3. THE CZECH REPUBLIC

Growth expected to gather speed but downside risks dominate

Economic growth is expected to fall to 2.2% in 2016 from 4.5% in 2015, largely due to the drop in investment linked to the cycle of EU investment funding. Growth is expected to pick up to 2.6% in 2017 and 2.7% in 2018 as investment activity recovers, also supported by the continuing strength in private and public consumption. The headline government deficit is forecast to decline to 0.2% in 2016, from 0.6% in 2015, but to creep upwards in 2017 and 2018.

Investment weighing on growth in 2016

The economy of the Czech Republic is forecast to grow by 2.2% in 2016, compared to 4.5% in 2015. There was a sharp fall in investment during the first half of 2016, partly due to a significantly lower level of EU co-financed investment activity. While investment activity is expected to recover somewhat during the second half of the year, it is forecast to detract from growth for the year as a whole. Private consumption growth was somewhat weak during the first half of the year. While it is expected to recover during the second half of the year, overall growth in 2016 is expected to be lower relative to 2015, giving rise to an increase in the savings rate. Net exports, by contrast, are expected to make a strong contribution to growth as the fall in investment reduces demand for investment-related imports.

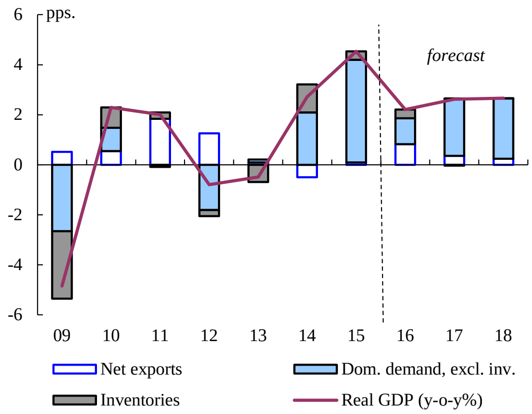
Acceleration of growth in 2017 and 2018

A forecast acceleration of investment growth in 2017 and 2018 is expected to contribute to higher real GDP growth as the Czech authorities increase their absorption of EU funds. Private consumption is also expected to make a large positive contribution, despite an expected slowdown in employment growth. As investment picks up, however, the positive contribution of net exports is expected to fade, as demand for investment-related imports increases. Risks to the outlook are tilted to the downside and include uncertainty over the timing and size of the recovery in investment activity and the possibility of lower-than-expected growth in global trade.

Improving trade balance

The trade surplus is expected to rise to 5.1% of GDP this year, from 4.5% in 2015, with lower investment and weaker consumption growth weighing on imports. While import growth is expected to recover over the forecast horizon, the trade surplus is expected to rise marginally due to slightly positive terms of trade changes.

Graph II.3.1: **Czech Republic - Real GDP growth and**



Employment growth expected to slow

The strong growth in employment in recent quarters has been driven by a sharp increase in the participation rate, with the population of working age falling during this period. This has been facilitated by the increased participation of women and older workers in the labour market. The scope for the participation rate to increase further above the EU average is likely to be limited and employment growth is forecast to be close to zero over the forecast horizon. With the unemployment rate expected to remain around 4% during this period, among the lowest rates in the EU, labour market conditions are expected to come under strain and wage growth to accelerate. Tight labour market conditions represent a further downside risk to economic growth in the Czech Republic as labour market shortages could potentially weigh on the competitiveness of the economy.

Slow return to inflation target

Inflation remained low during the first three quarters of 2016 and is expected to average 0.5% for the year as a whole. Inflation is forecast to increase in 2017 amid higher import prices and rising regulated prices, particularly in the energy sector. This rising trend is forecast to continue in 2018 and inflation is expected to return to the

Czech National Bank's target of 2% during the second half of the year. The Czech National Bank has stated that it expects to end its exchange rate commitment vis-à-vis the EUR in 2017. This could give rise to an appreciation of the CZK and represents a downside risk to inflation.

Improved fiscal position in 2016

The general government's 2015 deficit has been slightly revised from 0.4% to 0.6% of GDP, due to a reclassification of EU transfers as (deficit-increasing) national expenditure. The 2016 headline deficit is projected to improve to around 0.2% of GDP. Total tax revenues are projected to increase, with personal income taxes and social contributions expected to grow most strongly. Higher tobacco excises and the expected positive impact of the introduction of the VAT control statement should contribute to tax growth. Despite an increase in tax revenues, total revenues are expected to decline somewhat, mainly due to a fall in transfers received from EU. On the expenditure side, the falling drawdown of EU funds in 2016 is reflected in lower public investment. Continued strong growth in government consumption – mainly due to rising wages in state administration and for teachers – should partly offset the slowdown in investment.

The general government deficit in 2017 is projected to deteriorate to 0.6% of GDP. This is mainly due to an expected pick-up in public investment after the contraction in the previous year. Tax revenues are set to be bolstered by measures aimed at fighting tax evasion, such as the newly-implemented electronic sales reporting. These broad trends are expected to continue in 2018, when the headline deficit is forecast to reach 0.8% of GDP. Upward pressure on current expenditure is expected to abate in 2018. At the same time, capital investment is expected to continue as the use of EU funds to co-finance projects increases.

The structural deficit is forecast to decrease to ¼% of GDP in 2016. In 2017 and 2018, the structural deficit is expected to widen to ¾% and 1.0% of GDP respectively. The debt-to-GDP ratio is forecast to continue on a downward path and decline from around 40% in 2015 to 38.5% of GDP in 2018.

Table II.3.1:

Main features of country forecast - CZECH REPUBLIC

		2015		Annual percentage change						
	bn CZK	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP		4554.6	100.0	2.3	-0.5	2.7	4.5	**2.2**	**2.6**	**2.7**
Private Consumption		2139.7	47.0	2.1	0.5	1.8	3.0	**2.6**	**2.5**	**2.5**
Public Consumption		889.7	19.5	1.3	2.5	1.1	2.0	**2.8**	**2.4**	**2.1**
Gross fixed capital formation		1198.1	26.3	1.7	-2.5	3.9	9.0	**-2.8**	**2.5**	**3.3**
of which: equipment		542.3	11.9	3.6	0.3	6.4	8.5	**0.9**	**3.0**	**3.5**
Exports (goods and services)		3778.3	83.0	9.2	0.2	8.7	7.7	**5.1**	**4.4**	**4.7**
Imports (goods and services)		3499.1	76.8	8.2	0.1	10.1	8.2	**4.4**	**4.3**	**4.8**
GNI (GDP deflator)		4255.2	93.4	2.0	-0.2	1.9	4.7	**2.2**	**2.5**	**2.6**
Contribution to GDP growth:	Domestic demand			1.8	0.1	2.1	4.1	**1.0**	**2.3**	**2.4**
	Inventories			-0.1	-0.7	1.1	0.3	**0.3**	**0.0**	**0.0**
	Net exports			0.6	0.1	-0.5	0.1	**0.8**	**0.4**	**0.2**
Employment				-0.1	0.3	0.6	1.4	**1.4**	**0.1**	**0.1**
Unemployment rate (a)				7.0	7.0	6.1	5.1	**4.2**	**4.1**	**4.0**
Compensation of employees / head				5.7	-0.3	2.6	2.6	**3.5**	**4.1**	**4.3**
Unit labour costs whole economy				3.2	0.5	0.4	-0.5	**2.7**	**1.6**	**1.7**
Real unit labour cost				0.4	-0.9	-2.0	-1.5	**2.3**	**0.2**	**0.2**
Saving rate of households (b)				11.5	10.9	11.8	11.8	**12.3**	**12.3**	**12.2**
GDP deflator				2.8	1.4	2.5	1.0	**0.3**	**1.4**	**1.6**
Harmonised index of consumer prices				3.2	1.4	0.4	0.3	**0.5**	**1.2**	**1.6**
Terms of trade goods				-0.2	1.5	1.8	0.5	**0.3**	**0.1**	**0.1**
Trade balance (goods) (c)				-2.6	4.1	5.1	4.5	**5.1**	**5.3**	**5.4**
Current-account balance (c)				-3.9	-1.1	-1.2	-1.2	**-0.8**	**-0.7**	**-0.7**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-3.2	1.1	0.5	1.9	**1.2**	**1.2**	**1.2**
General government balance (c)				-3.8	-1.2	-1.9	-0.6	**-0.2**	**-0.6**	**-0.7**
Cyclically-adjusted budget balance (d)				-4.0	0.1	-1.0	-0.7	**-0.3**	**-0.8**	**-1.0**
Structural budget balance (d)				-	0.2	-0.8	-0.7	**-0.2**	**-0.8**	**-1.0**
General government gross debt (c)				27.0	44.9	42.2	40.3	**39.7**	**39.1**	**38.5**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.