21. CZECHIA

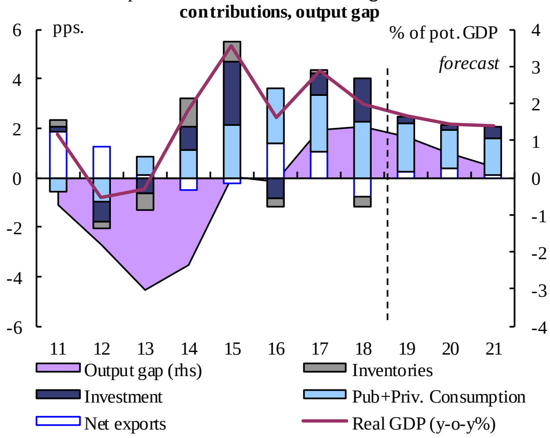
Growth remains robust but external risks are starting to materialise

Czechia's long economic expansion is expected to continue but its rate of growth is set to slow. Domestic demand remains the key growth driver, boosted by high wage increases in a tight labour market. The near-term outlook for private investment remains subdued and coincides with weakening trade activity. Inflation is forecast to remain within the tolerance band and to fall towards the central bank's 2% target rate. Public finances are expected to remain in balance throughout the forecast horizon.

Growth is driven by private consumption

Czechia's economy is forecast to grow by 2.5% this year, down from 3% in 2018. Growth is expected to continue slowing in 2020 and 2021 to 2.2% and 2.1%, respectively, which is broadly in line with the economy's estimated potential growth rate. On the back of a tight labour market, strong wage growth and robust consumer confidence will continue to support household consumption throughout the forecast horizon. Government consumption is also expected to remain strong, influenced by the ending of the current programming period for EU funds. Private investment growth and trade are expected to moderate significantly, influenced by weaker global demand and geopolitical uncertainties. A larger dampening effect on imports, due to a slowdown in production and investment, is expected to mean that the external balance will contribute positively to GDP growth over the forecast horizon.

Graph II.21.1: **Czechia - Real GDP growth and contributions, output gap**



Private investment decelerates, external risks start to materialise

After strong growth in 2018, investment is likely to abate in 2019 and 2020, before slightly rebounding in 2021 thanks to an expected ease in the external environment. Investment in equipment will be particularly affected in the near term, as the growth of industrial production was muted in the first three quarters of 2019. While the automotive industry remains resilient, other manufacturing sectors have witnessed a significant drop in economic activity. As manufacturing sentiment is rather weak, new orders have been declining throughout 2019. On the other hand, whereas labour market pressures may be slightly easing, the job market remains very tight and companies are still struggling to fill job vacancies (currently 1.6 job vacancies per unemployed worker). Unemployment is at very low levels and is forecast to remain at 2.1% in 2019, 2.2% in 2020 and 2.3% in 2021.

The recent drop in investment and industrial production has been mostly due to external uncertainties, as the Czech industrial sector is very dependent on the external sector. Slowing demand from euro area trading partners, global trade disruptions and revised standards in the automotive industry are weighing on investment decisions. In addition, the competitiveness of Czech exports may have already been negatively affected by the fast pace of real wage growth since 2016. As imports are expected to grow more slowly than exports due to weaker investment and production, the trade balance will likely remain positive throughout the forecast horizon.

Inflation is expected to fall towards target after the rise in 2019

HICP inflation is forecast to increase to 2.6% in 2019, above the Czech National Bank's target of 2%, influenced by steeper energy, services and processed food prices. For 2020 and 2021, inflation is expected to moderate slightly and reach 2.3% and 2.0%, respectively.

Public finances are likely to remain in balance

In 2019, the general government balance is expected to remain in surplus for the fourth year in a row. However, moderating economic growth and a significant increase in public expenditure are expected to reduce the surplus to around 0.2% of GDP. While local governments and the social security funds continue to run a surplus, the central government is expected to post a slight deficit. Similar to 2018, income tax receipts and social contributions are projected to be the main drivers of revenue developments. On the expenditure side, public wages, pensions and subsidies will continue to increase firmly. Public investment, on the other hand, is expected to moderate compared to the very high level seen in 2018.

This picture broadly holds true over the entire forecast horizon, despite the general balance being expected to turn slightly negative, at around -0.1% of GDP and -0.3% of GDP, in 2020 and 2021 respectively. In 2020, tax revenues are likely to benefit from the rollout of the final phases of the electronic registration of sales. In addition, there are new discretionary measures planned on the revenue side, such as an increase in excise duties for alcohol and tobacco products and the introduction of a new digital services tax for large corporations. Nonetheless, revenue growth is expected to continue to lag behind expenditure growth. The increase in public wages and social transfers is expected to continue, albeit at a more moderate pace compared to previous years. Growth in public investment is also likely to remain robust, as the current programming period for EU funds enters its final years. Interest expenditure is expected to remain low, reflecting the wider interest rate environment.

The structural balance is expected to remain slightly negative throughout the forecast horizon, in line with the shrinking general balance. Meanwhile, the general government debt is forecast to further decrease to around 30% of GDP by 2021, similar to levels last seen in 2008.

Table II.21.1:

Main features of country forecast - CZECHIA

		2018		Annual percentage change						
		bn CZK Curr. prices	% GDP	00-15	2016	2017	2018	2019	2020	2021
GDP		5328.7	100.0	2.8	2.5	4.4	3.0	**2.5**	**2.2**	**2.1**
Private Consumption		2530.1	47.5	2.2	3.6	4.3	3.2	**2.8**	**2.4**	**2.2**
Public Consumption		1064.1	20.0	1.3	2.7	1.3	3.9	**3.1**	**1.9**	**2.1**
Gross fixed capital formation		1358.4	25.5	3.0	-3.1	3.7	7.2	**1.1**	**1.0**	**2.1**
of which: equipment		592.0	11.1	4.4	-2.5	3.4	8.3	**-0.4**	**-0.8**	**0.9**
Exports (goods and services)		4177.0	78.4	8.7	4.3	6.7	4.4	**2.1**	**1.9**	**2.2**
Imports (goods and services)		3836.9	72.0	8.2	2.8	5.9	5.9	**2.0**	**1.6**	**2.3**
GNI (GDP deflator)		5031.9	94.4	2.4	2.7	4.7	3.6	**2.8**	**2.5**	**2.4**
Contribution to GDP growth:	Domestic demand			2.2	1.4	3.2	4.1	**2.2**	**1.8**	**2.0**
	Inventories			0.1	-0.4	0.1	-0.4	**0.0**	**0.0**	**0.0**
	Net exports			0.4	1.4	1.1	-0.8	**0.3**	**0.4**	**0.1**
Employment				0.4	1.6	1.6	1.3	**1.1**	**0.6**	**0.5**
Unemployment rate (a)				6.9	4.0	2.9	2.2	**2.1**	**2.2**	**2.3**
Compensation of employees / head				4.5	4.0	6.4	8.0	**5.2**	**4.7**	**4.4**
Unit labour costs whole economy				2.0	3.1	3.6	6.3	**3.7**	**3.0**	**2.8**
Real unit labour cost				0.2	1.8	2.1	3.7	**1.1**	**0.7**	**0.9**
Saving rate of households (b)				11.6	11.6	9.5	10.8	**11.4**	**11.7**	**11.9**
GDP deflator				1.8	1.3	1.4	2.5	**2.6**	**2.3**	**1.8**
Harmonised index of consumer prices				2.2	0.6	2.4	2.0	**2.6**	**2.3**	**2.0**
Terms of trade goods				-0.1	1.0	-1.4	-0.1	**-0.4**	**0.1**	**0.1**
Trade balance (goods) (c)				-0.5	5.4	5.0	4.2	**4.0**	**4.1**	**4.0**
Current-account balance (c)				-3.5	0.1	0.3	-0.2	**0.0**	**0.5**	**0.7**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-2.5	0.6	0.8	0.7	**1.0**	**1.7**	**2.2**
General government balance (c)				-3.3	0.7	1.6	1.1	**0.2**	**-0.1**	**-0.3**
Cyclically-adjusted budget balance (d)				-3.4	0.8	1.1	0.5	**-0.3**	**-0.4**	**-0.4**
Structural budget balance (d)				-	0.8	1.1	0.5	**-0.3**	**-0.4**	**-0.4**
General government gross debt (c)				32.3	36.8	34.7	32.6	**31.5**	**30.7**	**30.1**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.