

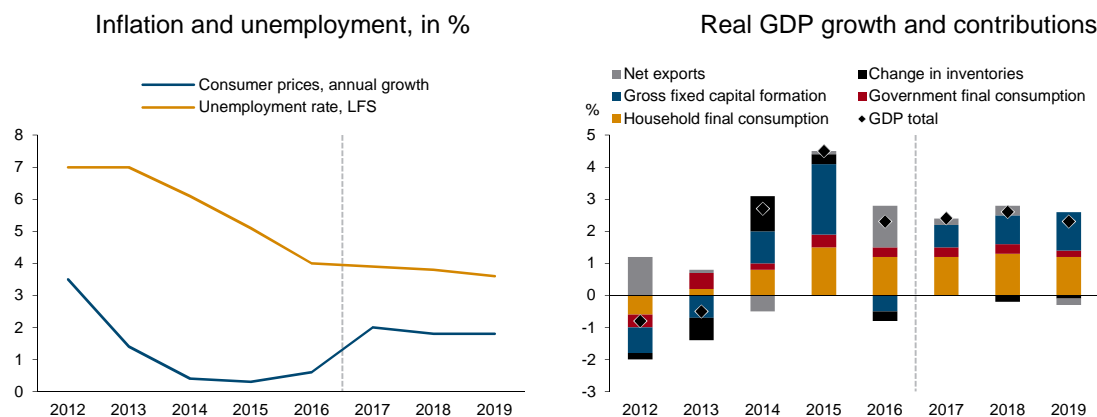


CZECH REPUBLIC: Close to full employment, growing moderately

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Solid external balances and low levels of indebtedness in both the private and the public sector will support moderate growth of above 2% in the period 2017-2019. Some uncertainties persist, however, as to the future course of fiscal policy and the impacts of the expected strengthening of the domestic currency.

Figure 38 / Czech Republic: Main macroeconomic indicators



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

At an estimated 2.4%, GDP growth in 2016 was perceptibly weaker than in the exceptionally good year 2015. Rising consumption (by the household and public sectors) was the main item behind the GDP growth, contributing about 1.7 percentage points (pp) to the overall growth rate. The contribution of foreign trade in goods and non-factor services (1.1 pp) was much higher than in 2013-2015. However, the contribution of gross fixed capital formation was relatively large and negative (-0.6 pp), while that of rising inventories was positive (+0.3 pp).

The strong decline in gross fixed capital formation (by an estimated 2.5% in 2016 vs 2015) is primarily due to the completion by 2015 of infrastructure projects co-financed by EU transfers under the financial package for 2007-2013. This is evidenced by the differential developments within the construction sector. The gross output of the whole construction sector fell, in volume terms, by 7.6% in 2016. However, the volume of civil engineering output – which primarily covers work on various infrastructure projects – fell by as much as 16%. (In 2015 the proportions were different: the whole

construction output rose by 7%, but the volume of civil engineering work rose by over 17%.) It is correct to expect infrastructure investment co-financed from EU structural funds to gradually recover in coming years; however, it is less realistic to expect too much in the current year.

The surplus in foreign trade (in goods and services) reached over 8% of GDP in 2016. This exceptional achievement is due not only to the slowdown in the growth of consumption, the recession in investment and the relatively low world market prices for raw materials, but also to the Czech economy's tight integration into the European (mostly German-dominated) manufacturing production networks (concentrated around the automotive industry). The export-oriented and technologically fairly advanced manufacturing sector represents an obvious strength of the Czech economy. But at the same time, it is also a potential risk factor, as it renders the whole national economy quite vulnerable to unforeseeable external developments. A high dependence on the export of mass-consumption goods is not necessarily a very good thing, given the turbulences shaking the global – and European – economy. This was demonstrated by a severe slowdown in the growth of goods' exports and imports in the second half of 2016 (in line with a marked deceleration of demand for personal cars in Western Europe).

With large trade and current account surpluses, the Czech currency has been subject to a nominal appreciation tendency. For several years now (since November 2013), the Czech national bank has been keeping the appreciation pressures in check by intervening (quite frequently in 2016) in the foreign exchange market. The policy of keeping the CZK/EUR exchange rate above the level of 27 (via unsterilised purchases of foreign exchange) has been quite easy to pursue, since inflation was not a threat and it was possible to keep the policy interest rate technically at zero.

Now inflation has returned, rather abruptly, to its 'target' level of 2%. Rising food prices (a sign of growing household incomes) have had a major impact on the current inflation. Inflation is likely to stay close to 2%, primarily on account of rising unit labour costs (with wages climbing by over 4% and close to stagnant labour productivity).

It is likely that control of the exchange rate will be abandoned sometime later in 2017 and inflation targeting reinstated. In consequence, the Czech currency may appreciate in nominal terms, though the precise scale of this remains quite hard to assess. Combined with higher inflation, this may strengthen the real appreciation of the Czech currency, with possibly negative consequences for foreign trade (primarily via higher demand for imports). Control of inflation via hikes in interest rates may not be very productive, at least in the short run, because it is likely to strengthen the exchange rate more (or faster) than it reduces inflation. It will be interesting to see how the Czech monetary authorities cope with the new challenges. In any case, the consequences of real appreciation are unlikely to be dramatic, because the present trade and current account surpluses are very high. The competitive advantages of the economy, derived from the relatively low unit labour costs, will take more time to be seriously eroded.

Emerging labour shortages are felt in many sectors. Demography is an important determinant of the labour market situation. Since 2006, the working-age population has been contracting very rapidly (from about 71% of the total population to about 66% at present). This trend will continue in the near and medium term. The labour shortages induce high inflows of foreign workers. In 2015, foreigners (primarily Ukrainians, Slovaks and Poles) accounted for about 8% of overall employment.

Despite a tight labour market, average wages are expected to increase rather moderately in the near future (despite the 11% rise in the official minimum wage as of 1 January 2017). This will also affect the dynamics of household consumption, which is unlikely to become more buoyant, not least on account of Czech households' saving habits. Under the impact of very low retail interest rates, the growth in loans (primarily mortgages) to the household sector accelerated in 2016. This was paralleled by the growth in households' bank deposits (which has been accelerating since 2014). At about 66%, the ratio of the stock of households' debt to their disposable income is very low by international standards. The share of non-performing loans to households is low (3.4% at the end of September 2016) and falling. Once the increases in interest rates take hold, demand for loans may weaken, negatively affecting household consumption (and investment) demand.

The financial positions of non-financial corporations continued to be quite strong in 2016. The faster rise in unit labour costs experienced in 2016 is likely to continue in 2017-2019. But this is unlikely to impair corporations' ability to expand further, because wages are still quite low by international standards.

The fiscal policy envisaged for 2017-2019 targets surpluses in public finances and further declines in the (already very low) GDP share of public debt. As long as GDP growth continues and the economy nears its 'potential', represented by the stock of available labour force, such a fiscal policy may seem understandable (though neither high inflation nor external deficit is on the horizon). Trouble might arise should the fiscal policy try to respond to unforeseeable developments (e.g. in foreign trade) with a more restrictive stance (as was the case in 2011-2013). Such an instinctive response may then only worsen the situation.

Summing up, private consumption will continue to be the main driver of moderate GDP growth in 2017-2019. A cumulative 'virtuous' cycle of rising domestic demand and rising wages, consumption and investment is expected. All in all, the country's prospects look pretty good, though this might change if the authorities decide to undertake another round of unnecessary fiscal consolidation.

Table 9 / Czech Republic: Selected economic indicators

	2012	2013	2014	2015	2016 ¹⁾	2017 Forecast	2018 Forecast	2019
Population, th pers., average	10,511	10,514	10,525	10,546	10,564	10,580	10,590	10,600
Gross domestic product, CZK bn, nom.	4,060	4,098	4,314	4,555	4,700	4,900	5,100	5,300
annual change in % (real)	-0.8	-0.5	2.7	4.5	2.3	2.4	2.6	2.3
GDP/capita (EUR at PPP)	21,900	22,400	23,800	25,200	25,800	.	.	.
Consumption of households, CZK bn, nom.	1,970	1,997	2,044	2,110	2,180	.	.	.
annual change in % (real)	-1.3	0.5	1.7	3.2	2.6	2.6	2.7	2.6
Gross fixed capital form., CZK bn, nom.	1,052	1,027	1,084	1,198	1,180	.	.	.
annual change in % (real)	-3.1	-2.6	4.0	8.9	-1.8	2.8	3.5	4.5
Gross industrial production								
annual change in % (real)	-0.8	-0.1	5.0	4.6	3.0	4.0	4.0	4.0
Gross agricultural production								
annual change in % (real)	-5.8	6.0	10.1	-6.1	4.8	.	.	.
Construction industry								
annual change in % (real)	-7.6	-6.7	4.3	7.0	-7.7	.	.	.
Employed persons, LFS, th, average	4,890	4,937	4,974	5,042	5,135	5,150	5,160	5,160
annual change in %	0.4	1.0	0.8	1.4	1.8	0.2	0.1	0.0
Unemployed persons, LFS, th, average	367	369	324	268	212	210	200	190
Unemployment rate, LFS, in %, average	7.0	7.0	6.1	5.1	4.0	3.9	3.8	3.6
Reg. unemployment rate, in %, end of period ²⁾	9.4	8.2	7.5	6.2	5.2	.	.	.
Average monthly gross wages, CZK	25,067	25,035	25,768	26,467	27,800	29,500	31,200	32,900
annual change in % (real, gross)	-0.8	-1.5	2.5	2.4	4.3	4.2	4.0	3.5
Consumer prices (HICP), % p.a.	3.5	1.4	0.4	0.3	0.6	2.0	1.8	1.8
Producer prices in industry, % p.a.	2.4	0.7	0.9	-2.4	-3.5	-1.0	1.0	1.5
General governm. budget, EU-def., % of GDP								
Revenues	40.5	41.4	40.3	41.3	41.5	41.6	41.6	41.6
Expenditures	44.5	42.6	42.2	42.0	41.9	42.0	42.0	42.3
Net lending (+) / net borrowing (-)	-3.9	-1.2	-1.9	-0.6	-0.4	-0.4	-0.4	-0.7
Public debt, EU-def., % of GDP	44.5	44.9	42.2	40.3	39.5	38.7	37.5	37.0
Stock of loans of non-fin.private sector, % p.a	2.3	4.1	2.7	6.6	6.7	.	.	.
Non-performing loans (NPL), in %, Dec	6.0	5.9	6.1	5.8	4.8	.	.	.
Central bank policy rate, % p.a., end of period ³⁾	0.05	0.05	0.05	0.05	0.05	0.3	1.0	1.5
Current account, EUR mn	-2,518	-829	281	1,473	2,720	2,200	1,730	1,600
Current account, % of GDP	-1.6	-0.5	0.2	0.9	1.6	1.2	0.9	0.8
Exports of goods, BOP, EUR mn	104,336	103,184	110,397	118,167	118,100	122,000	127,000	132,000
annual change in %	5.3	-1.1	7.0	7.0	-0.1	3.0	4.0	4.0
Imports of goods, BOP, EUR mn	99,413	96,735	102,417	110,463	108,600	112,000	118,000	123,000
annual change in %	3.5	-2.7	5.9	7.9	-1.7	3.5	5.0	4.0
Exports of services, BOP, EUR mn	18,863	18,059	18,915	20,491	21,100	22,000	23,000	24,000
annual change in %	5.2	-4.3	4.7	8.3	3.0	3.5	4.0	4.5
Imports of services, BOP, EUR mn	15,776	15,346	16,892	17,741	17,500	18,000	19,000	20,000
annual change in %	8.0	-2.7	10.1	5.0	-1.4	4.0	4.5	4.5
FDI liabilities, EUR mn	7,348	5,544	6,101	2,223	5,500	.	.	.
FDI assets, EUR mn	2,531	5,831	3,175	3,211	830	.	.	.
Gross reserves of NB excl. gold, EUR mn	33,560	40,460	44,528	58,903	80,624	.	.	.
Gross external debt, EUR mn	96,826	99,652	106,251	115,877	121,400	130,100	136,600	144,000
Gross external debt, % of GDP	60.0	63.2	67.8	69.4	69.8	71.0	71.0	72.0
Average exchange rate CZK/EUR	25.15	25.98	27.54	27.28	27.03	26.75	26.50	26.50

1) Preliminary and wiiw estimates. - 2) From 2013 available job applicants 15-64 in % of working age population 15-64, all available job applicants in % of labour force before. - 3) Two-week repo rate.

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