

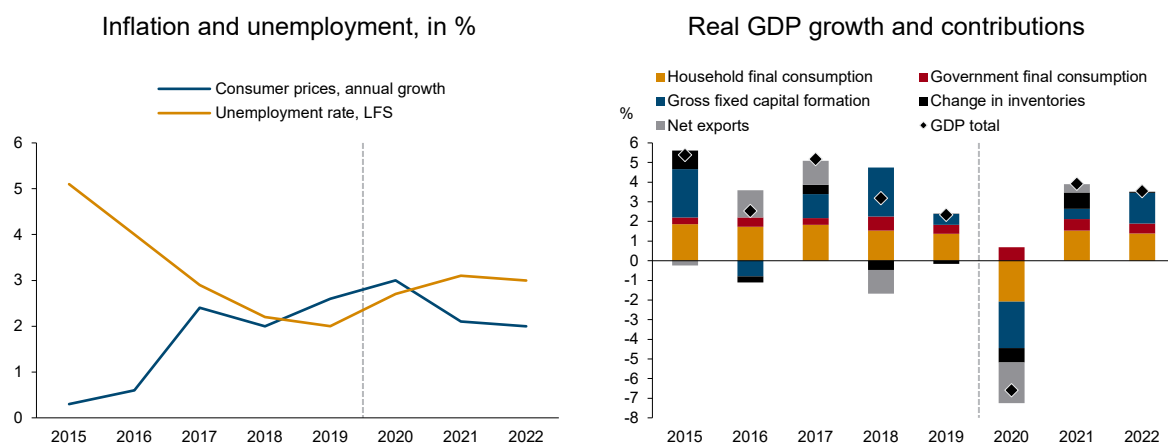


## CZECH REPUBLIC: No V-shaped recovery in sight

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In the first half of 2020, all the components of aggregate demand (except for public consumption) declined strongly, with foreign trade making a particularly big contribution to the overall drop in GDP. The rise in unemployment has been moderate, but real wages have declined. The modest improvements optimistically expected in the second half of the year will not be enough to compensate for the initial losses. Positive growth may return in 2021, but a strong showing is not expected.

Figure 4.6 / Czech Republic: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

**The authorities responded promptly to the initial outbreak of the pandemic.** This was very costly for economic activity, but brought some success in restricting the spread of COVID-19 and led to an easing of the lockdown as early as May. However, that may have been premature and the relaxation may have gone too far. Of late, the situation has deteriorated quite badly, and a second lockdown is likely in the last quarter. Depending on its severity and length, all current expectations for the economy may prove invalid. The (optimistic) assumption currently prevailing is that the slow economic recovery observed since April (the lowest point) will continue further in the second half of 2020 and in 2021.

**The Czech economy was not faring too well even before the pandemic.** GDP was declining even in the first quarter of 2020 (by 1.6%), primarily because of a big drop in capital formation. Then came the proper slump in the second quarter, with GDP falling by 11% and household consumption plummeting by an unprecedented 7.4%. Over the first half of the year as a whole, all the components of GDP saw a decline, apart from public consumption. The intensity of the recession in the second half of 2020 is

expected to be somewhat less pronounced. Nonetheless, 2020 will not end well: GDP will have fallen by close to 7%, if not more. Only in 2021 will the recession lift – provided the epidemic situation at home and abroad does not spin out of control. But no V-shaped recovery is on the cards. Growth in 2021-2022 will be moderate, on account of the inevitable losses suffered by firms during, and after, the lockdown.

**The very big declines in exports (of goods and services) were not matched by equally strong falls in imports.** In the second quarter of 2020, exports fell by over 23% in real terms, but imports by only 18.4%. In effect, the impact of trade on GDP growth turned strongly negative (-5 percentage points). Czech foreign trade (and much of the country's domestic economy) is exposed not only to the risks stemming from the foreign demand side, but also to those pertaining to cross-border supply chains. The Czech Republic is paying a high price for its external openness, its intensive participation in global value chains, its highly skewed production structure and its reliance on imports. Its main industrial sector (automotive) depends hugely on external demand, which may not be forthcoming. In addition, the Czech automotive industry will have to adjust to the global trend toward the increasing replacement of hydrocarbon-powered vehicles with hybrid and electric cars, as well as to changes in mobility patterns. The improvements in the euro area business climate generally expected in the closing months of 2020 and in 2021 will be helpful for the Czech economy. But a renewed recession in Germany would have grave repercussions for the Czech Republic.

**The decline in employment has been quite moderate, at least so far.** Instead, one observes a severe drop in terms of hours worked (by 11% in total, with 14% in manufacturing and 16% in trade, accommodation and catering) and stagnating average nominal wages (rising by 0.5%). Businesses seem to prefer to maintain employment, apparently counting on the return of better times and tight labour markets. Employees seem to prefer stable employment (even with lower wages) to the risk of having to seek out new working opportunities. Accordingly, real wages have been declining and unemployment has been rising, albeit quite slowly. The downward adjustments in employment, hours worked and wages will continue in 2021. However, as a gradual disinflation is under way, inflation will become less of a drag on real wages, household incomes and private consumption.

**The big drop in household consumption in the second quarter of 2020** was due not only to the erosion of real incomes (with average real wages falling by 2.7% and the total wage bill declining by over 5% nominally), but also to people's increased propensity to save – most probably related to the prevailing income uncertainties (but also to the restrictions imposed on the purchases of various services and non-essential goods during lockdown). With lower incomes and employment uncertainties, voluntary household savings are likely to return to normal, and the effective demand for durables, apparel and various services may even rise above normal levels, to make up for the recent restrictions. All in all, one should expect less of a decline in household consumption in the second half of 2020.

**In the first half of 2020, business investment fell markedly** (by an estimated 11%), but publicly financed investment in infrastructure (other than residential construction) still flourished (showing close to 10% real growth). This pattern will be preserved in the second half of the year. In addition, the inventories will likely continue to contract.

**Fiscal measures to aid firms and employees hit by the epidemic-related restrictions were introduced relatively early on.** As elsewhere, the scale of additional public spending has been significant: it is estimated to be in the region of 5% or more of GDP for the whole year – quite

unprecedented in the Czech context, but still fairly modest given the very low level of public debt. Fiscal support measures may need to be prolonged, especially if the pandemic situation deteriorates further.

**The national bank has reduced its policy rates quite aggressively, from 0.75% to 0.25%.** This has pushed down interbank interest rates (and also the yields on treasury bonds) without preventing the ongoing disinflation. Low interest rates may be important – not so much by way of promoting greater lending (or making the domestic public debt cheaper to service), but rather through their impact on the depreciated exchange rate of the domestic currency. The strong devaluation during the first half of 2020 (from an average of 25.6 CZK/EUR in the first quarter of 2020 to 27 CZK/EUR in the second) may be partly attributed to the fairly indiscriminate treatment of all ‘emerging markets’ in the early stages of the pandemic. But the Czech Republic’s economic fundamentals differ from those of emerging economies: the level of its foreign exchange reserves is quite high and the country’s trade balance is still in surplus. Moreover, neither the level nor the structure of the country’s foreign debt is a cause for concern. It may be assumed that the domestic currency’s depreciation is likely to be reversed (though not necessarily too fast) as soon as the initial dust settles. For some time to come, the devalued currency will act as a buffer, moderating the GDP decline through differential impacts on exports and imports.

**Table 4.6 / Czech Republic: Selected economic indicators**

	2017	2018	2019 <sup>1)</sup>	2020 1Q	2020 2Q	2020 1-2Q	2020 Forecast	2021 Forecast	2022
Population, th pers., average	10,594	10,630	10,672	10,694	10,697	10,695	10,700	10,720	10,740
Gross domestic product, CZK bn, nom.	5,111	5,409	5,749	1,354	1,338	2,691	5,480	5,800	6,130
annual change in % (real)	5.2	3.2	2.3	-1.6	-10.8	-6.4	-6.6	3.9	3.5
GDP/capita (EUR at PPP)	26,650	27,920	29,000	.	.	.	.	.	.
Consumption of households, CZK bn, nom.	2,383	2,524	2,670	652	635	1,287	.	.	.
annual change in % (real)	3.9	3.3	2.9	0.0	-7.4	-3.8	-4.5	3.3	3.0
Gross fixed capital form., CZK bn, nom.	1,273	1,423	1,507	314	343	657	.	.	.
annual change in % (real)	4.9	10.0	2.2	-3.8	-4.6	-4.2	-9.0	2.0	6.0
Gross industrial production									
annual change in % (real)	6.5	3.1	-0.3	-4.1	-23.5	-13.9	-10.0	6.0	6.0
Gross agricultural production									
annual change in % (real)	-6.2	-1.1	1.3	.	.	.	.	.	.
Construction industry									
annual change in % (real)	3.3	9.2	2.7	2.7	-8.7	-4.3	.	.	.
Employed persons, LFS, th, average	5,222	5,294	5,303	5,277	5,213	5,245	5,250	5,260	5,260
annual change in %	1.6	1.4	0.2	-0.5	-1.6	-1.1	-1.0	0.2	0.0
Unemployed persons, LFS, th, average	155	122	109	106	126	116	150	170	160
Unemployment rate, LFS, in %, average	2.9	2.2	2.0	2.0	2.4	2.2	2.7	3.1	3.0
Reg. unemployment rate, in %, eop	3.8	3.1	2.9	3.0	3.7	3.7	.	.	.
Average monthly gross wages, CZK	29,638	32,051	34,111	34,132	34,271	34,202	34,800	35,400	36,500
annual change in % (real, gross)	4.1	5.9	3.5	1.4	-2.7	-0.6	-1.0	-0.5	1.0
Consumer prices (HICP), % p.a.	2.4	2.0	2.6	3.7	3.3	3.5	3.0	2.1	2.0
Producer prices in industry, % p.a.	0.7	0.7	1.7	0.1	1.0	0.5	1.0	1.0	1.0
General governm. budget, EU-def., % of GDP									
Revenues	40.5	41.5	41.4	.	.	.	38.5	39.0	40.0
Expenditures	39.0	40.6	41.2	.	.	.	45.0	43.0	40.5
Net lending (+) / net borrowing (-)	1.5	0.9	0.3	.	.	.	-6.5	-4.0	-0.5
General gov.gross debt, EU def., % of GDP	34.2	32.1	30.2	.	.	.	39.0	41.0	40.0
Stock of loans of non-fin.private sector, % p.a.	6.5	6.8	5.2	6.4	5.6	5.6	.	.	.
Non-performing loans (NPL), in %, eop	4.0	3.3	2.5	2.4	2.4	2.4	.	.	.
Central bank policy rate, % p.a., eop <sup>2)</sup>	0.50	1.75	2.00	1.00	0.25	0.25	0.15	0.50	0.75
Current account, EUR mn	2,892	962	-660	3,103	275	3,302	1,000	100	500
Current account, % of GDP	1.5	0.5	-0.3	5.9	0.6	3.2	0.5	0.0	0.2
Exports of goods, BOP, EUR mn	129,241	136,370	139,277	33,977	26,324	60,099	119,600	130,400	139,500
annual change in %	9.2	5.5	2.1	-3.1	-26.5	-15.2	-14.1	9.0	7.0
Imports of goods, BOP, EUR mn	119,448	128,516	130,082	31,315	25,139	56,292	114,200	122,800	132,600
annual change in %	9.8	7.6	1.2	-2.9	-23.2	-13.4	-12.2	7.5	8.0
Exports of services, BOP, EUR mn	24,206	25,942	27,120	6,526	5,206	11,697	24,400	26,600	28,600
annual change in %	9.9	7.2	4.5	3.2	-22.7	-10.4	-10.0	9.0	7.5
Imports of services, BOP, EUR mn	19,468	21,262	23,054	5,015	4,174	9,166	20,700	22,500	24,500
annual change in %	7.7	9.2	8.4	0.5	-21.2	-10.9	-10.0	8.5	9.0
FDI liabilities, EUR mn	9,997	7,129	8,314	2,582	-624	1,871	2,500	.	.
FDI assets, EUR mn	8,288	5,156	5,942	2,591	-2,212	249	500	.	.
Gross reserves of NB excl. gold, EUR mn	123,273	124,142	133,059	131,906	134,744	134,744	.	.	.
Gross external debt, EUR mn	171,115	171,534	172,504	163,792	164,413	164,413	165,400	171,800	171,400
Gross external debt, % of GDP	88.1	81.3	77.0	79.2	79.5	79.5	80.0	77.0	72.0
Average exchange rate CZK/EUR	26.33	25.65	25.67	25.61	27.07	26.34	26.5	26.0	25.8

1) Preliminary. - 2) Two-week repo rate.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.