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The Czech Republic: Deeper in recession

A deep recession in the country's major export markets could have the most debilitating effect on the economy in the Czech Republic. Fiscal consolidation, which in all likelihood will continue in 2013, offers no promise of rapid recovery. Other risks do not seem serious. Monetary policy is unlikely to make irresponsible moves as long as the country's banks, as well as the corporate non-financial and household sectors, are financially sound and resilient enough to withstand any conceivable ruptures.

In the first quarter of 2013 the GDP decline went on, by a massive 2.8% against the same period of 2012 (seasonally and working-days' unadjusted). The seasonally adjusted decline looks slightly better (by 2.2%) but is worrying all the same. The major negative impulse has come from gross capital formation (and from strong reduction in inventories in particular). The decline in household consumption has actually moderated compared with the declines recorded during the previous four quarters. The volumes of exports and imports of goods and non-factor services declined rather strongly in real terms, with exports falling more than imports (by 3.8% and 3.5% respectively). The expectations that trade would act as a brake on recession have been disappointed. The contribution of foreign trade to GDP growth in the first quarter of 2013 was slightly negative (-0.1 percentage points).

Industrial production contracted throughout the first four months of 2013. In April industrial output was 6% below the level of April 2012. Cumulatively, production fell by 5.4% in the first quarter. Production of capital (investment) goods declined by 9%. Direct industry's export sales fell by 3% in nominal terms. The volumes of orders placed with industry contracted by 7.9% (domestic sales) or 5.8% (export sales). The decline in the construction output seems to be accelerating: in the first quarter it was down almost 11% (but in April already 20.6% below the previous year's April level).

The weakness of household consumption is a natural effect of anaemic labour market developments characterised by stagnant employment and nominal wages. However, after a strong decline in 2012, the decline in household consumption is likely to become less pronounced in the course of 2013. The fiscally motivated increases in the VAT rates and

hikes in administered prices (housing rents and utilities) which raised inflation in 2011-2012 by over 1 percentage point will affect the consumer price inflation in 2013 to a much lesser degree. Quite automatically, much lower ensuing 'fiscal inflation' will stop supporting the creeping erosion of real wages and other regular household sector incomes and therefore will result in a more moderate decline in household consumption. On the other hand, even if real disposable income of the household sector does not contract in 2013 as strongly as in both 2011 and 2012, this sector's propensity to save may rise further (from an estimated 9.8% and 12.7% in 2011 and 2012 respectively) to over 14.5% in 2013 and 2014. Such a development is a real possibility given the uncertain income and employment prospects facing the household sector – as well as the contracting availability of services and of transfers delivered by the sector.

The shares of non-performing loans to the corporate and household sectors are low and stable (at 7.4% and 5.3% respectively). Despite this – and despite relatively quite low interest rates on bank lending – the stock of loans to the private sector has remained quite flat (registering a 3.5% growth annually). The corporate and household sectors' demand for credit remains weak, reflecting the 'real' sector's overall gloomy outlook (but also overabundance of own financial resources of the corporates). The commercial banks' assets rise primarily on account of their net foreign positions expanding (by about 11% annually).

The Czech National Bank has done all it possibly could to ease the strain felt by the economy. Its desperate decision to reduce the policy rate to zero (literally to 0.05%) may have helped to weaken the Czech currency somewhat. But it had no perceptible effect as far as lending by the real sector is concerned – and as far as investment activities are concerned. Of course, it may have strengthened the financial and liquidity position of commercial banks. But, the monetary policy alone, even if competently executed, could not help stop the current recession from deepening. In particular, a 'quantitative easing' would not make much sense in the Czech context. A 'quantitative easing' makes some sense as a way of cheap financing of the public sector 'excessive' deficit. The Czech public sector deficit, though termed 'excessive' by the European Commission officials, is actually quite small, falling and otherwise cheap to finance by orthodox methods. (The interest rate on 10-year Czech government bonds is close to 2%.)

The fiscal policy definitely contributed to the recession in 2012. The fiscal 'effort' (i.e. additional discretionary measures reducing the public sector deficit) is estimated to have reached close to 1% of the GDP in 2012. Despite this the 3% public sector/GDP ratio target was missed by a large margin – not only because the tightening provoked (also through the VAT-induced inflationary erosion of wages) a recession instead of the

'planned' GDP stagnation. Also, the decision to compensate the Churches (primarily the Catholic Church) for the property expropriated during the Communist era is proving costly.

The discretionary measures will continue to have negative effects in 2013, 2014 and 2015, with taxation and expenditure measures bringing 'savings to the public purse' equivalent to 1.4%, 0.3% and 0.5% of GDP respectively. Clearly, fiscal consolidation will – if continued – do nothing to help moderate the recession. This fact does not seem to have dawned on the Czech fiscal authorities so far. While the consolidation may please the European Commission, it is less appreciated by competent macroeconomic experts. A rather unusually open – and critical – evaluation of the need to strive for fiscal consolidation in the Czech Republic has been repeatedly voiced by the IMF. The most recent (dated 20 May 2013¹) IMF statement concludes that '... pro-cyclical fiscal consolidation set to meet the Excessive Deficit Procedure target this year has induced cautious consumer and business behaviour, while room for further cutting policy interest rates is exhausted by reaching the zero lower band ...'.

Concluding, in 2013 the Czech economy is exposed to a number of risks. Bereft of anti-cyclical fiscal expansion and of meaningful monetary policy, it must rely primarily on external trade. Recession in the major export markets could have the most debilitating effects on the Czech economy. Some weakening of the Czech currency registered in the recent months may prove to be of vital importance – not so much as far as the promotion of the Czech exports are concerned, but primarily as providing some protection against competitive imports.

Other risks, possibly essential for other countries, do not seem very serious in the Czech case. The monetary policy is not going to make irresponsible moves while the country's banks, corporate non-financial and household sectors are financially sound and resilient to imaginable disturbances. The same applies to the public sector the debt of which is fairly low and quite cheap to finance.

All in all, the country's economy, free of significant internal and external imbalances, may be well equipped to benefit from a euro area recovery, when this eventually materialises. Of course, the country's growth potential could be mobilised even if euro area stagnation drags on for some time. But such a mobilisation would require a resolute change in the fiscal policy orientation, which is unlikely to happen as long as the present conservative-liberal government stays in power.

¹ <http://www.imf.org/external/np/ms/2013/052013.htm>

Table CZ

Czech Republic: Selected Economic Indicators

	2009	2010	2011	2012 ¹⁾	2012 1st quarter	2013	2013	2013	2014	2015
								Forecast		
Population, th pers., average ²⁾	10487	10520	10496	10509	.	.	10540	10570	10600	
Gross domestic product, CZK bn, nom.	3759.0	3790.9	3823.4	3830.5	905.2	891.2	3820	3900	4050	
annual change in % (real)	-4.5	2.5	1.9	-1.3	-0.1	-2.8	-0.8	1.4	2.4	
GDP/capita (EUR at exchange rate)	13600	14300	14800	14500	.	.	.	.	.
GDP/capita (EUR at PPP)	19400	19500	20100	20500	.	.	.	.	.
Consumption of households, CZK bn, nom.	1874.4	1889.2	1907.7	1899.2	455.3	455.6	.	.	.	
annual change in % (real)	0.2	1.0	0.5	-2.7	-1.8	-0.9	-0.5	1.0	2.0	
Gross fixed capital form., CZK bn, nom.	926.1	930.5	922.6	902.2	204.5	194.0	.	.	.	
annual change in % (real)	-11.0	1.0	0.4	-2.8	0.1	-5.3	-3.0	1.0	3.0	
Gross industrial production										
annual change in % (real)	-13.6	8.6	5.9	-0.8	2.7	-5.4	-1.5	2.0	6.0	
Gross agricultural production (EAA)										
annual change in % (real)	-3.6	-7.0	8.6	-6.6	.	.	.	.	.
Construction industry										
annual change in % (real)	-0.8	-7.4	-3.6	-7.7	-10.0	-10.9	-5.0	2.0	4.0	
Employed persons, LFS, th, average ³⁾	4934.3	4885.2	4904.0	4890.1	4834.9	4884.0	4890	4900	4910	
annual change in % ³⁾	-1.4	-1.0	0.4	0.4	0.1	1.0	0.0	0.2	0.2	
Unemployed persons, LFS, th, average ³⁾	352.2	383.5	353.6	366.8	369.2	392.8	.	.	.	
Unemployment rate, LFS, in %, average ³⁾	6.7	7.3	6.7	7.0	7.1	7.5	7.6	7.7	7.3	
Reg. unemployment rate, in %, end of period ⁴⁾	9.2	9.6	8.6	9.4	8.9	8.0	9.5	9.5	9.0	
Average gross monthly wages, CZK ⁵⁾	23344	23864	24455	25112	24146	24061	.	.	.	
annual change in % (real, gross)	2.3	0.7	0.6	-0.6	-0.4	-2.2	0.0	1.0	2.0	
Consumer prices (HICP), % p.a.	0.6	1.2	2.2	3.5	4.0	1.7	1.9	2.0	1.8	
Producer prices in industry, % p.a.	-1.5	0.1	3.7	2.3	3.8	0.8	0.5	1.5	1.5	
General governm. budget, EU-def., % of GDP										
Revenues	38.9	39.1	40.0	40.3	.	.	.	.	.
Expenditures	44.7	43.8	43.2	44.6	.	.	.	.	.
Net lending (+) / net borrowing (-)	-5.8	-4.8	-3.3	-4.4	.	.	-3.5	-3.2	-3.0	
Public debt, EU-def., % of GDP	34.2	37.9	41.0	45.9	.	.	46.9	48.5	49.5	
Central bank policy rate, % p.a., end of period ⁶⁾	1.00	0.75	0.75	0.05	0.75	0.05	0.05	0.25	0.50	
Current account, EUR mn	-3428	-5894	-4247	-3735	679	656	-2500	-2500	-3100	
Current account, % of GDP	-2.4	-3.9	-2.7	-2.5	1.9	1.9	-1.7	-1.6	-1.9	
Exports of goods, BOP, EUR mn	70983	86083	97972	102484	26444	25144	104000	111000	122000	
annual change in %	-16.3	21.3	13.8	4.6	8.4	-4.9	1.0	7.0	10.0	
Imports of goods, BOP, EUR mn	67684	83991	94298	96686	24381	22991	96000	100000	109000	
annual change in %	-19.2	24.1	12.3	2.5	5.9	-5.7	-1.0	4.0	9.0	
Exports of services, BOP, EUR mn	13924	15812	16646	17174	4029	4073	18000	19000	21000	
annual change in %	-6.6	13.6	5.3	3.2	6.8	1.1	3.0	8.0	9.0	
Imports of services, BOP, EUR mn	11126	12839	14262	15191	3443	3394	16000	17000	18000	
annual change in %	-6.9	15.4	11.1	6.5	6.7	-1.4	3.0	8.0	8.0	
FDI inflow, EUR mn	2082	4644	1632	8244	1460	2194	4800	6000	.	
FDI outflow, EUR mn	685	882	-231	1044	237	1084	1300	1300	.	
Gross reserves of NB excl. gold, EUR mn	28556	31357	30675	33536	31742	34240	.	.	.	
Gross external debt, EUR mn	61940	70498	72770	77205	77555	77078	.	.	.	
Gross external debt, % of GDP	43.6	47.0	46.8	50.7	50.9	52.0	.	.	.	
Average exchange rate CZK/EUR	26.44	25.28	24.59	25.15	25.08	25.57	25.75	25.50	25.25	
Purchasing power parity CZK/EUR	18.46	18.49	18.09	17.81	.	.	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2. Gross agricultural production refers to Economic Accounts for Agriculture (EAA).

1) Preliminary. - 2) From 2011 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) Including part of the Ministry of Defence and the Ministry of the Interior. - 6) Two-week repo rate.

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