

2.2. Macroeconomic Balances

The significant improvement of external imbalance during the years associated with economic crisis in the Czech Republic, compared to the years of previous boom, was accompanied by severe deterioration of internal imbalance measured by the situation in public finance when the deficit of public budgets and the general government debt increased rapidly. The imbalance on the labour market corresponded to the phase of the economic cycle. The relationship between gross fixed capital formation and level of its financing from external resources remained approximately the same in 2009 due to the sharp decrease of both investments and gross national savings.

External balance

- **The crisis year of 2009 deflected external imbalance only slightly, to the second best result in the decade**

In spite of the heavy impact of the economic crisis on the Czech economy in 2009 and the sharp fall into recession started in the second half of 2008, external relations with foreign countries improved in relative and nominal terms. In 2009, the current account of the balance of payments recorded the second best result during the entire decade; in 2008, external economic relations measured in this manner were in the best condition ever since 2000 in both nominal and relative terms.

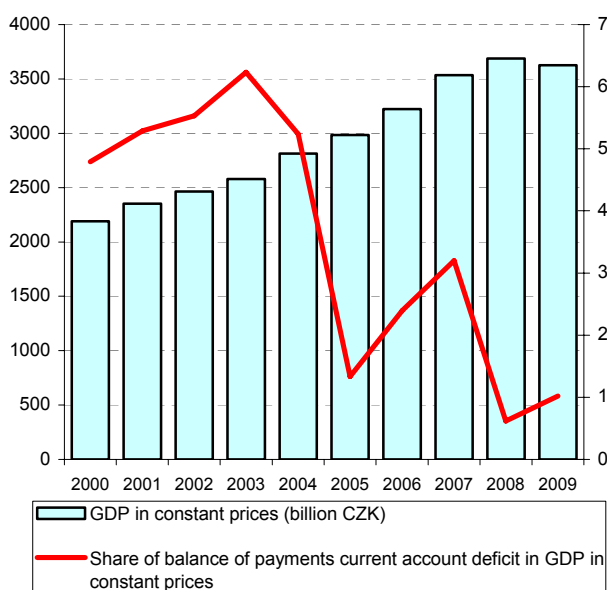
The surplus available on the financial account in 2009 once again covered the current account deficit, in nominal terms, roughly to the same extent as the average cover in the period 2000-2009; the capital account also recorded a historically highest surplus.

- **External imbalance improved substantially in 2008 and 2009, while the economy growth rate was slowing down and then negative**

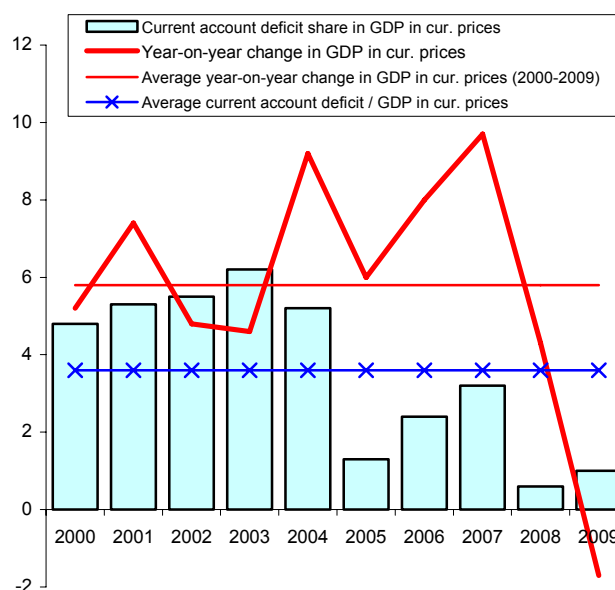
The current account deficit in 2009 was 37 billion CZK, which represented 1% of the nominal GDP of the Czech Republic. After the year of 2008, which – after revision of data by the Czech National Bank – appeared to be the most successful year of the decade with a current account deficit of as little as 22.9 billion CZK, i.e. 0.6% of the nominal GDP, effective stability of external economic relations was maintained in 2009 with only a slight deterioration.

Compared to the long-term average (2000-2009) with a deficit of 3.6% GDP in current prices, the current account contributed even more significantly to the improvement of the imbalance in the crisis years of 2008 and 2009 than during the boom period when the 2005-2008 average reached the already mentioned 2.3%. In 2008 and 2009, the result of the external imbalance was accompanied with changes in the structure of the components of the balance of payments current account, which were – in several cases – diametrically different from the development in the past years.

Graph No. 2.2.1 Nominal GDP and external imbalance
(current account deficit/GDP in current prices, in %)



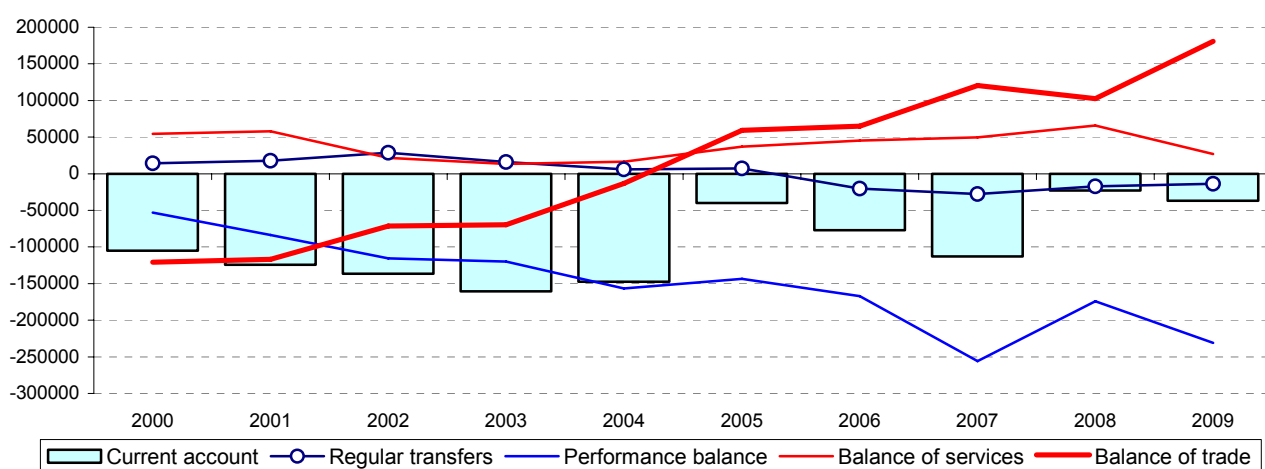
Graph No. 2.2.2 Nominal GDP growth rate and external imbalance (year-on-year change in %, current account deficit/GDP in current prices, in %)



- **Capital account strongly contributed to the achieved level of external balance** In assessing the external balance of the Czech economy, increasingly more weight can be attributed to the capital account¹ or, as the case may be, its continuously increasing surpluses marking the beginning of the period of Czech economic boom. Unlike in the years before EU accession, its positive balances not constitute a major contribution in favour of external balance.

From 1994 to 2003, the capital account balance oscillated around zero with a maximum magnitude of several hundred million of crowns. Since 2005 (+4.7 billion CZK), however, it has been contributing to external balance increasingly more intensely – in 2009, the surplus was already 41 billion CZK, which was on its own enough to compensate the deficit of the current account of the Czech Republic's balance of payment. The same was the case in 2008. External balance of the Czech economy was significantly strengthened also with the assistance of the capital account outcome. With its inclusion, it was not necessary to use only the level of coverage of the current account balance with the financial account surplus for its favourable evaluation in 2008 and 2009.

Graph No. 2.2.3 Developments in main components of the Czech Republic's balance of payments current account (balances, in billion CZK)



Source: CNB

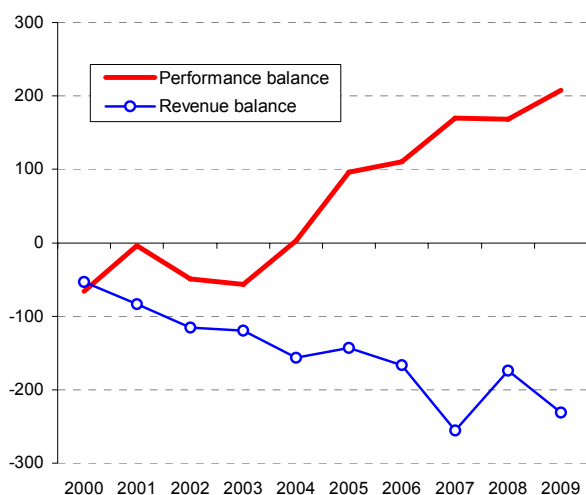
- **A record-high performance balance thanks to the surplus of trade in goods, with a decreased surplus of the balance of services** The performance balance recorded further improvement and its surplus in 2009 reached a record level, exceeding 207 billion CZK. A major share in this result came from trade in goods, since the surplus of the balance of services diminished strongly in 2009 and dropped below the 2001-2008 average.

There was a substantial improvement in the proportion of performance balance and revenue balance. While in 2004, the infinitesimal surplus of foreign trade in goods and services (3.2 billion CZK) entailed only a negligible coverage of the revenue balance deficit (-156.6 billion CZK), the performance balance surpluses during the following years were successfully reducing the increasing falls in the performance balance. The best ratio in the coverage of its deficits was recorded in the Czech economy in 2008 when only 6 billion CZK were missing for full coverage. In 2009, the revenue balance deficit (-230.9 billion CZK) was again markedly larger than the historically highest surplus of performance balance (207.5 billion CZK).

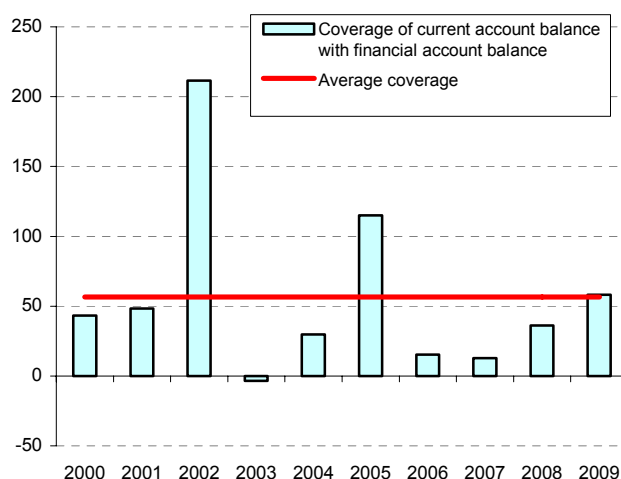
2009 was also marked by the historically largest share of performance balance on nominal GDP (5.7%); however, this was caused by not only its high positive balance, but also by the year-on-year decrease in GDP. During the boom period, the aforesaid share was 3.4% and 4.8% in 2006 and 2007, respectively.

¹ Capital account consists of transfers of capital nature related to population migration, debt relief, ownership rights to fixed assets (such as investment grants) and transfers of non-manufactured non-financial tangible assets (such as land – property for embassies) and intangible rights (patents, licences, copyrights and similar).

Graph No. 2.2.4 Performance balance and revenue balance (in billion CZK)



Graph No. 2.2.5 Coverage of current account deficit with financial account surplus (in billion CZK)



Source: CNB, own calculations

- **External balance further strengthened by positive results of foreign trade in goods, less in services**

As already mentioned, the performance balance entered the positive territory, for the first time ever, in 2004 (3.2 billion CZK) when foreign trade in goods was still in deficit, but substantially smaller than in the previous years of high deficits generated by strong imports. However, balance of services recorded a sufficiently high positive outcome in spite of the perceptible decrease of the surplus, since revenue – primarily from transport owing to the acceleration of foreign trade in goods around the time of the Czech Republic's accession to the EU – grew faster than expenditure.

The significant increases in the surplus of the performance balance since 2005 (96.3 billion CZK) culminated in 2009 (207.5 billion CZK) when its positive balance was 116% higher than in 2005, which was very helpful in compensating the deterioration of the revenue balance. The 2009 surplus of the performance balance was nearly four times higher than the average in the period 2001-2008.

- **Ambivalent foreign trade in goods – reduced volumes ...**

In 2008 and 2009, the development of foreign trade in goods was characterized by sharp decreases in the traded volumes, on one part, and by excellent results of balance of trades with growing surpluses, on the other side.

Turnover decreased by 15.7% in 2009 on a year-to-year basis as imports (-17.7%) dropped more than exports (-13.8%)². Yet 2008 was still marked by effective stagnation with a turnover increase by 0.1% (+6.9 billion CZK) – imports increased by 0.5% (+12.3 billion CZK), but exports were already facing difficulties on foreign markets (-0.2%, i.e. 5.5 billion CZK).

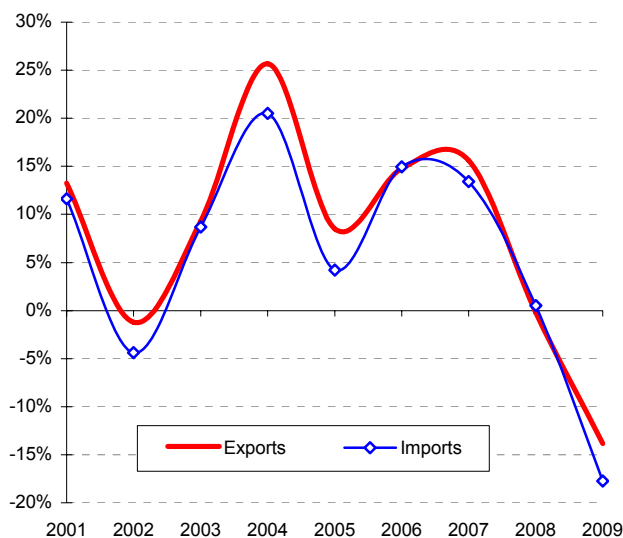
2009 was already marked by massive decreases of both exports (-342.4 billion CZK) and imports (-420.2 billion CZK). The reversal in commodity trading between the Czech Republic and foreign countries decreased by more than three-quarters of a billion crowns (-762.6 billion CZK).

- **... with a new record of the balance of trade**

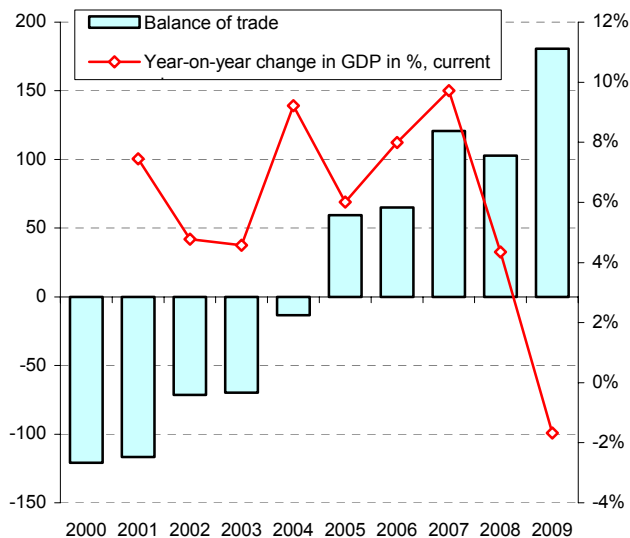
On contrary, the value difference between the exported and imported goods increased further to a significant extent in 2009. While in 2008, balance of trade decreased year-on-year by 14.8% to 102.7 billion CZK, the surplus for 2009 reached 180.6 billion CZK, which is 13 times more than the decade average.

² In both cases expressed in FOB prices.

Graph No. 2.2.6 Growth rates of imports and exports of goods (year-on-year in %, FOB prices)



Graph No. 2.2.7 Balance of trade and development of nominal GDP (in billion CZK)



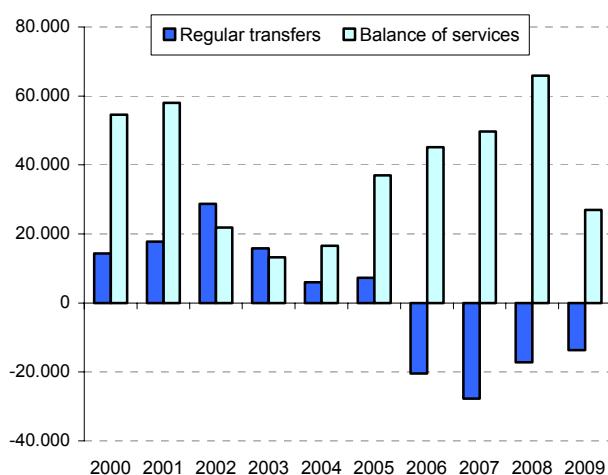
Source: CNB, own calculations

- Improvement of regular transfers due to lower payments to the EU during the crisis** As regards other components of the current account of the balance of payments, there was a further improvement in regular transfers, the deficit of which decreased for the third year in a row, reaching 13.7 billion CZK in 2009 (given the substantial surpluses in the period 2000–2005, its average for the past decade is also positive (1.1 billion CZK). Deficits since 2006 are determined by the existence of mandatory payments to the EU budget that are derived from the country's economic performance in the respective year.

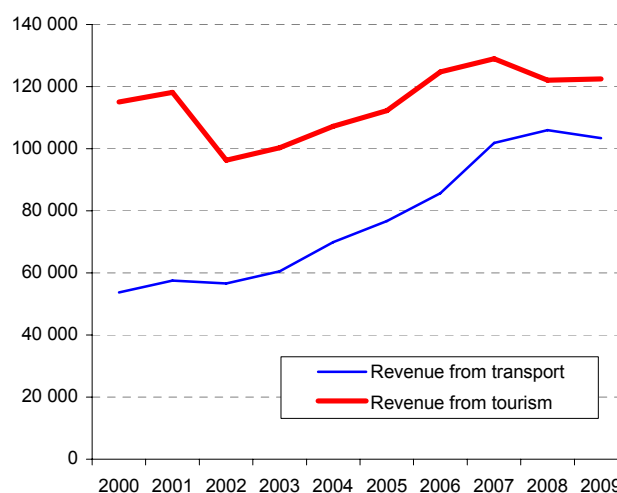
- Surplus of balance of services more than halved due to the development of trade in the so-called other services and the decreased revenue from transport** The balance of services reduced the record-high surplus from 2008 (65.9 billion CZK) to less than a half in 2009 (27 billion CZK). The item "Other services", in particular, suffered from a one-quarter growth on the expenditure side (from 151 billion CZK in 2008 to 205 billion CZK in 2009). Revenue from trade in other services was higher by 17 billion CZK on a year-to-year basis, but the balance for this component deteriorated to the worst result since 2004. Expenditure on telecommunication services increased by 3 billion CZK against 2008, expenditure on financial services by 4 billion CZK, and "other business services" by 47 billion CZK.

The economic crisis hit not only revenue from transport directly linked to the transported production, but indirectly also revenue from tourism. While revenue from transport was increasing by roughly 6.5 billion CZK per year in the 2001-2008 average and by as much as 10.3 billion CZK during the boom years (including 2004 with the extreme transportation performance in the period before and after the EU accession), in 2008 the year-on-year growth of revenue from transport was only 4.1 billion CZK. In 2009, this revenue declined by 2.6 billion CZK on a year-to-year basis.

Graph No. 2.2.8 Balance of services and regular transfers
(balance in million CZK)



Graph No. 2.2.9 Revenue from transport and tourism
(in million CZK)



Source: CNB

- **Revenue from tourism recovered slightly after the 2008 fall**

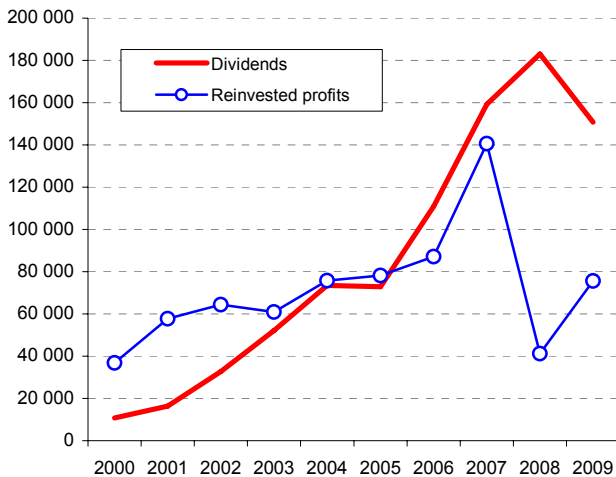
Following the previous year-on-year decrease, revenue from tourism in the balance of services did not deteriorate any further compared to 2008, which can be probably attributed to the fading away of the most severe impact of the crisis in countries of origin of the tourists coming to visit the Czech Republic.

However, the year of 2008 was marked by a decrease in revenue from tourism, which was the second time during the decade (this revenue dropped, even more sharply, in 2002 for the first time). Its decrease by 7 billion CZK was replaced with effective stagnation in 2009 (year-on-year increase by 438 million CZK). Travels abroad by residents, as regards tourist expenditure, were stagnating as well on a year-to-year basis so that the tourism balance itself did not show any year-on-year change and remained roughly the same as in 2002 and 2003.

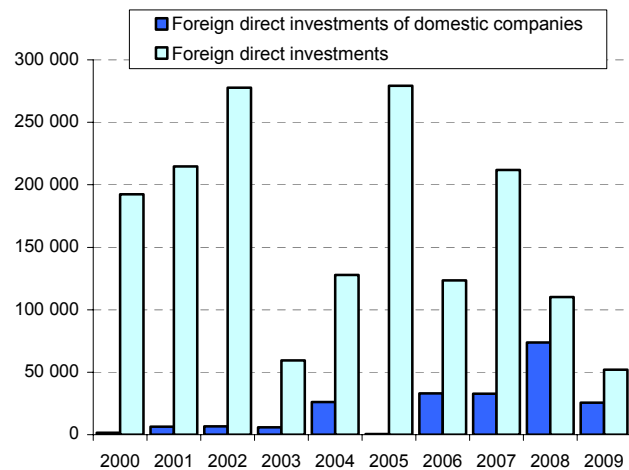
- **Reinvested profits decreased sharply in 2008; dividends at the highest ever level**

The financial crisis culminating in 2008 in both Western Europe and the world affected also the behaviour of direct investors and their ownership interests in the Czech Republic. In 2006 and 2007, profits left for reinvestments in the Czech economy were rising together with the sharp increase in the outflow of repatriated profits. 2008 was marked by another increase in the outflow of funds in the form of dividends paid to abroad (by 24 billion CZK); at the same time, however, reinvested profits dropped by nearly 100 billion CZK on a year-to-year basis. It appears that foreign shareholders wanted to be sure of their profits during the difficult times, because this phenomenon did not continue in 2009 – there were less funds flowing abroad in dividends than in 2008 and the volume of reinvested profits increased again. However, it did not even reach the level of 2005 (Graph No. 2.2.10).

Graph No. 2.2.10 Dividends and reinvested profits in the Czech Republic (in billion CZK)



Graph No. 2.2.11 Foreign direct investments (inflow and outflow in million CZK, cumulatively by quarter)



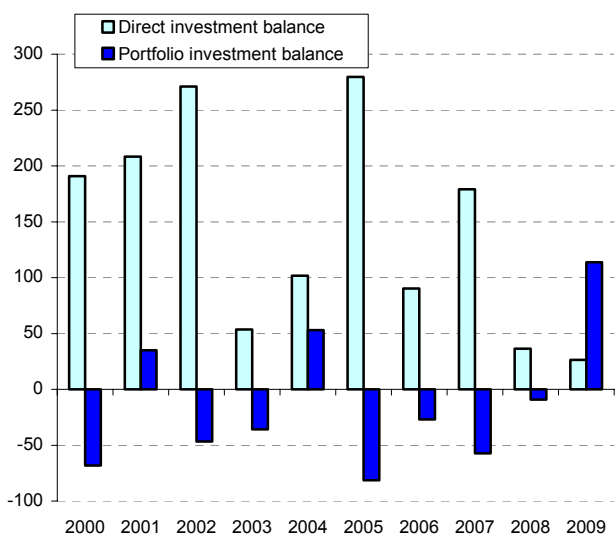
Source: CNB

• **Low direct investments and massive inflow of funds in the form of portfolio investments reduced the financial account surplus**

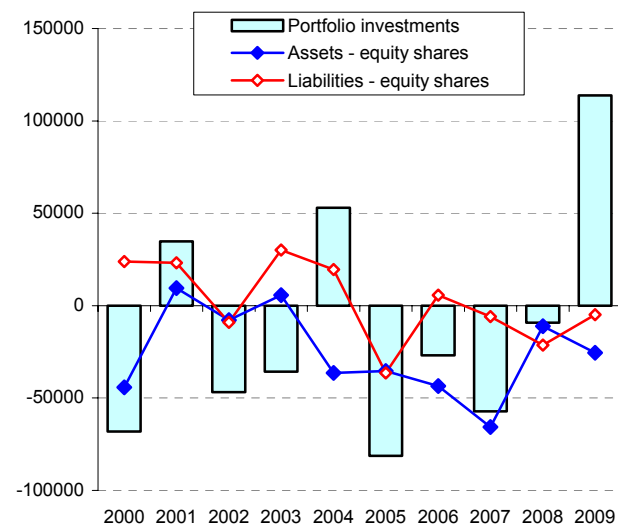
For the third year during the decade, the financial account recorded a surplus below the hundred-billion level (95.1 billion CZK in 2009 after 59 billion CZK in 2008, which was also the lowest positive balance of the financial account in the period 2000–2009). This was due to the weakening of direct investments – for 2009, their balance was the lowest during the entire monitored period (26.4 billion CZK).

In 2009 the Czech Republic attracted the least foreign direct investments in the period 2000–2009 – with 52 billion CZK, it was only one-third of this decade’s annual average (165 billion CZK). However, this average was influenced by the extreme inflow wave of foreign investments, which commenced in 1998 and continued with high intensity after 2000 (with interruption in 2003). The sale of strategic interests in state-owned enterprises partially contributed to that wave as well. However, there is no doubt that the limited inflow in 2009 was affected by the global economic crisis accompanied by risk aversion, also in direct investments.

Graph No. 2.2.12 Direct and portfolio investments (balance in billion CZK)



Graph No. 2.2.13 Balance of portfolio investments and equity securities (in billion CZK)



Source: CNB

- **Portfolio investments in equity shares significantly affected by the global financial crisis – foreign investors more precautionary than residents in 2009**

The influence of the global financial crisis on the capital market development is also apparent from the purchases and sales of equity shares. As implied in graph No. 2.2.13, the year of 2008 was characterized by vacating of positions held by residents on foreign stock markets as well as their reduction by foreign portfolio investors. The recovery of stock exchanges around the world in 2009 resulted in a slightly growing engagement of Czech investors on these markets compared to 2008 while, on the opposite side, there was – in total – no growth of investments in securities on the stock exchange in the Czech Republic (for 2009, the outflow of funds in foreign investors' trading in securities in the Czech Republic, amounting to 4.8 billion CZK, was less relevant than in 2008 with -21.3 billion CZK). Desire for higher risk investments such as securities has not come yet on either side.

- **Foreign portfolio investors purchased Czech bonds for nearly 100 billion CZK in 2009**

The Czech debt was more attractive for foreign portfolio investors. In 2009, they purchased bonds for 99 billion CZK in net terms. On contrary, Czech investors reduced their positions in foreign debt securities - this resulted in a massive inflow of money to the country (balance in bonds +45.1 billion CZK) to a larger extent than the Czech investments on foreign markets (balance of -25.4 billion CZK).

Against this background and together with the nature of activities of foreign portfolio investors in the Czech Republic as regards both securities and bonds, the resulting positive balance of portfolio investments in the balance of payments of the Czech Republic increased strongly to the highest level in the monitored period of 2000-2009.

- **Improvement of external imbalance also with the help of a significant deterioration in the internal balance**

As a result, this positive balance of portfolio investments or, to be more specific, its level – the highest ever in the history of the Czech Republic – crucially affected the surplus of the balance of payments financial account, which was recorded in spite of the lowest balance of direct investments and a deficit in other investments, which occurred for the first time since 2005. This also proves that the favourable development of external imbalance was largely the consequence of public finance deficit because foreign portfolio investors purchased, on a large scale, securities issued by the Czech state.

Internal balance

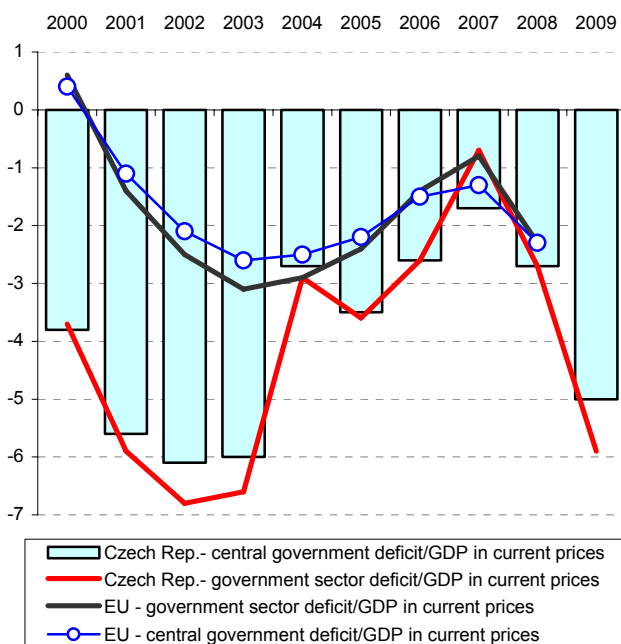
- **Internal imbalance deflected significantly in 2009, and a deficit at 5.9% of nominal GDP came close to the worst values in the period 2001-2003**

Public budgets in the Czech Republic experienced severe deterioration in 2009. A tremendous fall in tax collection caused by the economic crisis together with the increase in expenditure related to the measures to partially mitigate the consequences of the crisis pushed the balance between revenue and expenditure of the Czech Republic's government sector into a final deficit of 215 billion CZK. In 2008 the deficit was 100.3 billion CZK, in 2007 only 23.9 billion CZK, which was – in nominal terms – the best result of the decade and, with regard to the high growth of the Czech economy, the year was also marked by a good result in terms of the government deficit to GDP ratio (0.7%). Such moderate internal imbalance was not recorded in the Czech economy even during the years of culminating boom.

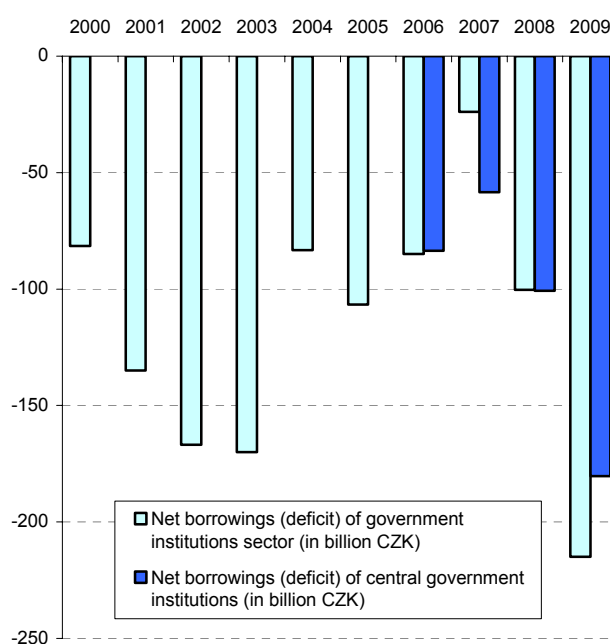
In spite of the severe deterioration of public finance situation in the Czech Republic in 2009, the year of 2009 was not among the worst years of the decade – that position belongs to 2002 and 2003 with public budget deficits of below 6% of nominal GDP (graph No. 2.2.14). The largest relative deficit was recorded in the Czech Republic in 1995 (-13.4% GDP), which was the worst result of all among all countries monitored in Eurostat tables in the 1995-2008 time series.

The national budget (central government institutions) participated in the 2009 government deficit of the Czech Republic with a deficit of 180.3 billion CZK, which was four-fifths higher than in 2008.

Graph No. 2.2.14 Government deficit and central government deficit (in % GDP)



Graph No. 2.2.15 Net borrowings (deficit) of the government institutions sector (in billion CZK)



Source: CZSO, Eurostat

- **In 2007 and 2008, public budget deficits better than the EU-27 average**

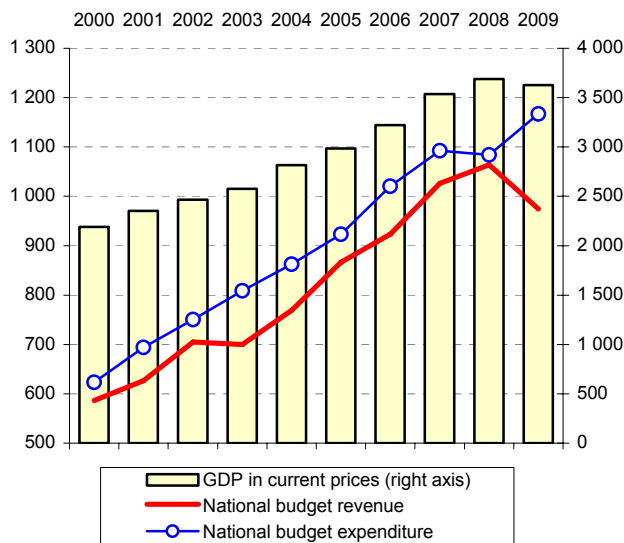
As shown in graph No. 2.2.14, the Czech Republic's public finance deficit as a share of GDP in 2007 and 2008 was more favourable than for the EU-27 as a whole, but slightly worse compared to the euro area. It can be expected that the 2009 data will bring a perceptible deterioration of the relative public sector deficit on the European average with regard to the rescue of banking sectors, particularly in the largest European countries, during the financial crisis. Although the Czech Republic was not forced to take any rescue actions in view of the financial solidness of its banking sector, the deterioration in situation of public budgets was affected by the aforesaid massive tax collection loss, particularly as regards corporate tax.

- **Deterioration of deficit affected primarily by public finance and the fall in tax collection ...**

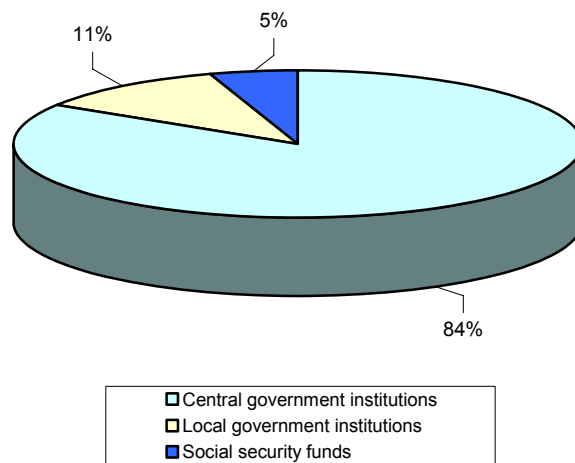
Consequently, it is possible to say that the sharp fall of public budget deficit in 2009 was not caused by the financial crisis in the Czech Republic or by its negative effects implanted from the external environment, but mainly by the economic crisis. Its "importation" in the form of shrinking foreign demand followed by shrinking domestic demand, frozen investment activity, delayed but still significant loss of growth in household consumption expenditure, increasing unemployment – all that had an impact on both revenue and expenditure sides of public budgets.

A reduction of the revenue side of the national budget in 2009 (in figures from cash implementation) by 9.4% was influenced by the decrease in tax collection (-10.4%), particularly in relation to corporate tax (-34.5% with a loss of 44 billion CZK compared to 2008). The national budget revenue was thus missing 97 billion CZK from taxes against 2008 and as much as 159 billion CZK against the already amended draft budget. On contrary, expenditure continued growing (+7.7%) with an above-average rate for items with the largest volumes, and significantly higher dynamics of capital expenditure. The extraordinary crisis measures adopted in spring 2009, aimed at supporting economic growth in the business sector, had a devastating effect on public finance because it limited its revenue (ceilings for social security/health insurance contributions, VAT deductions, allowances for acquisition of tangible assets, etc.).

Graph No. 2.2.16 National budget revenue and expenditure and GDP in current prices (in billion CZK, cash budget implementation)



Graph No. 2.2.17 Government sector deficit structure in 2009 (in % of deficit)



Source: CZSO, Ministry of Finance of the Czech Republic

- **... as well as by the rest of the government sector with increased deficit of local government institutions, and newly also deficit in social security funds**

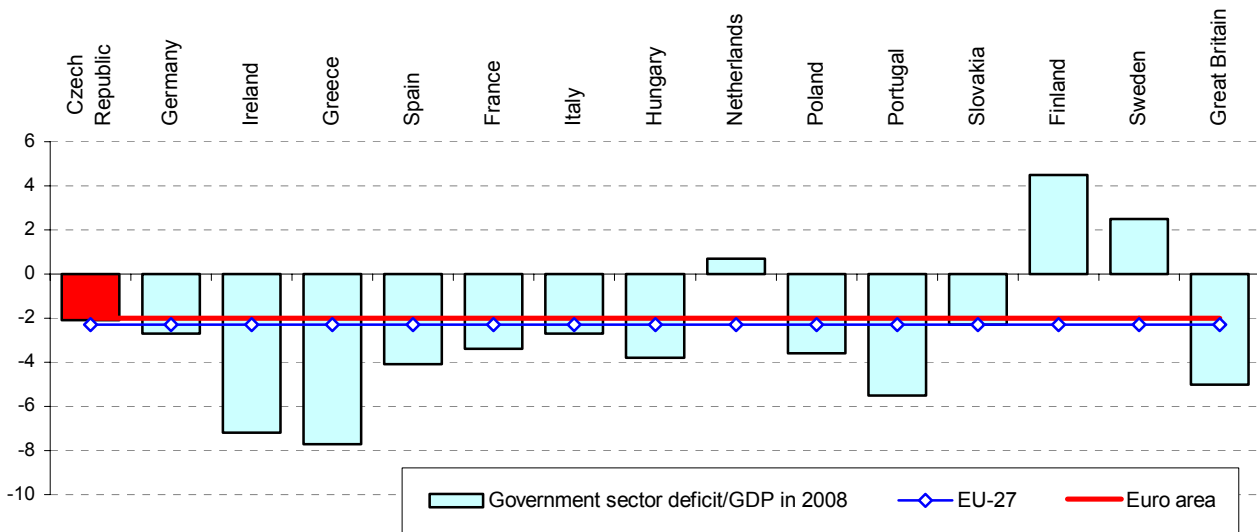
The notification of the government deficit and debt in ESA 95-based indicators implies that the state finance deficit in 2009 did not dominate in the deficit structure with the same strength as in the previous years (graph No. 2.2.15). It increased less on a year-to-year basis (5% GDP) than the deficit of the entire government sector (5.9%).

This means that substantial deterioration was also recorded in other components of public budgets. Social security funds, following long years of surpluses, ended up in deficit – against 10 billion and 16.1 billion CZK surpluses in 2008 and 2007, respectively, new borrowings (deficit) in 2009 amounted to 10.7 billion CZK, which represents a year-on-year deterioration by 20.7 billion CZK. The sector of local government institutions (municipalities and regions) was a similar case – here the fall into a deficit took place in 2008 already (-9.6 billion CZK) compared to the previous year's surplus (16.5 billion CZK). In 2009, the deficit of local government institutions deteriorated further to a substantial extent (24 billion CZK) – compared to the social security funds, there was not such a nominal depth of fall in 2009; nevertheless, both these components escalated the deficit of the entire government sector of the Czech Republic in that year by 34.7 billion CZK. Thus, the impact of the crisis was sector-wide for the government sector.

- **In 2008 at the outbreak of the global financial crisis, the Czech Republic was among countries with a rather average internal imbalance based on the government sector deficit**

In 2008, based on the government sector deficit compared to nominal GDP, the internal imbalance of the Czech economy was approximately at the level of EU-27 or euro area average. Graph No. 2.2.18 shows that the Maastricht fiscal criterion determining the threshold of three percent of nominal GDP for the government sector deficit would be markedly exceeded by large countries such as France, Great Britain or Spain. Germany and Italy were just below the required threshold. Within Europe, public budgets in surplus were nearly exclusively recorded in Nordic countries (Norway with as much as 18.8% GDP deficit) and, apart from those, only Cyprus and Bulgaria. A huge deficit of Iceland (-13.6% GDP) corresponded to a situation of national bankruptcy brought about by the collapse of the banking sector (three largest local banks had each a balance sum higher than the Icelandic GDP and uncovered risk assets in their portfolios).

Graph No. 2.2.18 Internal imbalance based on the government sector deficit in selected EU-27 countries as a share of their nominal GDP in 2008 (in %)



Source: Eurostat

- **Government debt grew by one-sixth, which was the highest increase since 2002**

The gross consolidated government debt reached a total of 1,282.3 billion CZK in 2009, while this debt level in 2008 was 1,104.9 billion CZK. The central government sector (state finance) participated in the total government debt with 1,186.6 billion CZK, and its debt level increased slightly more (+16.7%), on a year-to-year basis, than the debt of the entire government sector (+16.1%).

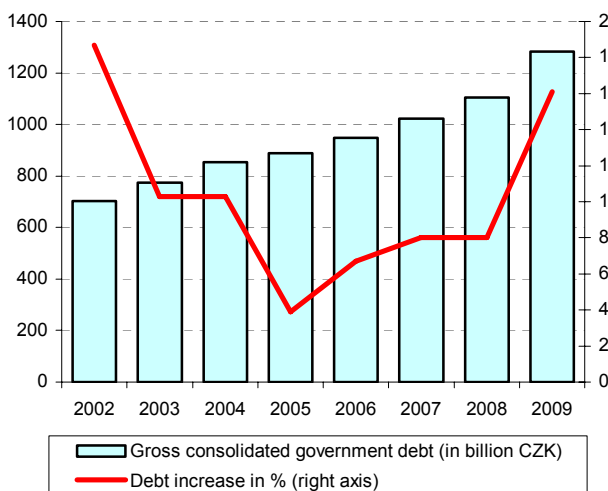
...

- **... and, in relation to GDP, it increased from 30% to 35.4%**

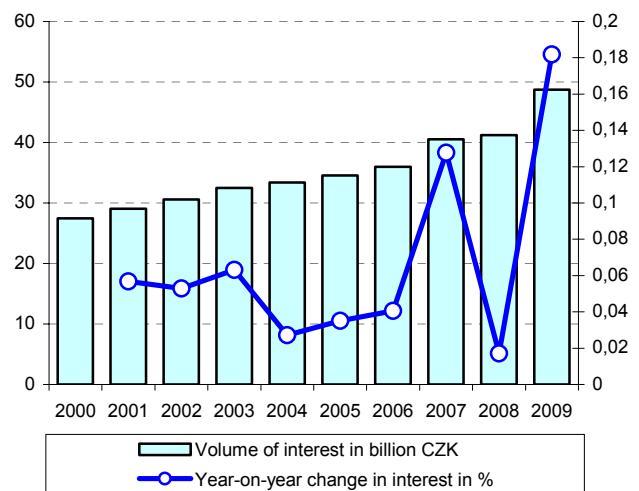
While the increase in gross government debt reached over 177 billion CZK in 2009 and was 96 billion CZK higher compared to the 2008 increase, the increase in the central government debt amounting to 170.4 billion CZK jumped up by 93 billion CZK compared to the 2008 increase. The weight of state finance in the change of gross government debt was higher than in case of the deficit in 2009.

The relative debt level increased from 30% share of gross consolidated government debt in GDP in 2008 to 35.4%. In spite of the lacking data in European comparison for 2009, it can be concluded that most countries, in general, experienced deterioration and that the position of the Czech Republic in debt level seems to have remained without major changes.

Graph No. 2.2.19 Consolidated gross government debt of the Czech Republic (in billion CZK, year-on-year change in %)



Graph No. 2.2.20 Interest on gross government debt (consolidated, in billion CZK, dynamics in %)



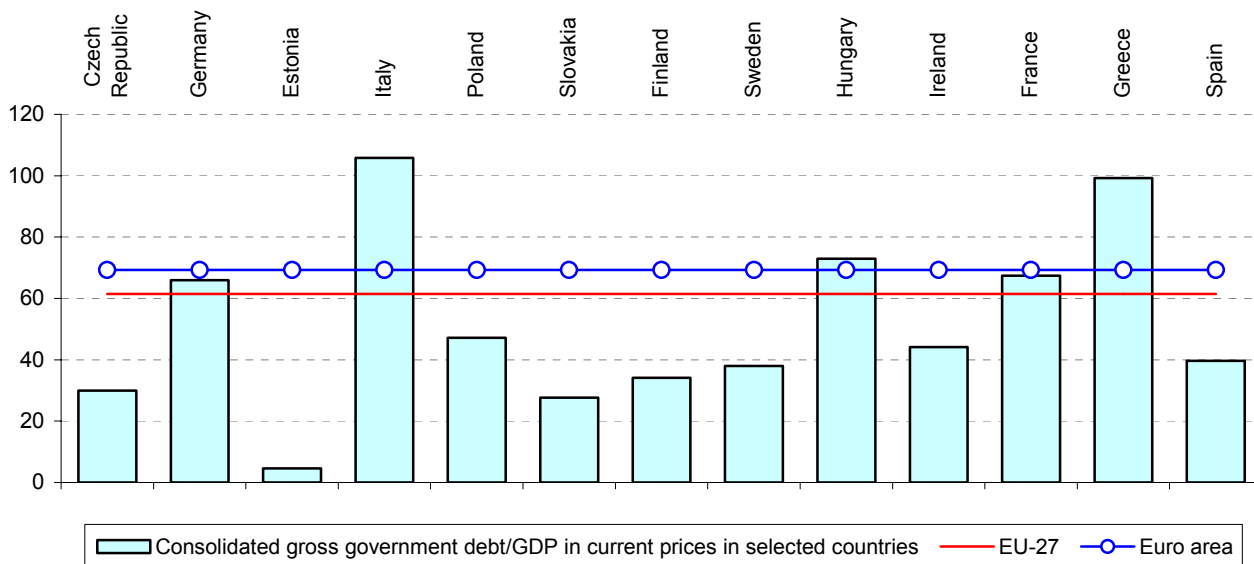
Source: CZSO, own calculations

- **Relative level of government debt at half of EU-27 average; its growth rate was the second highest in Europe**

According to graph No. 2.2.21, the relative gross consolidated government debt of the Czech Republic for 2008, amounting to 30%, was only at half of the EU-27 average (61.5%). This indicator was even much better compared to the euro area (69.6%) and, according to Eurostat, there were only seven countries with a lower debt level than Czech Republic in that year.

However, the growth rate of the relative government debt measured by the change in 2009 against 2000 shows that the Czech Republic faces the second highest growth rate of this debt level among all EU countries, by approximately two-thirds. Luxembourg recorded even a sharper increase, with the gross government debt growing 2.2 times in that period, and by roughly a half in Latvia. Among European countries, it was indeed the Czech Republic, Luxembourg and Baltic countries that had the lowest debt in 2000. Countries with a debt-to-GDP ratio above 60% do not meet the Maastricht fiscal criterion for sustainability of convergence (or, in case of EMU non-members, the threshold for joining the euro area).

Graph No. 2.2.21 Internal imbalance based on the gross consolidated government debt in selected EU-27 countries as a share of their nominal GDP in 2008 (in %)



Source: Eurostat

- **Sustainability of public budgets in the Czech Republic continues to be at risk**

The risk of slowdown in economic growth rate, which was the subject of warnings in connection with the development of public budgets during the economic boom, was materialized – the economy even declined. Although the situation of public finance does not reach a crisis level based on the relative deficit, insecurity as regards sustainability of public budgets in the medium, and particularly the long run, remains – or grows, where relevant.

Pointing to an even worse situation in countries that were forced to spend billions of euros from their budgets to rescue their banking systems is not an appropriate measure for comparison and assessment. Similarly to the situation when the Czech public budgets gradually eliminated its transformation debts from 1990's, the countries that supported their financial sector will recover these financial injections in the course of time in the form of debt repayments to a various scope. However, the problem caused by ageing population and excessive delay of reforms related to that is worse in a certain sense - it cannot be "amortized" in time. On contrary, the demographic development will result in further deterioration in objective terms. Compared to that, the need to postpone the adoption of single currency is only a secondary issue.