

CZECH REPUBLIC

Strong growth will continue in 2018 and 2019, driven by robust private demand and a dynamic external sector. Increasing wages will support household consumption and low interest rates will boost capital investment. Labour shortages will weigh on growth. Historically low unemployment will push inflation above the central bank's 2% target.

Following the removal of the exchange rate floor in April 2017, the value of the koruna has appreciated slightly. Monetary policy should continue to tighten gradually to counter inflation pressures. Given current and expected primary surpluses, the government could boost infrastructure investment and leverage EU funds. Structural policies to reduce labour shortages and raise labour productivity – such as reducing skills mismatches – would facilitate faster growth and sustain higher wage levels.

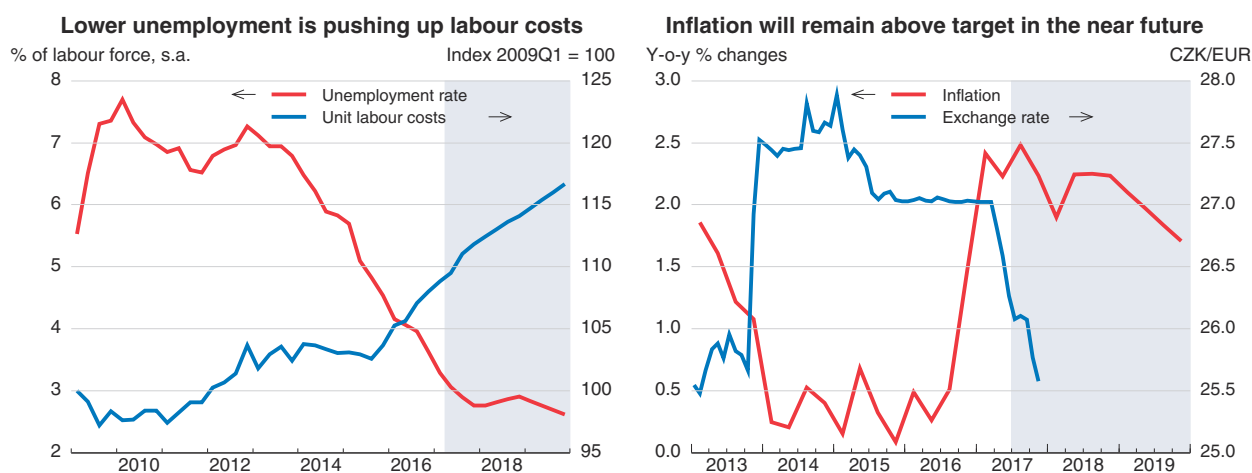
The financial sector is appropriately capitalised, liquid and profitable. However, the low levels of interest rates and strong economic activity have boosted mortgage credit demand and pushed up house prices. Decreased risk weights assigned to mortgage loans in many banks may amplify risks posed by the housing market and associated loans. A change in prudential rules may be needed as a result.

The economic boom is driven by both domestic and foreign demand


Economic activity continued to grow robustly in 2017 on the back of a broad-based expansion. Foreign demand contributed strongly to growth, which is above potential. Strengthening of growth in Europe contributed to drive exports and industrial production. Household consumption also supported growth thanks to low unemployment and high wage increases.

A tight labour market is becoming the binding constraint on growth. The unemployment rate has fallen to a historic low, creating labour shortages in some industries and pushing up labour costs. Moreover, the number of vacancies is high and the

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Source: OECD Economic Outlook 102 database; and Czech National Bank.

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

	2014	2015	2016	2017	2018	2019
	Current prices CZK billion	Percentage changes, volume (2010 prices)				
GDP at market prices	4 312.5	5.4	2.5	4.3	3.5	3.2
Private consumption	2 073.4	3.7	3.5	4.0	3.8	3.0
Government consumption	849.2	1.9	2.0	1.6	1.8	1.6
Gross fixed capital formation	1 083.4	10.4	-2.5	6.6	4.3	3.1
Final domestic demand	4 006.0	5.1	1.5	4.2	3.6	2.8
Stockbuilding ¹	32.3	0.8	0.0	-0.7	0.0	0.0
Total domestic demand	4 038.3	5.9	1.4	3.4	3.5	2.7
Exports of goods and services	3 558.6	6.2	4.3	7.4	5.8	5.4
Imports of goods and services	3 284.3	7.0	3.1	6.6	6.1	5.0
Net exports ¹	274.3	-0.2	1.1	1.2	0.2	0.6
<i>Memorandum items</i>						
GDP deflator	—	1.2	1.2	1.0	1.7	1.7
Consumer price index	—	0.3	0.7	2.3	2.2	1.9
Core inflation index ²	—	1.3	1.6	2.0	1.9	1.7
Unemployment rate (% of labour force)	—	5.0	3.9	3.0	2.8	2.7
Household saving ratio, net (% of disposable income)	—	6.6	6.9	6.7	6.5	6.6
General government financial balance (% of GDP)	—	-0.6	0.7	1.3	1.3	1.5
General government gross debt (% of GDP)	—	53.5	49.1	46.8	44.8	42.6
General government debt, Maastricht definition (% of GDP)	—	39.9	36.8	34.5	32.5	30.3
Current account balance (% of GDP)	—	0.2	1.1	0.7	0.8	1.0

1. Contributions to changes in real GDP, actual amount in the first column.

2. Consumer price index excluding food and energy.

Source: OECD Economic Outlook 102 database.

StatLink  <http://dx.doi.org/10.1787/888933632482>

ratio of unemployed persons per vacancy decreased to 1.3. The decline in unemployment will exert further pressures on wages and inflation.

It is time to boost investment in infrastructure and increase the inclusiveness of growth

Inflation is accelerating and will stay above the central bank's 2% target in 2018. Apart from wage pressures, food prices and industrial producer prices will keep driving up inflation. The Czech national bank is likely to increase interest rates by the end of 2017 and further tightening of monetary policy in 2018 will be necessary to keep inflation expectations anchored. Parallel tightening of monetary policy in the euro area would help limit the appreciation of the koruna. Moreover, the expected rising of credit costs should help limit the increase in house prices and mortgage loans. Monitoring of house prices developments and related bank loans is recommended, in particular in the face of tightening monetary policy.

The fiscal surplus will continue in 2018 and the public debt-to-GDP ratio will fall further. Pressures to increase civil servants' wages will continue. The strong fiscal position provides room to invest in the well-being of disadvantaged people, including old-aged individuals, to increase their inclusion in the labour market and society. Housing programmes and targeted education policies to better integrate Roma are affordable. Also,

developing childcare facilities and reforming family policies would bring more women into the labour market and facilitate work-life balance.

The fiscal room could also be mobilised to improve the use of EU funds. The implementation of identified infrastructure projects, such as highways, railways and the development of the Prague metropolitan area, should be accelerated, as this would increase long-run potential growth. Streamlining procedures for granting building permits and further reducing the administrative burden on businesses by rolling out key e-government services could accelerate infrastructure investments.

Strong growth will continue

Growth is projected to remain above 3% throughout the projection period. Strengthening of growth in Europe and wage gains will drive demand and growth. Progress in the use of EU funds should also boost investment.

Risks to the projections include developments in the labour market and inflation dynamics. In particular, persistent labour shortages could create a wage-price inflation loop that could derail growth. As wage gains accelerate, firms' prices will have to increase, raising inflation and diminishing the price competitiveness of Czech firms. Also, a greater differential between euro area and Czech interest rates would lead to an appreciation of the koruna that could affect exports and limit growth.