2.3. CZECH REPUBLIC

The economy of the Czech Republic expanded by 4.3% in 2017, its second fastest rate in a decade. All demand components contributed positively to GDP growth. Despite an easing of the pace in 2018-Q1 due to weak external demand in key trading partners, GDP growth is forecast at a solid rate of 3.0% for 2018 and 2.9% in 2019, thanks mainly to robust domestic demand. The very high confidence indicators readings seen in the first half of 2018 are fully consistent with these prospects.

Wage increases and high levels of consumer confidence should continue to support private consumption. Investment is also expected to remain vigorous, underpinned by a revival of construction activity, greater use of EU investment funding, and a general trend towards industrial automatisation. Meanwhile, public consumption is set to continue growing at a steady pace, supported by robust wage growth in the public sector.

On the downside, net exports are likely to detract from GDP growth, particularly in 2018. The intensity and duration of this effect will hinge on world trade developments and economic growth in the euro area, particularly in Germany. Labour shortages, which are increasingly cited as a production constraint, also pose a growing risk to the economy. The number of job vacancies was almost twice as large as the number of unemployed persons in 2018-Q1. Continued rapid house price inflation, coupled with rising household debt, also constitutes a vulnerability.

After a temporary slowdown in the first months of 2018, headline inflation is expected to return above 2% in the coming quarters, influenced by the positive output gap, wage dynamics, and oil prices. The gradual increase of interest rates by the Czech National Bank, whose latest hike at the end of June raised the policy rate by 25 bps. to 1.0%, should help temper inflationary pressures and maintain consumer price inflation close to the target of 2%. HICP inflation is forecast to average 2.1% in 2018 and 2.0% in 2019.

Graph 2.3: **Czech Republic - Real GDP growth and contributions**