

2. Macroeconomic development

2.1. Performance of the economy

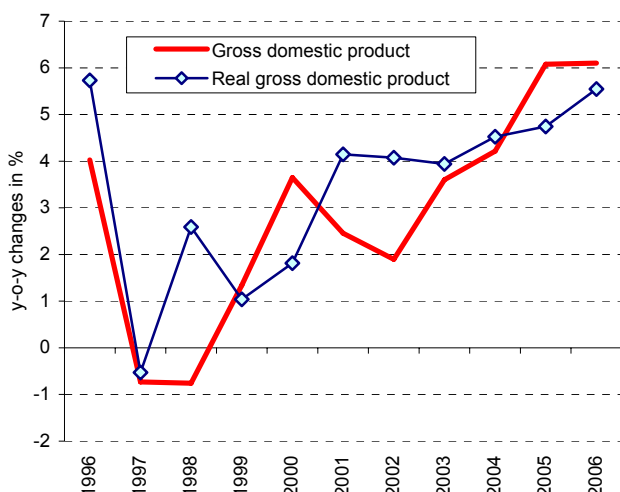
- **High dynamics of economic growth continued**

After a three-year acceleration of economic growth in the period 2003-2005, GDP in 2006 increased by 6.1%, i.e. similarly as in the previous year. From the medium-term (2002-2006) as well as the long-term (1996-2006) aspect when the GDP average annual growth rates were 4.0% and 2.9%, respectively, the growth is qualified as high, being 2.1 p. p. and 3.2 p. p., respectively, above the average.

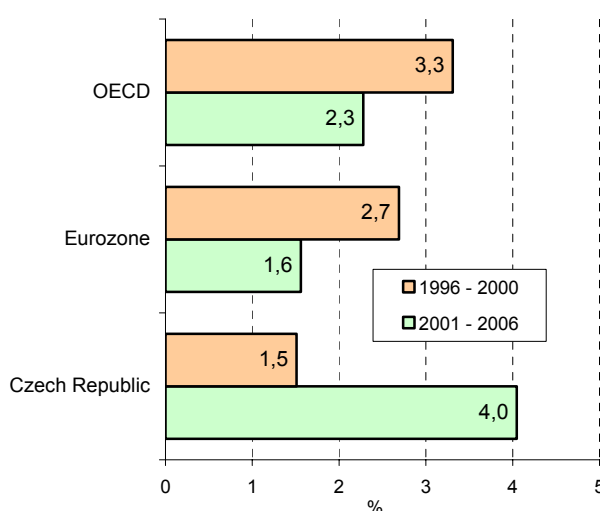
Due to this accelerated growth the CR in 2005 joined the group of rapidly growing countries. In 2006, it maintained one of leading positions within the Central European countries, behind Slovakia (GDP growth by 8.3%), and ahead of Hungary (3.9%) and Poland (5.8%). The difference between the GDP growth in the CR and in Euro area in 2006 exceeded 3 p. p. and indicated further progress in real convergence processes.

Another economy performance indicator recorded a different development compared with GDP, i.e. gross domestic income which reflects the impact of terms of trade. Its growth was, assessing medium-term and long-term trends, always faster than the GDP growth, on average by 0.5 p. p. p.a. However, in 2006, the trend was opposite due to unfavourable development of terms of trade.

Graph 4 Gross domestic product and real gross domestic income (y-o-y changes in %)



Graph 5 GDP – ČR, EU, OECD (average growth rates in %)



Source: OECD

- **Favourable conditions of economic growth prevailed**

In 2006, the economic growth conditions were mostly favourable. Mainly production potential coming from foreign direct investment contributed markedly to two-digit rates of growth of industrial production and exports.

In the last years, dynamic growth of GDP was largely contributed to by joining the duty-free EU zone, low interest rates, increasing employment and production factors productivity. Combination of unfavourable and favourable effects on economic growth showed the exchange rate growth. On the one hand, a relatively strong strengthening of CZK reduced competitiveness of exports but, on the other hand, strong CZK showed a deflation effect on import prices which consequently contributed to the growth of investment activities and household consumption.

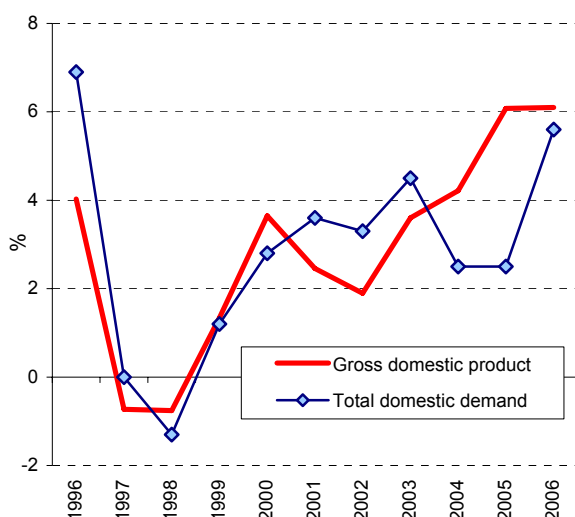
Dynamic growth of energy product prices is one of factors which could have an adverse effect on the economic performance growth. The substance of its negative effect on the economy lays in the fact that the growing costs/expenditure on energy products reduced the space for growing expenditure on other household consumption components. Reduction of investment activity of the company sector was caused by the same reasons.

Demand and its components

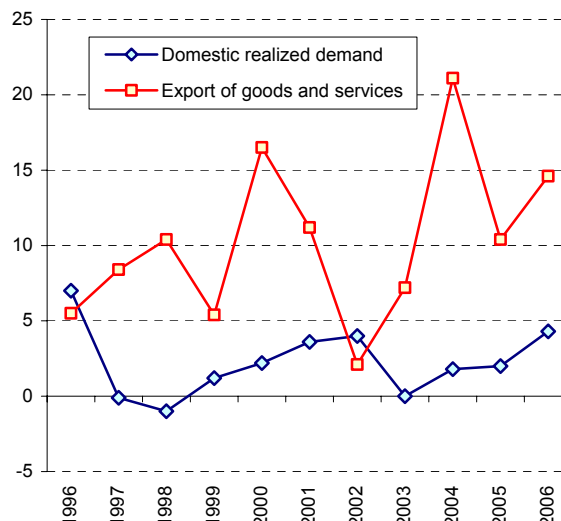
- **External demand grew faster than domestic demand**

Economic growth was, in the period 1996–2006, markedly affected by the development of domestic and external demand. Faster growth of external demand (exports), which in the period 1996 – 2006 increased by 150%, was the main long-term development trend. Domestic demand rose by 48%. Development of domestic and external demand showed fluctuations which were, to a significant extent, influenced by the character of the business cycle (both in the Czech Republic and the EU) and by specific development of the demand components.

Graph 6 GDP and domestic demand
(y-o-y changes in %)



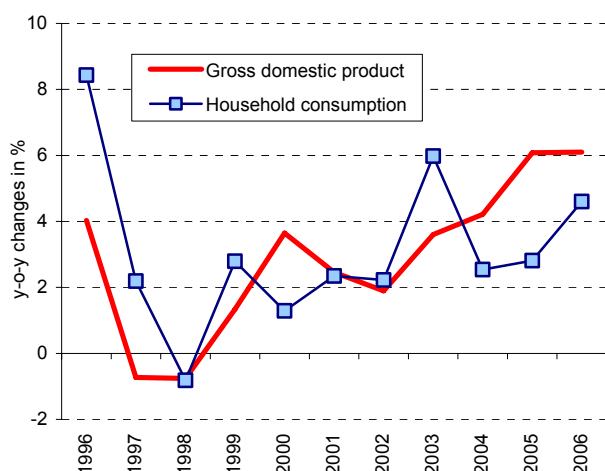
Graph 7 Domestic and external demand
(y-o-y changes in %)



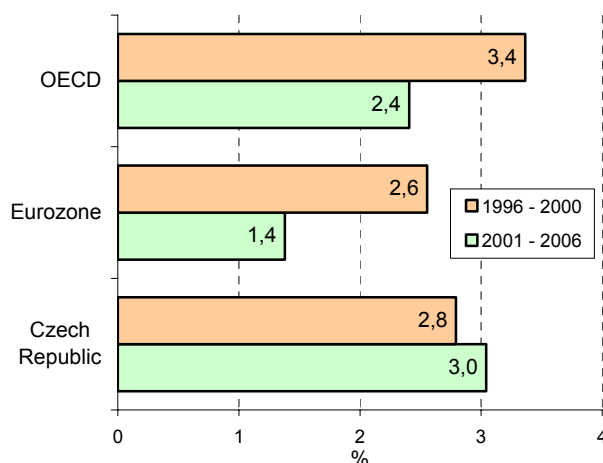
- **Fluctuating consumption was affected by more factors**

To the main characteristics of long-term tendencies of household consumption development in the period 1996–2000 belonged increasing fluctuations in growth and moderately higher average growth rate compared to GDP. The opposite developments were recorded in the period 2001–2006 when household consumption increased slightly slower than GDP. Instability in growth rates of household consumption was caused by higher number of factors. The most important factors were fluctuations in the growth of employment, real wages, inflation, savings of the population and also the cycle of renewal of durables. Probably the most significant role in the opening of scissors between the GDP development and household consumption in the period 2004–2006 was played by rapid development of construction and sales of dwellings supported by the supply of cheap financial products both in form of saving-in building and mortgages.

Graph 8 GDP and household consumption



Graph 9 Household consumption – ČR, EU, OECD (average growth rates in%)



Source: OECD

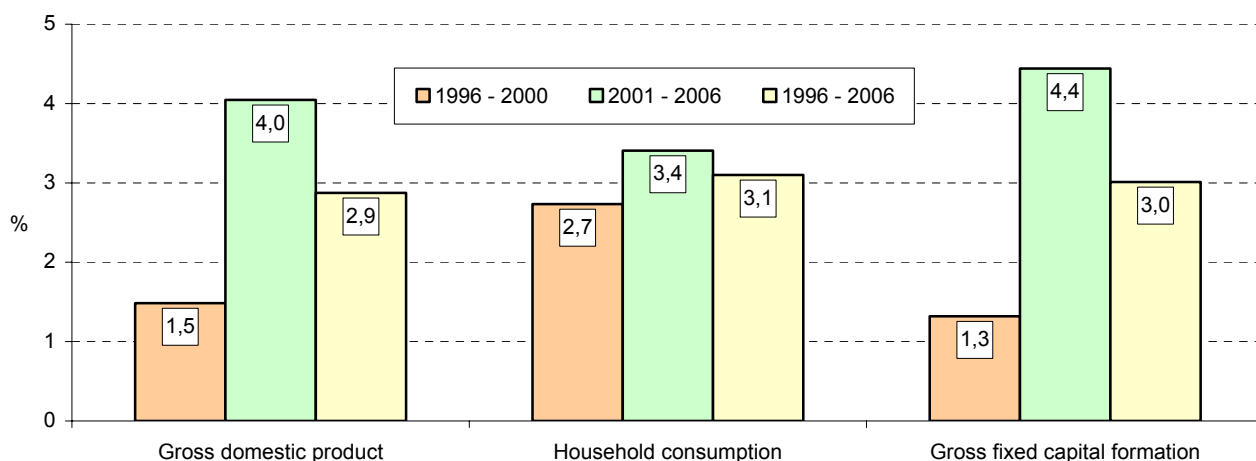
- Household consumption grows slower than GDP**

In 2006, household consumption growth accelerated compared to the previous year by 1.8 p. p. and came closer to the GDP growth. This development was supported mainly by the acceleration of the real wage volume growth by 0.7 p. p. which was attributed primarily to the increase of employment and decrease of unemployment. Higher propensity of the population to consume was indicated over the year by the improvement of consumer confidence indicator and by accelerated growth of retail sales.

- Changes in the structure of consumption continued**

The growth of economic and living standard was accompanied by the change of consumption structure. The share of food consumption in total consumption continued to decrease (from 19.6% in 1996 to 16.2% in 2006). Stagnating share in the consumption had a number of consumption components (recreation, culture, sport, clothing). On the other hand, in the consumption basket the share of expenditure on housing, water, electricity and gas increased and made almost one fourth of total consumption. A higher share of expenditure is recorded also for the segment of post and telecommunications.

Graph 10 GDP and its components – average rates of growth



- Contribution of the consumption of population to GDP in CR remained basically unchanged**

Position of the CR in international comparison of growth rates in relation to household consumption in the period 2001-2006 was not that high as for GDP. The average growth rate of household consumption in the CR was twice as fast compared to the average of Euro area (3.0% in the CR, 1.4% in Euro area – data provided by OECD) but compared to Central European countries save for Hungary it fell behind.

The contribution of household consumption to GDP in the CR is basically stabilized (around 50%). Compared to other countries the contribution is low. The EU average

is around 60%. It is explained mainly by higher contributions of investment and government consumption in the CR which consequently reduced the space for the population consumption growth.

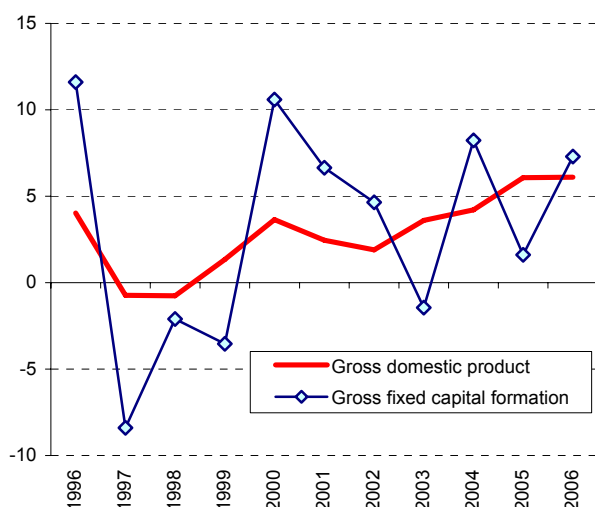
- **Significant contribution of investment to the GDP growth**

Fluctuation of investment activities markedly contributed to the economic activity contraction in the period 1997 to 1999 and to expanding stage of the business cycle in the period 2001 – 2006. Annual growth of gross fixed capital formation reached in the period 2001-2006 4.5% on average and moderately exceeded the GDP growth. To the main determinants of investment processes belonged foreign direct investment, prices of loan capital, specific features of the business cycle, dimensions of company profits and their repatriation across the state border, character of external demand and changes in the manner of fixed assets depreciation. The most important role belongs to foreign direct investment which decisively contributed to the growth of industry and exports. However, it also contributed to fluctuations in investment activity which shows the drop of investment in 2003 (-1.4%) and only a slow rate of growth in 2005 (1.6%).

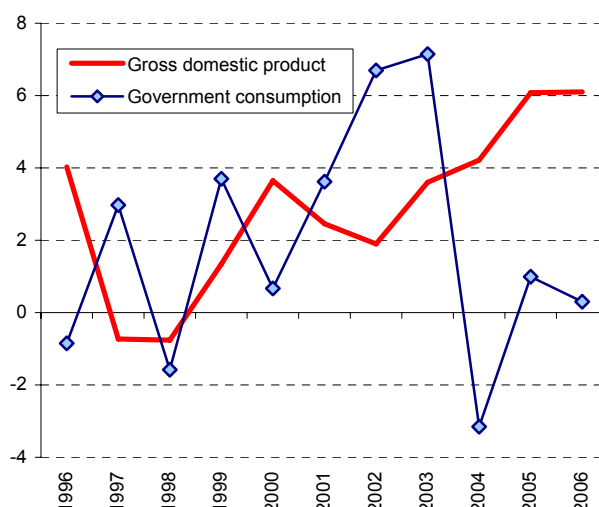
International comparison of the investment growth showed that the CR markedly improved its position in the period 2001–2006 when its average rate of growth was 4times faster than in Euro area. On the other hand, in comparison to Central European transition economies, the average growth of investment in the CR fell behind the development in Slovakia and Hungary.

Comparing the level of investment the CR shows higher value than Euro area, almost by 1/5, which can be explained by certain investment satiation of the advanced countries and by multinational companies' interest in wider investment in the countries with faster return of investment, i.e. in economies which are coming closer to the economic level of more advanced countries.

Graph 11 GDP and gross fixed capital formation (y-o-y changes in %)



Graph 12 GDP and government consumption (y-o-y changes in %)



- **Imports were significantly supported by restructuring**

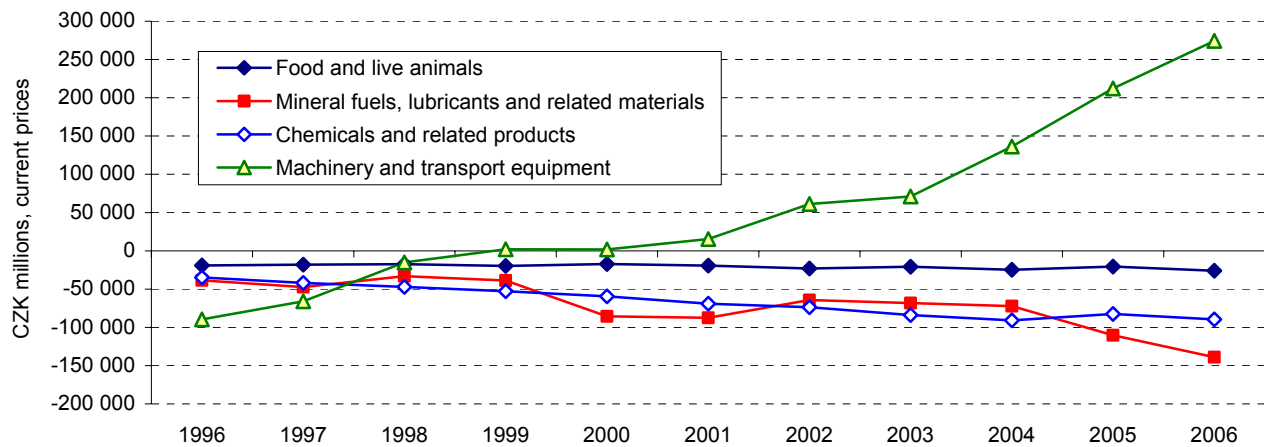
In the 1st stage of the upward phase of the business cycle in the period 2000-2004, significant changes of export conditions took place supported by foreign direct investment. Restructuring and increased dynamics of exports were largely contributed to by the increase of competitiveness due to faster growth of export prices than of import prices. In respect of expanding investment activities initiating the import of goods and services, the balance of external trade was passive. Its scope, however, did not indicate an excessive external imbalance.

- **In 2005 the stage of exceeding imports over exports was started up**

The years 2005 and 2006 represent the last stage of the external trade development where deficit turned into surplus. This process was initiated both by supply and demand. Restructuring processes continued to show their positive effect at the supply side of the economy, especially processes of gradual integration of small and medium-sized businesses into the sales networks of foreign-controlled enterprises. As a result, the imports of sub-deliveries from abroad were reduced. Another specific feature of this period was a certain mitigation of domestic demand which was

increasingly registered in 2005 while in 2006 it was smaller due to the accelerated growth of household consumption and investment. An important role in 2006 was attributed to the revival of economic growth in the EU where GDP increased by 2.8% and thus extended the space for the growth of exports to this territory.

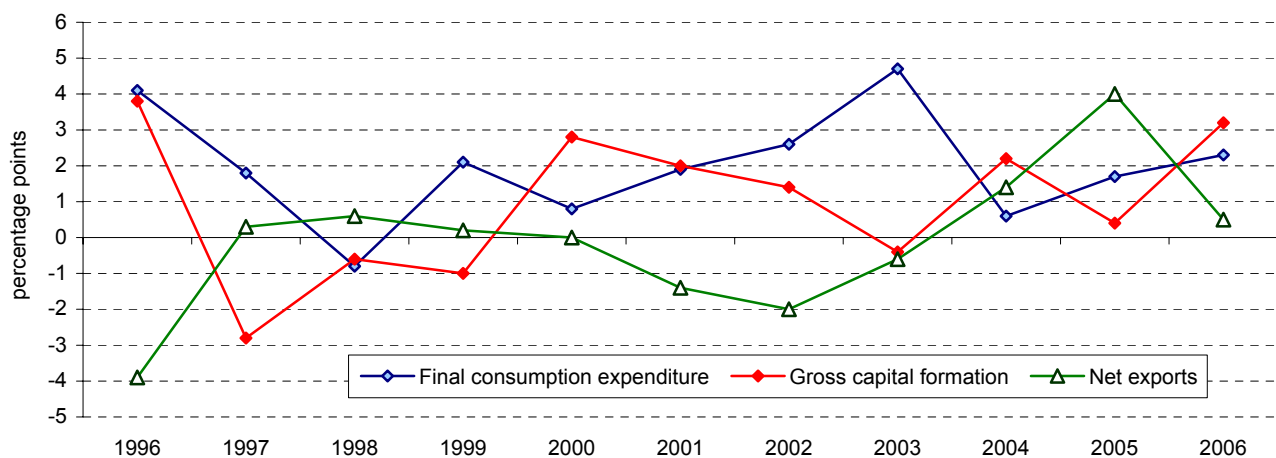
Graph 13 Net exports – selected classes of SITC rev. 3



• **Changes of demand component contributions to the GDP growth**

The most important feature of the demand component contributions to the GDP growth was the changes of their structure. The biggest contribution to the GDP growth was registered in the period 1996-2006 for household consumption, in the average amount of 1.6 p. p. per annum. The household consumption showed the least fluctuations in contributions to the growth. Higher fluctuation was recorded both in gross fixed capital formation and net exports. Recession in the years 1997 and 1998 was contributed to by decreases or slow-downs of gross fixed capital formation and household consumption while, in contrast, net exports showed positive contribution. The development in the period 2000-2006 was affected mainly by the fact whether the economic growth was driven predominantly by domestic or external demand. In the period 2000-2003 it was mainly domestic demand which means that the main contribution to the GDP growth was gross fixed capital formation and household consumption. In the period 2004-2006 the growth of external demand outstripped domestic demand and thus positive contribution of net exports to the GDP growth was registered. Record values of contribution were reached by net exports in 2005 (4 p.p.), while in 2006 contribution of gross capital formation dominated.

Graph 14 Contributions of demand components to GDP growth



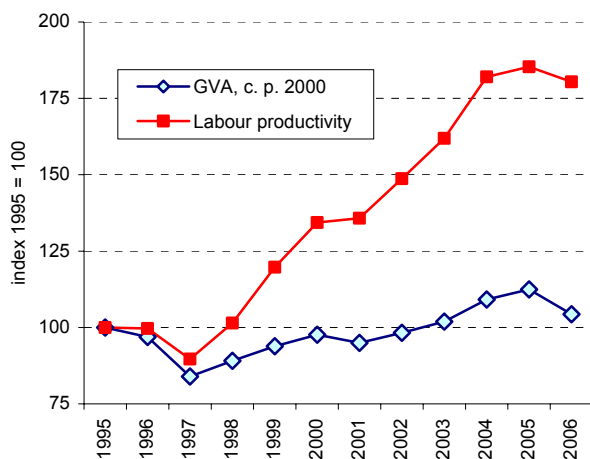
Supply and its components

In the period 1995-2006, the sector structure of the economy was changing gradually. The contributions of agriculture and construction continued to decrease; the contribution of industry first stagnated and then increased, the contribution of services first grew and then decreased.

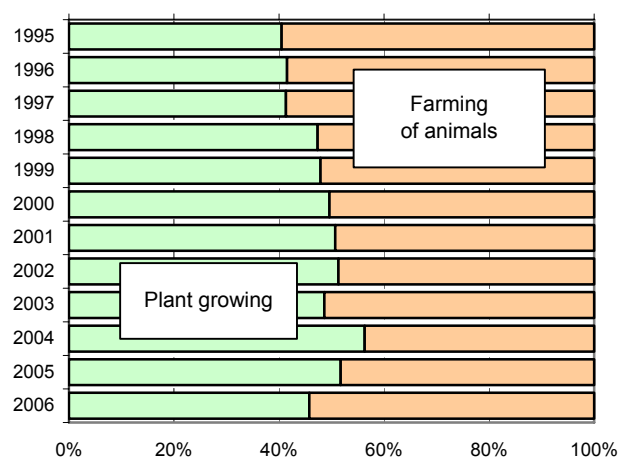
- **Growing of crops increased while farming of animals decreased**

In the long-term development of agricultural performance (Gross Value Added) (in the period 1995-2006) the stagnation trend was gaining ground as a consequence of hardly changing scope of domestic and external demand. To the specific features of the development belonged a marked structural change in the proportion of 'growing of crops' and 'farming of animals'. While the crop growing was increasing, the farming of animals was decreasing by about one fifth. The development was attributed to the advantages resulting from higher labour productivity in the crop growing which was the source of comparative advantage in international markets. In the farming of animals the development was different and consequently the meat production decreased (by approximately 40%, egg laying fell by half and populations of cattle and pigs dropped by more than a fourth).

Graph 15 Gross value added and labour productivity in agriculture



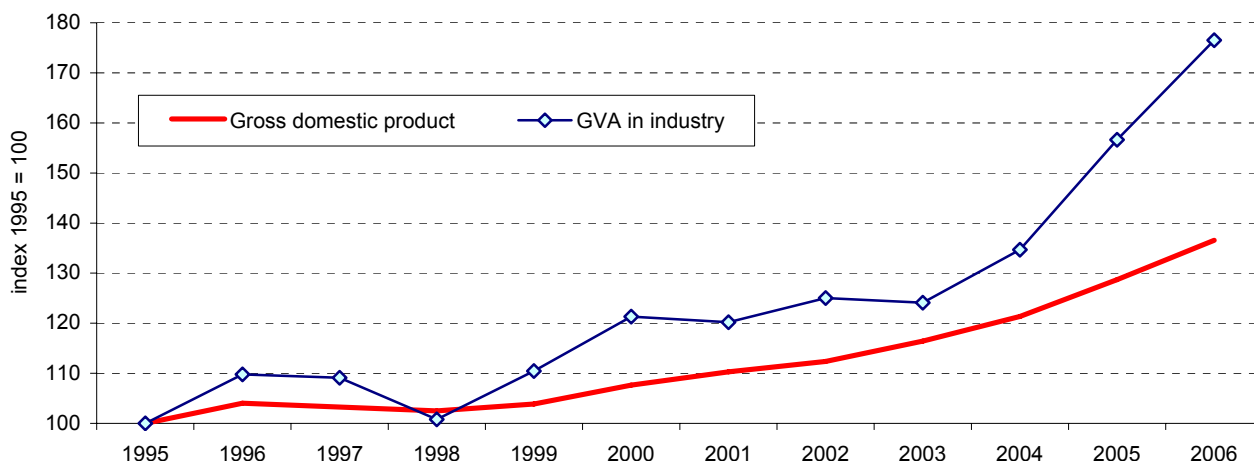
Graph 16 Structure of agricultural production (current prices)



- **Strengthened position of industry in the economy**

Position of industry in the Czech economy is very important. It is proved by the fact that its share in gross value added exceeds 30%; a higher share is recorded only for Ireland. Strong position of industry was apparent also in the period of recession (1997-1998) when its performance caused that the drop of GDP was only moderate and did not last long. In the upward phase of business cycle in the period 2000-2006 gross value added in manufacturing increased by 7.0% p.a. on average whilst in the years 2005 and 2006 the increase was 15.3% p.a.. The performance of industry was in the last years affected by many factors acting on the supply side (in the period 2003 - 2006 production capacities related to structural changes grew rapidly and were accompanied by deepening of intra-company and inter-branch cooperation) as well as on the side of demand, especially external.

Graph 17 GDP and GVA in industry (in real terms in %)



- **Deepening of specialization profile of industry continued**

The most important contribution to growing dynamics of industrial output was assigned to the continuing processes of restructuring. On the one hand, in the industrial structure the share of branches exposed to competition pressure of cheap imports mainly from Asia (many branches of heavy and light industry) decreased. In view of the fact that these were labour intensive industries, the employment shrank. On the other hand, the reduction of the above industries was markedly exceeded by industries and market segments with growth and sales potential. The composition of modified specialization profile is made primarily by manufacture of transport equipment whose share in total value added in industry increased from 5.5% in 1995 to 12.9% in 2006. Dynamically growing shares in industrial structure were recorded also for manufacture of electrical and optical equipment (from 7.4% to 11.5%) and manufacture of rubber and plastic products (from 2.0% to 6.4%).

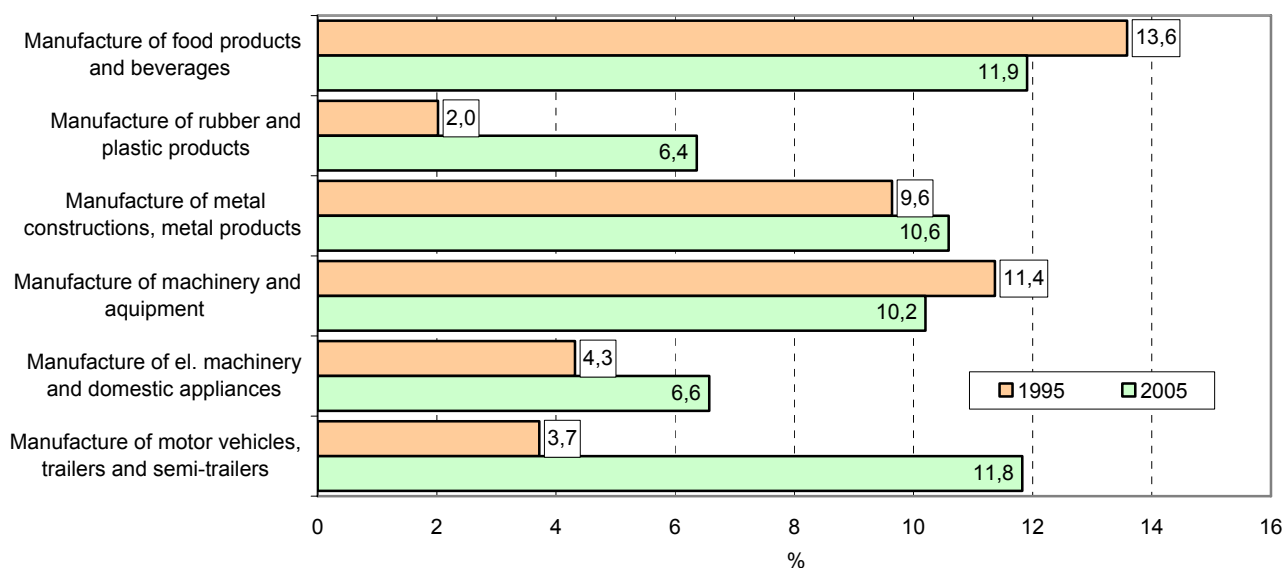
- **Most industries proved their competitiveness**

Most industries showed their competitiveness by exports exceeding over imports, more rapid growth rates of export prices than of import prices and their growing shares in external markets. To the pillars of industrial development belonged the activities of foreign-controlled enterprises. By massive investment they increased labour productivity, employment and output of exports. In the years 2005 and 2006, cooperation was set up with small and medium-sized Czech enterprises which helped to replace the imports by domestic production. Czech industry was doing well, although CZK in certain years strengthened excessively from the long-term view and reduced competitiveness of industrial products in global markets.

Weak points and risks

Among so far weak points of industry belong low competitiveness of some industries, especially chemical and food processing industry (high deficit of external trade). From short-term aspect the high dynamics of production and export of electricity is advantageous but it seems difficult to sustain it for a long period of time.

Graph 18 Development of structure in industry



- ***Suspended growth of services contribution to GDP***

Empirical data covering international comparison showed that in general, the economic growth induces the growth of service contribution to GVA. The causes include not only the changes in the demand structure and investment opportunities but also lower energy intensity of services compared with industry and higher resistance of service industry to fluctuations in economic activity. Development of services in the CR can be split into two periods. In the first period, from 1996 to 2003, significant inter-sectoral structural changes in employment and outputs took place. On the one hand, the outflow of labour force from agriculture and industry was recorded and, on the other hand, the employment increased and thus the output in the service sector. This type of economic development did not continue in the following period. The employment increased again as well as the output of industry and generating of new jobs in services was suspended. As a result, the contribution of services to GDP fell below 60%.

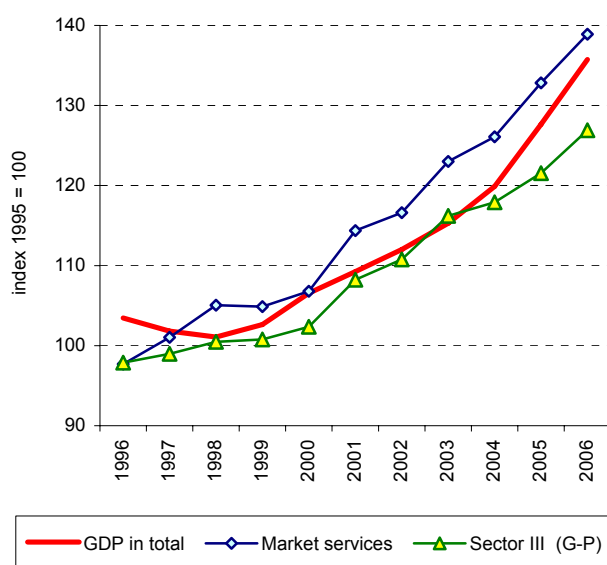
- ***Dominance of trade in growth of service sector***

In the observed period 1996-2006, the service sector recorded the fastest dynamics for sale and repair of motor vehicles, on average by 7.7 % per annum. Among other industries with higher dynamics belong transport, storage and communication and financial intermediation. Structural movements were at rapidly growing industries affected mainly by dynamics of demand, in industries with slower dynamics an important role was played by the supply side due to limited financial sources (education, health). Oddly enough, movements in service structure were only to a lesser extent affected by labour productivity which is for many types of services lower than in industry.

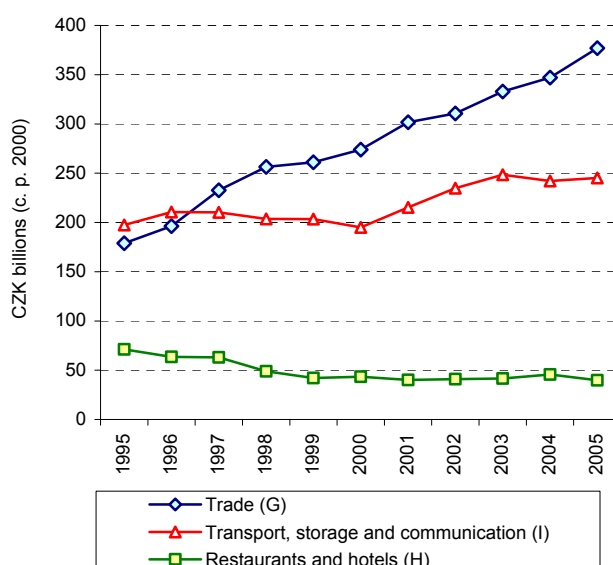
Table 2 Contribution of sectors to gross value added (in %)

Sector	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
I. Agriculture, fishing	6.4	5.9	5.3	5.4	5.3	5.4	5.0	5.1	4.9	5.2	4.9	4.5
II. Industry, construction	35.1	37.9	36.6	35.1	35.5	36.6	35.1	35.3	34.2	35.5	38.1	40.0
III. Services	60.4	57.2	58.7	60.1	59.3	58.0	59.9	59.7	60.9	59.4	57.5	56.5

Graph 19 Gross value added in services



Graph 20 Development of GVA in selected services



- International comparison showed insufficiently developed segments of services**

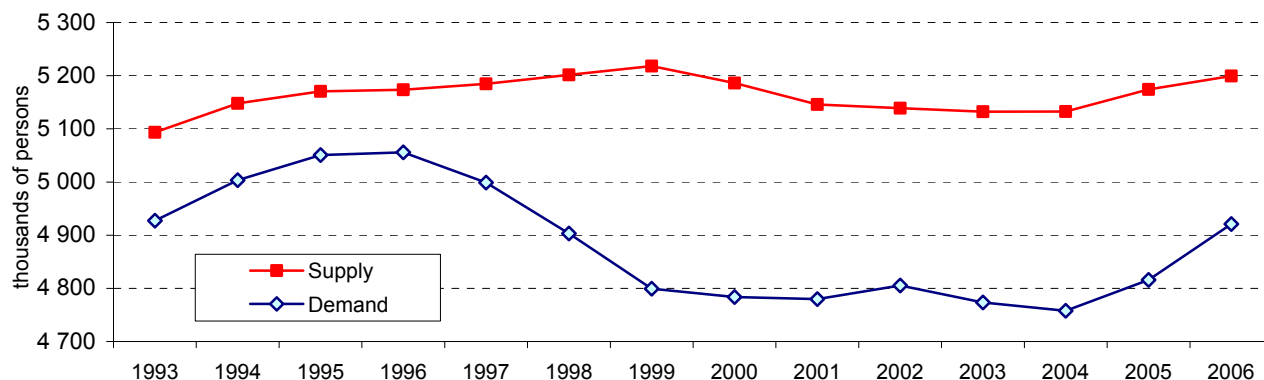
International comparison of value added structure showed differences in position of individual kinds of services in the CR. So far low share in the value added structure in services is recorded in the CR for banking, insurance, real estate and other services. Their contribution to gross value added is about 17% which is one of the lowest values in OECD countries. Similar contribution as recorded for advanced countries is, in the CR, recorded for sale, maintenance and repair of motor vehicles.

Sources of economic growth

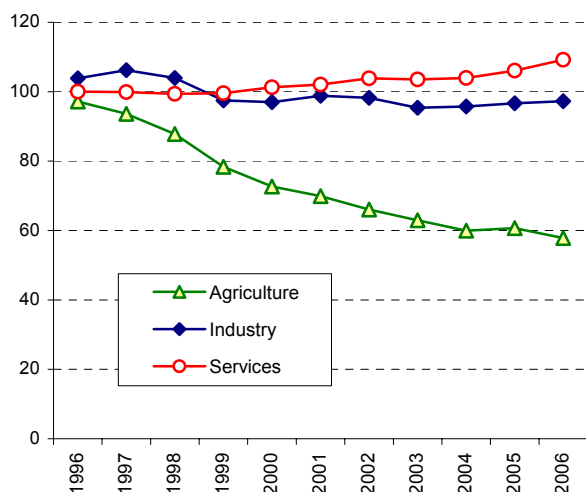
- Changes in the use of labour force sources were affected mainly by business cycle**

Effects of main sources of GDP growth, i.e. employment, fixed capital, labour productivity and capital productivity showed in the reference period 1996-2006 structural changes. Contribution of employment to the GDP growth was related, to a great extent, to the business cycle. In the period 1996 to 1999, employment affected by recession decreased by 1% per annum on average and employment contribution to the GDP growth fell into negative figures. Drop of demand by the end of the 1990s was not attributed only to GDP drop; it applies to the period of rationalization in the second stage of the transformation process when the ineffective employment (over-employment) decreased and labour productivity increased. However, not even the accelerating rate of growth of GDP after the year 2000 managed to create sufficient number of jobs for it was accompanied by a relatively rapid growth of labour productivity. In the period 2000-2006 variability in employment contributions to the GDP growth was shown. In the years of dynamic growth (2005 and 2006) the contribution of employment to the GDP growth approached the level of one percentage point.

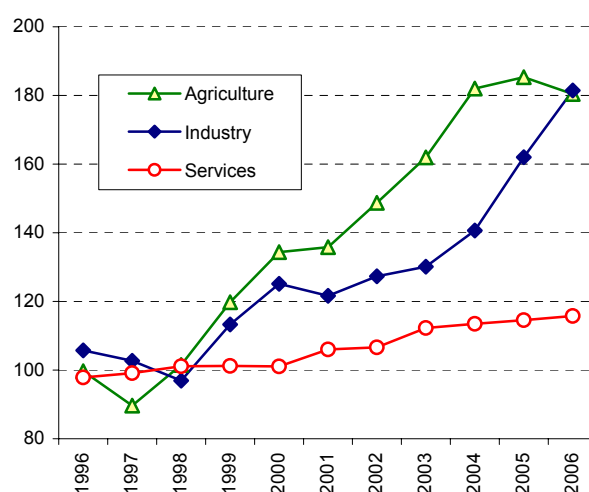
Graph 21 Labour market: supply and demand



Graph 22 Employment
(index 1995=100)



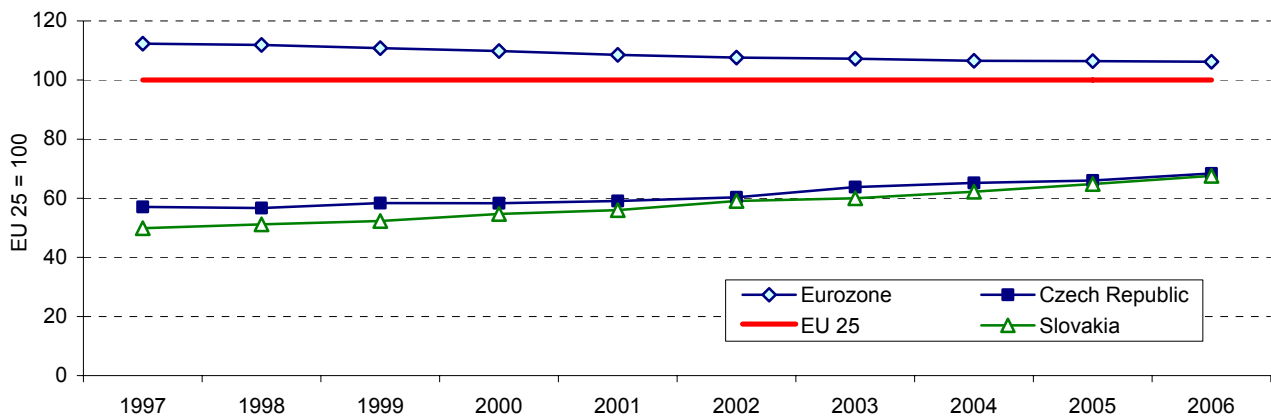
Graph 23 Labour productivity (related to GVA) (index 1994=100)



• **Increase of labour productivity contribution to GDP growth**

Contribution of labour productivity to the GDP growth in the reference period increased and in the period 2003-2006 was ranging from 4.1 to 5.4 p. p. This development was contributed to mainly by progress in technologies and organization. Accelerated growth of labour productivity recorded for the years 2000-2006 (average growth 3.6% p.a.) contributed to rapid approaching of the CR to the EU average (average annual growth of labour productivity was 1.0%). Variations in the development were caused particularly by reduction of investment activities in the advanced EU countries which, to a certain extent, responded to the trend to invest in the countries with lower price and wage level. On the other hand, the most important source of labour productivity growth in the CR were investments which helped to increase the capital-to-GDP ratio creating conditions for labour productivity acceleration.

Graph 24 Labour productivity – international comparison of GDP in PPS per employee

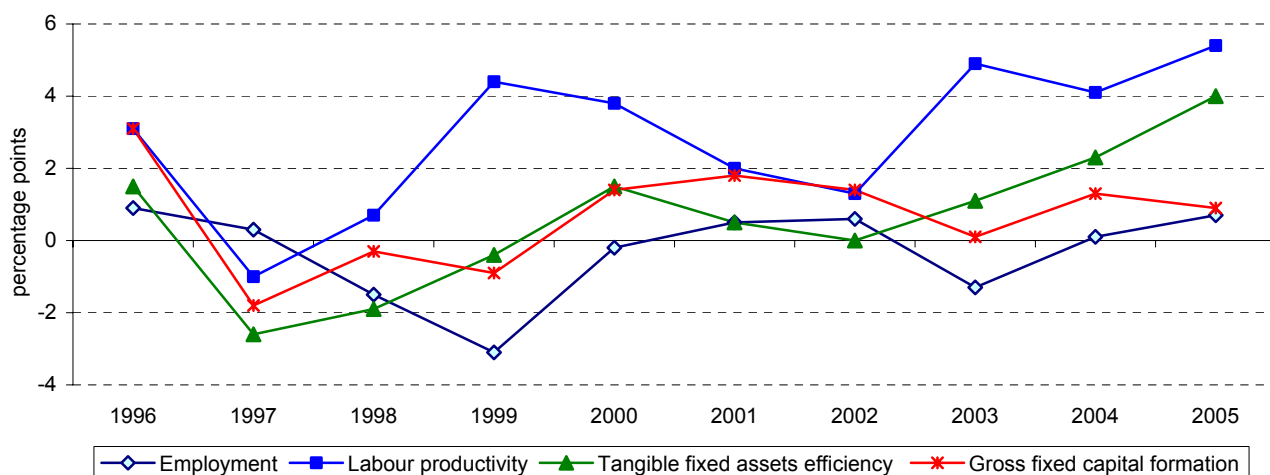


Source: Eurostat

• **Progress in productivity of tangible fixed assets**

In movements of capital productivity (tangible fixed assets) two stages of development were registered in the CR in the reference period. In the period 1996-1998, the stock of fixed capital productivity fell below zero due to recession. In the period 2000-2005, the average growth rate of 1.6% per annum was registered and in the last years the acceleration tendency was recorded. This positive development was contributed to by effects of computer and communication technologies.

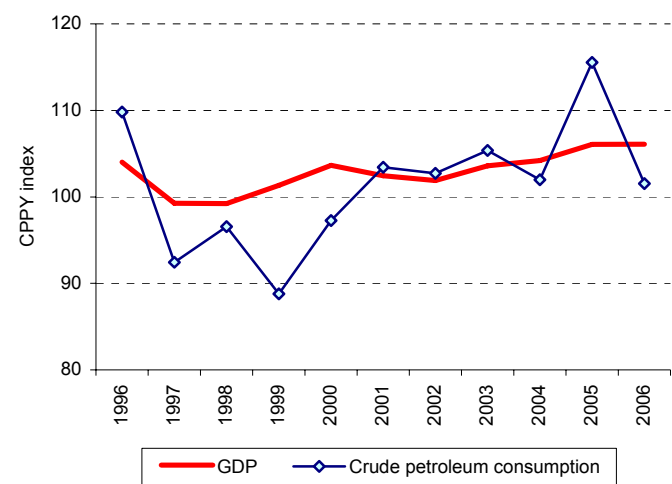
Graph 25 Production factors influence on GDP



• **High energy intensity persists**

In the period 1996-2005, the average drop of energy intensity was 2% per annum. At the beginning, energy intensity recorded the downward trend (in the latter half of the 90's) and then stagnated (2000-2002), in 2003 increased and in the following years started to decline again. In international comparisons the energy intensity is still high which is due to energy intensive technologies, big share of industry in the national economy structure, high consumption of energy sources in transport and insufficient thermal insulation of buildings.

Graph 26 GDP and oil consumption



Graph 27 Oil consumption

