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## The Czech Republic: In recession

***In 2013 the Czech economy is exposed to a number of risks. Deep recession in the major export markets would have the most debilitating effects on the Czech economy. The continuing fiscal consolidation, which is likely to take place, could produce effects that are hard to calculate. Other risks do not seem serious. Monetary policy is not going to make irresponsible moves while the country's banks, corporate non-financial and household sectors are financially sound and resilient to imaginable disturbances.***

In the third quarter of 2012 the GDP decline went on at 1.6% against the same period of 2011 (seasonally and working-days' unadjusted). The decline in household consumption moderated slightly (to -2.5%) while the contraction in government consumption temporarily halted. Gross fixed capital formation, which still grew (weakly) in the first half of the year, declined by 3% in the third quarter. The volume of exports of goods and non-factor services rose by 4.2% whereas the volume of imports remained almost flat (rising by 0.7%) in the third quarter. The decline in household consumption seems to have been even more pronounced in the fourth quarter, together with some temporary stabilization of gross capital formation (with rising inventories). Overall GDP must have declined in the fourth quarter again by over 1%.

The differential performances of exports and imports indicate that the recession continues to be deeply rooted in domestic developments, at least until now. The weakening of growth in the major destinations of Czech exports (Germany, Poland and Slovakia) has not yet led to their contraction (as was the case in 2009 when Europe was hit by deep recession). The Czech economy remains internationally competitive. The fact that the Czech currency has weakened (rather unexpectedly) strengthens the country's external position even further. It is generally assumed, correctly it seems, that foreign trade can remain a force positively contributing to Czech GDP growth even if stagnation in the country's foreign partners gets prolonged. However, foreign trade would be of little help if Europe enters a more serious recession.

The continuing weakness of household consumption is a fairly autonomous effect of anaemic labour market developments which are characterized by stagnant employment and modest nominal wage increases. Moreover, owing to the fiscally-motivated increases in the VAT rates and hikes in administered prices (housing rents and utilities) inflation in 2012 was again (as in 2011) raised by over 1 percentage point. These hikes were responsible for the erosion of real wages and other regular household sector incomes – and for the decline in household consumption. In addition, the household sector responds to its reduced disposable income with higher (gross) saving rates (reaching about 10.5% recently). The high uncertainties crippling household spending are also reflected in the sector's borrowing activities. Despite the relatively low interest rates on loans (consumer as well as mortgages), banks' unchanged lending standards and the unchanged (and low, at 5.2%) ratio of non-performing household loans, the demand for credit remains flat.

Despite the falling and low (7.5%) share of non-performing loans to the corporate sector, the standards for lending to that sector are gradually tightened. This tendency reflects banks' perceptions concerning the sector's prospects. But the tightening of the lending standards does only matter to a relatively small fraction of the corporate clients (e.g. in the energy sector). The corporate sector's aggregate demand for investment loans is almost flat, despite relatively low and falling interest rates charged by banks. This reflects the gloomy overall outlook – and overabundance of own financial resources<sup>1</sup>.

The Czech National Bank has done all it possibly could to ease the strain felt by the economy. Its desperate decision to reduce the policy rate to zero (literally to 0.05%) may have helped to weaken the Czech currency. Otherwise, it has probably prevented an outright – and unnecessary – credit crunch. But the monetary policy alone, even if competently executed, could not help stop the current recession from deepening.

The fiscal policy meaningfully contributed to the recession in 2012. The fiscal 'effort' (i.e. additional discretionary measures reducing the public sector deficit) is estimated to have reached close to 1% of the GDP in 2012. Despite this the 3% public sector/GDP ratio target was missed – primarily because the tightening provoked (also through the VAT-induced inflationary erosion of wages) a recession instead of the 'planned' GDP stagnation.

The discretionary measures will continue to have effects in 2013, 2014 and 2015, with taxation and revenue measures equivalent to 0.9, 0.6 and 0.4 per cent of GDP

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<sup>1</sup> Corporate clients' aggregate bank deposits exceed their liabilities by about 30%.

respectively. The effort will also produce some additional inflation via a further increase in indirect tax rates. (The scales of the inflationary effects of the fiscal effort will be gradually diminishing in 2013 and beyond as compared with 2012.)

Currently, the authorities seem to believe that the public sector deficit will be lower than 3% of GDP in 2013. This presumes not only a continuation of consolidation, but also positive GDP growth (of about 0.7%) in 2013. Whether the fiscal consolidation plans will be consistently carried through in 2013 cannot be ascertained at present. The government of Petr Nečas disposes of a tiny (and not necessarily reliable) parliamentary majority. In January 2013 it narrowly survived the latest non-confidence vote. The government's eventual fall may result in a softening of the fiscal consolidation projects. A rather unusually open (and critical) evaluation of the need to strive for fiscal consolidation in the Czech Republic, expressed in an IMF document<sup>2</sup>, may not have been lost on the Czech authorities in charge of the fiscal policy. If real growth in 2013 disappoints, the policy is now unlikely to enforce additional austerity measures (which had been its earlier intention). Rather, it is more likely to accept shortfalls in revenue and spending in excess of targets – and thus deficits larger than planned. In any case, even if the intensity of 'fiscal efforts' in 2013-2014 is not much lower than in 2012, it may have less of an impact on inflation and households' disposable incomes. For that reason the fiscal policy may prove to be less contractionary in 2013 (and beyond) than has been the case recently.

In 2013 the Czech economy is exposed to a number of risks. Deep recession in major export markets would have the most debilitating effects on the Czech economy. But such a recession does not seem very likely now. In contrast, the continuing fiscal consolidation which is likely to take place could produce effects that are hard to calculate with any precision. It may prove neutral as far as growth is concerned – but it can also have negative, as well as positive, effects in this respect.

Other risks, essential for other countries, do not seem serious in the Czech case. The monetary policy is not going to make irresponsible moves while the country's banks, corporate non-financial and household sectors are financially sound and resilient to imaginable disturbances. (The same applies to the Czech public sector whose debt is fairly low and quite cheap to finance.)

All in all, the country's economy, free of significant internal and external imbalances, may be well equipped to benefit from a euro area recovery, should this eventually materialize.

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<sup>2</sup> See <http://www.imf.org/external/pubs/ft/scr/2012/cr12115.pdf>

Of course, the country's growth potential could be mobilized even if euro area stagnation drags on for some time. But such a mobilization would require a change in the economic policy orientation, which is unlikely to happen.

The second round of the presidential elections (held in January 2013) was won by Miloš Zeman (an earlier Social Democratic PM) who defeated Prince Karel Schwarzenberg (the current foreign minister, a liberal conservative). In contrast to Václav Klaus, whose second term in office has come to an end, the new president will help bring the Czech policies towards the EU on a more balanced track.

Table CZ

## Czech Republic: Selected Economic Indicators

	2008	2009	2010	2011	2012 <sup>1)</sup>	2013	2014 Forecast	2015
Population, th pers., average <sup>2)</sup>	10424	10487	10520	10496	10510	10540	10570	10600
Gross domestic product, CZK bn, nom.	3848.4	3759.0	3799.5	3841.4	3840.0	3870	3960	4110
annual change in % (real)	3.1	-4.5	2.5	1.9	-1.2	0.3	1.6	2.4
GDP/capita (EUR at exchange rate)	14800	13600	14300	14900	14500	.	.	.
GDP/capita (EUR at PPP)	20200	19400	19500	20200	20300	.	.	.
Consumption of households, CZK bn, nom.	1856.7	1874.4	1899.0	1921.7	1890.0	.	.	.
annual change in % (real)	3.0	0.2	1.0	0.7	-3.0	0.0	1.0	2.0
Gross fixed capital form., CZK bn, nom.	1031.2	926.1	932.5	917.3	920.0	.	.	.
annual change in % (real)	4.1	-11.0	0.9	-0.7	-1.0	0.0	2.0	3.0
Gross industrial production								
annual change in % (real)	-1.9	-13.6	10.3	6.4	-1.2	1.0	4.0	6.0
Gross agricultural production (EAA)								
annual change in % (real)	6.8	-3.6	-7.0	8.6	-6.6	.	.	.
Construction industry								
annual change in % (real)	-0.2	-0.8	-7.1	-3.5	-6.6	0.0	2.0	4.0
Employed persons, LFS, th, average <sup>3)</sup>	5002.5	4934.3	4885.2	4904.0	4890.1	4890	4900	4920
annual change in % <sup>3)</sup>	1.6	-1.4	-1.0	0.4	0.4	0.0	0.2	0.5
Unemployed persons, LFS, th, average <sup>3)</sup>	229.8	352.2	383.5	353.6	366.9	.	.	.
Unemployment rate, LFS, in %, average <sup>3)</sup>	4.4	6.7	7.3	6.7	7.0	7.4	7.3	7.0
Reg. unemployment rate, in %, end of period	6.0	9.2	9.6	8.6	9.4	9.5	9.5	9.0
Average gross monthly wages, CZK <sup>4)</sup>	22592	23344	23864	24436	24970	.	.	.
annual change in % (real, gross)	1.4	2.3	0.7	0.5	-1.1	0.0	1.0	2.0
Consumer prices (HICP), % p.a.	6.3	0.6	1.2	2.2	3.5	2.0	2.0	1.8
Producer prices in industry, % p.a.	0.4	-1.5	0.1	3.7	3.1	2.0	2.0	1.5
General government budget, EU-def., % of GDP								
Revenues	38.9	38.9	39.0	39.8	40.1	.	.	.
Expenditures	41.1	44.7	43.7	43.0	43.6	.	.	.
Net lending (+) / net borrowing (-)	-2.2	-5.8	-4.8	-3.2	-3.5	-3.5	-3.2	-3.0
Public debt, EU-def., % of GDP	28.7	34.2	37.8	40.8	45.1	46.9	48.1	48.0
Central bank policy rate, % p.a., end of period <sup>5)</sup>	2.25	1.00	0.75	0.75	0.05	0.25	0.75	0.75
Current account, EUR mn	-3297	-3428	-5894	-4453	-2300	-2500	-2500	-3100
Current account, % of GDP	-2.1	-2.4	-3.9	-2.9	-1.5	-1.6	-1.6	-1.9
Exports of goods, BOP, EUR mn	84845	70983	86083	99580	105000	110000	121000	136000
annual growth rate in %	9.3	-16.3	21.3	15.7	5.4	5.0	10.0	12.0
Imports of goods, BOP, EUR mn	83811	67684	83991	95755	98000	100000	107000	120000
annual growth rate in %	10.4	-19.2	24.1	14.0	2.3	2.0	7.0	12.0
Exports of services, BOP, EUR mn	14910	13924	15812	16598	17000	19000	21000	23000
annual growth rate in %	17.9	-6.6	13.6	5.0	2.4	10.0	10.0	9.0
Imports of services, BOP, EUR mn	11949	11126	12839	13895	15000	17000	19000	21000
annual growth rate in %	13.7	-6.9	15.4	8.2	8.0	10.0	10.0	8.0
FDI inflow, EUR mn	4467	2082	4644	3868	6000	4000	4000	.
FDI outflow, EUR mn	2964	685	882	827	1300	1300	1300	.
Gross reserves of NB excl. gold, EUR mn	26386	28556	31357	30675	33457	.	.	.
Gross external debt, EUR mn	60511	61940	70498	72583	76000	.	.	.
Gross external debt, % of GDP	39.2	43.6	46.9	46.5	49.8	.	.	.
Average exchange rate CZK/EUR	24.95	26.44	25.28	24.59	25.15	25.25	25.00	24.75
Purchasing power parity CZK/EUR	18.24	18.46	18.49	18.09	18.01	.	.	.

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 and wiw estimates. - 2) From 2011 according to census March 2011. - 3) From 2012 according to census March 2011. - 4) Until 2008 enterprises with 20 and more employees, including part of the Ministry of Defence and the Ministry of the Interior, from 2009 all enterprises covered. - 5) Two-week repo rate.

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