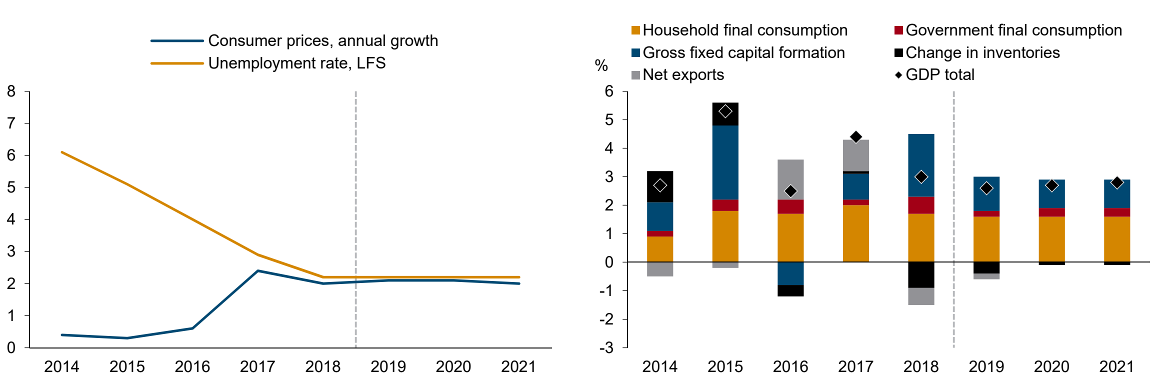
CZECH REPUBLIC: Stability and (undue) caution

LEON PODKAMINER

The strong rise in public investment in 2018 is to moderate in 2019 thus reducing overall growth accordingly. Tight labour markets and the ongoing wage push support private consumption. Despite this, higher inflation is not on the horizon while rising unit labour costs are responsible for falling corporate profitability and may weaken foreign trade performance. Monetary policy may become too restrictive. Fiscal policy targeting surpluses does little to support growth.

Figure 6.6 / 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 2017, moderate GDP growth of about 3% is provisionally posted for 2018. The household consumption growth rate has returned to a moderate level close to the ones recorded earlier (in 2015-2016). But foreign trade growth has weakened quite radically. Moreover, in contrast to 2016-2017, growth in exports of goods and services lagged behind the growth of imports. In effect the foreign trade balance reduced the 2018 GDP growth rate by about 0.6 percentage points. Contracting inventories also shaved off a large portion of the GDP growth rate. The negative impacts of trade and inventory developments were not fully compensated by the effects of very fast growth in gross fixed capital formation.

Gross fixed capital formation (GFCF) rose strongly in 2018, primarily due to the surge in public investment in the second half of the year. The drawdown of the EU funds may be lower in 2019-2020. In effect the rising public investment will not have much of an impact on the overall rate of growth of GFCF. Growth in private investment will continue to be quite moderate – also on account of much higher interest rates, some deterioration of corporate profitability indicators and enhanced external risks – all likely to further dampen optimistic expectations crucial for boosting private investment.

Close to full employment has been adding to the wage pressures. With the unemployment rate hovering below 2.5%, the reserves of employable domestic labour are rather limited. Although one observes a (slow) increase in participation rates and longer working hours as well as a rise in various forms of informal and part-time employment (also by migrant foreign workers), labour shortages may also persist due to pronounced population ageing. The tight labour market has natural consequences for wages. In 2018 the average wage in the corporate sector increased by close to 8% in nominal terms (about 6% in real terms). Wage hikes were even stronger in the non-market sectors (i.e. in public service sectors). Nominally, total employees' compensation rose by an estimated 9% while the gross operating surplus and mixed income (representing primarily corporate profits) by a 'mere' 4.7%. Strong wage pressures, higher economy-wide unit labour costs (up by an estimated 6.4%) and thus depressed corporate profits which have shaped economic conditions so far will remain in place also in the coming two years. Importantly, it may be worth remembering that at about 43% the wage share (employees' compensation as a percentage of GDP) still remains quite low by international standards.

A pickup in inflation is still a possibility. Rising unit labour costs and the relatively weak currency have not yet affected core inflation, which is running at about 1% annually. Inflation slightly in excess of 2% is currently due to fast rising prices of foodstuffs as well as to the hikes in administered prices. Neither the tight labour market, nor the huge increases in unit labour costs seem to matter. Such an outcome tends to be attributed, in contemporary mainstream economics, to the absence of 'inflationary expectations' emerging in stable economic environments (such as prevailing in the Czech Republic). Nonetheless, in the future rising production costs (especially unit labour costs) could affect overall inflation – or else depress the profit margins further. 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. Further substantial hikes in the policy interest rates cannot be ruled out – especially if the Czech currency refuses to appreciate (which seems to be expected and desired by the National Bank).

Private consumption lagging behind household disposable income indicates rising saving propensity. A rising proportion of household savings out of rising income is one reason why there is little evidence of an inflationary demand pull. Household incomes are financing domestic investment (e.g. into real estate) to a much greater extent than in the past. Price differentials could suggest that a real-estate expansion may be developing. In 2018 the transaction price index for housing rose by over 10% (year on year). The index of asking prices for new flats in Prague rose by over 12%. The excess of domestic bank deposits over domestic loans, currently coexisting with increased residents' investment abroad, may also represent – even if partially and indirectly – a temporary leakage of household savings.

Foreign trade growth has slowed down and the trade balance has deteriorated. In 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 7.2% a year earlier to an estimated 6.4%. The foreign trade contribution to GDP growth was negative for the first time since the third quarter of 2015. 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 substitute for labour) and higher imports of capital goods may thus result. Weaker growth in Germany (and in Germany's export destinations) is certain to additionally depress exports and output rather strongly. Brexit is yet another negative factor. Rising unit labour costs would also negatively affect trade performance. A stronger currency appreciation is also a risk for foreign trade (and real activity in general) – though possibly an advantage as far as inflation is concerned.

The exchange rate has not appreciated as much as expected. Initially, the central bank's discontinuation (in mid-April 2017) of its policy targeting a 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 (CNB) forecast an average rate of 25.4 for the first quarter of 2018, followed by 24.9 for the second quarter (and for the full year 2018). However, the koruna weakened thereafter. The actual average rate for the first half of 2018 was 25.5 (against the 25.15 implied by the CNB forecasts). The most recent CNB forecast (January 2019) envisages a less steep appreciation in the coming quarters. Nonetheless it maintains its earlier forecast for the fourth quarter of 2019 (at 24.5 CZK/EUR) and puts the forecast for the fourth quarter of 2020 at 24.2. Whether the expectation of appreciation of that size is realistic remains debatable. For some time now the CZK/EUR rate has fluctuated around 25.8. Much higher interest rates (e.g. 3M PRIBOR) do not seem to have strengthened the koruna. Such a development may be put down to the financial investors' widespread fears over prospects for emerging markets generally – or simply the expectation of the koruna possibly depreciating further. As such the failure of Czech currency to appreciate may have been a temporary 'aberration'. On the other hand, that could also suggest that the koruna's appreciation potential has been fundamentally overrated. If the trade and current account balances deteriorate further, the appreciation pressures may turn out to be much less pronounced than expected.

Fiscal policy eyes further cuts in public debt and monetary policy needs to avoid overreacting. Given the growth slowdown, the fiscal policy stubbornly targeting budgetary surpluses cannot be helpful. In the past the monetary policy conducted by the Czech National Bank served the economy well – by keeping its policy rates very low (practically at 0%) from November 2012 through August 2017. Since then the CNB has raised its rates several times – and seems to consider further hikes. But inflation is still quite low and does not seem to require much more interest rate activism. Keeping interest rates as low as possible may be essential in helping to prevent undue currency appreciation[30] and in encouraging expansion of private fixed capital formation.

Overall the Czech economy faces a period of slowing growth. Tight labour markets and the ensuing wage push, which have supported growth recently, 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 Czech goods proves insufficient and/or productivity advances are less impressive than generally assumed.

[30] Apparently, there is a belief at CNB that higher interest rates may be essential for avoiding currency depreciation. And currency depreciation is seen as an engine of inflation. Targeting exchange rates – instead of inflation itself – may be a rather inefficient strategy if only because, as the recent Czech experience has shown, higher interest rates (and higher interest rate differentials vs. the euro area) may fail to strengthen the Czech koruna. (Interestingly, the koruna was strong vs. the euro precisely when interest rates in the euro area were high and the Czech rates about zero.)

Table 6.6 / Czech Republic: Selected economic indicators

	2014	2015	2016	2017	2018 1)	2019	2020 Forecast	2021
Population, th pers., average	10,525	10,546	10,566	10,594	10,640	10,645	10,650	10,655
Gross domestic product, CZK bn, nom.	4,314	4,596	4,768	5,047	5,320	5,580	5,850	6,140
annual change in % (real)	2.7	5.3	2.5	4.4	3.0	2.6	2.7	2.8
GDP/capita (EUR at PPP)	23,800	25,300	25,600	26,900	27,900	.	.	.
Consumption of households, CZK bn, nom.	2,044	2,125	2,213	2,361	2,510	.	.	.
annual change in % (real)	1.8	3.8	3.6	4.2	3.6	3.5	3.4	3.4
Gross fixed capital form., CZK bn, nom.	1,084	1,216	1,189	1,250	1,400	.	.	.
annual change in % (real)	3.9	10.2	-3.1	3.7	9.0	5.0	4.0	4.0
Gross industrial production								
annual change in % (real)	5.0	4.3	3.4	6.5	3.0	3.0	3.0	3.0
Gross agricultural production								
annual change in % (real)	10.1	-4.8	7.0	-6.5	-0.1	.	.	.
Construction industry								
annual change in % (real)	4.2	6.8	-5.6	3.3	8.4	.	.	.
Employed persons, LFS, th, average	4,974	5,042	5,139	5,222	5,294	5,320	5,340	5,350
annual change in %	0.8	1.4	1.9	1.6	1.4	0.5	0.3	0.2
Unemployed persons, LFS, th, average	324	268	211	155	122	120	120	120
Unemployment rate, LFS, in %, average	6.1	5.1	4.0	2.9	2.2	2.2	2.2	2.2
Reg. unemployment rate, in %, eop	7.5	6.2	5.2	3.8	3.1	.	.	.
Average monthly gross wages, CZK	25,768	26,591	27,764	29,496	32,000	34,100	36,200	38,400
annual change in % (real, gross)	2.5	2.9	3.7	3.6	6.4	4.5	4.0	4.0
Consumer prices (HICP), % p.a.	0.4	0.3	0.6	2.4	2.0	2.1	2.1	2.0
Producer prices in industry, % p.a.	1.4	-2.4	-3.2	0.7	0.7	1.5	1.5	1.2
General governm. budget, EU-def., % of GDP								
Revenues	40.3	41.1	40.2	40.5	39.8	40.0	40.5	40.5
Expenditures	42.4	41.7	39.5	39.0	38.4	39.2	40.0	40.5
Net lending (+) / net borrowing (-)	-2.1	-0.6	0.7	1.5	1.4	0.8	0.5	0.0
General gov.gross debt, EU def., % of GDP	42.2	40.0	36.8	34.7	33.3	32.0	31.0	30.0
Stock of loans of non-fin.private sector, % p.a.	2.7	6.6	6.7	6.5	6.8	.	.	.
Non-performing loans (NPL), in %, eop	6.1	5.8	4.8	4.0	3.2	.	.	.
Central bank policy rate, % p.a., eop 2)	0.05	0.05	0.05	0.50	1.75	1.75	1.75	1.75
Current account, EUR mn	296	368	2,744	1,952	1,490	700	600	600
Current account, % of GDP	0.2	0.2	1.6	1.0	0.7	0.3	0.3	0.2
Exports of goods, BOP, EUR mn	110,401	115,573	118,033	128,344	137,067	145,000	153,700	161,400
annual change in %	7.0	4.7	2.1	8.7	6.8	5.8	6.0	5.0
Imports of goods, BOP, EUR mn	102,406	108,701	108,946	119,247	127,683	135,600	143,700	150,900
annual change in %	5.9	6.1	0.2	9.5	7.1	6.2	6.0	5.0
Exports of services, BOP, EUR mn	18,915	20,603	21,923	23,921	25,309	26,800	28,400	30,100
annual change in %	4.7	8.9	6.4	9.1	5.8	5.8	6.0	6.0
Imports of services, BOP, EUR mn	16,892	17,742	17,942	19,285	20,704	22,000	23,300	24,700
annual change in %	10.1	5.0	1.1	7.5	7.4	6.2	6.0	6.0
FDI liabilities, EUR mn	6,101	1,521	9,809	8,206	7,181	.	.	.
FDI assets, EUR mn	3,175	3,357	2,909	3,096	4,340	.	.	.
Gross reserves of NB excl. gold, EUR mn	44,528	58,903	80,999	123,028	124,142	.	.	.
Gross external debt, EUR mn	106,303	115,396	129,448	171,197	170,100	181,600	193,500	203,100
Gross external debt, % of GDP	67.9	68.5	73.4	89.3	82.0	83.0	84.0	84.0
Average exchange rate CZK/EUR	27.54	27.28	27.03	26.33	25.65	25.50	25.40	25.40

1) Preliminary and wiiw estimates. - 2) Two-week repo rate.

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