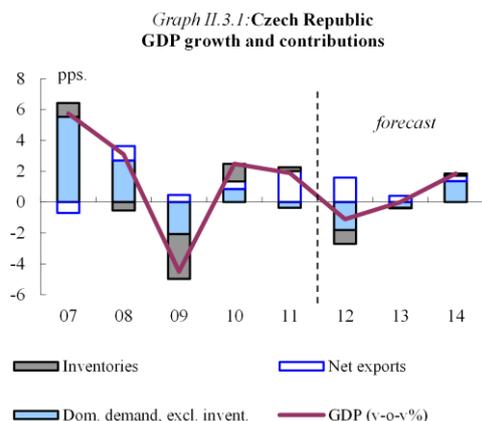


### 3. THE CZECH REPUBLIC

#### Anaemic consumption and a fragile labour market

##### Stagnation in 2013 followed by slow recovery

The Czech economy posted negative GDP growth in 2012, having continued to shrink for four consecutive quarters. The main driver of the decline was domestic demand, which was hit by several negative factors. Hikes in energy and food prices amidst ongoing fiscal consolidation and weak wage growth took the biggest toll on household consumption. The outlook for 2013 is one of stagnation as the domestic demand is projected to remain weak, while external demand is set to pick up and shore up output only in the second half of the year.



##### Lower job security weighs on spending

Throughout 2012, household consumption experienced losses as the saving rate rebounded to a level near 11%. This development is consistent with falling real disposable income and expectations of further fiscal tightening. It is, however, somewhat surprising, because it took place against a background of growing domestic employment and only a moderate rise in the unemployment rate. However, this labour market performance masks a persistent shift of labour from regular employment to self-employment as well as cuts in hours worked. Households are therefore under pressure not only from weak income growth but also from lower job security, with a clear impact on confidence. The saving rate is projected to rise further over the forecast horizon also on account of the introduction of a new funded pension pillar in 2013. Consumption is

therefore expected to decrease again in 2013 and to only edge upwards again in 2014.

In view of the spare production capacities and falling new orders in industry, fixed capital formation is also expected to stagnate in 2013. Construction investment is, however, forecast to contract further, as short-term indicators on construction activity do not suggest a quick recovery and favourable financing conditions are mostly used to refinance existing mortgages. The expected recovery in both domestic and foreign demand should help lift investment in 2014.

##### Trade surplus continues to rise

Export growth eased in recent quarters. However, as demand from the non-European economies is still holding up, Czech exports should overcome the soft short-term spell relatively quickly and pick up again in 2014, in line with the expected recovery in international trade. Stagnant demand is projected to weigh on imports and to give rise to a record trade surplus of 4.1% of GDP in 2013. The lower net borrowing needs of the government and of households are expected to narrow the external financing gap to close to 1% of GDP.

##### Price and wage growth remains subdued

Consumer prices are projected to grow by 2.1% in 2013. The January 2013 increases of VAT rates and of other excise taxes are estimated to account for 1.1 pps. of this rise. By contrast, energy and food inflation are expected to ease off in the first half of 2013 and overall inflation should remain subdued over the forecast horizon in the absence of near-term demand pressures.

Nominal wage growth slowed in 2012, in view of the lower labour demand, and it is expected to remain moderate also in 2013. Despite that, competitiveness, measured by the unit labour costs, deteriorated in 2012 as employers have so far tended to hoard labour in the current slowdown. The growth in unit labour costs is projected to diminish by 2014.

Risks to this outlook are still tilted to the downside. Should the recovery be delayed and sentiments change, unemployment could rise by

more than expected, further weakening real disposable income.

### Persistent general government deficit

After the sizeable reduction achieved in 2011, the headline general government deficit is expected to increase to 5.2% of GDP in 2012. This reflects the combined impact of two one-off operations, as well as revenue shortfalls. The adoption of the long-pending law on financial compensations to churches led to a one-off increase in the deficit by 1.5 pps. of GDP in 2012.<sup>(27)</sup> Irregularities in the management of EU funds resulted in financial corrections, with a one-off deficit-increasing impact of 0.3 pp. of GDP. The data for 2012 suggest a continued reduction in public investment and intermediate consumption, but stronger growth of public sector wages.

The general government balance is projected to improve to -3.1% of GDP in 2013 on the back of new consolidation measures (1.4 pps. of GDP), spread equally on the revenue and expenditure side. The deficit-increasing impact of the launch of

the fully-funded pension pillar in 2013 was revised down from 0.2 pp. of GDP to 0.1 pp. due to lower-than-expected participation in the new pillar at the beginning of the year. After posting a strong decline in previous years, public investment in value terms is projected to stagnate while government consumption slowly picks up. The structural deficit is projected to decline from 2.4% in 2012 to 2.2% of GDP in 2013.

In 2014, the general government balance is forecast to remain largely unchanged. Despite planned across-the-board cuts at the central level of 0.3% of GDP, public consumption and investment are expected to increase moderately. Revenues are expected to benefit from stronger activity and from further hikes in excise duties. Interest expenditure is projected to increase due to the rising debt-to-GDP ratio, which is forecast to be 49.5% of GDP in 2014. The structural deficit would reach 2.1% of GDP in 2014.

The fiscal forecast is subject to risks related to a higher-than-expected participation in the fully-funded pension pillar. Larger-than-planned deficits at the regional level and failure to fully implement planned expenditure cuts could also weigh on the budgetary outcome.

<sup>(27)</sup> The forecast assumes that the impact of financial compensations to churches will be recorded in 2012, not in any way prejudging the final Eurostat ruling on its recording.

Table II.3.1:

### Main features of country forecast - THE CZECH REPUBLIC

	2011			92-08	Annual percentage change					
	bn CZK	Curr. prices	% GDP		2009	2010	2011	2012	2013	2014
GDP	3841.4		100.0	3.2	-4.5	2.5	1.9	-1.1	0.0	1.9
Private consumption	1950.2	50.8		3.4	0.2	1.0	0.7	-3.0	-0.5	1.5
Public consumption	792.9	20.6		1.2	4.0	0.5	-2.5	-1.1	-0.8	0.1
Gross fixed capital formation	917.3	23.9		5.6	-11.0	1.0	-0.7	-0.2	0.2	2.5
of which: equipment	394.8	10.3		7.5	-18.8	6.0	0.0	4.4	2.0	3.5
Exports (goods and services)	2786.8	72.5		10.2	-10.9	15.5	9.4	4.3	2.4	5.6
Imports (goods and services)	2632.3	68.5		11.8	-12.1	15.8	6.7	2.3	2.1	5.6
GNI (GDP deflator)	3572.2	93.0		-	-6.5	1.6	2.4	-1.4	-0.1	1.9
Contribution to GDP growth:										
Domestic demand				3.5	-2.1	0.9	-0.4	-1.8	-0.4	1.4
Inventories				0.1	-2.9	1.2	0.2	-0.9	0.0	0.1
Net exports				-0.4	0.5	0.5	2.0	1.6	0.4	0.4
Employment				-	-1.8	-1.0	0.3	0.2	-0.1	0.5
Unemployment rate (a)				-	6.7	7.3	6.7	7.0	7.6	7.3
Compensation of employees/head				-	-0.6	3.6	2.7	1.8	1.8	2.7
Unit labour costs whole economy				-	2.2	0.0	1.1	3.1	1.7	1.3
Real unit labour costs				-	-0.1	1.4	1.9	2.2	0.4	0.2
Saving rate of households (b)				-	11.2	11.3	9.6	10.9	11.1	11.3
GDP deflator				6.0	2.3	-1.4	-0.8	0.9	1.3	1.1
Harmonised index of consumer prices				-	0.6	1.2	2.1	3.5	2.1	1.6
Terms of trade of goods				-	2.5	-2.3	-2.2	-0.9	-0.1	-0.3
Merchandise trade balance (c)				-2.6	2.3	1.4	2.3	3.9	4.1	4.2
Current-account balance (c)				-3.0	-3.3	-5.2	-3.9	-2.9	-2.7	-2.7
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-3.0	-1.2	-3.1	-2.0	-1.5	-1.0	-1.2
General government balance (c)				-	-5.8	-4.8	-3.3	-5.2	-3.1	-3.0
Cyclically-adjusted budget balance (c)				-	-5.4	-4.7	-3.3	-4.5	-1.9	-2.1
Structural budget balance (c)				-	-5.8	-4.8	-3.1	-2.4	-2.2	-2.1
General government gross debt (c)				-	34.2	37.8	40.8	45.5	48.0	49.5

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.