CZECHIA: A consumption-driven recovery

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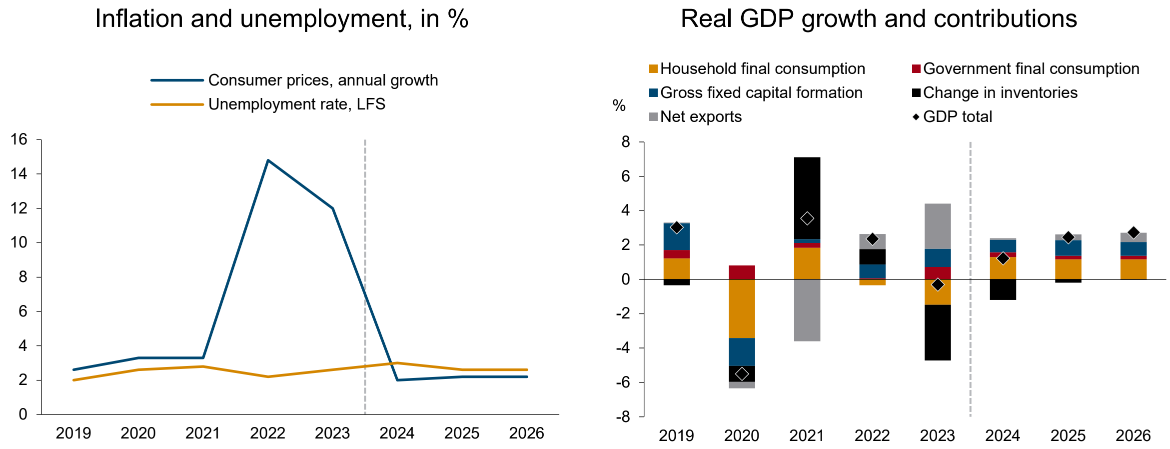
Following a minor contraction in 2023, the Czech economy will see a mild recovery this year. As inflation falls sharply and real wages rise, consumption will be the main driver behind this. Uncertainty looms over Czech industry, its trajectory hinging on the pace of growth in certain major economies, particularly Germany. A more dynamic growth path lies ahead in 2025 and 2026, as industry revives and capacity-expanding investment picks up.

Figure 6.6 / Czechia: Main macroeconomic indicators



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

The Czech economy experienced a slight contraction of 0.3% in 2023, falling below the EU's growth rate and coming into line with that of Germany. Household consumption (-1.2 percentage points (pp)) and inventory depletion (-3.1 pp) contributed to the GDP decline, while government consumption (+0.6 pp), gross fixed capital formation (+1.1 pp) and net exports (+2.2 pp) contributed positively.

Following a period of stiflingly high inflation, a steep decline is expected in 2024. Inflation reached 14.8% in 2022 and was still 12.0% in 2023, which implies a 28.6% growth in price levels in just two years. Together with the Baltic countries and Hungary, this makes Czechia one of the EU countries worst hit by inflation. The most recent figures suggest that inflation is stabilising. February saw a steep fall in the Harmonised Index of Consumer Prices to 2.2%, helped primarily by the high base of last year. The exact same figure was maintained in March. Still, a number of pro-inflationary factors remain, including the weaker Czech koruna against the euro and the dollar, the relatively high inflation in certain services, the abolition of energy price controls and the stretched labour market. Therefore, inflation is expected to hover at around its current level, without decreasing much further.

Real wages will finally rise, which will motivate Czech consumers to increase their spending. After two consecutive years of declining wages – which resulted in two consecutive years of declining household consumption – the purchasing power of Czech households will begin to recover. The tight labour market adds further to the pressure on employers to increase wages. Economic sentiment indicators already show recovering consumer confidence in the first months of 2024. Therefore, consumption is expected to rebound and become the main growth driver this year. The momentum is expected to be sustained throughout the forecast period.

The Czech National Bank (CNB) is advancing with its careful interest-rate cutting. The CNB began its monetary policy loosening in December of last year, when it first trimmed the two-week repo rate by 25 basis points. Another two cuts followed in February and March. At the time of writing, the policy rate stands at 5.75% – down from its peak of 7%. Despite the hawkish stance of the CNB, loosening is expected to continue, as inflation falls significantly and real interest rates turn positive. Our forecast sees the policy rate dropping by another 150 basis points this year to reach 4.25%, before stabilising at around 3% by the end of 2025. Reflecting the rate cuts, the Czech koruna has been depreciating in recent months, hitting a two-year low against the euro in April. Having reached its historically strongest point in 2023, the koruna will be somewhat weaker in the period ahead, though some appreciation is to be expected once the European Central Bank embarks on rate cuts of its own.

Industry continues to grapple with headwinds, particularly with the weak (albeit recovering) German economy. Industrial production declined modestly (by 1.3%) in 2023, cushioned primarily by the surprisingly strong automotive sector – the manufacture of motor vehicles grew by over 16% last year. As Czechia’s most important trading partner and third largest foreign direct investor, Germany’s bleak economic outlook limits the potential for dynamic industrial production in Czechia, at least in the first half of 2024. Industrial production figures in the first two months of 2024 painted a mixed picture: January saw stagnation year on year and a 2.3% decline month on month. February’s growth figures were more optimistic (partly on account of a lower comparison basis from February 2023): 0.7% year on year and 1.9% month on month. The automotive sector is weaker than last year, but is still strong, growing by 7.9% in the first two months of 2024. The most recent trade figures hint at recovering exports, as well as imports, though uncertainty remains high. The trade balance is expected to be slightly positive this year, with exports picking up more strongly than imports in the period to follow, as external demand accelerates.

A new gigafactory project appears to be on the horizon. The Czech government recently revealed that a foreign investor will be setting up a production plant for batteries near the town of Karviná, close to the border with both Poland and Slovakia. While the government has not yet disclosed the name of the investor, it claims the plant will produce batteries for electric vehicles and that the investment will total around EUR 7.8bn. After the Volkswagen gigafactory plans fell through at the end of last year, reportedly due to the low demand for batteries in Europe,[13] the current announcement puts Czechia back in the game of electric vehicle battery manufacturing.

[13] https://www.euractiv.com/section/politics/news/volkswagen-rejects-czech-gigafactory-location-citing-low-demand-for-ev-batteries/

The labour market remains stable, with the shortage of workers persisting as the primary concern. The labour market was largely shielded from the impacts of the economic contraction last year, seeing only a marginal increase in the unemployment rate. A small and temporary uptick in unemployment is to be expected this year, due to the struggles of industry. At 2.6% in 2023, unemployment is still lower than in any other EU member state. Czechia introduced the so-called 'Highly qualified worker programme' in 2021, a scheme that tries to simplify and accelerate the administrative process for immigrants in crucial sectors that face a shortage. In addition to the highly qualified worker scheme, there are visa programmes – aimed primarily at low-skilled workers – that will be augmented by 20,000 applications in 2024. These specifically target less-developed countries in Southeast Europe and Asia, including the Philippines, Mongolia and the Balkan countries, as well as Ukraine.[14]

The government's fiscal consolidation package came into force in January and imposes various austerity measures. Prime Minister Fiala's 'recovery package' – which sparked massive protests last year – brings reductions in state aid programmes, increases in several taxes and contributions, and cuts to public-sector wages. With inflation moderating, the government has also abolished a number of support measures related to the energy crisis, including revisions to regulated energy prices, the discontinuation of one-off payments to families with children and the reintroduction of fees for supported renewable energy sources. Some smaller, targeted support packages remain in place, such as housing support for low-income households.

EU finances will boost investment activity over the medium term, as fresh tranches from the Recovery and Resilience Facility (RRF) are unlocked and new cohesion policy funds spent. In the programming period 2021-2027, Czechia has EUR 21.4bn in EU cohesion policy funds at its disposal. In addition, the RRF totals over EUR 9.3bn, much of it dedicated to green and digital investment. Once combined, these funds represent over 10% of Czechia's 2023 GDP. While implementation of the country's recovery and resilience plan got off to a slow start, Czechia appears to have expedited progress in recent months, requesting the disbursement of the second and third tranches of RRF funds in December of last year. The second tranche – worth over EUR 700m – has just been transferred to Czechia (in April).

The Czech economy will see only a modest recovery (1.2%) in 2024, supported by domestic factors but constrained by external ones. This represents a downgrading (of 0.5 pp) from our previous forecast, reflecting the weak outlook for Germany and other major global actors. More dynamic growth is to be expected in 2025 (2.5%) and 2026 (2.7%), as industry recovers fully and capacity-expanding investment activity picks up. Inflation will fall more sharply than previously expected (a downward revision of 0.8 pp against our Winter forecast), plateauing at around 2% already this year. The fragile geopolitical landscape brings major downside risks to the outlook, however, as further supply-chain issues and spikes in energy prices will inevitably take their toll on the economy. In addition, Czechia faces a number of structural challenges that hamper its growth prospects over the long run, including major labour shortages, sluggish progress with the green transition and a slow transition from an economic model dependent on foreign direct investment.

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[14] https://www.exportmag.cz/mezinarodni-obchod/programy-pracovni-migrace-letos-prinesou-novinky/?utm_source=businessinfo&utm_medium=web&utm_campaign=portal_selfpromo

Table 6.6 / Czechia: Selected economic indicators

	2020	2021	2022	2023 1)	2024	2025 Forecast	2026
Population, th pers., average 2)	10,698	10,506	10,672	10,850	10,880	10,900	10,900
Gross domestic product, CZK bn, nom.	5,709	6,109	6,787	7,344	7,620	7,990	8,400
annual change in % (real)	-5.5	3.6	2.4	-0.3	1.2	2.5	2.7
GDP/capita (EUR at PPP)	28,050	29,990	32,040	34,190	.	.	.
Consumption of households, CZK bn, nom.	2,536	2,716	3,107	3,286	.	.	.
annual change in % (real)	-7.4	4.1	-0.8	-3.2	2.9	2.6	2.6
Gross fixed capital form., CZK bn, nom.	1,516	1,589	1,819	1,980	.	.	.
annual change in % (real)	-6.0	0.8	3.0	4.0	2.7	3.4	3.0
Gross industrial production							
annual change in % (real)	-7.1	6.8	2.1	-1.3	2.0	3.2	3.4
Gross agricultural production							
annual change in % (real)	5.2	1.5	-1.6	-1.6	.	.	.
Construction industry							
annual change in % (real)	-7.1	2.7	3.2	-2.7	.	.	.
Employed persons, LFS, th, average 3)	5,235	5,213	5,174	5,061	5,070	5,070	5,090
annual change in %	-1.3	-0.5	-0.8	1.4	0.2	0.0	0.4
Unemployed persons, LFS, th, average 3)	137	151	118	134	160	140	140
Unemployment rate, LFS, in %, average 3)	2.6	2.8	2.2	2.6	3.0	2.6	2.6
Reg. unemployment rate, in %, eop	4.0	3.5	3.7	3.7	.	.	.
Average monthly gross wages, CZK	36,176	38,277	40,317	43,341	46,000	48,600	50,900
annual change in % (real, gross)	1.4	1.9	-8.5	-2.9	4.0	3.3	2.5
Consumer prices (HICP), % p.a.	3.3	3.3	14.8	12.0	2.0	2.2	2.2
Producer prices in industry, % p.a.	0.5	6.2	18.4	4.4	2.8	2.6	2.5
General governm. budget, EU def., % of GDP							
Revenues	41.5	41.4	41.4	42.5	42.2	42.0	42.3
Expenditures	47.2	46.5	44.6	45.8	44.7	44.0	43.8
Net lending (+) / net borrowing (-)	-5.8	-5.1	-3.2	-3.3	-2.5	-2.0	-1.5
General gov. gross debt, EU def., % of GDP	37.7	42.0	44.2	44.4	44.8	44.6	44.4
Stock of loans of non-fin. private sector, % p.a.	4.1	8.4	4.5	6.5	.	.	.
Non-performing loans (NPL), in %, eop	2.8	2.4	1.9	1.7	.	.	.
Central bank policy rate, % p.a., eop 4)	0.25	3.75	7.00	6.75	4.25	3.00	3.00
Current account, EUR m	4,393	-6,639	-13,555	1,205	1,300	2,400	4,600
Current account, % of GDP	2.0	-2.8	-4.9	0.4	0.4	0.8	1.4
Exports of goods, BOP, EUR m	128,226	148,552	175,612	182,185	185,800	196,000	208,700
annual change in %	-8.0	15.9	18.2	3.7	2.0	5.5	6.5
Imports of goods, BOP, EUR m	117,611	145,936	176,533	170,081	173,800	182,700	193,300
annual change in %	-9.6	24.1	21.0	-3.7	2.2	5.1	5.8
Exports of services, BOP, EUR m	22,842	25,275	33,055	36,720	39,100	41,700	43,900
annual change in %	-16.0	10.7	30.8	11.1	6.4	6.7	5.2
Imports of services, BOP, EUR m	18,912	21,180	29,094	32,821	35,100	37,600	39,700
annual change in %	-18.1	12.0	37.4	12.8	7.0	7.0	5.7
FDI liabilities, EUR m	7,367	10,953	8,729	7,620	.	.	.
FDI assets, EUR m	1,788	9,818	5,312	6,923	.	.	.
Gross reserves of CB excl. gold, EUR m	134,905	152,755	130,626	132,442	.	.	.
Gross external debt, EUR m	164,648	181,763	186,324	186,944	187,500	199,800	210,000
Gross external debt, % of GDP	76.3	76.3	67.4	61.1	62.0	62.5	62.5
Average exchange rate CZK/EUR	26.46	25.64	24.57	24.00	25.2	25.0	25.0

Note: Introduction of new index 2021=100 (new weights) for gross industrial production, construction and producer prices in industry.

1) Preliminary and wiiw estimates. - 2) From 2022 including persons granted temporary protection. From 2021 according to census March 2021. - 3) From 2023 a new methodology in the LFS survey is applied. From 2021 new methodology in line with the Integrated European Social Statistics Regulation (IESS), excluding persons on parental leave from employed persons. - 4) Two-week repo rate.

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