Leon Podkaminer

The Czech Republic:
The second dip materialises

The Czech economy is entering a recession whose depth and duration will partly depend on the euro area developments. The recession may be moderated by the Czech currency's relative weakness. While the financial conditions and the monetary policy are essentially conducive to growth, the untimely – and actually unnecessary – fiscal consolidation implemented is the primary determinant of the overall poor performance of the real economy. The prospects for 2013 and 2014 may look better because by that time the fiscal consolidation will be either successfully completed – or discontinued.

Throughout 2011, GDP growth had been slowing down much more than originally reported (dropping to a mere 0.6% in the last quarter of the year, year-on-year). Defying an official forecast of 0.2% growth for the first quarter of 2012 issued by the Finance Ministry in April 2012, GDP (adjusted for seasonal and calendar effect) fell by 0.7% according to the provisional estimate released by the central statistical. As is usual practice, the latter estimate will probably be revised downwards. In all likelihood, foreign trade will have contributed positively to GDP growth in the first quarter of 2012 (primarily on account of very weak import growth). However, both domestic consumption and investments will, of necessity, have dropped steeply. Output in the construction sector contracted by over 7% in the first quarter, while industry's domestic sales fell in real terms (export sales, however, still rose, albeit not to any marked degree). The volume of new orders placed with industry does not look promising either: in quantitative terms, both domestic and export orders have been contracting quite rapidly. The most recent official forecasts for GDP growth in 2012 (a symbolic +0.2% according to the Finance Ministry's forecast published in April and 0% according to the forecast announced by the Czech National Bank in May)[1] look increasingly unrealistic.

One generally advanced explanation for the ongoing (since the first quarter of 2011) unanticipated and swift deceleration of growth throughout 2011 places the blame on the unexpected weakening of growth in the main Czech export markets. This explanation is plausible, yet it cannot be accepted uncritically. First, growth has not been slowing down all

[1] The EU Commission Spring 2012 Forecast also envisages economic stagnation in the Czech Republic in 2012 (thereby revising its own autumn forecast by -0.7 percentage points).

that much in Germany, Slovakia and Poland (which jointly absorb about half of the Czech merchandise exports). Secondly, Czech exports did not perform perceptibly worse than anticipated in 2011. At the beginning of 2011 (i.e. prior to the Czech growth slowdown), it was assumed that exports (of both goods and services) would grow by 12% over the year. In actual fact, they rose 11%. Moreover, the contribution of foreign trade to the GDP growth rate in 2011 reached 2.6 percentage points (p.p.) rather than the 1.8 p.p. expected).[2]

While a more serious weakening of exports (owing to a sudden deterioration in the business climate in key export markets) is still a real eventuality, the actual problem facing the Czech economy has much more to do with the fiscal consolidation fever that has befallen the country's current ruling elite. The liberal-conservative government of Mr Necas (in power since mid-2010) has persisted in the pursuit of fiscal consolidation policies. Active measures taken to restrict public sector deficitsamounted to about 2.2% of the GDP in 2010. According to the Finance Ministry's *Convergence Programme of the Czech Republic* (April 2012) [3], further measures to be implemented in 2011 amounted to another 1.6% of the GDP to be followed by further extraordinary measures amounting to another 0.7% in 2012. Previous consolidation programmes assumed a reduction in the general government deficit to 3.5% of the GDP in 2012. However, as proudly stated in the Convergence Report 2012 (p.3) '...*the vigour of consolidation measures accompanied by responsible budgetary behaviour in 2011...resulted in the deficit being significantly lower. The target for 2012 was therefore improved by 0.5 p.p. to 3% of the GDP*'.

It is a pity that the vigour of fiscal consolidation appears to be associated with a definite flagging of vigour in terms of capital formation (that has also dropped on account of cuts in government investment programmes) and consumption (that has also been reduced directly through cuts in public sector employment and wage rates, and indirectly lessened by hikes in the VAT rates). Indeed, it transpires that the 'over-fulfilment' of the fiscal consolidation programmes has fused with a more pronounced growth slowdown than initially assumed. The 2011 Convergence Programme (setting less ambitious deficit targets) assumed high GDP growth (2.3%) in 2012 (with private consumption rising close to 2% and the gross fixed capital formation increasing by over 2%). According to the current Convergence Programme, both items are projected to drop in 2012 – by 0.4% and close to 4%, respectively. Of course, the eventual rates of decline in both items, however,

[2] Similarly, the current (April 2012) Finance Ministry's forecast envisaged an external balance of trade in goods and services of 56 billion CZK in the first quarter of 2012. The actual surplus was over 80 billion KCZ (about 8% of the GDP). This is not exactly a sign of external weaknesses affecting the overall GDP growth.

[3] The substance and goals of the Czech government's fiscal consolidation programme were described in detail in *wiiw Current Analyses and Forecasts*, Issue 8 (July 2011).

are likely to be much higher because the real disposable income of the private sector is likely to fall by some 1-2% in 2012. The Czech consolidation overkill has not escaped the attention of the IMF Staff Report on the Czech Republic (dated April 2012)[4] The report tactfully suggested *'...that procyclical tightening in addition to the already ambitious consolidation would unnecessarily undermine short-term growth...and that the Czech Republic has the fiscal space to allow automatic stabilisers to work...the Czech Republic will still be able to meet the budget target in 2012 without further expenditure cuts...*'. The IMF suggestions fell on deaf ears: '...*while mindful of staff arguments, the authorities disagreed...they stressed that reducing the fiscal deficit below 3% in 2013...was critically important for preserving market confidence...and noted that the government had been elected on a platform of fiscal rectitude...*' (p.7)

Even if inflation (driven by hikes in both indirect tax rates and prices of imported energy carriers) surpasses its 2% target, the Czech National Bank will keep the policy rate at 0.75%. There is still some way to go before hitting 'zero-bound'. The interest rate on the three-month interbank loans has remained stable at close to 1.2%, thus showing that the money market conditions are not only more or less normal, but, in fact, they are over-liquid. Interest rates on loans to non-financial corporations are still quite low (recently 3.1% on average), while interest rates on lending to households are fairly low, especially on mortgage loans (for example, the average interest rate on new mortgage loans extended for 5 to 10 years was 4.8% in March 2012). The financial standing of the banking sector remains very strong, with the most recent Capital Adequacy Ratio standing at 15.2% (as at end 2011). Non-performing loans (recently 5.2% of the stock of loans to households, 8.8% of the stock of loans to corporations) have been creeping upwards. However, even under the 'second dip' scenario – and making allowances for more stringent regulatory standards – the stability of the banking sector as a whole would not in any way - be seriously jeopardised – according to the recent stress tests carried out by the Czech National Bank in February 2012. The sector should retain its ability to perform its functions vis-à-vis the real economy, even if its profits are squeezed.[5] However, the risk of excessive support being lent by the Czech banks to their foreign parent organisation may have to be contained, by way of some additional regulations (for example, by limiting exposure to foreign parent organisations).

[4] http://www.imf.org/external/pubs/ft/scr/2012/cr12115.pdf

[5] In the first quarter of 2012 banks' profits rose nominally some 8% over the same period of 2011. Profitability (return on equity) approaches 20%.

Low nominal interest rates and a strong banking sector have not led to monetary expansion. Money supply (M3) stock rose 4.7% in the year ending March 2012, with the stock of loans to households rising by 5.5% and those to the corporate sector by 5.4%. Neither households nor the corporate (non-financial) sector are over-indebted in any way (while the stock of financial sector's debt falls short of 55% of the GDP). Stagnant demand for loans reflects expectations of negative income growth in both the household and corporate sectors.

By now, it is quite certain that, even if the euro area continues to 'muddle through' and avert deep recession in 2012, the Czech economy will not escape recession. That recession may be moderated somewhat, should the Czech currency remain relatively weak against the euro (which is probable). None the less, some weakening of exports would then follow. A euro-area recovery in 2013 and beyond would naturally (by way of stronger exports) help speed up growth in the Czech Republic once again. Furthermore, by that time the fiscal consolidation measures will have become less intense (also on account of the next regular parliamentary elections to be held in 2014, at the latest). The good financial standing of the banking and corporate sectors, the relatively low level of household debt, combined with the competent policy pursued by the Czech National Bank (which is determined to keep its policy in a highly relaxed mode even in the face of temporary hikes in inflation) should also help accelerate growth – initially growth in investments followed by growth in private consumption and overall GDP. Political instabilities (that can become acute anytime, given the fragility of the ruling coalition that is dogged by ample evidence of widespread corruption in high places) are unlikely to affect the course of economic events. It is an open question whether other ('structural') reforms (pertaining to labour market flexibilisation, 'leaner' social welfare systems, partial privatisation of the pension system, limitation of corruption, etc.) would then help to speed up growth. Our guess is that, even if those reforms were implemented and ultimately yielded desirable results (which by no means can be guaranteed), the results could only materialise in a very long-term perspective – certainly not within the next 2-3 years.

Table CZ

Czech Republic: Selected Economic Indicators

	2008	2009	2010	2011 [1]	2011	2012	2012	2013	2014
					1st quarter			Forecast	
Population, th pers., average	10424	10487	10520	10495	.	.	10580	10610	10640
Gross domestic product, CZK bn, nom.	3848.4	3739.2	3775.2	3809.3	884.1	898.9	3870	3980	4130
annual change in % (real)	3.1	-4.7	2.7	1.7	3.1	-0.4	-0.3	1.5	2.4
GDP/capita (EUR at exchange rate)	14800	13500	14200	14700	.	.	.	.	.
GDP/capita (EUR at PPP)	20200	19300	19400	20100	.	.	.	.	.
Consumption of households, CZK bn, nom.	1856.7	1852.5	1871.8	1897.2	448.3	451.6	.	.	.
annual change in % (real)	3.0	-0.5	0.6	-0.4	-0.6	-2.8	-0.6	0.5	1
Gross fixed capital form., CZK bn, nom.	1031.2	927.5	923.0	911.1	193.7	197.5	.	.	.
annual change in % (real)	4.1	-11.5	0.2	-1.2	-1.7	1.2	-1	2	6
Gross industrial production									
annual change in % (real)	-1.9	-13.6	10.3	6.9	12.3	2.2	2	4	6
Gross agricultural production (EAA)									
annual change in % (real)	6.8	-3.6	-7.0	7.1	.	.	.	.	.
Construction industry									
annual change in % (real)	-0.2	-0.8	-7.1	-3.5	5.9	-10.1	-5	2	3
Employed persons - LFS, th, average	5002.5	4934.3	4885.2	4904.0	4864.4	4868.5	4900	4910	4930
annual change in %	1.6	-1.4	-1.0	0.4	0.7	0.1	0.0	0.2	0.5
Unemployed persons - LFS, th, average	229.8	352.2	383.5	353.6	376.2	368.0	.	.	.
Unemployment rate - LFS, in %, average	4.4	6.7	7.3	6.7	7.2	7.0	7.1	7	6.5
Reg. unemployment rate, in %, end of period	6.0	9.2	9.6	8.6	9.2	8.9	.	.	.
Average gross monthly wages, CZK [2]	22592	23344	23864	24436	23281	24126	.	.	.
annual change in % (real, gross)	1.4	2.3	0.7	0.5	0.7	-0.1	0.5	1	2
Consumer prices (HICP), % p.a.	6.3	0.6	1.2	2.2	1.9	4.0	3.2	2	2
Producer prices in industry, % p.a.	0.4	-1.5	0.1	3.7	3.2	3.8	.	.	.
General governm. budget, EU-def., % GDP									
Revenues	38.9	39.1	39.3	40.3	.	.	.	.	.
Expenditures	41.1	44.9	44.1	43.4	.	.	.	.	.
Net lending (+) / net borrowing (-)	-2.2	-5.8	-4.8	-3.1	.	.	-2.9	-2.5	-2.5
Public debt, EU-def., in % of GDP	28.7	34.4	38.1	41.2	.	.	43	45	46
Central bank policy rate, % p.a., end of period [3]	2.25	1.00	0.75	0.75	0.75	0.75	0.75	1.0	1.5
Current account, EUR mn	-3297	-3428	-5894	-4453	932	1967	-3700	-3800	-3500
Current account in % of GDP	-2.1	-2.4	-3.9	-2.9	2.6	5.5	-2.4	-2.4	-2.1
Exports of goods, BOP, EUR mn	84845	70983	86083	99580	24800	26606	110000	123000	139000
annual growth rate in %	9.3	-16.3	21.3	15.7	27.8	7.3	10	12	13
Imports of goods, BOP, EUR mn	83811	67684	83991	95755	23418	23879	102000	113000	128000
annual growth rate in %	10.4	-19.2	24.1	14.0	28.6	2.0	7	11	13
Exports of services, BOP, EUR mn	14910	13924	15812	16598	3929	4087	17000	19000	21000
annual growth rate in %	17.9	-6.6	13.6	5.0	11.4	4.0	3	10	10
Imports of services, BOP, EUR mn	11949	11126	12839	13895	3147	3572	15000	17000	19000
annual growth rate in %	13.7	-6.9	15.4	8.2	19.3	13.5	8	10	10
FDI inflow, EUR mn	4467	2082	4644	3868	710	977	3000	4000	4000
FDI outflow, EUR mn	2964	685	882	827	172	230	1300	1300	1300
Gross reserves of NB excl. gold, EUR mn	26386	28556	31357	30675	29435	31742	.	.	.
Gross external debt, EUR mn	60511	61940	70498	72583	69854	.	.	.	.
Gross external debt in % of GDP	39.2	43.8	47.2	46.9	45.1	.	.	.	.
Average exchange rate CZK/EUR	24.95	26.44	25.28	24.59	24.37	25.08	25.00	24.75	24.75
Purchasing power parity CZK/EUR	18.24	18.46	18.47	18.07	.	.	.	.	.

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) Enterprises with 20 and more employees, including part of the Ministry of Defence and the Ministry of the Interior. From 2009 all enterprises covered. - 3) Two-week repo rate.
Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.