

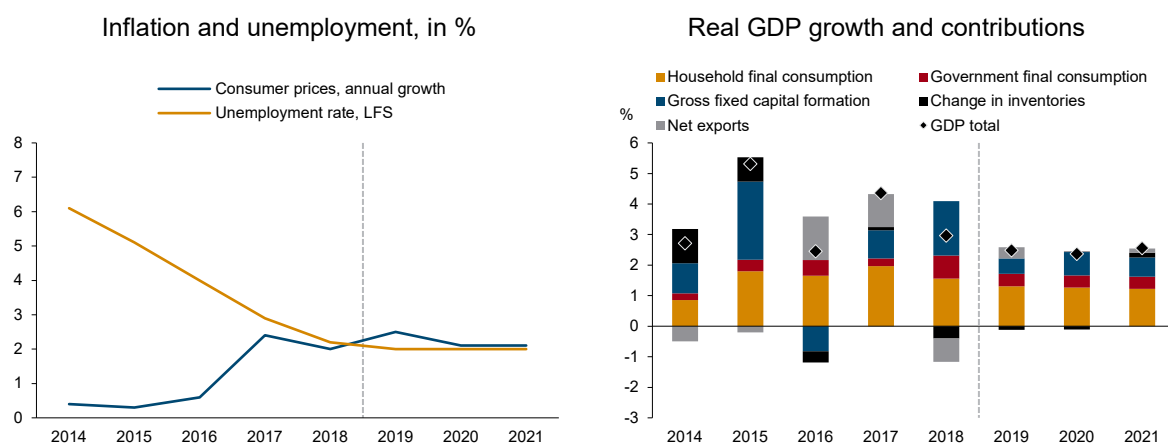


## CZECH REPUBLIC: Weak growth at full employment

LEON PODKAMINER

GDP growth has been losing momentum gradually as productive investment starts to decline. Labour resources are nearing depletion, but labour shortages have failed to prompt intensified capital formation. A high dependence on the car industry may become a problem. Signs of recession in Germany are spilling over into Czech manufacturing. Consumption remains the backbone of a subdued output growth. We forecast average growth of around 2.5% in the medium run.

Figure 5.6 / Czech Republic: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

**GDP growth has been losing momentum gradually.** Faltering investment spending is the main demand-side factor responsible for the weakening output growth. In the second quarter of 2019 the volume of gross fixed capital formation stagnated (after increasing at over 7% a year ago and 3% in the first quarter of 2019).

**Productive investment starts to decline.** The volumes of investment in the form of machinery, equipment and means of transportation declined in the first half of 2019 while only investment in dwellings and other buildings and structures (the latter are, primarily, related to the realisation of infrastructural projects) still keeps rising (though at very low rate).

**Labour shortages fail to prompt intensified capital formation.** This is a rather unexpected development. The conventional wisdom would rather suggest an opposite tendency – rising investment into labour saving technologies. However, under the rising unit labour costs – and thus declining

profitability of the business sector – the attractiveness of investing in the Czech Republic may have diminished generally, even with the labour-saving technologies. Labour shortages are likely to persist in the future, also on account of adverse demographic trends – and this too may discourage capital formation. Locating new production facilities in less costly countries where labour shortages are less acute (e.g. in Romania) may have become a viable alternative. Of course, that alternative may not be available to many smaller-scale domestic-owned firms. Also larger foreign firms (e.g. in the automotive industry), with factories already operating in the Czech Republic, may not be able to move out quickly. But they may have become more cautious when it comes to extending their existing production facilities.

**Labour resources are nearing depletion.** At the beginning of the year the number of vacancies reached an all-time high (with about 2 vacancies per unemployed person). Since then the number of vacancies has diminished slightly – still exceeding the number of unemployed by a large margin. Labour shortages are now particularly acute in the service sectors (especially in retail trade). Record-high economic activity rates permit only marginally higher employment (in manufacturing by 0.6% in the second quarter of 2019). Pretty high net inflows of migrants (primarily from Ukraine, but also from Russia, Slovakia and Romania) have continued, easing the labour shortages a bit. In the first half of 2019 the net migration inflow was close to 21000 people (4% more than a year ago).

**Interest rates on loans are no longer as low as they used to be.** Despite its ‘dovish’ reputation, The Czech National Bank has been responding to higher inflation with the policy interest rate increasing gradually. Although in real terms the policy rate has been negative, the money market interest rates are positive. It is very likely that this reflects the expectations of further hikes in the policy rate and/or higher inflation. The interest rates on loans to the non-financial private sector are also moderately positive. Correspondingly the growth in loans has been slowing down generally. But loans supporting the real estate activities have expanded quite dynamically, especially in Prague (which is not yet something to worry about).

**Exchange rate has been remarkably stable.** Despite the growing interest rates’ differentials vs. the Euro Area, the CZK has not been appreciating in nominal terms vs. the euro. This development runs counter to the widely held anticipations whereby the CZK must tend to appreciate. Absence of pronounced nominal appreciation moderates the scale of real appreciation and is beneficial for the foreign trade. On the other hand this development is not helping to control inflation. The interest rates’ disparities, under the stability of the nominal interest rates, are normally activating some amounts of the short-term carry trade and may also lead to larger net debts denominated in the euro.

**Exceptional dependence on the automotive industry starts exacting a price.** Manufacture of motor vehicles (and the related activities covered in the NACE 29 category) is the leading branch of the Czech economy. In 2018 the branch accounted for over 5% of total value added, over 23% of exports of goods and services and close to 9% of the total investment outlays. Together with its supplying industries, the automotive industry generates over 9% of total gross value added and accounts for over 8% of the total employment.

**The recessionary tendencies coming to the fore in Germany have started spilling over into Czech manufacturing** which is tightly integrated with the German industry. During the first eight months of 2019 manufacturing output rose 0.5% in real terms. Brexit and the tensions disrupting global trade will also affect the Czech economy (similarly as in most other industrial countries). The suppressed export

sales (by 1.5% in the second quarter of 2019) are already having negative repercussions for current production and employment. More ominously, the foreign recessionary tendencies are likely to discourage investment, especially in the automotive branch.

**Sound fiscal policy is continued** but the size of public sector surpluses is set to gradually diminish in the medium-term perspective. Thereby, the fiscal policy will be generating a modest pro-growth impulse which is likely to compensate, at least partly, for the effects of diminished private investment spending.

**Consumption remains the backbone of a subdued output growth.** Driven by strong rise in wages and pensions, the household consumption remains the main demand-side source of output growth. But consumption growth is not exorbitant as inflation follows, with some delay, the rising unit labour costs. In September 2019 the consumer price inflation reached 2.7% (y-o-y). Inflation (also due to the hikes in administered prices, already announced) will be thus eroding the real disposable incomes in 2020.

**The longer-term perspective remains uncertain.** The strong – but structurally skewed – manufacturing base will permit balanced (externally as well as internally) growth over a few more years. However, dwindling labour resources and stagnant levels of fixed capital formation do not bode particularly well in the longer run. The Czech economy may need a structural change with an aggressive technological reorientation. Whether such reorientations could be compatible with the strong reliance on foreign direct investment, characterising the Czech economy, remains an open question.

**Table 5.6 / Czech Republic: Selected economic indicators**

|   | 2015    | 2016    | 2017    | 2018 <sup>1)</sup> | 2018<br>January-June | 2019    | 2019<br>Forecast | 2020<br>Forecast | 2021    |
|---|---------|---------|---------|--------------------|----------------------|---------|------------------|------------------|---------|
| Population, th pers., average                       | 10,546  | 10,566  | 10,594  | 10,630             | .                    | .       | 10,645           | 10,650           | 10,655  |
| Gross domestic product, CZK bn, nom.                | 4,596   | 4,768   | 5,047   | 5,329              | 2,565                | 2,723   | 5,620            | 5,870            | 6,150   |
| annual change in % (real)                           | 5.3     | 2.5     | 4.4     | 3.0                | 3.1                  | 2.6     | 2.5              | 2.4              | 2.6     |
| GDP/capita (EUR at PPP)                             | 25,300  | 25,600  | 26,900  | 28,100             | .                    | .       | .                | .                | .       |
| Consumption of households, CZK bn, nom.             | 2,125   | 2,213   | 2,361   | 2,495              | 1,208                | 1,277   | .                | .                | .       |
| annual change in % (real)                           | 3.8     | 3.6     | 4.2     | 3.3                | 3.9                  | 2.7     | 2.8              | 2.7              | 2.6     |
| Gross fixed capital form., CZK bn, nom.             | 1,216   | 1,189   | 1,250   | 1,358              | 616                  | 643     | .                | .                | .       |
| annual change in % (real)                           | 10.2    | -3.1    | 3.7     | 7.2                | 6.8                  | 1.5     | 2.0              | 3.0              | 2.5     |
| Gross industrial production                         |         |         |         |                    |                      |         |                  |                  |         |
| annual change in % (real)                           | 4.3     | 3.4     | 6.5     | 3.1                | 2.7                  | 0.2     | 0.5              | 1.5              | 2.0     |
| Gross agricultural production                       |         |         |         |                    |                      |         |                  |                  |         |
| annual change in % (real)                           | -4.8    | 7.0     | -6.5    | -0.3               | .                    | .       | .                | .                | .       |
| Construction industry                               |         |         |         |                    |                      |         |                  |                  |         |
| annual change in % (real)                           | 6.8     | -5.6    | 3.3     | 9.2                | 10.1                 | 3.1     | .                | .                | .       |
| Employed persons, LFS, th, average                  | 5,042   | 5,139   | 5,222   | 5,294              | 5,274                | 5,301   | 5,320            | 5,340            | 5,350   |
| annual change in %                                  | 1.4     | 1.9     | 1.6     | 1.4                | 1.7                  | 0.5     | 0.5              | 0.3              | 0.2     |
| Unemployed persons, LFS, th, average                | 268     | 211     | 155     | 122                | 124                  | 106     | 110              | 110              | 110     |
| Unemployment rate, LFS, in %, average               | 5.1     | 4.0     | 2.9     | 2.2                | 2.3                  | 2.0     | 2.0              | 2.0              | 2.0     |
| Reg. unemployment rate, in %, eop                   | 6.2     | 5.2     | 3.8     | 3.1                | 2.9                  | 2.6     | .                | .                | .       |
| Average monthly gross wages, CZK                    | 26,591  | 27,764  | 29,638  | 31,868             | 31,023               | 33,295  | 34,100           | 36,200           | 38,400  |
| annual change in % (real, gross)                    | 2.9     | 3.7     | 4.1     | 5.3                | 5.8                  | 4.4     | 4.5              | 4.0              | 4.0     |
| Consumer prices (HICP), % p.a.                      | 0.3     | 0.6     | 2.4     | 2.0                | 1.9                  | 2.4     | 2.5              | 2.1              | 2.1     |
| Producer prices in industry, % p.a.                 | -2.4    | -3.2    | 0.7     | 0.7                | -1.3                 | 2.8     | 3.0              | 1.5              | 1.5     |
| General govern. budget, EU-def., % of GDP           |         |         |         |                    |                      |         |                  |                  |         |
| Revenues  | 41.1    | 40.2    | 40.5    | 41.5               | .                    | .       | 40.0             | 40.5             | 40.5    |
| Expenditures  | 41.7    | 39.5    | 38.9    | 40.6               | .                    | .       | 39.2             | 40.0             | 40.5    |
| Net lending (+) / net borrowing (-)                 | -0.6    | 0.7     | 1.6     | 0.9                | .                    | .       | 0.8              | 0.5              | 0.0     |
| General gov.gross debt, EU def., % of GDP           | 40.0    | 36.8    | 34.7    | 32.6               | .                    | .       | 32.0             | 31.0             | 30.0    |
| Stock of loans of non-fin.private sector, % p.a.    | 6.6     | 6.7     | 6.5     | 6.8                | 6.1                  | 5.4     | .                | .                | .       |
| Non-performing loans (NPL), in %, eop               | 5.8     | 4.8     | 4.0     | 3.3                | 3.4                  | 2.8     | .                | .                | .       |
| Central bank policy rate, % p.a., eop <sup>2)</sup> | 0.05    | 0.05    | 0.50    | 1.75               | 1.00                 | 2.00    | 2.00             | 2.25             | 2.00    |
| Current account, EUR mn                             | 368     | 2,744   | 3,058   | 628                | 2,236                | 3,016   | 800              | 700              | 500     |
| Current account, % of GDP                           | 0.2     | 1.6     | 1.6     | 0.3                | 2.2                  | 2.8     | 0.4              | 0.3              | 0.2     |
| Exports of goods, BOP, EUR mn                       | 115,573 | 118,033 | 129,242 | 137,024            | 69,097               | 70,694  | 141,100          | 149,400          | 156,900 |
| annual change in %                                  | 4.7     | 2.1     | 9.5     | 6.0                | 5.4                  | 2.3     | 3.0              | 5.9              | 5.0     |
| Imports of goods, BOP, EUR mn                       | 108,701 | 108,946 | 119,458 | 128,533            | 63,207               | 64,802  | 132,400          | 140,300          | 147,000 |
| annual change in %                                  | 6.1     | 0.2     | 9.6     | 7.6                | 6.9                  | 2.5     | 3.0              | 6.0              | 4.8     |
| Exports of services, BOP, EUR mn                    | 20,603  | 21,923  | 24,161  | 25,776             | 12,407               | 13,097  | 26,700           | 28,000           | 29,700  |
| annual change in %                                  | 8.9     | 6.4     | 10.2    | 6.7                | 7.9                  | 5.6     | 3.5              | 5.0              | 6.0     |
| Imports of services, BOP, EUR mn                    | 17,742  | 17,942  | 19,308  | 21,069             | 9,747                | 10,178  | 22,100           | 23,400           | 24,800  |
| annual change in %                                  | 5.0     | 1.1     | 7.6     | 9.1                | 7.1                  | 4.4     | 5.0              | 6.0              | 6.0     |
| FDI liabilities, EUR mn                             | 1,521   | 9,809   | 9,997   | 7,272              | 2,339                | 4,398   | 4,300            | .                | .       |
| FDI assets, EUR mn                                  | 3,357   | 2,909   | 8,288   | 3,730              | 1,612                | 3,817   | 2,000            | .                | .       |
| Gross reserves of NB excl. gold, EUR mn             | 58,903  | 80,999  | 123,273 | 124,142            | 123,348              | 128,577 | .                | .                | .       |
| Gross external debt, EUR mn                         | 115,396 | 129,448 | 171,115 | 169,308            | 166,453              | 170,630 | 176,300          | 180,300          | 184,000 |
| Gross external debt, % of GDP                       | 68.5    | 73.4    | 89.3    | 81.5               | 80.1                 | 77.4    | 80.0             | 78.0             | 76.0    |
| Average exchange rate CZK/EUR                       | 27.28   | 27.03   | 26.33   | 25.65              | 25.50                | 25.68   | 25.5             | 25.4             | 25.4    |

1) Preliminary. - 2) Two-week repo rate.

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