czech labour market strongly correlate with the slowdown in the Czech industry experienced since August 2001. In August, the industrial employment stopped to grow, significant drops being notable as of September (e.g. in November the employment in industry declined by 13.5 thousands employees, what represents 1.1 %).

While wage growth was only moderate in 2000 (6.6 %), the picture somewhat changed in 2001, wages accelerating to 9.2 % in 2001: Q1 – Q3. Wages in the business sector grew by 9.3 %, which was slightly slower than in the public sector (9.9 %). In spite of more rapid growth, the average wage in the public sector still remains lower than in the business one (by approximately 14 %). For a more complete picture, one should note that the volume of wages paid in the business sector makes for more than three quarters of the total volume of wages in the Czech Republic. The highest wages are paid by companies with foreign participation, their level exceeding the general average by 30 %. Wages in this segment account for about one quarter of wages in the business sector, their share gradually increasing. The impact of foreign owned companies on the level of wages in the Czech economy is quite strong.

While in 2000 the growth of wages supported the statement that economic recovery was based on a solid background, in 2001 wages could be one of possible future sources of destabilization. A major part of wage structures does not provoke cost inflationary pressures, however, the demand inflationary pressures seem to be more topical. Developments in consumer demand closely follow the growth of real wages. The structure of households expenditures shifted during last decade, services now accounting for more than 60 % of expenditures. Some of services with non-controlled prices seem to be a source of inflationary pressures (note the impact of foreign trips on summer inflation figures). We consider the growth of wages of about 9 % to be on the edge of mid-term sustainability, not provoking demand inflationary pressures. Wage bargaining for 2002 thus seems to be an important issue for future macroeconomic stability.

Figure 9  
**Consumer Demand and Real Wages** (growth in %)



Source: Czech Statistical Office.

### *Outlook for 2002*

Weakening demand will affect also the Czech labour market, especially the number of vacancies, which will continue to decrease. Domestic companies will be very cautious about demanding new labour force and the first half of 2002 will show whether more massive dismissals should be expected. The unemployment rate will not register any significant changes and can be expected around 8.5 % at the end of 2002. Nominal wages are expected to grow at a pace similar to 2001, that is approximately by 8 %.