



THE CZECH REPUBLIC: A change (for the better?)

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Recession is likely to come to an end in 2014, mostly on account of the discontinuation of negative developments such as fiscal consolidation (whose chief aims have already been realised) and contraction of inventories (which have been reduced in 2012-2013). Competitive devaluation will help preserve positive impulses from external trade. A very weak recovery in 2014 is likely to follow primarily from a slight strengthening of private and public consumption. But fixed capital formation is not likely to rebound strongly before 2015. Only in 2015-2016 growth can become adequate.

The early parliamentary elections held in October 2013 failed to give a strong political mandate to any of the contesting parties. The disgraced conservative-liberal parties ruling since 2006 were voted out of power but the Social Democrats' victory proved to be Pyrrhic. Unwilling to form an alliance with smaller parties (including the Communists), the Social Democrats (SD) entered, after three months' negotiation marathon, a coalition with ANO. ANO, formed and led (or perhaps owned) by Andrej Babiš, a wealthy businessman of Slovak origin active in food processing and the manufacture of chemicals, is generally characterised as a right-wing populist movement. Moreover, while Bohuslav Sobotka, the SD leader, has assumed the post of Prime Minister, it is Mr. Babiš in his capacity as the new Finance Minister and Deputy Prime Minister who can be expected to wield the real power. Whether the partnership of Social Democracy with ANO can be sustained for a meaningful period of time remains to be seen. Mr. Babiš has declared an intention to run the state finances as an ordinary private company's. But business tycoons usually fail as politicians. Probably running a private business enterprise – no matter how large and complex – requires qualities different from those needed for running a state. What is good for a single business need not be good for a whole economy (or even for the business sector). Of course, it is much too early to assess the performance of public finances under the new brush. The course of fiscal policy in 2014 has already been largely predetermined by previous governments. The new ideas (if any) will become identifiable only as the Finance Ministry works out 'further reform plans' and the new budget for 2015. Still, one important change has occurred. The new President, Miloš Zeman, and also the new government are – despite their otherwise tense relations – more 'pro-European' than used to be the case in the past. The forthcoming changes in the composition of the Board of the Czech National Bank can also change the CNB sceptical views on the advantages of giving up the national currency. Eventually, all this could lead to an initiation of a process leading to the adoption of the euro.

The prolonged (carried out since 2010) fiscal consolidation operation has ended in 2013 with a success: according to the Finance Ministry's recent provisional reports the fiscal deficit of the general government

was suppressed to about 2.5% of the GDP. The success on the consolidation front (achieved at the expense of recession in 2012-2013) has opened the door to a modest fiscal expansion in 2014-2015. Such an expansion could help support recovery. Further austerity is unlikely to be pursued by the government in 2014-2016.

The provisional data on the real economy in 2013 are not looking good. Private consumption was essentially flat while gross fixed investment continued to fall like a stone. Even foreign trade did not excel: the contribution of trade to GDP growth must have been close to zero. Although a number of detailed indicators for December 2013 suggest a possibility of a rebound (e.g. retail trade rising by 3.6% year-on-year, industrial production by 6.7%, new export orders jumping by over 28%) some others remain depressed (e.g. construction output remained flat, as did employment in industry and construction).

The rather modest recovery in 2014 is generally expected to be based primarily on a somewhat faster rise in public and private consumption which will be coupled with a replenishment of inventories (that have been reduced in 2012-2013). The revival of gross fixed capital formation will still be rather weak. Public investment (into transport infrastructure) which is cofinanced out of EU funds is likely to be increased (although the size of that investment in 2014 is difficult to assess at the moment: the absorption capacity remains low while the selection and implementation of projects is plagued by corruption). Given the depressed incomes of the household sector, investment into housing is unlikely to rise significantly. Ultimately, it is the business sector investment which must lead the recovery of gross fixed capital formation – and of GDP at large in 2014. The monetary conditions continue to be conducive to the recovery of business investment. Domestic interest rates on loans to business are quite low, and so are the levels of the business sector's indebtedness. Also commercial banks continue to be in a fairly comfortable position. But loans to the domestic-owned non-financial corporate sector remained flat while loans to foreign-owned non-financial firms have been contracting¹. Overall the stock of bank liabilities of the non-financial non-government sector rose 3.7% throughout 2013: the accrual in the stock was smaller than the interest charged by banks on those liabilities. The nominal stock of longer-term loans to the corporate sector fell about 1% in 2013.

The policy interest rates administered by the Czech National Bank are practically zero while a 'quantitative monetary easing' of the type applied in the UK or US could not make much of a difference (as neither the banking nor the corporate sectors are short of liquidity). Instead, the idea of exchange rate intervention aimed at weakening the Czech currency has been implemented (as of early November 2013). The goal is to keep the exchange rate at a level in excess of 27 CZK/EUR. So far this goal has been achieved (at a cost that is hard to assess). The CNB suggests it will stick to its exchange rate target throughout 2014. The record on the effectiveness of earlier interventions – which took place in 1998, 2000 and 2002 – is rather mixed, with the interventions in 2000 clearly failing to make any impact on the exchange rate dynamics and the interventions in 1998 and 2002 having rather short-lived desired effects.

¹ It may be remembered that much of the Czech business sector (and most of its commercial banking) is actually in foreign hands. The investment motives of the captains of 'Czech business' need not have much to do with the developments obtaining in the Czech economy. The most recent Inflation Report of the CNB (issue IV/2013) suggests (pp. 42-43) that the share of profits reinvested by the foreign-owned companies may have been low, with the sector contributing rather strongly not only to the decline in investments, but also in employment.

The strange thing about the new exchange rate policy is that it is justified by the concerns about too low inflation. In the words of the CNB Governor, 'a weaker koruna will simply import inflation'. However, this does not seem to be a valid justification for intervention even if higher import prices are actually passed through on the domestic ones. Higher import prices disassociated from higher activity levels actually represent a further drag on disposable income, not very different in consequences from e.g. higher indirect tax rates. In effect, they may – *ceteris paribus* – weaken domestic demand still further and thus strengthen rather than help stop the deflationary tendency.

Of course, a weakening currency may well help the real economy via higher exports and/or lower imports, though this does not seem to be an openly declared objective of the CNB, which – in the words of the CNB Governor – 'is not here to help exporters'. It is the foreign trade performance which prevents the current Czech recession from assuming dismal proportions. Given this fact it is neither surprising nor disturbing that the CNB implements a policy of classical competitive devaluation.

In 2011-2013 the exclusive reliance on foreign trade was a matter of limiting losses – currently it is becoming a matter of bare survival. Should investment remain flat in 2014, it is foreign trade that should carry the day. Given the forced devaluation of the domestic currency, this expectation is now more likely to be met already in 2014 – provided the business climate in the euro area (and in Germany in particular) does not deteriorate. Changes in the orientation of fiscal policy, made possible by earlier consolidations, will be equally important.

All in all, the recession is likely to come to an end in 2014, most on account of the discontinuation of negative developments such as fiscal consolidation (whose chief aims have already been realised) and contraction of inventories (which have been reduced in 2012-2013). Competitive devaluation will help preserve positive impulses from external trade. A very weak recovery in 2014 is likely to follow primarily from a slight strengthening of private and public consumption. But fixed capital formation is not likely to rebound strongly before 2015. Only in 2015-2016 growth can become adequate.

Table 1 / Czech Republic: Selected Economic Indicators

| | 2009 | 2010 | 2011 | 2012 | 2013 ¹⁾ | 2014 | 2015 | 2016 |
|---------------------------------------------------------------|--------|--------|--------|--------|--------------------|----------|--------|--------|
| | | | | | | Forecast | | |
| Population, th pers., average ²⁾ | 10444 | 10474 | 10496 | 10511 | 10514 | 10550 | 10580 | 10610 |
| Gross domestic product, CZK bn, nom. | 3759.0 | 3790.9 | 3823.4 | 3845.9 | 3830.0 | 3920 | 4070 | 4240 |
| annual change in % (real) | -4.5 | 2.5 | 1.8 | -1.0 | -1.4 | 1.4 | 2.4 | 3.0 |
| GDP/capita (EUR at exchange rate) | 13600 | 14300 | 14800 | 14600 | 14100 | . | . | . |
| GDP/capita (EUR at PPP) | 19500 | 19800 | 20300 | 20700 | 20700 | . | . | . |
| Consumption of households, CZK bn, nom. | 1874.4 | 1889.2 | 1907.7 | 1916.2 | 1940.0 | . | . | . |
| annual change in % (real) | 0.2 | 1.0 | 0.5 | -2.1 | -0.3 | 1.0 | 2.0 | 2.0 |
| Gross fixed capital form., CZK bn, nom. | 926.1 | 930.5 | 922.6 | 887.9 | 850.0 | . | . | . |
| annual change in % (real) | -11.0 | 1.0 | 0.4 | -4.5 | -4.8 | 1.0 | 3.0 | 3.0 |
| Gross industrial production | | | | | | | | |
| annual change in % (real) | -13.6 | 8.6 | 5.9 | -0.9 | 0.5 | 2.5 | 4.0 | 5.0 |
| Gross agricultural production | | | | | | | | |
| annual change in % (real) | -3.6 | -7.0 | 8.6 | -5.8 | 6.9 | . | . | . |
| Construction industry | | | | | | | | |
| annual change in % (real) | -0.8 | -7.4 | -3.6 | -7.7 | -8.2 | 2.0 | 4.0 | . |
| Employed persons, LFS, th, average ³⁾ | 4934.3 | 4885.2 | 4904.0 | 4890.1 | 4937.1 | 4950 | 4960 | 4970 |
| annual change in % ³⁾ | -1.4 | -1.0 | 0.4 | 0.4 | 1.0 | 0.2 | 0.2 | 0.2 |
| Unemployed persons, LFS, th, average ³⁾ | 352.2 | 383.5 | 353.6 | 366.8 | 368.9 | . | . | . |
| Unemployment rate, LFS, in %, average ³⁾ | 6.7 | 7.3 | 6.7 | 7.0 | 7.0 | 7.7 | 7.3 | 7.0 |
| Reg. unemployment rate, in %, end of period ⁴⁾ | 9.2 | 9.6 | 8.6 | 9.4 | 8.2 | 9.5 | 9.0 | . |
| Average monthly gross wages, CZK | 23344 | 23864 | 24455 | 25112 | 25260 | . | . | . |
| annual change in % (real, gross) | 2.3 | 0.7 | 0.6 | -0.6 | -0.8 | 1.0 | 2.0 | 1.5 |
| Consumer prices (HICP), % p.a. | 0.6 | 1.2 | 2.2 | 3.5 | 1.4 | 1.7 | 1.8 | 1.5 |
| Producer prices in industry, % p.a. | -1.5 | 0.1 | 3.7 | 2.3 | 0.4 | 1.5 | 1.5 | . |
| General governm. budget, EU-def., % of GDP | | | | | | | | |
| Revenues | 38.9 | 39.1 | 40.0 | 40.1 | 40.5 | 40.3 | 40.1 | 40.6 |
| Expenditures | 44.7 | 43.7 | 43.2 | 44.5 | 43.0 | 43.2 | 43.1 | 43.5 |
| Net lending (+) / net borrowing (-) | -5.8 | -4.7 | -3.2 | -4.4 | -2.5 | -3.0 | -3.0 | -2.9 |
| Public debt, EU-def., % of GDP | 34.6 | 38.4 | 41.4 | 46.2 | 49.0 | 50.6 | 52.3 | 52.0 |
| Central bank policy rate, % p.a., end of period ⁵⁾ | 1.00 | 0.75 | 0.75 | 0.05 | 0.05 | 0.25 | 0.50 | . |
| Current account, EUR mn | -3428 | -5894 | -4247 | -3735 | -1800 | -2100 | -2500 | -2800 |
| Current account, % of GDP | -2.4 | -3.9 | -2.7 | -2.4 | -1.2 | -1.5 | -1.6 | -1.7 |
| Exports of goods, BOP, EUR mn | 70983 | 86083 | 97972 | 102484 | 104530 | 109000 | 116000 | 123000 |
| annual change in % | -16.3 | 21.3 | 13.8 | 4.6 | 2.0 | 4.0 | 6.0 | 6.0 |
| Imports of goods, BOP, EUR mn | 67684 | 83991 | 94298 | 96686 | 96690 | 101000 | 105000 | 109000 |
| annual change in % | -19.2 | 24.1 | 12.3 | 2.5 | 0.0 | 4.0 | 4.0 | 4.0 |
| Exports of services, BOP, EUR mn | 13924 | 15812 | 16646 | 17174 | 17170 | 18000 | 19000 | . |
| annual change in % | -6.6 | 13.6 | 5.3 | 3.2 | 0.0 | 3.0 | 5.0 | . |
| Imports of services, BOP, EUR mn | 11126 | 12839 | 14262 | 15191 | 15190 | 16000 | 17000 | . |
| annual change in % | -6.9 | 15.4 | 11.1 | 6.5 | 0.0 | 3.0 | 5.0 | . |
| FDI inflow, EUR mn | 2082 | 4644 | 1632 | 8244 | 4000 | 6000 | . | . |
| FDI outflow, EUR mn | 685 | 882 | -231 | 1044 | 2000 | 1300 | . | . |
| Gross reserves of NB excl. gold, EUR mn | 28556 | 31357 | 30675 | 33550 | 40405 | . | . | . |
| Gross external debt, EUR mn | 61940 | 70498 | 72770 | 77205 | 75600 | . | . | . |
| Gross external debt, % of GDP | 43.6 | 47.0 | 46.8 | 50.5 | 51.3 | . | . | . |
| Average exchange rate CZK/EUR | 26.44 | 25.28 | 24.59 | 25.15 | 25.98 | 27.25 | 26.75 | 26.00 |
| Purchasing power parity CZK/EUR | 18.49 | 18.30 | 17.90 | 17.70 | 17.61 | . | . | . |

1) Preliminary and wiiw estimates. - 2) According to census March 2011. - 3) From 2012 according to census March 2011. -

4) From 2013 available job applicants 15-64 in % of working age population 15-64, available job applicants in % of labour force before. - 5) Two-week repo rate.

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