

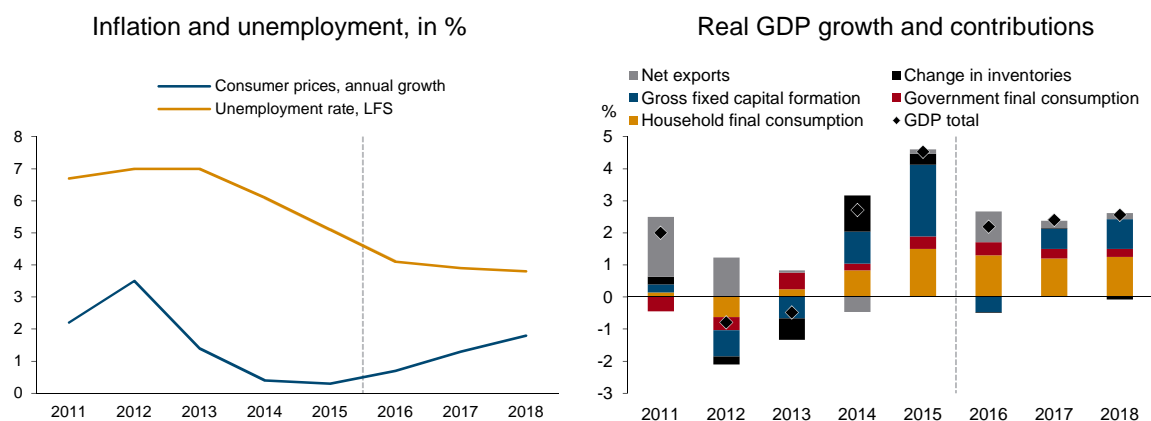


CZECH REPUBLIC: Economic growth driven by external surplus

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Solid external balances and low levels of indebtedness in both the private and public sectors will support moderate growth of above 2% over the period 2016-2018. Some uncertainties persist, however, as to the future course of fiscal policy and the impact of the expected strengthening of the domestic currency.

Figure 28 / Czech Republic: Main macroeconomic indicators



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

After an extraordinarily strong performance in 2015, growth slowed down in the first quarter of 2016 – though not as much as could have been expected. The real GDP growth rate (adjusted for seasonal and working-time effects) reached 3% vs. the same period of 2015. GDP growth slowed down further, to 2.6%, in the second quarter. Growth in all GDP components (except government consumption) decelerated. The growth rate of household consumption fell from 2.7% in the first quarter to 2.2% in the second. The rates of growth of exports (of goods and services) declined from 5.9% to 5.7% respectively, and those of imports (of goods and services) from 5.6% to 3.1%. Gross fixed capital formation, which still rose 2.6% in the first quarter of 2016, contracted by 4.4% in the second. Rising private consumption contributed 1.3 percentage points (pp) to overall GDP growth in the first quarter, and 1 pp in the second. The contribution of gross fixed capital formation, still positive (+0.7 pp), turned negative (-1.2 pp) in the second. However, the contribution of the trade balance rose from 0.1 pp in the first quarter to 1.6 pp in the second.

As elsewhere in the region, the weakening performance of gross fixed capital formation (GFCF) is essentially due to the finalisation of infrastructural investment projects co-financed under the EU financial perspective for 2007-2013. While investment in dwellings, transport equipment, machinery and installations is edging up generally, investment classified as taking the form of 'other buildings and structures' declined by about 19% in the second quarter of 2016. It is generally expected that infrastructural investment co-financed from the EU structural funds will be gradually recovering. However, it is unrealistic to expect much of its acceleration in the current year.

The foreign trade surplus reached about 9% of GDP in the first half of the year. This is a record level which is due not only to the recent slowdown in growth of consumption and investment and the exceptionally low world market prices of raw materials but also to the improvements in the external competitiveness of the Czech economy. No small role is played also by its tight integration into the European (mostly German-dominated) manufacturing production networks. The export-oriented and technologically fairly advanced manufacturing sector represents an obvious strength of the Czech economy. But at the same time it is also a potential risk factor because it renders the whole national economy unduly vulnerable to unforeseeable external developments. High dependence on exports is also not necessarily a good thing, given the turbulences shaking the global economy.

Given the large current account surpluses (further augmented by the trade surpluses) it is quite natural that the Czech currency has been subject to a nominal appreciation tendency. For several years now (since November 2013) the Czech National Bank has been keeping the appreciation pressures in check by resolutely intervening, when the need arose, in the foreign exchange market. For quite a long time the threat of such intervention sufficed to prevent appreciation. The policy of keeping the CZK/EUR exchange rate above the level of 27 through unsterilised interventions was easy to conduct as long as inflation was not a threat and it was possible to keep the policy interest rates low (technically at zero).

At present inflation is still very low but the likelihood of inflation exceeding the official 2% target in the second half of 2017 is now considered quite substantial. The return to 'normal' inflation targeting with the policy interest rates used for controlling inflation may be incompatible, in the longer run, with the attempts to control the level of the exchange rate (as it is claimed by the proponents of the 'impossible trinity' thesis). Once the policy interest rate (since November 2012 set at a 'technical zero') assumes magnitudes consistent with positive and rising inflation, the nominal appreciation may become hard to contain. Under such conditions positive interest rates would be attracting additional inflows of short-term capital ('carry trade') likely to strengthen the domestic currency, at least temporarily. But if the CZK is allowed to appreciate – possibly strongly – a part of the cost competitiveness of the economy may be gradually eroded.

Of course it is still much too early to be definitive about the risks facing the economy. These risks need not materialise anytime soon. The return of meaningful inflation is not quite certain and the eventual phasing out of the policy of controlling the exchange rate could take time. As the Czech labour market has proved to be rather exceptional (with very low unemployment rates, and emerging shortages of skilled labour coexisting with fairly stable wages) the eventual competitiveness losses due to a strong nominal appreciation might perhaps be partly neutralised through wage moderation, at least temporarily. Besides, it remains to be seen whether the strong external performance of the economy has been a matter of mere cost competitiveness.

The financial positions of households and non-financial corporations have been improving consistently, with the shares of their non-performing loans contracting consistently from the peaks reached in 2010-2011. Low and falling interest rates have supported the 'cleaning' of the balance sheets – as has also the revealed aversion to draw new credits and the preference for accumulation of bank deposits. The period of exaggerated financial caution may now be approaching an end as the private sector's demand for credit seems to be showing signs of recovery and banks seem to be more inclined to lower their lending standards. Changing moods may be essential as far as the private sector's investment and consumption spending is concerned. They are expected to strengthen growth in aggregate demand in tandem with rising employment and wages in 2016 and beyond. The cumulative 'virtuous' cycle is thus a real possibility to be sustained over the next two to three years.

The fiscal policy was unduly restrictive from 2011 through 2013, provoking stagnation in 2012-2013. The policy was also quite restrictive in 2015 – arguably unnecessarily so. The fiscal policy envisioned for 2016-2018 targets balanced public finances and further decline in the (already low) GDP share of public debt. As long as GDP growth continues and the economy nears its 'potential' represented by the stock of available labour force, such a fiscal policy is of course understandable. The trouble might arise should the fiscal policy try to respond to unwelcome developments (in domestic consumption, investment or foreign trade) with a more restrictive stance (as was the case in 2011-2013). Such an instinctive response may then only worsen the situation.

Summing up, private consumption will be the main driver of moderate GDP growth in 2016-2018. A cumulative 'virtuous' cycle of rising domestic demand and rising wages, consumption and investment is expected. Solid external balances will also be playing a positive role, even if rendering the country vulnerable to uncontrollable external shocks. Gradually growth is likely to accelerate from 2.4% in 2016 to 2.6% in 2017-2018 as infrastructural investment co-financed by the EU under the new financial perspective will be gaining momentum. Private investment is also likely to accelerate somewhat as the levels of utilisation of productive capacities are comparatively high and the financial standing of firms, households and banks is solid. All in all, the country's prospects are looking good, though this may change if the authorities decide to undertake another round of unnecessary – and harmful – fiscal consolidation.

Table 11 / Czech Republic: Selected economic indicators

	2012	2013	2014	2015 ¹⁾	2015 January-June	2016	2016 2017 Forecast	2018	
Population, th pers., average	10,511	10,514	10,525	10,546	.	.	10,525	10,525	10,525
Gross domestic product, CZK bn, nom.	4,060	4,098	4,314	4,555	2,196	2,289	4,690	4,860	5,080
annual change in % (real)	-0.8	-0.5	2.7	4.5	4.8	3.1	2.2	2.4	2.6
GDP/capita (EUR at exchange rate)	15,400	15,000	14,900	15,800	.	.	16,500	17,300	18,200
GDP/capita (EUR at PPP)	21,800	22,300	23,500	25,000	.	.	.	.	.
Consumption of households, CZK bn, nom.	1,970	1,997	2,044	2,110	1,028	1,055	.	.	.
annual change in % (real)	-1.3	0.5	1.7	3.2	3.5	2.6	2.8	2.6	2.7
Gross fixed capital form., CZK bn, nom.	1,052	1,027	1,084	1,198	551	538	.	.	.
annual change in % (real)	-3.1	-2.6	4.0	8.9	8.0	-2.4	-1.8	2.4	3.5
Gross industrial production									
annual change in % (real)	-0.8	-0.1	5.0	4.6	5.4	4.2	4.0	4.0	4.0
Gross agricultural production									
annual change in % (real)	-5.8	6.0	9.9	-6.1	.	.	.	.	.
Construction industry									
annual change in % (real)	-7.6	-6.7	4.3	7.0	11.2	-9.7	.	.	.
Employed persons, LFS, th, average	4,890	4,937	4,974	5,042	5,016	5,108	5,120	5,130	5,140
annual change in %	0.4	1.0	0.8	1.4	1.5	1.8	1.5	0.2	0.1
Unemployed persons, LFS, th, average	367	369	324	268	289	221	220	210	200
Unemployment rate, LFS, in %, average	7.0	7.0	6.1	5.1	5.5	4.1	4.1	3.9	3.8
Reg. unemployment rate, in %, end of period ²⁾	9.4	8.2	7.5	6.2	6.2	5.2	.	.	.
Average monthly gross wages, CZK	25,067	25,035	25,607	26,467	25,815	26,895	27,700	29,000	30,300
annual change in % (real, gross)	-0.8	-1.5	1.9	3.1	2.9	4.2	3.9	3.3	2.7
Consumer prices (HICP), % p.a.	3.5	1.4	0.4	0.3	0.4	0.3	0.7	1.3	1.8
Producer prices in industry, % p.a.	2.4	0.7	0.9	-2.4	-1.8	-4.2	-3.0	1.0	1.6
General governm. budget, EU-def., % of GDP									
Revenues	40.5	41.4	40.3	41.4	.	.	41.5	41.6	41.6
Expenditures	44.5	42.6	42.2	41.8	.	.	41.9	42.3	42.3
Net lending (+) / net borrowing (-)	-3.9	-1.2	-1.9	-0.4	.	.	-0.4	-0.7	-0.7
Public debt, EU-def., % of GDP	44.5	44.9	42.2	40.3	.	.	40.0	39.5	39.0
Central bank policy rate, % p.a., end of period ³⁾	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.5	1.5
Current account, EUR mn	-2,518	-829	281	1,473	2,247	4,059	2,080	1,640	1,150
Current account, % of GDP	-1.6	-0.5	0.2	0.9	2.8	4.8	1.2	0.9	0.6
Exports of goods, BOP, EUR mn	104,336	103,184	110,397	118,167	58,972	60,507	124,000	130,000	135,000
annual change in %	5.3	-1.1	7.0	7.0	6.6	2.6	5.0	4.5	4.0
Imports of goods, BOP, EUR mn	99,413	96,735	102,417	110,463	54,142	54,143	114,000	120,000	126,000
annual change in %	3.5	-2.7	5.9	7.9	7.5	0.0	3.0	5.5	5.0
Exports of services, BOP, EUR mn	18,863	18,059	18,915	20,491	9,810	10,282	21,000	22,000	23,000
annual change in %	5.2	-4.3	4.7	8.3	9.8	4.8	1.0	3.5	4.0
Imports of services, BOP, EUR mn	15,776	15,346	16,892	17,741	8,427	8,595	18,000	19,000	20,000
annual change in %	8.0	-2.7	10.1	5.0	9.5	2.0	1.0	3.5	4.5
FDI liabilities (inflow), EUR mn	7,348	5,544	6,101	2,223	980	2,171	4,000	.	.
FDI assets (outflow), EUR mn	2,531	5,831	3,175	3,211	628	3	1,000	.	.
Gross reserves of NB excl. gold, EUR mn	33,560	40,460	44,528	58,903	50,651	67,055	.	.	.
Gross external debt, EUR mn	96,826	99,652	106,251	115,877	109,064	123,596	121,600	129,000	136,100
Gross external debt, % of GDP	60.0	63.2	67.8	69.4	65.3	71.2	70.0	71.0	71.0
Average exchange rate CZK/EUR	25.15	25.98	27.54	27.28	27.50	27.04	27.00	26.75	26.50
Purchasing power parity CZK/EUR	17.70	17.49	17.44	17.29	.	.	.	.	.

1) Preliminary. - 2) From 2013 available job applicants 15-64 in % of working age population 15-64, all available job applicants in % of labour force before. - 3) Two-week repo rate.

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