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Main tendencies

The Czech economy entered year 2004 after a rather strong economic growth, nearly zero inflation, slight deterioration of external imbalance, markedly growing gap of the state budget and a high unemployment rate last year. The 2004 national economy development was a follow-up **to positive tendencies in 2003**; after the accession of the Czech Republic to the EU and after revival of European economy, having been influenced also by world prices of petrol and metals fluctuation. Greater mutual compliance among the GDP growth, rate of both external and internal (im)balance, changes in unemployment and the fluctuations level of consumer prices was managed to achieve.

Rest of account balance payments decreased to 5.2% in 2004 and its coverage by surplus of financial account sizeably increased (by 29.1%). The y-o-y balance of domestic current transactions in ratio to the gross domestic incomes dropped by 0.9 p. p. (to 5.5%) owing to the slacken rise of consumption expenditures. This resulted in **rate reduction of expenditures financing the gross capital formation from external resources**. Higher growth of state budget incomes than planned in comparison to state budget outcomes positively influenced the y-o-y **decrease of deficit to the GDP** by 0.9 p. p. As a result of intensive economic performance number of unemployed people increased. **The annual average unemployment rate** (according to the ILO methodology) was 8.3% in 2004, which was by 0.5 p. p. more than a year ago. Number of employed people dropped by 0.6%. The 2004 inflation rate was up to 2.8%.

The nominal volume of GDP has markedly been growing for two years. Its 2004 structure differed as against last year especially after distinct stepping up growth of external demand and external supply. In 2004 both share of final consumption household expenditures decreased and share of expenses for the gross capital formation increased in the nominal volume of GDP by sizeable jump down of foreign trade. **In real terms the y-o-y GDP growth 4.0% was by 0.3 p. p. faster than a year ago ensuing significant consolidation of the international economic position of the CR.** Final total consumption grew very slowly (only by 0.7% in real terms), expenditures for gross capital formation grew faster (0.9%). Its share in the GDP growth was 0.5 p. p. and 2.4 p. p., respectively. The exports growth surpassed the imports growth (really by 20.9% and 18.5%, respectively). After a long time of negative influence of the net exports volume on the **GDP development the y-o-y change in foreign trade deficit contributed to the GDP increase to a large extent.**

In the branch structure of the gross added value (GAV) considerable changes were recorded as well; share of industrial production (whose the y-o-y GAV also sizeably increased really by 6.7% in 2004) in its formation increased. GAV increased exceptionally in financial and commercial services (by 5.4%). In 2004 after preceding long-term lessening of the GAV in agriculture, forestry, fishing a growth 2.3% appeared. From now on the GAV has been fallen in construction.

An extreme high growth in net primary non-residents incomes caused tardy growth in gross disposable income than the GDP. Final consumption expenditures substantially less augmented than the gross disposable income, which led to **extensive enlargement of gross domestic savings** (by 15.5%) and at the same time to an evident expansion of its gain paces. **Savings rate augmented more than investment rate.** Financing expenses for the gross capital formation from external resources lessened.

A restrained monetary policy of the Czech National Bank indicating a slowdown of M2 growth reflected on the demand side by a larger enlargement of net foreign assets than net domestic assets; on the supply side volume expansion of transaction money surpassed the quasi money enlargement. **For the gross capital formation was needed imperceptibly less money than in 2003.** In 2004 the y-o-y average level of M2 increased by 7.7%, and its ratio to GDP (65.8%) changed minimally. The income velocity of M2 turnover rose just slightly.

Faster growth in incomes (9.9%) than in outcomes (6.7%) of the state budget resulted in the y-o-y fall of its deficit of CZK 15.6 bn. The 2004 deficit of CZK 93.7 bn in ratio to the GDP comprised 3.4% (a year ago it was 4.3%). In comparison to the state budget (after modifications) the deficit was lower by CZK

22.1bn, what faster than calculated growth in incomes as well as lower rise in expenses contributed to. A proportion of the **general government deficit** (net loans) **to the GDP dropped from 12.5% (in 2003) to 3.8% (in 2004)**. In the same time the consolidated gross debit of general government slightly cut down (from 37.5% to 37.4%).

Gross Domestic Product

- **Contribution to structural changes**

The 2004 macroeconomic atmosphere improved what reflected a speedup in the GDP growth and also in an evidently positive improvement its structure. Influences of constituent expenses on the demand side and basic branches on the supply side were largely positive. The slowdown in expansion of household consumption expenditures complied with the slump development in its disposable incomes. The quickening in expenditures expansion for the gross fixed capital formation as a result of improved state of affairs incomes of non-financial enterprises evinced in increase of expenses investments by own financial resources. The decrease of trade balance deficit favourably influenced net exports and its impact on the GDP gain what is, after few years of negative effect, a very favourable phenomenon.
- **Influence changes of prices level fluctuation**

Intensive prices fluctuations in all main spheres strongly influenced changes in the GDP structure. Combination of influences in physical volume and price modifications on constituent components of demand and supply was in 2004 dissimilar to 2003. Oscillation of total prices level substantially speeded up; in 2003 change of total prices fluctuation shared the increase of the nominal volume of GDP in one third (33.2%), in 2004 this share arrived at almost one half (47.7%). First of all it was effect of inflation growth rate; prices fluctuation participated in the increase of nominal volume of expenses in the 2003 final consumption by almost one third (29.7%); it arrived at 85.2% up to 2004. Effect of foreign trade prices changed substantially as well mainly in improvement of exchange relations. Overall, except gross capital formation expenses effect of prices fluctuation on the development of constituent components of the aggregate demand and supply predominantly increased; effect of physical volume on it concurrently decreased.
- **Changes in the GDP structure, demand and supply**

In 2004 share of final consumption expenses (from 74.9% in 2003 to 72.6% in 2004) in the GDP volume of CZK 2 751.1 bn at constant prices slashed; the share of expenses in gross capital formation increased moderately (from 27.3% to 27.8%). The remaining share -2.2% or -0.4%, respectively, fell to net exports and gave evidence of changes of foreign trade in domestic economy. Also proportion of both external demand and supply to aggregate demand and supply sizeably increased (from 38.1% to 41.7% or 39.4% to 41.0%, respectively); its ratio is demonstrating a consolidation of exports of goods and services in total final expenditures.
- **GDP increase really by 4.0% and acceleration of its growth by 0.3 p. p.**

The y-o-y produced gross added value (GAV) at current basic prices amounted to CZK 2 466.7 bn in 2004 was higher by 3.7% in real terms; its growth hastened by 0.6 p. p. Industrial production contributed most to this growth (2.2. p. p.); GAV produced CZK 803.9 bn at current prices and its y-o-y volume expanded really by 6.7%. A considerable swell of product taxes (7.1%) by a lower expansion of product subsidies (4.8%) resulted in a higher increase in GDP than GAV (4.0% in real terms). Among outcome components expenses for the gross fixed capital formation rose (really by 9.1%), its growth accelerated by 4.3 p. p., having a positive influence on the GDP enlargement by 2.4 p. p. Such noticeable enlargement of capital expenses was facilitated by a considerable expansion of profits and profitability of non-financial enterprises, as well as by a low money value. On the contrary, final household expenditures increased really only by 2.4% and its growth decelerated markedly (by 2.5 p. p.); its y-o-y contribution 1.2 p. p. to the GDP progress was substantially lower. Slacking up of household consumption expenses by simultaneous decrease of gross savings volume reflected decrease in growth of gross disposable income, especially wages and salaries, increased unemployment rate and fears for its subsequence, as well as jump in consumer prices. Paces of growth of both exports and imports of goods and services were extraordinary high in 2004. Increase in exports (in real

terms by 20.9%) outstripped increase in imports (in real terms by 18.5%) resulted in the substantial y-o-y modification of net exports effect on the progress of GDP. A favourable contribution of the lower total foreign trade deficit 1.1 p. p. to paces of the GDP gain showed a very significant change compared to its deterioration 0.6 p. p. in 2003. Rate of coverage of imports by means of exports increased both nominally and really.

Considerable acceleration of growth of both total demand and supply

The 2004 y-o-y volume of total demand and supply at current prices amounted to CZK 4 704.3 bn increased by 9.7% in real terms and its growth speed up by 4.0 p. p. Growth of total external demand 7.9 p. p., i.e. by 5.1 p. p. more than a year ago contributed to the increase of total demand; in the process effect of the y-o-y domestic demand 1.8 p. p. was by 1.1 p. p. lower. Proportions on the supply side to the total increase changed less, growth of external supply 7.3 p. p. (which was by 4.2 p. p. more than a year ago) contributed to its total increase; while an influence of domestic supply growth 2.4 p. p. only imperceptibly reduced. In 2003 growth of domestic supply fell behind growth of domestic demand by 0.4 p. p. in real terms, but in 2004 the domestic supply growth was faster by 1.1 p. p. than the domestic demand growth. The domestic demand coverage by means of domestic supply built up nominally and really. The total demand coverage by the 2004 domestic supply was down by 3.2 p. p. y-o-y.

Rate of financing of gross capital formation from external sources decreased

In 2004 the nominal volume of gross domestic savings CZK 622.6 bn was larger by CZK 83.7 bn, i.e. 15.5% than a year ago. On the other hand, household savings generated adversely, as decreased by 4.6%; so did savings of non-financial enterprises that increased by more than one fifth. The y-o-y proportion of gross household savings to total gross domestic savings decreased by 3.8 p. p. to 18.1%, as a consequence of volume enlargement of household consumption expenditures than its gross disposable income. The development in total incomes, outcomes and capital transactions is demonstrating that the apparent reason for growth deceleration of gross disposable domestic income as against the GDP growth is a very rapid increase of net primary incomes to non-residents (almost by one fifth), what also decrease of net current non-resident transfers contributed to. The gross disposable income growth influenced twofold positively increase in gross domestic savings than a negative effect of outcomes increase on final consumption. The y-o-y negative balance of current non-resident transactions amounted to CZK 143.3 bn was down by CZK 14.0 bn. Enlargement of gross domestic savings influenced it more positively than the negative effect of outcomes expansion on gross capital formation. In 2004 the gross savings rate 23.8% was by 1.8 p. p. higher y-o-y, while investment rate (THK) 29.3% increased less (by 0.9 p. p.). In accordance with it financing of gross capital formation from external sources decreased by 3.9 p. p. to 18.7% in 2004 and investment expenses coverage by means of domestic financial resources rose.

• **Growth of unit labour costs**

Proportion of primary incomes of employees to the GDP nominal volume decreased by 5.4 p. p. in 2004. Rise of primary incomes per employee overtook the labour productivity, what led to increase in unit labour costs by 1.3% in real terms. Unit labour costs decreased by 1.4% in real terms.

Economic Performance of Main Branches

Vast majority of branches intensified performance

In 2004 volume of production in main branches considerably increased and the growth accelerated mainly in Q1, but in Q2 a moderate (in construction significant) slow down was recorded. Industrial production contributed most to the annual positive development; the most favourable progress was monitored in construction and agriculture, especially due to plant production. Sales in selected services increased minimally. Labour productivity as well as growing fixed capital affected most expansion of production. Volume of new orders in industry and construction enlarged faster than production; swelling labour supplies (mainly in construction) were good prerequisites for further production enlargement.

• **Intensive rise**

In 2004 the y-o-y economic performance in industry (measured by an industrial

***in machinery
production and
direct export sales***

production indicator) jumped by 9.9%, expressed by sales in industry by 9.8% in real terms, which represented speedup of growth by 4.1 p. p. or 4.0 p. p., respectively. Industrial production developed largely in Q2; its growth accelerated most in Q2. Favourable external conditions, for instance growing foreign demand and a large volume of exports to EU member states, especially after the accession of the CR to the EU affected positively progress in industrial production. Enlargement of new production capacities and putting new fixed assets into the operation were internal conditions contributed to increase in economic prosperity in industry. To the favourable industrial growth contributed most manufacture of capital investment (by 15.2%) and manufacture of intermediate goods (by 12.9%); its common effect on the industrial production growth reached almost nine tenth. Increase in manufacture of energy was deeply under average (only 1.6%); however, it seems to be sufficient. Grow in machinery was extremely high (real terms 16.1%), it enhanced its position in the industrial production; its share in sales in industry already exceeded one half. Proportion of direct exports in machinery achieved 68.1% to total direct exports. Volume of direct exports sales (really by 17.0%) expanded substantially faster than total sales in industry, what resulted in a very low increase in domestic sales (really only by 3.1%). Prices of goods at external markets rose sluggish (2.3%) than prices of goods imported in internal market (5.8%).

• ***Rise in average
wages speeded up
and unit wage costs
decreased***

Total amount of wages and salaries in ratio to sales in industry further substantially dropped at constant prices. Wages demands of sales dropped by 6.9% and primary incomes, especially gross profits, sizeably rose in enterprises. The labour productivity growth by 10.4% was somewhat faster than a year ago, which resulted in drop of unit wage costs by 3.2%. It was imperceptible slow in fall; however it helped to increase competitiveness of industry in the CR.

***Substantial
deceleration of
growth in
construction in Q2***

In 2004 the y-o-y volume of construction work increased totally (including estimation) by 9.7% really, work performed in accordance with suppliers' contracts ("S") were up by 8.9% and construction outputs of smaller enterprises were up by 11.4%. While work growth accelerated totally by 0.8 p. p., paces of growth „S“ were slightly lower production gain of smaller enterprises was substantially higher. Despite slowing down of construction growth in Q2, the yearlong increase in construction work represents a follow-up to a huge expansion of construction especially work on infrastructure, which started in Q2 2003. Orders of investors – residents and domestic investments demand - entirely predisposed the construction growth.

• ***Considerable
growth of work on
new buildings
construction and
retarded growth in
ZSV***

The domestic "S" structure (which increased by 8.4% really) can be characterised by an intensive growth of new construction, work on reconstructions and modernisation (10.0%) which overtook progress in work on repairs and maintenance, whose volume decreased. Construction outputs growth in building construction speeded up to 9.5%, while in civil engineering climbed leisurely. Volume of work performed by own workers (ZSV – really by 5.9%, a slowdown by 2.0 p. p.) lag greatly behind volume of work performed in accordance with suppliers' contracts. Volume of subcontracted work provided mainly by smaller enterprises enlarged markedly by 15.3%. The balance between volume of subcontracts accepted and provided increased. Smaller enterprises have been performing orders contracted by larger companies and investors in progressive extent.

• ***Considerable
slowdown of labour
productivity***

Increase of labour productivity calculated from „S“ by 5.3% and from ZSV by 2.4% is representing a considerable slowdown (by 2.5 p. p. or 4.2 p. p., respectively) and together with it decrease and acceleration of drop of unit wage costs. Expansion of the total nominal volume of salaries and wages was lower than the growth in construction outputs at current prices, so wages demand decreased by 2.8%. Primary incomes of construction enterprises rose substantially faster than total salaries and wages of workers in construction.

• ***Supplies in
construction work
enlarged***

Increase in number of granted building permits, as well as estimated values of buildings considerably slowed down, in the process its matter-of-fact structure also modified. The nominal volume of new orders amounted to CZK 276.8 bn jumped (by 21.3%) and its growth accelerated (by 10.7 p. p.), as well. Influence of new public

orders on the new construction was a causal factor. It increased most in civil engineering constructions (metro, highways). The y-o-y volume capacity of domestic orders amounted to CZK 201.2 bn was higher less than one third presenting supplies in construction work for 8.8 months that is by 1.1 months more y-o-y. A very large volume of supplies of construction work has not been realised yet guarantees a further growth in construction and intermediate industrial products.

- **Most finished housings since 1992**

In 2004 construction of 39,037 housings started, which was more by 7.0% y-o-y, number of housings finished 32 268 was higher by 19.0%. Continuity coefficient of housing construction rather changed; while in 2003 proportion of started to finished housings arrived at 1.093, in 2004 decreased to 0.899. Number of partially built housings 145,801 at the end of 2004 compared to the end of 2003 was higher by 5.5% and its growth slackened by 1.8 p. p.

- **Slowdown in growth of retail sales**

In 2004 volume of sales in services enlarged by 3.2% in real terms y-o-y, i.e. the growth slowed down by 1.5 p. p. The highest paces of growth were recorded in transport and communication (6.2%). Such growth is self-same like last year, however, differed across quarters. Total retail sales increased minimally – only by 2.4%; its delay by distinct 2.2 p. p. arose due to even not a one fourth of gain paces in automotive segment, which was brought about by low increase of sales for selling cars and repairs of motor vehicles (1.0%). Large volume of company cars bought a year ago (possibility of VAT allowance) is representing one of factors contributing to the grow rate reduction. The sluggish yearlong sales accrual was monitored also in restaurants and canteens; in Q2 a great fall was confirmed. It was caused partly by an increase of VAT taxes, prices increase, partly by disinclination of households to spend money. On the other hand a development of a main item of purchasing funds and disposable incomes oh households did not affect a significant deceleration of growth in retail sales. This is demonstrating a restrained consumers' behaviour. Among selected market services sales in computers and information technology recorded seesaw paces of gain, when a yearlong drop in sales by 2.2%, i.e. slowdown by 4.8 p. p. is representing sizeable modifications over quarters (from 12.8 p. p. in Q2 to -22.2 p. p. in Q4). In 2004 sales in other services (predominantly personal ones) fell by 4.1% in real terms y-o-y, as a result of changes in consumers' preferences.

- **More than one sixth gain of agricultural production**

In 2004 an extremely large crop of cereals contributed to the historical largest volume of production and the y-o-y fastest paces of growth in agriculture, in spite of a slump in meat production and a slight reduce in dairy production. In 2004 the y-o-y volume of agricultural production (at current realisation prices) amounted to CZK 115.6 bn was higher by 16.3% in real terms, especially owing to increase of plant production volume by 33.1% in real terms. A favourable growing season as well as during harvest were considered to be important factors for extraordinary crop. The y-o-y volume growth of plant production most affected cereals; its harvest volume was almost by one half larger than in 2003, when a poor crop affected agriculture. Yields per hectare influenced this exceptionally good crop for the most part; its impact on it was substantially bigger than effect of sowing field area. Yield of basic cereals 5.48 t per hectare was higher than an average over past eleven years; yield of other cereals also highly exceeded level of previous years.

- **Animal production lags behind**

Progress in animal production markedly lags behind the plant production. Its y-o-y volume shrunk by 3.1% really in 2004. Farmers reduced herds of cattle and limited breeding of pigs, which reflected in production of both, pork and beef. In 2004 the y-o-y meat production reduced by 8.8%; production of beef and veal by 10.6% and production of pork by 8.4%. A drop rate systematically increased during the year. Furthermore farmers started to deliver live animals abroad, as prices are higher there than in the CR.

After the accession of the CR to the EU rules in agriculture modified; subsidies in

both primary production and other linked branches increased.

External Economic Relations

- ***Balance of both current account and financial account developed more favourably as against 2003***

The sum balance of payments accounts developed favourably in 2004. A surplus of CZK 23.6 bn was reached as against total debit balance at the 2003 balance of payments amounted to CZK -3.5 bn. The main reason was current account deficit went down (from CZK 160.6 bn to 143.3 bn) by coincident increase of financial account surplus from CZK 180.9 bn to 157.1 bn in 2003. In spite of adverse of balance of revenues from CZK -119.9 bn to -139.5 bn being influenced by profit repatriations of foreign investors after massive investments over the last decade (direct investments outlays in current account balance revenues amounted to CZK 125.6 bn as against 118.3 bn in 2003) current account developed satisfactorily. Surplus of balance of services slightly reduces from CZK 13.2 bn to 12.5 bn by the faster y-o-y growth in outlays. A very favourable result of foreign trade of goods adapted to changes after the accession of the CR to the EU taking advantage of economic revival in of greatest trade partner countries contributed to decrease of external imbalance.

- ***Foreign trade was the best over last ten years – exports of goods with higher added value intensify***

Imports exceed exports by CZK 22.3 bn as against CZK 69.4 bn in 2003. Trade balance was positively influenced by a positive development in exchange rate in imports from USD countries and exports to EUR countries – the CZK against USD exchange rate reached appreciation on average by 9.8% and in relation to EUR the Czech crown depreciated by 0.2%. Trade balance deficit was compensated with the surplus in trade with EU countries; on the other hand the trade deficit with China increased. Growth rate of exports climbed faster (by 4.5 p. p.) compared to rate of imports; the y-o-y exports and imports were up by 24.9 % and 20.5%, respectively. Volume of exports to new EU members exceptionally jumped. The Czech export is incredibly concentrated – one half of its exports comprise exports of about two hundred companies. Total export of goods is representing 62.3% of GDP of the Czech Republic. Location of the Czech Republic in the middle of the area with a high density of inhabitants and companies with the strong purchasing power implies a big advantage for the CR after the accession to the EU.

The y-o-y exports of machinery and means of transport increased by one fourth (26.9%) is representing more than one half. It was up about by CZK 180 bn than in 2003 and its proportion to total exports climbed from 50.1% to 50.6%. Surplus in this commodity enlarged also owing to flattering progress in imports whose dynamics (19%) was lower than growth rate of total imports. Despite the y-o-y imports of machinery and means of transport rose by CZK 117 bn by a slight drop in proportion to total imports (from 42.2% to 42.8%).

- ***Current account deficit is approximately compensated with financial account surplus***

Financial account reached surplus amounted to CZK 180.9 bn and contributed to the deficit coverage of balance of current account payments. This level of coverage is not enough high to cover up current account deficit; however, it poses an improvement as against 2003 when financial account did not suit the purpose to cover current account deficit. In 2004 external imbalance (expressed as proportion of current account deficit to GDP) reached 5.2%.

The y-o-y higher surplus of direct investments – CZK 100.7 bn as against CZK 53.5 bn in 2003 characterised by a substantial drop of direct foreign investments to the CR (direct capital investments were negative, so volume of direct foreign investments amounted to CZK 59.3 bn were re-invested profits) made a favourable impact on surplus of financial account. Last year direct foreign investments to the CR amounted to CZK 114.7 bn; basic capital and re-invested profits represented CZK 104.4 bn. Direct CR investments abroad jumped from CZK 5.8 bn to 14 bn; capital inputs and re-invested profits were CZK 12.7 bn. In 2004 payments for acquisitions of company CEZ were not carried out.

- ***Development***

Development of portfolio investments recorded even more substantial change

of portfolio investments demonstrates capital inflow to the CR

compared to direct investments. Final outflow of capital from the CR in 2003 (CZK - 35.7 bn) compensated capital inflow to the CR as well as surplus of portfolio investments (CZK 62.2 bn). Investments volume of residents abroad dropped on the whole – balance of portfolio investments amounted to CZK -61.1 bn compared to CZK -83.9 bn in 2003. While in 2003 residents left their invested positions in international stocks (in total purchase overtook, thereby active side of portfolio investments reached CZK 5.6 bn), in 2004 an outflow CZK -27.3 bn was recorded. Similar in obligations: if residents made investments in international bonds, bills and other instruments of money market CZK 89.5 bn at the end of 2003, compared to 2004 it was substantially less (CZK 33.8 bn). Foreign portfolio investors strengthened their position in the CR holding securities amounted to CZK 123.3 bn (obligation for CZK 103.7 bn). Their interest for purchase of domestic securities intensified despite low differential interests. Strategy of low-risk investments preponderated (credibility of the CR and domestic economic subjects increased after the accession of the CR to the EU).

• ***CZK against USD reached appreciation, against EUR somewhat depreciated***

The exchange rate CZK/USD markedly appreciated on average from 28.227 to 25.701 CZK/USD. In relation to EUR the CZK slightly depreciated from 31.844 to 31.904 CZK/EUR. Favourable growth of the Czech economy as well as USD depreciation (especially expected exchange rate USD/EUR development) and speculative investments connected with privatisation of huge Czech companies (Unipetrol, Czech Telecom) had positive impact on appreciation of CZK in relation to EUR.

• ***According to the change of real effective exchange rate index the competitiveness of the country dropped***

The nominal effective exchange rate index of CZK was year-on-year lower by 0.1 %. The real effective exchange rate index (REER) constructed on the basis of industrial producer prices (year 2000=100) increased year-on-year by 2.9 %, while it registered a decrease of 3.3 % in 2003. The REER index on the basis of consumer prices went up by 0.4 %. Both consumer inflation measured by the consumer prices index and the production sector inflation measured by the industrial producer prices index ended higher than in EU-15 countries. The development of price differentials in relation to EU-15 countries, the target for most Czech exports, thus meant lowered competitiveness of the Czech economy.

Trend of Prices

• ***Increased rate of inflation***

Overall level of consumer prices was in 2004 year-on-year higher on average by 2.8 %, which represented an acceleration of 2.7 p. p. compared to a completely negligible inflation in 2003. Depreciation of the internal purchasing power of Czech crown lead to residential households paying in 2004 for the same physical volume of goods and services more by around CZK 35 bn than in 2003. The prices of services in 2004 increased substantially faster (5.3 %) than the prices of goods (1.3 %). At the same time the prices of goods and services with regulated prices grew faster (5.6 %) than prices of non-regulated goods and services (1.9 %). The total growth of consumer prices was affected in three fifths by changes in regulated prices, tax adjustments and other administrative measures and in remaining two fifths by the impact of core inflation before seasonal adjustment.

• ***No price hike after the admission to EU***

The growth of the aggregate level of consumer prices was less varied in individual months of 2004 than in 2003. The fears of a sharp price hike following the admission of the CR into the EU has not come true. Vertical fluctuations of aggregate inflation rate were in 2004 principally higher than in 2003. Finer rates of variance of partial price movements show that the variance was in 2004 2.4 times higher than in 2003. Before the rise of the aggregate level of consumer prices in 2004, the largest gain (10.1 p. p.) occurred for prices of postal and telecommunication services by 12.9 %, however the increase in the overall price level was mostly affected by the grow of prices of housing, water, energy and fuels by 3.5 %. On the other hand the prices of clothing and footwear experienced a drop of 4.0 % and the prices of furniture, household equipment and repairs declined by 1.9 %; their common adverse effect on

the overall rate of inflation comprises more than one tenth (10.7 p. p.).

- ***Inflation differential widened***

Harmonised index of consumer prices shows, that while in 2003 the consumer prices in EU-15 rose year-on-year on average by 2.0 %, i.e. by 2.1 p. p. more than in the CR (signifying the halt of price convergence), in 2004 the price development turned around. In EU-15 countries, the consumer prices climbed again by 2.0 %, which is by 0.6 p. p. less compared to the ČR. This change of price relations lead to the convergence of comparative price levels and contributed to the growth of real effective exchange rate index of CZK constructed based on the consumer prices.

- ***Producer prices overhauled consumer prices***

Aggregate level of producer prices (agricultural, industrial, construction and market services) grew in 2004 by 4.4 % year-on-year and their growth was significantly faster than in 2003. Regarding producer prices, the prices of agricultural producers grew and accelerated the most, however had the smallest effect on the overall price level movement. The prices of market services increased and accelerated the least, nevertheless their effect on the aggregate price level increase was roughly one fifth. The growth of producer prices had the biggest effect on the whole (nearly two thirds). The effect of growth of construction prices was nearly one tenth. The ratio of growth of the level of producer prices to the growth of consumer prices changed considerably.

- ***Surge in prices of agricultural producers***

The prices of agricultural producers increased year-on-year by 8.1 % and their growth was compared to 2003 faster by 11.0 p. p. The prices of vegetable producers increased much faster (11.6 %), in that especially those of grains and potatoes, than prices of animal products (6.2 %). Year-on-year fluctuations of agricultural producer prices were remarkable ranging from 20.1 % (April) to 1.0 % in December of 2004. This variability was affected more by the movement of vegetable products prices (58.7 p. p.) than animal products (14.9 p. p.).

- ***Sharp growth of prices of basic metals, metallurgical and metalworking products***

The prices of industrial producers increased year-on-year by 5.7 % and their growth accelerated by 6.0 p. p. Prices of manufacturing products increased more than this average (6.0 %) and their effect on the growth of aggregate price level reached nearly nine tenths. With regards to the prices of manufacturing products, the decisive factor was the increase of prices of basic metals, metallurgical and metalworking products (by 18.5 %) and oil products (by 27.0 %). The prices of electricity, gas and water grew less than in 2003 (3.9 %), however their growth affected the costs of all sectors of economy. Among main industrial groups, the prices of energy rose the most (8.5 %), having an effect of one quarter on the growth of aggregate level of industrial producer prices. Nevertheless, the growth of prices of intermediate products by 8.4 % played a crucial role (more than one half). The prices of products of investment nature increased only negligibly (by 1.4 %).

- ***Negative correlation between the growth of prices and labour productivity***

The relation between the changes of industrial producer prices and the labour productivity in the branch activities suggests a negative correlation; price increases driving up the costs is not compensated by the improved productivity of labour. In those branch activities with the largest price increases the productivity of labour decreased or grew at a below average pace and on the contrary, prices dropped or grew below average in those activities with substantial labour productivity growth.

- ***Increased price differential***

The gap between a faster growth of industrial producer prices in the CR and their slower growth in the EU-15 countries was continuously increasing in the course of 2004. Negative price differential of 1.9 p. p. from 2003 (year-on-year growth of prices in the EU-15 of 1.6 % and 0.3 % decrease in the ČR) changed to a positive gap of 3.1 p. p. in 2004, with prices in the EU-15 growing by 2.6 %.

- ***The change of trends – input prices overtaking output prices***

The prices of construction works expanded year-on-year by 3.7 % and their growth accelerated by 1.6 p. p. Prices of materials and products used in construction jumped up faster (5.8 %) and accelerated by a notable 6.7 p. p. Increased prices of metals played a role in this price hike.

- ***Low growth and its negligible***

The prices of market services grew year-on-year by 2.3 % and their acceleration was minimal (by 0.7 p. p.). Above average growth of prices was recorded for prices of

speedup

business services a real estate and rental services (3.0 %) and in the finance sector (2.8 %).

- **Benefit of improved terms of trade and appreciation of national labour**

In 2004 the exports of goods went up by 3.7 % and imports of goods by 1.6 %. Terms of trade improved by 2.1 % and positively affected the trade balance. With regards to export prices, the largest growth (20.1 %) as well as acceleration (14.6 p. p.) experienced prices of mineral fuels, grease and related materials. The largest effect (nearly three fifths) registered the growth of prices of products classified by material (8.2 %) with a 7.0 p. p. acceleration. Marked decrease occurred for prices of beverages and tobacco (9.9 %), which represented a change of 16.5 p. p. in comparison to a 6.6 % growth in 2003. In relation to import prices, the prices of raw materials apart from fuels grew (9.1 %) and accelerated the most (8.1 p. p.). Their effect on the total growth of import prices was one quarter. Roughly the same effect but lower growth (6.5 %) had the prices of mineral fuels, grease and related materials. The largest impact (two thirds) had the increase of prices of products classified by material (4.3 %) accelerating by 2.8 p. p. The drop of import prices of machinery and transport vehicles (by 1.4 %) lead to a favourable influence of terms of trade of these products on the trade balance. Terms of trade highly and the most improved for mineral fuels, grease and related materials, however their effect on the overall change was only one half compared to the development of terms of trade of machinery and market products sorted by material. Improved terms of trade positively influenced the CZK exchange rate development against currencies used for foreign trade.

Labour Market

- **Considerable structural changes on the labour market**

The labour market in 2004 was again marked by large structural shifts; among the most significant are the comparably larger decrease of entrepreneurs and cooperating family members than the decrease in total number of employees and also notable extension in long-term unemployment in the 20-29 age group. The drop in the rate of employment and increased unemployment rate occurred in the environment of favourable business cycle situation and enhanced economic performance and growing inflation rate as well as higher growth of producer prices. In comparison to 2003, when the drop of employed exceeded by more than one quarter the increase in unemployed, in 2004 their opposing year-on-year movement was nearly the same; the gain in unemployed only slightly surpassed the decrease of employed persons. While the relative fall of the number of employed somewhat slackened, the rate of growth of unemployed stayed the same. Supply of the labour force on the labour market was relatively strong in 2004 (strong age-group). However, the rates of employment decrease as well as the rate of growth of unemployment widely differed in individual quarters.

- **The decrease of the number of employed slowed down**

Based on labour force sample survey, the number of employed persons of 4 706.7 thousand on average in 2004 was year-on-year lower by 26.5 thousand, i.e. by 0.6 %. Stated reduction was by 5.2 thousand lower on a year before. The largest year-on-year drop in employed persons occurred in Q1 (64.1 thousand), slowing down considerably in the course of the year and in Q4 the number of employed grew by 7.9 thousand. The average rate of employment of 54.3 % in 2004 declined year-on-year by 0.5 p. p., i.e. less than the year before. It is also substantially lower compared to the EU-15 average. Reduced number of employed persons – lower labour input – had only mild negative effect on the gross value added development, output of economic units rose exclusively thanks to the increased labour productivity, which accelerated. More than four fifths of total number of employed formed employees (82.7 %), whose average number of 3 890.2 thousand in 2004 was year-on-year lower only by 3.5 thousand (0.1 %), representing only little more than one tenth (13.2 %) out of total decline of employed. From the point of main employment status, entrepreneurs and cooperating family members had the largest impact on the sinking number as well as rate of employment. Their average number of 791.8 thousand in 2004 was year-on-year lower by 19.3 thousand, i.e. by 2.4 %. This decline represented nearly three quarters of the total decrease in employed persons.

Fall in the number of entrepreneurs was not connected to their economic results, since the gross operating surplus and mixed household sector income ended higher by 4.9 % on a year before. Despite the number of entrepreneurs falling substantially year-on-year in 2004, the share of enterprise sector in total employment in civil sector was in Czech Republic markedly higher than in industrial countries of western Europe (except for Portugal).

- **Quickening of labour force movement and changes in economic status**

Apart from the structural change of employed persons according to their status also eventuated sizeable branch structural changes. Except for business firms, including motor vehicle repairs, transportation, storage and communications firms and health and social care providers, which witnessed year-on-year increase of employed persons in 2004 (by 0.5 %, by 1.4 % and by considerable 5.4 %), all remaining branches recorded a dip in the number of workers (in total by 1.5 %). With respect to sectors, the number of employed went down in the primary sector by 5.1 % (10.8 thousand persons), in the secondary sector by 1.0 % (18.8 thousand persons) and mildly increased in the tertiary sector (by 0.1 %, i.e. 3.2 thousand persons). Overall outcome of employment structural shifts was year-on-year increase in the proportion of the services sector and diminished proportion of both primary and secondary sector in the total number of employed persons.

- **Low new job creation despite enhanced economic performance**

The number of unemployed persons of 425.9 thousand on average for 2004 was year-on-year higher by 26.8 thousand, i.e. by 6.7 %. This increase was by 1.8 thousand higher on a year before, nevertheless the rate of growth of unemployment remained the same. The number of unemployed surged in Q1 (55.5 thousand), while their year-on-year increases were gradually diminishing and in Q4 came down to 7 thousand persons. Average general unemployment rate 8.3 % in 2004 increased year-on-year by 0.5 p. p. and while this gain coincided with that of the previous year, in individual quarters it moved from marked acceleration in Q1 (1.1 p. p.) to negligible growth in Q4 (0.1 p. p.). Given unemployment rate is lower than the EU-15 average.

- **Growth of long-term and recurring unemployment**

Less than one half of the above mentioned number of unemployed fell in the category of frequent and short unemployment, long-term unemployment is prevailing and expanding; the number of 220.3 thousand persons soared year-on-year by 10.8 %. Predominating group of citizens, who lost job in the last two years, was unemployed for a period of more than one year. Short-term unemployment consisted of 205.6 thousand persons in 2004 and their number increased year-on-year by 2.6 %. The higher the unemployment rate and the longer its duration, the more difficult and complicated it is to remove extending unemployment. Extensive growth of long-term unemployment curtails household disposable income as well as their deposits level. Unemployment systematically affects mainly lower income groups of population.

- **Differences in the unemployment rate**

Rates of unemployment differ widely based on sex, age and education. Unemployment rose only for males, specifically in the working age, the number of unemployed females lowered. Vast number of unemployed (almost three quarters) is comprised of persons with secondary school education without GCSE and people with basic education. High unemployment rate of persons with basic education (26.1 %) and with secondary education without GCSE including skilled persons (9.4 %) contrasts with the low unemployment rate of university graduates (2.3 %) and persons with full secondary education with GCSE (5.3 %).

- **Considerable movements on the labour market**

According to MLSA, there were 541.7 thousand of registered unemployed job applicants by the end of 2004 and their number dwindled somewhat year-on-year (by 0.7 thousand persons). At the same time, 674.4 thousand persons were fired in the course of 2004 and on the contrary 675.1 thousand of persons were removed from the register of job applicants (either with a placement or without it); year-on-year change was an increase of 8.1 thousand and 36.8 thousand persons respectively. Overall movement of the labour force on the labour market was thus larger in 2004 than in the preceding year. Average rate of registered unemployment in 2004 (according to the original methodology of MLSA) reached 10.24 %, which was 0.32 p. p. higher on a year before. The highest rate of unemployment was registered in Q1

and after a mild dip during the year it typically rose again in December, following negative seasonal factors at the beginning and at the end of the year.

- **Moderate slowdown of the wages growth during an economic expansion**

Wage and salary development in all bigger economic units (business sector with 20 and more employees and non-business sector with all employees) in 2004 somewhat slowed down. The proportion of total nominal volume of wages to GDP in current prices decreased and equally the growth of wages in real terms was slower than the growth of GDP in constant prices. Tendencies from primary production sectors (industry and construction) about faster growth of business incomes (profits) to their gross value added and to labour incomes (wages and compensations to employees) are being confirmed. The development of average wages slightly outpaced the growth of total productivity of labour gauged by the gross domestic product, however less than in the preceding year.

- **Notable slowdown of real wage growth in the non-business sector**

Average monthly nominal wage of employees of CZK 18,035 in 2004 increased year-on-year by 6.6 % or less than in the previous year by 0.2 p. p. The growth of total productivity of labour (4.2 %) lagged behind this growth, even though its pace went up. Consequently the unit labour costs rose by 2.3 %. In real terms, the average wage grew by 3.7 % and the rate of growth was year-on-year lower by considerable 3.0 p. p. The development in two basic spheres of activity differed; the average nominal wage in the business sector of CZK 18,116 was year-on-year higher by 6.9 % and in the non-business sector it went up by 5.7 % to CZK 17,761, so the differential between the wage levels expanded (from CZK 155 in 2003 to CZK 355 in 2004). While in the business sector the growth of average monthly wage climbed up by 1.0 p. p., in the non-business sector it markedly slowed down (by 3.8 p. p.). Real wage grew in the business sector by 4.0 % and in the non-business sector by 2.8 %, having slowed down year-on-year by 1.8 p. p. and substantial 6.6 p. p. respectively, which in turn showed up in the household consumption expenditures. The differentials in the wage levels increased even more between individual branch activities, as an expression of above average growth of wages in total for those branches, in which their level was higher and vice versa, i.e. below average growth in branches with lower wage level. The scissors of CZK 21,186 between maximum level of monthly wage and its lowest level in 2003 (financial services CZK 33,200 and agriculture, game keeping, forestry CZK 12,014) opened up to CZK 22,315 in 2004 (CZK 35,446 and CZK 13,131). Inter-branch wage differentiation in 2004 remained the same. Variation coefficient of average wages in branch activities of 33.2 % has not changed.

Monetary Development

- **The rate of growth of money stock M_2 slowed down, when credit boom continued mainly for household loans – total domestic credit stagnated**

Money stock measured by M_2 came up to CZK 1,844.1 bn by the end of 2004. Year-on-year changes show the growth of M_2 by 4.4 %, which is lower than in 2003 (+6.9 %).

On the asset side of the monetary balance grew compared to the previous year faster net foreign assets (by 5.1 % to CZK 863.3 bn) than net domestic assets (by 3.8 % to 980.8). The stock of net domestic assets at the end of the year maintained larger volumes than net foreign assets, even though in eight months of 2004 was this ratio reversed. Regarding the structure of net foreign assets, the volume of net foreign assets of CNB slightly dropped (from CZK 687.5 bn to CZK 634.1 bn), while the net foreign assets of other monetary and financial institutions grew sharply from CZK 134 bn to CZK 229.2 bn.

The volume of domestic credit stagnated at the level of CZK 1,147 bn. In that credit in the business sector including households swelled by 12.4 % and at the same time the net credit to the government sector decreased. The most noticeable structural change is the continuing expansion of household credit. Its increase was 30.9 % in 2003 and already 32.7 % in 2004. Business loans rose only by 3.6 %.

- **Deposits began to rise again after two years of slump despite higher**

After significant year-on-year slump of quasi money volume in 2002 and stagnation in 2003, it grew slightly in 2004 from CZK 863.3 bn to CZK 881.8 bn. It confirms mild recovery of term deposits forming three quarters of quasi money volume, including mostly household deposits, which are more than double compared to the business

growth of transaction money against quasi money in M₂

sector savings. In total savings and term deposits of households grew by 5 % (savings alone by 6.7 %). The same deposits of the business sector decreased by 3.9 % last year. Year 2004 thus signified return of households to saving and a turn away from a year-on-year decline in 2003, when the term deposits fell by 2 % and saving deposits even by 4.4 %.

The rate of growth of transaction money (one day deposits and currency) in M₂ aggregate came to 6.6 % and it was approximately three times faster against the growth of quasi money (+2.1 %). The rate of growth of transaction money started decreasing since the second half of the year. Mainly one-day deposits of businesses registered lower growth (to 1.8 %), while the same deposits grew year-on-year by 10.4 % for households. Total households deposits reached CZK 1,064 bn by the end of 2004, business sector deposits were CZK 535.7 bn. Despite fast growth of household credit (CZK 315.2 bn against CZK 237.5 bn in 2003) remains their volume more than three times lower in comparison to the volume of household sector deposits.

The ratio of money stock to GDP fell from 69.6 % to 67.0 %. One crown of expenditure on GDP was served by CZK 0.35 of transaction money, which is approximately the same level as in 2003. One crown of M₁ balance financed CZK 2.86 of expenditures on GDP (CZK 2.83 in 2003). The velocity of money remained roughly the same.

• ***Client interest rates on deposits of commercial banks moderately increased during the year, but are negative in real terms***

With regard to a higher growth of inflation (2.8 % against 0.1 % in 2003) were the real interest rates on deposits negative in the amount of 1.52 %, for household deposits than 1.47 %. Bank houses were increasing the nominal interest rates – this trend has been visible in year-on-year comparison since the half of the year. However, interest rates on average (weighted by deposit volumes) grew year-on-year only slightly to 1.332 % from 1.330 % as a result of opposing movements – the growth of rates on deposits of non-financial institutions from 1.081 % up to 1.137 % on the one hand, and further decline of average rate on household deposits from 1.401 % down to 1.332 %. Bank interest rate spreads depicting the profitability of their loan-deposit transactions were slashed moderately during the year for transactions with the household sector (from 7.2 % at the beginning of the year to 6.6 % in December) and on the contrary spreads grew slightly for transactions with the non-financial institutions (from 3 % to 3.5 % in the given period).

State Budget

• ***More favourable budget outcome compared to both 2003 and the budget plan***

Year 2004 recorded higher year-on-year growth of actual receipts than outlays by 3.2 p. p., while the 2004 state budget assumed lead of only 0.2 p. p. The growth of actual state budget outlays has been characterised by a downward trend since 2002 with the lowest year-on-year growth of 6.7 % recorded just in 2004. State budget deficit of CZK 93.7 bn ended lower compared to the approved budget by CZK 21.3 bn. In relation to nominal GDP it fell from 4.3 % down to 3.4 %. This more favourable budget outcome was in nearly two thirds influenced by higher receipt fulfilment (102 %) and in one third by lower than planned drawing of outlays (98.7 %).

• ***Positive development of state budget receipts***

Total tax receipts hit the amount of CZK 718 bn. The tax and charges receipts achieved strong fulfilment as well as year-on-year growth. Their fulfilment was favourably affected especially by VAT and profit taxes, adversely then by consumption taxes and property tax. Expected year-on-year decrease manifested for customs duties, whose volume shrank by approx. one half. Receipts from social security taxes also fulfilled the budget plans and grew by 7.7 % on a year before. In that the pension insurance formed 82.9 % (76.9 % in 2003). Significant fulfilment of 29 % above the adjusted budget recorded the non-tax and capital receipts and received subsidies, comprising 6.7 % of total receipts (4.5 % in 2003).

• ***Most of the outlays items below***

Fulfilment of all items of current outlays (total volume of CZK 796.2 bn) except for the non-investment transfers and other payments to budgets was characterised by

the budgeted level savings against the budget plans. The largest item of social security benefits reached CZK 313.3 bn and also experienced fulfilment below the budget level and low growth. In that paid out pensions increased year-on-year by CZK 5.0 bn (2.2 %). Capital outlays registered year-on-year of 17.2 % (fulfilment 98.7 %) and their share in actual total outlays grew by 0.7 p. p. compared to 2003.

- ***Surplus on the pension account*** Negative balance of the receipts from social security insurance and state budget outlays on social security benefits of CZK 20.0 bn at the end of 2004 was below both the adjusted budget and the previous year (by CZK 2.0 bn and 12.7 bn respectively). In that the balance on so called pension account attained a positive value of CZK 12.3 bn, which is CZK 0.9 above the adjusted budget and marked improvement compared to the previous year (balance CZK –16.2 bn).

State debt climbed up to CZK 592.9 bn by the end of 2004, i.e. by nearly CZK 100 bn. Its ratio to nominal volume of GDP reached 21.6 %.

Data sources: CZSO, MF CR, CNB, MLSA: calculations CZSO.

Latest CZSO data used in this report are from 11 March 2005. The analysis is based on monthly statistical data from branch statistics and quarterly GDP estimates.

Table 1 Monthly Macroeconomic Indicators

	2003	Months 2004											
	XII	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Consumer prices, in %, y-o-y	1,0	2,3	2,3	2,5	2,3	2,7	2,9	3,2	3,4	3,0	3,5	2,9	2,8
Consumer prices, in %, m-o-m	0,2	1,8	0,2	0,1	0,0	0,4	0,2	0,4	0,0	-0,8	0,5	-0,1	0,1
Industrial producer prices, in %, y-o-y	0,2	1,6	1,5	2,1	3,7	4,9	6,2	7,3	8,1	8,0	8,6	8,2	7,7
Industrial producer prices, in %, m-o-m	0,9	0,8	0,3	0,8	0,8	0,8	1,1	0,8	0,9	0,3	1,1	0	-0,3
Imports of goods, in %, y-o-y	20,9	-0,8	12,9	20,5	25,7	32,1	28,8	18,8	22,6	18,7	15,1	20,4	6,4
Exports of goods, in %, y-o-y	21,7	-0,6	18,5	18,7	24,7	33,9	33,6	27,0	29,0	20,8	16,6	33,2	18,5
Trade balance, in CZK billion, cumulative year to date	-69,7	0,1	4,6	1,3	-10,5	-9,2	-8,4	-14,9	-18,6	-14,6	-17,1	-13,6	-22,3
Registered unemployment rate 3)	10,3	10,8	10,9	10,7	10,2	9,9	9,9	10,2	10,2	10,1	9,9	9,9	10,3
Industrial production, in %, y-o-y	8,9	3,8	7,1	15,3	10,1	12,7	15,1	11,0	8,7	6,6	8,1	10,9	8,3
Construction works, real %, y-o-y	8,6	15,0	9,9	21,4	62,4	-2,4	-2,9	0,3	9,4	3,2	2,9	9,9	1,3

3) proportion of unemployed registered with the labour offices to the total labour force in %

Sources: CZSO, MLSA

Table 2 Selected Quarterly Macroeconomic Indicators

		2003				2004			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Gross domestic product	In CZK billion, in current prices	601.1	655.8	647.6	646.2	648.8	705.1	700.8	696.4
Gross domestic product	Real % change, y-o-y	3.2	3.7	4.0	4.0	3.8	4.0	4.0	4.3
Final consumption	Real % change, y-o-y	4.7	5.1	4.8	4.2	1.8	1.4	0.2	-0.6
of which: household consumption	Real % change, y-o-y	4.9	5.2	5.5	4.1	3.3	2.5	2.0	1.9
Gross capital formation	Real % change, y-o-y	1.6	4.9	1.4	3.2	11.0	10.9	8.9	5.0
of which: fixed capital formation	Real % change, y-o-y	3.7	3.8	5.8	5.9	9.9	9.4	9.6	7.5
Export of services and goods	Real % change, y-o-y	4.9	5.6	9.5	9.3	10.6	27.4	23.0	22.2
Import of services and goods	Real % change, y-o-y	5.6	7.4	8.9	9.6	11.3	27.0	19.9	15.8
Net export as % of GDP	In current prices	-0.2	-1.4	-2.4	-4.8	0.5	-0.5	-0.4	-0.9