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The Czech Republic:
Growth slowdown after the 2010 speed-up

The positive GDP growth which started in the second half of 2009 accelerated in the second and third quarters of 2010. In the fourth quarter of 2010, the GDP growth rate may have even surpassed the 3% mark (year-on-year). Preliminary estimations suggest that in the whole year 2010 the GDP rose by 2.3%. Although representing a definite recovery (after a 4.1% contraction in 2009) the recent performance does not yet seem to signify the return of sustainable and more robust growth.

Rising inventories were the primary factor behind the 2010 growth. Replenishment of inventories could be a natural and welcome development (after their deep fall in 2008-2009) – paving the way for an expansion of gross fixed capital formation. However, it is hard to identify any signs of upcoming sustained expansion of fixed investment outside some selected segments of infrastructure (supported by EU funds). The overall investment stagnation is reflected e.g. in the fact that the output of the construction sector keeps contracting at accelerating speed. Worse still, much of the infrastructure investment which moderated the scale of the decline in the total level of gross fixed capital investment in 2010 is unlikely to get government backing of a comparable magnitude.[1] All in all, a further strong rise in inventories in 2011 may not occur if the return of proper pro-investment sentiments is postponed.

The return of such sentiments cannot now be predicted with any degree of certainty. Although in some sectors (e.g. industry) the business confidence indicator has returned to its pre-crisis levels, in other sectors that indicator either hovers at much depressed levels (in services) or continues a free fall (in construction). The latter fact may have something to do with the levels of interest rates (and fees) charged by banks on new housing loans to

1 2009-2010 has seen a genuine government-sponsored investment boom in the solar power-plants sector. These investments inflated the rate of growth of fixed capital formation (contributing to the 2010 GDP growth). At the same time the requisite imports of solar panels lowered the trade surplus by about 1% of the GDP (thereby reducing foreign trade's GDP growth contribution). The net GDP growth effect of the solar energy project may be positive but small – and the environmental impacts problematic. Given its unexpected scale, the project's wisdom is now questioned. New capacities imply steep rises in electricity prices and extra costs of public investment and subsidy into the transmission grids. No wonder the government has recently taken steps to stop the boom.

households (on average in excess of 6% p.a.). The fact that the interest rates on loans to business are reasonably low does not seem to matter: lending to business (at least from the domestic banks) keeps contracting. What seems to be missing to activate an expansion in the private sector (corporate) investment is the prospect of sustainably strengthening domestic (but also external) demand. Firms still name insufficient demand as the main worry. Besides, some segments of the business sector that could need external financing are cut off from borrowing because they are unable to service their debt obligations. Non-performing loans account for 9% of the stock of loans to the corporate non-financial sector. (This does not endanger the stability of the banking system whose capital/assets ratio is 15.5%, very high by all standards.)

In contrast to investment by the government, it looks as if its consumption stagnated in 2010. Moreover, government consumption is to contract strongly in 2011-2012 (by 3.5% and 2.7% respectively). Cuts in government consumption are part of the fiscal consolidation plan of the centre-right coalition government of Petr Nečas whereby the deficit is to fall from 4.8% of the GDP (recently envisaged for 2010) to below 3% in 2013 (with the governmental debt/GDP ratio rising from the 2010 38.9% mark to the maximum of 44% in 2013). That the cuts in government consumption will slow down the overall GDP growth is quite obvious. Moreover, the envisaged fiscal tightening is also affecting various social security/health benefit schemes which face reforms. In addition the government has raised effective income taxation (e.g. by reducing some allowed tax deductions and by taxing the incomes of employed pensioners). All in all, the fiscal consolidation will slow down GDP growth both directly and indirectly.

Household consumption has risen by about 1% in 2010 – and that despite the slightly falling wage bill and the whole sector's stagnant real disposable income. The 'discrepancy' between disposable income and consumption is due to households' gross saving rate falling consecutively since 2007 when it stood at 10.9% to approximately 8.7% in 2010. Saving rates are likely to go down further in the future (also because the interest rates on household bank deposits will stay negative). Thus household consumption is likely to grow in 2011, if not very spectacularly, even if the wage increases remain subdued and employment stagnates. Of course, growth in employment, wages and household income could speed up more significantly if there is progress on fixed investment and/or net exports. Otherwise, some fiscal relaxation (intended or otherwise) may help – especially in 2012 and beyond. The demographic developments may support the acceleration of private consumption, even if indirectly: the Czech population aged 15-64 years has just started falling very fast (from a peak in 2009). The loss of manpower may be even bigger on account of the imminent opening of the German and Austrian labour markets to Czech (and most other NMS) nationals. This may favour a stronger rise in wages, incomes – and eventually in household consumption demand.

In real terms the imports of goods and services rose definitely faster than exports in 2010, resulting in a reduced (but still very large) trade surplus. The contribution of foreign trade to GDP growth was positive but rather small. These tendencies are likely to prevail also in 2011-2013 especially if (i) growth slows down in the main Czech export destinations (euro area first of all); (ii) the business sector's fixed investment happens to stagnate; (iii) the domestic currency strengthens unduly.

Throughout 2010 the consecutive international financial crises in the euro area (also the events in Hungary) coincided with sharply changing sentiments concerning the Czech currency (and also the country's long-term treasury bonds). More recently the Czech currency is strengthening again – amid the return of high net financial inflows. These inflows over-compensate the current account deficits that arise primarily due to high (and rising) profits of the foreign-owned sector. The financial inflows include FDI (primarily in the form of reinvested profits) as well as very large portfolio investment targeting first of all treasury bonds (which prove attractive despite fairly low yields). The appreciation pressures due to high inflows of FDI and portfolio capital are moderated somewhat via quite high external lending by (nominally) Czech banks and non-financial firms.

Under Miroslav Singer, the new Governor of the Czech National Bank, the monetary policy is likely to remain relatively relaxed. The traditionally cautious CNB will not rush to raise its policy rates in response to the currently higher (and still rising) inflation as the latter is acknowledged to represent primarily the effects of the hikes in indirect tax rates and in administered (regulated) prices. Also, the CNB is unlikely to alter its reservations concerning the switch-over to the euro.

Summing up, the GDP growth speed-up experienced by the Czech economy last year will not continue in 2011. Growth of consumption and gross fixed investment will be anaemic at best and there are many unknowns as concerns foreign trade developments. Given the circumstances the monetary policy seems to be doing its best. But this is not the case with the fiscal policy which seems to have been led by unreasonable consolidation objectives. But, given the political realities, this policy may be sufficiently modified later on, possibly stimulating growth in 2012 and beyond.

Table CZ

Czech Republic: Selected Economic Indicators

	2005	2006	2007	2008	2009	2010 1)	2011	2012	2013
								Forecast	
Population, th pers., average	10235.8	10269.1	10334.2	10424.3	10487.2	10514.0	10540	10580	10610
Gross domestic product, CZK bn, nom.	2983.9	3222.4	3535.5	3689.0	3625.9	3690	3800	3970	4200
annual change in % (real)	6.3	6.8	6.1	2.5	-4.2	2.3	2.2	2.5	3.7
GDP/capita (EUR at exchange rate)	9800	11100	12300	14200	13100	13900	.	.	.
GDP/capita (EUR at PPP)	17100	18200	19900	20200	19300	19900	.	.	.
Consumption of households, CZK bn, nom.	1442.7	1537.2	1659.6	1804.2	1804.3	1850	.	.	.
annual change in % (real)	2.5	5.1	4.8	3.6	-0.3	1	1	2.5	3
Gross fixed capital form., CZK bn, nom.	741.9	796.3	890.3	883.2	814.0	800	.	.	.
annual change in % (real)	1.8	6.0	10.8	-1.5	-7.9	-1	2	4	6
Gross industrial production									
annual change in % (real)	3.9	8.3	10.6	-1.9	-13.6	10.6	6	7	8
Gross agricultural production									
annual change in % (real)	-2.0	-4.2	3.1	6.8	-3.5	-4.4	.	.	.
Construction industry									
annual change in % (real)	5.3	6.1	7.0	-0.2	-0.8	-7.8	.	.	.
Employed persons - LFS, th, average	4764.0	4828.1	4922.0	5002.5	4934.3	4885.3	4890	4910	4930
annual change in %	1.2	1.3	1.9	1.6	-1.4	-1.0	0	0.5	0.5
Unemployed persons - LFS, th, average	410.2	371.7	276.6	229.8	352.2	383.7	.	.	.
Unemployment rate - LFS, in %, average	7.9	7.2	5.3	4.4	6.7	7.3	7.5	7.0	6.5
Reg. unemployment rate, in %, end of period	8.9	7.7	6.0	6.0	9.2	9.8	.	.	.
Average gross monthly wages, CZK 2)	18344	19546	20957	22593	23488	24000	.	.	.
annual change in % (real, gross)	3.1	4.0	4.3	1.4	2.9	1	0.8	1.5	2
Consumer prices (HICP), % p.a.	1.6	2.1	2.9	6.3	0.6	1.2	2.0	2.0	2.0
Producer prices in industry, % p.a.	0.5	0.1	2.6	0.4	-1.5	0	2.2	.	.
General governm. budget, EU-def., % GDP									
Revenues	41.4	41.1	41.8	40.2	40.2	40.7	.	.	.
Expenditures	45.0	43.8	42.5	42.9	46.0	45.5	.	.	.
Net lending (+) / net borrowing (-)	-3.6	-2.6	-0.7	-2.7	-5.8	-4.8	-4.6	-3.5	-3.5
Public debt, EU-def., in % of GDP	29.7	29.4	29.0	30.0	35.3	38.9	42.1	43.0	44.0
Central bank policy rate, % p.a., end of period 3)	2.00	2.50	3.50	2.25	1.00	0.75	1.5	2.0	2.0
Current account, EUR mn	-1346	-2745	-4090	-962	-1465	-4000	-3800	-5000	-5200
Current account in % of GDP	-1.3	-2.4	-3.2	-0.7	-1.1	-2.7	-2	-3	-3
Exports of goods, BOP, EUR mn	62781	75706	89379	99158	80675	96000	108000	119000	129000
annual growth rate in %	16.1	20.6	18.1	10.9	-18.6	19	13	10	8
Imports of goods, BOP, EUR mn	60797	73415	85038	95031	73842	89300	102000	114000	123000
annual growth rate in %	11.5	20.8	15.8	11.8	-22.3	21	14	12	8
Exports of services, BOP, EUR mn	9491	11086	12311	14849	14575	16600	18000	20000	22000
annual growth rate in %	22.3	16.8	11.0	20.6	-1.8	14	11	12	10
Imports of services, BOP, EUR mn	8254	9494	10526	12210	13578	15900	18000	20000	22000
annual growth rate in %	13.9	15.0	10.9	16.0	11.2	17	12	12	10
FDI inflow, EUR mn	9354	4363	7667	4467	1935	6000	.	.	.
FDI outflow, EUR mn	-12	1172	1187	2964	960	600	.	.	.
Gross reserves of NB excl. gold, EUR mn	24868	23684	23456	26377	28556	31250	.	.	.
Gross external debt, EUR mn	39379	43415	51642	59689	60069	66500	.	.	.
Gross external debt in % of GDP	38.3	37.0	38.9	43.5	43.9	45.2	.	.	.
Average exchange rate CZK/EUR	29.78	28.34	27.77	24.95	26.44	25.28	24.5	24	24
Purchasing power parity CZK/EUR	17.10	17.23	17.17	17.54	17.94	17.67	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees, including part of the Ministry of Defence and the Ministry of the Interior. From 2009 all enterprises covered. - 3) Two-week repo rate.

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