

2.2. Macroeconomic balance

The economic growth in the Czech Republic in 2006 was characterized by repeated extending of imbalances both towards the external environment and in decisive indicators of internal imbalance – discrepancy between tangible flows (real economy) and financial flows (monetary and fiscal development) is retained. From the beginning of the recovery, i.e. from 2003, the accelerating growth of the Czech economy allowed for redemption of current account deficit of the balance of payments measuring external imbalance as well as public budget deficit which is a decisive indicator of internal imbalance. Even a record y-o-y growth of GDP at constant prices by 6.1% (like in 2005) was unable to sustain this trend and unbalancing trends began to grow stronger. The economy is again exposed to the risk of double deficit.

Internal balance

Rapid growth of key industries valuating previous investments, sucking of external resources satiating strong domestic demand and lower unemployment pictured in 2006 very favourable image of real economy of the Czech Republic. Culminating recovery is proved by the fact that for GDP by kind of activity the economy consumed increasing amounts of money and monetary conditions became more expansive. Extremely low value of money contributed to the increasing demand for loans. Strong credit expansion flowed into the household sector and the non-financial corporations sector. This particular credit expansion is the strongest reason of growing money supply in the Czech economy which in 2006 more than doubled compared to the previous year growth.

Such movements resulting from changes of supply and demand – and retroactively affecting supply and demand – had an impact on the change of indebtedness level and debt structure in the economy.

Public finance

Development of public finance in 2006 proved that fiscal area is probably the most serious problem of the Czech Republic reflecting both in convergence area and increasing imbalance between tangible and intangible (financial) part of the economy. Maintaining of public budgets deficit below 3% of GDP like in 2004 (-2.9%) failed in 2005 (-3.6%). In 2006, the CR met the convergence limit with a 2.9% deficit of GDP; however, given this result, the government deficit cannot be regarded as sustainable in respect of budget structure and demographic development in the country.

Public budget deficit in 2006 in the amount of 2.9% of GDP just below the convergence criterion limit

The year 2006 also proved how difficult it is for the Czech public finance to meet the Maastricht fiscal criterion – the 2.9% deficit of GDP was very significantly affected by strong economic growth supporting the revenue side of the budget (program of convergence for 2006 counted with a 3.8% deficit of GDP).

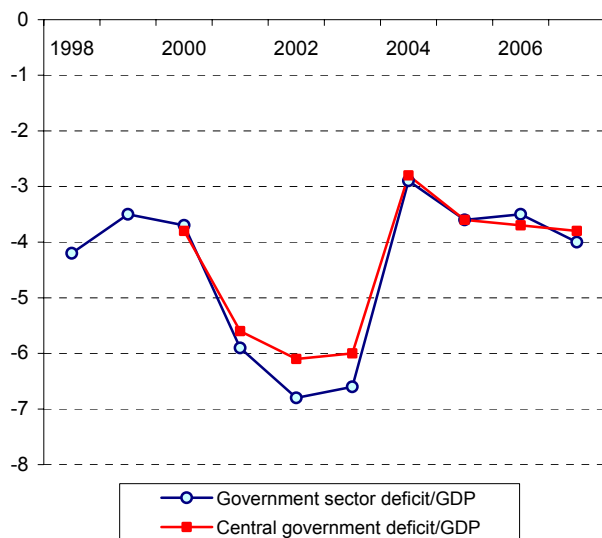
The state budget deficit as a decisive cause of public finance deficit increased in 2006 compared with 2005 due to lower than expected direct tax collection and higher dynamics of expenditure. Expenditure exceeded revenues by CZK 97.3 billion. The deficit ratio to nominal GDP reached 3.1%.

• Shares of mandatory expenditures in 2006 increased

Shares of mandatory state expenditure went up again. If in 2003 they made 61% of budget revenues and accounted for 53% of expenditures, in 2005 the shares were 54% and 51%, respectively. In 2006, the increase was recorded again, to 57% of incomes and 53% of expenditure. Due to jump increase of mandatory expenditure in connection with new social benefits (e.g. birth grants and parental benefits) in the approved budget for 2007 their shares make three fifths of the budgeted level which is more than in 2003.

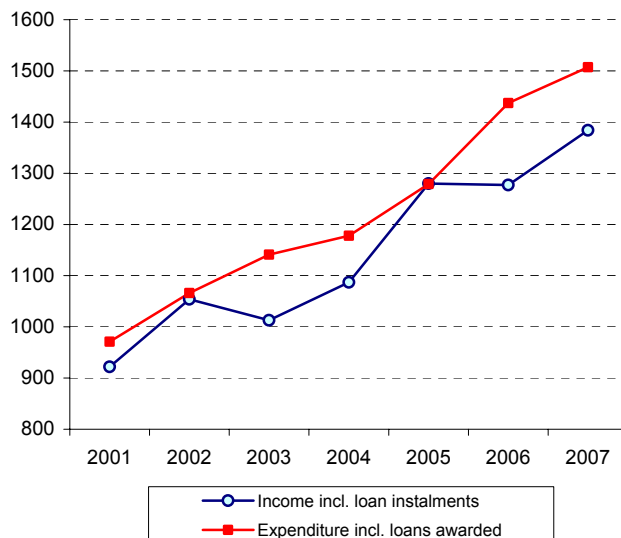
After the repeated growth of quasi-mandatory expenditure among which belong especially wages of employees in the budgetary and semi-budgetary sphere, defence expenditure or investment incentives, the state has available less than one fifth of the state budget revenues to fund the development because the proportion of mandatory and quasi-mandatory expenditure in the state budget of the Czech Republic exceeds 80% of budget revenues (graphs 30 and 31).

Graph 28 Government deficit and central government deficit (in % of GDP)



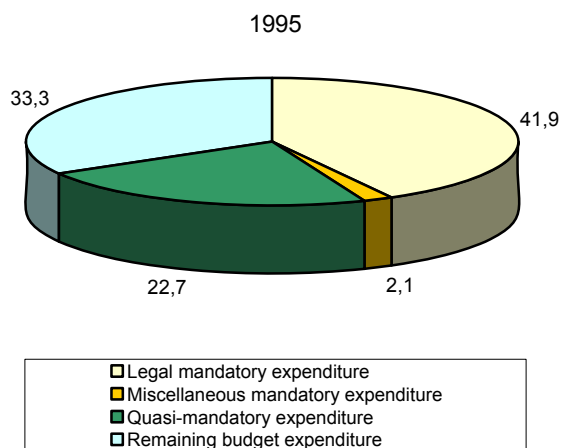
Source: MF CR

Graph 29 Income and expenditure of government sector of the CR (consolidated in CZK billion 2007 - newscast)



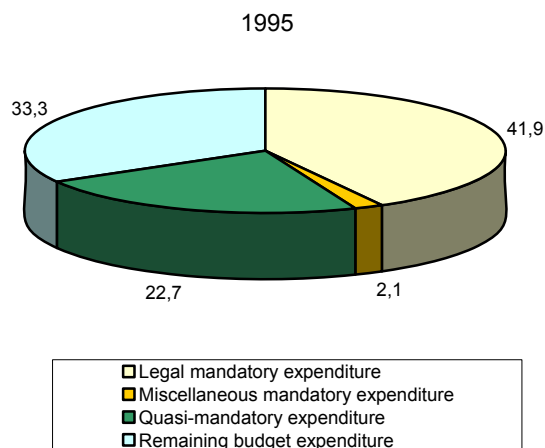
Source: MF CR

Graph 30 State budget expenditure structure (1995, in % of total expenditure)



Source: MF CR

Graph 31 State budget expenditure structure (draft for 2007, in % of total expenditure)

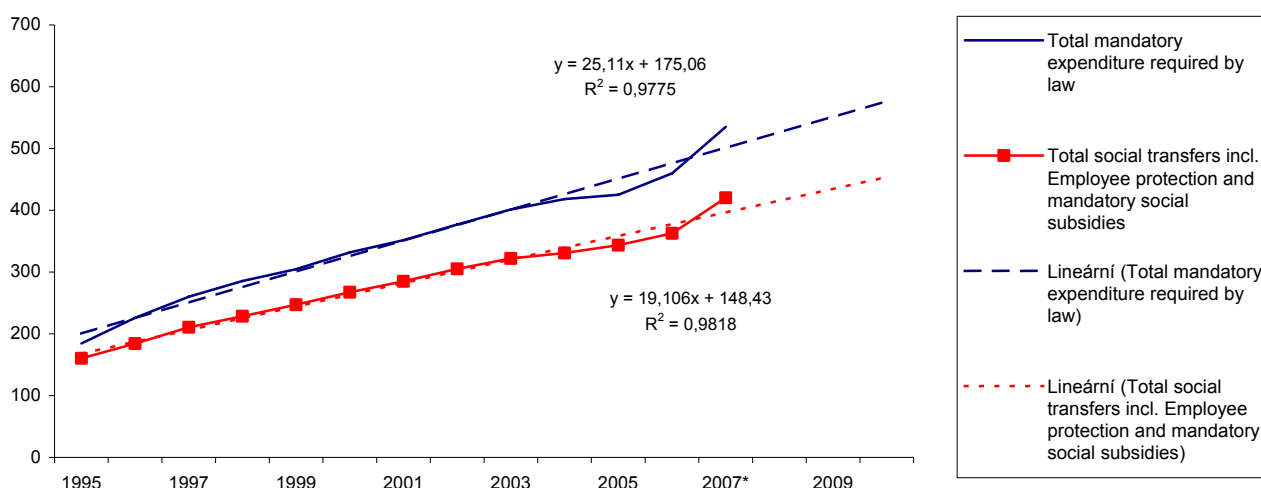


Source: MF CR

• **Robust growth adjusted relations to GDP**

Ratio of mandatory budget expenditure to GDP would show even higher values if the robust growth of the Czech economy since 2003 did not adjust this indicator. In 1995, the share of mandatory expenditure in budget income made 44% and in expenditure 44.8%.

Graph 32 Legal mandatory expenditure and social transfers (in CZK billion, years 2006 and 2007 draft budget, in 2008-2010 recourse settlement)



Source: MF CR, own calculations

- **Stabilization of gross government debt since 2003 at approximately 30% of GDP**

From 2003 the debt of the Czech government sector moves around 30% of GDP. This relatively favourable ration can be maintained – at rapid nominal increase of debt – thanks to robust growth of Czech economy. In case of downward trend of economic cycle the problem cannot appear if the amount of debt is proportional.

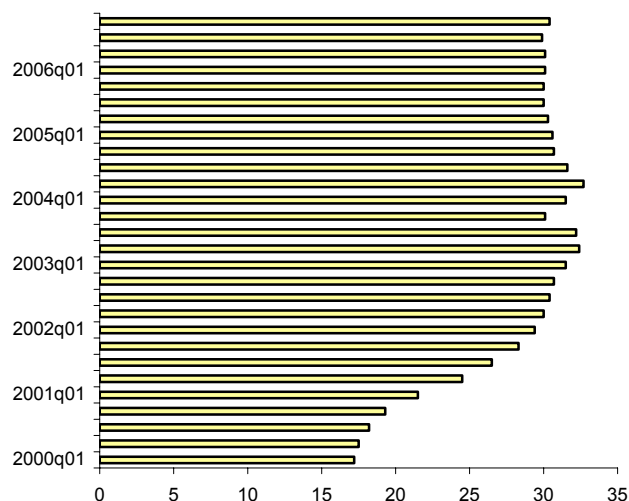
In 2006, gross consolidated government debt of the CR accounted for CZK 973 billion which was 30.4% of GDP. Its dynamics of growth is fast (in 2003, the debt accounted for 775 billion). Nevertheless, in nominal value the amount of debt in relation to GDP is deeply below the limit of Maastricht criterion for adoption of EUR. In 2006, the CR thus belonged to the EU countries with the lowest level of indebtedness.

- **State budget deficits most contribute to the government debt increase. Risks result also from other debt components**

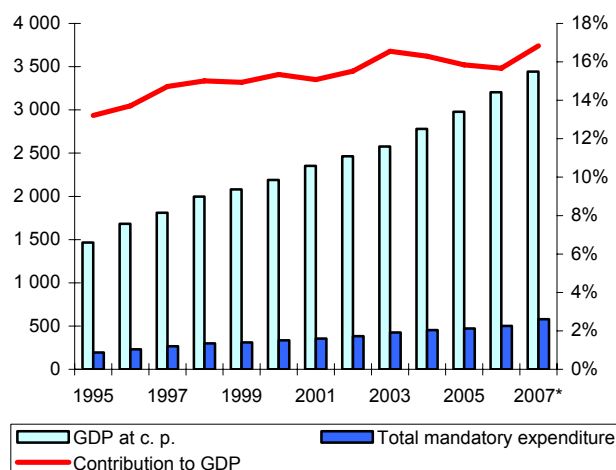
Despite the fact that the state budget deficits represent a decisive negative factor increasing the amount of the government debt, other debt components bring a few potential risks, as well. The health insurance system is imbalanced and unable to maintain a long-term balance using only its own potential. In out-of-budget funds there is a threat of exhausting their own sources.

Rapid dynamics of the Czech public debt recorded for the last years (in 2006 compared to 2002, the debt in absolute values was twice as high) slowed down markedly due to large collection of income from privatisation. This will be mitigated in the future since the sale of state ownership interests is mostly exhausted. The only way to reduce the debt in the future is the area of deficits generating the debt.

Graph 33 Debt of the government sector of the CR (gross, consolidated, in % of GDP)



Graph 34 Mandatory expenditure and GDP (in CZK billion, share in %)



Source: MF ČR

• **Favourable impact of economic boom**

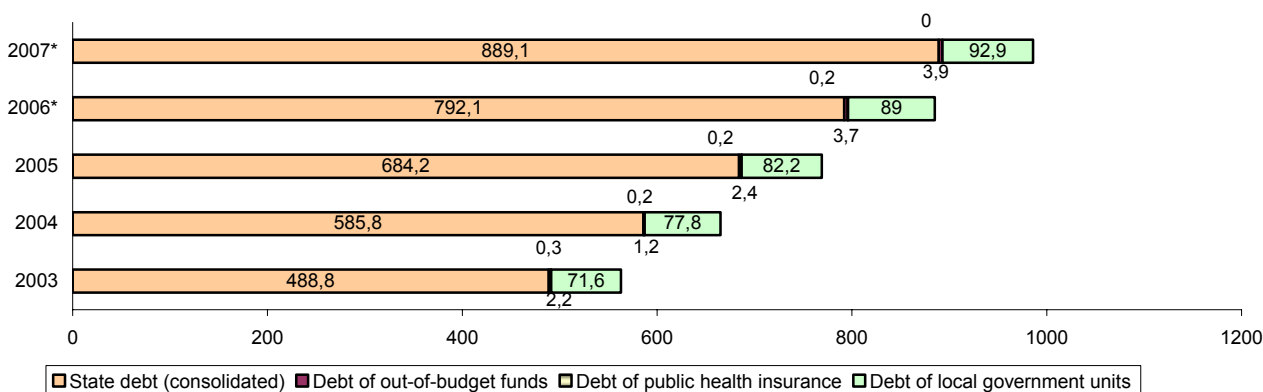
Besides contributions from privatisation income realized from the sale of state ownership interests in big companies – in 2005 these sales squeezed the government debt determined in relation to GDP by 3.5 p. p. - robust economic growth contributes to stabilization of the government debt share in GDP (growth of nominal GDP in the amount of 6-7.5% per annum will contribute to reduction of the government debt in relation to GDP approximately by 2–2.5 p. p.).

• **Which are the most severe risks of internal imbalance in fiscal sphere**

The most severe risk for internal balance of the Czech economy related to public finance is a delay risk. Ageing of population affects from fiscal aspect not only pension expenditure but also health and social expenditure.

Risk of increasingly expensive debt servicing (interest) is real. Volume of interest payments in view of new bond issues continued to grow (expenditure on debt servicing in 2000 accounted for CZK 17.4 billion, in 2006 CZK 33.9 and in 2007 CZK 40.4 billion is allocated for interests from the stage budget). However, debt allocation poses no problem because thanks to the good rating of the CR demand for debt exceeds the supply. Risk of negative developments at the bond market is high.

Graph 35 Government debt structure (2003-2007, in CZK billion, individual components, anticipated results for 2006, for 2007 draft budget projection)



Source: Eurostat, own calculations

External balance

- **Surplus at the financial account was not sufficient to cover in 2006 the balance of payments current account deficit...**

In 2006, external position of the Czech economy became weaker. Surplus at the balance of payments financial account in the amount of CZK 111.6 billion shrank y-o-y by CZK 43.2 billion and failed to cover the funding of current account deficit whose main components, save for the trade balance, showed negative development as it is clear from Graph 36.

Current account deficit reached CZK 133.8 billion and was markedly worse than in 2005 when the deficit of CZK 77.1 billion was so far most favourable result of the last decade. In 2006, the current account deficit made 4.2% of nominal GDP while in 2005 the deficit was only 2.6%. Growing external imbalance was attributed to the ever deteriorating income balance while the contribution of external trade was positive. Performance balance in relation to GDP at current prices was 1.8%.

- **... external balance of the Czech economy became worse due to almost all main current account components**

The Czech economy external balance compared to years 2004 and 2005 deteriorated. As it was mentioned, of individual components of balance of payments current account only external trade contributed to the balance when the value of exports exceeded the value of imports by CZK 44.4 billion which was the best trade balance in the history of the Czech Republic.

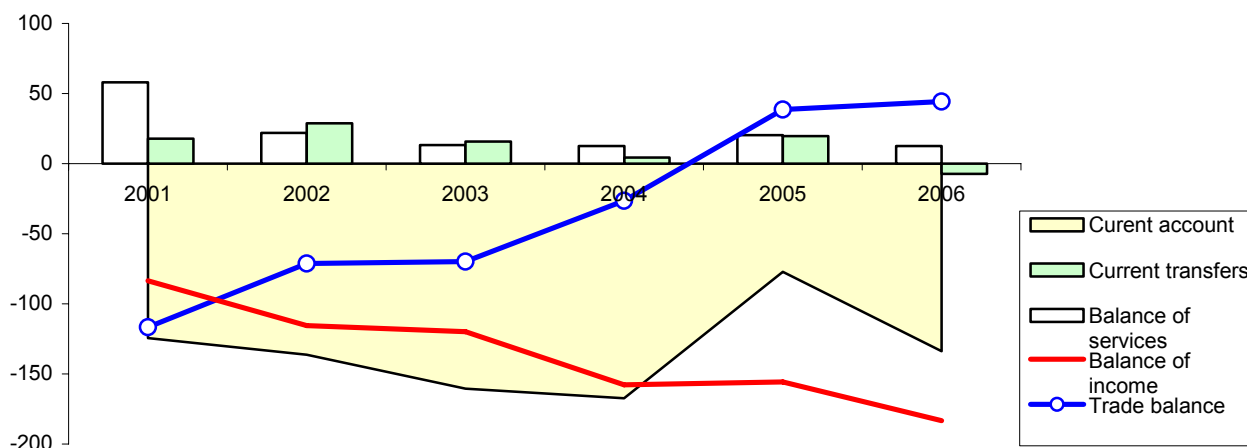
In contrast, the income balance, current transfers and partly also balance of services had an adverse effect on external balance of the Czech economy – deficit showed also current transfers which previously were constantly in surplus and the surplus in the balance of services shrank as well. Unfavourable development continued in the income balance (deficit in the amount of CZK 183.4 billion reached again its historical level, at the side of expenditure the outflow of money from the CR accounted for CZK 304.8 billion). The income balance mainly reflects current stages of the investment cycle of foreign direct investment into the Czech economy (proportion of repatriated and reinvested profits of foreign investors indicates the second stage of this cycle to be followed by the stage with prevailing repatriations).

Surplus of trade balance was higher than in 2005 thanks to basically same dynamics of imports as exports – contribution of net exports to the GDP dynamics was significantly lower than in 2005 (its contribution to GDP growth was almost three fourths and in 2006 the contribution made only 0.6 p. p. due to changes of growth of other GDP components, especially investments and household consumption).

The change compared to previous development was attributed to further shrinkage of the balance of services surplus (surplus accounting for CZK 12.5 billion represented approximately the same result as in 2004 which was, however, markedly worse than in 2005 when the balance of services surplus was over CZK 20 billion). In 2006, the balance of services surplus decreased by more than one third. Mainly in tourism the income was lower than the costs, and the income from transport services showed the same level as in 2005.

Influence of individual components on the balance of payments current account is shown in factor analysis in Table 3.

Graph 36 Changes in balance of payments current account structure of the CR (balances of main components in CZK billions)



Source: CNB

- **Surprising deficit in current transfers**

A brand new element in current transfers is deficit. This relatively floating component of the balance of payments current account became negative for the first time in 2006 when expenditure exceeded income by CZK 7.2 billion (surplus in 2005 accounted for CZK 19.7 billion). Negative value increases due to private transfers to abroad, taxes paid, charges and contributions of the CR to the EU budget included to the balance of payments current account. In 2006, transfers to the CR dropped by approximately 11.5 billion, transfers from the CR increased by CZK 15.4 billion.

- **Balance of income determines intensity of external imbalance of the CR not only due to the direct investors profit outflow to abroad**

However, the key factor acting with increasing intensity and causing that the Czech economy tends to external imbalance remains the balance of income which in 2006 was -183.4 billion compared to -155.7 billion in 2005. Expenditure in the balance is affected by the outflow of part of direct investors profits in the CR created by the entry to the Czech market. Over a three year period the volume of money at the expenditure side of balance increased by more than one third - in 2003, expenditure accounted for CZK 195.4 billion, in 2006 the already mentioned amount of CZK 304.8 billion. The dynamics of income in the balance of income reached a remarkable level (+61%) which means that it was even higher than the dynamics of expenditure. In nominal terms the incomes are, however, substantially lower, in 2006, they reached CZK 121.4 billion compared with CZK 75.5 billion in 2003.

- **... but at a growing extend by the outflow of money in form of foreign workers wages**

For the Czech Republic it is typical that in form of compensations of employees – non residents – the volume of money flowing out from the country is bigger than the inflow of money in form of compensations of employees – residents working abroad. In 2006, compensations of employees (which in addition to wages include the contributions of employers to insurance) accounted for CZK 23.7 billion (residents working abroad) while compensations of non-residents working in the CR accounted for CZK 59.4 billion. The difference between inflow and outflow of money in form of compensations to the employees is increasing, year by year, and becomes another factor contributing to external imbalance.

- **Slovakia contributes most to wages of foreign workers in the CR**

In 2005, the amount of approximately CZK 21.8 billion, i.e. almost 50% of the total volume of wages of non-residents employed in the CR flew out to Slovakia. Slovakia as well as Ukraine belongs to countries participating tremendously in the net outflow of contributions of employees to abroad. In 2005, the total net outflow of compensations made up CZK 31.3 billion due to the fact that compensations for the Czech work in these countries reached the value (CZK 0.4 billion) which is far from tangible. Compensations for the work performed by Ukraine workers in the CR in the period 2001-2004 were on average CZK 6.5 billion showing rather downward trend, however the year 2005 recorded the growth of CZK 9.6 billion. In the middle of 2006 for which period the data are available, compensations of workers from Ukraine accounted for CZK 6.1 billion. On the basis of the above a significant growth for the whole 2006 can be expected. New inflow of workers from abroad can be attributed to the increasing attractiveness of the country upon joining the EU.

The highest income from work performed abroad flows to the CR from Germany.

The whole 50% of the volume of money in form of compensations of employees - residents working abroad represented in 2005 the four following countries: Germany (CZK 7 billion), Austria (2.8 billion), Great Britain (1.4 billion) and Ireland (CZK 1 billion). As it is clear from the data covering three quarters of 2006 (Germany CZK 5.9 billion, Austria 2.5 billion, Britain 3.1 billion and Ireland 0.7 billion) the data covering the whole year 2006 obviously show further growth of shares of the above countries in the whole volume of compensations of employees – residents working abroad.

Table 3 Analysis of contributions of individual components of the balance of payments current account to its deficit in the period 1995-2006

Year	Current account (balance +/- (in CZK billion))	Trade balance (in %)	Balance of services (in %)	Balance of income (in %)	Current transfers (in %)
1995	-36.331	+269	-135	+8	-42
1996	-111.869	+138	-44	+18	-9
1997	-113.037	+137	-49	+22	-10
1998	-40.492	+207	-153	+87	-41
1999	-50.596	+130	-82	+92	-40
2000	-104.877	+115	-52	+51	-14
2001	-124.478	+94	-47	+67	-14
2002	-136.378	+52	-16	+85	-21
2003	-160.615	+43	-8	+75	-10
2004	-167.348	+16	-7	+94	-3
2005	-77.070	-50	-26	+202	-26
2006	-133.764	-33	-9	+137	+5

Source: calculations from data supplied by CNB and CZSO

Note:

Mark "+" for percentage contributions means that the component in the given year adds to the current account deficit, i.e. increases the deficit, mark "-" means that the component in the given year deducts from the deficit (reduces the deficit); in case of current account surplus the meaning shall be reverse.

- **Financial account surplus was insufficient**

Comfortable coverage of the balance of payments current account deficit from financial account surplus belongs to the past. As it is clear from Graph 37, for the years 2001 and 2002 the highest positive balances at the financial account were recorded when double and even triple coverage of relatively big deficits was possible. Almost the same was the positive balance at the balance of payments accounts in 2003, however, the year 2006 showed actual imbalance for the first time when the current account deficit is not covered. Thus, it is not only an actual level of the current account deficit ratio to the GDP but also an important feature of external imbalance.

- **Foreign direct investments to CR dropped**

A significant decrease of direct investment to the CR was recorded while the reinvested profit grew moderately. Foreign direct investments to the CR reached in 2006 the total of CZK 134.7 billion and were lower, y-o-y, by CZK 144.5 billion, i.e. by 51.8%. This applies to a relatively significant drop. The capital inputs into the Czech enterprises decreased by CZK 148.8 billion which was of key significance for balance of direct investment into the CR.

Foreign investors, however, reinvested the profit in the amount of CZK 82.1 into the Czech Republic which was by 4 billion more than in 2005. In Q4, the direct investment balance at the balance of payments financial account accounted for CZK 29.5 billion, i.e. less than in the same period in the year (CZK 54 billion).

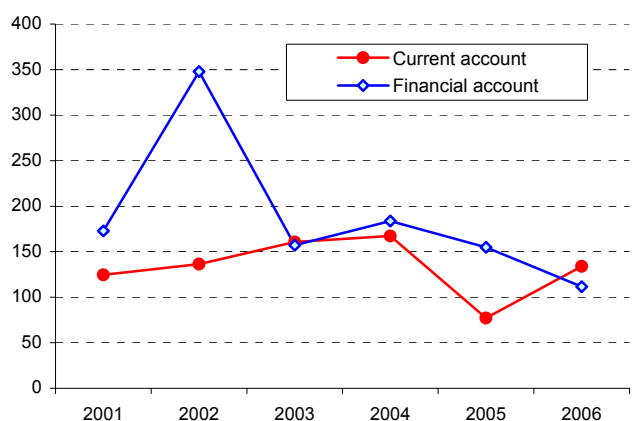
- **External acquisitions of the Czech companies increased significantly**

The Czech companies begin to invest in abroad. For the advanced countries characteristic feature is the two-way direction of capital flows which accompanies economic globalisation as well as flows of goods and services. Low equity to GDP ratio which for a long time impeded the Czech companies to fund the expansion not even in the domestic market not malestioning external market, improved markedly with time progress mainly thanks to a significant growth of profit.

- **Portfolio capital returned to the Czech Republic**

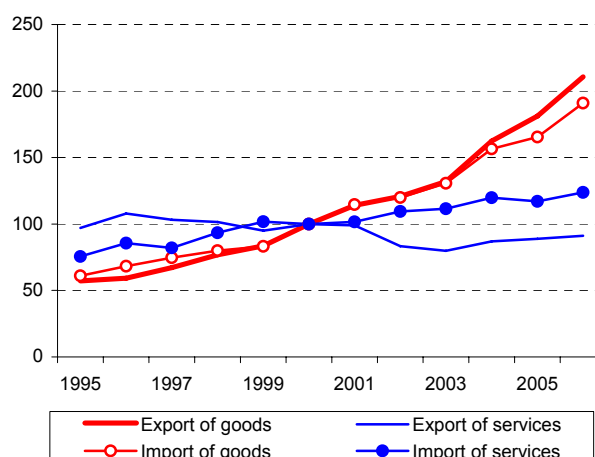
Portfolio investments indicate the change of capital flows for the benefit of the CR. Reducing of negative balance to CZK 26.9 billion from CZK 81.2 billion in 2005 was due to the recovered interest of foreign investors in Czech securities and mainly in Q4 when the net inflow in the amount of CZK 29.8 billion was recorded. Over the year 2006, the outflow in form of portfolio investment accounted for CZK 68.4 billion, the inflow to the CR in form of investments accounted for CZK 41.5 billion – in 2005 assets prevailed over liabilities (-81.2 billion) when the inflow on liabilities side was negligible.

Graph 37 Covering of current account balance by financial account balance (in CZK billion)

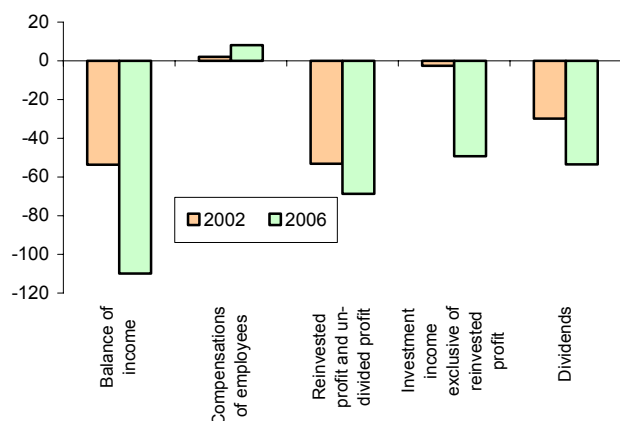


Source: CNB. own calculations

Graph 38 Performance balance (goods and services trade, volume indices. 2000=100)

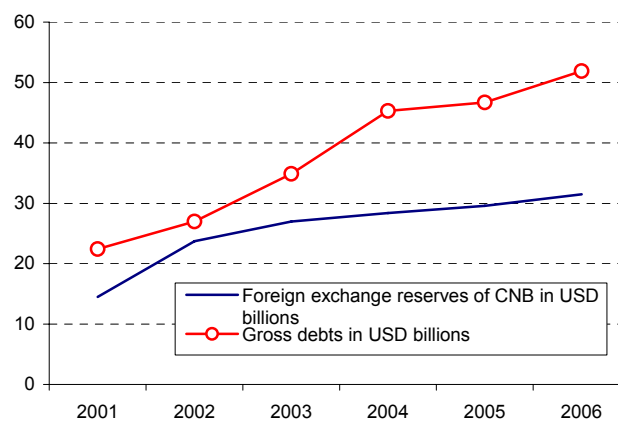


Graph 39 Balance of income of the CR with EU15 (balances of selected items in CZK billions)



Source: CNB

Graph 40 Gross external indebtedness and foreign exchange reserves of the CNB (in USD billions)



Source: CNB

• **Lower inflow of foreign investment presents the risk for external balance ...**

Generally, it can be stated that the current account deficit is conditioned mainly by market factors and is, therefore, a market element. As opposed to this, the development of deficit public budgets is hugely affected by government interventions be it in negative or positive sense. The amount of the deficit is, in view of relatively very low cyclic component, within the powers of the executive.

External funding of the current account deficit can be threatened by lower inflow of direct investment upon exhausting of privatisation potential of the Czech economy. Of strategic companies in which the Czech state has an ownership interest, the following are not privatised: CEZ, Česká pošta and České dráhy. If it is not decided that the state property interests in these companies are maintained, the above are, save for a few other interests in mining companies or in airlines, actually the only potential sales of interests in the future. Possibility to fund the current account deficit within the balance of payments will thus depend on the inflow of foreign net investment, i.e. investment independent of the sale of state property interests. Those will be massively affected also by business cycle in the countries of future potential investors, especially acquisition skills of local companies.

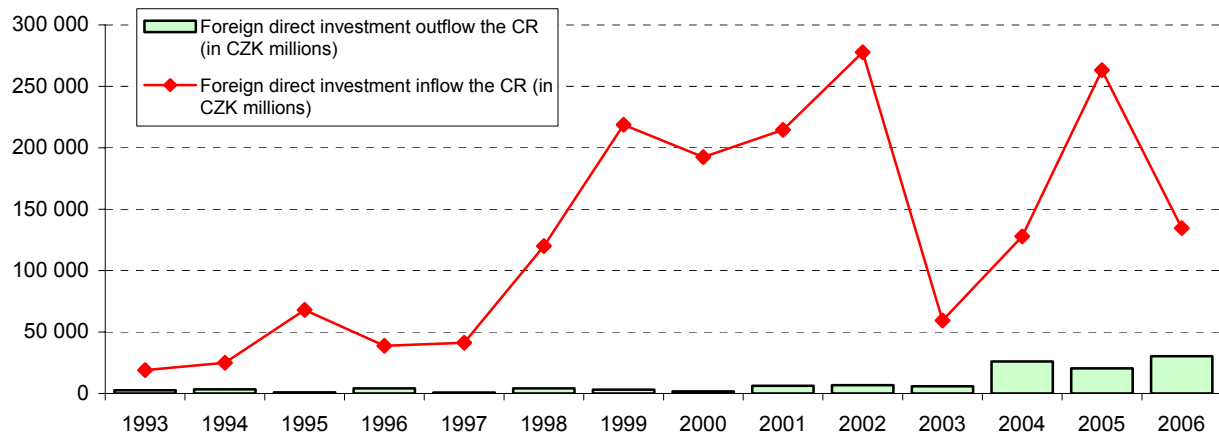
• **... in combination with the outflow of profit or deterioration of terms of trade in external trade**

Outflow of profits from the country conditioned by foreign direct investment will negatively affect the balance of income – the adverse balance of investment income will be increased by repatriation of profits to the countries of foreign investors given the current reduced volume of profits reinvested in the Czech Republic.

Further drop of the balance of income poses a risk, especially if there was a dramatic

change of current mutual proportion in the import and export rates of growth and sharp deterioration of the terms of trade. It can be expected that highly deficit balance of income whose deficit contributed in 2006 to the final current account deficit by 137% will affect adversely the external imbalance of the Czech economy measured by the balance of payments current account deficit in the upcoming years. This is supported also by estimates in both most important balance components – scissors between wages of the Czech in abroad a wages of foreign workers in the CR are opening wide given the growing volumes at both sides, and component of investment income affecting the increasing transfers of dividends of foreign investors in the CR to their native countries given current reduced volume of profits reinvested in the Czech Republic.

Graph 41 Foreign direct investment – two-way capital flows (in CZK millions)



Source: CNB

Employment and unemployment

- ***Imbalance at the labour market begins to equalize***

Czech labour market in 2006 showed very favourable development as it is clear from unemployment figures and unemployment level. For Q4 the highest employment was recorded since July 1998. The general level of unemployment in the CR is in the long-run lower than the EU25 average and fell even below the EU15 average.

- ***Employment stands at the European average with more hours worked with high contribution of entrepreneurs to the total employment and low contribution of part-time jobs***

Of the age group from 15 to 64 years of age, in the CR 65.3% persons were employed which is slightly more than the European average which is 64.6% (employment of females however does not reach the EU25 average). The Czech economy employs relatively more people than Poland (53.9%) or Slovakia (59.3%) but less than Germany (67%), Austria (70%) or, e.g. Denmark (76.9%). The number of entrepreneurs increased by 30 thousand. Of economic sectors most significant increase was recorded for the number of workers in industry (by 39 thousand persons).

In services the number of employees increased by 27 thousand and in agriculture, the number of employees dropped by 8 thousand. Besides manufacturing industry the tangible growth of the number of employees was recorded in the real estate branch and also in health sector and in social services. This development is desirable because the above mentioned applies to services which in the CR belonged to categories with the lowest employment, compared to the EU.

Generally, the Czechs work per week more hours than workers in other European countries – full time workers work 39.4 hours per week and entrepreneurs 47.4 hours per week. Most hours spend in their major occupation people employed in construction and accommodation and public catering (41.7 hours), the smallest number of hours work employees in education (33.3 hours). The reason why the CR occupies a leading position in international context in terms of the number of hours spent at work is high contribution of entrepreneurs to total employment, an extra high share of full-time workers and above-average number of hours worked in full-time major occupation.

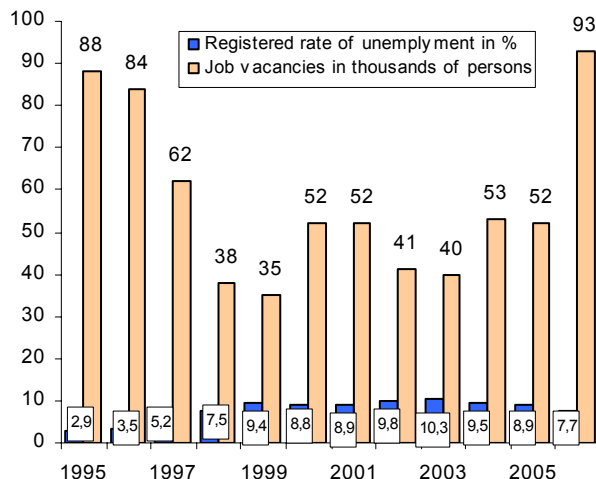
- **Since 2003 the unemployment rate is decreasing**

General rate of unemployment in the CR reached 7.1% and is, in long-term, lower than in the EU25 countries (8.3%) and EU15 countries (7.8%). Among figures supplied by labour offices showing the registered rate of unemployment (7.5%) and reported general rate of unemployment (including persons without employment searching actively for work and able to start their employment within a two week period) there exist differences but in the CR the trend in both cases tend to show downward effect.

Graph 42 Employment and unemployment
(in thousands persons, as measured by LFSS)



Graph 43 Unemployment rate and job vacancies at the year end



Source: MPSV ČR

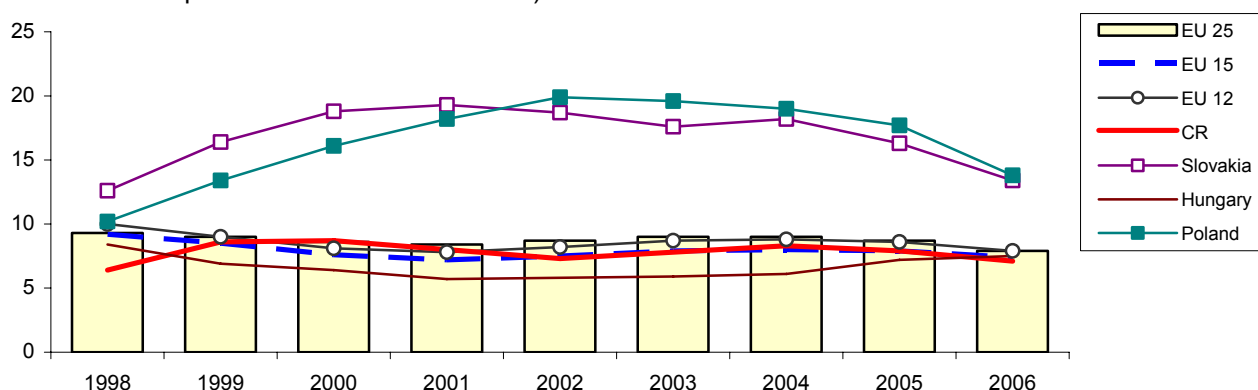
- **Low employment in services poses a risk and indicates loss of trend towards advanced economic level**

Economy creates more jobs (in 2006 the number of jobs doubled compared to 2005 given considerable reduction of the number of people without employment). The situation in the regions tends to balance although compared to 2005 the most decrease of unemployment was recorded for regions with traditionally highest number of the unemployed – in Moravian–Silesian region (by 18 thousand persons up to 10.5%), in Usti region (by 8.1 thousand up to 13.4%) and in the Olomouc region (by 7.1 thousand up to 7.5%).

High share of employment in industry and construction (40.2% against 27.5% in the EU25) remains a weak point as well as relatively lower representation in services (55.9% against 67.8% in the EU).

While in the period 2000-2004 development of employment reduced the growth of potential Czech economy product, the last two years an opposite trend was recorded – in the years 2005 and 2006 employment contributes to its growth by approximately 0.3 p. p. Similar development is anticipated also in the years 2007-2009 while the contribution of higher employment to the potential GDP growth is expected to be slightly lower than in the years 2005 and 2006.

Graph 44 Comparison of the unemployment rate in selected European countries (unemployment as percentage of labour force, age of the unemployed is between 15-74, unemployment in compliance with the ILO definition)



Source: Eurostat

Material balance of the economy

2006 was the second consecutive year showing an extra favourable development of real economy

Relatively high acceleration of investment and, in contrast, moderate growth of exports compared to imports, increased spending of households – these were the main features of development of demand side of the Czech economy compared to 2005. In 2006, material processes in the economy were not exposed to any extraordinary wobbles caused by the development of external environment or impulses coming from inside the economy.

An extra favourable development of main divisions continued both in terms of production indices and the sales. Growth of industry and construction was of an expansive character as it is clear from graphs 47 and 48.

- **Domestic supply exceeded demand**

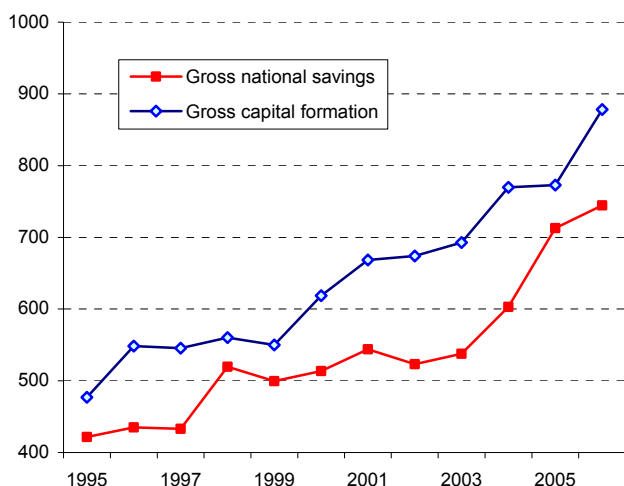
Compared with the development in 2005 influence of domestic demand grew strongest and influence of domestic supply weakened. Domestic supply continued to exceed domestic demand. Covering of domestic demand from domestic sources slightly decreased in 2006 in real terms and, in contrast, covering from external sources increased markedly. Funding of gross capital formation from external sources increased substantially compared to the previous year. The amount of CZK 133.7 billion of external sources was used (graph 45).

- **Expenditure of households exceeded their disposable income**

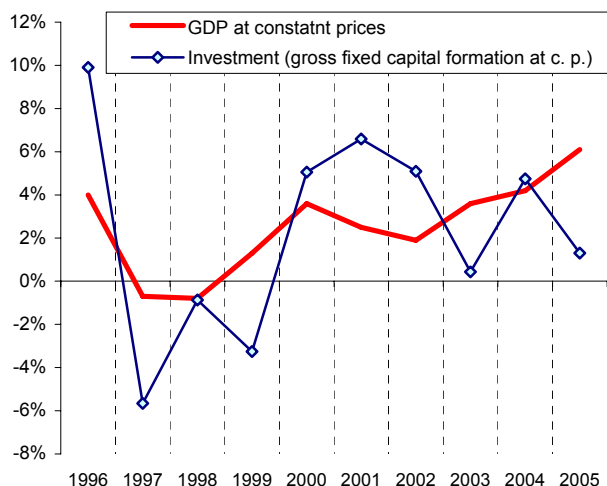
In 2006, households' spending grew faster than their income which strengthened the trend to consume. Deviation from balance was attributed to substantially higher growth of consumer expenditure in this sector compared to the growth of its disposable income. As a consequence, gross savings of households in 2006 compared to gross savings in 2005 decreased.

The real growth of GDP in 2006 by 6.1% was contributed to by expenditure of households on final consumption by 2.2 p. p., expenditure on gross fixed capital formation by 1.8 p. p and net exports by 0.6 p. p. The remaining part of the Czech GDP growth was attributed to a change of reserves in the economy where the material supplies were increasing while the finished products grew less progressively.

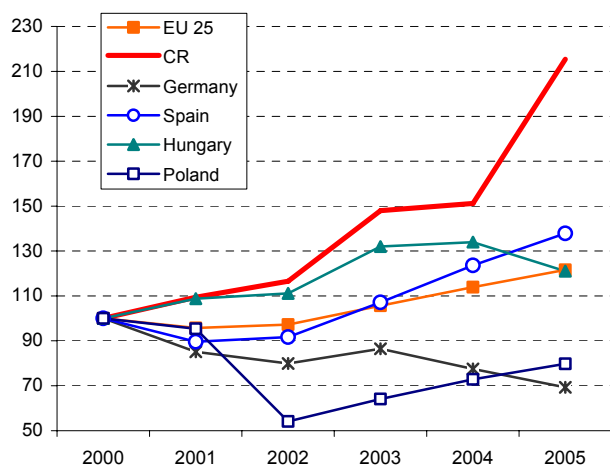
Graph 45 Coverage of gross capital formation from external sources (in CZK billions)



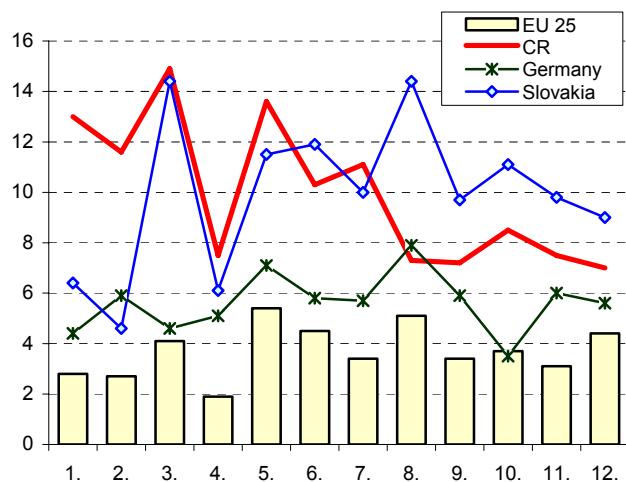
Graph 46 Investment and GDP (y-o-y changes in %, in real terms)



Graph 47 Number of building permits granted (construction of dwellings 2000=100)



Graph 48 Industrial production index (2006. y-o-y growth in %, selected countries)



Source: Eurostat