



THE Czech Republic: Second dip left behind

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The Czech economy has finally recovered from the effects of fiscal consolidation. Given the relatively low level of debt burden in both the government and private sectors and the ‘growth-friendly’ monetary and fiscal policies, recovery over the period 2015-2017 seems assured. Acceleration of growth, however, may only be gradual as fixed investment is unlikely to expand at a markedly high rate. Doubts have recently been voiced about the country’s foreign trade performance in the years to come.

The moderate recovery that had started in the last quarter of 2013 continued steadily throughout 2014. Still the 2014 real GDP fell short of the 2008 level. Growth in household consumption accelerated in 2014 and there was a substantial turnaround in gross fixed capital formation: from a strong decline to strong growth. Despite this the current volume of GFCF is still about 16% below the level recorded in 2008. Inventories, which had decreased strongly throughout much of 2013, showed a considerable increase in the second and third quarter of 2014. The contribution of rising inventories to GDP growth in 2014 equalled, approximately, 0.3 percentage points. In the second quarter of 2014 foreign trade (in goods and services) stopped contributing to GDP growth positively. In the whole of 2014 the volume of exports rose by an estimated 8% while that of imports by 8.8%. The overall contribution of foreign trade to GDP growth in 2014 was minus 0.2 percentage points, thereby disappointing the earlier official expectations.

The changing orientation of the fiscal policy seems to be playing an important role in the strengthening of consumption growth – and partly also of fixed capital formation. After five years of fiscal consolidation (2010-2013) the public sector deficit/GDP ratio had been suppressed from 5.8% to about 1.5%. Public debt to GDP was increasing anyway, largely due to the suppressed GDP development. The deficit ratio is projected (by the Finance Ministry) to rebound to close to 2% in 2015, and public consumption to rise by about 2%, slightly more than in 2014. The wage bill for the public administration sector is to be increased in 2015.¹ Most importantly, government spending on gross fixed capital formation has been planned to jump strongly (after still contracting, by 12%, in 2013). Higher public investment spending is complementing investment spending financed out of the unutilised means still available until the end of 2015 under the EU programmes for 2007-2013. The fiscal relaxation underway – while clearly supporting GDP growth² – is nonetheless expected to further suppress the public debt/GDP ratio in 2015.

¹ In addition, the official minimum monthly wage is to rise in 2015, from an equivalent of approximately 310 to 334 euro.

² According to the Finance Ministry, the fiscal effort (the increase in GDP shares of the general government *structural* balance) has become negative (-1 percentage point) in 2014 – meaning actual relaxation of the fiscal policy. Nearly as

The extremely relaxed monetary policy will remain unchanged in the near future. The very low policy interest rate (two-week repo rate) of 0.05%, in force since early November 2012, has not induced any inflationary tendency. Actually, the consumer price index is quite close to zero now – and is not expected to rise in 2015 (especially given the continuing suppression of fuel prices). Low policy interest rates have had little impact on commercial lending rates. The volume of lending to the domestic private non-financial sector has been contracting and the volume of lending to the household sector has been rising very slowly (primarily on account of housing loans). In 2014 the stocks of loans to households and non-financial corporations rose 4% and 0.9% respectively. At the same time the corporate sector's deposits increased by 7.9% and households' by 6.1%. The private (non-financial) sector's deposits exceed the stock of the loans extended to the sector by over 33%. The shares of non-performing loans have been low and falling (or at worst stable) at 6% recently.

The commercial banks seem quite resilient to unfavourable shocks – not only on account of their clients' borrowing and depositing habits, but also due to the banks' high capital adequacy and the relatively low shares of their domestic assets denominated in foreign currencies. All in all, the private sector's saving propensities remain high, which could be a rational attitude given the deflationary risks and fresh memories of the recent recession.

The strategy of targeting a 'competitive' exchange rate level (while at the same time formally sticking to inflation targeting) has so far proven to be a success.³ Although the strategy has not visibly accelerated the return of inflation to the desirable level (which was the 'official' justification of the strategy) it may have been beneficial with respect to foreign trade developments (and in particular for the restriction of price-competitive imports) recorded in the fourth quarter of 2013 and the first quarter of 2014.

The most recent trade developments suggest that the impact of the enforced devaluation of the Czech koruna could be temporary and limited. As already mentioned, in real terms imports grew faster than exports in 2014. This is likely to continue in 2015 because of higher expected growth in domestic demand and lacking an improvement in the business climate in the euro area. Of course some deterioration in the trade surplus is not disquieting in itself – even if one takes into account that the country's primary income balance (primarily representing net payments to the foreign owners of Czech assets) is consistently negative – and rather large.

When all is said and done, the verdict on the near-term prospects of the Czech economy is positive. The economy has finally recovered after a period of disrupting fiscal consolidation. Given the relatively low levels of debt burden of the government and the private sector (both corporate and households) and growth-friendly monetary and fiscal policies, further recovery in 2015-2017 seems assured. But the growth speed-up of around two and a half per cent may be gradual as fixed investment (especially in housing) is unlikely to expand further at a high rate. It will take more time before investment enters a path of fast and sustained growth. Moreover, there are doubts now – hopefully transient – about the performance of foreign trade in the coming years.

much is envisioned for 2015. (During the fiscal consolidation period 2010-2013 the fiscal effort was positive, averaging 1.1 pp per year.)

³ The strategy was inaugurated in early November 2013. So far it has 'cost' the National Bank some EUR 7.5 billion, initially placed on the foreign exchange market. No further interventions have followed: the participants of the foreign exchange markets do not seem to doubt the CNB resolve to keep the CZK/EUR rate above 27.

Table 1 / Czech Republic: Selected Economic Indicators

	2010	2011	2012	2013	2014 ¹⁾	2015	2016	2017
						Forecast		
Population, th pers., average ²⁾	10,474	10,496	10,511	10,514	10,534	10,534	10,534	10,534
Gross domestic product, CZK bn, nom. ³⁾	3,954	4,022	4,048	4,086	4,190	4,300	4,470	4,650
annual change in % (real) ³⁾	2.3	2.0	-0.8	-0.7	2.0	2.3	2.4	2.4
GDP/capita (EUR at exchange rate)	14,900	15,600	15,300	15,000	14,400	.	.	.
GDP/capita (EUR at PPP)	20,600	21,400	21,800	21,600	22,100	.	.	.
Consumption of households, CZK bn, nom. ³⁾	1,920	1,957	1,970	1,999	2,030	2,090	2,170	2,260
annual change in % (real) ³⁾	1.0	0.3	-1.8	0.4	1.2	2.4	2.5	2.5
Gross fixed capital form., CZK bn, nom. ³⁾	1,066	1,069	1,055	1,019	1,070	1,130	1,210	1,290
annual change in % (real) ³⁾	1.3	1.1	-2.9	-4.4	4.5	5.5	5.5	5.0
Gross industrial production								
annual change in % (real)	8.6	5.9	-0.9	0.0	4.8	4.5	5.0	4.5
Gross agricultural production								
annual change in % (real)	-7.0	8.6	-5.8	6.9	7.3	.	.	.
Construction industry								
annual change in % (real)	-7.4	-3.6	-7.7	-6.6	2.2	.	.	.
Employed persons, LFS, th, average ⁴⁾	4,885	4,904	4,890	4,937	4,960	4,970	4,980	4,990
annual change in %	-1.0	0.4	0.4	1.0	0.5	0.3	0.2	0.2
Unemployed persons, LFS, th, average ⁴⁾	384	354	367	369	340	.	.	.
Unemployment rate, LFS, in %, average ⁴⁾	7.3	6.7	7.0	7.0	6.4	6.0	5.8	5.8
Reg. unemployment rate, in %, end of period ⁵⁾	9.6	8.6	9.4	8.2	7.7	6.8	6.4	6.2
Average monthly gross wages, CZK	23,864	24,455	25,067	25,078	25,680	.	.	.
annual change in % (real, gross)	0.7	0.6	-0.8	-1.3	2.0	3.0	2.5	2.5
Consumer prices (HICP), % p.a.	1.2	2.2	3.5	1.3	0.4	0.4	1.5	1.5
Producer prices in industry, % p.a.	0.1	3.7	2.3	0.7	1.3	1.0	1.3	1.5
General governm. budget, EU-def., % of GDP								
Revenues	38.6	39.6	39.8	40.7	40.3	.	.	.
Expenditures	43.0	42.5	43.8	42.0	41.7	.	.	.
Net lending (+) / net borrowing (-)	-4.4	-2.9	-4.0	-1.3	-1.5	-1.5	-2.0	-1.5
Public debt, EU-def., % of GDP	38.2	41.0	45.5	45.7	45.0	44.8	44.5	44.3
Central bank policy rate, % p.a., end of period ⁶⁾	0.75	0.75	0.05	0.05	0.05	0.05	0.5	1.5
Current account, EUR mn ⁷⁾	-5,708	-3,466	-2,518	-2,171	462	-1,560	-1,940	-2,580
Current account, % of GDP	-3.7	-2.1	-1.6	-1.4	0.3	-1.0	-1.2	-1.5
Exports of goods, BOP, EUR mn ⁷⁾	86,836	99,123	104,336	103,230	110,019	116,000	122,000	127,000
annual change in %	20.0	14.1	5.3	-1.1	6.6	5.0	5.0	4.5
Imports of goods, BOP, EUR mn ⁷⁾	85,283	96,048	99,413	96,912	101,417	106,000	112,000	118,000
annual change in %	22.0	12.6	3.5	-2.5	4.6	5.0	6.0	5.5
Exports of services, BOP, EUR mn ⁷⁾	16,577	17,923	18,863	17,919	17,999	19,000	19,000	19,000
annual change in %	12.3	8.1	5.2	-5.0	0.4	3.0	2.0	2.0
Imports of services, BOP, EUR mn ⁷⁾	13,479	14,614	15,776	15,275	16,222	17,000	18,000	19,000
annual change in %	15.6	8.4	8.0	-3.2	6.2	4.0	3.0	3.0
FDI inflow (liabilities), EUR mn ⁷⁾	7,707	3,025	7,348	5,250	3,580	.	.	.
FDI outflow (assets), EUR mn ⁷⁾	3,945	1,161	2,531	3,053	-1,198	.	.	.
Gross reserves of NB excl. gold, EUR mn	31,357	30,675	33,550	40,459	44,610	.	.	.
Gross external debt, EUR mn ⁷⁾	86,371	89,627	96,826	99,294	102,200	.	.	.
Gross external debt, % of GDP	55.2	54.8	60.2	63.1	67.2	.	.	.
Average exchange rate CZK/EUR	25.28	24.59	25.15	25.98	27.54	27.60	27.60	27.00
Purchasing power parity CZK/EUR	18.30	17.90	17.71	17.98	17.96	.	.	.

1) Preliminary and wiiw estimates. - 2) According to census March 2011. - 3) According to ESA 2010. - 4) From 2012 according to census March 2011. - 5) From 2013 available job applicants 15-64 in % of working age population 15-64, all available job applicants in % of labour force before. - 6) Two-week repo rate. - 7) BOP 6th edition.

Source: wiiw Databases incorporating Eurostat and national statistics.