CZECH REPUBLIC

Economic growth is projected to pick up in 2017. The increase in the minimum wage in January and ongoing strong labour demand will benefit workers and boost consumption. Private and public investment are recovering. Labour shortages will constrain growth in 2018 and add some inflationary pressure, keeping inflation above the 2% target through 2018.

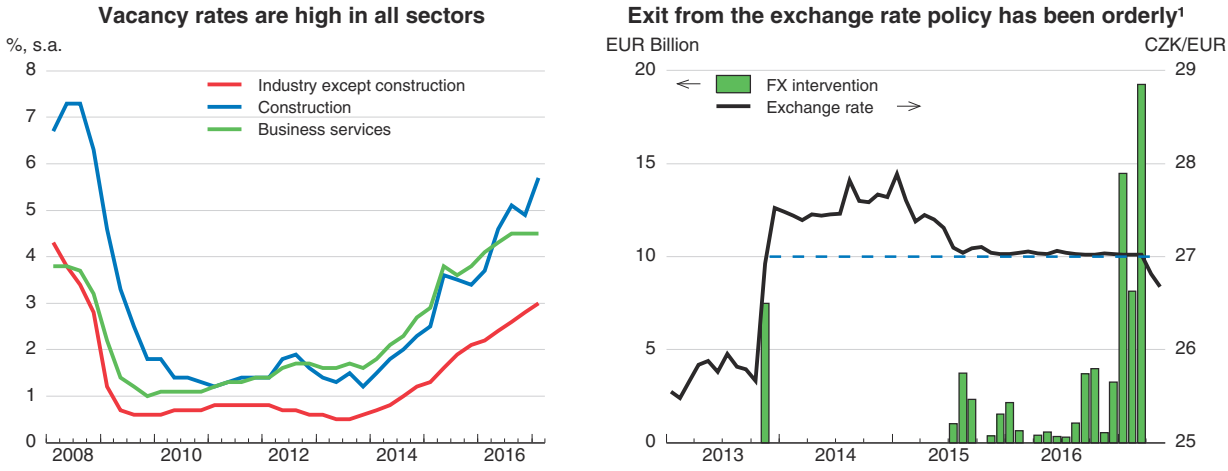
In April, the central bank successfully ended its unconventional policy of capping the koruna exchange rate against the euro, allowing it to float freely. Monetary policy is assumed to tighten gradually from late 2017 to counter rising inflation. Slightly expansionary fiscal policy in 2017 will give the central bank scope to raise interest rates. Structural policies that reduce labour shortages and raise productivity – such as expanding childcare to allow mothers to return to work – would facilitate faster growth and sustain higher wages.

The economy is highly integrated into global value chains due to foreign investment. Foreign firms were previously attracted by low wages, but the challenge now is to increase value added to raise the returns from globalisation. Incentives to increase R&D by Czech firms should be increased. Lifelong learning would help the workforce adapt to these changes.

External demand is providing a tailwind

Weak domestic demand weighed on GDP growth in 2016, largely due to the anticipated fall in investment associated with the transition to the new EU programming period. But a strong pick-up in external demand boosted exports. Housing investment is also growing strongly. Labour demand remains high and is fuelling wage growth and consumer confidence. Male and female employment rates have reached historical highs, and labour market slack is disappearing. Business confidence and profits have softened in most sectors, even though financial conditions remain supportive. Diminishing slack and higher food and energy prices pushed headline inflation above 2% in early 2017.

Czech Republic



1. The dotted line is the exchange rate floor set by the Czech National Bank on 7 November 2013 and removed on 6 April 2017.
Source: Eurostat; and Czech National Bank.

StatLink http://dx.doi.org/10.1787/888933502978

Czech Republic: **Demand, output and prices**

	2013	2014	2015	2016	2017	2018
	Current prices CZK billion	Percentage changes, volume (2010 prices)				
GDP at market prices	4 097.0	2.7	4.6	2.3	2.9	2.6
Private consumption	2 024.7	1.8	3.1	2.8	3.0	2.6
Government consumption	826.0	1.1	2.0	1.2	1.8	1.8
Gross fixed capital formation	1 026.3	3.9	9.1	-3.9	1.7	4.1
Final domestic demand	3 877.0	2.2	4.5	0.6	2.4	2.9
Stockbuilding[1]	- 15.9	1.1	0.3	0.7	-0.1	0.0
Total domestic demand	3 861.1	3.4	4.8	1.4	2.2	2.8
Exports of goods and services	3 147.9	8.7	7.9	4.0	3.8	4.5
Imports of goods and services	2 912.0	10.1	8.4	3.0	3.0	4.9
Net exports[1]	235.9	-0.5	0.1	1.0	0.9	0.0
Memorandum items						
GDP deflator	_	2.5	1.0	1.1	1.4	2.0
Consumer price index	_	0.4	0.3	0.7	2.3	2.2
Private consumption deflator	_	0.6	0.1	0.6	2.1	1.8
Unemployment rate	_	6.1	5.0	4.0	3.3	3.3
General government financial balance[2]	_	-1.9	-0.6	0.6	0.4	0.6
General government gross debt[2]	_	56.9	53.9	49.7	48.5	47.2
General government debt, Maastricht definition[2]	_	42.2	40.3	37.2	36.0	34.7
Current account balance[2]	_	0.2	0.2	1.1	1.0	1.4

1. Contributions to changes in real GDP, actual amount in the first column.
2. As a percentage of GDP.
Source: OECD Economic Outlook 101 database.

StatLink http://dx.doi.org/10.1787/888933505771

Macroeconomic policies remain supportive

With headline and core inflation rising above the 2% target, in April 2017 the central bank ended the exchange rate policy that had prevented appreciation against the euro and thereby fended off deflationary pressures. Large interventions to contain currency appreciation in early 2017 raised foreign exchange reserves to 70% of GDP. Exchange rate movements have been moderate so far. Assuming that this continues, the bank should gradually raise the policy rate, as assumed in the projections. House prices and credit are accelerating. To mitigate financial stability risks, counter-cyclical capital buffers were introduced in January and the parliament is currently discussing legislation that would give the central bank the authority to limit loan-to-value ratios for mortgages.

Income growth and increased tax compliance have contributed to strong revenue growth and a record fiscal surplus in 2016. Fiscal policy is projected to be slightly expansionary in 2017, reflecting public sector wage increases and also national and EU-funded projects ramping up again, and neutral in 2018. Further efforts are needed to increase the take-up of EU funds, with better co-ordination across government. Public sector wage increases and a pension supplement in 2017 will make growth more inclusive. The new, welcome, fiscal framework has been approved. It involves a fiscal council and expenditure and debt brake rules.

Policies to expand labour supply and productivity would increase the sustainability of wage growth. The availability of childcare is increasing, but more places are needed and the tax-benefit system discourages mothers from returning to work. The government plans to make skilled migration programmes easier for businesses to use, which holds the promise of relieving skill shortages. The updated export strategy seeks to diversify export markets and improve entrepreneurs' access to information and finance, which should increase the domestic value-added embodied in Czech exports. Fiscal incentives for business R&D spending should be increased and complemented by government co-financing schemes.

Domestic demand will drive growth

Buoyant income growth and a falling saving rate are projected to continue to drive private consumption growth. As EU-funded projects take off, investment growth will rise. Export growth is projected to remain solid in 2017 and pick up in 2018 as the European recovery continues. Strong labour demand and limited labour supply will push the unemployment rate to new lows, boosting wages. Inflation is expected to remain just above the 2% inflation target in both years.

The main risks are external. The key risk is a strong exchange rate appreciation, which would harm Czech export competitiveness. Uncertainty surrounding Brexit or a slowing economy in China would also hurt Czech exporters via global value chains. Conversely, the European economy could surprise on the upside, boosting exports. If government investment projects increased faster than expected or firms invested in equipment to combat labour shortages, growth would be stronger. Improvements in the efficiency of public spending, if implemented fully, would raise growth.