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The Czech Republic: stagnant investment augurs overall growth slowdown

GDP growth, which had accelerated until the fourth quarter of 2005, has been slowing down since. Although, at over 6%, growth in the first quarter of 2007 looks again impressive, the slowdown appears to be associated with rather unfavourable longer-term changes in the composition of final demand. Throughout 2005 growth was driven primarily by foreign trade (in goods and non-factor services), contributing 4.8 percentage points to the overall GDP growth rate of 6.5%; household consumption contributed a further 1.2 p.p. (and the government consumption 0.5 p.p.) while gross fixed capital formation a mere 0.6 p.p. Throughout 2006 the contribution of foreign trade was diminishing. In the first quarter of 2007 that contribution was already negative (-0.6 p.p.). Private consumption has gradually become the main driver of growth (its contribution advanced from 2.1 p.p. in the whole of 2006 to 3.1 p.p. in the first quarter of 2007). Gross fixed capital formation, which grew remarkably throughout 2006, sagged suddenly in the first quarter of 2007, contributing a mere 0.3 p.p. to overall growth. However, it is the performance of inventories which is most intriguing. Inventories increased strongly already in 2006 (generating 1.1 p.p. of the overall GDP growth). The further rise in inventories, presently registered, turns out to be the major factor behind overall GDP growth (contributing an unprecedented 3.1 p.p.). Quite obviously, such a massive accumulation of inventories cannot be sustained for very long. In case there is no further growth in inventories, the quarterly GDP growth rate would – *ceteris paribus* – fall to 3%. If part of the inventories turns out to be excessive, which cannot be ruled out, their liquidation would then depress the overall growth even more. Unfortunately, the official statistics are mute on the nature of rising inventories. However, some evidence on the construction sector (volumes of dwellings under construction, new orders for other types of construction activities, etc.) suggests that the levels of works in progress is about normal (by the standards of the past few years). Thus the rising inventories may rather represent unsold stocks of products and stockpiling supplies of raw materials. Should this be the case, the eventual halt (or reversion) of the inventory accumulation is likely to come sooner rather than later. Moreover, it would have a more disturbing character compared to a situation when a large share of inventories represents investment projects awaiting completion.

The sudden, and wholly unanticipated, strong slowdown in growth of gross fixed capital formation in the first quarter of 2007 is quite remarkable as it comes at a time when gross value added in the corporate sector is reported to be rising substantially and when, simultaneously, loans and credits to the non-financial corporate sector have been expanding very rapidly (at about 20% year-on-year).[1] Clearly, it is not a shortage of funds that limits investment in fixed domestic assets. Rather, one might speculate about a worsening of medium-term sales' prospects as deterring investment. This could be a natural development given the accumulation of inventories. Alternatively, the reasons for the falling propensity to invest may have something to do with firms' growing interest in moving their activities abroad and/or rising repatriation of profits. The possible diversion of investment and funds from the domestic to foreign markets should not come as a big surprise. After all, much of the Czech economy is actually owned/controlled by foreign parties[2] which are unlikely to have become local patriots.

Rising private consumption will continue to be a firm pillar of growth in both 2007 and 2008. The strong increase in private consumption is firmly supported by a strengthening wage bill. This trend is combined with rising demand for labour, rising employment (also of foreign migrant workers) and falling unemployment. The tightening labour market, with increasing incidence of labour shortages, will be strengthening the employees' position vis-à-vis their employers. It may be important though to observe that this is not really threatening high profits, at least not in the near future. In actual fact, owing to strong gains in labour productivity and rising levels of utilization of the production capacities, gross operating surpluses (*cum* mixed income of the household sector) have been rising faster than employees' compensation. Thus the current strengthening of wages can be seen as a return to the proportions between wages and profits that were there in the past.[3] Nonetheless, concerns about the medium-term consequences of rising wages are legitimate – especially given the slowdown of investment in fixed productive assets. One does not need to fear so much the negative consequences of eroding profit margins; these are high enough. But one can expect a somewhat higher acceleration of wage hikes which may be fuelled simultaneously by rising unit labour costs and stronger consumer demand.

The weak growth of gross fixed investment (and a possible stagnation of the stock of inventories) will most probably somewhat reduce the demand for imports of investment goods and intermediate inputs. The general stabilization of prices (at levels lower than in 2006) of imported energy expected in 2007 will also help to reduce imports – though the consumer demand for imports of goods and services is likely to remain robust. At the same time growth of exports is expected to remain quite strong even if the domestic (i.e. actually predominantly foreign-owned) export-oriented manufacturing firms have to mobilize

[1] Gross fixed investment (rising 1.5% in the first quarter of 2007) comprises investment by business as well as by private households (primarily dwellings) and by the government (transport infrastructure, public buildings etc). Investment by business may be proxied by the volume of machinery and equipment installed. That volume *fell* by about 4% in real terms.

[2] The share of foreign-owned firms in industrial output (sales) is over 60%. They account for about 90% of manufacturing exports.

[3] For example in 2003, when employees' compensation constituted 47.9% of the gross value added (against 47.0% in 2006).

reserves to achieve rates of growth of sales as recorded in 2005 or 2006. A new surge in export activities, in 2008 and beyond, may have to await the completion of new FDI projects. All in all, foreign trade will continue to generate surpluses of the same order as in recent years. However, the contribution of trade to overall GDP growth is forecasted to be close to zero in both 2007 and 2008.

The tightening labour market and high levels of capacity utilization are cited as reasons for concern at the Czech National Bank. Although at the moment inflation is still quite low, the CNB forecasting model, as of April 2007, predicts inflation ranging between 3.2% and 4.2% by December 2007 and between 2.7% and 4.1% by December 2008.[4] The CNB responded accordingly, by raising its interest rates (first by 0.5 p.p. in September 2006, and by a further 0.25 p.p. on 31 May 2007). The market rates have been on the rise as well – but still remain quite low. Yields on ten-year government bonds are still lower than in the euro area. Despite this the Czech currency does not weaken nominally vs. the euro. The CNB decisions look traditionally cautious. Nonetheless they will not be conducive to any faster rise in gross fixed investment, or in consumer credit.

The political situation remains unstable because the liberal-conservative government installed in December 2006 has a fairly shaky parliamentary backing. Despite this it has recently tabled a proposal for a fiscal reform which is likely to prove controversial. The draft reform stipulates substantial cuts in various social benefits and in spending on public health care – but a rise in the lower (i.e. applied to foodstuffs) of the country's two VAT rates (from 5% to 9%). The corporate income tax rate is to be gradually reduced from the current 24% to 19% by the year 2010. A flat tax rate of 15% (on a broader base) is to replace the present progressive personal income tax system (with rates ranging between 12% and 32%). There is little doubt that on the whole the reform will serve well primarily the relatively well-off population strata. At the same time it will probably do very little (if anything) to support a sustainable consolidation of public finances. Despite strong GDP growth (and other favourable conditions: low level of public debt, low long-term interest rates) the general government deficit is now expected to surpass 4% of the GDP in 2007. This is a clear breach of the Convergence Programme. This outcome is blamed on the high growth of mandatory social spending. However, this is inaccurate. One cannot ignore the fact that it is the revenue side which has been contracting, relative to the GDP, very fast in recent years.[5] Given the plans to cut taxes even further, one cannot expect the deficit to fall below 3% of the GDP also in 2008 and even in 2009.

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4 See www.cnb.cz/forecast. The same source predicts GDP growth in 2007 ranging between 4.9% and 6.5%, followed by 3.8-6.8% for 2008. Interestingly, the inflation forecasts excluding the first-round impacts of rising indirect taxes are much lower (e.g. 2.1-3.5% by March 2008). It appears that the CNB essentially fights an inflation driven by higher taxes rather than higher demand or higher costs.

5 Between 2004 and 2007 the overall general government revenue/GDP ratio has fallen by 3.4 percentage points, but the expenditure/GDP ratio by 2.3 p.p.

The stubborn persistence of the public sector's fiscal deficits is one the chief reasons for the Czech authorities' cautiousness concerning the prospects of adoption of the euro. The current (as of October 2006) official position (co-authored by the CNB and the government) stipulates the postponement of the *potential* entry into the euro area beyond the originally planned horizon of 2009-10. But there are other concerns such as over allegedly low flexibility of the Czech labour market and the persistent differences (vs. the euro area) in the price levels. All in all, the Czech authorities simply do not seem convinced that an early adoption of the common European currency will be particularly beneficial.

Summing up, GDP growth in 2007 will be lower than in 2005-06, primarily on account of weak growth of gross fixed investment and a possible stagnation (or downward adjustments) in the level of inventories. After the adjustment in inventories and the inauguration of fresh production capacities in manufacturing, growth may accelerate again in 2008. Private consumption, fuelled by rising employment and wages, will be the main force behind growth in both 2007 and 2008. Growth in exports and imports will be less impressive in 2007 – also because of emerging supply-side bottlenecks. But the contribution of foreign trade to GDP growth is likely to be neutral in both 2007 and 2008. The consolidation of public finances will proceed very slowly with the entry into the euro area delayed until 2011, at the earliest.

Table CZ

Czech Republic: Selected Economic Indicators

	2002	2003	2004	2005	2006 1)	2006	2007	2007	2008
						1st quarter		forecast	
Population. th pers.. mid-year	10200.8	10201.7	10206.9	10234.1	10266.6	.	.	.	.
Gross domestic product. CZK bn. nom. 2)	2464.4	2577.1	2817.4	2994.4	3220.3	742.6	816.1	3480	3760
annual change in % (real) 2)	1.9	3.6	4.6	6.5	6.4	6.6	6.1	5	5.2
GDP/capita (EUR at exchange rate) 2)	7841	7933	8652	9824	11067	.	.	.	.
GDP/capita (EUR at PPP - wiiw) 2)	14580	15390	16600	17430	19090	.	.	.	.
Gross industrial production									
annual change in % (real) 3)	1.9	5.5	9.6	6.7	9.7	14.8	12.4	8	9
Gross agricultural production									
annual change in % (real)	-4.4	-7.6	14.9	-4.8	.	.	.	.	.
Construction industry									
annual change in % (real)	2.5	8.9	9.7	4.2	6.6	0.5	29.0	.	.
Consumption of households. CZK bn. nom. 2)	1248.1	1317.4	1400.0	1445.8	1532.0	349.7	376.8	.	.
annual change in % (real) 2)	2.2	6.0	2.9	2.4	4.4	3.8	6.7	6	5
Gross fixed capital form.. CZK bn. nom. 2)	677.8	687.5	727.2	746.1	812.9	179.9	185.3	.	.
annual change in % (real) 2)	5.1	0.4	3.9	2.3	7.6	6.8	1.5	2	4
LFS - employed persons. th. avg. 4)	4764.9	4733.2	4706.6	4764.0	4828.1	4785.2	4864.9	.	.
annual change in %	0.8	-0.7	-0.6	1.2	1.3	1.7	1.7	1.3	1.3
LFS - employed pers. in industry. th. avg. 4)	1463.1	1424.7	1409.0	1422.0	1493.3	1476.3	1515.7	.	.
annual change in %	-0.1	-2.6	-1.1	0.9	5.0	5.4	2.7	.	.
LFS - unemployed. th pers.. average	374.1	399.1	425.9	410.2	371.3	414.1	311.2	.	.
LFS - unemployment rate in %. average 4)	7.3	7.8	8.3	7.9	7.1	8.0	6.0	6.3	6
Reg. unemployment rate in %. end of period	9.8	10.3	9.5	8.9	7.7	8.8	7.3	7	6.5
Average gross monthly wages. CZK 5)	15866	16917	18041	18992	20207	18918	20399	.	.
annual change in % (real. gross)	5.4	6.5	3.7	3.3	3.8	4.1	6.2	4.4	4.4
Consumer prices. % p.a.	1.8	0.1	2.8	1.9	2.5	2.8	1.6	3	2.8
Producer prices in industry. % p.a.	-0.5	-0.4	5.7	3.0	1.6	0.3	3.2	2.5	2
General governm. budget. EU-def.. % GDP 6)									
Revenues	39.5	40.7	41.5	40.4	39.5	.	.	38.0	38.0
Expenditures	46.3	47.3	44.4	44	42.5	.	.	42.2	41.5
Deficit (-) / surplus (+)	-6.8	-6.6	-2.9	-3.5	-2.9	.	.	-4.2	-3.5
Public debt. EU-def.. in % of GDP 6)	28.5	30.1	30.7	30.4	30.4	.	.	31.4	32.2
Discount rate. % p.a.. end of period	1.8	1.0	1.5	1.0	1.5	1.0	1.5	.	.
Current account. EUR mn	-4442	-5028	-4651	-1638	-3561	616.5	477.4	-5400	-6000
Current account in % of GDP	-5.6	-6.2	-5.3	-1.6	-3.1	2.4	1.6	-4.3	-4.4
Gross reserves of NB incl. gold. EUR mn	22614	21340	20884	25054	23882	24570	23826	.	.
Gross external debt. EUR mn	25738	27624	33212	39379	44263	38607	.	.	.
Gross external debt in % of GDP	32.2	34.1	38.1	39.5	39.2	.	.	.	.
FDI inflow. EUR mn	9090	1875	4009	9354	4760	541.2	1079.5	.	.
FDI outflow. EUR mn	221	183	824	-12	1073	88.1	142.3	.	.
Exports of goods. BOP. EUR mn	40713	43055	54091	62781	75684	17939.7	21352	86000	100000
annual growth rate in %	9.2	5.8	25.6	16.1	20.6	24.9	19.0	14	16
Imports of goods. BOP. EUR mn	43034	45239	54517	60797	73283	16856.6	19847.6	84000	97000
annual growth rate in %	5.7	5.1	20.5	11.5	20.5	25.7	17.7	14	16
Exports of services. BOP. EUR mn	7502	6880	7761	9478	10603	2365.1	2387.9	11000	12000
annual growth rate in %	-5.3	-8.3	12.8	22.1	11.9	20.9	1.0	5	5
Imports of services. BOP. EUR mn	6796	6464	7245	8254	9384	2111.9	2200	10000	11000
annual growth rate in %	9.3	-4.9	12.1	13.9	13.7	28.2	4.2	5	5
Average exchange rate CZK/USD	32.74	28.23	25.70	23.95	22.61	23.79	21.40	.	.
Average exchange rate CZK/EUR (ECU)	30.81	31.84	31.90	29.78	28.34	28.59	28.04	28	27.5
Purchasing power parity CZK/USD	14.27	13.89	14.03	14.08	14.15	.	.	.	.
Purchasing power parity CZK/EUR	16.57	16.41	16.63	16.79	16.43	.	.	.	.

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

1) Preliminary. - 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.