

Summary of Major Developments

External Factors

1. The development of world's economy has seen a number of pronounced changes in the course of the last decade. Liberalization and deregulation processes have paved the way for further acceleration of world trade and investment activities. Information and communication technologies have become a significant drive for economic growth and productivity of labour. Economic integration of economies of the EU has deepened bringing about low inflation in particular, and supporting trade and cutting down transaction costs. Alas, the process of globalization has also been accompanied by more frequent supply and demand shocks associated with swings in energy prices and tension arising from worsening geopolitical situation.

2. The current world economic situation points to the recession phase of the business cycle giving way to recovery. According to IMF predictions of April 2004, the world economy is projected to grow this year at a rate of 4.6%, an increase of some 0.6 percentage point compared to last year. GDP is estimated to grow by 4.6% in the USA, 3.4% in Japan and 1.7% in the Euro area. The global development is characterized by dynamic growth of world trade, surges of oil prices and metals along with increasing geopolitical risks. The pace of recovery in the Euro area is impeded by weak domestic demand. Growth dynamics are expected to diverge while the unemployment ceases to grow and tensions concerning fiscal stance persist. Growth in the transitional economies of Central Europe is set to gather further speed at an average rate of close to 4%. Estimates suggest that growth of consumer prices will accelerate while fiscal and external imbalances, which can nevertheless be financed, will continue.

Trends and Factors Underpinning the Economic Development in the CR

3. A characteristic feature of the **long-term development of the economy** over 1990-2003 is regarded the instability of economic performance. The economy suffered two recessions, the first during the early stage of transformation followed by the downturn in 1997-1999, both of which hampered the process of economic convergence between the CR and the countries of the EU. When comparing the long-term average growth rate of GDP over the 1994-2003 period, reaching some 2.2 %, with the period of 2000-2003 during which growth averaged 2.8 %, it becomes clear that economic growth edged up somewhat. On the one hand, this acceleration allowed to restart the process of real convergence with then current EU members, on the other hand, GDP growth fell short of both its potential given the prevailing investment level and economic performance of the other countries acceding to the EU.

4. The cause of volatility of economic activity observed in the course of the transformation process may be attributed for the most part to **internal and external imbalances**. These were reflected particularly in swings of monetary and fiscal development, inequality between savings and investment levels, over-indebtedness and over-investment in the economy, excessive use of external sources, divergence between productivity of labour and the level of wages, postponement of structural changes, low productivity of fixed capital, excessive level of classified credit, mismatch of demand and supply in the labour market, discrepancy between public revenues and expenditures. Factors stemming from changes of the external economic environment, be it volatile oil prices or cyclical nature of the world economy, seem to have had a fairly restricted impact on the Czech economy.

5. The economic development was to a great degree shaped by trends and conditions of domestic and foreign, both investment and consumer, demand. Empirical data point to a high correlation between **gross fixed capital formation** and the impact it has on the domestic business cycle. While the boom of 1994-1996 saw fixed capital grow by an annual average of 12.4 %, it declined by an annual average of 2.5 % during the 1997-1999 recession, only to pick up again by 3.8 % p.a. during the upswing that took place in the course of 2000-2003. As a result, the contribution of investment activity to GDP growth moved in tandem. The development was influenced in particular by availability and the cost of financing, foreign direct investment inflows, firms' profitability, the region's investment climate and the gap between the level of domestic savings and that of investment. The gap associated with savings and investment levels, one of the internal imbalances, widened further during the period of 1998-2003 as the rate of investment was more or less stagnating around 30 %, while the rate of gross national savings fell from 28.1 % in 1998 down to 22.6 % in 2003.

6. In contrast to fixed capital formation, the dynamics of **household consumption** was of rather less cyclical nature, rising by an average of 3.7 % p.a., i.e. 1.5 percentage point above GDP growth, over the 1994-2003 period. The fastest growth of household consumption, on average a respectable 6.4 %, was

recorded during 1994-1996, to be followed by a slowdown to 0.8 % in 1997-1999, before climbing up to 3.9 % during 2000-2003. In 2003 growth reached a remarkably high 5.5 %, underpinned by the simultaneous occurrence of a number of exceptional favourable conditions – namely, the stagnation of consumer prices, low costs of financing, high wage growth as well as expectations of gradual increases in consumer prices. The less cyclical nature of the household consumption development can be explained by the fact, that in the midst of volatile economic climate, the population seems reluctant to make significant changes in their consumption patterns and prefers to adjust the rate of savings, as evidenced by a lower propensity to save in the past years.

7. The long-term development of **foreign trade** was characterized by high dynamics of imports and exports, which on most occasions exceeded GDP growth by a treble. Over the period of 1991 to 2003, the average year-on-year growth of exports reached 8.4 %. Given that during the past two recessions export performance came close to the above mentioned trend value of their growth, exports clearly had a major role to play in smoothing out the course of economic downturns. The acceleration of the pace of export growth in 2003 and 2004 was predominantly driven by favourable terms of trade coupled with a pick up in the EU economy. Having occurred in the past two years, a rather novel feature is a looser correlation between the growth of GDP and that of current account deficit.

8. The **price development** reflected a long-term tendency towards a lower inflation rate from the average 9.3 % over 1994-1996 to 7.1 % during 1997-1999, and to go as low as 2.5 % during 2000-2003. In some of the periods the disinflation process was not neutral in relation to economic growth and could thus have slowed down its pace. This is essentially what occurred in the course of the 1997-1999 recession, but also in the years 2002 and 2003, when strong disinflation pressures had materialized only to reduce room for the business sector's profitability and competitiveness, and hence impeding investment activity. By the end of 2003, the long-term trend had given way to price increases. At the same time, the correlation between the tax system and hikes in the price of oil and metals on the world markets plays a key role. As a result, the price development is then heavily impacted by the supply side of the economy.

9. In the long-term development of **unemployment and employment** two different trends became evident. Full employment, i.e. the minimal unemployment rate of 3 %, was in effect recorded during the transformation recession as well as the first stage of the upswing throughout 1994-1996. This was due to limited structural changes and the high absorption capacity of the underdeveloped service sector. The registered unemployment rate has been rising (except for the year 2000) since 1997 to hit a 10.9 % mark in February 2004. The increase in unemployment is subject to a wide range of factors. Perhaps the most significant one was the effect of the downturn in the Czech Republic and the EU during 1997-1999 and 2001-2003, respectively. The effects of the restructuring processes and gains in productivity of labour in the business sector have, to a much greater degree, started to draw labour force from the industrial sector. The widening gap between supply and demand in the labour market has to a large extent contributed to a halt in the tertiary sector's ability to absorb excess labour force.

10. The development of **external economic relations** reveals a trend of growing external imbalances as monitored by the current account of the balance of payments. While in 1998 the current account deficit amounted to 2.2 % of GDP, in the following years it was deteriorating further to reach 6.5 % of GDP in 2003. The factors fuelling the widening of the deficit include in particular the deterioration of the growth of revenues and a decrease in the surplus balance on the services account. This outcome appears to be a consequence of growing internal imbalance in terms of an expanding gap between national savings and investment levels. Thus far, the current account deficit has been financed via a surplus on the financial account; nevertheless, the excess of the financial account over the current account began to diminish, with the excess in 2003 amounting to a moderate CZK 7 billion.