Deloitte.

Czech Economic Outlook for 2018

Controlled Slowdown

December 2017

Introduction

The Czech Republic is a small open market economy with solid growth dynamics which does not suffer from excessive internal, external or financial imbalances.

Living standards are at 90.5% of the EU average measured by GDP per capita based on the purchasing power parity (Deloitte's estimate for 2017). In the past two decades, the average GDP growth rate amounted to 2.7%. Sector-wise, the creation of gross added value is dominated by services (60%), with industry, construction and agriculture amounting to 32%, 5% and 3%, respectively.

Central to economic development is foreign trade. The goods and services export ratio to GDP is at 80% and has been on the rise over the long term. Key business partners include EU member states: Germany, Slovakia, Poland and France.

The stable macroeconomic situation and the relatively low government debt have been reflected in positive ratings. Standard & Poor's has given the Czech Republic's long-term obligations in the local currency an 'AA' rating, Fitch Ratings an 'A+' rating and Moody's an 'A1' rating.

The sections below provide a more detailed analysis of the Czech economy, an assessment of the current situation and the stability of the Czech economy, and an outlook for 2018.

Global Economy

Easing and prosperity. These are the words that best describe the 2017 global developments in a nutshell. The geopolitical risk has diminished. The situation in the Middle East is slowly stabilising and no major epicentre of problems that could affect financial markets and the global economy has occurred elsewhere in the world.

European milestones included elections in France and Germany. The French presidential election saw Emmanuel Macron defeat the far right candidate Marine Le Pen, diminishing the perceived risk of a rise in populism and radicalisation and strengthening the idea of closer European integration, of which the newly elected French president is a proponent. Markets also gave a sign of relief after the election for Germany's Bundestag, from which the CDU/CSU bloc headed by the present Chancellor Angela Merkel emerged victorious. Nevertheless, negotiations on forming a government coalition have reached a stalemate and early elections cannot be ruled out.

Brexit, or its form, remains an open question. Uncertainty primarily surrounds the British position and the delays in negotiations, which indicates that the result is more likely to be a hard Brexit, i.e. loose or no trade agreements with the European Union. This gives rise to concerns about the economic impacts on the United Kingdom and other countries, which could be substantial compared to a soft Brexit.

In the long term, international trade agreements are of central importance for the global economy. In 2017, two milestones occurred in this respect. The good news is that the European Parliament approved the trade agreement between the EU and Canada (CETA). The negative moment was the decision of the US President, Donald Trump, to withdraw the US from the Trans-Pacific Partnership (TPP).

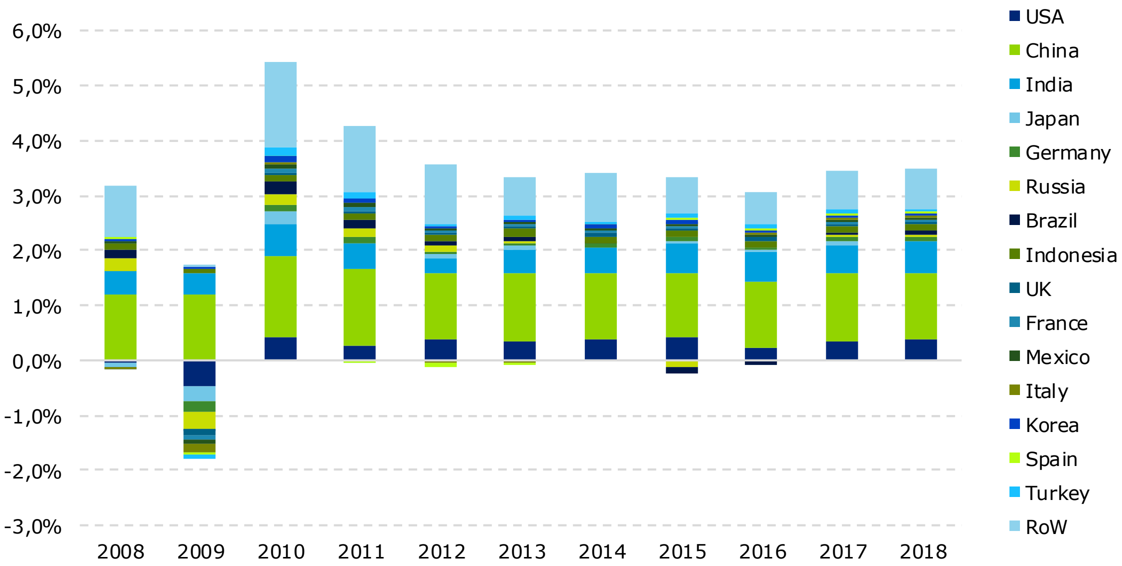
Stability and economic growth were reflected in financial market developments. Virtually all key share indices recorded major increases. The MSCI World index rose by 20%, the American S&P 500 index also by 20% and the pan-European STOXX Europe 600 index by 8%[1]. The reduction in the perceived risk manifested itself by a drop in the prices of CDS contracts in respect of almost all countries (the only exception being Venezuela). The markets' optimism is also illustrated by Greece's return to bond markets after a forced break during the local debt crisis.

In certain areas, optimism is excessive. The dramatic rise in the value of Bitcoin or the substantial increase in the volume of ICO (initial coin offering) transactions lack economic merits: rather than not, they point to the efforts to circumvent regulation on traditional markets, which may plant the roots of potential future problems.

The reduction in geopolitical risks, the tranquillity on financial markets, the still relatively low prices of commodities and the loose monetary policy in advanced countries contributed to the acceleration of the global economy's growth rate from 3.0% in 2016 to 3.5% in 2017. This was particularly aided by the acceleration of growth in the US and Europe, and the end of recession in Russia.

2018 should be marked by favourable economic development. The global economy's growth rate should remain at 3.5%. The US, Mexico, India and Russia should see their economic growth accelerate, and Brazil should finally emerge from the grip of recession. China's economy should grow at a slightly slower pace.

Figure 1 Contribution to global GDP growth



Source: IMF, Deloitte

In advanced countries, continued boom should lead to a tighter monetary policy. The US and the UK will continue increasing interest rates. The ECB will call a halt to bond purchases and is likely to start increasing rates as late as 2019.

In 2018, key political events will include elections in Italy, Brazil and Mexico, continued negotiations about Brexit and negotiations about NAFTA. In the global context, North Korea probably remains the greatest geopolitical risk.

2018 is also vital in that a series of new regulations will commence to apply, affecting numerous European firms. These include MiFID2, PSD and the GDPR.

[1] Change between 31 December 2016 and 20 December 2017

The uplifting events of 2018 will include the winter Olympics set to be held in February in Pyeongchang, South Korea.

Czech Republic

GDP

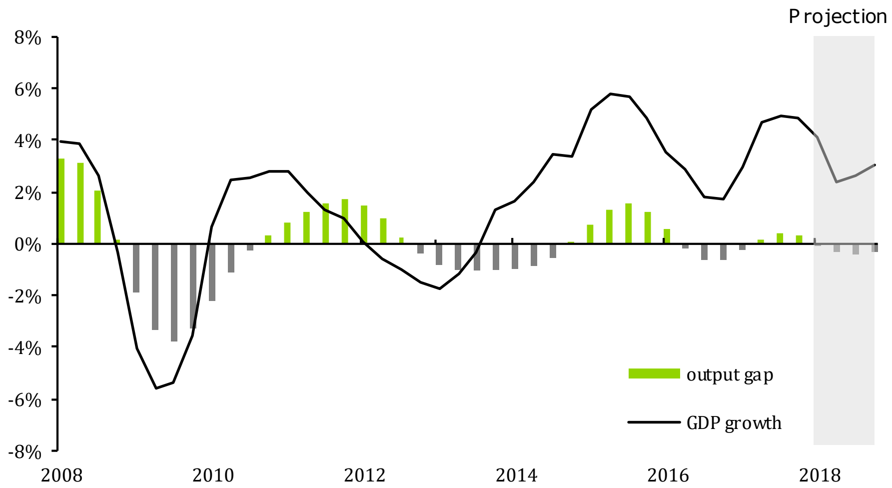
2017 was marked by renewed acceleration of economic growth, which was aided by the better-than-expected Eurozone developments and an improvement in all components of domestic demand, and supported by low interest rates and greater utilisation of EU funds.

The information available at the year-end only includes the first three quarters. According to our projections, GDP grew by 4.3% in 2017. Growth in household consumption accelerated to 3.9%, namely owing to the low unemployment rate and faster-growing salaries. In terms of government consumption, growth of 2.6% is expected. In respect of investments in fixed capital, EU fund utilisation improved and cheap debt funding prevailed. As a result, investments should increase by 5.6%. Foreign trade also contributed to GDP growth in that the export of goods and services grew by 6.3% while import by 5.5%. The contribution of net export to GDP should amount to 1.0 percentage point.

Breakdown by sector shows that the greatest contributors to the growth of overall added value included the manufacturing industry (1.3 percentage points), trade and transport (0.9 percentage points) and the public sector (0.5 percentage points).

As a result of the fast GDP growth, the difference between the actual economic performance and its potential widened during 2017. In the third quarter, the difference amounted to 1.0% if the potential is calculated using the production function method, or 1.3% if the Hodrick-Prescott filter is applied.

Figure 2 GDP growth and the output gap



Source: Czech Statistical Office, Deloitte

In 2018, GDP growth is expected to slow down to 2.9%. Key assumptions include the growth of the Eurozone's GDP of 1.6%, continued increase in interest rates and a slightly negative fiscal impulse. GDP growth should be supported by domestic demand and primarily aided by household consumption and corporate investment. The contribution of net export should be negative, with the growth of import faster than that of export.

The Czech economy will grow faster than that of the EU as a whole, for which reason real convergence to the average EU level should continue. In purchasing power parity terms, GDP per capita should move up to 91.5% of the EU level.

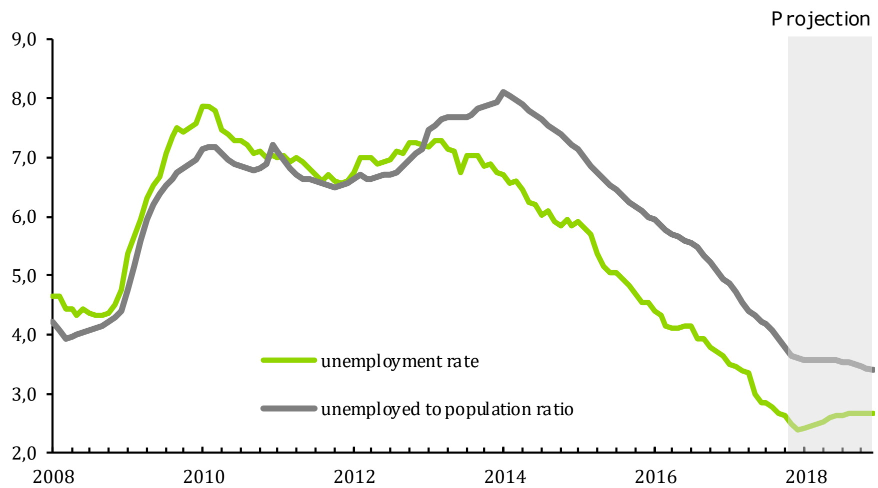
Labour Market

The labour market had already been highly strained in 2016 and it seemed that there was not much room for unemployment to fall even lower. Nevertheless, the acceleration of economic growth and the substantial volume of new orders created tens of thousands of new jobs. The unemployment rate dropped from 3.6% at the end of 2016 to 2.6% in October 2017 and, as such, was the lowest unemployment rate in the entire EU. In addition, the economic activity rate (the ratio of the employed and unemployed to working-age population) increased from 75.8% to 76.5%.

The continued growth in labour demand further deepened the issue of insufficient labour force on the Czech labour market. The unemployment rate is currently below its natural level, or NAIRU (non-accelerating inflation rate of unemployment), which, by our estimate, amounted to 3.6% in 2017. As the labour market is overheating, the pressure for wage growth is rising. In 2016, the average wage increased by 3.7%. In the first three quarters of 2017, wage inflation reached 6.6%.

The Czech economy starts off 2018 with more than 200 thousand vacancies offered by labour offices, while the number of the unemployed amounted to 139 thousand in October 2017 according to the Czech Statistical Office. Companies are trying to fill at least a portion of the necessary capacities by importing foreign labour force, yet given its difficulty and costliness, it is not a universal solution. Therefore, minimal changes in the unemployment rate are expected in 2018, as is the ongoing pressure on fast wage growth.

Figure 3 Unemployment



Source: Czech Statistical Office, Ministry of Labour and Social Affairs, Deloitte

External Relations

In terms of external stability, it still applies that the Czech economy is within the safe boundaries of all key parameters. The substantial increase in foreign debt may seem confusing, yet this is also nothing to be concerned about if looked at in closer detail.

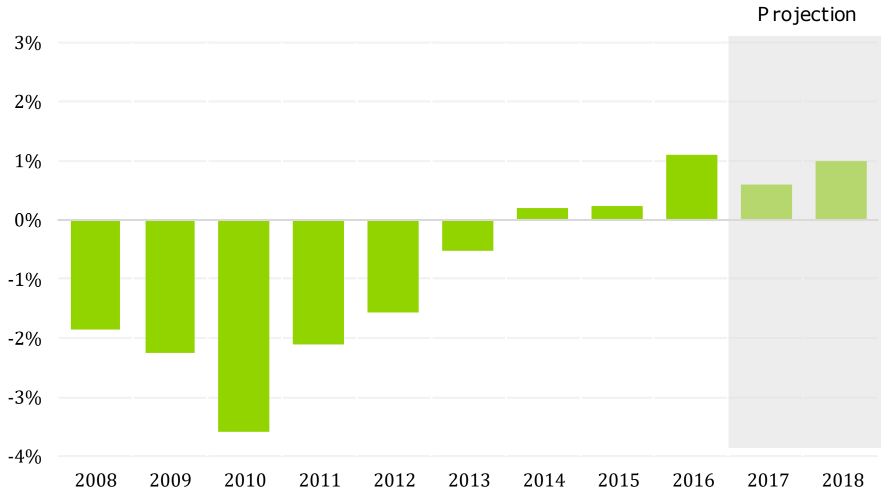
In 2017, the current-account surplus decreased. Between January and October, the balance was positive, standing at CZK 145 billion, while in the same period in 2016, it amounted to CZK 172 billion. This is owing to the worsening in terms of trade. On average, export prices recorded a year-on-year increase of 0.5% in 2017 (January-October) and import prices of 1.9%. Import prices saw the greatest increase in respect of mineral fuels (17.6%) and other raw materials (13.4%). If the export and import prices had remained unchanged, the current-account surplus would have actually risen by CZK 17 billion. This explains the positive contribution of net export to GDP growth.

In the first three quarters on 2017, the current account of balance of payments resulted in a surplus of CZK 51 billion. In the same period in 2016, the amount was CZK 75 billion. The current account has been in a slight surplus for four years.

During the first half of 2017, the Czech Republic's foreign debt grew to 91.9% of GDP, while at the end of 2016, it amounted to 73.9% of GDP. The rather dramatic rise in debt is related to the financial transactions connected with the inflow of a high volume of speculative capital in the Czech Republic before the end of the Czech National Bank's exchange rate commitment. In closing the positions of foreign investors, foreign debt will drop again. The Czech Republic's net investment position continued the trend of gradual improvement. In mid-2017, it reached -24% of GDP.

In 2018, a slight decline in the current-account surplus is expected. This should be mainly owing to the faster growth of domestic demand as opposed to foreign demand. Domestic demand should grow by 3.4%, effective foreign demand by 2.2% (weighed GDP growth average in 36 countries worldwide where the weight is the ratio of the countries to the Czech Republic's total export). As the crown's exchange rate strengthens, the exchange relations should improve, yet, at the same time, domestic production should become less competitive. The strengthening of the crown's nominal exchange rate combined with fast salary growth substantially strengthens the real exchange rate. The current account surplus should reach 1.0% of GDP.

Figure 4 Current account of balance of payments (in % of GDP)



Source: Czech Statistical Office, Czech National Bank, Deloitte

Inflation

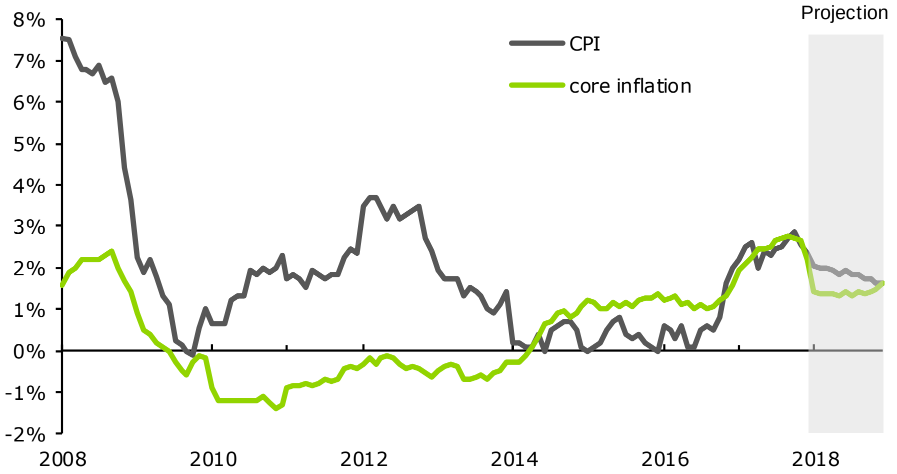
After a long time when it oscillated around zero, inflation returned to its usual values and was at 2-3% throughout 2017, with the rising prices of foodstuffs making the greatest contribution to the growth of the overall price level. At first, these were the prices of butter, replaced in late 2017 by the prices of eggs. Above-average inflation was also recorded in respect of the prices of restaurant and accommodation services, where the pretext for increasing prices was the cost of introducing electronic sales records. Salary growth and growing domestic demand also constitute an important factor for the growth of inflation. This is evidenced by the acceleration of core inflation to 2.6% in November 2017 from 1.6% at the end of 2016.

While inflation remained under control in respect of consumer prices, the real estate market is clearly overheating. In the third quarter of 2017, the prices of new apartments in Prague were

16.4% higher than the year before. In respect of the prices of old apartments, inflation reached 15.3% in the entire Czech Republic.

The growing domestic demand and price inflation will also play a key role in the development of production and consumer prices in 2018. Nevertheless, another major factor should come into play: the strengthening of the crown's exchange rate. As the exchange rate strengthens, the prices of imported goods fall down. In addition, the effect of the one-off increase in restaurant prices resulting from the introduction of electronic sales records will no longer apply. If the prices of foodstuffs cool down and no expense-related price shock occurs, inflation should gradually decline. For the best part of 2018, inflation should be below the Czech National Bank's 2% inflation target.

Figure 5 Inflation



Source: Czech Statistical Office, Czech National Bank, Deloitte

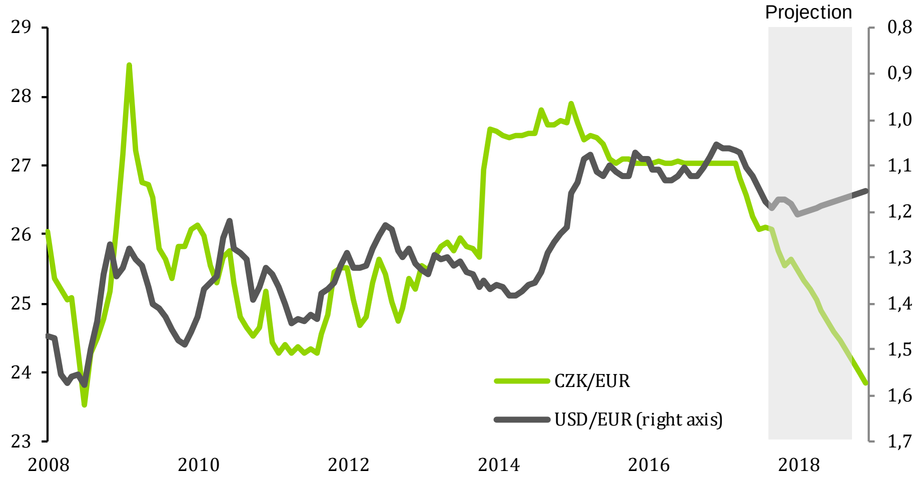
Monetary Policy

In April 2017, the Czech National Bank discontinued its exchange rate commitment. The threat of deflation evaporated, economic growth accelerated and the volume of foreign exchange interventions to retain the exchange rate below the threshold of CZK 27 per euro started to dramatically increase. After the extraordinary form of monetary policy was discontinued, the crown immediately started to pick up strength. Nevertheless, no drama surrounded this. In fact, a specific situation occurred on the foreign exchange market. The crown is "over-purchased", i.e. a substantial volume of open speculative positions exists waiting for the exchange rate to become stronger so that profit may be taken by selling crowns. As a result, with every major increase in strength, opposing pressure automatically occurs for the exchange rate to become weaker. During 2017, the exchange rate to the euro grew by 5%.

Nevertheless, strengthening the crown's exchange rate does not tighten currency terms enough to reduce the pressure on rising prices. Therefore, the Czech National Bank set to increasing interest rates. The first time was in August, when it increased the key two-week repo rate by 20 basis points to 0.25% and the second time in November by another 25 basis points.

In 2018, the Czech National Bank is likely to continue increasing interest rates. The economy is making use of the production capacity more than is usual. The labour market and the real estate market are overheating. The central bank's reaction function model shows that the two-week repo rate could increase to 1.75%.

Figure 6 Foreign exchange rates



Source: Czech Statistical Office, Deloitte

Fiscal Policy

In 2016, the government sector balance progressed from a chronic deficit to a slight surplus, with the positive trend continuing in 2017. In the first half of the year, the government sector's total income increased by 8.6% year-on-year owing to the fast economic growth and improved tax collection. Expenditure grew by 5.5%. On an annual basis, the government sector surplus increased from 0.7% of GDP at the end of 2016 to 1.2% of GDP in mid-2017. In the second half of the year, fiscal discipline was eased and the government approved an increase in certain expenses (namely public sector salaries).

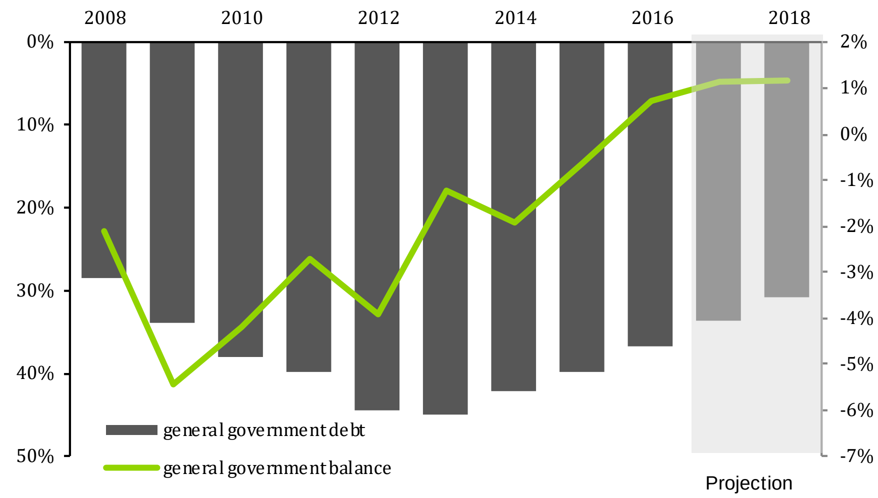
In contrast, government debt slightly increased. At the end of 2016, it was at 36.8% of GDP. In mid-2017, it had grown to 39.4% of GDP as the Ministry of Finance intensified its issuing activities.

In 2018, government sector income is expected to increase by 5.7% and expenditure to grow by 6.5%. The government sector balance should remain positive and reach 0.9% of GDP. The primary budget balance should amount to 2.2% of GDP, or 1.8% of GDP after cyclical adjustment. Government debt should continue trending downwards, amounting to 31.3% of GDP at the year-end.

If the existing fiscal policy parameters, the present level of government debt interest rates and economic growth in line with its current potential are preserved, and inflation is maintained near the inflation target, the debt relative to GDP will continue to decline. From this perspective, the Czech Republic's public finance may be considered to be sustainable.

This position is reflected in the favourable ratings given to the Czech Republic by rating agencies and the low risk premiums to Czech financial assets. If anything, the Czech Republic's rating is currently limited by the country's economic level. If economic growth and convergence to more advanced countries prevails, the likelihood of receiving a rating higher than the current AA/AA- will be greater (Standard & Poor's assessment of long-term obligations in local/foreign currencies).

Figure 7 Government sector balance and debt (in % of GDP)



Source: Czech Statistical Office, Deloitte

Summary

The overall assessment of the state of the Czech economy in 2017 is positive. GDP grew at a fast pace, resulting in closer convergence to more advanced countries. The Czech Republic should reach 90.5% of the EU average measured by GDP per capita in purchasing power parity terms.

The basic parameters of macroeconomic stability remain within reasonable boundaries. Inflation temporarily accelerated slightly above the inflation target, yet it remained in a tolerable zone (+/-1 percentage point). The current amount of balance of payments is slightly in surplus. Given the existing fiscal policy parameters, public finance may also be considered sustainable.

Nevertheless, signs of the economy overheating are growing more numerous. Real estate prices grow at a double-digit pace that is the fastest in Europe. The very low unemployment rate and continued growth in labour demand on the part of companies have resulted in the acceleration of wage growth that exceeds growth in productivity and is not sustainable.

The monetary policy responded to this situation by terminating the exchange rate commitment, following which the crown's exchange rate started to pick up strength, and by increasing interest rates. In addition, the Czech National Bank is gradually tightening the parameters of the macro-prudential policy.

In 2018, economic growth may be expected to slow down owing to the lower growth in foreign demand and the effects of a stronger exchange rate and higher interest rates. GDP is expected to increase by 2.9%.

However, such easing will not be enough to reduce the pressure on the labour market. In late 2017 and early 2018, the number of vacancies in the Czech Republic is greater than the available labour force actually looking for employment.

The combination of fast growth in domestic demand and slower growth in foreign demand should result in a minor decline in the current account balance, yet with concurrent improvement in terms of trade. The change in the current account balance and the current account of balance of payments will thus be relatively small.

Inflation should temporarily drop back to below the central bank's 2% target. On the one hand, pressures on rising wages and domestic demand are gaining strength, yet, on the other hand, the effects of the crown's strengthening exchange rate should prevail.

A stronger exchange rate results in the tightening of monetary conditions, yet this is not sufficient. Therefore, the Czech National Bank will continue increasing interest rates. We assume that its key repo rate will be at 1.75% at the year-end.

Based on the proposed state budget, the government should run a deficit in 2018. However, surpluses in the budgets of regions and municipalities should prevail and the overall government sector balance should reach 0.9% of GDP. Government debt should continue to experience a downward trend, amounting to 31.3% of GDP at the year-end.

General Data and Projections

	2012	2013	2014	2015	2016	2017p	2018p
GDP, CZK billion, current prices	4,060	4,098	4,314	4,596	4,773	5,047	5,274
GDP, USD billion, current prices	207.3	209.5	207.9	186.8	195.4	204.1	227.0
GDP, real growth, %	-0.7	-0.5	2.7	5.4	2.5	4.3	2.9
Industrial production, real growth, %	-0.7	0.1	5.0	4.6	3.6	5.4	4.1
Construction sector, real growth, %	-6.5	-5.6	5.5	6.3	-5.7	2.1	2.8
Retail sales, real growth, %	-0.7	-0.1	2.9	6.3	5.8	5.3	5.1
Unemployment rate, average, %	7.0	7.0	6.1	5.1	4.0	2.9	2.6
Consumer prices, average, %	3.3	1.4	0.3	0.3	0.7	2.4	1.5
Consumer prices, year-end, %	2.4	1.4	0.1	0.0	2.0	2.3	1.2
Industrial producer prices, average, %	2.2	0.8	-0.7	-3.2	-3.2	1.9	1.4
Industrial producer prices, year-end, %	1.3	1.6	-3.7	-2.9	-0.3	1.8	1.3
Average salary growth, %	2.5	-0.1	2.9	3.2	3.7	3.7	6.4
Current account balance, CZK billion, national terms	64	107	146	131	164	150	146
Current account, CZK billion	-63	-22	8	11	53	31	52
in % of GDP	-1.6	-0.5	0.2	0.2	1.1	0.6	1.0
Financial account, CZK billion	12	68	59	176	118	53	115
in % of GDP	0.3	1.7	1.4	3.8	2.5	1.0	2.2
Foreign direct investment (inward), CZK billion	185	144	168	42	176	-	-
in % of GDP	4.5	3.5	3.9	0.9	3.3	-	-
Foreign debt, USD billion	127.7	137.4	125.1	129.3	140.8	150.8	159.0
in % of goods and services export	79	87	80	86	93	88	83
in % of GDP	60	67	66	70	74	70	67
Foreign exchange reserves, USD billion	44.9	56.2	54.5	64.5	85.7	153.7	178.6
in months of goods and services import	3.6	4.5	4.1	5.5	7.3	12.4	12.9
State budget, CZK billion	-101	-81	-78	-63	62	-	-
Government sector balance, in % of GDP	-3.9	-1.2	-1.9	-0.6	0.7	1.1	0.9
Government debt, CZK billion	1,805	1,840	1,819	1,836	1,755	1,697	1,652
in % of GDP	44.5	44.9	42.2	40.0	36.8	33.6	31.3
Growth in money supply (M3), %	4.6	5.0	6.6	8.4	6.6	-	-
2-week repo rate, year-end, %	0.05	0.05	0.05	0.05	0.05	0.50	2.00
3M PRIBOR, average, %	1.00	0.46	0.34	0.29	0.29	0.39	1.84
3M PRIBOR, year-end, %	0.50	0.38	0.34	0.29	0.29	0.74	2.28
CZK/EUR, average	25.1	26.0	27.5	27.3	27.0	26.1	24.5
CZK/EUR, year-end	25.1	27.4	27.7	27.0	27.0	25.3	23.7
CZK/USD, average	19.6	19.6	20.7	24.6	24.4	24.7	23.2
CZK/USD, year-end	19.1	19.9	22.8	24.8	25.6	23.8	22.7

Source: Czech Statistical Office, Czech National Bank, Ministry of Finance of the Czech Republic. Projection: Deloitte

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