THE CZECH REPUBLIC: The second dip about to be left behind

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The Czech economy is finally recovering from the effects of fiscal consolidation. Given the relatively low levels of debt burdening both the government and the private sector (corporate as well as household debts) coupled with growth-friendly monetary and fiscal policies, recovery over the biennium 2014-2015 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 arisen about the country's foreign trade performance in the years to come.

GDP grew by 2.7%, year-on-year, in the second quarter of 2014. The moderate recovery which started in the last quarter of 2013 has still left the quarterly GDP short of its levels registered in 2008, prior to the outbreak of the global crisis. Growth in consumption (both private and public) turned out to be slightly faster than generally expected (about 1.9% and 2.3% respectively). Gross fixed capital formation rose by 6.9%, also much stronger than expected. However, the current volume of GFCF is still about 15% below the level recorded in early 2008. Inventories, which had decreased strongly in the first quarter of 2014 (as also throughout much of 2013), showed a considerable increase in the second quarter. The contribution of rising inventories to GDP growth equals, approximately, 0.9 percentage points. In the second quarter of 2014 foreign trade (in goods and services) stopped contributing to GDP growth positively. The volume of exports rose by 8.9% while that of imports by 11.3%: the overall contribution of foreign trade to GDP growth was minus 1.2 percentage points, unexpectedly negative.

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 four years of fiscal consolidation (2010-2013) the public sector deficit/GDP ratio had been suppressed from 5.8% to about 1.5%. The deficit ratio is expected to stay at that level, although it is likely to rebound to close to 2% in 2014-2015 if GDP growth turns out to be weak (thus resulting in lower tax revenue). Public consumption is to rise by about 2% 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 by close to 30% (after still contracting, by 12%, in 2013). Higher public investment spending is complementing investment spending financed out of the unutilised means still available under the EU programmes for 2007-2013. The fiscal relaxation underway – while clearly supporting GDP growth – is nonetheless

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

expected to further suppress the public debt/GDP ratio in 2014 (to less than 45%, from 46% estimated for 2013).[2]

The extremely relaxed monetary policy, which probably prevented the consolidation-driven recession from assuming devastating dimensions in 2012-2013, is unlikely to be changed 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. Also, low policy interest rates have had little impact on commercial lending rates. Average interest rates on loans to the private domestic sector have remained close to 6% for household loans and over 3% for loans to corporate clients. 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). At the same time the corporate sector's deposits increase quite strongly (with the household sector's deposits also rising, but at a slower pace). The shares of non-performing loans are low and falling (or at worst stable) at 7.4% and 5.2% for the corporate and household sectors respectively. The loans/deposits ratios (65% for the household sector, 117% for the non-financial corporate sector) are much lower than elsewhere (and in the euro area in particular). 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.

Raising the policy interest rates would make no sense in the current circumstances. Raising that rate carries the risk of provoking a still further strengthening of the commercial rates and could only strengthen the deflationary tendency – while certainly exerting a negative impact on lending to the private sector (and on its spending).

Most importantly, higher interest rates could be rather incompatible with the strategy of keeping – through foreign exchange interventions – the CZK/EUR exchange rate over 27. 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 is 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 may suggest that the impact of the enforced devaluation of the Czech koruna could be fairly limited and transient yet. As already mentioned, the real growth rates of exports and imports for the second quarter 2014 are not looking all that good. Also in nominal terms growth of exports has now been outpaced by growth of imports. Consequently, while the trade balance rose to CZK 83.4 billion in the first quarter of 2014 (from 57.2 billion in the same period of 2013), in the

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

second quarter it has risen much less impressively, to CZK 77.2 billion from 69 billion respectively. It may be added that the relative deterioration in trade balances is due primarily to the greatly diminished surplus of trade in services.[4]

While the decision to start targeting a weaker exchange rate has had positive effects so far (i.e. possibly preventing a more discomforting performance in foreign trade) it may be too early to pass a definitive judgement on that decision's longer-term consequences. In any case the expectations, nurtured until quite recently, concerning the positive role to be played by foreign trade may need to be qualified. The reliance of the relatively unsophisticated export sector on 'competitive' labour costs may make it difficult for the Czech economy to combine fast growth in domestic demand with excellent performance in foreign trade. In any case, the continuing weakness of the euro area and the Ukraine-related turmoil does not make the situation any easier.

When all is said and done, the verdict on the near-term prospects of the Czech economy is positive. The economy is finally recovering after the period of disrupting fiscal consolidation. Given the relatively low levels of debt burdening, the government and the private sector (both corporate and households) and growth-friendly monetary and fiscal policies, the recovery in 2014-2015 seems assured. But the growth speed-up can be gradual as fixed investment (especially in housing) is unlikely to expand further at the very high rate observed most recently. 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.

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4 The trade balances referred to above are in current (domestic) prices. Given the fact that the CZK/euro rates in the first two quarters of 2014 are close to 7% higher than in the same quarters of 2013, the growth rates of the trade surpluses are correspondingly lower when measured in the current euro.

Table 1 / Czech Republic: Selected Economic Indicators

	2010	2011	2012	2013 1)	2013	2014	2014	2015	2016
					January-June		Forecast		
Population, th pers., average 2)	10,474	10,496	10,511	10,514	10,512	10,519	10,550	10,580	10,610
Gross domestic product, CZK bn, nom. 3)	3,954	4,022	4,048	4,086	1,962	2,062	4,230	4,390	4,550
annual change in % (real) 3)	2.3	2.0	-0.8	-0.7	-2.0	2.5	2.5	2.4	2.6
GDP/capita (EUR at exchange rate)	14,900	15,600	15,300	15,000	.	.	.	.	.
GDP/capita (EUR at PPP)	20,600	21,400	21,800	22,100	.	.	.	.	.
Consumption of households, CZK bn, nom. 3)	1,920	1,957	1,970	1,999	968	981	.	.	.
annual change in % (real) 3)	1.0	0.3	-1.8	0.4	-0.6	1.1	1.5	2.0	2.0
Gross fixed capital form., CZK bn, nom. 3)	1,066	1,069	1,055	1,019	471	496	.	.	.
annual change in % (real) 3)	1.3	1.1	-2.9	-4.4	-7.5	4.2	5.0	4.0	4.0
Gross industrial production									
annual change in % (real)	8.6	5.9	-0.9	0.0	-4.3	6.4	5.0	5.0	5.0
Gross agricultural production									
annual change in % (real)	-7.0	8.6	-5.8	6.4	.	.	.	.	.
Construction industry									
annual change in % (real)	-7.4	-3.6	-7.7	-6.6	-11.6	5.7	.	.	.
Employed persons, LFS, th, average 4)	4,885	4,904	4,890	4,937	4,919	4,943	4,960	4,970	4,980
annual change in %	-1.0	0.4	0.4	1.0	1.2	0.5	0.5	0.2	0.2
Unemployed persons, LFS, th, average 4)	384	354	367	369	375	338	.	.	.
Unemployment rate, LFS, in %, average 4)	7.3	6.7	7.0	7.0	7.1	6.4	6.4	6.3	6.3
Reg. unemployment rate, in %, end of period 5)	9.6	8.6	9.4	8.2	7.3	7.4	7.6	7.5	7.2
Average monthly gross wages, CZK	23,864	24,455	25,067	25,078	24,467	25,159	.	.	.
annual change in % (real, gross)	0.7	0.6	-0.8	-1.3	0.4	2.8	2.0	2.0	1.5
Consumer prices (HICP), % p.a.	1.2	2.2	3.5	1.4	1.6	0.3	0.5	1.8	1.5
Producer prices in industry, % p.a.	0.1	3.7	2.3	0.7	0.5	1.2	1.2	1.5	1.5
General governm. budget, EU-def., % of GDP									
Revenues	37.5	38.0	38.3	38.9	.	.	.	.	.
Expenditures	41.9	41.0	42.3	40.3	.	.	.	.	.
Net lending (+) / net borrowing (-)	-4.5	-3.0	-4.0	-1.4	.	.	-1.4	-1.4	-1.4
Public debt, EU-def., % of GDP	36.8	39.4	43.9	43.8	.	.	42.8	42.8	42.8
Central bank policy rate, % p.a., end of period 6)	0.75	0.75	0.05	0.05	0.05	0.05	0.25	0.50	0.8
Current account, EUR mn	-5,894	-4,247	-2,040	-2,150	-153	1,392	-800	-2,000	-2,800
Current account, % of GDP	-3.8	-2.6	-1.3	-1.4	-0.2	1.9	-0.5	-1.2	-1.6
Exports of goods, BOP, EUR mn	86,083	97,972	103,252	102,103	50,536	57,032	111,000	117,000	122,000
annual change in %	21.3	13.8	5.4	-1.1	-3.7	12.9	9.0	5.0	4.0
Imports of goods, BOP, EUR mn	83,991	94,298	97,342	94,849	46,065	51,830	103,000	108,000	112,000
annual change in %	24.1	12.3	3.2	-2.6	-5.5	12.5	9.0	5.0	4.0
Exports of services, BOP, EUR mn	15,812	16,646	17,726	16,869	8,188	8,450	17,000	18,000	18,000
annual change in %	13.6	5.3	6.5	-4.8	-2.0	3.2	1.0	3.0	2.0
Imports of services, BOP, EUR mn	12,839	14,262	15,249	14,829	7,088	7,347	15,000	15,000	15,000
annual change in %	15.4	11.1	6.9	-2.8	0.5	3.7	1.0	3.0	2.0
FDI inflow (liabilities), EUR mn	4,644	1,632	6,211	3,783	3,028	2,050	6,000	.	.
FDI outflow (assets), EUR mn	882	-231	1,394	2,491	1,616	-1,160	1,300	.	.
Gross reserves of NB excl. gold, EUR mn	31,357	30,675	33,550	40,459	33,028	42,880	.	.	.
Gross external debt, EUR mn	70,498	72,770	77,664	80,764	78,691	82,401	.	.	.
Gross external debt, % of GDP	45.1	44.5	48.3	51.3	49.5	53.5	.	.	.
Average exchange rate CZK/EUR	25.28	24.59	25.15	25.98	25.70	27.44	27.50	26.75	26.00
Purchasing power parity CZK/EUR	18.30	17.90	17.71	17.98	.	.	.	.	.

1) Preliminary. - 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, available job applicants in % of labour force before. - 6) Two-week repo rate.

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