Czech Economy
Achievements and Challenges

How far to Euro?

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Headlines

1. Current stage of economic development
2. New members on the way to Euro
3. Questions
More of the growth expected (?) ...

- The negative effects of weak foreign demand and strong CZK in 2001-02 have been overcome;
- GDP growth 4.1% in Q2/04;
- The structure has changed in favour of investments and export;
- The growth reflected in most macro variables (GDP and its structure, labour market, inflation, etc.);
- Impact of 1st May is still to be verified.
...and more inflation ...

- Driven mainly by tax changes, food prices and other cost factors;
- Despite acceleration in core inflation, demand conditions still were not generating inflationary pressures (negative output gap);
- PPI: 8 % y/y (oil and metal prices), food prices volatile.
... while external balance „good“

- Current account deficit around 6% of GDP and TB do not signal loss of competitiveness;
- Trade balance improving in nominal terms;
- Growing deficit of incomes balance (reflects mostly profits of foreign investors, partly reinvested).
Improvement not „structural“

- Employment decline continues, but has moderated, unemployment has fallen slightly;
- Wage growth uneven between quarters, but overall so far in line with expectations;
- Only very moderate labour market reforms, uncertainty high.
GDP forecast

- GDP growth around 4% in 2004, accelerates to 4.5% in 2005;
- Investment supported by loose monetary conditions, strong export performance, good financial results of companies and renewed credit growth;
- Consumption likely to remain robust (some acceleration after slow down in H1/04) due to relatively low interest rates and real disposable income growth;
- Growing employment (+0.3% in 2005) and falling unemployment, but this will be limited by structural rigidities in labour market.
CNB inflation forecast (X.04)

Target band

Point target

Inflation forecast

Horizon of most effective transmission
Risk of the forecast

- Oil prices – current and forward prices substantially above CF (upwards risk):
  - "Alternative scenario would imply higher inflation, lower foreign and domestic growth, and on balance a pressure on slightly higher IRs;"
- The impact of other raw material high prices on inflation (upward risk);
- Uncertainty over the exact magnitude of food price decline;
- Current monetary conditions slightly tighter than in forecast (downward risk);
- Wage growth and its impact (upward risk).
Risks for the Economy

- Large deficits and unsustainable fiscal policy in general;
- Structural issues not being addressed:
  - Pensions
  - Health care
- Over regulation and inflexible labour market causing low labour participation;
- On macro side, balance of income will keep on pushing CA into deficit in future.
Czech Republic and Euro
Transformation is only 15 years old ...

- Speed of catch up was moderate
- Macro fundamentals were stable
... and new members are reviewing criteria of Maastricht Treaty ...

- Price stability below the target ...
- Long interest rates too ...
... but fiscal policy is a source of concern ...

- The deficits are high...
- ...And debt is going up ...
... So how far we are from Euro ...
CR vs. Maastricht

• Even 3 % limit of public deficit requires a substantial reform;
• Current reform does not include the pension and health care reform;
• Uncertainty about the ability to limit the volatility of the FX rate, the issue of monetary policy regime could be discussed.
"Real convergence"

- Correlation of the macro indicators “moderate” at maximum
- Structure of the economy still different from most EU members
- ... 

- The EU growth very strong determinant of our GDP
- Very high proportion of foreign trade with EU and FDI as well
- ... 

If anything matters, than it is flexibility of the economy ...
...
... but how to measure it ?????
Current CR strategy

- The fiscal consolidation is not bringing deficits below 3% until 2007;
- The time of entry to Euro zone should be 2009 or 2010;
- CZK will not join ERM II until it is very likely that conditions will be fulfilled after minimum stay.

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