

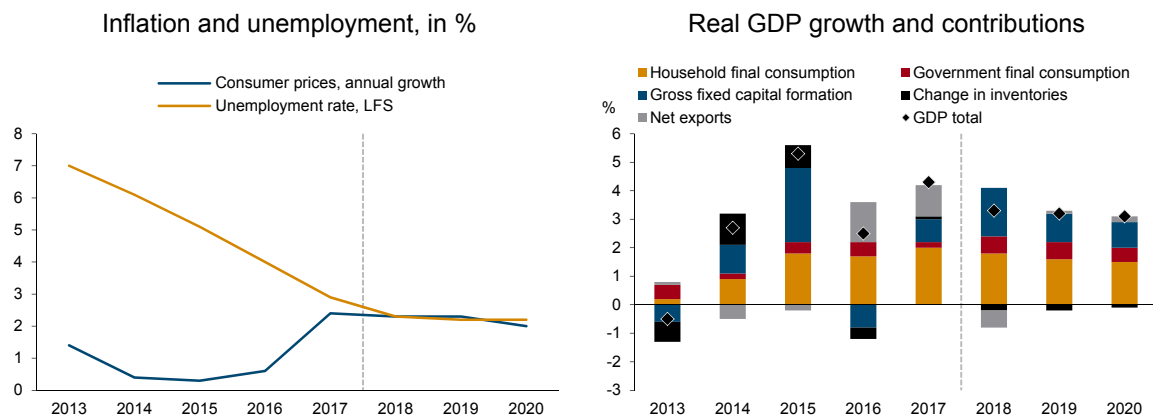


CZECH REPUBLIC: Balanced but moderating growth

LEON PODKAMINER

The Czech economy may face a period of slowing growth. Tight labour markets and the wage push which have supported growth recently may produce second-round effects such as rising unit labour costs, falling corporate profitability and weakened foreign trade performance. These effects may actually depress growth especially if monetary policy becomes too restrictive, foreign demand for Czech goods proves insufficient and productivity advances are less impressive than generally assumed.

Figure 41 / Czech Republic: Main macroeconomic indicators



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

After an exceptionally strong performance in the second half of 2017, growth has moderated in the first and second quarters of 2018 posting (seasonally unadjusted) GDP growth rates of 3.4% and 2.7% respectively. Consumption (both household and public), however, continued to increase strongly. At the same time the gross wage bill (compensation of employees) increased in the first half of 2018 by about 7.5% in real terms – much faster than private consumption. As in Poland, the earnings of a large number of foreigners employed are sent back home (mostly to Ukraine) thereby reducing the effective domestic consumer demand in the Czech Republic. However, the widening gap between the wage bill and household consumption indicates, primarily, households' rising savings rate. Household incomes are financing investment (e.g. into real estate) to a much greater extent than in the past. Price differentials provide evidence of this. A real-estate expansion may be developing. In the first quarter of 2018 the transaction price index for housing rose by over 9% compared with the same period in 2017.

The index of asking prices for new flats in Prague rose by close to 15% (year on year) in the second quarter of 2018.

Gross fixed capital formation (GFCF) has continued to increase strongly, continuing the recovery that started over a year ago. Rising GFCF contributed about 2.2 percentage points (pp) to overall GDP year-on-year growth in the first half of 2018. However, a strong contraction in inventories shaved close to 1pp off the GDP growth rate. Rising private sector investment played the most important role. In the first quarter of 2018 investment by the nonfinancial corporate sector was responsible for about half of the overall rate of growth of GFCF. Household investment contributed about one third while the contribution of government investment was still marginal. In the first half of 2018 capital formation in the form of machinery and equipment rose by about 8.5% in real terms while that of dwellings by about 12% and that of 'other buildings and structures' by about 11%. In the second half of 2018 the strong expansion of investment may continue. A stronger drawdown of the EU funds will probably accelerate government investment growth. Household investment may go on expanding strongly not only on account of rising disposable incomes but also due to persistently low interest rates on mortgages and the continuing fast rise in the volume of housing loans. Of course, a change in the monetary policy stance could put an end to booming household investment. Also, at some point rising household debt may hinder further expansion.

Foreign trade growth has slowed down and the trade balance has deteriorated. In the first half of 2018 the growth rates of exports of goods and non-factor services slowed down as compared with 2017. The rate of growth of imports also fell, although less so. The trade surplus/GDP ratio fell from over 9.5% a year ago to 8.7% in the first half of 2018. The foreign trade contribution to GDP growth was negative for the first time since the third quarter of 2015. Weaker external demand is one reason for lower growth in exports. As the import intensity of Czech exports is rather high, this also contributes to slower growth in imports. A weaker net trade performance in the near future is a real possibility because of the speedup of capital formation by the corporate sector which may be seeking to modernise its productive capital and higher imports of capital goods may thus result. A strengthening koruna (and rising unit labour costs) may also negatively affect trade performance. The koruna appreciated against the Euro by about 5% on average in the first half of 2018 (against the same period in 2017). Moreover, between April 2017 (when the National Bank gave up control of the exchange rate) and mid-April 2018, the koruna strengthened by 7% against the Euro. Since mid-April 2018, however, the koruna has depreciated by 2%. The nominal koruna was by 5% stronger on average in the first half of 2018 compared to the same period of 2017. No doubt this also negatively affected the trade performance.

The exchange rate has not appreciated as much as expected. Initially, the central bank's discontinuation (in mid-April 2017) of its policy targeting the CZK/EUR exchange rate of 27 was followed by rapid appreciation. Within one year the koruna strengthened by 7%. That seemed to justify the expectation of further appreciation. As late as January 2018 the Czech National Bank forecast an average rate of 25.4 for the first quarter of 2018, followed by 24.9 for the second quarter (and for the entire 2018). However, the CZK has weakened recently. The actual average rate for the first half of 2018 is 25.5 (against the 25.15 implied by the CNB forecasts). The most recent CNB forecast (July 2018) envisages a less steep appreciation in the coming quarters. Nonetheless it maintains its earlier forecast for 2019 (24.5 CZK/EUR) and puts the forecast for 2020 at 24.2. Whether the expectation of appreciation of that size is realistic remains debatable. On the one hand, increased outflows of short-term capital (in response to financial investors' widespread fears over prospects for emerging markets

generally) may indeed have been temporary. On the other hand, since August 2017 the CNB policy interest rates (associated with rising money market interest rates) have been gradually rising, implying widening spreads versus Euro area interest rates. In such circumstances one would expect the koruna to strengthen versus the Euro, but this has not happened recently. That would suggest that the koruna's appreciation potential is overrated. If the trade and current account balances deteriorate further, appreciation pressures may be less pronounced. (Paradoxically, the koruna continues to appreciate much more versus the US dollar, despite the fact that the interest rate spread against that currency is negative.)

Close to full employment has added to wage pressures. With the unemployment rate hovering at less than 2.5%, the reserves of employable domestic labour may be rather limited. Although one observes a (slow) rise in participation rates and longer working hours and a rise in various forms of informal and part-time employment (also by foreigners), labour shortages may also persist due to pronounced population aging. Strong wage pressures, higher unit labour costs and thus depressed corporate profits have shaped economic conditions so far. In the first half of 2018 the average wage increased by 8.6% in nominal terms (about 6.4% in real terms). Nominally, total employees' compensation rose over 10%, while the gross operating surplus and mixed income (representing primarily corporate profits) by a mere 1.7%.

Inflation pickup is a possibility. Rising unit labour costs have not yet affected core inflation, which is running at about 1%. Inflation in excess of 2% is currently due to fast rising prices of fuel and foodstuffs as well as to hikes in administered prices. In the near future rising production costs may increasingly affect overall inflation and/or depress profit margins. Higher inflation might also erode the purchasing power of household incomes and suppress the growth of household consumption. The prospect of higher inflation has alerted the National Bank which responded by tightening its policy.

Fiscal policy eyes further cuts in public debt. Given the growth slowdown, this will not be helpful. Keeping interest rates as low as possible may be essential in helping to prevent undue currency appreciation and in encouraging further expansion of private fixed capital formation.

Overall the Czech economy may face a period of slowing growth. Tight labour markets and the ensuing wage push, which have supported growth recently, may now produce second-round effects such as rising unit labour costs, falling corporate profitability and possibly disadvantageous foreign trade performance. These effects may actually depress growth especially if monetary policy becomes too restrictive, the foreign demand for the Czech goods proves insufficient and/or productivity advances are less impressive than generally assumed.

Table 16 / Czech Republic: Selected economic indicators

	2014	2015	2016	2017 ¹⁾	2017 January-June	2018	2018 Forecast	2019 Forecast	2020
Population, th pers., average	10,525	10,546	10,566	10,570	.	.	10,595	10,605	10,615
Gross domestic product, CZK bn, nom.	4,314	4,596	4,768	5,045	2,423	2,558	5,310	5,600	5,890
annual change in % (real)	2.7	5.3	2.5	4.3	3.6	3.0	3.3	3.2	3.1
GDP/capita (EUR at PPP)	23,800	25,300	25,500	26,400	.	.	.	.	.
Consumption of households, CZK bn, nom.	2,044	2,125	2,213	2,362	1,141	1,215	.	.	.
annual change in % (real)	1.8	3.8	3.6	4.3	4.1	3.9	3.8	3.5	3.3
Gross fixed capital form., CZK bn, nom.	1,084	1,216	1,189	1,246	575	622	.	.	.
annual change in % (real)	3.9	10.2	-3.1	3.3	1.9	8.8	7.0	4.0	3.5
Gross industrial production									
annual change in % (real)	5.0	4.3	3.4	6.5	6.3	2.5	3.0	3.0	3.0
Gross agricultural production									
annual change in % (real)	10.1	-4.8	7.0	-8.6	.	.	.	.	.
Construction industry									
annual change in % (real)	4.2	6.8	-5.6	3.3	4.8	8.6	.	.	.
Employed persons, LFS, th, average	4,974	5,042	5,139	5,222	5,183	5,274	5,290	5,310	5,320
annual change in %	0.8	1.4	1.9	1.6	1.5	1.7	1.4	0.3	0.2
Unemployed persons, LFS, th, average	324	268	211	155	172	124	120	120	120
Unemployment rate, LFS, in %, average	6.1	5.1	4.0	2.9	3.3	2.3	2.3	2.2	2.2
Reg. unemployment rate, in %, eop	7.5	6.2	5.2	3.8	4.0	2.9	.	.	.
Average monthly gross wages, CZK	25,768	26,591	27,764	29,496	28,608	31,059	32,000	34,000	35,800
annual change in % (real, gross)	2.5	2.9	3.7	3.6	3.3	6.4	6.0	4.0	3.3
Consumer prices (HICP), % p.a.	0.4	0.3	0.6	2.4	2.4	1.9	2.3	2.3	2.0
Producer prices in industry, % p.a.	1.4	-2.4	-3.2	0.7	1.9	-1.3	1.0	1.5	1.5
General governm. budget, EU-def., % of GDP									
Revenues	40.3	41.1	40.2	40.5	.	.	40.0	40.0	40.5
Expenditures	42.4	41.7	39.5	38.9	.	.	38.6	39.2	40.0
Net lending (+) / net borrowing (-)	-2.1	-0.6	0.7	1.6	.	.	1.4	0.8	0.5
General gov.gross debt, EU def., % of GDP	42.2	40.0	36.8	34.7	.	.	32.7	32.0	32.0
Stock of loans of non-fin.private sector, % p.a.	2.7	6.6	6.7	6.5	7.3	6.1	.	.	.
Non-performing loans (NPL), in %, eop	6.1	5.8	4.8	4.0	4.3	3.4	.	.	.
Central bank policy rate, % p.a., eop ²⁾	0.05	0.05	0.05	0.50	0.05	1.00	1.50	1.75	1.50
Current account, EUR mn	296	368	2,744	1,952	3,303	2,530	1,300	1,800	1,700
Current account, % of GDP	0.2	0.2	1.6	1.0	3.7	2.5	0.6	0.8	0.7
Exports of goods, BOP, EUR mn	110,401	115,573	118,033	128,344	65,177	68,987	136,000	144,200	152,900
annual change in %	7.0	4.7	2.1	8.7	8.1	5.8	6.0	6.0	6.0
Imports of goods, BOP, EUR mn	102,406	108,701	108,946	119,247	59,188	62,905	127,000	134,600	142,700
annual change in %	5.9	6.1	0.2	9.5	9.1	6.3	6.5	6.0	6.0
Exports of services, BOP, EUR mn	18,915	20,603	21,923	23,921	11,445	12,433	25,400	26,900	28,500
annual change in %	4.7	8.9	6.4	9.1	9.0	8.6	6.0	6.0	6.0
Imports of services, BOP, EUR mn	16,892	17,742	17,942	19,285	9,133	9,695	20,500	21,700	23,000
annual change in %	10.1	5.0	1.1	7.5	6.4	6.1	6.5	6.0	6.0
FDI liabilities, EUR mn	6,101	1,521	9,809	8,206	4,426	3,222	6,100	.	.
FDI assets, EUR mn	3,175	3,357	2,909	3,096	1,118	1,039	4,000	.	.
Gross reserves of NB excl. gold, EUR mn	44,528	58,903	80,999	123,028	124,403	123,348	.	.	.
Gross external debt, EUR mn	106,303	115,396	129,448	171,197	167,870	168,625	183,200	193,000	200,600
Gross external debt, % of GDP	67.9	68.5	73.4	89.3	87.6	81.0	88.0	87.0	86.0
Average exchange rate CZK/EUR	27.54	27.28	27.03	26.33	26.79	25.50	25.50	25.25	25.25

1) Preliminary. - 2) Two-week repo rate.

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