THE CZECH REPUBLIC: Benefiting from a positive demand shock

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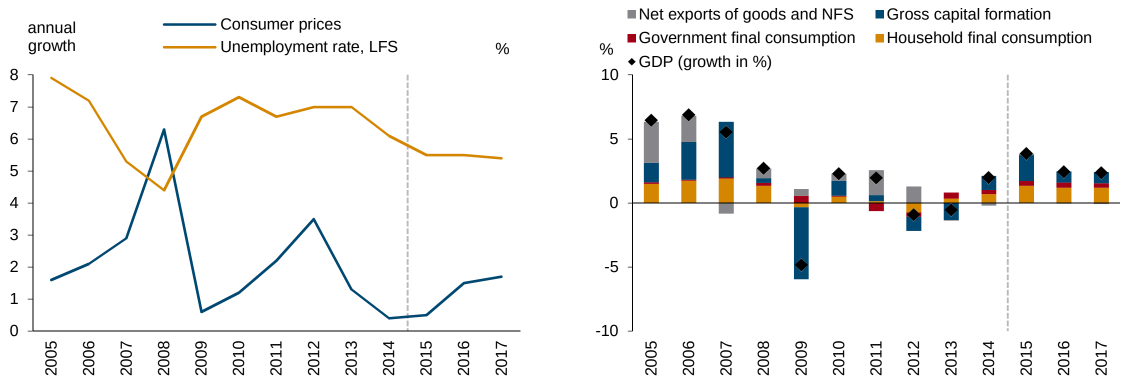
Given the relatively low level of debt in the private sector and the growth-friendly monetary policy, a further moderate recovery should be forthcoming in 2016-2017 (with growth averaging 2.35%). However, the current expansion of infrastructural investment is not going to extend into the years ahead. Uncertainties also persist where the performance of foreign trade is concerned. Furthermore, growth might be seriously impaired, were the previous fiscal consolidation policy to be reintroduced.

Figure 44 / Czech Republic: Main macroeconomic indicators

Inflation and unemployment, in %

Real GDP growth and contributions



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

GDP grew by 4.2% (seasonally adjusted, year-on-year) in the first half of 2015. Last time growth that strong was recorded in the first half of 2008. The rates of growth of household and government consumption also approached pre-crisis magnitudes (the former rose by about 3%, the latter by 2.5%). The dynamics of exports and imports was less impressive (by Czech standards). Volumes of exports and imports (of goods and non-factor services combined) rose by 7% and 7.7% respectively (year-on-year). Nominally, the (positive) trade balance was almost unchanged – but its real-term contraction had quite a significant impact on the GDP growth rate: foreign trade contributed to the GDP growth negatively (by close to -0.3 percentage points). Gross fixed capital formation rose unusually strongly, by about 4.5%, contributing some 1.2 percentage points to the overall GDP growth of 4.2%. Expanding inventories (primarily representing work in progress and also the acquisition of valuables) appear to have been important contributors to GDP growth (adding another 1.3 percentage points to overall growth).

In the first half of 2015 investment in ICT, machinery, equipment, etc. – constituting about one third of the entire gross fixed capital formation (GFCF) – increased rather weakly, by about 1.3% in real terms. Also residential investment (about 13% of total GFCF) rose moderately, by about 3.4%. The strongest growth (by 12.5%) was recorded for transport equipment (representing about 12% of total GFCF).

However, the greatest impact has had the 7.8% growth in investments assuming the form of 'other buildings and structures" (whose GFCF share is 30%). The infrastructural investments, broadly understood, included in this category had been declining since 2007, by 22% cumulatively. The current sharp rebound – actually not expected even by the Czech authorities – seems to represent a 'last-moment" attempt to tap the EU funds earmarked under the financial perspective for 2007-2013.

The past years' failure to draw available funds from the EU resources need not be attributed to the Czech side's 'technical' unpreparedness. During the four-years fiscal consolidation period (2000-2013) public spending – including the co-financing of EU-financed infrastructural projects – was suppressed. The fiscal relaxation that started in 2014 allows more meaningful government investment spending now. This spending is to rise from approximately 3.9% of GDP in 2014 to 4.8% in 2015 (before being allowed to fall back to about 3.8% later on).

The fiscal relaxation in 2015 (with the general government deficit close to 2% of GDP) is to reduce the public debt/GDP ratio in 2015 to about 40.9%. This is to be achieved largely on account of faster output growth. The ongoing reduction in the debt/GDP ratio, achieved quite 'painlessly', would indicate that supportive fiscal policy could continue to be fairly relaxed also in the future. However, the current (April 2015) governmental Convergence Programme envisages renewed fiscal consolidation in 2016-2018, with progressively falling public sector expenditures and fiscal deficits. According to the Programme, the fiscal deficit is to fall to 0.6% of GDP in 2018, with a primary surplus of about 0.5% of GDP and the public debt/GDP ratio falling to 40.2%. It is perhaps not surprising that – consistent with its vision of fiscal policy – the Programme does not promise too much as far as growth prospects are concerned. Actually, for the coming years it envisages steady growth *slowdown* to little over 2% in 2018. Of course, if the ambitious consolidation plans are put into action, the eventual GDP growth may well fall short of the magnitude expected.[47] In other words, the intentions expressed by the government could pose a little appreciated threat to the near-future economic prospects.

[47] In 2013 a major fiscal consolidation effort took place, with the general government balance/GDP ratio being reduced from -3.9% (in 2012) to -1.2%. This happened to coincide with GDP *contracting* by 0.5% (against *growth* 'planned' to be 1.6%). It is well beyond the scope of this report to analyse, extensively, the reasons for the Czech authorities' revealed predilection for fiscal consolidation. One possible reason may be fairly 'technical'. The Convergence Programme shows large and growing positive 'output gaps' *estimated* for 2016-2018. Accordingly, these estimates (whose derivation is subject to legitimate doubts on conceptual and practical grounds) suggest that real (if anaemic) growth forecasted will soon exceed some hypothetical 'potential' GDP growth. From this it has been concluded that the 'cyclically adjusted budget deficits' (again hypothetical) are much larger than the actual (statistically measurable) budget deficits and – as such – will necessitate renewed consolidation efforts.

The output recovery (most pronounced in the manufacturing and construction sectors) has supported labour market improvements. The average real wage increased by more than 2.7% in the second quarter of 2015, employment rose by over 2%, the hours worked by over 2% and the unemployment rate (LFS) fell, within a year, by close to 1 percentage point, to 5.2% (as of end-August)[48]. Despite the marked labour market improvements, consumer price inflation is very low (while producer prices continue to fall rather strongly). The revealed insensitivity of inflation to the apparent tightening of the labour market conditions seems to suggest that consumer demand continues to be depressed – possibly on account of a rather low GDP share of wages and the Czech households' saving habits. Of course, some supply-side factors such as falling prices of energy carriers may have also moderated inflation.

The extremely relaxed monetary policy, which prevented the consolidation-driven recession from assuming devastating dimensions in 2012-2013, is very likely to remain unchanged for the time being. The very low policy interest rate (two-week repo rate) of 0.05% in force since early November 2012 has had no perceptible impact on inflation. The devaluation of the Czech currency enforced by the National Bank in November 2013 has also proved unable to activate inflationary tendencies. Right now the National Bank seems to believe that inflation will be gradually recovering in 2016. By that time the Bank may also give up its resolution to keep the CZK/EUR exchange rate above 27. Whether the floating Czech koruna will resume its earlier appreciation tendency is hard to predict now. Very likely it will not: the koruna has remained weak with very little visible effort on the part of the National Bank.

Interest rates on loans to private households have remained moderate (though falling somewhat recently). Loans to corporate clients appear to be rather inexpensive. The shares of non-performing loans extended to households and firms are quite low and falling. However, lending to both households and business has been expanding rather slowly so far. The private sector's bank deposits still exceed the volume of loans extended. Probably the improving consumer and business sentiments can spur a stronger demand for loans in the coming quarters.

The unexpected acceleration of investment in 2015 is unlikely to have significant demand- or supply-side consequences, at least in the medium term. The economy is expected to grow rather moderately in 2016-2017. No major imbalances could be identified even if growth of aggregate demand were to be stronger than could be realistically expected. As in the past, the monetary policy is likely to support stable growth while the fiscal policy's declared intentions suggest the possibility of the return of unnecessary fiscal austerity.

[48] The current unemployment rate is as low as in 2007 – and yet higher than in 2008 (5.3% and 4.4% respectively). The registered unemployment rates are about 1 percentage point higher than those based on LFS.

Table 11 / Czech Republic: Selected economic indicators

	2011	2012	2013	2014 1)	2014	2015	2015	2016	2017
					January-June			Forecast	
Population, th pers., average 2)	10,496	10,511	10,514	10,525	10,519	10,538	10,525	10,530	10,545
Gross domestic product, CZK bn, nom. 3)	4,023	4,042	4,077	4,261	2,050	2,161	4,450	4,630	4,820
annual change in % (real)	2.0	-0.9	-0.5	2.0	2.2	4.4	3.9	2.4	2.3
GDP/capita (EUR at exchange rate) 3)	15,600	15,300	14,900	14,700	.	.	15,300	16,100	16,900
GDP/capita (EUR at PPP) 3)	21,600	21,800	21,900	22,900	.	.	.	.	.
Consumption of households, CZK bn, nom. 3)	1,957	1,971	2,001	2,042	986	1,018	.	.	.
annual change in % (real) 3)	0.3	-1.5	0.7	1.4	1.2	2.9	2.8	2.5	2.5
Gross fixed capital form., CZK bn, nom. 3)	1,069	1,052	1,025	1,065	490	523	.	.	.
annual change in % (real) 3)	1.1	-3.3	-2.7	2.0	2.0	5.2	6.0	3.0	3.0
Gross industrial production									
annual change in % (real)	5.9	-0.8	-0.1	5.0	6.5	5.0	4.5	5.0	4.5
Gross agricultural production									
annual change in % (real)	8.6	-5.8	6.9	7.3	.	.	.	.	.
Construction industry									
annual change in % (real)	-3.6	-7.6	-6.7	4.3	8.5	9.1	.	.	.
Employed persons, LFS, th, average 4)	4,904	4,890	4,937	4,974	4,943	5,016	5,020	5,030	5,040
annual change in %	0.4	0.4	1.0	0.8	0.5	1.5	1.0	0.2	0.2
Unemployed persons, LFS, th, average 4)	354	367	369	324	338	289	300	290	290
Unemployment rate, LFS, in %, average 4)	6.7	7.0	7.0	6.1	6.4	5.4	5.5	5.5	5.4
Reg. unemployment rate, in %, end of period 5)	8.6	9.4	8.2	7.7	7.4	6.2	6.6	6.0	6.0
Average monthly gross wages, CZK	24,455	25,067	25,035	25,607	25,083	25,807	26,500	27,600	28,800
annual change in % (real, gross)	0.6	-0.8	-1.5	1.9	2.7	2.9	3.0	2.5	2.5
Consumer prices (HICP), % p.a.	2.2	3.5	1.3	0.4	0.3	0.3	0.5	1.5	1.7
Producer prices in industry, % p.a.	3.7	2.4	0.7	1.0	1.2	-1.8	1.0	1.3	1.5
General governm. budget, EU-def., % of GDP									
Revenues	39.7	39.9	40.9	40.1	.	.	40.3	39.5	39.5
Expenditures	42.4	43.8	42.0	42.1	.	.	42.3	41.5	41.0
Net lending (+) / net borrowing (-)	-2.7	-3.9	-1.2	-2.0	.	.	-2.0	-2.0	-1.5
Public debt, EU-def., % of GDP	39.9	44.6	45.1	42.6	.	.	41.0	41.5	41.0
Central bank policy rate, % p.a., end of period 6)	0.75	0.05	0.05	0.05	0.05	0.05	0.05	0.5	1.5
Current account, EUR mn 7)	-3,466	-2,518	-829	958	1,980	3,469	1,620	0	-1,790
Current account, % of GDP 7)	-2.1	-1.6	-0.5	0.6	2.7	4.4	1.0	0.0	-1.0
Exports of goods, BOP, EUR mn 7)	99,123	104,336	103,184	110,524	55,202	58,830	118,000	124,000	130,000
annual change in %	14.1	5.3	-1.1	7.1	8.6	6.6	7.0	5.0	4.5
Imports of goods, BOP, EUR mn 7)	96,048	99,413	96,735	101,841	49,896	53,661	109,000	116,000	122,000
annual change in %	12.6	3.5	-2.7	5.3	7.1	7.5	7.0	6.0	5.5
Exports of services, BOP, EUR mn 7)	17,923	18,863	18,059	18,956	8,958	9,835	20,000	21,000	21,000
annual change in %	8.1	5.2	-4.3	5.0	1.8	9.8	8.0	4.0	2.0
Imports of services, BOP, EUR mn 7)	14,614	15,776	15,346	16,925	7,662	8,387	18,000	19,000	20,000
annual change in %	8.4	8.0	-2.7	10.3	5.7	9.5	8.0	3.5	3.0
FDI liabilities (inflow), EUR mn 7)	3,025	7,348	5,544	3,679	1,272	564	2,800	.	.
FDI assets (outflow), EUR mn 7)	1,161	2,531	5,831	-1,181	-2,289	627	2,000	.	.
Gross reserves of NB excl. gold, EUR mn	30,675	33,550	40,459	44,547	42,942	50,659	.	.	.
Gross external debt, EUR mn 7)	89,627	96,826	99,652	103,035	100,673	106,458	106,600	110,000	113,800
Gross external debt, % of GDP 7)	54.8	60.3	63.5	66.6	65.1	65.8	66.0	65.0	64.0
Average exchange rate CZK/EUR	24.59	25.15	25.98	27.54	27.44	27.50	27.50	27.25	27.00
Purchasing power parity CZK/EUR	17.76	17.66	17.74	17.65	.	.	.	.	.

1) Preliminary. - 2) According to census March 2011. - 3) According to ESA 2010. - 4) From 2012 according to census March 2011. -
5) From 2013 available job applicants 15-64 in % of working age population 15-64, all available job applicants in % of labour force before. -
6) Two-week repo rate. - 7) BOP 6th edition.

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