CZECH REPUBLIC: Back to normal

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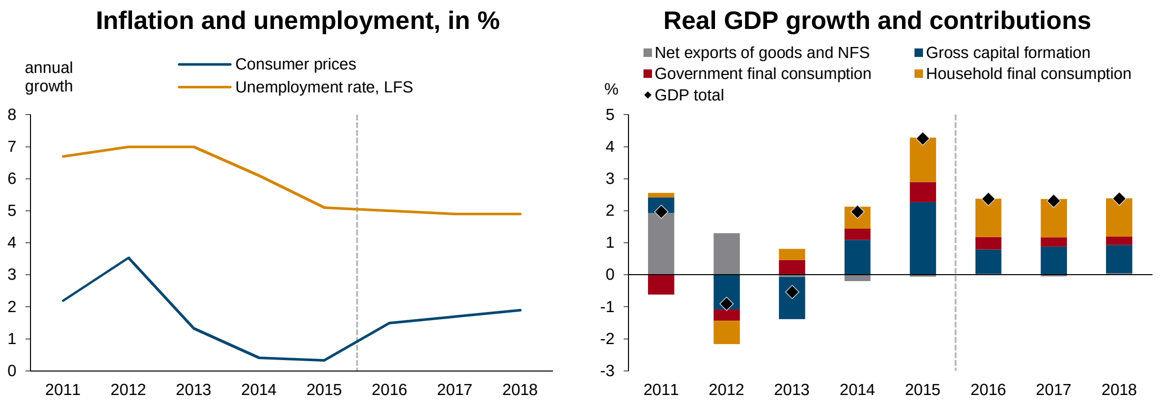
The recent expansion of infrastructural investment is not going to extend into the years ahead. However, in the light of the low level of debt in the private sector and the pursuit of monetary policy conducive to growth, further moderate recovery, with growth averaging 2.4%, should be assured over the period 2016-2018, notwithstanding the uncertainties that persist concerning the future course of fiscal policy and foreign trade performance given the (expected) strengthening of the domestic currency.

Figure 41 / Czech Republic: main macroeconomic indicators



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

According to very first provisional estimates, GDP grew by 3.9% (seasonally adjusted, year-on-year) in the last quarter of 2015. That rate is a clear disappointment as a growth rate well in excess of 5% was generally expected. The composition of growth in the fourth quarter is yet unknown. Very possibly lower growth was due to a decisive slowdown of growth of gross fixed capital formation financed from EU transfers earmarked under the financial perspective for 2007-2013 (with its disbursement period ending in 2015).

In the third quarter, household consumption continued to grow by about 3% while government consumption rose by 4.4% – much faster than in the first half of the year. During that period the dynamics of exports and imports was quite impressive (even by Czech standards). Volumes of exports and imports (of goods and non-factor services combined) rose by 8.2% and 9.1% respectively (year-on-year). The tendency of import volumes to grow faster than export volumes had set in in the second half of 2013. Nominally, the (positive) trade balance was almost unchanged and quite high – also on account of falling import prices of raw materials (and of energy carriers in particular). But its real-term contraction had an impact on the GDP growth rate: foreign trade contributed negatively to GDP growth (by -0.2 percentage points). Gross fixed capital formation rose unusually strongly – by about 6.8%, contributing about 2 percentage points to the overall GDP growth of 4.7% recorded in the third quarter. Expanding inventories appear to have been important contributors to GDP growth (adding over 0.5 percentage points to overall growth).

In the third quarter of 2015 investment in ICT, machinery, equipment, weapon systems etc., constituting about one third of the entire gross fixed capital formation (GFCF), increased by 4.4% in real terms. Residential investment (about 13% of total GFCF) remained stagnant. Strong growth (by 15.3%) was recorded for transport equipment (representing about 12% of total GFCF).

However, the greatest impact has had the 12.5% growth in investments assuming the form of 'other buildings and structures' (whose GFCF share is 30%). The infrastructural investments, broadly understood, included in this category had been declining since 2007, by 22% cumulatively. The current sharp rebound (which was visible already in the second quarter of 2015) – actually not expected even by the Czech authorities – represents a 'last-moment' attempt to tap the EU funds earmarked under the previous financial perspective.

The past years' failure to draw available funds from the EU resources need not be attributed to the Czech side's 'technical' unpreparedness. During the four-year fiscal consolidation period (2000-2013) public spending – including the co-financing of EU-financed infrastructural projects – was suppressed. The fiscal relaxation that had started in 2014 allowed meaningful government investment and consumption spending in 2015.

While the government-driven investment 'boom'[44] cannot be expected to extend into 2016, there is some uncertainty as concerns the private sector's investment growth. There are reasons to believe that the private corporate sector's investment will return to its 'normal' anaemic speed experienced since 2010 – and that although the circumstances seem conducive to fast growth. Interest rates on loans to the sector are quite low, the sector's profitability and liquidity are quite high and its debt is relatively low. Sales prospects are improving (demand deficiency is becoming less of a problem), the capacity utilisation ratio is relatively high (as compared e.g. to Poland) while the labour availability barrier is not yet a serious issue. The reason why – despite all that – the dynamics of investment continues to be moderate may have something to do with the ownership structure of the Czech economy. To a much higher degree than e.g. Poland's, it is an economy dominated by large foreign firms.[45] It is natural that these firms are not constrained by the national borders while choosing the optimal (in terms of taxation, labour and other costs) locations for their new investments. Actually, since 2013 the Czech Republic has been a net lender to the rest of the world. In 2015 net lending may have reached as much as 3.8% of GDP. A part (possibly a major one) of that lending may well have represented new fixed assets of the corporate sector acquired abroad rather than on Czech territory.

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44 Also the purchase of military aircrafts realised in 2015 is not going to be repeated anytime soon. Investment in these aircrafts may have added up to 1 percentage point to GDP growth in 2015.

45 Curiously, information on the ownership structure of the Czech non-financial corporate sector is difficult to come by. (The Czech sources do not conceal data on the foreign ownership of the banking sector, whose share in the entire sector is over 80% – more than in Poland, but less than in Hungary.) The scale of FDI involvement in the Czech economy can be gauged by the size of the country's primary balance (or the difference between GDP and GNI – i.e. the part of GDP amassed by non-residents). That difference has been approaching 8% of GDP.

The general government deficit (slightly over 1% of GDP) was associated with a public debt/GDP ratio falling in 2015 to about 41%. The ongoing reduction in the debt/GDP ratio, achieved quite 'painlessly', would indicate that supportive fiscal policy could continue to be fairly relaxed also in the future. However, the most recent (April 2015) governmental Convergence Programme envisages renewed fiscal consolidation in 2016-2018, with progressively falling public sector expenditures and fiscal deficits. According to the Programme, the fiscal deficit is to fall to 0.6% of GDP in 2018 (with a primary surplus of about 0.5% of GDP) and the public debt/GDP ratio to fall to 40.2%. It is perhaps not surprising that – consistent with its vision of fiscal policy – the Programme does not promise too much as far as growth prospects are concerned. Actually, for the coming years it envisages steady growth *slowdown* to little over 2% in 2018. Of course, if the ambitious consolidation plans are put into action, the eventual GDP growth may well fall short of the magnitude expected. The government's intentions could pose a threat to the mid-term economic prospects. So far there are no indications that the government means to deviate from the Programme. According to the most recent Macroeconomic Forecast presented by the Czech Finance Ministry, government consumption is to rise by 2.1% in 2016, 1.5% in 2017 and only 1.3% later on. For comparison, in 2014 government consumption rose by 1.8% and in 2015 by 3.2%. A recent analysis available from the Czech National Bank suggests that the primary fiscal balance of the general government will reach a surplus of 0.6% of GDP in 2016, to be followed by a surplus of 1% in 2017. That compares with a deficit of 0.6% of GDP in 2014 and (an estimated) deficit of 0.1% in 2015.

The output recovery (most pronounced in the manufacturing and construction sectors) has supported labour market improvements. A part of the improvement observed may have been due to demography as the ageing of the Czech population is very pronounced. Despite the marked labour market improvements, consumer price inflation is very low (while producer prices continue to fall rather strongly). These developments are partly attributed to low energy prices and the strengthening domestic currency. The revealed insensitivity of inflation to the apparent tightening of the labour market conditions seems to suggest that consumer demand continues to be depressed – possibly on account of a rather low GDP share of wages (the GDP share of compensation is about 40%) and the Czech households' saving habits[46].

The extremely relaxed monetary policy, which prevented the consolidation-driven recession from assuming devastating dimensions in 2012-2013, is very likely to remain unchanged for the time being. The very low policy interest rate (two-week repo rate) of 0.05% in force since early November 2012 has had no perceptible impact on inflation. The devaluation of the Czech currency enforced by the National Bank in November 2013 has also proved unable to activate inflationary tendencies. Right now the National Bank seems to believe that inflation will be gradually recovering in 2016. By that time the Bank may also give up its resolution to keep the CZK/EUR exchange rate above 27. Whether the floating CZK will resume its earlier appreciation tendency is hard to predict now. During the closing months of 2015 the National Bank had to intervene massively to prevent the CZK/EUR rate from strengthening above the declared rate of 27.[47]

[46] The Czech household sector has been saving about 11% of its disposable income.

[47] The government and the National Bank have recently jointly reiterated their intention to stay clear of the euro area. Formally the country does not satisfy the exchange-rate (Maastricht) criterion. However, the aversion to the idea of euro adoption seems to have deeper motives. The authorities may rightly realise that the common currency may be hardly compatible with the country's real convergence. Besides, participation in the euro area does not seem to have offered any obvious advantages (at least not since 2008).

Interest rates on loans to private households have remained moderate (though falling somewhat recently). The shares of non-performing loans extended to households (and firms) are quite low and falling. However, borrowing by both households and business has continued to expand rather reluctantly so far. The private sector's bank deposits still exceed the volume of loans extended. This structural regularity is unlikely to change anytime soon. Consumption and private investment will continue growing at moderate speeds.

The unexpected acceleration of public (mostly infrastructural) investment in 2015 is unlikely to have significant demand-, or supply-side consequences, at least in the medium run. The economy is expected to grow rather moderately in 2016-2018. In addition, inventories – whose expansion in 2014 and 2015 added to the reported GDP growth – are likely to stagnate (or even get downsized) thereby reducing growth in 2016.

No major imbalances could be identified even if growth of aggregate demand were to be stronger than could be realistically expected. As in the past, the monetary policy is likely to support stable growth while the fiscal policy's declared intentions suggest the possibility of a return of unnecessary fiscal austerity. Not unlike Germany, with which the Czech Republic shares some structural and economic policy similarities, the country's growth may remain steady, if fairly unimpressive.

Table 10 / Czech Republic: selected economic indicators

	2011	2012	2013	2014	2015 1)	2016	2017 Forecast	2018
Population, th pers., average	10,496	10,511	10,514	10,525	10,525	10,525	10,525	10,525
Gross domestic product, CZK bn, nom.	4,023	4,042	4,077	4,261	4,460	4,640	4,830	5,040
annual change in % (real)	2.0	-0.9	-0.5	2.0	4.3	2.4	2.3	2.4
GDP/capita (EUR at exchange rate)	15,600	15,300	14,900	14,700	15,500	16,500	17,300	18,100
GDP/capita (EUR at PPP)	21,600	21,700	22,200	23,200	24,900	.	.	.
Consumption of households, CZK bn, nom.	1,957	1,971	2,001	2,042	2,110	.	.	.
annual change in % (real)	0.3	-1.5	0.7	1.4	2.9	2.5	2.5	2.5
Gross fixed capital form., CZK bn, nom.	1,069	1,052	1,025	1,065	1,140	.	.	.
annual change in % (real)	1.1	-3.3	-2.7	2.0	6.8	2.5	3.5	4.0
Gross industrial production								
annual change in % (real)	5.9	-0.8	-0.1	5.0	4.4	4.5	4.5	4.0
Gross agricultural production								
annual change in % (real)	8.6	-5.8	6.0	9.9	-6.1	.	.	.
Construction industry								
annual change in % (real)	-3.6	-7.6	-6.7	4.3	5.5	.	.	.
Employed persons, LFS, th, average 2)	4,904	4,890	4,937	4,974	5,020	5,030	5,040	5,050
annual change in %	0.4	0.4	1.0	0.8	0.9	0.2	0.2	0.1
Unemployed persons, LFS, th, average 2)	354	367	369	324	268	260	260	260
Unemployment rate, LFS, in %, average 2)	6.7	7.0	7.0	6.1	5.1	5.0	4.9	4.9
Reg. unemployment rate, in %, end of period 3)	8.6	9.4	8.2	7.5	6.2	.	.	.
Average monthly gross wages, CZK	24,455	25,067	25,035	25,607	26,500	27,600	28,800	30,100
annual change in % (real, gross)	0.6	-0.8	-1.5	1.9	3.0	2.5	2.5	2.5
Consumer prices (HICP), % p.a.	2.2	3.5	1.3	0.4	0.3	1.5	1.7	1.9
Producer prices in industry, % p.a.	3.7	2.4	0.7	1.0	1.0	1.3	1.5	1.6
General governm. budget, EU-def., % of GDP								
Revenues	40.2	40.5	41.3	40.6	41.1	41.0	40.0	40.0
Expenditures	42.9	44.5	42.6	42.6	42.4	42.3	41.0	41.5
Net lending (+) / net borrowing (-)	-2.7	-4.0	-1.3	-1.9	-1.3	-1.3	-1.0	-1.5
Public debt, EU-def., % of GDP	39.9	44.7	45.2	42.7	41.0	40.5	40.5	40.5
Central bank policy rate, % p.a., end of period 4)	0.75	0.05	0.05	0.05	0.05	0.25	1.0	1.0
Current account, EUR mn	-3,466	-2,518	-829	958	2,745	870	0	-950
Current account, % of GDP	-2.1	-1.6	-0.5	0.6	1.7	0.5	0.0	-0.5
Exports of goods, BOP, EUR mn	99,123	104,336	103,184	110,524	118,362	124,000	130,000	135,000
annual change in %	14.1	5.3	-1.1	7.1	7.1	5.0	4.5	4.0
Imports of goods, BOP, EUR mn	96,048	99,413	96,735	101,841	110,367	117,000	123,000	129,000
annual change in %	12.6	3.5	-2.7	5.3	8.4	6.0	5.5	5.0
Exports of services, BOP, EUR mn	17,923	18,863	18,059	18,956	20,294	21,000	22,000	23,000
annual change in %	8.1	5.2	-4.3	5.0	7.1	4.5	3.5	4.0
Imports of services, BOP, EUR mn	14,614	15,776	15,346	16,925	17,379	18,000	19,000	20,000
annual change in %	8.4	8.0	-2.7	10.3	2.7	4.0	3.5	4.0
FDI liabilities (inflow), EUR mn	3,025	7,348	5,544	3,679	1,970	.	.	.
FDI assets (outflow), EUR mn	1,161	2,531	5,831	-1,181	2,875	.	.	.
Gross reserves of NB excl. gold, EUR mn	30,675	33,550	40,459	44,547	59,190	.	.	.
Gross external debt, EUR mn	89,627	96,826	99,652	103,035	106,600	112,700	116,600	118,000
Gross external debt, % of GDP	54.8	60.3	63.5	66.6	65.2	65.0	64.0	62.1
Average exchange rate CZK/EUR	24.59	25.15	25.98	27.54	27.28	26.75	26.50	26.50
Purchasing power parity CZK/EUR	17.76	17.70	17.49	17.44	17.03	.	.	.

1) Preliminary and wiiw estimates. - 2) From 2012 according to census March 2011. - 3) From 2013 available job applicants 15-64 in % of working age population 15-64, all available job applicants in % of labour force before. - 4) Two-week repo rate.

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