

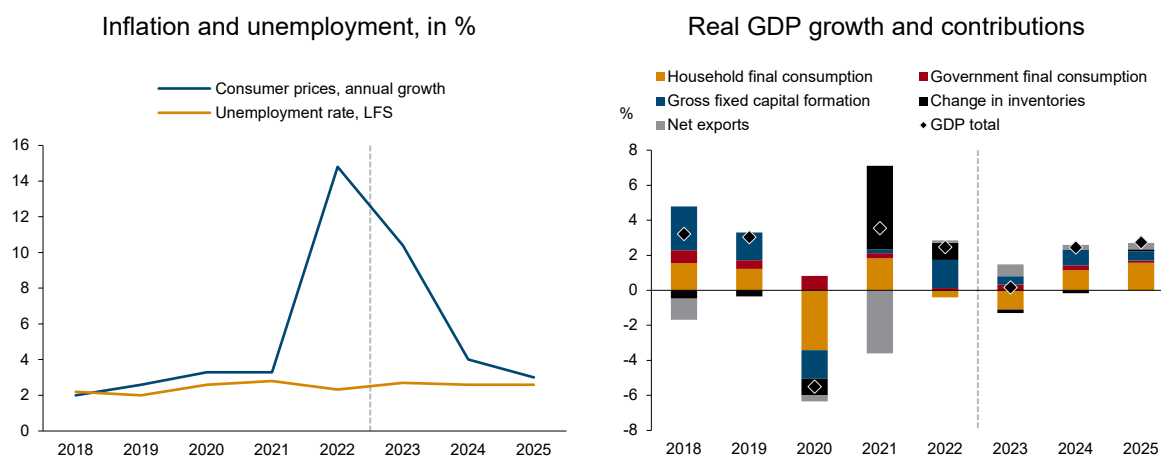


CZECHIA: Inflation proving hard to tame

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With persistently high inflation, cooling internal and external demand, tight monetary conditions and a deteriorating fiscal position, the macroeconomic challenges facing Czechia are mounting. The Czech economy will manage to keep its head just above water and will avoid a recession, but it will be stagnant this year. The slowdown is expected to be temporary, and the economy should be in a position to see renewed growth from 2024 onwards.

Figure 5.6 / Czechia: Main macroeconomic indicators



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

The Czech economy grew by 2.5% in 2022 – below the figure for the EU overall, but still ahead of other highly industrialised economies, such as Germany or Slovakia. Fixed investment acted as the main contributor to growth (+1.6 pp), along with a significant accumulation of inventory stocks (+1.0 pp). By contrast, household consumption contributed negatively to growth (-0.9 pp), while other components made a fairly negligible contribution.

Price pressures remained strong in Q1 2023, with consumer prices maintaining double-digit growth (year on year) for 14 consecutive months. There are multiple contributory factors to the persistently high inflation (selected food items, housing, water supply and sewerage, solid fuels), but a recent acceleration in the price of services (particularly in the areas of accommodation, catering, recreation and culture) has further intensified the situation. Assisted by the base effect, most recent figures suggest a slight slowdown in the pace of price growth, and the coming months are likely to see further deceleration. Nevertheless, inflation will remain high throughout much of 2023, and is expected to average 10.4% this year. In 2024, we will see a return to lower – albeit still somewhat elevated – inflation levels (4%).

The tight labour market could further add to the inflationary pressure. Last year saw a decline in the unemployment rate, combined with relatively dynamic nominal wage growth (7.9% year on year in Q4), and this is likely to be maintained over the forecast horizon. Still, wages have so far not been able to keep up with the steep rise in inflation. In 2022, Czech average gross real wages saw their biggest drop in three decades, falling by 7.5%. A deterioration in purchasing power will continue in 2023, before starting to recover in 2024 as inflation eases and workers demand an adjustment of their wages. Given Czechia's long-standing structural problems with labour shortages, employees are expected to be relatively well-positioned for the wage bargaining.

With depressed real wages, household consumption will continue to drag down growth in 2023. Sales in retail trade has fallen markedly in year-on-year terms. The latest (February) figures suggest that households may be trimming their spending, particularly on groceries and household equipment. Consumer confidence remains very weak,¹⁷ well below the levels observed even at the height of the COVID-19 crisis. Concerned with their financial situation, consumers are indicating that they will be putting off making big-ticket purchases in the coming months. However, following two years of constrained spending, household consumption is expected to become the main growth driver in 2024 and 2025, as purchasing power begins to recover.

Industrial performance paints a mixed picture, and the future trajectory is highly uncertain. Industrial production was surprisingly resilient throughout 2022 and in the first months of 2023. February's figures revealed a growth of 2.6% against last year in manufacturing output, with the automotive sector posting double-digit growth for 9 months straight (year on year). In large part, this has been driven by the low base, since the comparison is against months when supply-chain issues were at their most acute. Still, it suggests that the large backlog in automotive orders is now being made up. At the same time, new orders have also been able to maintain solid growth (especially in motor vehicles and transport equipment), though non-domestic orders appear to be cooling. With depressed demand – both external and internal – Czech industry will likely struggle this year to maintain the level of resilience it has hitherto displayed.

A partial recovery in the automotive sector from chip shortages, combined with weak domestic demand, will contribute positively to the country's net export position this year. Trade figures from the first months of 2023 suggest a relatively strong international trade performance by the country. Exports to Czechia's most important partner, Germany, have been particularly upbeat in recent months, mirroring the developments in automotive production. The growth in the price of imports, as well as exports, is gradually moderating, reflecting global trends in energy prices. Exports are expected to outpace imports over the forecast period as a whole, which will help the country gradually reduce the negative current account balance it has maintained since 2021.

It is anticipated that gross fixed capital formation will be boosted by EU funds, as old money needs to be spent as the new money comes in. The remaining 2014-2020 Multiannual Financial Framework funds need to be spent by year-end, and Czechia has roughly 15% of its allocation still unspent. With regard to the Recovery and Resilience Facility, Czechia successfully completed all the milestones needed for the first payment of over EUR 1bn at the end of 2022, and will likely request the

¹⁷ Based on the Business Cycle Survey of the Czech Statistical Office from March 2023.

second disbursement of over EUR 800m in the second half of 2023. With high interest rates and looming uncertainty, EU finances will mitigate an otherwise tough private investment climate.

The tight monetary policy stance taken by the central bank is unlikely to be eased any time soon.

Comments made by the Czech National Bank (CNB) suggest that no major changes to the policy rate can be expected before the end of the calendar year – after which a gradual easing can be anticipated, to around 3% by 2025 (from the present 7%). The Czech koruna has been exceptionally strong in recent months, which has partially aided the CNB's fight against inflation. It is likely to depreciate slightly in the coming months, as interest rate differentials vis-à-vis the euro lessen. Nevertheless, it is projected to remain stronger than the average over recent years.

On the fiscal side, Czechia has been struggling with a deteriorating public financial situation.

In 2022, the country accumulated the highest government debt ever since its foundation in 1993 (45% of GDP) and posted a fiscal deficit of 3.9% of GDP. Public spending will remain high, as energy-related support measures continue to be provided to both households and firms. As of February 2023, over 40% of the deficit budgeted for the whole year had already been incurred.¹⁸ While government revenue is also expected to be boosted by windfall taxes on the exceptional profits made by certain firms, this will not be enough to offset the higher spending. Although a gradual fiscal consolidation can be expected, a deficit will be maintained across the forecast horizon.

Overall, growth will be highly constrained in 2023, but this will be followed by a mild revival in 2024. This largely mirrors inflation developments, which are temporarily depressing both internal and external demand. EU funds will provide a boost to private investment in 2023, but the release of accumulated inventories will drag down gross capital formation. Net exports will act as the main positive contributor to GDP growth this year. In 2024 and 2025, household consumption will lead growth, as real wages start to recover and households begin to purchase the durable items they have put off buying over the past two years. However, this outlook is clouded by major uncertainty caused by the war in Ukraine, the energy transition, and supply-chain bottlenecks and chip shortages.

¹⁸ Based on data from the Ministry of Finance: <https://www.mfcr.cz/cs/aktualne/tiskove-zpravy/2023/pokladni-plneni-sr-50533>

Table 5.6 / Czechia: Selected economic indicators

	2019	2020	2021	2022 ¹⁾	2023	2024	2025
					Forecast		
Population, th pers., average	10,672	10,698	10,506	10,525	10,550	10,580	10,600
Gross domestic product, CZK bn, nom.	5,791	5,709	6,109	6,795	7,430	7,900	8,340
annual change in % (real)	3.0	-5.5	3.6	2.5	0.2	2.4	2.7
GDP/capita (EUR at PPP)	29,180	28,050	29,710	32,060	.	.	.
Consumption of households, CZK bn, nom.	2,663	2,536	2,716	3,130	.	.	.
annual change in % (real)	2.6	-7.4	4.1	-0.9	-2.4	2.5	3.4
Gross fixed capital form., CZK bn, nom.	1,568	1,516	1,589	1,838	.	.	.
annual change in % (real)	5.9	-6.0	0.8	6.2	1.8	3.2	1.9
Gross industrial production							
annual change in % (real)	-0.3	-7.2	6.9	2.5	0.5	3.0	3.3
Gross agricultural production							
annual change in % (real)	2.0	5.2	1.5	-0.8	.	.	.
Construction industry							
annual change in % (real)	2.7	-6.3	2.7	2.6	.	.	.
Employed persons, LFS, th, average ²⁾	5,303	5,235	5,213	5,171	5,140	5,170	5,180
annual change in %	0.2	-1.3	-0.5	-0.8	-0.5	0.6	0.2
Unemployed persons, LFS, th, average ²⁾	109	137	151	123	140	140	140
Unemployment rate, LFS, in %, average ²⁾	2.0	2.6	2.8	2.3	2.7	2.6	2.6
Reg. unemployment rate, in %, eop	2.9	4.0	3.5	3.7	.	.	.
Average monthly gross wages, CZK	34,578	36,176	37,903	40,353	43,500	46,600	49,100
annual change in % (real, gross)	4.9	1.4	0.9	-7.5	-2.4	2.9	2.2
Consumer prices (HICP), % p.a.	2.6	3.3	3.3	14.8	10.4	4.0	3.0
Producer prices in industry, % p.a.	1.7	0.6	6.2	18.6	8.0	3.5	2.5
General governm. budget, EU def., % of GDP							
Revenues	41.3	41.5	41.4	40.1	42.2	41.5	41.5
Expenditures	41.1	47.2	46.5	44.0	46.4	44.0	43.4
Net lending (+) / net borrowing (-)	0.3	-5.8	-5.1	-3.9	-4.2	-2.5	-1.9
General gov. gross debt, EU def., % of GDP	30.0	37.7	42.0	45.0	45.8	45.0	43.0
Stock of loans of non-fin. private sector, % p.a.	5.2	4.1	8.4	4.5	.	.	.
Non-performing loans (NPL), in %, eop	2.5	2.8	2.4	1.9	.	.	.
Central bank policy rate, % p.a., eop ³⁾	2.00	0.25	3.75	7.00	6.50	4.75	3.00
Current account, EUR m	747	4,393	-6,639	-16,911	-8,650	-5,400	-1,750
Current account, % of GDP	0.3	2.0	-2.8	-6.1	-2.8	-1.7	-0.5
Exports of goods, BOP, EUR m	139,428	128,226	148,552	174,999	189,300	196,700	208,500
annual change in %	2.2	-8.0	15.9	17.8	8.2	3.9	6.0
Imports of goods, BOP, EUR m	130,088	117,611	145,936	179,041	190,700	196,800	204,700
annual change in %	1.2	-9.6	24.1	22.7	6.5	3.2	4.0
Exports of services, BOP, EUR m	27,204	22,842	25,275	31,985	35,800	39,000	42,000
annual change in %	4.9	-16.0	10.7	26.5	12.0	9.0	7.7
Imports of services, BOP, EUR m	23,078	18,912	21,180	28,333	31,900	34,300	37,300
annual change in %	8.5	-18.1	12.0	33.8	12.6	7.5	8.8
FDI liabilities, EUR m	9,582	7,367	10,953	10,045	.	.	.
FDI assets, EUR m	4,243	1,788	9,818	3,009	.	.	.
Gross reserves of CB excl. gold, EUR m	133,059	134,905	152,755	130,626	.	.	.
Gross external debt, EUR m	172,544	164,648	181,763	184,682	202,900	212,100	223,900
Gross external debt, % of GDP	76.5	76.3	76.3	66.8	66.1	65.5	65.5
Average exchange rate CZK/EUR	25.67	26.46	25.64	24.57	24.2	24.4	24.4

1) Preliminary and wiiw estimates. - 2) From 2021 new methodology in line with the Integrated European Social Statistics Regulation (IESS), excluding persons on parental leave from employed persons. -3) Two-week repo rate.

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