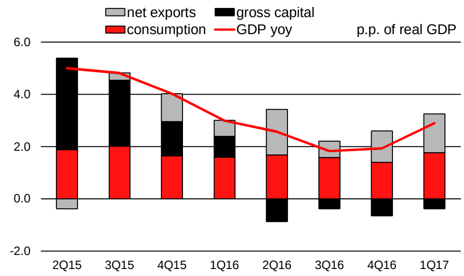
Czech Economic Quarterly

June 16, 2017

Gearing up

- In 1Q17, real GDP staged a quantum leap to 1.3% qoq and 2.9% yoy, with all major demand-side components improved. Importantly, net exports delivered an input worth 1.5 pp of GDP on the export dynamic reaching 5.4% yoy. In a qoq comparison, fixed capital formation was sharply higher (3.6%).
- High-frequency data on 2Q17 suggest that positive trends are ongoing. We currently predict GDP for the period to grow (adjusted) 0.7% qoq and 2.7% yoy, with all major components, i.e. consumption, fixed capital formation and net exports, contributing to yoy growth.
- Private consumption is set to remain the key supporting factor of GDP growth in the whole of 2017. This will be facilitated by nominal wage growth probably exceeding 5%. Along with solid foreign trade momentum, higher private consumption stands behind our upward revision in the 2017-GDP growth to 3.0%. The 2018 real GDP dynamic is projected at 2.6%.
- We expect a moderate fiscal impulse for both 2017 (via investment spending) and 2018 (via current expenditures). CZK gains versus EUR have reached 3% since the end of CNB interventions and we expect for EUR-CZK a correction above 26.50 sometime in 2H17. The first CNB repo rate hike is seen in 3Q17 or 4Q17, with more to come in 2018.

Breakdown of GDP growth by demand*



*/ Contributions to real GDP growth in percentage points
Sources: CZSO, UniCredit Research.

All the three major components of GDP on the demand side improved in 1Q17 vis-à-vis 4Q16, measured by yoy changes. Consumption accelerated on a higher dynamic of the government sub-part. The share of net exports in total GDP growth was the second highest for all quarters since the start of 2014. Gross capital narrowed its negative input to GDP growth and concluded the streak of four negative quarters.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	1Q17		4Q16 revised	
	YoY change	**% of change in GDP***	**YoY change**	**% of change in GDP***
GDP total	**2.9**	**2.9**	**1.9**	**1.9**
Household consumption (%)	2.8	1.3	2.9	1.3
Government consumption (%)	2.4	0.5	0.1	0.0
Fixed capital formation (%)	-0.6	-0.2	-6.9	-1.8
Change in inventories	-	-0.2	-	1.2
Net exports	-	1.5	-	1.2

Source: Czech Statistical Office. Calculations: UCB CZ.
**/ Real GDP in the same period of previous year*
Remark: The national accounts are based on chain-linked data, which introduces a discrepancy between GDP and real demand components.

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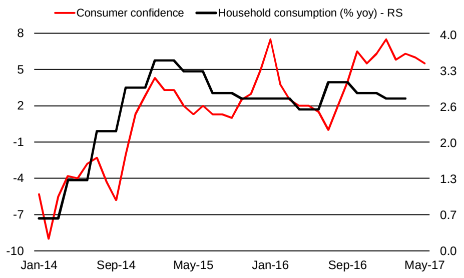
1Q17: ALL MAJOR GDP COMPONENTS IMPROVED

In 1Q17, real GDP staged a quantum leap to 1.3% qoq and 2.9% yoy. All major demand-side components of GDP improved. With private consumption expanding at a fairly stable pace (2.8% yoy), government spending gained momentum to 2.4% yoy. Fixed capital formation eased its contraction to -0.6% yoy, subtracting from GDP growth the same portion (-0.2 pp) as a change in inventory stock did. Net exports delivered an input worth of 1.5 pp of GDP on the export dynamic (5.4% yoy) sharply improved from previous two quarters. Nominal GDP increased 3.8% yoy, leaving GDP deflator at a modest 0.9% yoy. The low value of GDP deflator was impacted by negative terms of foreign trade with import prices picking up (2.2% yoy) but export prices lagging behind (0.4% yoy).

Two aspects should be stressed as particularly positive in the latest data. First, the comparison of 1Q17 and 4Q16 reveals a jump in exports and imports (4.8% and 5.3% qoq, respectively) and, even more importantly, in fixed capital formation (3.6% qoq). This suggests that investment is soon set to stop acting as a brake of growth in yearly GDP. That said, the investment recovery still appears to be subdued, as it has not comprised an infrastructure construction part. Second, labor productivity has resumed growth after its 2016 stagnation, adding in 1Q17 1.4% yoy per worker and 0.3% per hour worked (or 1.3% per hour worked in non-adjusted terms).

Consumer confidence and private spending



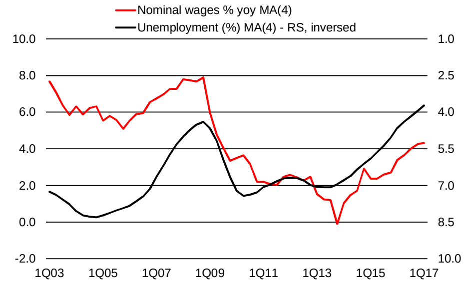
Sources: CZSO, UniCredit Research.

The consumer confidence remains close to an all-time high, which keeps supporting private consumption growth at around 3% yoy. With nominal wage growth accelerating and inflation subsiding after a recent spike, household spending may not necessarily slow in the end.

2Q17: FIXED CAPITAL TO RESUME GROWTH

Data published on 2Q17 to-date suggest that positive trends from 1Q17 are ongoing. April industrial output was reported down 2.5% yoy in unadjusted terms but that actually meant a higher calendar-adjusted growth (5.9% yoy) than in 1Q17 (4.9% yoy). In the same vein, April exports (-2.9% yoy in CZK terms) were dragged by the Easter break and not by poor external demand. April retail sales saw an expansion in their core segment (2.7% yoy), declining only for car sales and repairs. New car (passenger and LUV) registrations posted a 9.7% yoy rise in May, confirming as temporary their decline from April. Construction output was up in April by 4.0% yoy despite the unfavorable calendar effect. A growing momentum, also supported by new orders, was observed in both residential and non-residential building projects, with only infrastructure construction lacking any optimism. In terms of household consumption, all of the wage, inflation and labor market trends look positive. In 1Q17, nominal wage growth exceeded 5% yoy for the first time since 2008. In April, yoy dynamics went further up from 1Q17 for industry and construction where monthly wages are published. Average CPI is in contrast set to be lower in 2Q17 (our forecast stands at 2.1% yoy) than 1Q17 (2.4% yoy). Unemployment rate hit an all-time low in May. As a bottom line, we predict GDP to grow (adjusted) 0.7% qoq and 2.7% yoy in 2Q17, with all major components, i.e. consumption, fixed capital formation and net exports, contributing to yoy growth.

Unemployment and wage growth



Sources: MPSV, UniCredit Research.

Recent tight conditions on the labor market are demonstrated by declining unemployment rate and a rising dynamic of nominal wages. The situation resembles the period of 2007-2008, the major difference being that nominal wage growth was even stronger then.

2H17, 2018: POSITIVE OUTLOOK ON MORE FRONTS

Global trade momentum appears to be the highest since 2011, which already had a positive impact on Czech exports in 1Q17 and the impact is set to continue. We predict this year's **exports** to grow by 5.5% in volume terms. Net exports may add to GDP growth less than in 1Q17 but its contributions are expected to stay positive in each of the remaining quarters of 2017, in total accounting for 1.0pp of the 2017-GDP growth. On a negative note and relating more to 2018 than 2017, slowdown of car demand in Western Europe is in the pipelines, which Czech-based producers may only partially offset by selling on average higher-value-added cars.

Economic growth will also benefit from an upturn in **fixed capital formation** this year and the next. The change should stem from stronger construction activity and higher corporate spending on machinery and equipment. Reasons for the former include the 1Q17 data on housing starts (up 26% yoy, the highest level since 2012) and new permits (in CZK terms up 42% yoy, the highest reading since 2011). In the same vein, new construction orders from the public sector in 4M17 rose by 86% yoy, albeit from an extremely low base. (Sustainability in the recovery of construction activity is however not guaranteed, as public tenders have started to decline again.) Corporate investment in machinery is necessary to overcome the existing labor shortage and to boost productivity, the dynamic of which was poor until 1Q17. The upturn is also supported by the base effect after last year's 5.7% decline in machinery investment.

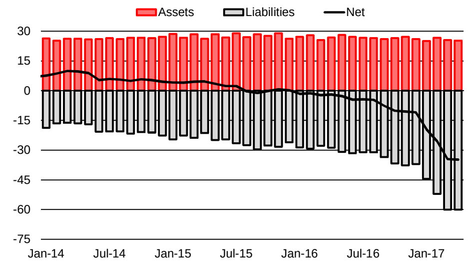
Private consumption is set to remain the key supporting factor of GDP growth. The 2017 **nominal wage growth** is believed to exceed 5% after accelerating to 5.3% yoy in 1Q17. This may broadly offset a rise in **average inflation** to (estimated) 2.4%, leaving the pace of expansion in household real disposable income at close to 3% yoy. **Growth in employment** will on the other hand bolster disposable income less than in 2016 due to an ever tighter labor market. The (ILO definition) unemployment rate stood at 3.2% in April, the lowest in the EU. A local survey shows that only large corporations intend to boost employment in 2H17, with smaller ones probably giving up their efforts.

On balance, we are revising our **2017 GDP growth** up to 3.0%, bringing marginally up to 2.6% also our 2018 forecast via the carry-over effect.

FISCAL POLICY: A MODERATE EASING

The parliamentary elections to be held in October have put an upward pressure on government spending. This may contribute to moderate fiscal easing in 2017, although public investments in 2H17 will rather be key to determine this year's fiscal stance. Mandatory expenditures may however affect fiscal position more profoundly in 2018 when all the legal amendments set in. We believe that the next year's plan to keep the government deficit within CZK 50bn would only be achievable with deep cuts in the public investment budget (which, however, faced underspending regularly in recent years). The bottom line is that a moderate fiscal impulse

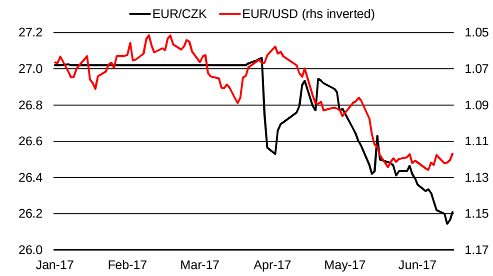
External assets and liabilities of Czech banks (EUR bn)



Sources: Macrobond, UniCredit Research.

Since the start of CNB interventions in November 2013, net external position of the Czech banking sector has switched from EUR +12.5bn to EUR -34.8bn. However, a half of the change was recorded in mere three months in early 2017. April has brought stabilization but no reversal in net external position. We believe that as long as the position remains wide negative, potential exists for an upward correction in EUR-CZK.

EUR-CZK and EUR-USD



Sources: CNB, UniCredit Research.

A short spell after the end of CNB interventions gave an impression that EUR-CZK has recalled its link to EUR-USD that had existed until November 2013. The latest couple of weeks drove CZK to a stronger level than would be supported by EUR-USD. This may serve as yet another (albeit not overly strong) reason to expect an upward correction in EUR-CZK.

may again be in place in 2018 but rather via current than investment spending.

FX AND THE CNB POLICY: RATE HIKES ARE NEEDED

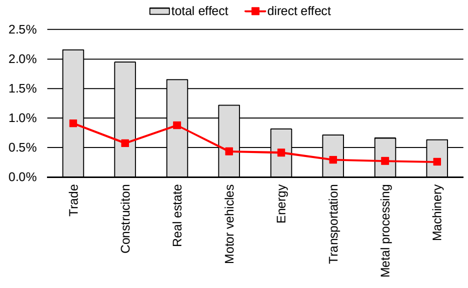
The koruna gains versus EUR have reached 3% since the end of CNB interventions. The EUR-CZK drift was helped by solid macroeconomic data as well as (probably) the euro appreciation against the dollar. A further moderate downward pressure on EUR-CZK cannot be ruled out. Yet, we regard a correction of EUR-CZK above 26.50 fairly likely sometime in 2H17, driven by 1) a need of foreign investors to close their persisting (huge) net long CZK positions and 2) more mixed macro data arriving. Therefore, this year's CZK gains look insufficient to satisfy the CNB needs for tightening monetary conditions, leaving good chance for introducing an interest rate hike in 3Q17 or 4Q17. Hiking is set to continue next year, with a pace determined by the ECB policy of tapering and the exchange rate development. Two CNB steps (25bp each) are part of our baseline scenario.

FOCUS: WHICH SECTOR IS THE MOST SHOCKING?

Complacency would not be a proper reaction to current strong macroeconomic fundamentals. Looking at input-output tables which are part of the national accounts, we therefore try to analyse what a demand shock in a certain sector of the Czech economy would do to the overall GDP and employment. Obviously, the shock (measured by a 10% loss of demand in the sector, all else staying equal) would affect GDP not only via gross value added of the particular sector (direct effect) but in addition via lower intermediate consumption from the chain of other sectors, which would make their output lower as well. As another consequence (mitigating the domestic impacts), imports would be dragged. Output losses would also hit to certain extent employment and wages in individual sectors, causing an additional drop of demand. The analysis was run on 2013 data, which are the latest available. As structural shifts in the economy are very gradual and long-lasting, we believe that the four-year time lag leaves our results still plausible.

Breaking down the economy into 80 NACE sectors, we conclude that trade (wholesale and retail) has proved to be the biggest drag on both GDP and employment in case of a 10% drop in its output. Of the sectors where the origin of a shock is more conceivable, construction and real estate came in as the second and the third most important for GDP. Only then follows the first representative of manufacturing – production of motor vehicles. For employment, this sector would nevertheless be more influential than real estate. The overall GDP and employment losses are not seen much above 2% in case of a 10% drop of output in the most important sectors, which looks serious but not devastating. We point out, however, that this is the result of a rather theoretical exercise. A shock (in one sector) would seldom stay alone but would be followed by (other sectors') after-shocks.

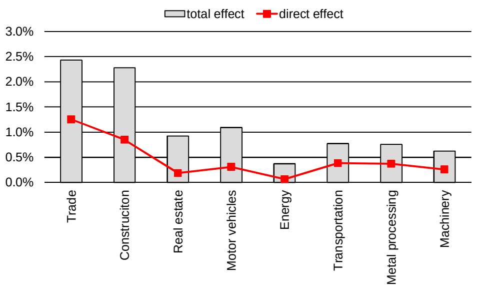
Effect of a 10% output loss on GDP (%)



Sources: CZSO, UniCredit Research.

Trade has proved to be the most influential economic sector for total GDP, as a 10% decline of output in the sector would induce up to 2.2% total drop of GDP (of which direct effect would be 0.9%). Other important sectors' total (and direct) impacts on GDP include construction 1.9% (0.6%), real estate 1.7% (0.9%) and motor vehicles production 1.2% (0.4%). The total effect gets higher with a higher share of the respective sector on GDP, a lower share of direct as well as indirect imported inputs and higher labor intensity.

Effect of a 10% output loss on employment (%)



Sources: CZSO, UniCredit Research

Trade and construction have also proved to be the two most influential economic sectors for total employment in case of a 10% drop of output in any of the two sectors. Other sectors appear to be much less influential and their rankings look different for employment than for GDP.

Czech Republic Macroeconomic Outlook

	2014	2015	2016	2017 forecast	2018 forecast
GDP growth (real yoy change, %)	2.7	4.6	2.3	3.0	2.6
Household consumption (real yoy change, %)	1.8	3.1	2.8	2.6	2.5
Gross fixed capital formation (real yoy change, %)	3.9	9.1	-3.6	2.7	4.0
Industrial output (real yoy change, %)	5.0	4.6	3.5	3.5	2.5
Unemployment rate (average, %)	7.7	6.5	5.5	4.4	4.4
Inflation rate (CPI yoy change, average, %)	0.4	0.3	0.7	2.4	2.1
Average wages (nominal yoy change, %)	2.9	3.2	4.2	5.1	4.6
Interest rates (3-M PRIBOR, end of period, %)	0.34	0.29	0.28	0.55	1.05
Interest rates (3-M PRIBOR, average, %)	0.36	0.31	0.29	0.36	0.75
EUR/CZK exchange rate (end of period)	27.73	27.03	27.02	26.50	26.00
EUR/CZK exchange rate (average)	27.53	27.28	27.03	26.65	26.25
Current account balance (% of GDP)	0.2	0.2	1.1	1.1	1.3
FDI net inflow (% of GDP)	1.9	-1.1	3.0	2.6	2.4
General government balance (% of GDP)*	-1.9	-0.6	0.6	-0.6	-0.8
Public debt (% of GDP)	42.2	40.3	37.2	36.1	35.5

Remarks:
**/ ESA 2010 definition.*
Sources: Czech National Bank, Czech Statistical Office.
Forecasts: UniCredit Bank CZ.