

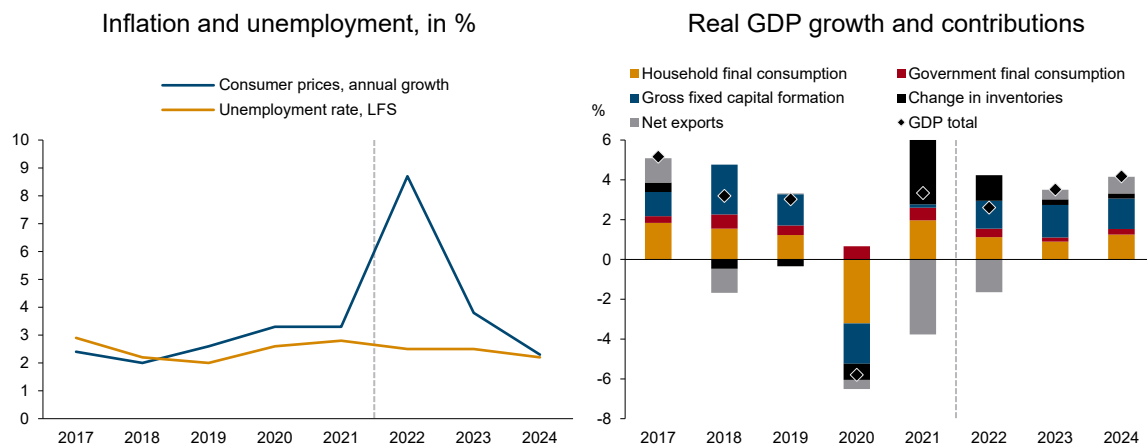


CZECHIA: Mounting challenges depress otherwise solid growth prospects

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The Czech economy grew in line with expectations in 2021, driven by household consumption as pandemic concerns faded into the background and savings started to be spent. Despite persistent supply-side troubles and sharply rising prices in the first two months of 2022, the pre-war outlook for growth over the forecast period was relatively favourable. The supply-chain pressures limiting exports showed signs of easing, and – boosted by the inflow of EU funds – investment activity was expected to accelerate. The war in Ukraine now limits these prospects. Great uncertainty, disruption and surging prices will dampen most channels of growth this year. We expect real GDP to grow modestly, by 2.6% in 2022, gradually picking up in 2023 and 2024.

Figure 4.6 / Czechia: Main macroeconomic indicators



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

In 2021, the Czech economy expanded by 3.3% against the previous year, fuelled by household consumption and inventory accumulation. The easing of COVID-related restrictions put the economy on track for solid recovery in Q2 and Q3 2021, but the year-end exposed the vulnerabilities associated with the Czech export-oriented model. Strong domestic demand boosted imports by 11.5% year on year in 2021 in real terms. By contrast, exports struggled to keep pace amidst supply-chain disruptions, growing only modestly (5.1%). As a result, foreign trade put a major damper on real GDP growth, negatively contributing 3.8 percentage points (pp).

Prior to the war in Ukraine, Czech industry was dealing fairly well with the headwinds of rapidly rising input prices, supply-side issues and labour shortages. Operating conditions for goods manufacturers showed signs of improvement at the beginning of 2022, and industrial production picked up by 3.1% in January 2022 against the previous month. The Czech Purchasing Managers' Index remained above the threshold of 50 in the first two months of 2022, echoing signs of improved manufacturing-sector health. As a result, in the pre-war baseline, it was anticipated that pressures on producer prices would ease in the first half of the year, reviving the country's industrial core and releasing pent-up exports. Investments deferred due to the pandemic were also expected to gain momentum and to become a key driver of growth in the three years ahead.

Russia's invasion of Ukraine renders these prospects bleaker, as external pressures intensify. Inflation is unlikely to subside in the coming months, and will instead climb to historic highs. In February, even before the war, the rise in harmonised consumer prices was in double digits (10.0%) year on year – the steepest increase since 1998 and the third highest in the EU. Producer prices reached even higher levels (21.3%), with energy and chemical producers impacted most significantly.

The Czech National Bank (CNB) continues to adopt a tight monetary stance, again raising the policy rate by 50 basis points at its latest meeting, on 31 March. In what is now the seventh consecutive hike, the CNB showed its readiness to go beyond the nominal 5% mark to ensure price stability. Still, given the horizon of monetary policy, this year's inflation rate is expected to reach just below 9% and to return to the tolerance range only in 2024. In line with this outlook, another interest rate hike is likely in 2022, followed by a cut in 2023.

The Czech koruna was subject to considerable volatility in the days following the Russian invasion, depreciating by over 5% in the first week of the war. The value of Eastern European currencies – including the koruna – was initially driven downwards, as investors considered flocking to safety. The markets have since calmed down and the koruna has fully regained its pre-war strength, lessening concern about capital flight from the country. In the first instance, the rebound was also helped by the CNB's prompt interventions in the foreign exchange market.

In the light of recent events, we have revised our real GDP growth forecast for 2022 downwards by 1.4 pp, to 2.6%. Most channels of growth are expected to be depressed. Household consumption and gross fixed capital formation will grow modestly, amidst deteriorating purchasing power and high uncertainty. Despite the stretched labour markets exerting upward pressure on wages, wages failed to keep pace with prices in Q4 2021, falling by 2% in real terms. Consumer sentiment indicators crumbled in March (by 9.3 points, the largest decline in nine years), as Czechs became warier of their financial situation in the coming 12 months and deferred spending. In similar fashion, the index of business sentiment compiled by the Czech Chamber of Commerce reveals a reduced appetite for investment.²⁹ Still, supported by incoming EU funds, gross fixed capital formation is expected to fuel growth over the forecast period.

²⁹ https://komora.cz/press_release/index-podnikatelske-nalady-malych-a-strednich-podniku-klesl-skoro-polovina-podniku-je-nucena-utlumit-investice/

The main damper on growth in 2022 will again be the external environment. Ukraine and Russia are not significant trading partners for Czechia, jointly accounting for roughly 3% of Czech imports and exports. Therefore, reduced demand from these countries will not have any major repercussions. However, both economies are important suppliers of various critical goods, particularly for automobile production, including cable harnesses, palladium and aluminium. Disruption to the supply of these inputs has already led car makers to temporarily halt production. At the same time, the reintroduction of lockdowns in China not only offers a stark reminder that the pandemic is not yet over, but also points to the likelihood of more bottlenecks ahead. These factors are expected to dampen Czech exports. Soaring energy and other input prices will, on the other hand, push up imports, sending the current account into negative territory. This will be coupled with a build-up of inventory stock, temporarily contributing positively to GDP.

The Czech economy will continue to post twin deficits. The budget was approved in March: it contains a planned deficit of CZK 280bn (representing roughly 4% of GDP), which represents a 25% reduction against the proposal of the former administration. Despite the new Civic Democratic Party-led government's efforts to cut public spending, a return to a period of budget surpluses is unlikely over the forecast period. Plant stoppages, rising energy costs, increased defence spending and the ever-growing influx of Ukrainian refugees will likely put pressure on public expenditure and limit revenues.

Given the resilient underlying economic conditions, the Czech economy should regain reasonable dynamism by 2024, assuming that the acute impacts of the war are limited to this year. Yet, there are major downside risks to the forecast, dictated by the highly uncertain geopolitical environment and the ongoing pandemic.

Table 4.6 / Czechia: Selected economic indicators

	2018	2019	2020	2021 ¹⁾	2022	2023	2024
					Forecast		
Population, th pers., average	10,630	10,672	10,698	10,609	10,740	10,760	10,775
Gross domestic product, CZK bn, nom.	5,410	5,790	5,694	6,121	6,970	7,580	8,090
annual change in % (real)	3.2	3.0	-5.8	3.3	2.6	3.5	4.2
GDP/capita (EUR at PPP)	27,910	29,160	27,800	29,520	.	.	.
Consumption of households, CZK bn, nom.	2,524	2,663	2,545	2,737	.	.	.
annual change in % (real)	3.3	2.6	-7.0	4.4	2.5	2.0	2.8
Gross fixed capital form., CZK bn, nom.	1,423	1,568	1,490	1,559	.	.	.
annual change in % (real)	10.0	5.9	-7.5	0.6	5.5	6.4	6.0
Gross industrial production							
annual change in % (real)	3.1	-0.3	-7.2	6.9	2.5	5.0	3.5
Gross agricultural production							
annual change in % (real)	-0.9	2.0	5.1	-1.0	.	.	.
Construction industry							
annual change in % (real)	9.2	2.7	-6.3	2.7	.	.	.
Employed persons, LFS, th, average ²⁾	5,294	5,303	5,235	5,213	5,220	5,220	5,230
annual change in %	1.4	0.2	-1.3	-0.3	0.1	0.0	0.2
Unemployed persons, LFS, th, average ²⁾	122	109	137	150	130	130	120
Unemployment rate, LFS, in %, average ²⁾	2.2	2.0	2.6	2.8	2.5	2.5	2.2
Reg. unemployment rate, in %, eop	3.1	2.9	4.0	3.5	.	.	.
Average monthly gross wages, CZK	32,051	34,578	35,662	37,839	40,300	43,500	46,700
annual change in % (real, gross)	5.9	5.0	-0.1	2.1	-2.0	4.0	5.0
Consumer prices (HICP), % p.a.	2.0	2.6	3.3	3.3	8.7	3.8	2.3
Producer prices in industry, % p.a.	0.7	1.7	0.6	6.2	17.0	5.5	3.0
General governm. budget, EU def., % of GDP							
Revenues	41.5	41.4	41.6	40.2	40.5	41.5	41.5
Expenditures	40.6	41.1	47.2	47.0	45.5	44.2	42.0
Net lending (+) / net borrowing (-)	0.9	0.3	-5.6	-6.8	-5.0	-2.7	-0.5
General gov. gross debt, EU def., % of GDP	32.1	30.0	37.7	40.3	43.6	45.0	44.5
Stock of loans of non-fin. private sector, % p.a.	6.8	5.2	4.1	8.4	.	.	.
Non-performing loans (NPL), in %, eop	3.3	2.5	2.8	2.4	.	.	.
Central bank policy rate, % p.a., eop ³⁾	1.75	2.00	0.25	3.75	5.25	3.75	3.00
Current account, EUR m	962	747	4,393	-2,074	-6,200	-3,750	50
Current account, % of GDP	0.5	0.3	2.0	-0.9	-2.2	-1.2	0.0
Exports of goods, BOP, EUR m	136,370	139,428	128,226	148,002	173,200	191,200	204,000
annual change in %	5.5	2.2	-8.0	15.4	17.0	10.4	6.7
Imports of goods, BOP, EUR m	128,516	130,088	117,611	145,221	174,300	189,600	199,300
annual change in %	7.6	1.2	-9.6	23.5	20.0	8.8	5.1
Exports of services, BOP, EUR m	25,942	27,204	22,842	25,116	28,100	30,300	32,900
annual change in %	7.2	4.9	-16.0	10.0	12.0	8.0	8.6
Imports of services, BOP, EUR m	21,262	23,078	18,912	20,819	22,300	24,500	27,300
annual change in %	9.2	8.5	-18.1	10.1	7.0	9.7	11.5
FDI liabilities, EUR m	7,129	9,582	7,367	6,491	.	.	.
FDI assets, EUR m	5,156	4,243	1,788	6,280	.	.	.
Gross reserves of CB excl. gold, EUR m	124,142	133,059	134,899	152,755	.	.	.
Gross external debt, EUR m	171,534	172,544	164,648	179,866	214,500	236,100	252,000
Gross external debt, % of GDP	81.3	76.5	76.5	75.3	76.0	76.0	76.0
Average exchange rate CZK/EUR	25.65	25.67	26.46	25.64	24.7	24.4	24.4

1) Preliminary and wiiw estimates. - 2) From 2021 new methodology in line with the Integrated European Social Statistics Regulation (IESS), excluding persons on parental leave from employed persons. -3) Two-week repo rate.

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