

3. THE CZECH REPUBLIC

From recession to gradual recovery

Economic slump and policy response in 2009...

The Czech Republic was one of the best economic performers in Central and Eastern Europe in recent years. Real GDP grew by an average 5% over 2003-08, which helped to take GDP per capita from 73% to 80% of the EU average over the same period. This performance was guided by overall sound macroeconomic and structural policies, and underpinned by a vibrant export sector. This sustained economic expansion did not trigger unsustainable dynamics. Credit growth, although rapid, was consistent with underlying convergence; the current account deficit remained at readily financeable levels; and inflation remained low for most of the period, with the exception of 2008 when consumer prices increased temporarily due to tax increases and emerging capacity constraints.

These strong fundamentals have helped the Czech economy to weather the global financial crisis, although a large loss of output could not be avoided. Like other export-orientated economies, the Czech economy slowed down significantly in 2008, suffering from the collapse of external demand. The downturn intensified in the first half of 2009, when exports and industrial production both fell by 18% and real GDP contracted by 5% in year-on-year terms. While the global crisis affected the Czech economy mainly via the trade channel, the worsening of output prospects, tighter credit conditions and shrinking foreign investment inflows also triggered a sizeable decline of investment (down 7.4% in the first half of 2009), which amplified the economic contraction. As in other countries, a sharp correction in inventories took place at the turn of the year, which will also be a significant drag on growth in 2009. Despite the large shock to the real economy, unprecedented turbulences in international capital and financial markets, and a decline in real estate prices, the financial sector has remained relatively stable, mainly due to prudent regulation, a strong domestic deposit base and low exposure to toxic assets and foreign exchange loans.

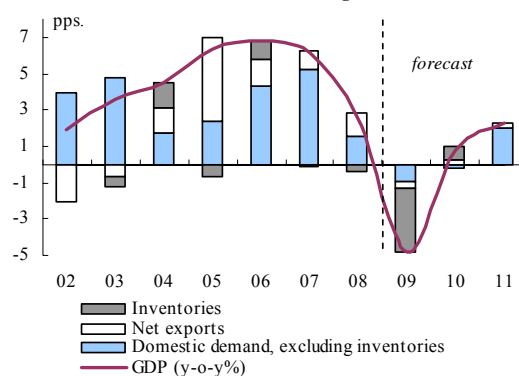
In response to the economic crisis, the Czech government adopted two stimulus packages, amounting to some 2% of GDP. The main measures included cuts in social security contributions, increases in public infrastructure investment, financial support to businesses and

measures to support employment. The objective was to provide some bridging support for businesses during the downturn and to stimulate domestic demand, partially compensating for the slump in export growth. At the same time, the increase in government investment in transport infrastructure is expected to bring longer-term benefits to the economy.

...followed by a gradual recovery in 2010-11

Recent high-frequency indicators have provided some signs of stabilisation in economic activity. Business confidence seems to be recovering slowly, while exports have stopped falling and the inventories cycle has turned. At the same time, the economy is benefitting from the easing of stress in international financial markets – CDS spreads have declined by 260 bps since January 2009 and are now close to pre-crisis levels. Against this background, the recession ended in the second quarter of 2009 with a stabilisation of real GDP. Over the coming quarters, the recovery is expected to remain shallow, reflecting diverging impulses from the underlying drivers of growth.

Graph II.3.1: The Czech Republic - Contributions to GDP growth



On the one hand, the global recovery in 2010 should support a rebound of exports. In parallel, following a sharp contraction in 2009 (-7.2%), investment is expected to stop falling and to recover slowly in the second half of 2010 if expectations about the future pace of the recovery continue to improve. A gradual rebound of foreign investment inflows and the positive impact of EU funds should also contribute to this movement. On the other hand, consumer demand is likely to suffer in 2010 from the sharp deceleration in

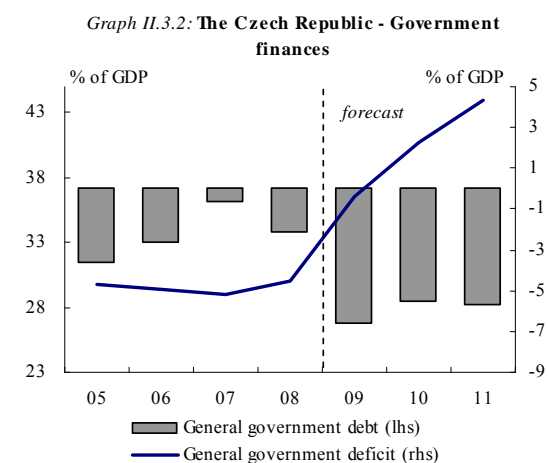
disposable income. Declining employment, slowing wages, and the recently-approved fiscal consolidation measures should weigh on private consumption next year. The planned tax increases are set to push inflation up slightly despite low commodity prices and the negative output gap. The sluggishness of private consumption should persist up to the end of 2010, when labour market conditions are expected to improve. Overall, following the sharp contraction of 4.8% this year, real GDP is expected to increase by 0.8% in 2010 and to gather pace in 2011 with growth above 2%. It appears that, despite considerable uncertainty, the risks to the growth outlook are broadly balanced. On the upside, a faster recovery would be possible if demand for Czech exports were to pick up more rapidly than expected. The downside risks are linked to the steeply rising unemployment and weak private consumption.

Unemployment is set to rise...

One of the main challenges facing the Czech economy in the post-crisis environment will be to ensure a rapid adjustment of the labour market to the downturn. There is a risk that the large drop in economic activity, which is particularly pronounced in some export-oriented areas like the automotive sector, might translate into an extended period of high unemployment in some regions. This could affect the growth potential of the economy through hysteresis and losses in human capital. The unemployment rate, while lower than in most of other new Member States, is expected to increase markedly (by around 3 percentage points) over the forecast horizon. Also, following the large fall in labour productivity during the crisis – 3 percent in 2009, compared to average annual gains of around 4 percent during the boom phase – the risk exists of a jobless recovery. A rapid adjustment of wages could help ensure convergence toward a desirable equilibrium in the labour market. The impact of the recession on labour market developments also depends on the speed at which longer-term structural constraints on labour market participation and flexibility such as low regional and sectoral mobility as well as skills mismatches are alleviated, allowing reallocation of the labour force from those sectors that were hard-hit during the crisis – including the large automotive sector – to those with the most favourable medium-term outlook.

The speed of future real convergence also depends on developments in external competitiveness and

the capacity of the Czech economy to continue its successful integration in the global economy. Available indicators suggest that the external position of the Czech economy has remained strong during the crisis, with the koruna valued at a level broadly in line with fundamentals. However, while a relative advantage in labour-intensive goods still exists, it is diminishing over time given the increasing competition from lower-wage EU members and non-EU countries.



...while public finances deteriorate further

Years of pro-cyclical policy during the boom phase had left Czech public finances in a structurally weak position at the outset of the crisis. While the headline deficit improved by one percentage point between 2004 and 2008, the structural deficit increased from 2½% to over 4% of GDP over the same period. Also, the fiscal room for manoeuvre was limited by the risks implied by an ageing population for the long-term sustainability of public finances. Although the first stages of the pension and healthcare reforms were initiated in 2008, both pension- and healthcare-related expenditures remain high and are set to increase markedly in future.

The public finances are expected to worsen considerably in 2009. The general government deficit is set to widen from 2.1% of GDP in 2008 to 6.6% of GDP in 2009, mainly as a result of the economic downturn. The structural deficit should also increase, reflecting anti-crisis measures. On the revenue side, cuts in social security contributions and a reduction of the corporate income tax rate from 21% to 19% will contribute to the estimated fall in the revenue-to-GDP ratio. The expenditure-to-GDP ratio will increase

sharply on account of higher social transfers and public investment. The contraction in GDP combined with a high deficit will drive up the government debt level, which is projected to deteriorate from 30% in 2008 to around 44% in 2011. Unavoidably, debt service costs will rise, crowding out some productive public spending.

Faced with a larger-than-planned deterioration of government finances, the Czech government has started to take measures to correct fiscal imbalances. A sizeable fiscal consolidation package for 2010 - estimated at approximately 1½% of GDP - was adopted in October 2009, in the context of the 2010 budget. The main measures include increases in VAT, excise duties and real estate tax and withdrawal of some anti-crisis measures such as higher unemployment benefits and temporary reductions in social security contributions, all implemented in the course of 2009. Cuts in public wages have also been announced. The consolidation package is expected to reduce the general government deficit to around 5½% of GDP in 2010. Under the no-policy-change assumption, public finances are projected to deteriorate slightly in 2011 despite higher real GDP growth, as parliamentary elections planned spring 2010 make consolidation efforts after 2010 more uncertain. Given the large degree of openness of the economy, and the high level of the

government deficit in 2009, a credible fiscal consolidation plan for the medium term should not be detrimental to growth. Direct negative effects could be offset by a positive impact on private sector agents' confidence.

Table II.3.1:

Main features of country forecast - THE CZECH REPUBLIC

	2008			92-05	Annual percentage change					
	bn CZK	Curr. prices	% GDP		2006	2007	2008	2009	2010	2011
GDP	3689.0		100.0	2.4	6.8	6.1	2.5	-4.8	0.8	2.3
Private consumption	1834.0		49.7	3.7	5.2	5.0	3.6	1.0	-0.5	1.7
Public consumption	753.2		20.4	1.0	1.2	0.7	1.0	1.4	0.1	0.8
Gross fixed capital formation	883.2		23.9	4.7	6.0	10.8	-1.5	-7.2	0.3	4.5
of which : equipment	380.0		10.3	8.5	8.4	16.9	-0.6	-11.0	-0.5	5.8
Exports (goods and services)	2844.0		77.1	10.1	15.8	15.0	6.0	-16.5	2.1	5.8
Imports (goods and services)	2676.0		72.5	13.1	14.3	14.3	4.7	-17.0	1.8	5.9
GNI (GDP deflator)	3426.0		92.9	-	6.3	3.9	2.3	-4.7	1.2	2.6
Contribution to GDP growth :										
Domestic demand				3.4	4.3	5.2	1.5	-0.9	-0.2	2.0
Stockbuilding				0.2	1.0	-0.2	-0.4	-3.5	0.8	0.0
Foreign balance				-1.2	1.5	1.1	1.3	-0.4	0.3	0.3
Employment				-	1.8	2.7	1.5	-2.0	-1.4	0.3
Unemployment rate (a)				-	7.2	5.3	4.4	6.9	7.9	7.4
Compensation of employees/head				-	6.0	6.4	6.0	0.5	1.6	3.3
Unit labour costs whole economy				-	1.1	3.0	5.1	3.4	-0.7	1.3
Real unit labour costs				-	0.0	-0.4	3.2	2.1	-2.0	-0.4
Savings rate of households (b)				-	-	10.7	10.2	11.0	11.6	11.9
GDP deflator				7.3	1.1	3.4	1.8	1.3	1.3	1.7
Harmonised index of consumer prices				-	2.1	3.0	6.3	0.6	1.5	1.8
Terms of trade of goods				-	-1.7	1.2	-2.3	1.4	0.4	0.1
Trade balance (c)				-4.1	2.0	3.4	2.7	3.2	3.5	3.6
Current account balance (c)				-3.6	-2.1	-2.6	-3.3	-2.5	-1.4	-0.8
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-3.9	-1.7	-1.9	-2.2	-1.5	-0.7	-0.4
General government balance (c)				-	-2.6	-0.7	-2.1	-6.6	-5.5	-5.7
Cyclically-adjusted budget balance (c)				-	-4.2	-3.1	-4.1	-6.0	-4.5	-4.8
Structural budget balance (c)				-	-4.0	-3.1	-4.1	-6.3	-4.7	-4.9
General government gross debt (c)				-	29.4	29.0	30.0	36.5	40.6	44.0

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