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The Czech Republic: slowdown ahead

Stagnant capital formation

The fast GDP growth which has continued for three years is expected to slow down in 2008. Some early symptoms of the upcoming deceleration can already be detected in the available statistics for the closing months of 2007. The dynamics of industrial production has weakened quite strongly while the output of the construction sector stopped growing already at mid-year. The value of orders placed with construction sector companies (employing over 20 workers) fell by close to 6% in the third quarter of 2007. Concurrently these firms have started to reduce employment. These clear signs of an impending contraction of construction activity suggest a further deceleration of growth of investment into fixed productive assets and into new housing projects. In addition, the growth of retail sales has been faltering recently. Nonetheless, the overall growth rate in 2007, provisionally estimated at 6.2%, was still quite impressive – though one could nurture doubts about the quality of the Czech national accounts statistical reporting which exhibits a particularly high propensity to make frequent, and quite substantial, revisions. There is also the issue of a continuing massive accumulation of inventories, reported in the Czech national accounts. Rising inventories appear to have been responsible for about 1.2 percentage points of the overall GDP growth in the first three quarters of 2007, i.e. roughly as much as gross fixed investment.¹

A stabilization (let alone reduction) of inventories would automatically reduce GDP growth in 2008. Apart from this, other demand-side factors will probably be determining the near-term developments. First, despite reportedly high levels of productive capacity utilization, apparently high average profitability of the non-financial corporate sector and relatively low interest rates, the growth of gross fixed capital formation – which has been consistently anaemic since 1996 – will probably slow down further.² The reason for this is that the overall conditions in 2008 are likely to be even less conducive to any extension of fixed investment. Investment conditions will deteriorate not only on account of generally depressed investors' sentiment – which is only natural under the turmoil spreading throughout the financial markets everywhere, including the Czech Republic; more importantly, investment conditions will not become any more favourable on account of the

¹ It must be remembered that the current expansion of inventories comes after another fairly abnormal expansion in 2006. If one takes the official data at face value, the rise in inventories was responsible for 1.5 percentage points out of the 6.4% GDP growth in 2006.

² Gross fixed investment has on average grown by 2% p.a. since 1996 (while the GDP by 3.2%). The secular weakness of growth of investment in the Czech Republic must be qualified on account of its very high GDP share in the early 1990s (e.g. 32% in 1996). The current share (about 24%) is about the same as in other NMS. Fixed capital may have been too abundant, relative to the available labour resources. The average productivity of capital may be adequate, but its marginal productivity (i.e. the profitability on expanding the fixed capital stock) need not be high enough to justify high rates of investment growth.

(generally expected) hikes in interest rates. Moreover, these conditions will be adversely affected by the upcoming repression of consumer spending which will be worsening the sales prospects of domestic firms. Some boost to investment can be expected as a result of increased EU transfers.

Reform of public finances affects growth

Consumer spending will be repressed in 2008 (which of course will also be restricting the overall GDP growth directly – and immediately) despite a continuing (and fairly strong) rise in average wages and expanding (albeit moderately) overall employment. The slowdown in the growth of private consumption primarily follows as a consequence of the reform of public finances (squeezed through the parliament by Mirek Topolánek's government in September 2007). The reform, modelled after the Slovak fiscal reform, overhauls the entire tax system. It also stipulates some effective cuts in social benefits/transfers and restricts the scope of public provision of various services (e.g. by introducing co-payments for health services rendered). The 15% flat tax on personal incomes which favours the higher-income strata will lower the entire household sector's overall propensity to consume out of disposable income. But the major role in restricting private consumption will be played by hikes in indirect tax rates (on basic necessities) and in some regulated prices. Changes in the indirect tax rates will hit, with full force, primarily the lower-income population groups which anyway will not benefit much from lower personal income taxation. Overall, the reform is likely to depress the growth of private consumption in 2008 by at least some 0.8 percentage points and reduce the overall GDP growth by at least 0.5 percentage points. The authorities believe that the 2008 growth slowdown will be temporary – and that the reform will serve good purposes in the longer-term perspective. Although the public finances may need to be reformed, the success of the current version of reforms is debatable: (i) public sector deficits are likely to remain excessive in many years to come – especially if the plans to gradually reduce the corporate income tax rate (to 19% in 2010) are carried through; (ii) higher household sector's saving propensity may be depressing private consumption permanently – without helping, in any identifiable way, to accelerate growth in fixed capital formation; (iii) labour market conditions need not be positively affected simply because there are already shortages of skilled labour. Cuts in social benefits are therefore irrelevant for raising the supply of such labour. (At best such cuts may perhaps increase the supply of labour offered by very low-skill individuals, not much in demand anyway.)

The reform of public finances has also an unwelcome shorter-term consequence in the form of much higher inflation in 2008. Higher indirect tax rates/regulated prices may result in CPI inflation higher by at least 2 percentage points. This is likely to induce hikes in interest rates and also to support a further strengthening of the Czech koruna. Neither of these effects will be conducive to GDP growth in 2008. Higher interest rates will have obvious impacts on both household consumption and fixed investment (also in housing)

while a strongly appreciating koruna is no good news to export-oriented (and import-competing) firms.

The key role of foreign trade

With domestic demand unlikely to support fast growth in 2008, a good performance of foreign trade will be critical. In 2007 foreign trade performed very well, and that despite nominal (and real) appreciation much stronger than generally expected. A good performance in foreign trade may be more difficult to maintain because: (i) economic growth in major export destinations is likely to be slower than in 2007, and (ii) the strengthening Czech koruna may finally become a problem for some branches. On the other hand, the overall trade balance may improve further, and add more strongly to GDP growth (though perhaps not on the scale observed in 2005 when foreign trade generated 4.8 percentage points out of 6.4% of GDP growth). Further improvements on the external front are quite likely though, because: (i) the repressed growth in household spending may happen to be linked to some cuts in the demand for imports; (ii) growth in industrial unit labour (and other) costs is still quite moderate, labour productivity gains are still considerable; and (iii) the major (foreign-owned) export-oriented branches (such as the automotive industry) are still capable of increasing the supplies of competitively priced products.

After 2008 the overall growth is likely to accelerate again. The tax-induced inflationary impacts will wear off in the course of 2008. This will allow a substantial reduction in interest rates and may brake (or possibly reverse) the nominal appreciation tendency. Under such conditions consumer credit and growth in consumption and investment may accelerate, while a weaker Czech koruna may support some broader-based growth in exports.

Table CZ

Czech Republic: Selected economic indicators

	2002	2003	2004	2005	2006	2007 ¹⁾	2008	2009	2010
	Forecast								
Population, th pers., mid-year	10,201	10,202	10,207	10,234	10,267	10,326	.	.	.
Gross domestic product, CZK bn, nom. ²⁾	2,464	2,577	2,815	2,988	3,232	3,540	3,880	4,190	4,510
annual change in % (real) ²⁾	1.9	3.6	4.5	6.4	6.4	6.6	4.5	5	5
GDP/capita (EUR at exchange rate)	7,841	7,933	8,644	9,802	11,106	12,349	.	.	.
GDP/capita (EUR at PPP - wiiw)	14,420	15,220	16,260	17,160	18,500	20,080	.	.	.
Gross industrial production									
annual change in % (real) ³⁾	1.9	5.5	9.6	6.7	11.2	8.2	8	9	8
Gross agricultural production									
annual change in % (real)	-4.4	-7.6	14.9	-4.8	-4.2	.	.	.	.
Construction industry									
annual change in % (real)	2.5	8.9	9.7	4.2	6.6	6.7	.	.	.
Consumption of households, CZK bn, nom. ²⁾	1,248	1,317	1,399	1,443	1,554	1,700	.	.	.
annual change in % (real) ²⁾	2.2	6.0	2.9	2.3	5.4	6.2	4	5	5
Gross fixed capital form., CZK bn, nom. ²⁾	677.8	687.5	727.2	746.1	794.8	860	.	.	.
annual change in % (real) ²⁾	5.1	0.4	3.9	2.3	5.5	4.5	3	4	5
LFS - employed persons, th, avg. ⁴⁾	4,765	4,733	4,707	4,764	4,828	4,922	.	.	.
annual change in %	0.8	-0.7	-0.6	1.2	1.3	1.9	1.5	1	1
LFS - employed pers. in industry, th, avg. ⁴⁾	1,463	1,425	1,409	1,422	1,493	.	.	.	.
annual change in %	-0.1	-2.6	-1.1	0.9	5.0	.	.	.	.
LFS - unemployed, th pers., average	374.1	399.1	425.9	410.2	371.3	276.3	.	.	.
LFS - unemployment rate in %, average ⁴⁾	7.3	7.8	8.3	7.9	7.1	5.3	5.5	5	4.5
Reg. unemployment rate in %, end of period	9.8	10.3	9.5	8.9	7.7	6.0	6.5	.	.
Average gross monthly wages, CZK ⁵⁾	15,866	16,917	18,041	18,992	20,207	21,915	.	.	.
annual change in % (real, gross)	5.4	6.5	3.7	3.3	3.8	5.5	3.5	5	5
Consumer prices, % p.a.	1.8	0.1	2.8	1.9	2.5	2.8	5.0	2.8	2.5
Producer prices in industry, % p.a.	-0.5	-0.4	5.7	3.0	1.6	4.1	4	3	2
General governm. budget, EU-def., % GDP ⁶⁾									
Revenues	39.5	40.7	42.2	41.3	40.7	41.1	.	.	.
Expenditures	46.3	47.3	45.1	44.9	43.6	43.0	.	.	.
Net lending (+) / net borrowing (-)	-6.8	-6.6	-2.9	-3.5	-2.9	-1.9	-3.0	-2.7	-2.6
Public debt, EU-def., in % of GDP ⁶⁾	28.5	30.1	30.4	30.2	30.1	30.4	.	.	.
Discount rate, % p.a., end of period	1.8	1.0	1.5	1.0	1.5	2.5	3	2.5	1.5
Current account, EUR mn	-4,442	-5,028	-4,650	-1,638	-3,561	-4,100	-4,900	-5,500	-6,000
Current account in % of GDP	-5.6	-6.2	-5.3	-1.6	-3.1	-3.2	-3.3	-3.5	-3.5
Gross reserves of NB incl. gold, EUR mn	22,614	21,340	20,884	25,054	23,882	23,707	.	.	.
Gross external debt, EUR mn	25,738	27,624	33,212	39,379	44,263	47,400	.	.	.
Gross external debt in % of GDP	33.0	34.7	35.9	38.2	37.7	35.7	.	.	.
FDI inflow, EUR mn	9,090	1,875	4,009	9,354	4,760	5,600	6,000	.	.
FDI outflow, EUR mn	221	183	824	-12	1,073	800	1,000	.	.
Exports of goods, BOP, EUR mn	40,713	43,055	54,091	62,781	75,684	89,000	103,000	117,000	131,000
annual growth rate in %	9.2	5.8	25.6	16.1	20.6	18	16	14	12
Imports of goods, BOP, EUR mn	43,034	45,239	54,517	60,797	73,283	85,000	99,000	113,000	127,000
annual growth rate in %	5.7	5.1	20.5	11.5	20.5	16	16	14	12
Exports of services, BOP, EUR mn	7,502	6,880	7,761	9,478	10,603	12,000	13,000	.	.
annual growth rate in %	-5.3	-8.3	12.8	22.1	11.9	10	7	.	.
Imports of services, BOP, EUR mn	6,796	6,464	7,245	8,254	9,384	10,000	11,000	.	.
annual growth rate in %	9.3	-4.9	12.1	13.9	13.7	7	6	.	.
Average exchange rate CZK/USD	32.74	28.23	25.70	23.95	22.61	20.31	.	.	.
Average exchange rate CZK/EUR (ECU)	30.81	31.84	31.90	29.78	28.34	27.76	26.5	26.3	26.5
Purchasing power parity CZK/USD	14.32	14.02	14.27	14.40	14.19	14.26	.	.	.
Purchasing power parity CZK/EUR	16.76	16.60	16.96	17.02	17.01	17.08	.	.	.

Note: The term 'industry' refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices). - 3) According to new calculation. - 4) From 2002 weighted according to census 2001. - 5) Enterprises with more than 20 employees, including part of the Ministry of Defence and the Ministry of the Interior. - 6) According to ESA'95, excessive deficit procedure.

Source: wiiw Database incorporating national statistics; Eurostat; wiiw forecasts.