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## **The Czech Republic: slowdown underway**

### **Weak consumption growth and stagnant investments**

After 11 quarters witnessing the GDP rising by more than 6% (year-on-year), growth has slowed down perceptibly, to 5.3%, in the first quarter of 2008. The rate of growth of gross industrial production even halved (to 5.7%). Despite favourable weather conditions the construction sector came close to stagnation (after experiencing real growth of nearly 30% a year earlier). The value of orders placed with the industry remained virtually stagnant (and the total value of export orders declined). Yet strong growth in production volumes and in values of new orders placed has been continuing in the major (foreign-controlled) exporting branches which have been boosting the economy (e.g. manufacture of medical, precision and optical instruments; transport equipment; electrical machinery and apparatus, etc.). Production and sales of domestic manufacturing products (such as food products) have declined in real terms, suggesting that the food price hikes are having significant negative effects on consumer demand. While information on the commodity composition of consumer demand is available upon a long delay, the current data on the volume of aggregate consumer demand suggest that its growth has slowed down considerably – from 7% in the first quarter of 2007 to 2.7% in the first quarter of 2008. Also capital formation performed very weakly, while rising inventories have had inordinately high contributions to GDP growth.<sup>1</sup> Foreign trade, with exports of goods and services rising by 12.5% and imports by 10.8% (both in real terms), remains a bright spot presently contributing 2.1 percentage points to the overall GDP growth.

### **Fiscal reform taking its toll**

Inflation, still very low in the first half of 2007, became significantly higher in the closing months of the year, with the externally-conditioned increases in prices of food peaking in October and November 2007. In December inflation was calming down – only to be given a strong push by some provisions of the fiscal reform which was inaugurated on 1 January 2008. The reform introduced a higher VAT tax rate on food (9% instead of 5%) and raised regulated prices/tariffs in transportation, energy (including electricity), public utilities, housing rents and also some fees in public health services. The consumer price index jumped by 3% (month-on-month) in January (up from 0.5% in December

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<sup>1</sup> According to the recently revised official statistics, in 2006 and 2007 the rising inventories contributed 1 and 1.1 percentage points respectively to the overall GDP growth. In the first quarter of 2008 that contribution was 1.3 percentage points.

2007), with food prices rising 2.3%<sup>2</sup> and the price index of housing, water, energy and fuels by 5.2%. A record hike was registered for the price index for the aggregate encompassing health services which at one stroke moved up by no less than 30%. All in all, out of the 7.4% (year-on-year) inflation in the first quarter of 2008, some 4.2 percentage points are attributed to changes in indirect taxes and the regulated prices (the latter alone rising by an estimated 15%).

Rising indirect tax rates and regulated prices had one-off effects on inflation at the beginning of 2008. The second-round effects will follow but – unless associated with strong compensatory hikes in wages and other incomes (such as pensions) – will be dying down relatively quickly. This is acknowledged by the Czech National Bank which, though likely to remain watchful, does not seem to realize any urgent need to tighten its policy. Consistent – and much stronger than generally believed even recently – nominal appreciation of the Czech currency will be acting as a quite powerful brake on inflation, which in 2009 is likely to fall below the 3% mark.

The fiscal reform's consequences for real growth do not seem to be as benign, or short-lived, as is the case with inflation. The short-term effects are already having a negative impact on aggregate private consumption: the latter's dynamics has become rather anaemic recently. Of course, it may be argued that the effects of the administered price shock on consumer demand are transient and due to temporarily enhanced uncertainties because aggregate disposable household incomes (and even average wages) have been rising in real terms. In actual fact, a part of that rise in aggregate disposable income is a by-product of the fiscal reform itself (lower personal income tax with a single rate of 15%, gradually lowered corporate income tax rate). However, even if the average household realizes the facts (improving disposable incomes and falling inflation), its propensity to consume out of the disposable income may have been permanently lowered. This is so because on balance the whole reform stipulates a definite redistribution of the total available disposable income among household classes distinguished by the levels of affluence. The reform is clearly anti-egalitarian in character, with the affluent classes gaining (via lower personal tax rates and lower social security contributions) most and the poor ones losing (via higher VAT on food and higher regulated prices of necessities, but also because of reduced levels of potential publicly financed benefits) most. Given the fact that low-income households tend to spend proportionately more out of their incomes than the rich ones, the redistribution implicit in the fiscal reform is no doubt reducing the average private consumption propensity (and will have important additional structural effects as well)<sup>3</sup>. Alternatively, the fiscal reform is increasing the household sector's propensity to save. Indeed, this is an important motivation of the reform. (However, it is hard to see what is so positive about having a higher private saving propensity – perhaps except mitigating dangers of a credit-financed spending boom.) Unless rising saving propensity happens to be associated with higher private propensity to invest (in fixed

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<sup>2</sup> In one of the reports of the Czech National Bank it has been suggested that the actual inflationary impact of the increased VAT on food may have been higher, as the retail food price increases in the fourth quarter of 2007 already factored-in higher VAT rates.

<sup>3</sup> For example, consumer demand for basic necessities (important for the poor households) may become especially depressed. The decline in sales of the products of the food industry recorded in the first quarter of 2008 may be a reflection of such a structural change.

assets), the higher saving propensity is likely to act as a permanent impediment to overall GDP growth.

### **Anaemic fixed investment and vigorous foreign trade**

As expected, gross fixed investment remains anaemic – and that despite domestic conditions that are generally considered conducive (high levels of productive capacity utilization, adequate average profitability of the non-financial corporate sector and still relatively low real interest rates). Apart from enhanced uncertainties over e.g. exchange rates or global demand or price developments, there seem to be some secular reasons for the weakness of gross fixed investment in the Czech Republic. Given the fairly high levels of fixed capital installed, the return on rising fixed assets may be judged rather unsatisfactory (for instance as compared with the returns to be achieved elsewhere). Of course, the returns to investments in selected branches are still very high, which is evidenced by the size (and concentration) of the recent FDI inflows. Besides, investments are and will be supported by increased EU transfers.

Investments apart, increased EU transfers and high inflows of FDI help to support the strong appreciation of the Czech koruna. Neither the strengthening currency, nor the ongoing growth slowdown in the 'old' EU, are affecting the performance of foreign trade too much – at least for the time being. In euro terms, exports of both goods and services continue to rise strongly. Growth of imports was slightly faster – which is justified e.g. by higher world market prices of energy carriers. In the first quarter of 2008 the positive balance of trade in goods has remained unchanged though, while the positive balance of trade in goods and services rose by close to 25% (to over EUR 2.5 billion).

The positive trends in foreign trade will persist in 2008 as well as in 2009-2010. Trade will continue to contribute positively to GDP growth, especially as the moderated household spending is likely to reduce imports of consumer goods. Gains in exports will be made possible by the ongoing expansion of production capacities in the key export-oriented branches (such as the automotive and related industries). Given the still comparatively low levels of unit labour (and other) costs in manufacturing and the ongoing productivity and quality improvements, the rising nominal wages (and even some additional nominal appreciation) need not be a problem for the large foreign-controlled firms.

The growth slowdown in 2008 has clearly domestic roots – the shock generated by the fiscal reform being the major one. In 2009 and 2010 some effects of the shock will most probably wear off. But a renewed pronounced acceleration of overall growth is not guaranteed. Much will depend on the evolution of the business sector's investment sentiments. If the cuts in the corporate income tax rates prove effective enough in promoting a much faster pace of fixed capital formation, the overall growth may become impressive again. Otherwise, growth rates may hover at about 5% per year – still not a bad result for a country that is relatively well off in per capita income terms (more than 80% of the EU average) and blessed with low levels of unemployment.

Table CZ

**Czech Republic: Selected Economic Indicators**

	2004	2005	2006	2007 <sup>1)</sup>	2007 1st quarter	2008	2008	2009	2010
							Forecast		
Population, th pers., mid-year	10206.9	10234.1	10266.6	10325.9	.	.	10350	10380	10410
Gross domestic product, CZK bn, nom. <sup>2)</sup>	2814.8	2983.9	3215.6	3551.4	821.9	893.2	3940	4250	4570
annual change in % (real) <sup>2)</sup>	4.5	6.3	6.8	6.6	6.6	5.2	4.7	5	5
GDP/capita (EUR at exchange rate)	8644	9789	11051	12388	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	16260	17130	18410	20120	.	.	.	.	.
Gross industrial production									
annual change in % (real) <sup>3)</sup>	9.6	6.7	11.2	8.2	11.3	5.7	6.5	8	8
Gross agricultural production									
annual change in % (real)	14.9	-4.8	-4.2	.	.	.	.	.	.
Construction industry									
annual change in % (real)	9.7	4.2	6.6	6.7	28.8	4.2	.	.	.
Consumption of households, CZK bn, nom. <sup>2)</sup>	1399.2	1442.7	1543.0	1680.3	386.6	424.6	.	.	.
annual change in % (real) <sup>2)</sup>	2.9	2.5	5.4	5.9	7.0	2.7	4	5	5
Gross fixed capital form., CZK bn, nom. <sup>2)</sup>	727.2	741.9	792.4	857.0	187.3	199.1	.	.	.
annual change in % (real) <sup>2)</sup>	3.9	1.8	6.5	5.8	5.1	2.0	2	4	5
LFS - employed persons, th, avg.	4706.6	4764.0	4828.1	4922.0	4865.0	4958.3	.	.	.
annual change in %	-0.6	1.2	1.3	1.9	1.7	1.9	1.5	1	0
LFS - employed pers. in industry, th, avg.	1409.0	1422.0	1493.3	1532.5	1515.7	1553.9	.	.	.
annual change in %	-1.1	0.9	5.0	2.6	2.7	2.5	.	.	.
LFS - unemployed, th pers., average	425.9	410.2	371.3	276.3	311.2	243.8	.	.	.
LFS - unemployment rate in %, average	8.3	7.9	7.1	5.3	6.0	4.7	5.0	5	4.5
Reg. unemployment rate in %, end of period	9.5	8.9	7.7	6.0	7.3	5.6	5.5	.	.
Average gross monthly wages, CZK <sup>4)</sup>	18041	18992	20219	21694	20411	22531	.	.	.
annual change in % (real, gross)	3.7	3.3	3.9	4.4	6.2	2.8	3	4	4
Consumer prices, % p.a.	2.8	1.9	2.5	2.8	1.6	7.4	6	2.8	2.5
Producer prices in industry, % p.a.	5.7	3.0	1.6	4.1	3.2	5.7	4	3	2
General governm. budget, EU-def., % GDP <sup>5)</sup>									
Revenues	42.2	41.4	41	40.8	.	.	40.7	40.7	.
Expenditures	45.1	44.9	43.6	42.4	.	.	42.2	41.8	.
Net lending (+) / net borrowing (-)	-2.9	-3.6	-2.6	-1.6	.	.	-1.4	-1.1	.
Public debt, EU-def., in % of GDP <sup>5)</sup>	30.4	29.7	29.4	28.7	.	.	28.1	27.2	.
Discount rate, % p.a., end of period	1.5	1.0	1.5	2.5	1.5	2.8	3	2.5	1.5
Current account, EUR mn	-4650	-1638	-3575	-3222	806	1058	-4600	-4300	-4700
Current account in % of GDP	-5.3	-1.6	-3.2	-2.5	2.7	3.0	-3.0	-2.5	-2.5
Gross reserves of NB incl. gold, EUR mn	20884	25054	23882	23705	23826	24016	.	.	.
Gross external debt, EUR mn	33212	39379	43415	50669	43467	.	.	.	.
Gross external debt in % of GDP	35.9	38.3	37.1	38.0	.	.	.	.	.
FDI inflow, EUR mn	4009	9354	4804	6711	1327	1125	6000	.	.
FDI outflow, EUR mn	824	-12	1172	979	108	309	1000	.	.
Exports of goods, BOP, EUR mn	54091	62781	75706	89142	21444	24895	103000	117000	131000
annual growth rate in %	25.6	16.1	20.6	17.7	19.9	16.1	16	14	12
Imports of goods, BOP, EUR mn	54517	60797	73414	84914	19815	23263	99000	113000	127000
annual growth rate in %	20.5	11.5	20.8	15.7	17.6	17.4	16	14	12
Exports of services, BOP, EUR mn	7761	9478	10936	12307	2649	3427	13000	.	.
annual growth rate in %	12.8	22.1	15.4	12.5	8.5	29.4	15	.	.
Imports of services, BOP, EUR mn	7245	8254	9449	10318	2219	2502	11000	.	.
annual growth rate in %	12.1	13.9	14.5	9.2	4.8	12.8	10	.	.
Average exchange rate CZK/USD	25.70	23.95	22.61	20.31	21.40	17.05	.	.	.
Average exchange rate CZK/EUR (ECU)	31.90	29.78	28.34	27.76	28.04	25.55	25.4	25.0	24.5
Purchasing power parity CZK/USD	14.27	14.40	14.19	14.42	.	.	.	.	.
Purchasing power parity CZK/EUR	16.96	17.02	17.01	17.10	.	.	.	.	.

Note: The term 'industry' refers to NACE classification C+D+E.

1) Preliminary. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices). - 3) According to new calculation. -

4) Enterprises with more than 20 employees, including part of the Ministry of Defence and the Ministry of the Interior. - 5) According to ESA'95, excessive deficit procedure.

Source: wiiw Database incorporating national statistics; Eurostat; wiiw forecasts.