

## Economic Situation in Czech Republic: Recent Development and Future Expectation

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### Introduction

The effects of the Covid-19 pandemic mark the current situation of the Czech economy. Efforts to curb the pandemic while compensating for the effects of the pandemic on the population and the corporate sector have resulted in a significant increase in the state budget deficit. The Czech government, in its recent *Policy Statement*, confirms that the country needs a responsible budgetary policy that finds savings, sets the long-term direction of public finances and ensures a reasonable public economic management. The path to stability, according to the government, lies in the reform of state spending and efficient management.

The Czech Republic is the ninth most advanced economy in the European Union (EU). In the newly compiled *Czech Prosperity Index*, the country defeats countries such as Ireland and Italy. *The Czech prosperity Index* is a joint research product of the “Europe in Data” project and Ceska sporitelna (a bank), which compares the quality of life and prosperity of the country with other EU countries. Similar to other EU countries, the country is currently also affected by the impact of the recent negative events (pandemic, Ukraine crisis), which translates into pressures on state budget deficit and increasing inflationary pressures.

### Macroeconomic performance and policy of the Czech economy

The dynamic economic growth, experienced by the country in recent years, has not been effectively used to implement the necessary reforms. Therefore, the country now faces a number of challenges. From tackling the coronavirus pandemic and the ensuing economic recovery, to the global issues, which affect citizens (e.g., rising inflation and energy prices). Nevertheless, some of the challenges became apparent even before the outbreak of the Covid-19 pandemic. Therefore, the new Czech government does not want to allow any further unnecessary indebtedness and wants to prepare measures to enable a continuous reduction of budget deficits. Its goal is not to allow budget savings to affect negatively the situation of citizens who depend on state support. It plans to create favorable conditions for corporate sector. State action must be predictable for citizens and businesses. Therefore, the government aims to pass the fundamental changes resulting from the policy statement in the middle of the government’s mandate (January 2024), which will provide sufficient time for their preparation. Box 1 shows the new government’s program announcement in the area of public finances. There is an effort to improve business conditions and motivate foreign investors to reinvest their profits in the country.

#### Box 1: Policy statement of the Czech government in 2022 – part “Public finance”

The new government’s goals in the area of public finance are:

- to support responsible economic management and growth;
- to gradually strengthen capital expenditures (involving EU resources);
- to include *the Act on the Rules of Budgetary Responsibility* in the Czech constitutional order;

- to adjust the spending rule so that it will not be possible to increase government spending without regard for reserves and economic situation;
- to set a ceiling on the tax burden;
- to prevent tax evasion and to address the issue of the outflow of dividends abroad;
- to provide better measures against transfer pricing abuses, illegal optimization practices and tax evasion and to cut tax haven companies off from public money;
- to promote transparent reporting of multinational companies based on the country of origin of sales and limiting the scope for illegal tax optimization;
- to support the implementation of the OECD two-pillar solution for global taxation;
- to take firm action against illegal gambling;
- to examine the possibility of abolishing non-systemic tax exemptions.

Source: Vláda (2022), modified by the author.

The macroeconomic situation in the Czech Republic is gradually returning to normal with the improving pandemic situation. Table 1 provides an overview of the main macroeconomic indicators of the Czech economy. The foreign trade balance was positive, e.g., with Germany, Slovakia and the United Kingdom, while it was most negative in trade with China.

**Table 1: Main macroeconomic indicators – Czech economy**

Indicator	Period	y-o-y growth/decline (in %)
Gross Domestic Product (GDP)	4Q 2021	3.6
Consumer Price Index (CPI)	December 2021	6.6
Inflation rate	December 2021	3.8
Industrial production	December 2021	-2.1
Construction production	December 2021	8.1
Retail sales (CZ-NACE 47)	December 2021	3.3
Average wage - nominal	3Q 2021	5.7
Average wage – real	3Q 2021	1.5
Producer price indices - agricultural	December 2021	18.8
Producer price indices - industrial	December 2021	13.2
Producer price indices - construction work	December 2021	8.3
Producer price indices - market services	December 2021	1.7
Foreign trade with goods – import	December 2021	19.9
Foreign trade with goods – export	December 2021	8.2
Export and import price indices - imports	November 2021	12.8
Export and import price indices - exports	November 2021	10.5
General unemployment rate *	December 2021	2.2*

Note: \*) value of indicator in %

Source: CSO (2022).

The Czech transformation model of the 1990s based on liberal markets, openness, massive inflows of foreign direct investments, cheap and skilled labor and quality infrastructure, have already reached its limits. Among positive factors of the country remain an attractive geographical location, skilled labor and highly diversified production base. Very high economic complexity of the country (2nd place in the EU and seventh in the world) means that its economy is not dependent on a few industries. Such diversity of production helps the economy better cope with shocks. It strengthens resilience to production outages or demand declines in a single sector. Relatively stable position of

the economy is reflected in the Czech National Bank (CNB)ʼs forecast published on February 3, 2022. Table 2 shows the values and estimates for the period 2021 - 2023.

**Table 2: Main macroeconomic indicators - Czech economy (F = forecast)**

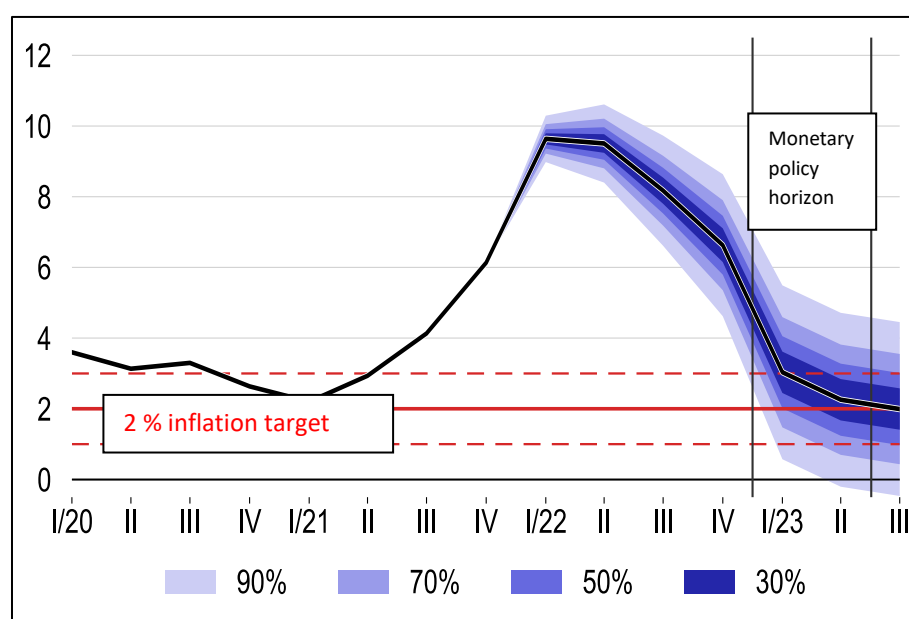
Indicator/Year	2021	2022	2023
Inflation	3.8	8.5 (F)	2.3 (F)
GDP (y-o-y changes, in %)	3.1 (F)	3.0 (F)	3.4 (F)
Interest rates 3M PRIBOR (%)	1.1	4.3 (F)	3.3 (F)
Exchange rate (CZK/EUR)	25.6	24.1 (F)	23.9 (F)

Source: CNB (2022)

In 2021, headline inflation in the country reached 3.8 %. The CNB forecast from February 2022 assumes headline inflation at 8.5 % in 2022 and 2.3 % in 2023. According to the national methodology of the Czech Statistical Office (CSO), inflation in the country accelerated to 9.9 % year on year (y-o-y) in January 2022 compared with 6.6 % in December 2021. Month-on-month (m-o-m) price growth of 4.4 % is the highest in the history of the country. The sharp increase is mainly due to higher energy prices, the change in the price lists of goods and services or higher prices of fuels and food. Consumer prices rose by 4.4 % m-o-m in January 2022, the highest level since January 1993. While in previous months inflation in the country was rather average (according to the EU methodology), in January 2022 it exceeded the EU average. In January 2022, the harmonized index of consumer prices in the country rose to 8.8 % compared to the value of December 2021, 5.4 %. The estimate for January 2022 for the euro zone is 5.1 %.

The exchange rate (CZK/EUR) was 25.6 in 2021 and is forecasted to be 24.1 for 2022 and 23.9 for 2023. Graphs 1 and 2 below show the price and GDP developments.

**Graph 1: Recent development of headline inflation and forecast (1/2020 – 3/2023)**

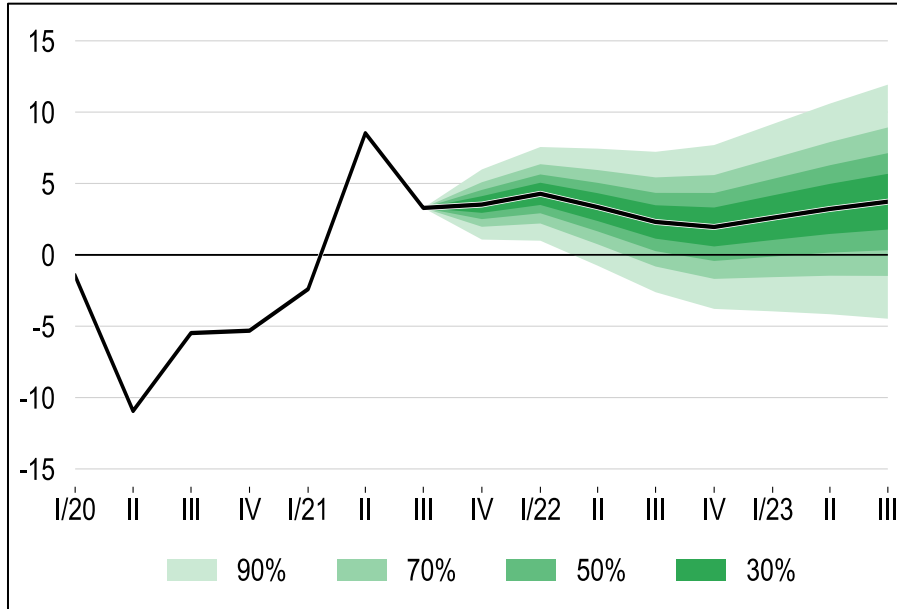


Note: The confidence intervals of the headline inflation forecast reflect the predictive power of past forecasts and are symmetric. They are widening only for the first five quarters and then stay constant.

Source: CNB (2022)

According to the CNB's forecast, GDP should grow by 3 % in 2022 and its growth should accelerate slightly in 2023. Year-on-year changes (in %) for the development of gross domestic product (GDP) are thus forecasted at 3.1 % (2021), 3.0 % (2022) and 3.4 % (2023). The growth of the Czech economy will continue to be generated by household consumption and by growing private and government investment. Export growth will resume in the second half of 2022. By the end of 2022, domestic economic activity is expected to reach pre-Covid-19 levels.

**Graph 2: Development of GDP growth and forecast (1/2020 – 3/2023, y-o-y changes)**



Note: The confidence intervals of the GDP growth forecast reflect the predictive power of past forecasts. They are symmetric and linearly widening.

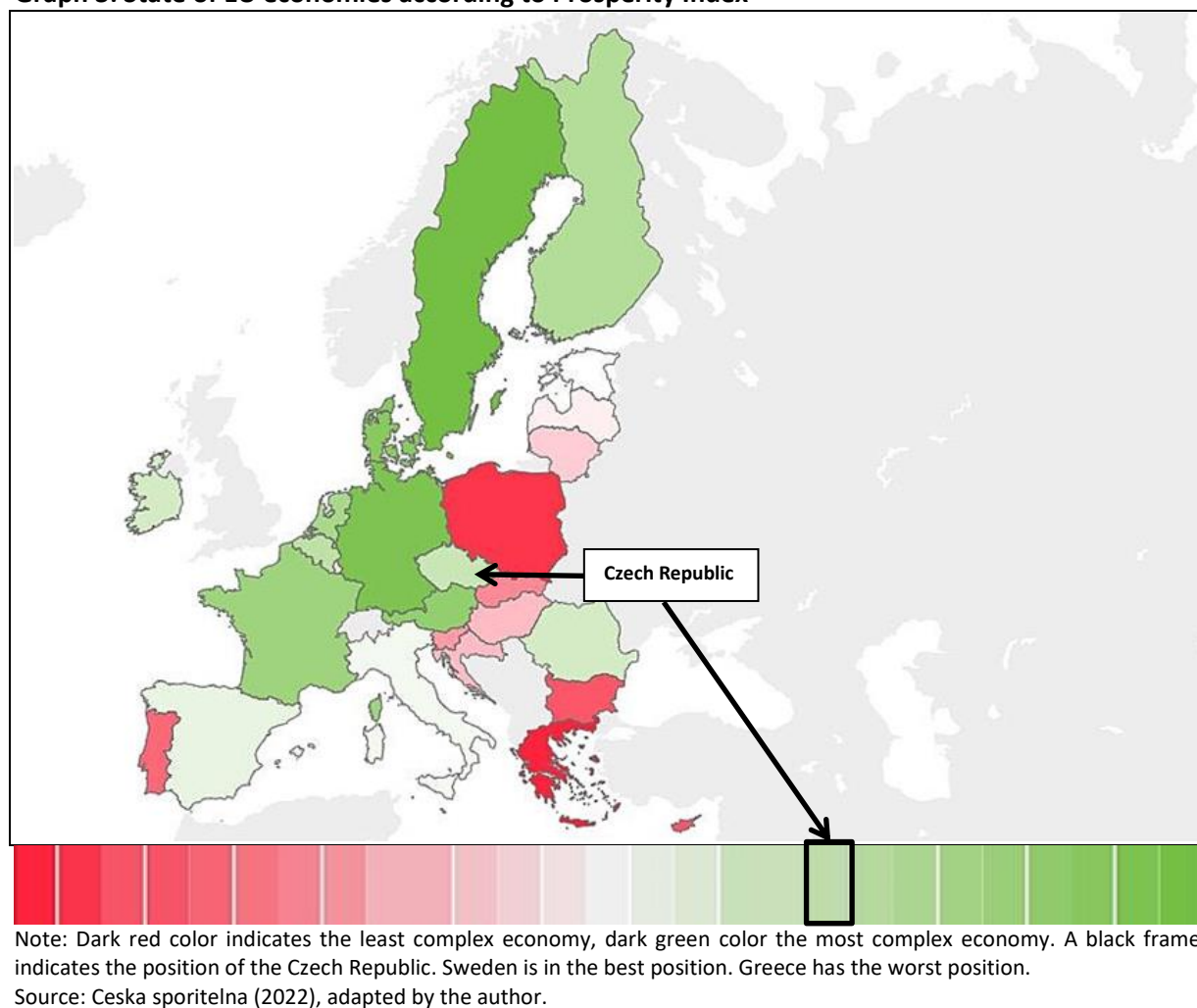
Source: CNB (2022)

In 2020, there was the largest y-o-y decline in GDP since 1993. Gross domestic product in 2020 decreased by 5.8 % y-o-y and gross value-added (GVA) decreased by 5.6 % compared to 2019. The development was mainly influenced: (1) by a decline in expenditure on fixed capital formation and household consumption and (2) by a positive contribution made by the government expenditures. Before 2020, the worst situation was in 2009, when GDP fell by 4.7 % because of the global economic crisis, and the best in 2006, when GDP grew by 6.8 %. While there have been some structural changes in the economy, industry currently still plays an important role. Its share in GVA has long been around one third. However, the share of traditional sectors (agriculture, forestry and fishing) has rapidly decreased since 1993 and it accounted for only 2.1 % of GVA in 2020.

In addition to macroeconomic data, *the Czech Prosperity Index* also examines aspects that affect the prosperity of individuals and looks for ways to improve living and business conditions in the country. The index represents almost one hundred indicators divided into ten pillars, which examine, e.g., macroeconomic data, quality of education, environment, health care, housing or digitization. According to this Index, Sweden is the most advanced economy in the EU followed by Germany and Denmark. Greece has the worst position. The Czech economy is currently the ninth healthiest in Europe. Some indicators are very good (economic complexity or investment rate relative to GDP), in others the economy lags behind (low value added, e-government and high inflation). Its ninth place (see Graph 3) means that the Czech Republic left behind eighteen EU countries, including all the

former post-socialist economies. Its economic level - measured by GDP per capita - is higher than is that of Italy or Spain. This is a success of the economic transformation in the 1990s. However, the country may lose its position and remain among the middle-income economies due to underinvestment, the less flexible labor market and the economic structure. The country is still failing to boost its economy. For example, it has already dropped out of the world's Top-20 most robotic economies. The country can achieve better evaluation by investing in changing the structure of the economy, innovation and education. In addition, there are signs of inflationary pressures. Despite the fact that the temporary remission of VAT on energy had helped temporarily to consumers, this VAT remission ended in January 2022 and therefore energy prices to consumers are expected to rise sharply in the coming months. This is confirmed by the fact that m-o-m increase for electrical energy was 38.6 % and for gas 31.3 % in January 2022.

**Graph 3: State of EU economies according to Prosperity Index**



The state budget ended 2021 with a deficit of CZK 419.7 billion (bn). The expected deficit in the revised draft state budget law for 2022 will be CZK 280 bn. Compared to the previous government's proposal, this is CZK 96.6 bn less and CZK 220 bn less y-o-y. Total revenues in the new budget for 2022 will reach CZK 1,613.2 bn and total expenditures CZK 1,893.2 bn. The government's main priorities are responsible anti-inflation management without raising taxes. The state budget deficit will fall from CZK 376.6 bn to CZK 280 bn. On the expenditure side, state budget expenditures also

decreased by CZK 76.6 bn. Additional budget revenues of CZK 62.2 bn, according to forecast of the Ministry of Finance, will allow to finance additional expenditures (CZK 42 bn). Among them are: extraordinary valorization of pensions (CZK 21 bn), increase in housing allowance (3 bn), corporate compensation for entrepreneurs (CZK 3 bn) or increased interest on government debt (CZK 5 bn). Additional budget revenues are mainly social insurance premiums (CZK 35 bn) and tax revenues, especially higher revenues from VAT (CZK 18.3 bn), corporate tax (CZK 12.4 bn) and physical person tax (CZK 6.4 bn). However, the Ministry of Finance expects a lower collection on excise duties (CZK - 5.9 bn). The Table 3 shows the key state budget indicators.

**Table 3: State budget indicators (in bn CZK)**

	State budget 2021	State budget 2022 (original)	State budget 2022 (current)	Difference 2022-2021	Difference 2022-2022 (original)
Budget revenue	1 385,6	1 551,1	1 613,2	227,6	62,1
Budget expenditure	1 885,6	1 927,7	1 893,2	7,6	-34,5
Budget balance	-500	-376,6	-280	220	96,6

Source: Czech Ministry of Finance (2022).

The new government wants to start a period of anti-inflation management and this should be made without raising taxes. It offers a proposal with a deficit almost 100 bn lower than the previous government. On the expenditure side of the budget, there was a decrease of CZK 76.6 bn. Despite this reduction, the new budget for 2022 envisages record investments of CZK 203.3 bn, which corresponds to more than 10 % of total budget expenditures.

### **Future Macroeconomic Expectations**

The country will face a number of challenges and opportunities in the coming years brought by the changing global economy and the situation within the EU. It is crucial for the country to be able to make right and timely decisions, e.g., in the area of monetary policy. Year-on-year growth in producer prices accelerated again in January 2022. According to the CSO, prices increased the most in agriculture by 21.4% compared to last January after an increase of 18.8% in December. Year-on-year rise in prices of industrial producers accelerated to 19.4% from 13.2% in December and in construction to 8.3% from 8.2%. Prices of market services for enterprises were 3.2% higher y-o-y in January 2022, while in December 2021 they were 1.7% higher. Producer prices indicate the future development of prices for consumers. According to the CNB, inflation will continue to rise significantly at the beginning of 2022, exceeding 9 %. The acceleration of price growth will be mainly due to a further increase in core inflation and a sharp rise in regulated prices. Inflation will peak in the first half of 2022 and then gradually slow down. The strengthening of the exchange rate and the stabilizing effect of monetary policy through domestic demand will contribute to this. Current developments, in comparison with the CNB's estimates, are likely to delay the return of inflation to the 2% target; however, inflation should reach 2 % in 2023.

The recovery of public finances and the restoration of citizens' confidence in a just and fair state are the two key challenges for the Czech government in the economic field. The government is convinced that in the near future the economy will grow relatively dynamically. This optimism is reflected in the official predictions but it may be reassessed due to the recent development in Ukraine. Nevertheless, according to the CSO, the rise in energy prices, which has been significantly affecting inflation

recently (since January 2022), will continue. According to the CNB, the conflict between the Russian Federation and Ukraine will have a pro-inflationary effect (mainly due to higher gas and oil prices) and the conflict will negatively affect economic growth.

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