



Leon Podkaminer

The Czech Republic: policy eased to limit the damage

In the first quarter of 2009 the GDP declined by 3.3% (over the same period of 2008). In real terms exports of goods and services fell faster than their imports. Foreign trade in goods and services contributed -1.7 percentage points (p.p.) to the overall GDP growth. Gross fixed investment fell moderately, but a massive contraction in inventories resulted in gross capital formation contributing -4.1 p.p. Rising consumption (public and private combined) limited the GDP decline, contributing +2.5 p.p.

The decline in industrial production which started already in October 2008 has been deepening: in April production was down 22%, year-on-year, from 17% in March. The value of new orders placed with industry was lower than a year earlier by 26.7%. Production of intermediate and durable consumer goods is most affected, followed by capital goods. Production of non-durable consumer goods is also declining, though less so. Employment in larger industrial firms (i.e. staffed with over 50 persons) was down 11% year-on-year in April, the average monthly wage was up 2.3%.

In nominal terms, foreign trade in goods contracted massively. The decline in imports was only marginally faster than that of exports. In CZK terms the trade surplus increased. The depreciation of the koruna, which had started in July 2008 and culminated in February 2009, turned out too weak to reduce imports much more strongly. Nevertheless, that depreciation was sufficient to reduce the trade and current account surpluses expressed in euro.¹ (In CZK terms the surpluses in question rose in the first quarter of 2009.)

The levels of risks facing the Czech banking system remain quite low. At the end of March 2009, most prudential indicators stood at highly satisfactory levels, generally much better than reported a year earlier. The capital adequacy ratio is 12.9, the share of liquid assets in total assets is over 25%. The deposit/loans ratio exceeds 1 by a wide margin, the net external position of Czech banks is positive (uniquely among the NMS). Moreover, unlike in other NMS, the value of loans denominated in foreign currencies has been limited.² The share of non-performing loans is fairly low – but it is likely to rise to about 5-6% if the real activity

¹ In July 2008 the CZK/EUR rate fell below 23, in February 2009 it touched 29.5. Since early March 2009, the rate oscillates around 26.6. The period of the weakening Czech koruna was marked by increased outflows of portfolio capital and falling official reserves. The recent (moderate) strengthening of the koruna is associated with the return of larger capital inflows and a renewed rise in official reserves.

² The share of foreign exchange-denominated loans to business is about 18%. The share of such loans to households has been negligible.

contracts further. Net post-tax profits earned by banks in the first quarter of 2009 stood at CZK 11.9 billion (6.3% less than a year earlier). The good position of banks notwithstanding, some precautionary measures were taken by the authorities. These measures include an increased level of deposit guarantee (50 thousand euro) and the introduction of repurchase facilities to improve the distribution of liquidity. The range of instruments acceptable as collateral has been quite narrow (limited to treasury bonds). This does not seem to matter so far because of the persisting excess liquidity of the banking sector. In anticipation of harder times ahead, the Czech National Bank (CNB) has been easing its policy. The most recent CNB decision (May 2009) lowered its basic interest rate to 1.5% and the deposit rate to 0.5%. Further cuts in CNB rates are very likely soon because of rising dangers of price deflation.

The ongoing easing of monetary policy has proved incapable of stopping unfavourable monetary developments. One reason for this is the banks' response to the eased monetary policy. So far banks fail to pass the CNB interest rate cuts on to their lending rates. The latter remain flat. Because of the ongoing fast disinflation, the real lending rates are becoming quite high. Given the developing massive slack in the non-financial business sector, its demand for credit cannot be strong. But rising real interest rates surely suppress the corporates' demand for credit even further. The nominal stock of loans to the real economy rose a mere 0.3% in the first quarter of 2009. (Prior to the outbreak of the crisis, the stock of loans kept rising much faster – on average by 5.5% quarterly in 2006-2008.) The stock of loans to households has been performing quite well, rising by 3% during the first quarter of 2009 (and by 4.4% in the last quarter of 2008). But the non-financial business sector is doing badly. The stock of loans to the sector which contracted by 0.9% already during the last quarter of 2008 fell by another 2% in the first quarter of 2009.³ The figures for April are even less encouraging.

While the monetary policy appears unable do much more to stimulate the real economy, higher hopes are staked on the fiscal policy. Two fiscal packages have so far been introduced. The first, approved already in December 2008, lowered the fiscal revenues by decreasing the social security contributions paid by employees and raised the expenditure – primarily on various items related to infrastructure investment. Overall, the package claimed to have raised the deficit/GDP ratio by about 0.7 percentage points. Apart from that, according to that package, the Czech Export Bank and an agriculture support fund received some capital injections. In January the government decided on one-off measures extending additional subsidies and, at the same time, streamlining the planned ordinary expenditure. The net effect of these measure reduces the deficit/GDP ratio by 0.1 percentage points. The last (as yet) stimulation package was proposed in February 2009. Most of its measures do not need Parliament's approval. (But some, e.g. on the reduction of social security contributions, await such approval.) On the revenue side, the package reduces the employers' social security contributions, allows faster depreciation of fixed assets and extends the VAT deductions on personal vehicles. On the expenditure side, the package stipulates the extension of various subsidies, also to credits to

³ The recent rates of decline of the nominal stock of loans to the business sector underestimate the true size of credit contraction. The stocks of these loans are inflated on account of the strong depreciation of CZK which started in July 2008 and culminated in February 2009.

small and medium-sized enterprises. Some provisions of the package are one-off, some (e.g. relating to VAT) are permanent. In total, the package will increase the deficit/GDP ratio by 1.1 percentage points in 2009. The public sector deficit in 2009 would thus rise to at least 4.5% of the GDP. Of course it is hard to assess the eventual longer-term consequences for growth of the fiscal stimuli described above. In the shorter term, these stimuli will certainly be helpful. This is evidenced by the data for the first quarter of 2009 – with the growth of public consumption accelerating to 5.3%.⁴

Several unknowns enter the equation determining GDP growth in 2009 and thereafter. The first is the GDP growth rate in the EU itself which, to a large extent, will affect the Czech export performance. While it is now clear that exports are unlikely to recover anytime soon, uncertainties about imports persist. In the first quarter of 2009 imports trailed behind exports – but this is likely to be corrected. If the Czech koruna remains relatively weak, domestic production should become sufficiently competitive to replace at least some imports. Weak exports may also reduce the demand for imported components and raw materials. All in all, the (negative) contribution of foreign trade to GDP growth is likely to become smaller in the course of 2009. Gross fixed investment is likely to continue declining, but the reductions in inventories may become less pronounced.

Private consumption will probably carry the day. Aided by continuing growth of lending to households, 3% growth of private consumption in 2009 continues to be quite likely. Rapid disinflation and cuts in social security premia support private spending. In addition, public consumption is likely to be supportive – just as in the first quarter.

The overall wiiw point-estimate of the GDP growth in 2009 is -1.5%. This is more optimistic than recently projected by the Czech Ministry of Finance and the Czech National Bank. The former expected (in its forecast announced in April 2009) a GDP growth rate of -2.3%. For the first quarter the Ministry's forecast envisaged growth rates of private and public consumption much lower than actually recorded. The Ministry had expected total consumption to rise by 2%, while actually consumption rose by 3.6%.⁵ The entire 2009 growth rates of private and public consumption envisaged by the Ministry's forecast (0.9% and 1.8% respectively) may now need to be revised upwards. (The same applies to the May 2009 CNB forecast which envisaged 0.4% decline in private consumption in 2009.)

⁴ Public consumption stagnated in 2006 through 2008. The last time public consumption rose in excess of 5% was the third quarter of 2005.

⁵ The Ministry's forecasts for gross fixed investment, exports and imports in the first quarter of 2009 turned out fairly accurate. But the Ministry failed to predict the abrupt fall in inventories: in effect it expected only a moderate decline in gross capital formation (-1.2%) – far off the true one (-13.9%).

Table CZ

Czech Republic: Selected Economic Indicators

	2005	2006	2007	2008 ¹⁾	2008 1st quarter	2009	2009	2010	2011
							Forecast		
Population, th pers., average	10235.8	10269.1	10334.2	10427.9	.	.	10500	10550	10600
Gross domestic product, CZK bn, nom. ²⁾	2983.9	3215.6	3530.2	3705.9	874.2	878.0	3690	3800	4010
annual change in % (real) ²⁾	6.3	6.8	6.0	3.2	3.5	-3.3	-1.5	1	3
GDP/capita (EUR at exchange rate)	9800	11100	12300	14200	.	.	.	.	.
GDP/capita (EUR at PPP)	17100	18300	20000	20400	.	.	.	.	.
Consumption of households, CZK bn, nom. ²⁾	1442.7	1543.0	1669.3	1812.3	419.3	437.0	.	.	.
annual change in % (real) ²⁾	2.5	5.4	5.2	2.9	2.8	3.0	2	3	3
Gross fixed capital form., CZK bn, nom. ²⁾	741.9	792.4	857.7	888.3	201.7	203.0	.	.	.
annual change in % (real) ²⁾	1.8	6.5	6.7	3.1	0.5	-3.4	-8	0	4
Gross industrial production									
annual change in % (real) ^{3/4)}	6.7	11.1	9.0	0.4	2.2	-21.0	-12	1	4
Gross agricultural production									
annual change in % (real)	-2.0	-4.2	3.1	6.9	.	.	.	.	.
Construction industry (build.& civil engin.)									
annual change in % (real) ^{3/4)}	2.4	6.6	5.8	0.1	0.7	-11.5	.	.	.
Employed persons - LFS, th, average	4764.0	4828.1	4922.0	5002.5	4958.4	4946.8	.	.	.
annual change in %	1.2	1.3	1.9	1.6	1.9	-0.2	-0.5	-0.5	0.5
Unemployed persons - LFS, th, average	410.2	371.7	276.6	229.8	244.5	302.8	.	.	.
Unemployment rate - LFS, in %, average	7.9	7.1	5.3	4.4	4.7	5.8	7	7.0	6.5
Reg. unemployment rate, in %, end of period	8.9	7.7	6.0	6.0	5.6	7.7	.	.	.
Average gross monthly wages, CZK ⁵⁾	18992	20219	21694	23542	22407	22941	.	.	.
annual change in % (real, gross)	3.3	3.9	4.4	2.1	2.6	0.3	1.5	3.5	4
Consumer prices (HICP), % p.a.	1.6	2.1	2.9	6.3	7.6	1.5	1.0	2.0	2.5
Producer prices in industry, % p.a. ⁴⁾	1.4	0.1	2.6	0.0	1.1	1.9	.	.	.
General governm. budget, EU-def., % GDP ⁶⁾									
Revenues	41.4	41.2	42.0	40.9	.	.	38.0	38.5	.
Expenditures	45.0	43.8	42.6	42.4	.	.	42.5	42.5	.
Net lending (+) / net borrowing (-)	-3.6	-2.6	-0.6	-1.4	.	.	-4.5	-4.0	-3.5
Public debt, EU-def., in % of GDP ⁶⁾	29.8	29.6	28.9	29.8	.	.	34.0	37.0	.
Discount rate of NB, % p.a., end of period	1.0	1.5	2.5	1.25	2.75	0.75	0.5	1	2.5
Current account, EUR mn	-1346	-2924	-4024	-4610	1185	897	-2500	-2000	-3000
Current account in % of GDP	-1.3	-2.6	-3.2	-3.1	3.5	2.8	-1.8	-1.4	-1.9
Exports of goods, BOP, EUR mn	62781	75706	89379	98824	25186	18982	84000	90000	97000
annual growth rate in %	16.1	20.6	18.1	10.6	17.4	-24.6	-15	7	8
Imports of goods, BOP, EUR mn	60797	73415	85038	94677	23508	17432	78000	83000	88000
annual growth rate in %	11.5	20.8	15.8	11.3	18.6	-25.8	-18	7	6
Exports of services, BOP, EUR mn	9491	11086	12493	15133	3497	2974	14200	.	.
annual growth rate in %	22.3	16.8	12.7	21.1	31.5	-15.0	-6	.	.
Imports of services, BOP, EUR mn	8254	9449	10459	11847	2625	2413	11000	.	.
annual growth rate in %	13.9	14.5	10.7	13.3	17.8	-8.1	-7	.	.
FDI inflow, EUR mn	9354	4363	7667	7356	1137	1305	.	.	.
FDI outflow, EUR mn	-12	1172	1187	1299	295	669	.	.	.
Gross reserves of NB excl. gold, EUR mn	24868	23684	23456	26377	23761	27413	26000	.	.
Gross external debt, EUR mn	39379	43415	51642	57778	54281	.	72000	.	.
Gross external debt in % of GDP	38.3	37.1	39.0	41.9	39.4	.	43	42	42
Average exchange rate CZK/EUR	29.78	28.34	27.77	24.95	25.55	27.62	26.5	26.0	25.5
Purchasing power parity CZK/EUR	17.09	17.12	17.13	17.40	.	.	.	.	.

1) Preliminary. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices). - 3) Enterprises with more than 20 employees. - 4) Quarterly data and forecasts according to NACE Rev. 2. - 5) Enterprises with more than 20 employees, including part of the Ministry of Defence and the Ministry of the Interior. - 6) According to ESA'95, excessive deficit procedure.

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