

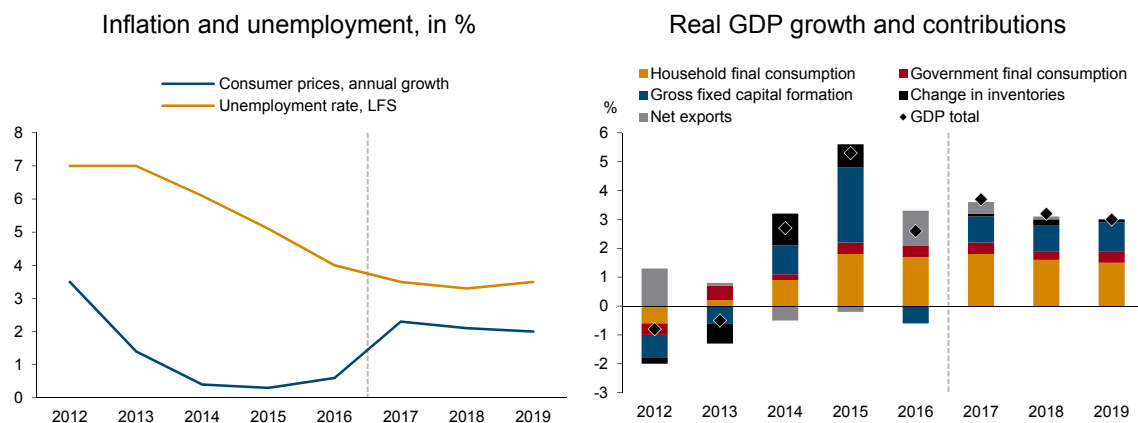


## CZECH REPUBLIC: Broad-based growth

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Demand, profitability and indebtedness conditions are conducive to rapid, broad-based growth. The emerging labour shortages support a faster rise in wages, yet without eroding profits in industry. Monetary policy faces no serious dilemmas. The fiscal policy orientation of the new government will remain essentially unchanged.

**Figure 35 / Czech Republic: Main macroeconomic indicators**



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

**After very strong performance in the first quarter of 2017, growth slowed down somewhat in the second quarter**, with GDP growth rates (year on year, seasonally unadjusted) falling from 4.0% to 3.4%. Growth of household consumption remained steady (at about 3.8%) while gross fixed capital formation was expanding at an accelerated pace (with the rates of growth rising from 2.4% in the first quarter to 5.2% in the second). Inventories were reduced strongly throughout the first half of 2017 which may augur the emergence of some supply bottlenecks. Foreign trade in goods and services performed very well in the first quarter, with volumes of exports and imports rising by 7.4% and 3.9% respectively. In the second quarter the volumes grew at much lower rates (and not so different from each other, 3.9% and 2.9% respectively). Consequentially the unusually large trade surplus recorded in the first quarter (10.2% of GDP) fell to a surplus of 8.3% of GDP in the second quarter. The contribution of foreign trade to GDP growth was reduced from about 2 percentage points (pp) in the first quarter to about 1 pp in the second.

**Unemployment has been very low and is expected to fall further.** This development has much to do with the unfavourable demography (but not so much with outward migration as is the case in other

CESEE countries). The size of the working-age population has been contracting since at least 2010 (on average by close to 1% annually). This tendency will continue in the foreseeable future. The strong output growth currently observed has also been important in raising the number of employees (as well as the lengthening of working hours) and thus reducing the size of unemployment.

**Emerging labour shortages are felt throughout the economy** (including the foreign-owned firms) and may already be reducing the levels of output that could be produced. In an attempt to alleviate the staffing difficulties, firms tend to hire foreign workers (primarily recruited in Slovakia and Poland or coming from Ukraine). A longer-term option possibly already implemented (by e.g. foreign direct investors) would require the introduction of more labour-saving and efficiency-augmenting technologies and production modes. This option would include moving parts of the particularly labour-intensive (and low value added) production abroad.

**Under the impact of tightening labour markets the wage rate is rising quite strongly, though not exorbitantly.** The Czech labour market has been characterised by the coexistence of low unemployment with a good deal of wage moderation. (To some extent this may reflect the age structure of the Czech labour force.) It is rather unlikely that the wage movements would fuel strong inflation or seriously erode profitability of the corporate sector. In actual fact, despite the strong rise in wages, unit labour costs in industry have been falling recently.

**The rising wage bill underlies continuing growth in private consumption and will also be vital for the expansion of households' housing investment.** All conditions are in place for an acceleration of firms' productive investments as well. The firms' financial position is very strong (their operating surpluses increased at close to 15% in the first quarter of 2017), the interest rates on loans are low and the portfolios of orders (including export orders) are full. Public investments (co-financed out of EU structural funds) into infrastructure projects are also expected to gain momentum starting in 2018.

**The Czech currency has been strengthening moderately.** In the first quarter of 2017 the upcoming discontinuation of the policy of keeping the exchange rate stable (at a level not lower than 27 CZK/EUR) was generally anticipated – as was the prospect of immediate nominal appreciation of the Czech currency. In fact, the re-floating of the Czech currency (on 6 April) was momentarily followed by its nominal (as well as real) appreciation. It is yet too early to see a new equilibrium level of the exchange rate emerging under the absence of the National Bank's active participation in the foreign exchange market. The huge CZK positions taken before April 2017 (primarily by speculative investors who had rightly expected the imminent CZK nominal appreciation) do not seem to have been liquidated. After rising turbulently in the first quarter of 2017, foreign exchange reserves of the Czech National Bank (CNB) have remained unchanged thereafter. This may be due to high demand for Czech government securities, which prove attractive despite the relatively low yields offered. The attractiveness of the Czech governmental securities is understandable given the country's low public debt, 'sound fiscal policy' and the overall economic and social stability.

**Imports rising faster than exports are a real possibility.** The extraordinary foreign trade developments in the first quarter of 2017 may have come about under rather exceptional circumstances that need not repeat themselves over the rest of 2017. The expectation of currency appreciation may have provided incentives to sign export contracts in advance (that is already in the first quarter of 2017) – and to suppress or delay imports accordingly. It is natural to expect that under a strong CZK exports will be less dynamic over the rest of 2017, but imports more so – especially in the environment of strong

growth of consumption and investment. Another reason to anticipate exports to lose momentum and imports to gain more of it is that the Czech economy could be already close to exhausting its spare production capacities as shortages of labour (and possibly intermediate inputs) are becoming widespread. However, even if imports rise faster than exports in the near future so that foreign trade will be reducing GDP growth, the trade surplus is highly unlikely to turn into deficit any time soon.

**Inflation is 'back to normal'.** One of the (declared) reasons for giving up control over the exchange rate was the prospect of inflation returning to 'normal' (after running at close to nil since the beginning of 2014). The return of inflation is a fairly natural consequence of the tight labour markets and very low levels of unemployment – and, consequently, rising wages and costs (e.g. embodied in the prices of raw materials and components which temporarily could be in short supply).

**The National Bank is unlikely to be opposing inflation very actively, by high interest rates hikes –** as this would do some harm to the investment activities and possibly also additionally strengthen the Czech currency. In August 2017 the policy rate was increased (for the first time since February 2008) from a symbolic 0.05% to (almost equally symbolic) 0.25%. The policy interest rate hikes may be expected to passively follow inflation rather than pre-empt it. Also the CNB may rely on the currency strengthening on its own, which also stabilises inflation. The 'hike' in the policy interest rates has not affected the market interest rates on loans. The latter remain unchanged nominally (and fall in real terms) encouraging a strong rise in the demand for loans (both by firms and households).

**Fiscal policy has been successfully targeting a balanced budget of the general government.**

Actually the Finance Ministry plans slight fiscal surpluses (of around 1% of GDP) in 2017-2019, implying a decline in the public debt/GDP ratio to about 30% in 2019. Very low cost of servicing public debt is one component of the successful fiscal consolidation. Fast growth and disappearing unemployment (as well as spending on unemployment benefits) facilitate the fiscal consolidation as well.

**The overall orientation of the economic policy will be unchanged.** The parliamentary elections held on 21-22 October 2017 were decidedly won by the ANO party, the junior partner in the outgoing coalition government (in power since 2013). The Social Democrats (ČSSD), formerly the senior coalition partner, suffered heavy losses. Nine parties will sit in the new parliament – including clearly exotic ones ('Pirates', Communists, etc). The liberal-conservative ODS, the traditional political force ruling the country throughout much of the past 28 years, has come second. Quite possibly ODS will join ANO in the next coalition government to be led by Andrej Babiš, the leader of ANO. (From 2013 through May 2017 he was the deputy PM and finance minister in the ČSSD-led government. He was then forced to step down over corruption allegations.) The new government's economic policy agenda is likely to remain essentially unchanged. Given ANO's (and Mr Babiš' personal)<sup>24</sup> background one could perhaps expect a slightly more pro (domestic) business emphasis in matters of taxation and administrative regulation. Neither the CNB nor the new government are likely to change their sceptical stance on the issue of euro accession. Also on other important European matters (e.g. on the readiness to accept large-scale quotas of migrants) the new government will remain uncooperative.

**Summing up, a virtuous cycle of rising incomes, consumption (and investment) demand and output is in place.** Despite the emergence of labour shortages (and supply bottlenecks) inflation will be contained while the growth rate may well exceed 3% in the period 2017-2019.

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<sup>24</sup> Mr Babiš is a successful businessman, active primarily in the food processing and distribution industry. He is considered the second-richest Czech citizen ('worth' some USD 4 billion).

Table 10 / Czech Republic: Selected economic indicators

	2013	2014	2015	2016 <sup>1)</sup>	2016 January-June	2017	2017 Forecast	2018 Forecast	2019
Population, th pers., average	10,514	10,525	10,546	10,566	10,559	10,581	10,580	10,590	10,600
Gross domestic product, CZK bn, nom.	4,098	4,314	4,596	4,773	2,323	2,427	5,100	5,400	5,700
annual change in % (real)	-0.5	2.7	5.3	2.6	3.6	3.7	3.7	3.2	3.0
GDP/capita (EUR at PPP)	22,400	23,800	25,400	25,700	.	.	.	.	.
Consumption of households, CZK bn, nom.	1,997	2,044	2,125	2,214	1,073	1,138	.	.	.
annual change in % (real)	0.5	1.8	3.8	3.6	4.0	3.7	3.8	3.5	3.2
Gross fixed capital form., CZK bn, nom.	1,027	1,084	1,216	1,192	553	584	.	.	.
annual change in % (real)	-2.5	3.9	10.2	-2.3	-1.1	3.8	3.8	3.5	4.0
Gross industrial production									
annual change in % (real)	-0.1	5.0	4.6	3.5	4.9	5.3	5.0	4.5	4.0
Gross agricultural production									
annual change in % (real)	6.0	10.1	-6.1	4.8	.	.	.	.	.
Construction industry									
annual change in % (real)	-6.7	4.3	7.0	-5.9	-8.1	3.3	.	.	.
Employed persons, LFS, th, average	4,937	4,974	5,042	5,139	5,108	5,183	5,190	5,200	5,200
annual change in %	1.0	0.8	1.4	1.9	1.8	1.5	1.0	0.1	0.0
Unemployed persons, LFS, th, average	369	324	268	211	220	172	190	180	190
Unemployment rate, LFS, in %, average	7.0	6.1	5.1	4.0	4.2	3.3	3.5	3.3	3.5
Reg. unemployment rate, in %, eop	8.2	7.5	6.2	5.2	5.2	4.0	.	.	.
Average monthly gross wages, CZK	25,035	25,768	26,591	27,575	26,874	28,619	29,500	31,300	33,000
annual change in % (real, gross)	-1.5	2.5	2.9	3.0	3.3	4.0	4.5	4.0	3.5
Consumer prices (HICP), % p.a.	1.4	0.4	0.3	0.6	0.3	2.4	2.3	2.1	2.0
Producer prices in industry, % p.a.	0.7	0.9	-2.4	-3.2	-4.2	2.2	-1.0	1.0	1.5
General governm. budget, EU-def., % of GDP									
Revenues	41.4	40.3	41.1	40.0	.	.	40.7	41.0	41.0
Expenditures	42.6	42.2	41.7	39.4	.	.	40.3	40.6	41.0
Net lending (+) / net borrowing (-)	-1.2	-1.9	-0.6	0.6	.	.	0.4	0.4	0.0
Public debt, EU-def., % of GDP	44.9	42.2	40.0	36.8	.	.	35.5	34.4	33.0
Stock of loans of non-fin.private sector, % p.a	4.1	2.7	6.6	6.7	6.7	5.8	.	.	.
Non-performing loans (NPL), in %, eop	5.9	6.1	5.8	4.8	5.3	4.3	.	.	.
Central bank policy rate, % p.a., eop <sup>2)</sup>	0.05	0.05	0.05	0.05	0.05	0.05	0.25	1.0	1.25
Current account, EUR mn	-829	296	368	1,946	3,635	3,326	1,160	410	220
Current account, % of GDP	-0.5	0.2	0.2	1.1	4.2	3.7	0.6	0.2	0.1
Exports of goods, BOP, EUR mn	103,184	110,401	115,573	118,494	60,550	65,023	124,000	129,000	135,000
annual change in %	-1.1	7.0	4.7	2.5	4.9	7.4	4.5	4.0	5.0
Imports of goods, BOP, EUR mn	96,735	102,406	108,701	109,224	54,438	58,847	115,000	121,000	127,000
annual change in %	-2.7	5.9	6.1	0.5	2.0	8.1	5.5	5.0	5.0
Exports of services, BOP, EUR mn	18,059	18,915	20,603	21,618	10,379	11,377	22,000	23,000	24,000
annual change in %	-4.3	4.7	8.9	4.9	6.2	9.6	3.5	4.0	4.5
Imports of services, BOP, EUR mn	15,346	16,892	17,742	17,880	8,554	9,249	19,000	20,000	21,000
annual change in %	-2.7	10.1	5.0	0.8	2.2	8.1	3.5	4.5	4.5
FDI liabilities, EUR mn	5,544	6,101	1,521	5,875	2,198	4,428	5,500	.	.
FDI assets, EUR mn	5,831	3,175	3,357	661	-558	1,012	3,500	.	.
Gross reserves of NB excl. gold, EUR mn	40,460	44,528	58,903	80,999	67,055	124,403	.	.	.
Gross external debt, EUR mn	99,652	109,067	118,252	130,573	122,363	171,064	150,700	174,100	193,700
Gross external debt, % of GDP	63.2	69.6	70.2	74.0	69.3	88.6	78.0	84.0	88.0
Average exchange rate CZK/EUR	25.98	27.54	27.28	27.03	27.04	26.79	26.40	26.05	25.90

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

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