CZECH REPUBLIC: Broad-based but quite moderate growth

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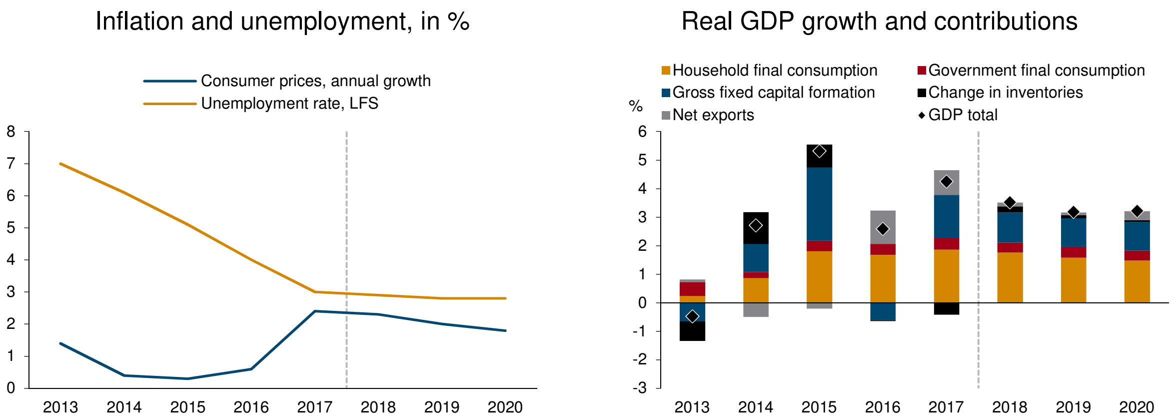
The robust demand for consumer, investment and export goods is conducive to broad-based growth. However, deepening labour shortages are preventing further strong output expansion, while rapidly rising wages are starting to affect profitability. Monetary policy does not face any serious dilemmas. Under the new government, stability-oriented fiscal policy will be preserved.

Figure 45 / Czech Republic: Main macroeconomic indicators



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

After quite a strong performance in the first half of 2017, growth speeded up further in the third quarter, with GDP growth rates (year on year, seasonally unadjusted) rising by 4.7% (up from about 3.7% in the first half of the year). Growth in household consumption accelerated from 3.7% in the first half of 2017 to about 4.1% in the third quarter. Gross fixed capital formation expanded even more rapidly – by 6.3% (from 3.5% in the first half of the year). Foreign trade in goods and services performed quite well in the first half of 2017, with volumes of exports and imports rising by 5.8% and 4.3%, respectively. In the third quarter, the volumes grew much more rapidly (but at a fairly similar pace) – 6.3% and 6.2%, respectively. The large trade surplus recorded in the first quarter (10.2% of GDP) fell to a surplus of 8.3% of GDP in the second quarter and to 5.5% in the third. Foreign trade's contribution to GDP growth fell from about 1.7 percentage points (pp) in the first half of the year to about 0.4 pp in the third quarter.

Unemployment is very low and falling. This has much to do with unfavourable demography (but not so much with outward migration as in the case of other CESEE countries). The size of the working-age population has been contracting since at least 2010 (on average by close to 1% annually). This tendency will continue in the foreseeable future. The strong output growth observed recently has also been important in raising the number of employees (as well as lengthening working hours), and thus reducing the size of unemployment.

Emerging labour shortages are being felt throughout the economy and may already be reducing the levels of output. Firms tend to alleviate their staffing problems by hiring foreign workers (primarily recruited in Slovakia and Poland or from Ukraine). A longer-term option could require the introduction of more labour-saving and efficiency-raising technologies and production modes. This option would include moving parts of any particularly labour-intensive (and low value-added) production abroad. Apart from this, one may anticipate a strengthened reallocation of the domestic labour force from low value-added activities (such as agriculture or certain services) into more promising sectors, such as some higher-tech branches of manufacturing.

Under the impact of tightening labour markets, wage rates are now rising quite strongly. The Czech labour market has long been characterised by the coexistence of low unemployment with a good deal of wage moderation, which to some extent reflects the age structure of the Czech labour force. But given the scale of labour shortages, a stronger push for higher wages is now under way. In many industrial branches, the effects of the wage hikes are neutralised by rising productivity. Nonetheless the unit labour costs are generally on the rise – restricting improvements in profitability and at the same time contributing to a return to more 'normal' levels of inflation, after a long spell of price stability.

The rising wage bill underlies continuing growth in private consumption and will also be vital for the expansion of households' housing investment. Conditions are conducive for an acceleration of firms' productive investments as well. The financial position of firms remains quite strong (although it has worsened recently under the impact of rising labour costs). The interest rates on loans to firms are low, and firms' order books (including export orders) are full. Public investment (co-financed by EU structural funds) in infrastructure projects is also expected to gain momentum from 2018.

The Czech currency has been strengthening. The floating of the Czech koruna (on 6 April 2017) was followed by a continuing strong nominal (as well as real) appreciation. This trend was temporarily reversed in December 2017, but resumed in January 2018. In the absence of the National Bank's active participation in the foreign exchange market, it is still too early to discern the emergence of a new stable level for the exchange rate. The huge CZK positions taken before April 2017 (primarily by speculative investors who had correctly anticipated imminent CZK nominal appreciation) do not seem to have been liquidated. After rising turbulently in the first quarter of 2017, the foreign exchange reserves of the Czech National Bank (CNB) have since remained unchanged. This may be due to high demand for Czech government securities, which, despite the relatively low yields offered, have proved attractive – understandably so, given the country's low public debt, 'sound fiscal policy' and overall economic and social stability.

There is a real possibility that imports could rise faster than exports. The extraordinary foreign trade developments in the first half of 2017 may have occurred in rather exceptional circumstances that may not have repeated themselves during the rest of 2017. The expectation of currency appreciation may have provided incentives to sign export contracts in advance and to suppress or delay imports accordingly. It is natural to expect that, with a strong CZK, exports will have been less dynamic in the second half of 2017. Another reason for expecting exports to lose momentum and imports to surge is that the Czech economy could already be close to exhausting its spare production capacities, as shortages of labour (and possibly of domestically produced intermediate inputs) are becoming widespread. However, even if imports rise faster than exports, the trade surplus is highly unlikely to turn to a deficit in the foreseeable future.

Inflation is 'back to normal'. One of the (declared) reasons for giving up control over the exchange rate was the prospect of inflation returning to 'normal' (after running at close to zero since the beginning of 2014). The return of moderate inflation is a fairly natural consequence of the tight labour market and very low levels of unemployment – and, consequently, of rising wages and costs (e.g. seen in the prices of raw materials and components, which could temporarily be in short supply). Inflation in excess of 2% is expected in 2018, following temporary hikes in the price of foodstuffs and one-off rises in controlled prices (electricity and other utilities). The effects of these additional factors will fade in 2019. Strengthened CZK exchange rates would also help contain inflation.

The CNB is unlikely to oppose moderate inflation very actively, as that would harm investment activities, and possibly also additionally strengthen the Czech currency. In August 2017, the policy rate was increased (for the first time since February 2008) from a symbolic 0.05% to (almost equally symbolic) 0.25%. Other small increases in the policy rate are possible in 2018, but the CNB may prefer to rely on the currency strengthening on its own. The recent 'hike' in the policy interest rates has not affected the market interest rates on loans. The latter remain unchanged nominally (and have fallen in real terms), encouraging a stronger rise in the demand for loans (by firms, and especially by households).

Fiscal policy has been successfully targeting a balanced budget for the general government. In fact, the Finance Ministry plans a fiscal surplus (over 1% of GDP) each year until 2020, implying a decline in the public debt/GDP ratio to about 30% in 2019. The very low cost of servicing public debt is one component of successful fiscal consolidation. Rapid growth and dwindling unemployment (as well as the corresponding decline in spending on unemployment benefits) may facilitate fiscal consolidation.

Overall, the orientation of economic policy will remain unchanged. The parliamentary elections held on 21–22 October 2017 were won by the ANO party, the junior partner in the coalition government that had been in power since 2013. ANO's leader, Mr Babiš, has so far failed to build a broad-based coalition government. The presidential election held on 26–27 January was won by Mr Zeman, who has been siding with Mr Babiš. Most probably (notwithstanding his problems in the courts) Mr Babiš will run the government without a parliamentary majority. His government's economic policy agenda is likely to remain unchanged. Given ANO's (and Mr Babiš's personal background)[63] one may perhaps expect a slightly more pro-(domestic) business emphasis in matters of taxation and administrative regulation. Neither the CNB nor the new government is likely to change its sceptical stance on the issue of euro accession. Also on other important European matters (e.g. on the readiness to accept large-scale quotas of migrants), the new government will remain uncooperative.

To sum up, there is a virtuous cycle of rising incomes, demand and output. Despite the emergence of labour shortages (and supply bottlenecks), inflation will be contained, while the growth rate may well exceed 3% in the period 2017-2019.

[63] Mr Babiš is a successful businessman, active primarily in the food-processing and distribution industry. He is considered the second-richest Czech citizen ('worth' some USD 4 billion).

Table 15 / Czech Republic: Selected economic indicators

	2013	2014	2015	2016	2017 1)	2018	2019 Forecast	2020
Population, th pers., average	10,514	10,525	10,546	10,566	10,570	10,580	10,590	10,610
Gross domestic product, CZK bn, nom.	4,098	4,314	4,596	4,773	5,030	5,310	5,590	5,890
annual change in % (real)	-0.5	2.7	5.3	2.6	4.2	3.5	3.2	3.2
GDP/capita (EUR at PPP)	22,400	23,800	25,300	25,600	26,700	.	.	.
Consumption of households, CZK bn, nom.	1,997	2,044	2,125	2,214	2,330	.	.	.
annual change in % (real)	0.5	1.8	3.8	3.6	4.0	3.8	3.4	3.2
Gross fixed capital form., CZK bn, nom.	1,027	1,084	1,216	1,192	1,280	.	.	.
annual change in % (real)	-2.5	3.9	10.2	-2.3	6.0	4.2	4.0	4.0
Gross industrial production								
annual change in % (real)	-0.1	5.0	4.6	3.5	5.7	4.5	4.0	4.0
Gross agricultural production								
annual change in % (real)	6.0	10.1	-4.8	7.0	-8.6	.	.	.
Construction industry								
annual change in % (real)	-6.7	4.3	7.0	-5.9	1.8	.	.	.
Employed persons, LFS, th, average	4,937	4,974	5,042	5,139	5,222	5,240	5,260	5,270
annual change in %	1.0	0.8	1.4	1.9	1.6	0.4	0.3	0.2
Unemployed persons, LFS, th, average	369	324	268	211	155	160	150	150
Unemployment rate, LFS, in %, average	7.0	6.1	5.1	4.0	2.9	2.9	2.8	2.8
Reg. unemployment rate, in %, eop	8.2	7.5	6.2	5.2	3.8	.	.	.
Average monthly gross wages, CZK	25,035	25,768	26,591	27,575	29,500	31,400	33,100	34,900
annual change in % (real, gross)	-1.5	2.5	2.9	3.0	4.4	4.0	3.5	3.5
Consumer prices (HICP), % p.a.	1.4	0.4	0.3	0.6	2.4	2.3	2.0	1.8
Producer prices in industry, % p.a.	0.7	0.9	-2.4	-3.2	1.8	1.0	1.5	1.0
General governm. budget, EU-def., % of GDP								
Revenues	41.4	40.3	41.1	40.1	40.7	41.0	41.0	41.0
Expenditures	42.6	42.2	41.7	39.4	39.8	40.2	40.3	40.4
Net lending (+) / net borrowing (-)	-1.2	-1.9	-0.6	0.7	0.9	0.8	0.7	0.6
General gov.gross debt, EU def., % of GDP	44.9	42.2	40.0	36.8	34.1	32.4	31.0	31.0
Stock of loans of non-fin.private sector, % p.a.	4.1	2.7	6.6	6.7	6.5	.	.	.
Non-performing loans (NPL), in %, eop	5.9	6.1	5.8	4.8	4.0	.	.	.
Central bank policy rate, % p.a., eop 2)	0.05	0.05	0.05	0.05	0.50	0.75	1.00	1.00
Current account, EUR mn	-829	296	368	1,946	2,408	1,400	2,210	2,100
Current account, % of GDP	-0.5	0.2	0.2	1.1	1.3	0.7	1.0	0.9
Exports of goods, BOP, EUR mn	103,184	110,401	115,573	118,494	128,218	135,900	144,100	152,700
annual change in %	-1.1	7.0	4.7	2.5	8.2	6.0	6.0	6.0
Imports of goods, BOP, EUR mn	96,735	102,406	108,701	109,224	118,605	126,300	133,900	141,900
annual change in %	-2.7	5.9	6.1	0.5	8.6	6.5	6.0	6.0
Exports of services, BOP, EUR mn	18,059	18,915	20,603	21,618	23,491	24,900	26,400	28,000
annual change in %	-4.3	4.7	8.9	4.9	8.7	6.0	6.0	6.0
Imports of services, BOP, EUR mn	15,346	16,892	17,742	17,880	18,968	20,200	21,400	22,700
annual change in %	-2.7	10.1	5.0	0.8	6.1	6.5	6.0	6.0
FDI liabilities, EUR mn	5,544	6,101	1,521	5,875	8,283	.	.	.
FDI assets, EUR mn	5,831	3,175	3,357	661	3,077	.	.	.
Gross reserves of NB excl. gold, EUR mn	40,460	44,528	58,903	80,999	123,067	.	.	.
Gross external debt, EUR mn	99,652	109,067	118,252	130,573	164,300	183,200	199,200	216,800
Gross external debt, % of GDP	63.2	69.6	70.2	74.0	86.0	88.0	90.0	92.0
Average exchange rate CZK/EUR	25.98	27.54	27.28	27.03	26.33	25.50	25.25	25.00

1) Preliminary and wiiw estimates. -2) Two-week repo rate.

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