

## CZECH REPUBLIC

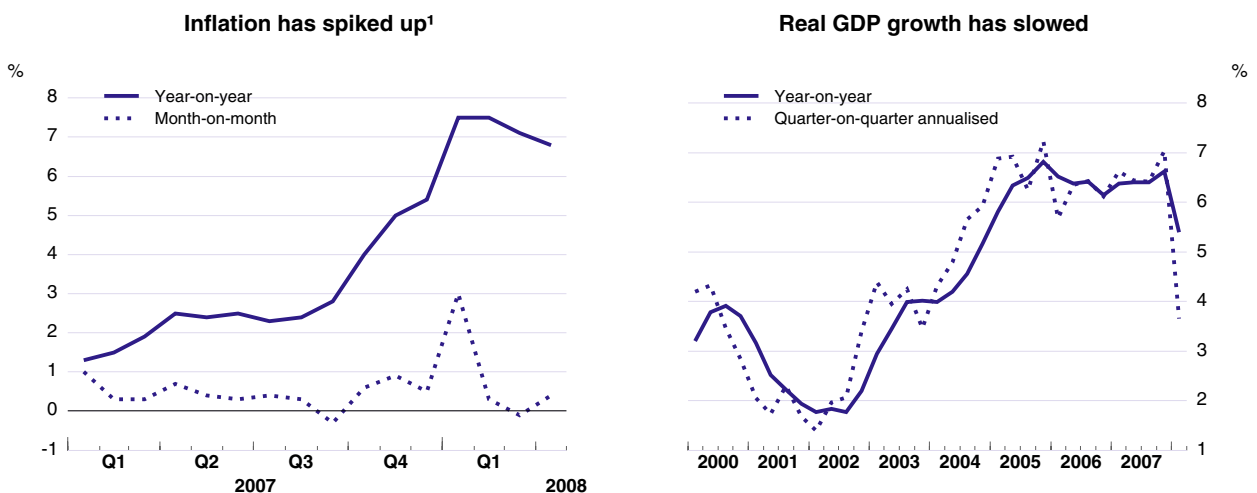
Following three years of growth in excess of 6%, real GDP is expected to decelerate to around 4½ per cent for 2008 before picking up again in 2009. Most of the slowdown is due to a spike in inflation that has squeezed real household disposable incomes.

The inflation spike reflects to a considerable extent several measures that formed part of a fiscal package passed late last year. The government is pushing ahead with further reform but its weak political mandate means progress is slow. The key challenges are to ensure fiscal sustainability in the light of upcoming population pressures and to expand the labour supply and improve education systems so as to prevent employment and skills shortages from constraining growth potential.

**Growth slowed significantly in the first quarter**

Real aggregate demand growth slowed significantly in the first quarter of this year, largely due to increasing consumer prices. Market developments in food and oil prices had already been pushing headline inflation up in the second half of 2007, despite the strong appreciation of the Czech koruna. Then, in January an increase in the lower rate of value-added tax (VAT) and other policy driven price hikes increased inflation further. In February and March, month-on-month growth in the consumer price index was close to zero, notably with slight falls in the food component of the index. Despite this, inflation was 7.5% year-on-year in the first quarter. Inflation developments have significantly slowed real household consumption spending and are likely to have a lagged impact on consumption looking forward. As regards other components of aggregate demand, export volume growth notably turned out at 14.5% in 2007. Typical of recent years, this increase was a good margin above estimates of export market growth. The recent slowdown in growth has not had a significant impact on the labour market; the unemployment

### Czech Republic



1. Inflation is measured by the consumer price index.

Source: Czech Statistical Office and OECD Economic Outlook database.

StatLink <http://dx.doi.org/10.1787/366467527834>

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

	2004	2005	2006	2007	2008	2009
	Current prices CZK billion	Percentage changes, volume (2000 prices)				
Private consumption	1 416.5	2.4	5.5	5.6	2.8	4.0
Government consumption	621.6	2.2	0.0	0.9	0.0	0.1
Gross fixed capital formation	727.2	2.3	5.5	6.1	8.6	7.8
Final domestic demand	2 765.3	2.3	4.2	4.7	3.7	4.2
Stockbuilding <sup>1</sup>	48.2	-0.7	1.4	1.0	0.0	0.0
Total domestic demand	2 813.5	1.6	5.6	5.6	3.6	4.0
Exports of goods and services	1 968.6	12.0	15.0	14.5	11.9	11.4
Imports of goods and services	1 967.7	5.1	14.4	13.6	11.1	10.8
Net exports <sup>1</sup>	0.9	4.8	0.9	1.1	1.1	1.0
GDP at market prices	2 814.4	6.4	6.4	6.5	4.5	4.8
GDP deflator	–	-0.2	1.7	3.4	7.0	2.5
<i>Memorandum items</i>						
Consumer price index	–	1.9	2.6	3.0	6.8	2.9
Private consumption deflator	–	0.9	2.3	2.9	7.1	2.9
Unemployment rate	–	7.9	7.2	5.3	4.6	4.4
General government financial balance <sup>2</sup>	–	-3.6	-2.6	-1.6	-1.5	-1.3
Current account balance <sup>2</sup>	–	-1.6	-3.1	-2.5	-2.6	-1.8

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook Sources and Methods* (<http://www.oecd.org/eco/sources-and-methods>).

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

2. As a percentage of GDP.

Source: OECD Economic Outlook 83 database.

StatLink  <http://dx.doi.org/10.1787/365105444452>

rate remains low following the large falls due to the strong economic growth in recent years.

### Monetary policy rates have increased in recent months

The global financial turbulence has, so far, not had significant effects on the Czech financial sector and has therefore not prompted special measures by the Central Bank. The spike in inflation will probably not significantly affect underlying inflation but it is presenting challenges in the Bank's communication to markets and the public. Communication is further complicated by an upcoming reduction in the inflation target. As of January 2010, the inflation target, expressed as annual consumer price inflation, will be lowered by 1 percentage point to 2% with the same  $\pm 1$  percentage point tolerance band.

### The government deficit outturn for 2007 was lower than expected

The general government deficit for 2007 was 1.6% as a share of GDP, which is much lower than expected. For 2008, reforms are bringing some uncertainty in revenues and spending. The increases in the lower rate of VAT and other indirect taxes are part of a package which simultaneously lowered direct taxation through a move to a single rate of personal income tax and a schedule of reductions in the corporate tax rate. There have also been various measures on the spending side.

**Growth is expected to pick up**

Annual real GDP growth is projected to ease to 4.5% in 2008, due primarily to the squeeze on real household consumption. But in addition, a slight easing in export growth is expected up to the final quarter of 2008, reflecting developments in demand elsewhere in Europe. By 2009, any lagged effects of the inflation spike on consumption are likely to have largely worn off. This, combined with some increase in export growth, is expected to drive annual growth for 2009 up to 4.8%, and by the final quarter it will have reached a little over 5% year-on-year. Inflation is projected to drop off significantly between the first and second quarters of this year and to decline slowly thereafter. Nevertheless, annual inflation is projected to turn out at 6.8% for 2008; however, it will be much lower in 2009 at 2.9% and by the final quarter it is expected to be down to 2.6%, year-on-year. Small reductions in the general government deficit are expected with outturns of 1.5% and 1.3% of GDP in 2008 and 2009, respectively.

**Risk factors are mainly on the downside**

Risks are predominantly, but not exclusively, on the downside. Second-round effects on inflationary expectations from the spike in inflation may be more significant than expected. Also, future price developments in food and energy markets are particularly uncertain, but could nevertheless moderate more than projected. Although Czech financial markets do not appear to have strong direct linkages with the global financial turmoil, any further negative effects on the global economy could feed through to the domestic economy, principally through export demand.

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### This book has...



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### Conventional signs

\$	US dollar	.	Decimal point
¥	Japanese yen	I, II	Calendar half-years
£	Pound sterling	Q1, Q4	Calendar quarters
€	Euro	Billion	Thousand million
mb/d	Million barrels per day	Trillion	Thousand billion
..	Data not available	s.a.a.r.	Seasonally adjusted at annual rates
0	Nil or negligible	n.s.a.	Not seasonally adjusted
-	Irrelevant		

## Summary of projections

	2007	2008	2009	2007		2008				2009				Fourth quarter		
				Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2007	2008	2009	
Per cent																
<b>Real GDP growth</b>																
United States	2.2	1.2	1.1	0.6	1.0	-0.5	0.7	0.2	1.0	1.4	2.2	3.0	2.5	0.3	1.9	
Japan	2.1	1.7	1.5	2.6	3.3	1.1	1.0	1.3	1.6	1.6	1.7	1.7	1.5	1.7	1.6	
Euro area	2.6	1.7	1.4	1.2	3.1	0.2	1.1	1.2	1.4	1.7	1.8	1.9	2.1	1.4	1.7	
Total OECD	2.7	1.8	1.7	1.7	2.1	0.5	1.2	1.2	1.7	2.0	2.4	2.7	2.6	1.3	2.2	
<b>Inflation<sup>1</sup></b>																
United States	2.5	3.2	2.0	3.9	3.5	3.6	2.4	2.0	1.8	1.7	1.6	1.6	3.4	2.9	1.6	
Japan	0.1	0.9	0.4	1.6	1.2	0.6	0.3	0.3	0.3	0.4	0.5	0.6	0.5	0.6	0.5	
Euro area	2.1	3.4	2.4	4.8	4.2	3.3	2.6	2.4	2.3	2.2	2.1	2.0	2.9	3.1	2.1	
Total OECD	2.2	3.0	2.1	3.5	3.4	3.2	2.5	2.3	2.0	1.9	1.8	1.8	2.8	2.8	1.9	
<b>Unemployment rate<sup>2</sup></b>																
United States	4.6	5.4	6.1	4.8	4.9	5.2	5.5	5.8	6.0	6.2	6.2	6.1	4.8	5.8	6.1	
Japan	3.9	3.8	3.8	3.9	3.8	3.8	3.8	3.9	3.9	3.8	3.7	3.7	3.9	3.9	3.7	
Euro area	7.4	7.2	7.4	7.1	7.1	7.2	7.2	7.3	7.4	7.4	7.5	7.5	7.1	7.3	7.5	
Total OECD	5.6	5.7	6.0	5.5	5.6	5.7	5.7	5.9	6.0	6.0	6.0	6.0	5.5	5.9	6.0	
<b>World trade growth</b>																
	7.1	6.3	6.6	4.8	6.5	6.1	6.1	6.3	6.6	6.9	7.0	7.1	7.2	6.2	6.9	
<b>Current account balance<sup>3</sup></b>																
United States	-5.3	-5.0	-4.4													
Japan	4.8	4.4	4.4													
Euro area	0.2	0.1	0.0													
Total OECD	-1.4	-1.3	-1.1													
<b>Cyclically-adjusted fiscal balance<sup>4</sup></b>																
United States	-3.2	-5.2	-4.4													
Japan	-2.6	-1.6	-2.5													
Euro area	-0.7	-1.0	-0.8													
Total OECD	-2.0	-2.8	-2.5													
<b>Short-term interest rate</b>																
United States	5.3	2.7	3.1	5.0	3.2	2.6	2.6	2.5	2.3	2.6	3.4	4.0				
Japan	0.7	0.8	0.7	0.8	0.8	0.9	0.9	0.8	0.7	0.7	0.8	0.8				
Euro area	4.3	4.5	4.1	4.7	4.5	4.5	4.5	4.4	4.2	4.1	4.1	4.1				

*Note:* Real GDP growth, inflation (measured by the increase in the consumer price index or private consumption deflator for total OECD) and world trade growth (the arithmetic average of world merchandise import and export volumes) are seasonally and working-day-adjusted annual rates. The "fourth quarter" columns are expressed in year-on-year growth rates where appropriate and in levels otherwise. Interest rates are for the United States: 3-month eurodollar deposit; Japan: 3-month certificate of deposits; euro area: 3-month interbank rate.

Assumptions underlying the projections include:

- no change in actual and announced fiscal policies;

- unchanged exchange rates as from 13 May 2008; in particular 1\$ = 104.44 yen and 0.64 ;

The cut-off date for other information used in the compilation of the projections is 23 May 2008.

1. USA; price index for personal consumption expenditure, Japan; consumer price index and the euro area; harmonised index of consumer prices.

2. Per cent of the labour force.

3. Per cent of GDP.

4. Per cent of potential GDP.

Source: OECD Economic Outlook 83 database.





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