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## **The Czech Republic: Bottoming out?**

The continuing output decline seems to have become somewhat less steep in the final quarter of 2009 as GDP declined by an estimated 2.4% vs. the same period of 2008. Nonetheless, the entire year 2009 was a bad one, with GDP plummeting by over 4%. Provisional calculations indicate that a rise in consumption prevented an even deeper recession. Household consumption rose by 1.5% and public consumption even more, by about 4%. Public and private consumption contributed positively to the overall GDP growth, by 0.8 and 0.7 percentage points (pp) respectively. Gross fixed capital formation fell by some 8%. Inventories were reduced very strongly (particularly in the second and third quarters) resulting in the entire gross capital formation falling by close to 20% in 2009. Gross capital formation thus contributed about minus 5 pp to GDP growth.

Household consumption proved relatively dynamic despite the total value of compensation of employees most probably falling in real terms. A measured decline in the households' gross savings rate was one reason for that outcome. The second reason had much to do with the extraordinary fiscal policy measures in force in 2009. According to data available from the Finance Ministry, taxes and social contributions burdening the household sector fell by 6% in 2009, while social benefits and transfers received by the sector rose by 8% (nominally). All in all, the household sector's gross disposable income rose by about 1% (in real terms) in 2009.

In 2010 the conditions will be much more restrictive as far as household incomes are concerned. Awed by the general government deficit reaching 6.6% of GDP in 2009, the new, liberal-leaning caretaker government abandoned the policy of stimulating demand followed under the previous government of Mr. Topolánek. The caretaker government has enacted the budget for 2010 stipulating a number of 'austerity' measures aimed at cutting the deficit to 5.3% of GDP. Transfers to the household sector are to be 'streamlined' (as with the sickness and pension payments) with the effect they would rise by less than 3% nominally. At the same time the tax burden on households is to rise. As of 1 January 2010, the VAT and excise rates have been raised accordingly (while the rate of the corporate income tax has been *lowered* from 20% to 19%). The wage bill of the public sector employees is to be cut. All in all, the household sector's disposable income is set to shrink by about 2% in real terms in 2010. Under such conditions it is a fall in the households' saving rate that would be needed to generate growth in private consumption. Such a fall is not unlikely. Currently the household savings rate (gross) of about 10% is much higher than it used to be only a couple of years ago. The gross savings rate of the household sector was 7.5% (years 2002-2005). The low levels of household debt and the quite low interest rates expected to prevail for quite some time now will also be supportive of growth of private consumption. But public consumption is unlikely to grow

all that much. (In actual fact, the Finance Ministry seeks to engineer a rather massive decline in public consumption as well.)

Foreign trade, which for many years was positively contributing to GDP growth, proved a disappointment in 2009. Unlike elsewhere in most of the new EU member states, exports of goods and non-factor services have not fallen more strongly in real terms than their imports. This is not unusual because the Czech Republic has been unique in showing a consistently positive balance of trade (i.e. exports by far greater than imports). Under recession in the main trading partners, the trade-surplus countries are likely to suffer more than the endemic trade-deficit countries. On the same principle, the export-led economies benefited more from fast growth in their trading partners than the import-fed countries. The Czech Republic is no exception in this respect. Its exports to the main ailing partners (primarily in the euro area) have been hit hard. In real terms both exports and imports of goods and non-factor services contracted by an estimated 13% in 2009. Overall, the external trade contributed negatively to GDP growth (minus 0.6 pp) in 2009. But the scale of these negative contributions has been declining rapidly in the course of the year. Further improvements in trade (resulting in its making meaningful positive contributions to GDP growth) seem now quite likely. The year-on-year indicators for manufacturing production, sales and exports seem to have stopped falling in the closing months of 2009. Although this reflects the fact that all these items started to decline strongly only in the second half of 2008, one must notice a quantum jump in new export (and total) orders placed with industry. The January 2010 business climate survey shows a rather strong improvement in entrepreneurs' confidence, quoting rising external demand, higher production capacity utilization, and expectations of rising production and employment. Not surprisingly (given the fiscal austerity measures), consumer sentiments deteriorated significantly in January 2010.

On the import side one cannot count on radical improvements. The recovery of exports will certainly be associated with a recovery of imports. Moreover, the current nominal appreciation of the Czech koruna will encourage imports. The current appreciation trend, which started in May 2009, does not show any sign of bending towards depreciation. Rather, it is likely to continue. Given the already very low levels of interest rates administered by the Czech National Bank (and very low levels of interest rates at which the Czech commercial banks finance themselves domestically) the policy is unable to weaken the appreciation trend to any perceptible degree – even if the policy makers desired that eventuality. But, even if imports and exports start to grow at equal speeds, the overall contribution of trade to GDP growth is likely to be positive in 2010 (and rising further later on).

The main recessionary impact which determined the final scale of the GDP decline in 2009 came from the item that is exceptionally difficult to predict, namely, the change in inventories. The decline in inventories had been in the cards well before the outbreak of the crisis. No doubt the crisis has made the downsizing of inventories even more urgently necessary. The recovery of exports and industrial production is likely to necessitate some restocking of inventories. Even if gross fixed capital formation remains flat (which is not unlikely), the overall impact of gross capital formation (equal the change in inventories plus gross fixed capital formation) will contribute to GDP growth in 2010.

The levels of risks facing the Czech banking system continue to remain very low – generally much lower than elsewhere, and not yet any worse than reported a year earlier. It has a uniquely low loans/deposit ratio (77%), negligible gross external debt (and a positive external investment position, quite uniquely among the NMS). The exchange rate risks it faces are small (only 18% of loans to the corporate sector are denominated in foreign currency, and virtually 0% of loans to households). Although the shares of non-performing loans to the household and corporate sector stood, as of end-September 2009, at some 4% and 10% respectively, the strong rise in profits (retained) raised the Capital Adequacy Ratio to 14% – well above the levels considered satisfactory. Despite the Czech National Bank's not engaging in any 'quantitative easing', the banking sector is liquid (actually excessively liquid). This is not to say that there are no problems. Lending to the corporate sector has been contracting, despite quite low interest rates. But this is not the banks' fault. The business sector's demand for loans has been contracting, reflecting the slack in demand for 'real' goods and services. If the demand for goods and services rebounds, the banking sector would be in a position to accommodate the rising demand for loans without any difficulty.

The overall, if still muted, recovery generally expected for the euro area in 2010 should spill over into the Czech Republic. It is now quite reasonable to estimate the Czech GDP growth rate at about 1% in 2010. But the risks persist. If the recovery abroad does not materialize, or turns out to be rather weak, the recession in the Czech Republic may well continue, or even deepen. The fiscal policy restricting domestic demand in 2010 may well prove premature. A modest acceleration of GDP growth is forecast for 2011-2012, but the expected growth will be much slower than before the crisis.

Table CZ

**Czech Republic: Selected Economic Indicators**

	2004	2005	2006	2007	2008	2009 <sup>1)</sup>	2010	2011	2012
	Forecast								
Population, th pers., average	10216.0	10235.8	10269.1	10334.2	10424.3	10490	10550	10600	10650
Gross domestic product, CZK bn, nom.	2814.8	2983.9	3222.4	3535.5	3689.0	3560	3650	3820	4050
annual change in % (real)	4.5	6.3	6.8	6.1	2.5	-4.1	1.0	2.6	3.5
GDP/capita (EUR at exchange rate)	8600	9800	11100	12300	14200	12800	.	.	.
GDP/capita (EUR at PPP)	16300	17100	18200	19900	20200	19500	.	.	.
Consumption of households, CZK bn, nom.	1399.2	1442.7	1537.2	1658.8	1803.7	1830	.	.	.
annual change in % (real)	2.9	2.5	5.1	4.8	3.6	1.5	1	2	3
Gross fixed capital form., CZK bn, nom.	727.2	741.9	796.3	890.3	883.2	830	.	.	.
annual change in % (real)	3.9	1.8	6.0	10.8	-1.5	-8.0	0	4	6
Gross industrial production									
annual change in % (real)	10.4	3.9	8.3	10.6	-1.9	-15	0	4	6
Gross agricultural production									
annual change in % (real)	16.3	-2.0	-4.2	3.1	6.6	-0.5	.	.	.
Construction industry									
annual change in % (real)	8.7	5.3	6.1	7.0	-0.2	-1	.	.	.
Employed persons - LFS, th, average	4706.6	4764.0	4828.1	4922.0	5002.5	4930	4860	4860	4910
annual change in %	-0.6	1.2	1.3	1.9	1.6	-1.4	-1.5	0	1
Unemployed persons - LFS, th, average	425.9	410.2	371.7	276.6	229.8	350	.	.	.
Unemployment rate - LFS, in %, average	8.3	7.9	7.1	5.3	4.4	6.7	8.5	8.5	7.5
Reg. unemployment rate, in %, end of period	9.5	8.9	7.7	6.0	6.0	9.2	.	.	.
Average gross monthly wages, CZK <sup>2)</sup>	18041	18992	20219	21694	23542	24150	.	.	.
annual change in % (real, gross)	3.7	3.3	3.9	4.4	2.1	2	1	3	3
Consumer prices (HICP), % p.a.	2.5	1.6	2.1	2.9	6.3	0.6	1.5	2.0	2.5
Producer prices in industry, % p.a.	4.2	0.5	0.1	2.6	0.4	-1.4	.	.	.
General governm. budget, EU-def., % GDP									
Revenues	42.2	41.4	41.1	41.9	40.9	40.3	41.0	40.9	.
Expenditures	45.1	45.0	43.7	42.5	42.9	46.9	46.5	46.6	.
Net lending (+) / net borrowing (-)	-2.9	-3.6	-2.6	-0.7	-2.0	-6.6	-5.5	-5.7	-4.5
Public debt, EU-def., in % of GDP	30.1	29.7	29.4	29.0	30.0	35	39	42	45
Discount rate of NB, % p.a., end of period	1.5	1.0	1.5	2.5	1.3	0.3	0.5	2.5	2.5
Current account, EUR mn	-4650	-1346	-2745	-4090	-4610	-960	-1500	-2000	-2000
Current account in % of GDP	-5.3	-1.3	-2.4	-3.2	-3.1	-0.7	-1.1	-1.3	-1.2
Exports of goods, BOP, EUR mn	54091	62781	75706	89379	98824	80393	86000	93000	104000
annual growth rate in %	25.6	16.1	20.6	18.1	10.6	-18.7	7	8	12
Imports of goods, BOP, EUR mn	54517	60797	73415	85038	94677	73514	79000	84000	92000
annual growth rate in %	20.5	11.5	20.8	15.8	11.3	-22.4	7	6	10
Exports of services, BOP, EUR mn	7761	9491	11086	12311	15133	14580	15000	17000	19000
annual growth rate in %	12.8	22.3	16.8	11.0	22.9	-3.7	4	10	10
Imports of services, BOP, EUR mn	7245	8254	9494	10526	11847	12448	13000	15000	17000
annual growth rate in %	12.1	13.9	15.0	10.9	12.5	5.1	8	12	10
FDI inflow, EUR mn	4009	9354	4363	7667	7356	3369	5000	.	.
FDI outflow, EUR mn	824	-12	1172	1187	1299	2014	1500	.	.
Gross reserves of NB excl. gold, EUR mn	20745	24868	23684	23456	26377	28478	.	.	.
Gross external debt, EUR mn	33212	39379	43415	51642	57778	58000	.	.	.
Gross external debt in % of GDP	35.9	38.3	37.0	38.9	42.1	43	.	.	.
Average exchange rate CZK/EUR	31.89	29.78	28.34	27.77	24.95	26.44	26.0	25.5	25.0
Purchasing power parity CZK/EUR	16.96	17.09	17.23	17.17	17.55	17.39	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees, including part of the Ministry of Defence and the Ministry of the Interior.

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