CZECH REPUBLIC

Economic growth picked up strongly in 2015, driven by private demand and a boost from EU-financed public investment. Supportive financial conditions, growth in wages and profits and strengthening external demand are projected to support robust growth in 2016 and 2017. Rising domestic costs will push inflation to the 2% target level in 2017.

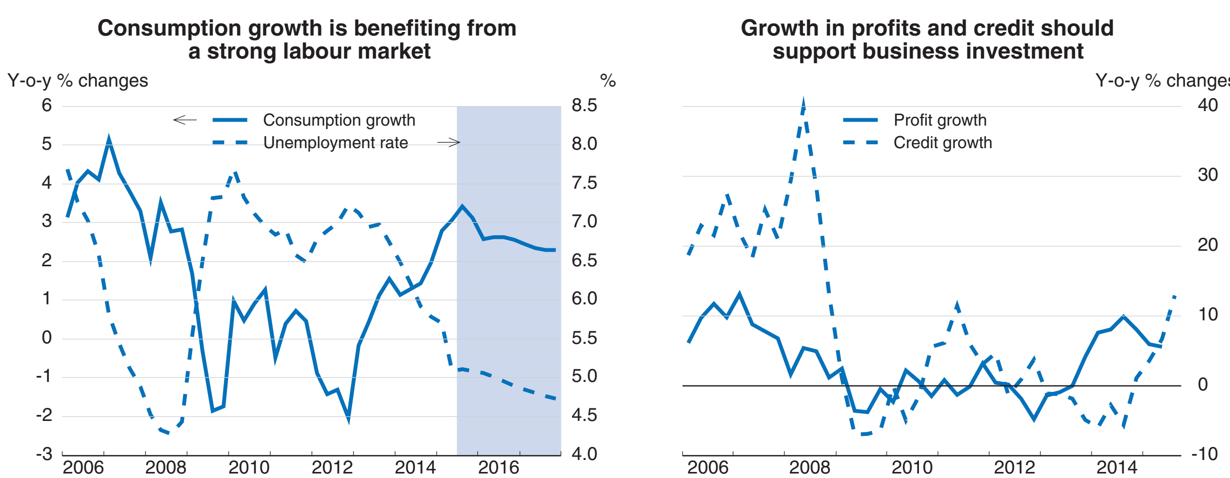
Monetary policy remains appropriately expansionary to ensure that inflation returns to the target. But as soon as inflation is clearly increasing towards the target, the unconventional exchange rate policy – preventing appreciation against the euro – should be ended. Fiscal policy will become slightly restrictive, consistent with medium-term budgetary objectives. Reforms to expand labour supply, reduce skills mismatches and increase competition would boost economic convergence and help to make growth more inclusive.

The challenge for climate change policy is to reduce the high energy and carbon intensity of growth by shifting away from coal and improving energy efficiency. Subsidies and grants for investment in renewable energy and improving energy efficiency have been expanded. The effective tax rate on CO_2 emissions is low relative to other OECD countries and could be increased.

Domestic demand growth has surged

Economic growth is set to rebound in 2015 to its fastest pace since 2007, driven by domestic demand. Strong income growth, easier borrowing conditions and diminishing spare capacity have buoyed consumer and business confidence. Public investment has risen sharply, largely using expiring EU funds. Exports benefited from competitiveness gains early in the year but have slowed subsequently. Core inflation has risen steadily in year-on-year terms, but falling food and energy prices have weighed on headline inflation.

Czech Republic



Source: OECD Economic Outlook 98 database; OECD, Quarterly National Accounts database; and European Central Bank.

StatLink http://dx.doi.org/10.1787/888933296142

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

	2012	2013	2014	2015	2016	2017
	Current prices CZK billion	Percentage changes, volume (2010 prices)				
GDP at market prices	4 041.9	-0.5	2.0	4.3	2.3	2.4
Private consumption	1 998.0	0.7	1.5	3.1	2.6	2.3
Government consumption	782.7	2.3	1.8	2.2	1.8	1.7
Gross fixed capital formation	1 052.3	-2.8	2.0	6.7	3.3	3.1
Final domestic demand	3 832.9	0.1	1.7	3.9	2.6	2.4
Stockbuilding[1]	9.0	-0.6	0.6	1.0	-0.1	0.0
Total domestic demand	3 841.9	-0.5	2.3	4.9	2.4	2.4
Exports of goods and services	3 097.1	0.0	8.9	6.7	4.7	5.9
Imports of goods and services	2 897.1	0.1	9.9	7.6	5.0	6.2
Net exports[1]	200.0	0.0	-0.2	-0.3	0.1	0.2
Memorandum items						
GDP deflator	_	1.4	2.5	1.0	1.2	1.7
Consumer price index	_	1.4	0.4	0.4	1.3	2.0
Private consumption deflator	_	0.9	0.5	0.4	1.2	1.8
Unemployment rate	_	6.9	6.1	5.2	5.0	4.8
General government financial balance[2]	_	-1.3	-1.9	-1.9	-1.3	-0.8
General government gross debt[2]	_	58.1	57.2	56.1	56.1	56.1
General government debt, Maastricht definition[2]	_	45.2	42.7	40.5	40.5	40.5
Current account balance[2]	_	-0.5	0.6	0.7	0.2	-0.2

1. Contributions to changes in real GDP, actual amount in the first column.
2. As a percentage of GDP at market value.
Source: OECD Economic Outlook 98 database.

StatLink http://dx.doi.org/10.1787/888933297041

Macroeconomic policies should gradually become less expansionary

Monetary policy remains focussed on preventing deflation, with the policy rate almost at zero and the central bank committed to retaining the exchange rate floor against the euro until at least mid-2016. Nonetheless, once inflation is clearly rising towards the 2% target, the exchange rate should be allowed to float freely, with careful communication and timing to limit volatility. The first increase in the policy rate is not likely until late 2017, when the normalisation of the euro area policy rate is also assumed to start.

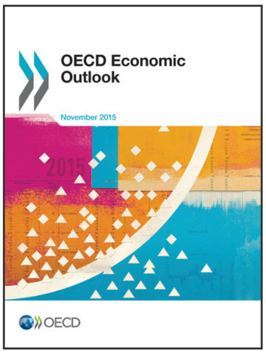
Fiscal policy is expected to become slightly restrictive. Revenue growth will be supported by intensified efforts to reduce tax evasion. Falling borrowing costs and improved liquidity management have reduced government debt. Implementation of the planned fiscal responsibility package, with a debt-brake rule and an independent fiscal council, should reinforce fiscal control. Better management and take-up of available EU funds, including the structural programmes and the EU Investment Plan, would increase capital deepening and productivity.

Structural policy reforms are needed to boost productivity and potential output growth. Greater competition in services markets would raise productivity. Ensuring the effective expansion of childcare provision and the quality of post-school training would expand labour supply, particularly of women with care obligations and graduates from disadvantaged backgrounds, and reduce skills mismatches. Upcoming changes will see more children from disadvantaged backgrounds attend mainstream schools, and raising educational quality in schools would strengthen inclusiveness further. Subsidies and grants related to climate change should be monitored for efficacy and cost-effectiveness and incentives strengthened where appropriate.

Growth will remain solid

Domestic demand will continue to drive GDP growth, though at a slower pace than in 2015. Although private investment will remain robust, public sector investment will fall in early 2016 as the boost from spending on EU-financed projects fades. Rising labour demand will reduce the unemployment rate further and push up wage growth, supporting household incomes and consumption. Export growth will increase gradually, reflecting the slow recovery in external demand. As spare capacity diminishes and the disinflationary effects of commodity prices wane, domestic costs will drive inflation to the 2% target.

If firms' optimism falters, private investment could be weaker than expected. A shock transmitted through the automotive industry would dent growth, as would renewed euro area difficulties or geopolitical tensions. There is also a risk that after the exchange rate floor is lifted an appreciation of the koruna overshoots, damping growth and inflation. On the other hand, consumption growth would be stronger if wages accelerate more than expected. On the external side, exporters may offset rising costs to make further market share gains than projected.



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