The Economist Intelligence Unit

Czech Republic

An industrial powerhouse in central Europe

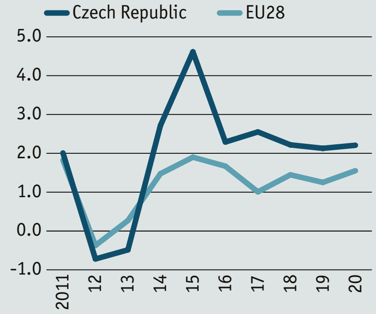
crf Prague
CORPORATE RESEARCH FORUM

The Czech Republic has a lot to boast about right now.

Last year, it recorded 4.6% real GDP growth, double-digit growth in the automotive sector and the lowest unemployment rate in the EU. Solid industrial output growth has boosted employment, allowing the government to spend more and yet still bring the public deficit close to balance. Public debt is half the EU average; the current account is in surplus; and bond yields are the lowest in the region. The Czech economy's reputation as an industrial powerhouse and one of the most attractive investment locations in central Europe seems well deserved. But in fact this is far from new: the Czech Republic's edge stems from the late 1800s, when it occupied the industrial heartland of the Austro-Hungarian Empire.

Real GDP growth

(% change, year on year)

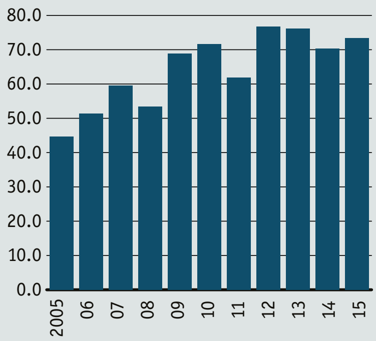


Note: 2011-15 actuals; 2016-20 Economist Intelligence Unit forecasts.

Sources: Czech Statistical Office; Eurostat The Economist Intelligence Unit

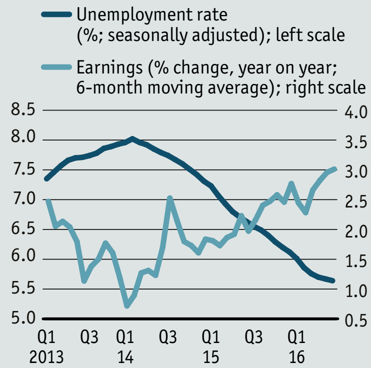
Foreign direct investment

(% of GDP)



Sources: World Investment Report; Czech Statistical Office; The Economist Intelligence Unit.

Unemployment and earnings



Sources: Czech Statistical Office; Ministry of Labour and Social Affairs; The Economist Intelligence Unit.

As a consequence of their 19th Century role, producing around 70% of the Austro-Hungarian Empire's industrial output, by the late 1930s the Czech regions of Bohemia and Moravia had a higher GDP per capita than France. Industrial skill levels were above those in Austria, and the region had a manufacturing base specialising in leather goods, motor vehicles, high-tech arms and luxury goods. However, over the next 20 years, under Soviet rule, what was then Czechoslovakia saw a dramatic regression. Living standards fell steeply as the country was constrained to produce lower value-added products — such as shoes and steel — under the centrally planned command economy.

The country's recovery after this was a long time coming, after the fall of the Iron Curtain in 1989. The Czech Republic joined the EU in 2004, and GDP growth in the next four years accelerated to an annual average of 6%.

The glory days of foreign direct investment

One of the main drivers of growth since EU accession has been foreign direct investment (FDI). The Czech Republic's closeness to west European markets, skilled workforce and competitive business environment have led the country's inward FDI stock to climb rapidly, to the equivalent of almost three-quarters of national GDP today—the highest in central and eastern Europe. Companies such as Skoda (Germany) have contributed to a thriving automotive sector—the backbone of the country's export-driven economy—and boosted related industries such as mechanical engineering, metallurgy, the chemical sector, and rubber and plastic processing. The Czech Republic has also become closely integrated into the German-central European supply chain, with a dense array of just-in-time manufacturing links. Today, one-third of Czech exports go to Germany, with over 80% ending up in the EU.

As might be expected, the capital, Prague, and the surrounding region, has historically received the largest proportion of FDI inflows. Prague hosts the majority of the country's foreign-owned firms, the financial sector, and the headquarters of most large companies—as well as the main authorities of the government administration. It accounts for one-quarter of total GDP.

GDP growth in 2015 surges to 4.6%

Right now, the Czech economy is seeing a strong recovery from the deep recession of 2009 and the shallower one of 2012-13. A surge in industrial output and exports in 2014 fed into broader-based growth in 2015, with private consumption seeing its strongest annual rise since 2007, and investment powering ahead by 9.1%. This latter owed much to inflows of EU structural and cohesion funds.

One result of the economic pick-up has been an impressively steep and steady fall in unemployment, from just over 8% at the start of 2014 to just over 5% in mid-2016. Wage growth is now picking up as firms compete for workers, and the government finds itself in an unusual position, with job creation no longer a top priority.

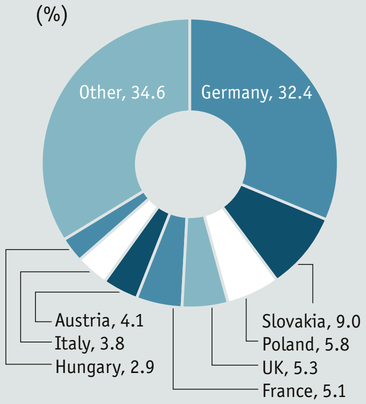
Unconventional central bank policy supports exports

Rising wages should eventually feed into stronger inflation, which — as across Europe —remains very low. However, in the meantime, the central bank's efforts to boost price growth include a ceiling on the value of

GDP and industrial production
(% change, year on year)

Sources: Czech Statistical Office; The Economist Intelligence Unit.

Share of 2015 exports
(%)



Sources: IMF; The Economist Intelligence Unit.

the currency (the koruna) against the euro. This unconventional step is intended to make imports more expensive; but a side effect is of course that Czech exports are less expensive abroad — thereby boosting export growth. The weak euro and strong Czech growth have stoked appreciation pressures since mid-2015, so the central bank has been intervening heavily on the currency markets (buying euros and selling koruna) to keep the currency weak. It plans to allow the koruna to appreciate from around mid-2017, once inflationary pressures have started to return.

With a small public deficit, debt at around 40% of GDP and consistently large trade surpluses, the Czech Republic is considered the safest place in central and eastern Europe to invest, and this is reflected in exceptionally low government bond yields which helps to keep the government's borrowing costs low. A liquid and stable banking system is another draw for investors; the complicated tax system is the biggest drawback of the business environment, which overall ranks second in the region.

Economic growth will slow this year, then stabilise

Given strong market, consumer and business confidence in the country at present, it may come as a surprise that the Czech economy is now slowing. This primarily reflects the EU funding cycle, with projects financed under the 2014-20 period yet to get under steam, after the dramatic spike in EU-funded infrastructure spending in 2015. Investment is likely to contract slightly this year. However, less robust investment activity will also mean reduced imports, which should allow net exports to support growth, partly offsetting this. As in 2015, private consumption growth will be strong, consumer spending being the main driver of growth this year, thanks to rising employment and wages.

The Economist Intelligence Unit forecasts growth of 2.3% this year and 2.6% next year—well above the EU average of 1.3%—slowing to just over 2% in the medium to long term. However, as income levels and living standards continue to improve, the advantages of low labour costs will become less compelling, forcing Czech exporters to compete more on quality than on price.

External risks and domestic opportunities

In the medium term the main risks to Czech growth will come from outside the country. The UK's vote to leave the EU will mean a less robust UK economy over the next few years, and while this will have little direct effect on the Czech Republic (only 5% of exports went to the UK last year), the downturn in sentiment across the EU and the hit to German growth may prove more significant. Other potential risks stem from the Volkswagen emissions-rigging scandal; the possibility of a Greek exit from the euro zone; and the slowdown in growth in emerging markets (especially Russia and China). With exports equivalent to over 80% of GDP, external demand is crucial for the Czech Republic.

Of course, there are upside risks to the country's outlook as well. Policies to improve the absorption of EU funds, reduce administrative burdens on firms and improve public procurement are being pursued and should help to streamline the functioning of firms in the private sector. Further ahead, improvements in R&D spending, more focused education and a simplified tax system could boost longer-term growth rates and the Czech Republic's reputation as a dynamic industrial hub in central Europe seems assured for the medium term. ■

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