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The Czech Republic:
approaching standstill

The third quarter of 2008 scarcely differed from the first half of the year. The GDP growth rate (4.3%) was driven by consumption and foreign trade. Gross fixed investment (primarily in the form of machinery, equipment and means of transport) rose 4.5%. Growth was still combined with rising employment, while inflation kept decreasing. The first signs of the impending change in trends, however, emerged in the form of a steep depreciation of the Czech currency: the previous prolonged appreciation that had been especially prominent in the second quarter of the year went into reverse.

Simultaneously, the activities of commercial – mostly foreign-owned – banks started to change in terms of structure. Foreign assets held by the banks and their loans to monetary financial institutions contracted, while stocks of securities expanded. On the liabilities side, the stock of both residents' deposits and foreign assets declined, but were offset by the increase in government sector deposits (other than those of the central government). The emerging tensions (reflected in the growing preference for liquidity, including a weakening of the inter-bank market and rising interest rates on loans to households), prompted the decision to lower the central bank's interest rates policy. That decision, taken at the beginning of August, was the first to be taken by any central bank in the EU in 2008 (at that time, the Czech rate had dropped below that of the ECB). It was followed by further cuts totalling 200 basis points. The current reference rate (2 week repo) of 1.75% will certainly be cut still further in the near future. This certainty derives not only from the sharp drop in inflation expected in 2009 – but also because of risk of deflation.

The ongoing easing of monetary policy, though possibly moderating the tensions, has proved incapable of stopping unfavourable monetary developments. In the fourth quarter 2008, the stock of loans to business remained flat; the stock of loans to other monetary financial institutions fell by 26%; foreign assets dropped by 6.4%; and the stock of securities held by commercial banks rose by 19%. The preference for security is also to be seen in terms of the banks' liabilities – with a 2% drop in residents' total deposits (deposits with agreed maturity fell by 8%).

Negligible exposure of banks to sub-prime securities (and other similar toxic assets) did not prevent the problems spilling over into the Czech economy. Moreover, the fact that the risk levels facing the Czech banking system are quite low has provided no relief. The precautionary measures adopted by the CNB to improve the distribution of liquidity (a higher level of deposit insurance and the introduction of repurchase facilities) have still not improved the situation; however, the range of instruments acceptable to the CNB as collateral has been quite narrow.

Quite possibly the prevailing attitudes of banks, households and firms already reflect the expectations of hard times ahead: the possibility of domestic recession-cum-deflation hitting the real economy first (and the financial system a little later). Indeed, some symptoms of such a development occurring could hardly be ignored towards the end of 2008. In October, industrial production growth took a steep negative turn (-8.7% year-on-year), followed by another sharp decline (-8.3%) in November and December (-14.6%). The two main export branches, manufacture of machinery and equipment and of transport equipment fared very badly, with double-digit rates of decline in production in both months. The future is bleak: the value of the new orders placed with industry fell by 25% (year-on-year) at the end of November. The same index for the orders placed by foreign importers of Czech industrial products was -29%. Foreign trade had already fallen space (year-on-year) in October – but the real shock came in November, with exports and imports falling in EUR terms by 13% and 8%, respectively. The reason for the dismal trade performance is obvious: the slackening foreign demand indicating the advent of recession in the 'old' EU – and particularly in Germany.

As elsewhere, the Czech authorities are lagging behind developments. The government's National Economic Council – a group of ten prominent Czech economists – that only came into being on 9 January 2009 will focus on further measures to preserve stability in the financial sector and to alleviate the stress felt by the real sector. Most probably, the budget plan for 2009 will also come for further revision. The public sector deficit will certainly be much higher than that envisaged in the current plan which provides for a structural deficit of 1.5% of the GDP. The Czech authorities have not yet decided to make a genuine fiscal contribution to the European Economic Recovery Plan. The recent statement made by the Finance Ministry ('Addendum to an updated Convergence Programme') creates the impression that the central government will contribute in the form of measures to increase households' disposable income by an amount equivalent to about EUR 700 million. The second group of measures mentioned in the Addendum relates primarily to spending supporting investment, the bulk of which will go to transport infrastructure. These measures are worth about 600 million euro, the equivalent to about 0.4% of the GDP. Should these measures really represent additional spending on top of the current budget for 2009, they would be welcome – even though they miss the 1.5% mark recommended by the European Council. It is not at all clear, however, whether these measures have not already been included in the current budget in any event. In that case the additional fiscal stimulus would be zero (just as in Poland). As public debt is quite low, about 30% of the GDP, there seems to be some room for a measure of fiscal expansion. Such measures may only now be forthcoming. The plan announced on 18 February stipulates, among others, an additional fiscal impulse of 0.85% of the GDP in 2009.

Several unknowns enter the equation determining the GDP growth in 2009 and thereafter. The first is the GDP growth rate in the EU itself (primarily in Germany), which, to a large extent, will affect Czech export performance. Given the country's high reliance on exports (the exports/GDP ratio is about 77% at present), foreign trade plays a crucial role in economic growth. It is reasonable to assume that exports will fall in real terms in 2009 by about 2%, more or less in line with the German GDP. The decline in imports may perhaps be more pronounced as the import intensity of the GDP is also lower. All in all, the contribution of foreign trade to GDP growth is likely to be neutral in 2009.

But gross fixed investment is unlikely to grow. Large investments, such as those in the automotive industry, will not continue and the demand for housing is likely to remain depressed (infrastructure investments financed largely from EU transfers will continue).

Private consumption will probably carry the day. A 3% growth in private consumption in 2009 is quite likely for a number of reasons: (i) the household sector's debt is fairly low, only about 22% of the GDP; (ii) household disposable income has been positively influenced by the cut in social security premia; (iii) the same effect follows in the wake of the current rapid disinflation; (vi) despite the ongoing slowdown in production, residents' employment (and hence their wage incomes) will not necessarily suffer heavy losses.

The overall point-estimate of the GDP growth in 2009 is only 0.4% – less than the 1.5% currently projected by the Czech Ministry of Finance. Were the government to aspire to achieving a higher rate of growth, a pronounced relaxation of the fiscal policy would be required in the form of much higher spending rather than just cutting taxes, which has been the preferred policy of the present government. Unlike many other NMS, the Czech Republic would not run large risks by relaxing fiscal policy, as its public debt is reasonably low (as is its foreign debt), 80% of which devolves on the private sector. In addition, the banks are reportedly in good shape. Finally, the current account deficits are under control and low while foreign reserves exceed the country's short-term foreign debt by a very wide margin.

The prospects for 2010 should be much better, provided the recession in the 'old' EU comes to an end by the end of 2009, at the latest. The resumption of growth in the eurozone would boost Czech exports in 2010, with for a major impact on overall GDP growth.

Table CZ

Czech Republic: Selected Economic Indicators

	2003	2004	2005	2006	2007	2008 [1]	2009	2010	2011
								Forecast	
Population, th pers., average	10207.4	10216.0	10235.8	10269.1	10334.2	10427.9	10500	10550	10600
Gross domestic product, CZK bn, nom. [2]	2577.1	2814.8	2983.9	3215.6	3530.2	3720	3790	3970	4220
annual change in % (real) [2]	3.6	4.5	6.3	6.8	6.0	3.5	0.4	2.4	3.8
GDP/capita (EUR at exchange rate)	7900	8600	9800	11100	12300	14300	.	.	.
GDP/capita (EUR at PPP)	15200	16300	17100	18300	20000	20200	.	.	.
Consumption of households, CZK bn, nom. [2]	1317.4	1399.2	1442.7	1543.0	1669.3	.	.	.	
annual change in % (real) [2]	6.0	2.9	2.5	5.4	5.2	3	2.5	3	3
Gross fixed capital form., CZK bn, nom. [2]	687.5	727.2	741.9	792.4	857.7	.	.	.	.
annual change in % (real) [2]	0.4	3.9	1.8	6.5	6.7	4.5	-4	2	4
Gross industrial production									
annual change in % (real) [3]	5.5	9.6	6.7	11.1	9.0	0.4	2	3	5
Gross agricultural production									
annual change in % (real)	-5.7	16.3	-2.0	-4.2	3.1	6.9	.	.	.
Construction industry (build.& civil engin.)									
annual change in % (real) [3]	7.7	7.7	2.4	6.6	5.8	0.9	.	.	.
Employed persons - LFS, th, average	4733.2	4706.6	4764.0	4828.1	4922.0	5002.5	.	.	.
annual change in %	-0.7	-0.6	1.2	1.3	1.9	1.6	0	-0.5	0.5
Unemployed persons - LFS, th, average	399.1	425.9	410.2	371.7	276.6	229.8	.	.	.
Unemployment rate - LFS, in %, average	7.8	8.3	7.9	7.1	5.3	4.4	6	6.0	5.5
Reg. unemployment rate, in %, end of period	10.3	9.5	8.9	7.7	6.0	6.0	.	.	.
Average gross monthly wages, CZK [4]	16917	18041	18992	20219	21694	23450	.	.	.
annual change in % (real, gross)	6.5	3.7	3.3	3.9	4.4	1.5	3	3.5	4
Consumer prices (HICP), % p.a.	-0.1	2.5	1.6	2.1	2.9	6.3	1.5	2.2	2.5
Producer prices in industry, % p.a.	0.1	4.9	1.4	0.1	2.6	0.0	.	.	.
General governm. budget, EU-def., % GDP [5]									
Revenues	40.7	42.2	41.4	41.2	41.6	41.0	40.5	40.0	.
Expenditures	47.3	45.1	45.0	43.8	42.6	42.2	42.5	42.0	.
Net lending (+) / net borrowing (-)	-6.6	-2.9	-3.6	-2.7	-1.0	-1.2	-2.0	-2.0	-2.0
Public debt, EU-def., in % of GDP [5]	30.1	30.4	29.8	29.6	28.9	29.4	30.5	31.2	.
Discount rate of NB, % p.a., end of period	1.0	1.5	1.0	1.5	2.5	1.25	1.5	2	2.5
Current account, EUR mn	-5028	-4650	-1346	-2924	-2270	-4200	-2500	-2000	-3000
Current account in % of GDP	-6.2	-5.3	-1.3	-2.6	-1.8	-2.8	-1.7	-1.3	-1.8
Exports of goods, BOP, EUR mn	43055	54091	62781	75706	89379	100000	95000	102000	110000
annual growth rate in %	5.8	25.6	16.1	20.6	18.1	12	-5	7	8
Imports of goods, BOP, EUR mn	45239	54517	60797	73415	85038	96000	91000	97000	103000
annual growth rate in %	5.1	20.5	11.5	20.8	15.8	13	-5	7	6
Exports of services, BOP, EUR mn	6880	7761	9491	11086	12493	15000	.	.	.
annual growth rate in %	-8.3	12.8	22.3	16.8	12.7	20.1	.	.	.
Imports of services, BOP, EUR mn	6464	7245	8254	9449	10459	12000	.	.	.
annual growth rate in %	-4.9	12.1	13.9	14.5	10.7	15	.	.	.
FDI inflow, EUR mn	1875	4009	9354	4363	6710	7000	.	.	.
FDI outflow, EUR mn	183	824	-12	1172	979	1000	.	.	.
Gross reserves of NB excl. gold, EUR mn	21189	20745	24868	23684	23456	26339	26000	.	.
Gross external debt, EUR mn	27624	33212	39379	43415	50669	65000	72000	.	.
Gross external debt in % of GDP	34.7	35.9	38.3	37.1	38.2	47.0	43	42	42
Average exchange rate CZK/EUR	31.85	31.89	29.78	28.34	27.77	24.95	26.5	26.0	25.5
Purchasing power parity CZK/EUR	16.60	16.96	17.09	17.12	17.13	17.63	.	.	.

Note: The term 'industry' refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices). - 3) Enterprises with more than 20 employees. - 4) Enterprises with more than 20 employees, including part of the Ministry of Defence and the Ministry of the Interior. - 5) According to ESA'95, excessive deficit procedure.

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