

CZECH REPUBLIC

Exports continue to drive the recovery in real GDP, which is set to grow by 2.4% in 2010 and 2.8% in 2011, with domestic demand more subdued because of the weak labour market and fiscal consolidation. By 2012 the economy is likely to be growing by 3.2%. Temporary inflationary pressures are coming from energy prices and housing costs, but the inflation target of 2% should be achieved.

The new government has proposed fiscal consolidation for 2011, focusing primarily on cuts in operational expenditures. The opportunity offered by the economic recovery should be seized to address structural issues to improve the underlying balance of the public finances and enhance economic potential.

The recovery is underpinned by improving exports and strengthening orders

The economy has been growing in tandem with Germany since the second half of last year. Recovery continues to be driven by exports but private consumption has also shown some resilience. Industrial production, in particular the important automotive sector, is recovering strongly from last year's slump while new orders remain strong. Private consumption held up fairly well during the downturn and it started to grow again at the beginning of this year. However, construction still remains weak and below the levels of last year. Also, the recovery in confidence indicators has slowed somewhat.

Domestic inflationary pressures have emerged

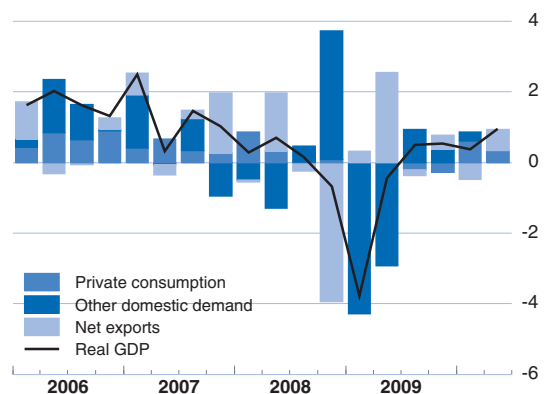
The main monetary policy rate remains at the historically low level of 0.75%. The headline inflation rate has picked up somewhat to 2% year-on-year in October. There are further inflationary pressures on the horizon but monetary policy can remain accommodative for some time due to ongoing fiscal consolidation. Continuing deregulation of rents is increasing housing costs. Moreover, electricity prices are expected to rise in 2011. This is due to over-subsidisation of solar-energy production that

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Trade growth has resumed



Domestic demand is also recovering
Contributions to quarterly real GDP growth, %



Source: European Commission; OECD, National Accounts database.

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


	2007	2008	2009	2010	2011	2012
	Current prices CZK billion	Percentage changes, volume (2000 prices)				
Private consumption	1 688.0	3.5	-0.1	1.5	1.5	2.4
Government consumption	718.2	1.0	4.2	1.1	0.6	1.1
Gross fixed capital formation	890.3	-1.5	-9.2	-3.6	5.8	6.2
Final domestic demand	3 296.4	1.6	-1.5	0.2	2.3	3.0
Stockbuilding ¹	66.9	-0.5	-2.0	1.3	0.0	0.0
Total domestic demand	3 363.4	1.1	-3.6	1.6	2.2	2.9
Exports of goods and services	2 836.0	5.7	-10.5	11.4	7.7	6.0
Imports of goods and services	2 660.3	4.3	-10.4	11.0	7.2	5.8
Net exports ¹	175.7	1.3	-0.6	0.9	0.7	0.5
GDP at market prices	3 539.1	2.3	-4.0	2.4	2.8	3.2
GDP deflator	–	1.8	2.6	0.0	2.2	1.4
<i>Memorandum items</i>						
Consumer price index	–	6.3	1.0	1.6	1.9	1.7
Private consumption deflator	–	4.9	0.3	0.8	1.8	1.7
Unemployment rate	–	4.4	6.7	7.5	7.1	6.8
General government financial balance ²	–	-2.7	-5.8	-5.2	-4.2	-3.4
Current account balance ²	–	-0.6	-1.0	-1.9	-0.8	-0.7

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 88 database.

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led to rapid expansion in producing capacities and whose generous feed-in tariffs translate into increases in the regulated component of the energy price.

Restrictive fiscal policy is needed to achieve targets

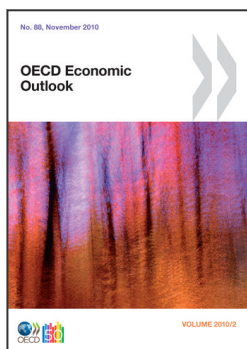
Fiscal retrenchment is already under way in 2010 and the proposed budget for 2011 continues the consolidation. In contrast to this year's budget, in which the improvement in the balance was based mainly on VAT and excise tax increases, the draft for 2011 puts emphasis on cuts in recurrent expenditures and central government wage restraint. The projection takes account of the proposed 2011 consolidation, which aims for a deficit target of 4.6% GDP. Furthermore, it assumes a continued prudent fiscal policy for 2012. Broad fiscal targets have been set in the framework of medium-term expenditure ceilings. These aim at a general government deficit of 3% in 2013 and a balanced budget by 2016. Specific steps on how to get to these targets have yet to be decided. At a time when much of the improvement in headline budget numbers can occur from increased economic growth, the recovery phase of the cycle needs to be used for addressing structural issues, including efficiency gains in public sector operations. The current coalition government, given its majority in the parliament, is in a position to seize the opportunity to implement a number of reform proposals such as in tertiary education or pensions.

Prospects have improved with the recovery in world trade and domestic demand

Growth has accelerated in 2010 as the main export markets picked up strongly in the first half of the year. Growth is likely to ease somewhat during 2011 with both private and government consumption subdued, but then will rise again in 2012 as investment is expected to recover quickly. Adjustment in the labour market will be gradual but the unemployment rate is expected to have peaked this year. Together with fiscal restraint, the weak labour market situation will weigh on private consumption, which is nonetheless expected to pick up in 2012. Foreign trade will continue to perform strongly. Inflationary pressures at the beginning of next year will be temporary and as the economy will be below potential, the 2% inflation target should be reached.

Risks relate mainly to external developments

There are balanced risks, primarily based on developments in major export markets, in particular the euro area. On the downside, households' response to the governmental spending restraint and announced increases in housing and electricity prices could result in weaker domestic demand.



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