3. THE CZECH REPUBLIC
GDP growth to remain solid amid downside risks

After a strong 2017, economic growth in the Czech Republic is expected to moderate in 2018 and continue declining towards potential growth over the next two years. Domestic demand looks set to be the main driver of GDP growth, with labour shortages and dependence on the external sector seen as potential downside risks for the economy. Inflation is forecast to gradually stabilise at around the 2% target rate. The government budget surplus is expected to decline but remain positive over the forecast horizon.

Domestic demand driving GDP growth in 2018

The Czech economy is expected to grow by 3.0% in 2018, somewhat less than in 2017, when GDP expanded at its second-highest rate in a decade (4.3%). Domestic demand, excluding inventories, propelled GDP growth in the first half of 2018. Investment gained momentum boosted by the automation needs in manufacturing and the surge of public investment supported by EU funds. Wage dynamics and consumer confidence boosted private consumption, while raises in public salaries lifted public expenditure. Conversely, net exports and inventories contributed negatively to year-on-year growth. These dynamics are forecast to continue in the second half of 2018. Overall, domestic demand, excluding inventories, is expected to remain the principal driver of annual GDP growth, while inventories and, to a lesser extent, net exports will depress growth in 2018.

GDP growth converging towards potential in the medium term

GDP growth is expected to slow slightly in 2019 and 2020 (2.9% and 2.6%, respectively) towards estimated potential growth rates. Household consumption will benefit from rapid wage growth and social transfers, while their savings will recover to a rate of close to 11% of gross disposable income. Investment growth is set to moderate after peaking in 2018, although both the private and the public sector will continue to support investment activity, especially in machinery. Likewise, the moderation in investment growth is expected to lead to a slight deceleration in import growth due to the relatively high import content of Czech investment. As a result, the contribution of net exports to GDP growth is forecast to be neutral in 2019 and slightly positive in 2020.

External environment and labour shortages remain the main downside risks

As a small open economy, the Czech Republic is highly dependent on the external sector. In the first half of 2018, weak external demand coupled with exchange rate appreciation weighed on economic growth. These two factors pose a risk in the near term. Moreover, the competitiveness of Czech exports could be affected by rising real unit labour costs, which are forecast to grow strongly in the short term (around 5% in 2018) and moderate later (to about 2½% in 2019 and 1% in 2020). On the one hand, the combination of very low unemployment and a low ratio of job seekers per vacancy (both the lowest in the EU) should stoke wage pressures. On the other hand, there seems to be a lag in the realisation of productivity gains from investment in automation that may persist in the near term.

Gradual return to inflation target supported by monetary policy normalisation

HICP inflation is forecast at 2.1% in 2018, down from 2.4% in 2017. Price dynamics will accelerate at the turn of 2018-2019, influenced by base effects and higher energy prices. Headline inflation is expected to gradually return to the Czech National Bank’s (CNB) 2% target in the second half of 2019 and remain close to it in 2020. Annual HICP inflation is forecast at 2.2% in 2019 and...
1.8% in 2020. While pro-inflationary factors (in particular wage growth and oil prices) are still prevailing, the ongoing normalisation of the CNB’s monetary policy rates – there have been six rate hikes since August 2017 – should temper inflationary pressures.

**General government surplus to decrease**

In 2018, the general government budget surplus is expected to reach 1.4% of GDP (down from 1.5% in 2017), driven by almost equal rises of around 7% in both revenues and expenditures. The central and the local government balances and the social security funds are all expected to stay in surplus. The public wage hike and the higher indexation of pensions will most likely be fully offset by strong tax and non-tax revenue increases. Recent measures to address tax avoidance seem to have been successful in increasing VAT receipts, while the buoyant economy and rising wages are likely to bring in additional revenue from income taxes. Although some increases have been postponed to 2019, public wages are expected to grow by double digits in 2018.

In 2019, the headline budget surplus is expected to fall to 0.8% of GDP due to higher public wage growth and discretionary pension measures. While revenues are expected to grow in line with the economy, expenditures are expected to increase significantly. Public wage hikes and recently adopted pension increases are expected to raise expenditure by around ½% of GDP. In 2020, the headline budget surplus is expected to remain broadly steady at around 0.7% of GDP. As the end of the current EU funding cycle is approaching, public investment is expected to grow faster than GDP over the forecast horizon. Interest payments are also expected to increase somewhat over the forecast horizon.

The structural balance remained in surplus in 2017 at around 1% of GDP and a similar value is expected for 2018. Nonetheless, as the headline balance is expected to decrease, the structural balance is also expected to narrow. The debt-to-GDP ratio is set to decrease steadily from 34.7% of GDP in 2017 to 31.2% of GDP in 2020.