3. THE CZECH REPUBLIC

Soft landing amid capacity and labour constraints

The Czech economy expanded by 4.4% in 2017. GDP growth is expected to moderate but remain above potential in 2018 and 2019, with domestic demand continuing as the main driver of the economy. The unemployment rate is now the lowest in the EU and rising labour market shortages could constrain economic growth in the near future. After three interest rates hikes since August 2017, inflation seems to have been tamed. The government balance is forecast to remain positive in 2018 and 2019.

Steady growth ahead

Real GDP growth jumped to 4.4% in 2017 from 2.6% in 2016, with positive contributions from all demand components. Quarterly growth was particularly dynamic in the first half of 2017 before moderating somewhat in the second half (0.8% q-o-q growth in 2017-Q4). Overall, GDP is forecast to expand by 3.4% in 2018 and then by 3.1% in 2019.

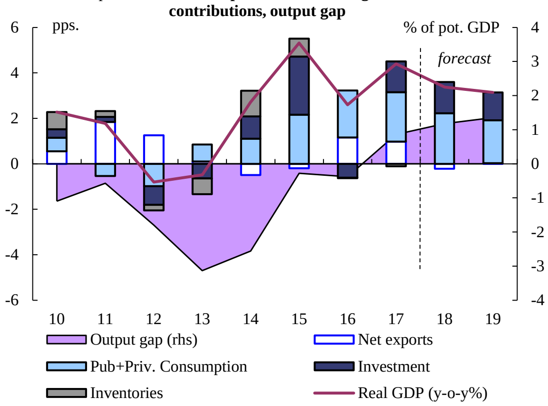
Boosted by wage dynamics and consumer confidence, private consumption is expected to remain the main driver of economic growth in 2018 and is forecast to increase by 3.9%, roughly the same pace as in 2017. Investment growth is expected to maintain strong momentum, rising by an expected 5.4% in 2018, as firms will turn to capital to compensate for workforce shortages. The public sector is also expected to contribute positively to investment, supported by EU funds under the 2014-2020 financial framework. After contributing 1.0 pp. to GDP growth in 2017, net exports are expected to detract slightly from growth in 2018. Imports are likely to grow faster than exports, driven by the upswing in private consumption and investment. Risks to the outlook for the external sector mainly concern the possibility of a stronger-than-assumed appreciation of the koruna.

Minimal spare capacity in the economy

The unemployment rate fell to 2.9% in 2017 and is projected to stabilise at 2.4% in 2018 and 2019. At the end of 2017, the Czech Republic had the lowest unemployment rate in the EU and the highest job vacancy rate. Employment growth is forecast to slow down to 0.7% in 2018, and to 0.2% in 2019. Labour market shortages are limiting capacity to increase production across all sectors, especially in manufacturing and construction. Mismatches between supply and demand are fuelling rising wages in both the private and public sectors. Nominal compensation per employee rose by 6.7% in 2017 and is forecast to increase equally strongly in 2018 and 2019.

Most of the downside risks for the Czech economy are associated with tightness in the labour market. The resulting pay rises have also to be viewed in the context of convergence with the EU and gains in productivity. However, they could contribute to the overheating of the economy and reduce the capacity of firms to react in the event of an adverse shock. Wage pressures and labour shortages could also affect foreign direct investment, particularly in the manufacturing industry.

Graph II.3.1: **Czech Republic - Real GDP growth and contributions, output gap**



Inflation set to stabilise near targeted level

Year-on-year inflation accelerated firmly towards the end of 2016 and the start of 2017. However, the appreciation of the koruna and three successive interest rate hikes since then should help to put a lid on inflationary pressures in import prices and services. Headline inflation is forecast at 2.1% in 2018, down from 2.4% in 2017; prices for services and food are expected to be the main contributors to price growth. Consumer price inflation (HICP) was weaker than expected in the first quarter of 2018 (1.7%), influenced by base effects and a particularly significant weakening in food prices. However, inflationary pressures remain strong due to rising wage growth, robust domestic demand and a positive and widening output gap. In this context, the HICP inflation rate is expected to again exceed the 2% target over the coming quarters. Inflation is forecast to moderate in 2019 to average 1.8% over the year.

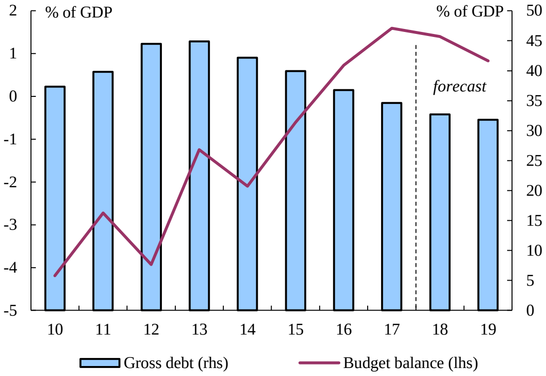
Public surplus to last

The 2017 general government balance surprised on the upside with a surplus of 1.6% of GDP. This surplus was supported by tax-rich growth on the back of a strong labour market. Tax revenue growth also benefited from measures addressing tax evasion. As for expenditure, investment growth fell short of previous expectations. Other notable developments were significant public sector pay rises and falling debt service payments.

In 2018, the general government surplus is expected to be around 1.4% of GDP. While tax growth moderates slightly, public investment activity is forecast to pick up pace and reach double-digit growth. Interest payments are likely to start increasing, after three consecutive years of decline. Public wages are expected to continue to grow by almost 8%. Similarly, pensions are being bolstered by stronger indexation.

As for 2019, the headline surplus is expected to decline to 0.8% of GDP, as a result of faster wage growth and discretionary pension measures. Plans to lower effective tax rates and simplify the tax system currently being discussed could cost an estimated 0.5% of GDP, if enacted.

Graph II.3.2: **Czech Republic - General government budget balance and gross debt**



The structural balance remained in surplus at around 1¼% of GDP in 2017 and is expected to further narrow as the positive output gap widens in 2018 and 2019. The debt-to-GDP ratio is forecast to decrease steadily, from 34.6% in 2017 to 31.8% in 2019.

Table II.3.1:

Main features of country forecast - CZECH REPUBLIC

	2016		Annual percentage change						
bn CZK	Curr. prices	% GDP	98-13	2014	2015	2016	2017	2018	2019
GDP	4773.2	100.0	2.3	2.7	5.3	2.6	**4.4**	**3.4**	**3.1**
Private Consumption	2241.6	47.0	2.0	1.8	3.7	3.6	**4.0**	**3.9**	**3.1**
Public Consumption	917.1	19.2	1.1	1.1	1.9	2.0	**1.5**	**1.9**	**2.1**
Gross fixed capital formation	1191.5	25.0	1.9	3.9	10.2	-2.3	**5.4**	**5.4**	**4.8**
of which: equipment	543.4	11.4	3.8	6.4	9.3	-1.1	**7.2**	**6.1**	**5.8**
Exports (goods and services)	3796.7	79.5	8.7	8.7	6.0	4.5	**6.5**	**4.8**	**4.7**
Imports (goods and services)	3439.5	72.1	7.8	10.1	6.8	3.4	**5.8**	**5.6**	**5.1**
GNI (GDP deflator)	4467.8	93.6	2.0	1.9	5.3	3.0	**5.2**	**3.2**	**3.0**
Contribution to GDP growth:	Domestic demand		1.8	2.1	4.7	1.5	**3.5**	**3.6**	**3.1**
	Inventories		0.0	1.1	0.8	0.0	**-0.1**	**0.0**	**0.0**
	Net exports		0.6	-0.5	-0.2	1.2	**1.0**	**-0.2**	**0.0**
Employment			0.0	0.6	1.4	1.3	**1.6**	**0.7**	**0.2**
Unemployment rate (a)			7.2	6.1	5.1	4.0	**2.9**	**2.4**	**2.4**
Compensation of employees / head			5.0	2.6	3.0	4.6	**6.7**	**6.8**	**6.2**
Unit labour costs whole economy			2.6	0.4	-0.8	3.3	**3.8**	**4.1**	**3.2**
Real unit labour cost			0.3	-2.0	-2.0	2.0	**2.4**	**1.4**	**1.6**
Saving rate of households (b)			11.5	11.8	12.0	11.2	**10.6**	**10.1**	**9.8**
GDP deflator			2.3	2.5	1.2	1.2	**1.4**	**2.7**	**1.5**
Harmonised index of consumer prices			2.8	0.4	0.3	0.6	**2.4**	**2.1**	**1.8**
Terms of trade goods			-0.2	1.8	0.5	1.0	**-1.2**	**1.1**	**-0.3**
Trade balance (goods) (c)			-1.8	5.1	4.1	5.2	**4.8**	**4.8**	**4.3**
Current-account balance (c)			-3.6	-1.2	-1.6	-0.1	**0.5**	**0.3**	**-0.3**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-2.9	0.5	1.2	0.4	**1.0**	**0.8**	**0.2**
General government balance (c)			-3.6	-2.1	-0.6	0.7	**1.6**	**1.4**	**0.8**
Cyclically-adjusted budget balance (d)			-3.7	-1.0	-0.5	0.9	**1.2**	**0.9**	**0.2**
Structural budget balance (d)			-	-0.7	-0.5	1.0	**1.2**	**0.9**	**0.2**
General government gross debt (c)			29.0	42.2	40.0	36.8	**34.6**	**32.7**	**31.8**

(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.