

Robust Czech growth masks underlying weaknesses

Czech GDP expanded by 2.2% year-on-year in the first quarter of 2025. However, household consumption was almost stagnant. Economic uncertainty in the months ahead highlights the need for a more relaxed monetary policy stance

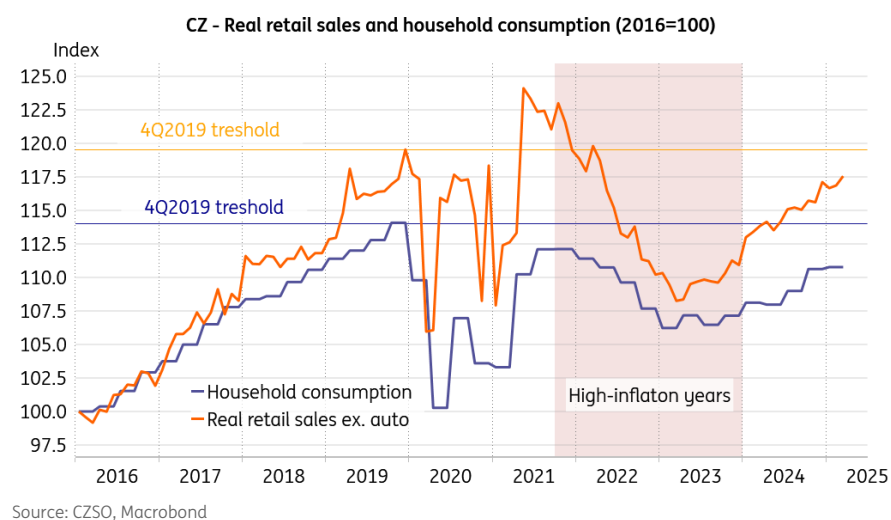


Prague, Czech Republic

Czech GDP grew by 0.8% quarter-on-quarter and 2.2% year-on-year at the start of the year, with both figures revised upward from initial estimates. The quarterly increase was primarily driven by industry (+1.6%), construction (+3.4%), and finance and insurance (+5.9%). Other services also performed well. In contrast, the trade, transport, and catering sectors negatively impacted the gross value-added performance.

On the demand side, the primary factors driving quarterly GDP growth were rising household consumption and gross capital formation. Government consumption expenditure exerted a negative contribution, while the impact of the foreign trade balance was neutral. Higher final consumption and changes in inventories supported annual GDP growth. The foreign trade balance had a negative impact.

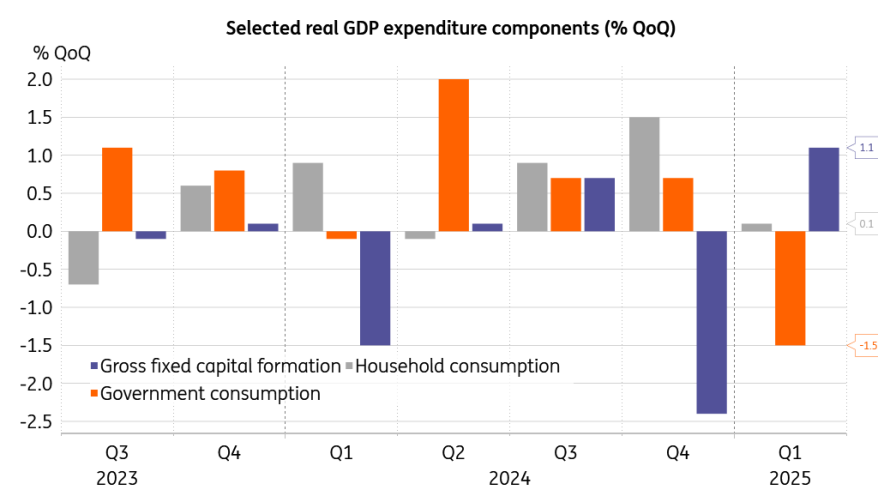
Consumption is still below 2019 levels



Gross fixed capital formation grew by 1.1% QoQ but decreased by 0.6% YoY. The annual decline was primarily attributed to investments in other machinery and equipment, as well as transport. Only investments in other buildings and structures increased.

Real exports grew by 2.8% QoQ and 3.6% YoY, with the growth in exports of electrical equipment and machinery the most significant factor. Imports increased by 2.1% QoQ and 4.6% YoY. The volume of wage costs in 1Q25 increased by 7.0% YoY. Total employment picked up by 0.7% QoQ and 1.1% YoY. Total hours worked increased by 0.1% QoQ and 2.0% YoY.

Recent investment gains barely offset previous declines



The overall GDP growth figure is a positive surprise, however there are some weaknesses when examining the structure and levels. The quarterly increase in fixed investment is welcome news, but it hardly offsets the sharp deterioration of the preceding quarter. That said, fixed investment remains in annual decline and broadly at the level observed in mid-2022.

Household expenditure added a mediocre 0.1% QoQ despite the still-solid real wage gains in historical comparison, remaining almost flat over the quarter and still well below the pre-pandemic level. As a result, the headline figure may support a more hawkish tone from the Czech National Bank (CNB). However, the underlying GDP composition and the uncertain growth outlook for Europe still leave room for a softer monetary policy stance.

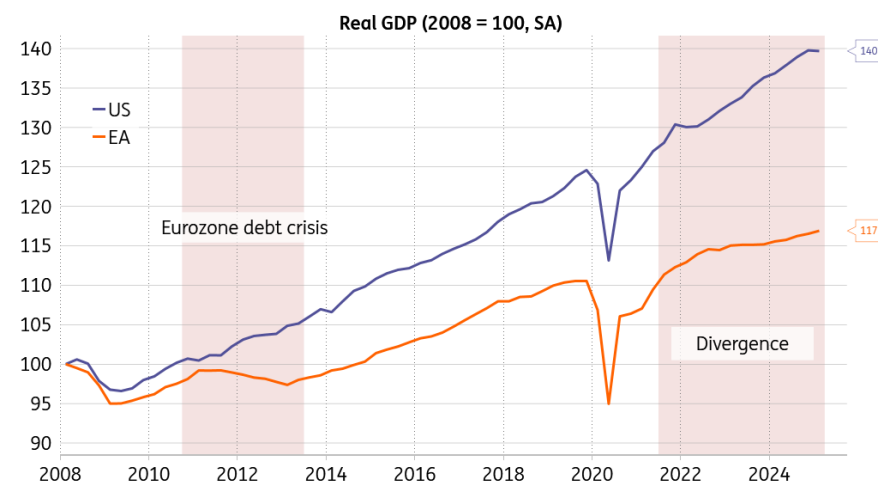
Europe appears to be recognising the need for fundamental change

The European Commission recently came up with an initiative to remove or reduce the barriers still present in the seemingly single European market. The base document has five broad chapters:

1. Removing barriers: doubling down on the 'Terrible Ten'.
2. Boosting European services markets.
3. SMEs in the single market.
4. Digitalising the single market.
5. Enforcing respect for single market rules.

We view this initiative as potentially beneficial to Europe's long-term economic prosperity. However, its success hinges on avoiding the fate of the 2000 Lisbon Strategy, which ambitiously aimed to make the EU "the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth." A vision that ultimately fell short of realisation.

The US and EA are drifting apart



Source: Macrobond

Another important point is that internal market issues should have been addressed around five years ago, given the lengthy and negotiation-heavy nature of the process. Unfortunately, during that time, a new set of urgent challenges took precedence. Today, it is widely recognised that the most pressing concerns – and the easiest wins that could offer immediate relief to Europe's industrial base – lie elsewhere.

There are also fundamental reasons why internal trade barriers remain in place, despite clear incentives for their removal. As the European Commission itself acknowledges, member states

play a central role in the daily implementation of EU rules. This leads to a diffusion of responsibility – a complex, multi-headed challenge that is notoriously difficult to tackle.

This brings us to several key questions regarding the latest initiative: what has truly changed, apart from a heightened sense of crisis? Why should this effort succeed now when previous attempts have failed? And realistically, how long will it take to turn this initiative into tangible outcomes?

The current situation gives the impression of: “Yes, everyone knows what needs to be addressed – but hold on, that’s unfamiliar territory within the Europe 2020 Strategy framework. So instead, let’s stick to what we know, follow the familiar playbook, and hope that’s enough.”

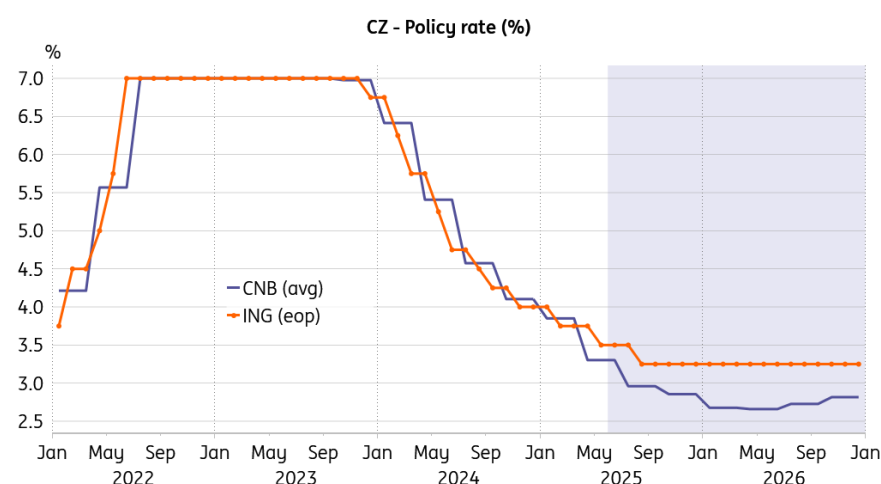
The concern is that this new initiative risks diverting attention from Europe’s most pressing and well-defined challenges. The world has moved on, and the moment calls for a more fundamental revamp – perhaps a Europe 2025 Strategy. As the old saying goes: *Mundus vult decipi, ergo decipiatur* – the world wants to be deceived, so let it be deceived.

Room for rate cuts

Around three months ago, we believed that both Czech and broader European industry had reached their cyclical low and were poised for a steady and sustainable recovery. This momentum was seen as the final piece needed for the Czech economy to start firing on all cylinders, with industrial output playing a crucial role in ensuring the durability of the rebound.

Such a scenario would mark a shift from a primarily cyclical upswing to a more structurally driven expansion. In such a world, the economy was expected to approach its potential output by early 2026, creating a more inflationary environment. Based on this outlook, we assessed 3.25% as the optimal terminal rate for the Czech National Bank’s base rate, with 3.5% also considered a plausible alternative.

Uncertain growth prospects create space for rate cuts

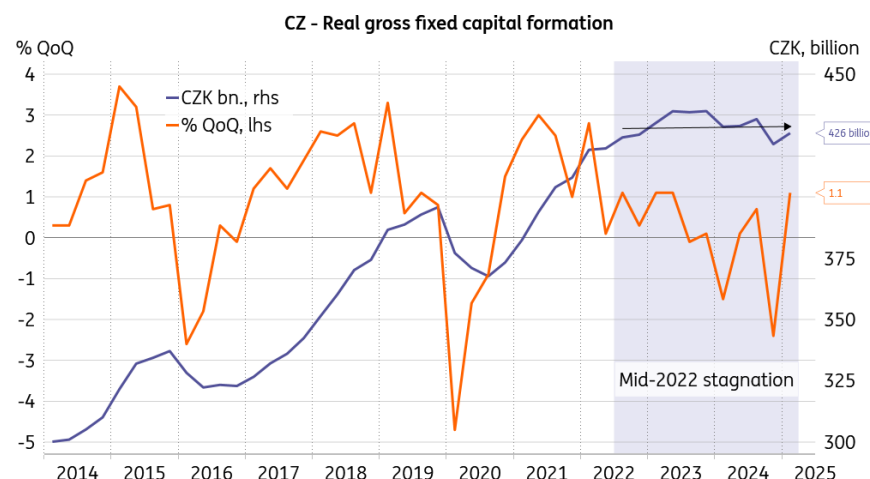


Meanwhile, growth conditions have yet to improve decisively or swiftly enough to meaningfully boost investment appetite. Uncertainty continues to cloud the future role of industry across Europe, with many commitments still wrapped in vague assurances. Consider, for instance, the pledge not to impose additional reporting requirements on small and medium-sized enterprises

(SMEs). While the intention to ease the regulatory burden on SMEs is certainly commendable, it raises a broader question: why not extend similar relief to large firms, which are the ones competing on the front lines of global markets?

Correcting past policy missteps should apply across the board. SMEs undeniably play a vital role, particularly in driving innovation and technological advancement. But once these firms reach a level where they can compete with larger players, is the goal to sideline them from the European ecosystem? It's puzzling, to put it mildly.

Fixed investment remains dormant



Source: CZSO, Macrobond

Given these conditions, the outlook for solid and sustainable growth in the Czech economy appears increasingly uncertain – despite the recent upside surprise in headline GDP figures. Slower expansion implies a more gradual improvement in potential output, a prolonged period of operating below capacity, subdued inflationary pressures, and, consequently, greater scope for lower nominal interest rates.

In this context, we still assess 3.25% as the optimal finish line for the CNB cutting cycle, which is likely to be reached at the August meeting. However, a further reduction to 3.00% remains a credible alternative.

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