Czech Economic Quarterly

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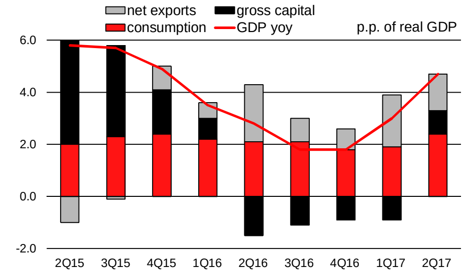
Heading off the cyclical peak

- Real adjusted GDP soared in 2Q17, reaching 2.5% qoq and 4.7% yoy. All major demand-side components of GDP showed a positive impact. The adjusted data were heavily affected by four fewer working days in 2Q17 against the base period. Our preferred view on the economy is hence via the aggregation of 1Q17 and 2Q17, which shows real dynamic of 3.8% yoy.
- Recently released data suggest that conditions in the Czech economy have remained solid at least until the end of 3Q17. Translating the figures into more general macroeconomic trends, we believe that a 3Q17 GDP growth could again be above 4% yoy.
- We are revising upwards our GDP growth forecasts to 4.0% for 2017 and 3.1% for 2018 due to the surprisingly strong and broad-based economic activity. The economy will continue to run above potential, failing to alleviate tensions in the red-hot labor market and stoking inflationary pressures.
- All available information speaks for significant monetary policy tightening going forward. A 25bp hike in November appears to be almost certain, while three more hikes in 2018 may be consistent with our 2018-end EUR-CZK forecast of 25.50. Yet, even this amount of tightening may be insufficient to turn real monetary conditions neutral.

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 contributed positively to 2Q17 GDP growth yoy. In comparison with 1Q17, the share of consumption in total GDP growth was moderately higher, as household spending turned significantly stronger while government spending growth was slightly weaker. The share of net exports in total GDP growth declined compared to 1Q but remained positive for the seventh quarter running. Gross capital reversed to a positive effect on GDP after four quarters of negative inputs.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	2Q17		1Q17 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**4.7**	**4.7**	**3.0**	**3.0**
Household consumption (%)	4.4	2.0	3.0	1.4
Government consumption (%)	1.7	0.3	2.4	0.5
Fixed capital formation (%)	7.9	2.0	-0.1	0.0
Change in inventories	-	-1.0	-	-0.9
Net exports	-	1.4	-	2.0

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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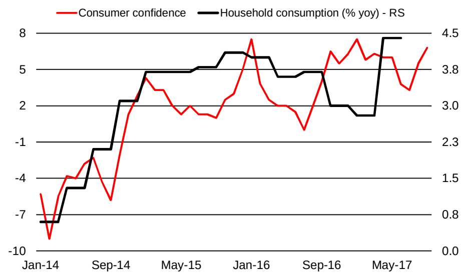
2Q17: ALL MAJOR COMPONENTS BOOSTING GDP

Real adjusted GDP soared in 2Q17, reaching 2.5% qoq and 4.7% yoy. All major demand-side components of GDP showed a positive impact. With private consumption accelerating to 4.4% yoy, government spending eased the momentum to 1.7% yoy. Fixed capital formation reversed after four quarters of a negative input to add 2.0 pp to GDP on a 7.9% yoy growth. With the inventory stock adjusting, gross capital in total contributed a more moderate 1.0 pp to GDP. Net exports delivered an input worth of 1.4 pp of GDP on the highest export dynamic since 4Q14 (7.3% yoy). From the production side, manufacturing was once again the key contributor to GDP growth, rising 7.9% yoy. Nominal GDP increased 5.7% yoy, leaving GDP deflator at 1.0% yoy. The low value of GDP deflator was impacted by negative terms of foreign trade with imports prices growing faster than the prices of exports. As the most noteworthy statistics in the national accounts, compensation of employees grew by 8.6% yoy, the fastest pace since 1Q08.

The adjusted yoy data were heavily affected by four fewer working days in 2Q17 against the base period. On the unadjusted data, real GDP hit a more modest 3.4% yoy, slowing from 4.0% yoy recorded in 1Q17 when the number of working days was in contrast higher by three in a yoy comparison. Our preferred view on the economy is hence via the aggregation of 1Q17 and 2Q17, which shows real dynamic of 3.8% yoy.

Consumer confidence and private spending



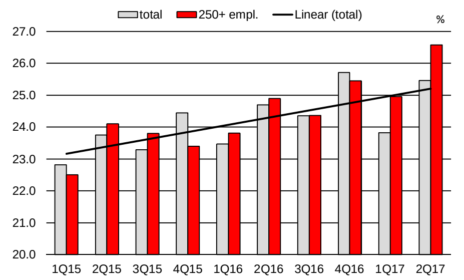
Sources: CZSO, UniCredit Research.

Consumer confidence remains close to an all-time high, looking in general terms consistent with the observed private spending boom. In a more micro view, the slowdown in private spending momentum from 4Q16 and 1Q17 was not signaled by a change in consumer confidence but the deviation was removed in 2Q17.

3Q17 ECONOMIC CONDITIONS REMAINED SOLID

Recently released data suggest that conditions in the Czech economy have remained solid at least until the end of 3Q17. Of the indicators for which evidence on the July-August period is available, industrial output grew by 4.5% yoy, while (ex-auto) retail sales added 4.7% yoy. Sales in restaurants were up 5.9% yoy (slowing from its previous double-digit expansion), car sales and repairs dipped 0.3% yoy. The number of new car registrations rose 1.7% yoy in the whole of 3Q17. Construction output was higher by a sluggish 1.9% yoy in July-August despite the value of building permits posting a 45% rise yoy and housing starts expanding 9%. Translating the figures into more general macroeconomic trends, we believe that a 3Q17 GDP growth could again be above 4%, more specifically 4.3% yoy. The structure of growth would see only limited changes, with private consumption maintaining its pivotal role while net exports contributing slightly less. Within fixed capital formation, the motor vehicles sub-part may show up a slowdown, raising a relative significance of construction projects.

Retail trade margin



Sources: ČSÚ, UniCredit Research.

After two years of a rapid and accelerating growth, retail margins in 2Q17 were 1.7pp higher for the whole sector and as much as 2.5pp higher for the units with more than 250 employees. Historically, the figures were only observed that high in 2007. We interpret the growing margins as a sign that demand-side inflationary pressures are creeping in.

THE OUTLOOK FOR FULL-2017 AND 2018: HEADING OFF SLOWLY FROM THE CYCLICAL PEAK

We are revising upwards our GDP growth forecasts to 4.0% for 2017 and 3.1% for 2018 due to the surprisingly strong and broad-based economic activity. While momentum is set to start easing gradually, the economy will continue to run above potential, failing to alleviate tensions in the red-hot labor market and stoking inflationary pressures.

Private consumption is set to remain the most powerful driver of GDP growth. Given acute labor shortages, with unemployed per vacancy ratio at the all-time low of 1.4, there are reasons to believe that wage expansion will continue, with full-year real wage growth estimated at 4.7% in 2017 and 4.4% in 2018. The latter could push consumer prices higher, especially for services, maintaining Czech inflation above euro area readings. The wage cost as a share of GDP is set to hit an all-time high already in 2017. By 2018, it may cause first lay-offs by businesses with thin margins that cannot absorb higher wage costs.

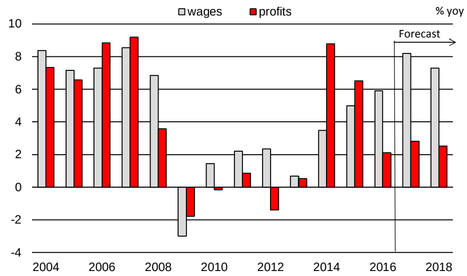
The turning point on the labor market may also be determined by **external demand**. Notably, as much as a third of Czech export's annual growth in 7M17 was due to vehicles, whose key market is the EU and whose point of saturation may be near. With eurozone demand expected to rise at a slower pace next year, car production may increase slower in 2018 than in 2017. Overall, we assume real export growth at a still respectable 5.4% in 2018. Import dynamics are seen weakening less than exports due to robust household demand for foreign goods and investment-related orders.

All major components of **fixed capital formation** rose in annual terms in 2Q17: dwellings, other buildings and structures, transport vehicles, other machinery and intellectual property products. This happened only once this decade, and for a short period, in 2015. Yet, the outlook is more mixed. On the one hand, the future of residential construction projects looks solid, as indicated by growing housing starts. Infrastructure investment (part of the 'other buildings and structures' group) may finally pick up, as the volume of orders from public investors has been on the rise since the start of 2017. On the other hand, machinery investment may benefit in 2H17 from last year's lower base, but thereafter a further expansion is less certain. For transport equipment, a slowdown is even more imminent, as the streak of unbroken growth has entered its fifth year. Overall, 4% growth for fixed capital formation is possible in 2018.

EXPECTATIONS OF A NEW GOVERNMENT POLICY ARE LOW

The ANO Movement appears to be the likely winner of general elections with roughly 25% of votes, the final configuration of the next parliament is however rather uncertain. In terms of the next government's agenda, election promises of mainstream parties provide limited guidance, looking largely financially unrealistic. Hence, we assume that most promises will be ignored. A new government could focus instead on spreading the financial burden of measures already implemented, which would likely mean spending cuts in case of a center-right coalition or financing the current level of spending with a moderate tax hike in case of a center-left coalition. Deeper economic reforms would only be considered if economic growth loses momentum. For fiscal policy, this probably means a moderate easing in 2018, followed by tightening thereafter.

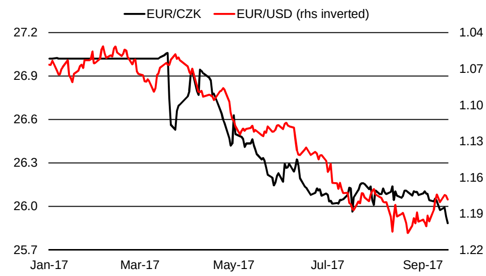
Compensation of employees and profits



Sources: CZSO, UniCredit Research.

The Czech currency weakening as a result of CNB interventions caused a one-off spike in gross operating surplus. Since 2016, however, compensation of employees has been growing fast, with corporate profits lagging behind. The situation contrast with the spell of 2004-2007 when both indicators were staying in balance. With the wage pressure not abating, employee compensation as a share of GDP is set to hit an all-time high for 2017 and grow further in 2018.

EUR-CZK and EUR-USD



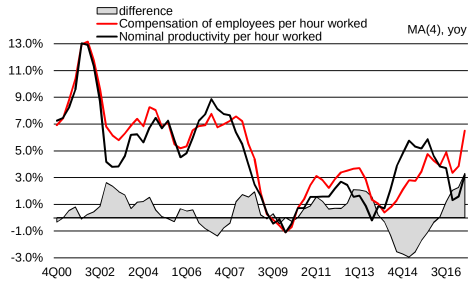
Sources: CNB, UniCredit Research.

It took the Czech koruna almost five months since the end of CNB interventions to break on the firm side of the EUR-CZK psychological level of 26.0. In a step-wise process tracing the EUR-USD development, the decisive moment for EUR-CZK to sink below 26.0 came alongside the FX basis swap repricing that effectively removed the cost of carry for holding CZK long positions against EUR. In our view, CZK would now need a strong new impulse to get firmer from its current levels.

THE CNB POLICY: TIGHTENING GETTING MORE CERTAIN AND GOING FARTHER

Macroeconomic data from both the external and domestic environment are coming firmer than the CNB predicted, which calls for an upside revision to the CNB's GDP forecast in November. In addition, the CZK remains weaker than the central bank hoped. All of that speaks for significant monetary policy tightening going forward. A 25bp hike in November appears to be almost certain, while three more hikes in 2018 may be consistent with our 2018-end EUR-CZK forecast of 25.50. Yet, even this amount of tightening may be insufficient to turn real monetary conditions neutral, meaning that tightening is set to continue beyond 2018.

Productivity and wages



Sources: CZSO, UniCredit Research.

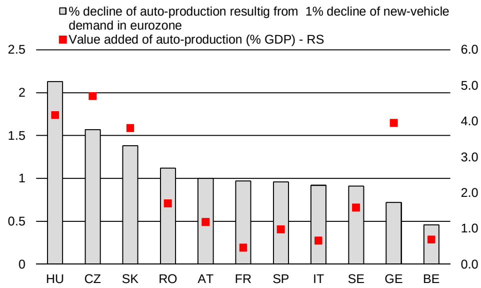
Historically, labor productivity and compensation of employees have been developing in a close link. The deviation observed lately, with wage costs growing faster than productivity, looks rather high but not yet extreme if considered as an offset of the opposite episode from 2014-2015. That said, risks for financial stability of the corporate sector are clearly mounting.

FOCUS: THE EUROZONE DEMAND FOR CARS AND THE CZECH ECONOMY

It is a well-known fact that the Czech economy is highly dependent on the production of motor vehicles. With a vast majority of production being exported, performance of the sector is strongly dependent on foreign demand. How to quantify the link? Considering data constraints, we have tried to estimate the effect of a 10% drop of demand for new passenger cars and LUV in the eurozone to the Czech GDP and employment. The analysis was made in two steps. First, we estimated the elasticity of Czech auto-production for new-vehicle registrations in the eurozone using a regression analysis. Second, we estimated an influence of the auto segment in the Czech economy using input-output analysis. By doing that, we took into account both direct and indirect effects, as a shock in one sector would affect GDP not only via gross value added of that particular sector (direct effect) but also via lower intermediate consumption (as well as employment and wages) from the chain of other sectors, making their output lower as well. On the other hand, the auto segment is highly import-intensive (our analysis shows that each unit of auto production needs nearly 0.6 units of import), so a decline of imports would mitigate the negative effect of the production decline under consideration.

In our findings, car output sensitivity on the eurozone demand is the second highest in Czechia of all EU countries (after Hungary). Other things staying equal, a 1% drop of demand would cause a 1.6% drop of Czech car production (2.1% for Hungary, 1.4% for Slovakia, but only 0.7% for Germany). Such a decline in production would cause an estimated 0.17% drop of Czech GDP and a 0.15% decline in local employment, with about 8,000 workers thus losing their jobs. Obviously, the presented figures are just approximate, as "other things" would hardly stay equal.

Elasticity of auto-production on EMU demand



Sources: CZSO, UniCredit Research

The Czech economy is the most dependent on auto-industry of all EU countries. In 2015, the direct share of the sector's gross value added in Czech GDP hit 4.7%. Moreover, our model shows that the auto-production in Czechia (as well as Hungary and Slovakia) is highly sensitive to demand for new vehicles in the eurozone. In general, a potential car demand shock would hurt CEE economies more than West Europe.

Czech Republic Macroeconomic Outlook

	2014	2015	2016	2017 forecast	2018 forecast
GDP growth (real yoy change, %)	2.7	5.4	2.5	4.0	3.1
Household consumption (real yoy change, %)	1.8	3.7	3.5	4.1	3.9
Gross fixed capital formation (real yoy change, %)	3.9	10.4	-2.5	4.6	4.0
Industrial output (real yoy change, %)	5.0	4.6	3.5	4.0	2.5
Unemployment rate (average, %)	7.7	6.5	5.5	4.2	3.9
Inflation rate (CPI yoy change, average, %)	0.4	0.3	0.7	2.4	2.5
Average wages (nominal yoy change, %)	2.9	3.2	3.7	7.3	7.0
Interest rates (3-M PRIBOR, end of period, %)	0.34	0.29	0.28	0.75	1.50
Interest rates (3-M PRIBOR, average, %)	0.36	0.31	0.29	0.40	1.10
EUR/CZK exchange rate (end of period)	27.73	27.03	27.02	26.30	25.50
EUR/CZK exchange rate (average)	27.53	27.28	27.03	26.50	25.80
Current account balance (% of GDP)	0.2	0.0	0.0	0.0	0.0
FDI net inflow (% of GDP)	1.9	0.9	3.3	3.8	3.6
General government balance (% of GDP)*	-1.9	-0.6	0.7	0.2	-0.6
Public debt (% of GDP)	42.2	40.0	36.8	34.7	33.8

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

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