CZECH REPUBLIC

Despite ongoing fiscal tightening real GDP growth is expected to reach 2.4% this year, driven primarily by strong foreign demand. Growth will broaden and rise further to 3.5% in 2012, as consumption picks up. Headline inflation will spike temporarily due to scheduled indirect tax increases in 2012, but core inflation will remain low given the remaining output gap.

The authorities should continue with fiscal tightening to achieve medium-term targets and use the upswing of the economy as an opportunity to secure the long-term sustainability of pension and healthcare systems. Monetary policy should normalise gradually as the recovery takes stronger hold.

External demand is driving the recovery

GDP expanded by 2.2% in 2010, reflecting strong export performance and restocking as the Czech economy, which is well integrated in international supply chains, benefited from the upswing in world trade. In contrast, private consumption remained weak and investment declined despite a temporary solar panel investment boom ahead of cuts in subsidies. However, capacity utilisation increased to over 80%, setting the stage for stronger investment in the coming quarters.

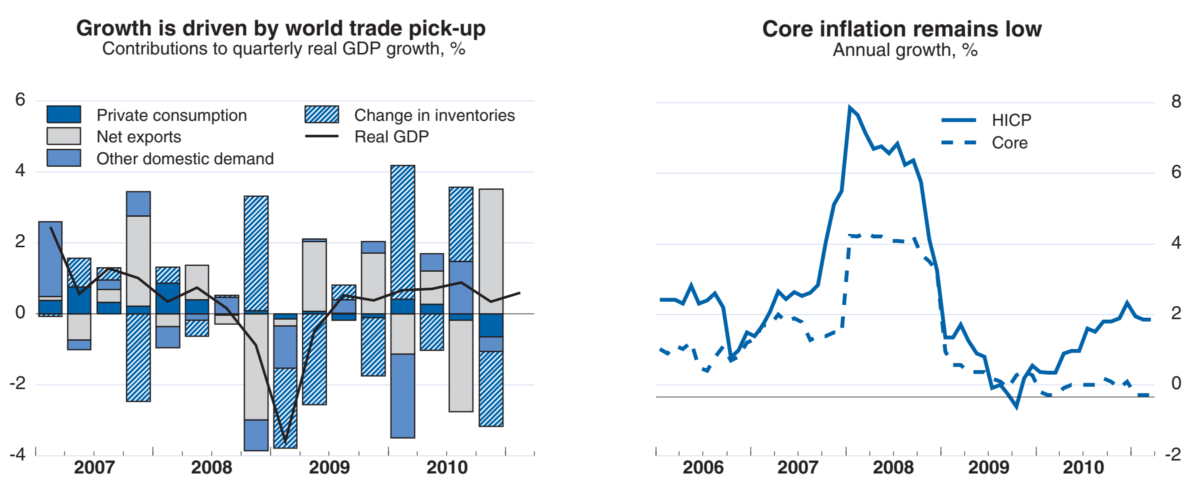
Indicators point to a broadening of the recovery

Both industrial production and new orders continue to grow at a double digit pace and exports are also growing rapidly. Confidence indicators give a more mixed picture, but retail sales have slowly started to recover. The unemployment rate has been gradually decreasing and stood at 6.9% in March 2011.

Headline inflation has edged up

Inflation rose during 2010 mainly due to increases in indirect taxes, regulated prices and commodity prices. Headline inflation stood at 1.6% in April and core inflation remained close to zero. The central bank has

Czech Republic



Note: Core refers to the harmonised index of consumer prices (HICP) excluding food, energy, alcohol and tobacco.

Source: Eurostat; OECD, National Accounts database.

StatLink http://dx.doi.org/10.1787/888932429488

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

	2007	2008	2009	2010	2011	2012
	Current prices CZK billion	Percentage changes, volume (2000 prices)				
GDP at market prices	3 539.1	2.3	-4.0	2.2	2.4	3.5
Private consumption	1 688.7	3.5	-0.1	0.4	0.5	2.6
Government consumption	717.0	1.1	2.6	0.3	-1.2	1.3
Gross fixed capital formation	890.3	-1.5	-7.9	-4.6	3.9	4.8
Final domestic demand	3 296.0	1.6	-1.5	-0.8	0.9	2.8
Stockbuilding[1]	67.4	-0.5	-2.0	1.9	-0.5	0.0
Total domestic demand	3 363.4	1.1	-3.6	1.2	0.3	2.8
Exports of goods and services	2 836.0	5.7	-10.5	17.6	9.4	9.5
Imports of goods and services	2 660.3	4.3	-10.4	17.6	7.2	9.2
Net exports[1]	175.7	1.3	-0.6	1.0	2.0	0.8
Memorandum items						
GDP deflator	_	1.8	2.5	-1.1	0.1	1.5
Consumer price index	_	6.3	1.0	1.5	2.2	3.1
Private consumption deflator	_	4.9	0.3	1.3	2.9	3.0
Unemployment rate	_	4.4	6.7	7.3	6.6	6.3
General government financial balance[2]	_	-2.7	-5.8	-4.7	-3.8	-2.8
Current account balance[2]	_	-0.6	-3.2	-3.8	-3.0	-3.4

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods *(http://www.oecd.org/eco/sources-and-methods).*

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.

Source: OECD Economic Outlook 89 database.

StatLink http://dx.doi.org/10.1787/888932430742

maintained the policy interest rate at a historically low level of 0.75%, which is currently a half percentage point below the main ECB rate.

Fiscal consolidation continues

The 2010 general government deficit of 4.7% of GDP turned out better than originally budgeted due to lower debt servicing costs and savings in operational costs of the administration. This year, the authorities are pursuing budgetary tightening with an emphasis on expenditure restraint. In particular, cuts in the central-government wage bill are underway. Backed by recently approved medium–term expenditure ceilings, the fiscal deficit is to fall to 3.5% of GDP, and debt is to be held close to 40% of GDP in 2012. With government receipts picking up as a result of renewed growth and additional revenues from a planned VAT increase, these targets are likely to be undershot again. A number of structural reforms are planned for 2012, notably in pensions, healthcare and the tax structure. However, only the tax-structure changes are likely to have a substantial fiscal impact over the projection period.

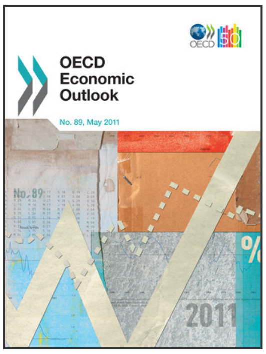
The recovery will broaden and accelerate further

Output is expected to grow by 2.4% in 2011 and pick up speed to 3.5% in 2012. Exports are expected to perform well and investment is projected to recover strongly. In contrast, private consumption will pick up only in 2012, as this year's fiscal consolidation will have a restraining effect.

Inflation will accelerate temporarily in 2012, due to the scheduled hike in the lower VAT rate and ongoing rent deregulation, but underlying inflationary pressures will remain moderate.

Risks remain broadly balanced

Given its significant export orientation, the Czech economy is dependent on the continued recovery of world trade and an orderly resolution of the debt crisis in the euro area. On the positive side, the fiscal tightening may have less of an impact on domestic demand so that growth could pick up more strongly than projected.



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