

MACROECONOMIC IMPACT OF THE GLOBAL CRISIS ON THE CZECH ECONOMY

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Czech economic growth is due to its high external openness significantly influenced by international environment, namely the impact of the global crisis, which dates back to the beginning of the end of 2007. Adversely affected by its consequences, in particular domestic growth performance, which reached its peak in 2006-2007, the economic performance decreased sharply and its prospects are still uncertain. The EU economy, where 85% of Czech exports is going to and where most foreign direct investment is coming from, probably has bottomed out and the projections assume a slight recovery. CR, however, faces a growing fiscal imbalance, which sought and probably still require a significant restrictive interventions. Space for a growth stimulus is very limited. Priority of economic policy is to keep public finance deficit within manageable limits in terms of interim uncertainty of predicted economic recovery (and thus improving the revenue side). This paper assesses the development of indicators of GDP growth on the supply side and demand (according to their components), the labor market (employment and unemployment) and the internal and external balance. Evaluation takes into account the situation of the external economic environment, global and especially European economy, including current trends, including forecasts of foreign and domestic economic organizations.

Current developments in the Czech economy in the global environment

Economic growth in the world economy peaked in 2007 but in 2008 came decline accompanied by the slowdown in world trade. The immediate impetus to this development was a financial crisis in the U.S.. Negative economic news depressed the trust of the subjects, led to a decline in property prices, a liquidity crisis and eventually to a decline in household consumption. Impacts, however, differed in each country. Decreasing demand on the world market (and higher global crop) caused the trend of rapidly rising oil and other commodity prices in mid-2008 change in the price collapse. Developments in capital markets in 2008 marked the fall of the share price accompanied by turbulence.

Economic growth in the CR in the new millennium has evolved quite favorably with the peak in 2005-2007. In identifying the causes is the first thing to be mentioned restructuring and modernization of the supply side, which precipitated a strong inflow of foreign direct investment. Sector of corporations under foreign control is characterized by extremely high performance and also significantly contributed to the rise of exports. Domestic investments were supported by greater availability of bank funds, completing privatization and restructuring of banks, decline in interest rates and expansive fiscal policy. EU accession in 2004 has improved the institutional environment and the extended opportunities for the free movement of goods, services, capital and labor. The Czech economy has been positively affected by the recovery in Western Europe (mainly Germany). Acceleration of the growth rates were not matched by macroeconomic imbalances. Balance of trade gradually moved into surplus, current account deficit declined, reducing the budget deficit and the situation on the labor market also improve.

Table 1: Quarterly GDP growth (in %)

	q-o-q growth (seasonally adjusted)					y-o-y growth (not SA)				
	2008	2009				2008	2009			
	Q4	Q1	Q2	Q3	Q4	Q4	Q1	Q2	Q3	Q4
EA16	-1,9	-2,5	-0,1	0,4	0,1	-1,8	-5,3	-5,7	-3,9	-1,7
EU27	-1,9	-2,4	-0,3	0,3	0,1	-1,6	-5,3	-5,8	-4,1	-2,0
BE	-2,1	-1,7	-0,1	0,7	0,3	-0,9	-4,0	-4,4	-2,9	-1,1
BG	:	:	:	:	:	3,5	-3,5	-4,9	-5,4	:
CZ	-0,7	-4,4	0,2	0,8	0,7	-0,1	-4,2	-5,0	-4,7	-2,8
DK	-2,5	-1,4	-2,3	0,6	0,2	-3,6	-3,8	-7,1	-5,2	-3,4
EE	-4,5	-6,0	-3,4	-3,0	:	-9,2	-15,0	-16,1	-15,6	-9,5
FI	-4,1	-4,9	-0,3	0,3	0,0	-2,6	-7,5	-9,2	-9,1	-5,1
FR	-1,5	-1,4	0,3	0,3	0,6	-1,8	-3,3	-3,3	-2,0	-0,3
IE	-5,4	-2,1	-0,6	0,3	:	-8,0	-9,1	-7,9	-7,4	:
IT	-2,1	-2,7	-0,5	0,6	-0,3	-2,9	-6,5	-6,2	-4,3	-2,7
CY	0,1	-0,7	-1,0	-0,8	-0,3	2,4	0,7	-1,5	-2,5	-3,0
LT	-1,2	-11,3	-7,7	6,1	0,5	-2,2	-13,3	-19,5	-14,2	-12,8
LV	-5,0	-11,4	-0,2	-4,0	-2,9	-10,3	-18,0	-18,7	-19,0	-16,9
LU	-3,1	-0,9	-2,7	4,2	:	-4,7	-6,3	-7,3	-2,5	:
HU	-2,3	-2,3	-1,4	-1,2	-0,4	-2,5	-6,7	-7,5	-7,1	-4,0
MT	-1,0	-0,8	-0,7	0,4	0,9	0,8	-1,7	-3,2	-2,1	0,5
DE	-2,4	-3,5	0,4	0,7	0,0	-1,7	-6,4	-7,0	-4,7	-1,7
NL	-1,2	-2,3	-1,1	0,5	0,3	-0,7	-4,5	-5,5	-3,7	-2,2
PL	-0,1	0,1	0,5	0,5	1,2	2,6	0,9	1,2	1,2	3,3
PT	-1,7	-2,0	0,5	0,7	-0,2	-1,8	-4,5	-4,1	-2,5	:
AT	-1,3	-2,2	-0,5	0,5	0,4	-0,3	-4,9	-5,1	-3,2	-1,4
EL	-0,7	-0,5	-0,1	-0,4	-0,8	0,7	-0,5	-1,2	-1,7	-2,5
RU	:	:	:	:	:	2,9	-6,2	-8,7	-7,1	-6,5
SK	0,6	-8,1	1,2	1,6	2,0	1,6	-5,7	-5,5	-4,9	-2,6
SI	-4,0	-6,2	0,6	1,0	0,1	-0,8	-8,2	-9,2	-8,3	-5,5
ES	-1,1	-1,6	-1,1	-0,3	-0,1	-0,9	-3,9	-5,1	-3,4	-2,2
SE	-4,8	-0,8	0,3	0,2	-0,6	-4,9	-6,7	-6,8	-5,1	-0,9
UK	-1,8	-2,5	-0,7	-0,2	0,3	-1,3	-5,5	-6,5	-4,5	:

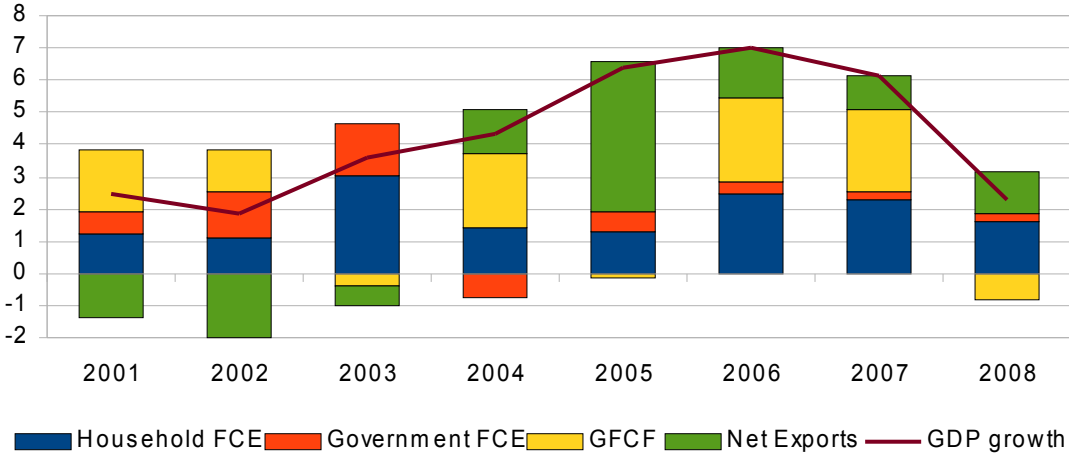
Source: EUROSTAT – Main tables, 17. 3. 2010.

Soundness of the sources of growth of the Czech economy achieved in the previous period were and even will be examined by the impact of global economic crisis. Depending on the evolution of major trading partners is essential. In 2008, GDP growth slowed significantly in CR (to 3.2%), but before growth performance has weakened from their peak in 2006. The turning point came in 4th quarter, when sharp decline in real gross domestic income was caused by worsening terms of trade. Simultaneous slowdown in growth of gross national disposable income, reflecting the expansion of production factors, payments to foreign countries (mainly the repatriation of profits associated with FDI). Also the gross savings were reduced and could no longer finance the gross capital formation and had to be supplemented by foreign sources.

On the decrease of the growth of domestic final expenditure all its components involved, but mainly household spending affected by the negative impact of high inflation on wage developments and also on their savings. Government consumption increased only slightly, significantly decreased gross fixed capital formation, especially change in inventories. Failure of external demand (particularly in manufacturing exports) was in the second half of 2008 only partially dampened by the Czech crown depreciation. However, net exports were a major factor in the whole growth weakened in 2008 (see Figure 1), while the contribution of gross

capital formation was negative. Component of capital formation thus most strongly reacted to the growing decline in economic activity due to the spreading global crisis.

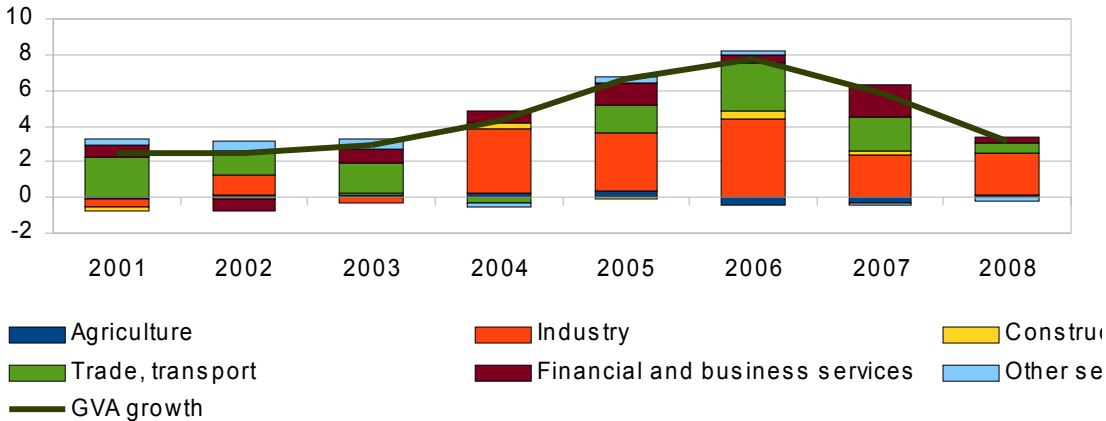
Figure 1: Demand-side components contribution (in p. b., constant prices 2000, SA)



Source: CZSO, Quarterly NA for 4th quarter 2009.

Structural characteristics of the supply side (see Figure 2) mainly affected the value added of industry slump. Driver of the weakened growth in 2008 thus became the service sector. Supply-side structural differences are apparent in comparison with 2004, when it began an upward phase of the economy to pick up the intensity of the dominant role of pro-growth industry. Consequences of its decrease are significant in the Czech economy and adversely affect long-term employment as well. Services are not yet able to offset this decline. Significant role in the structure of industry value added is the specificity of the Czech economy in comparison with more developed countries, and enhanced sensitivity to change of (external) demand during increases and declines in the economic cycle.

Figure 2: Sectoral structure of the GDP growth (in p. b., constant prices 2000, SA)



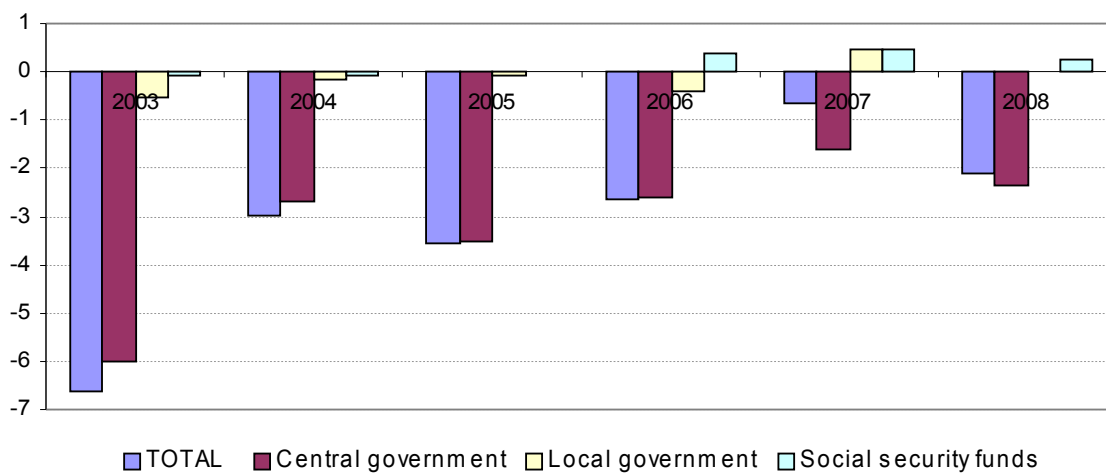
Source: CZSO, Quarterly NA for 4th quarter 2009.

Industrial development at the expense of services was supported in particular by foreign direct investment into technologically less demanding branches and the development of cost-sensitive activities. Adaptation of supply to the declining industrial demand needs a reduction

in capacity, resulting in cuts in employment (affecting in particular the first wave of foreign agency staff). This will have a conclusion to and plants closures (and their transfer to cheaper foreign locations). Economic crisis will accelerate the relocation motivated by the need for cost-effectiveness, which intensified as a result of the growing maturity of the Czech economy. It is questionable whether it will compensate the loss of the development of new investment opportunities.

Improvement (but unfortunately only temporary) occurred when the budget deficit (see Figure 3) fell at roughly half the average level from 2001 to 2007 (1.5% of GDP). Slightly increased the consolidated gross debt (29.8% of GDP). Result of public finances was due to the slowdown in growth performance as relatively positive (but this is changing fundamentally in the next period). In the structure of the general government deficit recorded even local government surplus, while the central government deficit is worse than in 2007.

Figure 3: Government deficit – total and breakdown by subsectors (% of GDP)



Source: CZSO, Government statistics, www.czso.cz (4. 3. 2009).

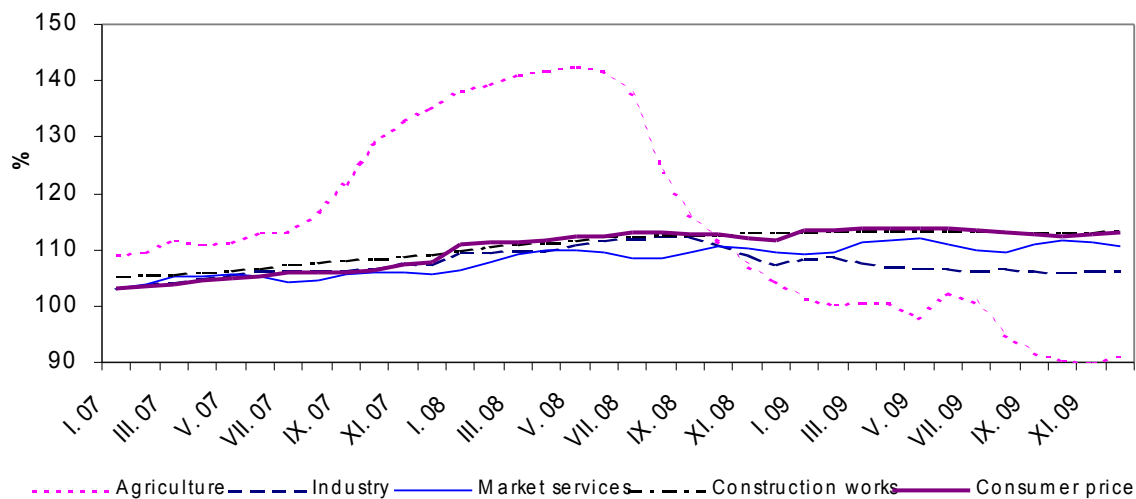
Extent of external imbalances (current account deficit in % of GDP) in 2008 remained unchanged (3.1%), like its coverage of the financial account surplus, but the structure changed. Significantly strengthened the balance of services and greatly increased revenue deficit. Dividends were for the third year in excess of reinvested profits and the wages of foreign workers outflow most money in history (the attractiveness of work in the CR for non-residents, alongside the boom supported by the strengthening crown, which in turn reduced the interest of residents to work abroad). The financial system in the Republic, although not directly affected by the global crisis, but more cautious banks (influenced by their ties to foreign headquarters) significantly affected the market for interbank deposits and then lending to domestic entities (companies and households), including mortgages.

Impacts of the economic slowdown was also evident in the labor market, but with some delay, so overall results in 2008 were more favorable. Unemployment has fallen and employment has grown up since 1996. The long-term unemployment was reduced as well as its share of total unemployment. In the 4th quarter, however, unemployment after four years of continuous decline has slightly risen and the number of vacancies has fallen. As a result, more-enduring tensions in the labor market (supply shortage of working capacities especially

for the expanding industry) significantly increased the nominal wage, but its real growth was due to inflation the lowest in ten years.

Very negative in 2008 was the development of the price level, particularly for consumer prices and inflation exceeded the level in the EU 27. The reason for this growth was particularly energy and food prices on international markets in the first half, but also administratively influenced prices. CR thus significantly exceeded the Maastricht criterion on price stability. Development of producer prices in 2008 was marked by two distinct trends. The first half of 2008, as 2007 marked a relatively strong rise in the price level. Turnover occurred around mid-2008 when prices for agricultural products fell into negative values (see Figure 4). High growth of industrial producer prices, which since January 2008 was above the 5% level, in the context of the emerging recession slowed and in December has been changed to 0.2% decrease (the first decline since October 2003). Price growth in the manufacturing industry in 2008 was driven mainly by the sectors concerned with the processing of energy (oil) and non-energy raw materials (especially metal-based). Contrast, prices of construction work and market services virtually stagnated.

Figure 4: Price level change (consumers and producers, in %, year 2005 = 100)

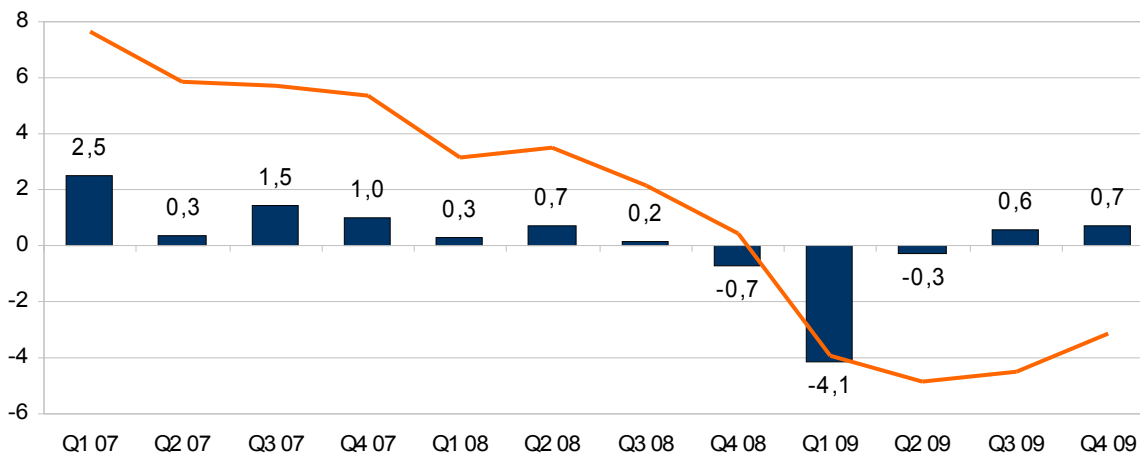


Source: CZSO, Producer's prices, Consumer's prices, www.czso.cz (3. 3. 2010).

Developments in the Czech economy in 2009

Decrease in overall performance of the Czech economy in comparison with the 2nd quarter of 2009 accelerated (see Figure 5), so that GDP in the 1 half of 2009 actually decreased by 5.0%, mainly due to decline in GVA in manufacturing. However, q-o-q GDP increased by 0.1%, halted the decrease from the previous quarter. The positive development of terms of trade led to a small decline in real gross domestic income compared to GDP.

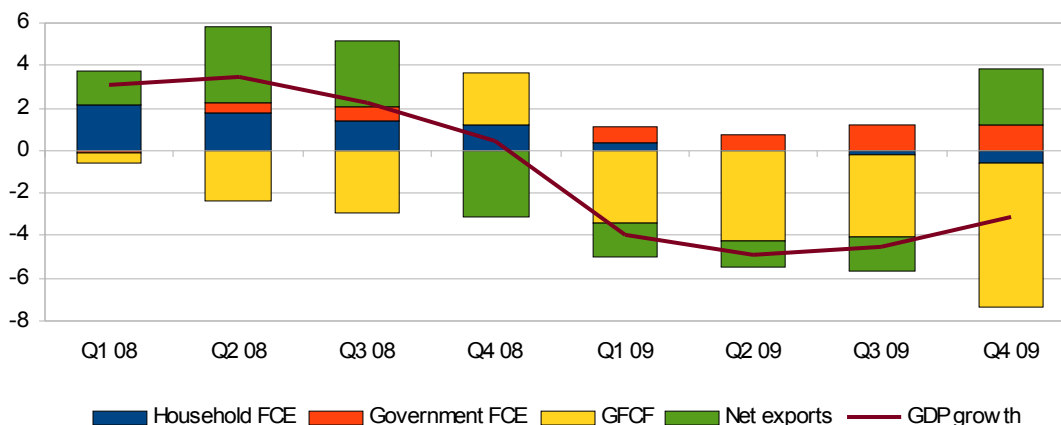
Figure 5: Quarterly real GDP growth (y-o-y, q-o-q, %)



Source: CZSO, Quarterly NA for 4th quarter 2009.

In the structure of expenditures in GDP was still a decisive influence decline in gross capital formation (see Figure 6), in particular stocks (under pressure to maintain cash flow in the corporate sector in intensified economic conditions), and net exports. In contrast, the contribution of final consumption expenditure was positive thanks to the government, whereas consumer spending by households slightly decreased. Most purchases of transport equipment fell, followed by investment in other machinery. Many investment projects are delayed and reassessed.

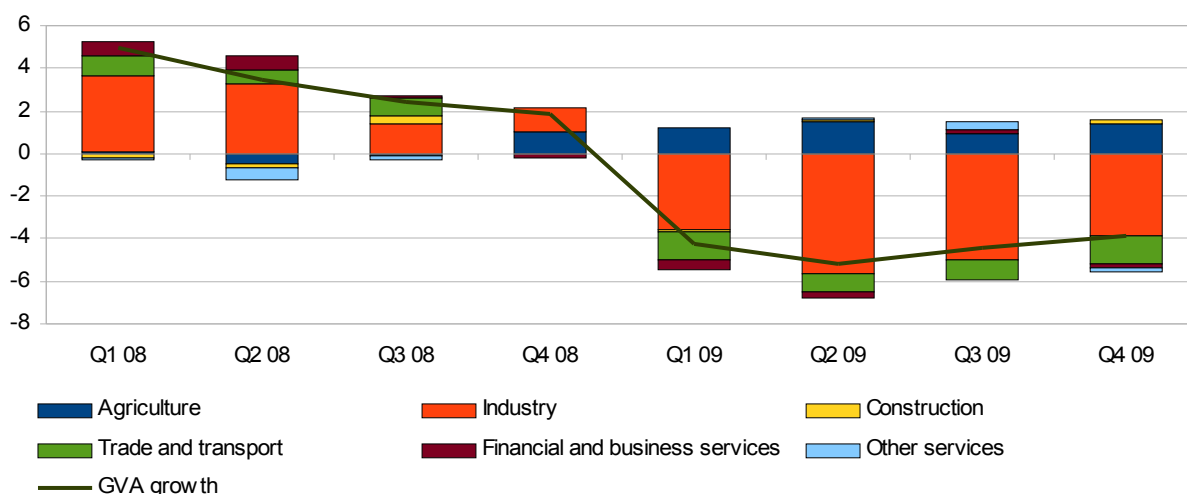
Figure 6: Demand-side components contribution (in p. b., constant prices 2000, SA)



Source: CZSO, Quarterly NA for 4th quarter 2009.

A significant change occurred in 2009 in the field of external economic relations, which significantly reduced the foreign trade turnover in goods and services balance with a negative impact on the evolution of real GDP. Only in the last three months situation changed and foreign trade contributed significantly positively to decrease drag on the economy. Gradual improvement in the contribution of external trade in goods and services to GDP growth during 2009 reflects the impact of the actions of some governments especially in the automotive industry. This effect, however, will act only temporarily.

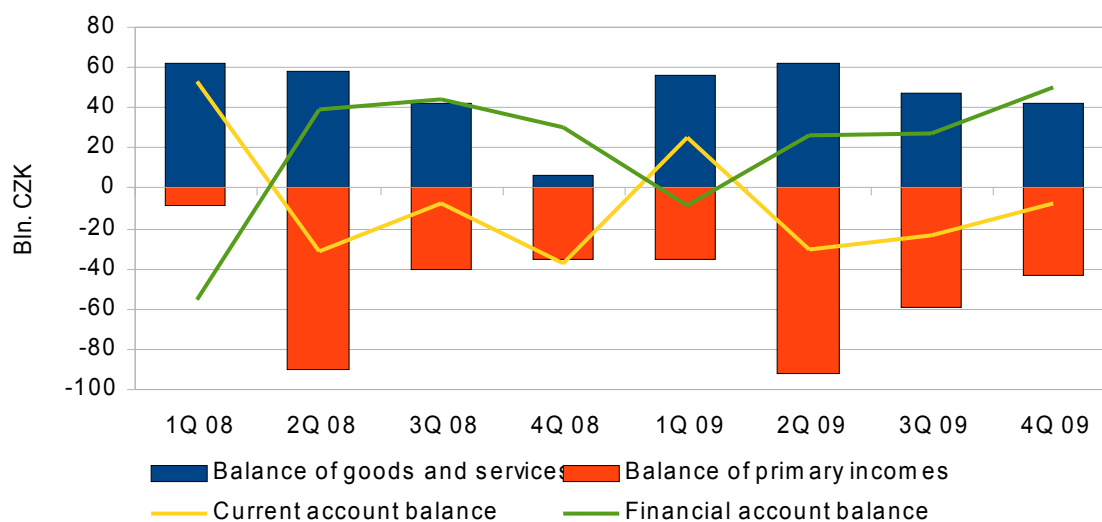
Figure 7: Sectoral structure of the GDP growth (in p. b., constant prices 2000, SA)



Source: CZSO, Quarterly NA for 4th quarter 2009.

On the supply side, the annual decline in real gross value added for the full year 2009 accounted for 4.4% of the sector during the year varied considerably. In the largest volume sector of manufacturing, the creation of GVA after a sharp drop in 1st quarter by more than 10% gradually stabilized and this decline has not deepened in the following quarters. Conversely, in sectors of trade and business services the more pronounced declines in quarterly GVA were also recorded at the end of the year. Notable increases were (with the exception of Q1) accrued in banking, insurance and telecommunication services. Positive contribution to the growth of GVA at constant prices last year gave the agricultural sector, but at current prices GVA as a result of substantial price decline outcomes decreased.

Figure 8: Current and financial account balance (end of period, bln. CZK)

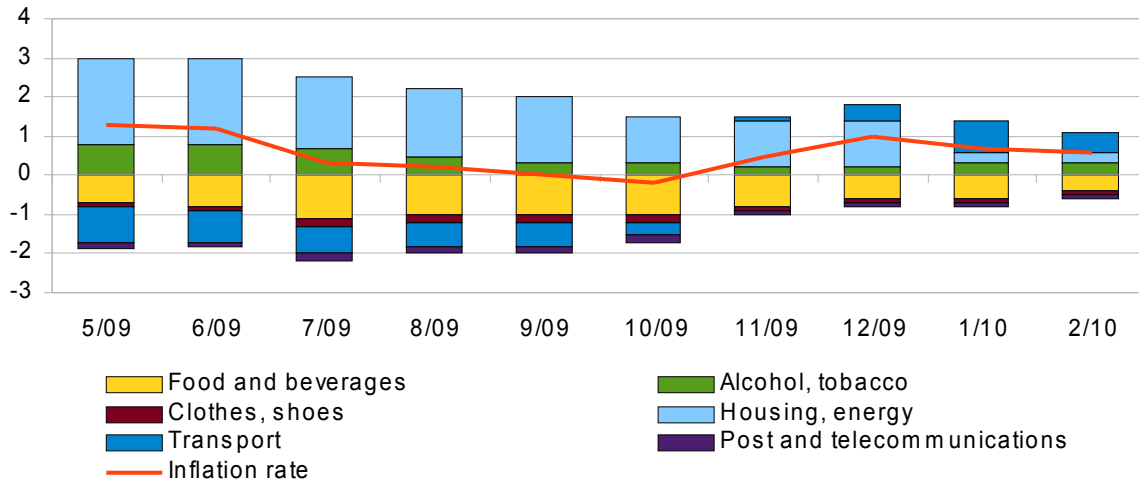


Source: CZSO, Analysis of the Czech economy in the 1st half of 2009.

The current account deficit of balance of payments has improved year on year (see Figure 8), with stagnating balance of goods and services and rising balance of income. The current account deficit was adequately covered by the financial account surplus. FDI inflows fell to less than half compared with 2008, reflecting the global economic downturn. Foreign trade in goods reached the highest surplus in history, CZK 180

billion. Significant increase in this balance, however, was somewhat offset by a decline in the services balance. Deterioration of balance was evident particularly in the balance of other services, especially the rise of the business operations of multinational companies associated with the evaluation of imported goods into the CR and its subsequent export to foreign countries (so-called branding).

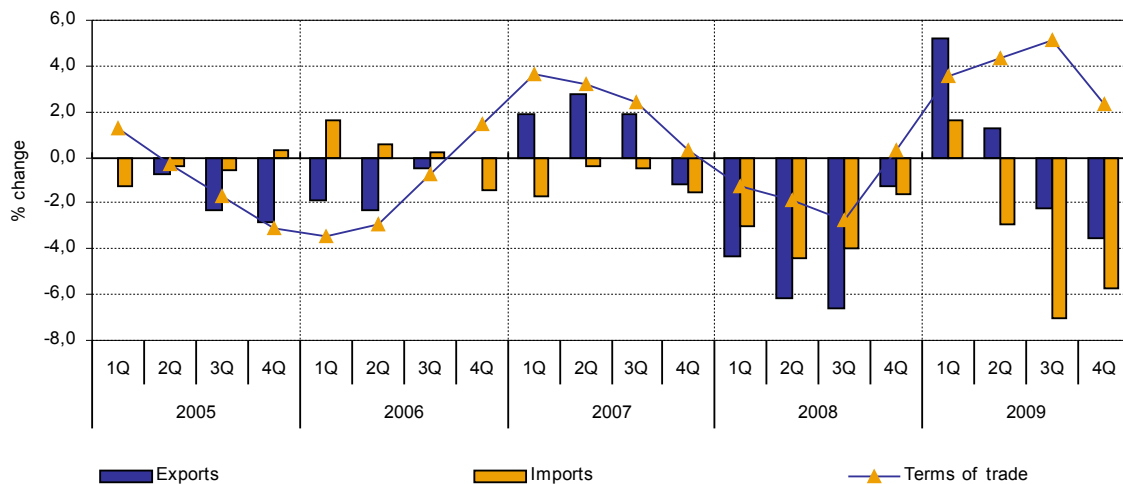
Figure 9: CPI increase decomposition (y-o-y data, in pct points)



Source: CZSO, Consumer prices. www.czso.cz (5. 3. 2010)

Prices were adjusting to the economic development very differently. For agricultural producers, there was a significant downturn in industrial producers only slightly (at the same time, prices of electricity, gas and water increased). The rise in prices recorded construction works (despite the lower prices of materials), as well as market services. Consumer prices in 2009 increased by 1.0%, mainly influenced by housing and power (see Figure 9). After exclusion of those influenced administratively prices actually fell by 0.7%. The inflation rate for the peak in October 2008 (6.6%) consistently reduced (to 0.6% in February 2010). In the near future, that would not be a problem for macro equilibrium.

Figure 10: Import and Export prices, Terms of trade (in %, y-o-y)



Source: CZSO, Export and Import prices in 4th quarter 2009.

Export prices in 2009 grew faster than import prices, leading to relatively strong annual growth in terms of trade by 3.8% (see Figure 10). Their development are in the short-term influenced in particular by oil prices, and to some extent also by the development of the crown against the euro and the dollar, and their relation (in dollars relatively more imports than exports). This meant a considerable appreciation of the Czech national work and strong business earnings, which reflected positively in the development of the real gross domestic income (in 2008 it was in contrast loss due to adverse terms of trade).

The labor market situation reflected decrease in the performance of the economy with delay by accelerated growth in unemployment. Employment has fallen below the level in 2nd half of 2007 and the unemployment rate returned to the level of mid-2006. Number of job vacancies was significantly reduced. The labor market has been affected by the economic downturn very significantly. In addition to a significant loss of jobs it is significant effort of companies to keep the jobs for ordinary workers, in many cases, at the expense of temporary reduction in price-time jobs and wages reduction. As a result of decreased demand, reducing redundancy and scale of production and working hours significantly slowed the growth of average wage and the amount of wages fell in y-o-y comparison. Significantly decreased the number of registered foreign workers (mainly affected by reducing demand in the manufacturing industry).

The growth rate of labor productivity in the economy measured by gross value added per worker in the last quarter of 2008 dropped dramatically from y-o-y 2-3% in previous quarters, close to zero. During 2009, productivity declined by about 5% mainly due to a substantial fall in gross value added. The evolution of labor productivity in individual sectors differed significantly, the largest decline of 10% occurred in the industry, both raw material extraction and manufacturing, as well as energy industry. In a similar level productivity decreased in the trade, in other segments of the service sector the drop was not so dramatic. Generally, due to time dynamics the performance indicators prior employment decline occurred in the first wave, which led to a sharper decline in the productivity than in performance. It can be expected gradual adjustment, after which employment and productivity will correlate with the development of value added.

Economic outlook of the Czech economy

As has been mentioned several times, further economic development is still associated with significant uncertainty. In addition to the above forecasts of international organizations in the CR is currently available (at the end of January), especially the Ministry of Finance forecasts (see Table 2), which reflects more favourable report on the external economic environment, and (contrarily acting) effects of the so-called power-saving package draft budget for 2010.

The world economy is recovering from recession. Since spring 2009, situation on the stock markets improved and about the same time recovery of industrial production and exports began. The strong growth has returned to China and other Asian economies. In advanced economies is expected in 2010 the growth of around 2% following a sharp fall in the previous year and further acceleration of 0.5 percentage points in 2011. Despite it these economies do not get to pre-crisis level before the end of 2011. Despite the recovery in economic performance problems of high unemployment and government debt will remain.

Downside influence will have at the beginning of 2010 introduction of stabilization measures. GDP growth prediction according to the Ministry of Finance for 2010 is 1.3% in the mutual

alignment of budget restrictions and improved environmental performance. Such compensation should be reflected also in the structure of economic growth, when the driver instead of household consumption should become a contribution of foreign trade. In 2011, it might be a slight acceleration of GDP to 2.6%. Real gross domestic income could rise by 0.8% in 2010 to 2.5% in 2011. Fall in income structure of GDP in 2009 hit the profitability of the business sector only negligibly (down 0.1%), in 2010 is expected to grow by 1.8%.

Table 2: Main economic indicators as predicted by MoF (January 2010)

		2006	2007	2008	2009	2010	2011
Gross domestic product	% growth, const. p.	6,8	6,1	2,5	-4,0	1,3	2,6
Household consumption	% growth, const. p.	5,2	5,0	3,6	1,4	-0,8	2,0
Government consumption	% growth, const. p.	1,2	0,7	1,0	4,0	-1,7	1,0
Fixed capital formation	% growth, const. p.	6,0	10,8	-1,5	-7,5	-3,7	2,5
Contrib. of for.trade to GDP	p.p., const. p.	1,5	1,1	1,3	-0,6	1,5	0,6
GDP deflator	growth in %	1,1	3,4	1,8	3,1	0,5	1,0
Average rate of inflation	%	2,5	2,8	6,3	1,0	2,0	1,8
Employment (LFS)	% growth, const. p.	1,3	1,9	1,6	-1,4	-1,8	0,0
Unemployment rate (LFS)	average in %	7,1	5,3	4,4	6,7	8,8	8,6
Wages and salaries volume	% growth, curr. p.	7,9	9,4	8,7	-0,3	-0,7	4,5
BoP Current account/GDP	%	-2,4	-3,2	-3,1	-1,0	0,5	-0,2
Exchange rate CZK/EUR		28,3	27,8	24,9	26,4	25,8	24,8
Long-term interest rates	% p.a.	3,8	4,3	4,6	4,7	3,8	4,0
Price of petrol (Brent)	USD/barrel	65,0	73,0	98,0	62,0	81,0	92,0
Eurozone GDP	% growth, const. p.	3,0	2,7	0,6	-3,9	1,1	1,9

Source: Macroeconomic prediction, MoF CR 2010 (January), p. 16.

The structure of GDP will be influenced by conflicting trends in consumption. Downside will affect declining employment and the worsening income situation of households, combined with their desire to create savings to cover the risks. Conversely a low inflation rate could encourage household consumption (in 2010 it is anticipated decline in household consumption by 0.8% due to the impact of restrictive measures). In the case of government consumption, it is expected in relation to expenditure savings on wages and salaries and goods and services fall in government consumption by 1.7%.

With considerable skepticism is rated investment development, when many projects are deferred and reconsidered. Gradually, we can expect (in the longer term) the restructuring of production capacity. Willingness of foreign investors for new investment as well as reinvesting profits from business in the CR will depend on the situation in home countries. Economic results of enterprises have negative hit stabilization measures. It is also expected continued decline in investment in housing (partially correcting overheating of the market in 2007 and 2008) and given the less favorable situation of households over the previous period. Some compensation could be a stimulus measures (VAT is charged on company cars, faster depreciation of assets, expedite highway construction) and infrastructure investments with contributions from EU funds. For the year 2010 is anticipated decline in gross fixed capital formation by 3.7%.

The contribution of external trade in goods and services will also be influenced by conflicting effects. Domestic demand will cushion the impact of restrictive measures, while external demand should develop positively due to recovery in major trading partners (In Germany after the elections drastic pro-growth program at the expense of deterioration in the fiscal stability has been announced). After the negative impact of foreign trade in the development of gross

domestic product in 2009 it is forecasted the positive contribution of 1.5 percentage points in 2010.

Expectations of the labor market are rather pessimistic. It is further contemplated closing unprofitable plants and as a result of legislative changes (including termination of relief on premiums for low-income workers) is likely to be further redundancies. Particularly hard hit will be disadvantaged in the labor market (school leavers, older workers). In 2010, the annual decrease in employment will deepen to 1.9% (1.4% in 2009). At the same time is supposed the rise in unemployment to 8.8% (registered at 10.1%). Wage growth is likely to be only very modest (but real development will favorably affect low inflation), in the government sector in 2010 should be a drop in salary (which will affect the private sector).

Indicator of external balance (current account balance as % share of GDP) would be relatively low after a negative balance in 2009 (-1.0%) had a swing in 2010 to slightly positive 0.5%. This positive trend is expected based on the assumption of lower oil prices, slowdown in real imports (lower growth in domestic demand and high import intensity of exports) and a smaller outflow of income (due to lower profitability of foreign companies and lower compensation for work by non-residents).

Critical point in the economic development of the CR is a fiscal imbalance. General government deficit in 2009 alone according to the October Notification 6.6% of GDP in 2010 is estimated at 5.3%. Long-term deficit well above the Maastricht criterion (3%) could significantly increase the cost of financing government debt as a result of the reduced-rating or even impede the sale of government bonds, and thus delay or completely prevent the implementation of some government spending. These dangers should face the package for 2010, which is not part of the system changes towards longer term sustainability of public finances. CR does not have any plan for fiscal consolidation after 2010, including the procedure for reaching medium-term fiscal objectives, which is committed to the European Commission. The high general government deficit is reflected in the sharp increase in the debt ratio from 30.0% of GDP in 2008 to 35.4% reached in 2009.

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