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The Czech Republic:
Fragile recovery

The dismal year 2009 ended with GDP falling less steeply in the fourth quarter than earlier. Although the pace of contractions of private consumption and inventories even accelerated, on a number of counts things were clearly improving. Strong positive growth in public consumption was sustained, despite the officially declared intention to carry through a determined consolidation of public finances. The fall in fixed capital formation became more moderate, though the very strong fall in the volume of newly installed machinery and equipment continued. Most importantly, after a year of sustained massive contraction, exports of goods and services resumed growth. Growth of exports was still accompanied by falling imports.

In the first quarter of 2010 export growth accelerated further. In current euro terms, exports of goods jumped by 18%, definitely ahead of imports which rose by 16%. Strengthening foreign demand for the products of Czech manufacturing (which account for over 90% of total exports) pulled up industrial production (by 7.5% in real terms). However, because of protracted deflation in industrial production prices, the sales of industry (at current prices) were up by mere 2.5% vs. the same period of 2009. Export sales rose by over 8% while the domestic sales of industrial goods contracted further in both nominal and real terms. The average wage in larger industrial firms (employing over 50 persons) went up quite nicely (5.8% nominally, or 5.1% in real terms). But these firms reduced overall employment massively (by 11%). Labour productivity and unit labour costs improved strongly. Provisional data for April indicate that the above tendencies have been continuing, but they may become slightly less intensive. Importantly, the producer price index seems to have stabilized (after 16 months of trending downwards).

While the performance of industry gives rise to muted optimism, the situation in the construction sector continues to be bad. In real terms the volume of construction output declined by 22% (in residential construction by 27%). Although this can be partly attributed to particularly harsh weather conditions in January and February, there is no doubt that the demand for construction is still weak. In the first quarter of 2010 the larger construction firms reduced employment (by 7%), while raising average wages by 1.8% in real terms.

In the first quarter of 2010 the GDP grew for the first time since the third quarter of 2008. The fall of private consumption nearly stopped, while the growth of public consumption slowed down strongly. Gross fixed capital formation has continued to decline at high speed, the decline in inventories has stopped. Actually, inventories have risen, contributing 0.6 percentage points to the overall growth. Real growth of exports of goods and services has accelerated further. Also imports started to grow strongly – for the first time since the third quarter of 2008. The contribution of foreign trade to the GDP growth (+1.9 p.p.) was lower than in the last quarter of 2009 (+2.9 p.p.).

The steady decline in output levels throughout 2009 was followed, with some delay, by falling average numbers of hours worked and employment. Even though this put a brake on the growth of average wages (not very effective yet in the case of the corporate sector), labour productivity has declined resulting in unit labour costs increasing somewhat. Continuing deflation in producer prices strengthened – during 2009 – the rise in real unit labour costs (or in the share of wages in nominal output). That indicated the presence of 'profit squeeze'. Ongoing gradual recovery of output in 2010 will not prevent further downward adjustments in employment levels. It is estimated that with the GDP rising by 1-2% in 2010, the dishoarding of employment will only be concluded sometime in 2011. In the meantime the losses on labour productivity (and unit labour costs) suffered by firms in 2009 will have been reduced to the levels justifying renewed growth in employment. Consequently, growth in the total economy's wage bill is likely to be subdued in 2010. This will probably restrict growth of household consumption, at least temporarily. It may be remarked that also other types of household income are likely to remain depressed. Mixed income and especially the property income received fell quite dramatically in 2009: not only the employees are affected by the recession. Although these incomes will not fall as dramatically in 2010, they may not fully recover from the losses suffered earlier. Higher taxes and mandatory social security contributions that are part of the fiscal consolidation package officially enforced will, if carried through mercilessly, further erode the real purchasing value of the household sector's disposable income. Under such conditions even a falling household saving rate may not prevent a fall in households' real consumption.[1]

Inventories – whose strong contraction was the main source of output decline in 2009 – are hoped to recover in 2010. However, growth in fixed investment is not likely to

[1] The budget for 2010 enacted by the liberal-leaning caretaker government stipulates a number of 'austerity' measures aimed at cutting the deficit to 5.3% of GDP. Transfers to households (e.g. sickness benefits, pensions) are to be streamlined, the tax burden on households raised, the public sector's wage bill reduced, and rates of indirect taxation increased. But taxation of the corporate sector is to become lighter,

accelerate. Firms' financial position is still weak, the levels of unused capacities quite high and prospects of higher consumer demand rather bleak. Moreover, even though the Czech National Bank's policy has been very relaxed, the commercial banks' interest rates on loans to the business sector are not – given deflationary producer price tendencies – very encouraging. Indeed, the stock of loans to the corporate sector has been generally declining. Also the stock of loans to households, which increased moderately in the first half of 2009, has been contracting recently. Overall, the stagnant stock of debt of the entire non-financial private sector reflects that sector's weak demand for credit, and its own weak growth outlook. It may be added that the commercial banking sector's position is very good: the sector earns handsome profits on its assets (whose quality is reportedly very high). Czech banks continue their 'safety first' policies. The capital adequacy ratio even increased in 2009, reaching 14.1%, liquidity has been more than satisfactory. Besides, the total values of loans made continue to fall short of those of the deposits accepted, minimizing the need for external financing.

Under simultaneous contractions in exports and imports, foreign trade proved a disappointment in 2009 – contributing negatively to the overall GDP growth. This will be changing in 2010 and beyond. The contributions of foreign trade to overall growth will become positive even if exports and imports keep rising at the same speeds. However, the size of those contributions may still be rather moderate. The demand for Czech exports may turn out to be restricted by rather weak recovery in the euro area (and in Germany in particular). Moreover, the Czech currency – which has regained some of its 2008 strength – will not prevent an undue rise in imports. On the other hand, improving industrial competitiveness may induce sizeable FDI inflows.

Overall, a muted recovery in 2010 is possible. However that recovery critically hinges on the performance of foreign demand. Although it is generally expected that in 2010 the euro area should record positive growth, its actual strength may turn out to be a disappointment. If the euro area is visited by renewed recession, the Czech Republic will not be spared another recession too. Staking one's own prosperity on foreign prosperity is not only very risky; in the Czech case it is also unreasonable. Unlike many other countries the Czech economy has remarkable buffers allowing the active conduct of a more expansionary fiscal policy. In the same vein, its commercial banking sector has also vast room for a more active policy. Under these conditions the pursuit of fiscal consolidation and a certain passivity on the monetary front certainly insulates the economy from fiscal and monetary-instability risks even further. But, by leaving the economy at the mercy of foreign trade, the policy seems to enhance the overall risks facing the whole economy all the same.

Against expectations, the parliamentary elections did not bring to power the opposition Social Democrats. The next government will be formed by a broad liberal-conservative coalition. That government cannot be expected to stray off the fiscal consolidation plans in the near future. But if those plans bring much social discontent and not real growth recovery, the fiscal plans for 2011 may get a bit less ambitious. Consequently, growth in 2011 and beyond may accelerate under the impact of domestic demand becoming stronger due to a more relaxed fiscal stance.

Table CZ

Czech Republic: Selected Economic Indicators

	2006	2007	2008	2009 1)	2009	2010	2010	2011	2012
					1st quarter			Forecast	
Population, th pers., average	10269.1	10334.2	10424.3	10490.0	.	.	10550	10600	10650
Gross domestic product, CZK bn, nom.	3222.4	3535.5	3689.0	3627.2	875.9	870.6	3720	3890	4130
annual change in % (real)	6.8	6.1	2.5	-4.2	-3.6	1.1	1.0	2.5	3.5
GDP/capita (EUR at exchange rate)	11100	12300	14200	13100	.	.	.	.	.
GDP/capita (EUR at PPP)	18200	19900	20200	18900	.	.	.	.	.
Consumption of households, CZK bn, nom.	1537.2	1658.8	1803.7	1804.4	430.3	430.3	.	.	.
annual change in % (real)	5.1	4.8	3.6	-0.3	0.8	-0.4	0	2	3
Gross fixed capital form., CZK bn, nom.	796.3	890.3	883.2	822.1	189.7	174.2	.	.	.
annual change in % (real)	6.0	10.8	-1.5	-8.3	-9.4	-6.6	-3	4	6
Gross industrial production									
annual change in % (real)	8.3	10.6	-1.9	-13.4	-19.1	7.5	3	4	6
Gross agricultural production									
annual change in % (real)	-4.2	3.1	6.6	-0.3	.	.	.	.	.
Construction industry									
annual change in % (real)	6.1	7.0	-0.2	-0.8	-11.4	-32.1	.	.	.
Employed persons - LFS, th, average	4828.1	4922.0	5002.5	4934.3	4946.8	4829.2	4860	4860	4910
annual change in %	1.3	1.9	1.6	-1.4	-0.2	-2.4	-1.5	0	1
Unemployed persons - LFS, th, average	371.7	276.6	229.8	352.2	302.8	422.7	.	.	.
Unemployment rate - LFS, in %, average	7.2	5.3	4.4	6.7	5.8	8.2	8.5	8.0	7.5
Reg. unemployment rate, in %, end of period	7.7	6.0	6.0	9.2	7.7	9.7	.	.	.
Average gross monthly wages, CZK 2)	20219	21694	23542	23488	22263	22748	.	.	.
annual change in % (real, gross)	3.9	4.4	2.1	3.0	0.8	1.5	1	3	3
Consumer prices (HICP), % p.a.	2.1	2.9	6.3	0.6	1.5	0.4	1.5	2.0	2.5
Producer prices in industry, % p.a.	0.1	2.6	0.4	-1.5	1.9	-3.9	.	.	.
General governm. budget, EU-def., % GDP									
Revenues	41.1	41.8	40.2	40.3	.	.	41.4	41.7	.
Expenditures	43.7	42.5	42.9	46.1	.	.	47.0	47.4	.
Net lending (+) / net borrowing (-)	-2.6	-0.7	-2.7	-5.9	.	.	-5.6	-5.7	-4.5
Public debt, EU-def., in % of GDP	29.4	29.0	30.0	35.4	.	.	39	42	45
Discount rate of NB, % p.a., end of period	1.5	2.5	1.3	0.3	0.8	0.3	0.5	2.5	2.5
Current account, EUR mn	-2745	-4090	-962	-1465	904	621	-1000	-2000	-2000
Current account in % of GDP	-2.4	-3.2	-0.7	-1.1	2.9	1.8	-0.7	-1.3	-1.2
Exports of goods, BOP, EUR mn	75706	89379	99158	80675	18921	22311	89000	96000	108000
annual growth rate in %	20.6	18.1	10.9	-18.6	-25.1	17.9	10	8	12
Imports of goods, BOP, EUR mn	73415	85038	95031	73842	17411	19889	80000	85000	94000
annual growth rate in %	20.8	15.8	11.8	-22.3	-26.1	14.2	8	6	10
Exports of services, BOP, EUR mn	11086	12311	14849	14575	3491	3526	15000	17000	19000
annual growth rate in %	16.8	11.0	20.6	-1.8	2.0	1.0	4	10	10
Imports of services, BOP, EUR mn	9494	10526	12210	13578	2956	3810	15000	17000	19000
annual growth rate in %	15.0	10.9	16.0	11.2	10.6	28.9	8	12	10
FDI inflow, EUR mn	4363	7667	4467	1935	814	2062	5000	.	.
FDI outflow, EUR mn	1172	1187	2964	960	281	663	500	.	.
Gross reserves of NB excl. gold, EUR mn	23684	23456	26377	28478	27392	29443	.	.	.
Gross external debt, EUR mn	43415	51642	59689	60069	56800	61033	.	.	.
Gross external debt in % of GDP	37.0	38.9	43.5	43.8	41.5	42.7	.	.	.
Average exchange rate CZK/EUR	28.34	27.77	24.95	26.44	27.62	25.88	26.0	25.5	25.0
Purchasing power parity CZK/EUR	17.23	17.17	17.55	18.30	.	.	.	.	.

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

1) Preliminary - 2) Enterprises with 20 and more employees, including part of the Ministry of Defence and the Ministry of the Interior. From 2009 all enterprises covered.

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