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The Czech Republic:
Fiscal consolidation amid elevated political tensions

Economic growth in the current year will slow down. Fiscal consolidation measures – if consistently implemented – will restrict household consumption. However, it is hoped that fixed investment will register a modest take-off. Foreign trade, depending predominantly on exports to Germany, has assumed the lead – and positive - role. Monetary policy is expected to remain relaxed, thus helping to check currency appreciation. The political situation will remain highly volatile.

The consolidation of public finances has been the overwhelming economic priority of the centre-right coalition government of Petr Nečas, in office since May 2010. Already in that year important (albeit somewhat 'ad hoc') decisions were implemented to reduce the size of the contemporaneous deficit of the public sector. Additional tax revenue amounting to 1.8% of GDP was collected and public expenditure was additionally cut by about 1% of GDP. Those emergency actions reduced the public sector deficit reported for 2010 to 4.7% of GDP (down from close to 6% recorded in 2009). But by reducing the growth rate of government consumption from 2.6% in 2009 to a mere 0.3%[1], the fiscal consolidation was partly responsible for a relatively slow pace of GDP recovery in 2010 (2.3%). The consolidation measures that are currently implemented have been worked out more systematically – and constitute a part of the long-term overall economic (but in fact also social) strategy which aims at the elimination of the deficit in 2016.[2] For 2011 these measures stipulate additional (personal) taxation amounting to 0.5% of the projected GDP and additional expenditure cuts of about 1.6% of the GDP. Additional cuts in social benefits (including unemployment benefits and sickness pay) are to reduce public expenditure by 0.3% of GDP, cuts in wages of government sector employees by another 0.3%, additional cuts in other expenditure items by some 0.9%. Government consumption is to fall 3.4% in 2011. All in all, the consolidation measures are to reduce the public sector fiscal deficit to 4.2% of the projected GDP in 2011. But, according to the official Convergence Programme, GDP growth is assumed to weaken to 1.9% in 2011.

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1 Government consumption rose by 1.5% in the first half of 2010 – but declined in the second half (by 0.4%).

2 See: 'Convergence Programme of the Czech Republic', Czech Finance Ministry, April 2011.

The GDP growth recorded (provisionally) in the first quarter of 2011 stands at a respectable 3.1%, much higher than planned. To some extent the recorded GDP growth reflects the 'low-base effect' as meaningful GDP recovery started only in the second quarter of 2010. Private consumption fell, as generally expected, if not much. Growth of private consumption is negatively affected by the fiscal consolidation measures (higher personal taxation and lower social transfers, restraints on the government sector's wage bill) and remains weak – even though both employment and nominal wages in the business sector (primarily in industry) have risen (slightly) in the first quarter of 2011. In real terms the household sector's disposable income probably remained flat. Moreover, the growth rate of loans extended to the household sector continues to decline. This is rather understandable as interest rates on consumer credit (other than mortgage loans) remain very high (over 14%), reflecting pessimistic perceptions of households' financial stance. However, government consumption fell only 1.2% – way off the 3.2% that would have been consistent with the fiscal consolidation plan. It is not clear yet why the cuts in government consumption did not follow the plan. One possibility is political in character. Grave tensions have recently surfaced, threatening the survival of the current coalition government. The prospect of early elections may have blunted the enthusiasm for the consistent implementation of some austerity measures.

In contrast to interest rates on consumer loans, the rates on loans to the business sector are fairly moderate (ranging between 3% and 4%) and generally decreasing. This does not induce any meaningful recovery in business sector borrowing. The weak demand for loans primarily reflects firms' cautious assessment of the overall sales developments in the coming quarters. Given the levels of spare production capacities, firms find it possible to expand production without incurring more external financing. A more pronounced demand for such financing (including for bank loans) has to await an authentic and sustained push into creation of new production capacities.

The bulk of growth registered in the first quarter of 2011 was generated by foreign trade in goods and non-factor services. In real terms exports rose by 16.7%, imports by 14%. The importance of exports is attested also by available statistics on sales of industrial production. While direct export sales increased by close to 22% (at current prices) in the first quarter of 2011, domestic sales rose only slightly over 5%.[3] Recent data on new orders placed with industry do not signal any change in destination of industrial production. In March 2011 the value of new export orders rose by 20% (year on year) while the value of domestic orders fell by close to 5%.

[3] All industrial sales rose by 12.9% in nominal terms, roughly as much as in real terms.

While the strong foreign trade performance is of course very welcome, it carries – in the Czech case – some risks. First of all, because of its current role as a chief determinant of overall growth, it exposes the whole national economy to the whims of business climate developments abroad. Worse still, Czech foreign trade (and industry) is singularly dependent on the developments in a single partner country: Germany. Rising Czech exports to Germany have recently been of crucial importance for the overall dynamics of exports. Germany has recently been absorbing about one third of the country's merchandise exports (while supplying one fourth of its merchandise imports). The overall Czech trade surplus has recently been matched by its surplus in trade with Germany. Now, as long as the German economy performs well, Czech foreign trade may thrive too. But should Germany slow down, the Czech export and industrial machinery may have to slow down as well. This could have highly negative consequences for the overall economy.

Summing up, growth in the current year will be slowing down from the level achieved in the first quarter. The 'low-base effects' will no longer be present while the effects of fiscal consolidation measures – if consistently implemented – will be restricting private (and total) consumption. Signs of a take-off in fixed investment (both private and public) have surfaced in the first quarter: hopefully more investment materializes soon. What remains as a reasonably secure source of growth is foreign trade, with exports to Germany playing the lead role. No doubt the internal productivity and cost developments will support positive developments in foreign trade. Also, the interest rate policy of the Czech National Bank may be expected to be supportive – by acting to moderate the appreciation of the domestic currency.

The prospects for 2012 (and beyond) are highly uncertain. In an optimistic scenario, Germany fares well – and Czech exports (and industry) perform well too. In due time, this might then be expected to activate a self-supporting expansion of investment (by both domestic and foreign parties) in fixed productive assets. Rising wages, household income and consumption would then follow, with the trade performance gradually losing in importance. Of course, less optimistic scenarios are no less possible, starting with one in which the German economy returns to its traditional (pre-crisis) near-stagnation. Even if Germany performs well (due to its own continuing export offensive), the transition from an export-led to an investment-led growth path would not be unproblematic. In the first place it is not clear why the new productive capacities (particularly by foreign parties) should be installed in the Czech Republic – in preference to other equally (or more) attractive locations in other New Member States. Of course, there are 'structural reforms' to be implemented in 2012 and beyond. These reforms, which are integral parts of the longer-term fiscal consolidation strategy, stipulate further downsizing of public spending (e.g. on health, social protection and education), advanced deregulation of business activities, and further flexibilization of the labour market. The reforms may enhance the investment attraction of the Czech Republic and make it more competitive even vs. some non-European emerging markets. On the other hand these reforms, if consistently enforced, may make the Czech Republic increasingly unattractive to its own labour force – and to its voting population. For that reason the reform (and consolidation) impetus may well get blunted. In effect by becoming more inward-oriented, growth in 2012 (and beyond) may also get faster and more robust.

Table CZ

Czech Republic: Selected Economic Indicators

	2007	2008	2009	2010 1)	2010 1st quarter	2011 1st quarter	2011 Forecast	2012 Forecast	2013 Forecast
Population, th pers., average	10334	10424	10487	10514	.	.	10540	10580	10610
Gross domestic product, CZK bn, nom.	3535.5	3689.0	3625.9	3669.8	870.1	888.9	3780	3950	4180
annual change in % (real)	6.1	2.5	-4.2	2.3	1.2	3.1	2.2	2.5	3.7
GDP/capita (EUR at exchange rate)	12300	14200	13100	13800	.	.	.	.	.
GDP/capita (EUR at PPP)	19900	20200	19300	19500	.	.	.	.	.
Consumption of households, CZK bn, nom.	1659.6	1804.2	1804.3	1835.4	430.0	439.6	.	.	.
annual change in % (real)	4.8	3.6	-0.3	0.4	-0.4	-0.5	1	2.5	3
Gross fixed capital form., CZK bn, nom.	890.3	883.2	814.0	771.1	171.7	176.2	.	.	.
annual change in % (real)	10.8	-1.5	-7.9	-4.6	-7.8	3.7	2	4	6
Gross industrial production									
annual change in % (real)	10.6	-1.9	-13.6	10.0	6.8	12.7	8	7	8
Gross agricultural production									
annual change in % (real)	3.1	6.8	-3.5	-4.6	.	.	.	.	.
Construction industry									
annual change in % (real)	7.0	-0.2	-0.8	-7.1	-21.4	5.9	.	.	.
Employed persons - LFS, th, average	4922.0	5002.5	4934.3	4885.2	4829.2	4864.4	4910	4930	4950
annual change in %	1.9	1.6	-1.4	-1.0	-2.4	0.7	0.5	0.5	0.5
Unemployed persons - LFS, th, average	276.6	229.8	352.2	383.5	422.7	376.2	.	.	.
Unemployment rate - LFS, in %, average	5.3	4.4	6.7	7.3	8.2	7.3	7.3	7.0	6.5
Reg. unemployment rate, in %, end of period	6.0	6.0	9.2	9.8	9.7	9.2	.	.	.
Average gross monthly wages, CZK 2)	20957	22592	23344	23797	22673	23144	.	.	.
annual change in % (real, gross)	4.3	1.4	2.3	0.4	1.9	0.4	0.8	1.5	2
Consumer prices (HICP), % p.a.	2.9	6.3	0.6	1.2	0.4	1.9	2.0	2.0	2.0
Producer prices in industry, % p.a.	2.6	0.4	-1.5	0.1	-3.9	3.2	2.5	.	.
General governm. budget, EU-def., % GDP									
Revenues	41.8	40.2	40.1	40.5	.	.	41.2	41.2	.
Expenditures	42.5	42.9	45.9	45.2	.	.	45.8	45.2	.
Net lending (+) / net borrowing (-)	-0.7	-2.7	-5.8	-4.7	.	.	-4.6	-4.1	-3.5
Public debt, EU-def., in % of GDP	29.0	30.0	35.3	38.5	.	.	41.3	42.9	44.0
Central bank policy rate, % p.a., end of period 3)	3.50	2.25	1.00	0.75	1.00	0.75	1.5	2.0	2.0
Current account, EUR mn	-4090	-962	-4396	-5563	248	811	-4000	-5000	-5200
Current account in % of GDP	-3.2	-0.7	-3.2	-3.8	0.7	2.2	-2.6	-3.0	-3.0
Exports of goods, BOP, EUR mn	89379	99158	77006	95398	21503	26968	111000	122000	132000
annual growth rate in %	18.1	10.9	-22.3	23.9	19.8	25.4	16	10	8
Imports of goods, BOP, EUR mn	85038	95031	73946	93298	20391	25684	107000	120000	130000
annual growth rate in %	15.8	11.8	-22.2	26.2	18.7	26.0	15	12	8
Exports of services, BOP, EUR mn	12311	14849	14594	16350	3475	3926	18000	20000	22000
annual growth rate in %	11.0	20.6	-1.7	12.0	3.2	13.0	11	12	10
Imports of services, BOP, EUR mn	10526	12210	12125	13743	2854	3260	15000	17000	19000
annual growth rate in %	10.9	16.0	-0.7	13.3	2.2	14.2	12	12	10
FDI inflow, EUR mn	7667	4467	2082	5104	1846	715	4000	.	.
FDI outflow, EUR mn	1187	2964	685	1283	664	170	.	.	.
Gross reserves of NB excl. gold, EUR mn	23456	26386	28556	31357	29110	29486	.	.	.
Gross external debt, EUR mn	51642	59689	61940	71379	62918	.	.	.	.
Gross external debt in % of GDP	40.6	40.4	45.2	49.2	43.3	.	.	.	.
Average exchange rate CZK/EUR	27.77	24.95	26.44	25.28	25.88	24.37	24.5	24	24
Purchasing power parity CZK/EUR	17.17	17.54	17.94	17.87	.	.	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.
1) Preliminary. - 2) Enterprises with 20 and more employees, including part of the Ministry of Defence and the Ministry of the Interior. From 2009 all enterprises covered. - 3) Two-week repo rate.

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