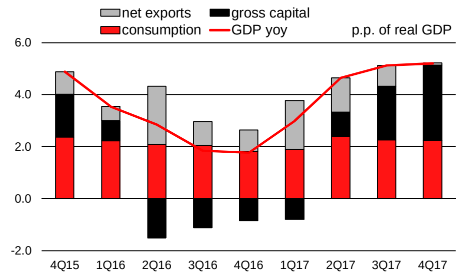
Czech Economic Quarterly

March 19, 2018

Getting ready for soft landing

- In 4Q17, real GDP added 0.5% qoq, inching up to 5.2% in the yoy dynamic. Growth rates of major demand-side components were remarkably stable, while net exports contributed a mere 0.1 pp to yoy growth. Full-2017 GDP growth hit 4.5%.
- At the start of 2018, economic situation continued to be firm both externally and inside the Czech economy, even as some leading indicators were retreating from their all-time highs and January trade balance deteriorated. We put our 1Q18 GDP forecasts at 0.7% qoq and 4.4% yoy.
- The economy is probably entering a slowing phase, which may translate into a soft landing rather than an abrupt downturn. Private consumption in particular may smooth the slowdown. We predict GDP growth at 3.7% for 2018 and 2.8% for 2019.
- Monetary conditions will continue to tighten at a moderate pace in 2018-2019, reacting to ongoing inflationary pressures. Our baseline scenario counts on two more 25bp repo rate hikes in 2018 and additional two in 2019. This would be consistent with the EUR-CZK exchange rate not breaking below the 25.0 level systematically before 2019.

Breakdown of GDP growth by demand*



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

In 4Q17, consumption continued to power ahead at a stable pace, accounting for slightly less than a half of total GDP growth. The remaining part was delivered by gross capital, in which fixed capital made a stable contribution while an inventory change saw the biggest input for ten quarters. Net exports served as an offset for the inventory accumulation, showing the smallest input to GDP growth since 3Q15.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	4Q17		3Q17 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**5.2**	**5.2**	**5.1**	**5.1**
Household consumption (%)	4.3	2.0	4.3	2.0
Government consumption (%)	1.1	0.2	1.3	0.2
Fixed capital formation (%)	7.9	2.0	7.8	1.9
Change in inventories	-	1.0	-	0.1
Net exports	-	0.1	-	0.8

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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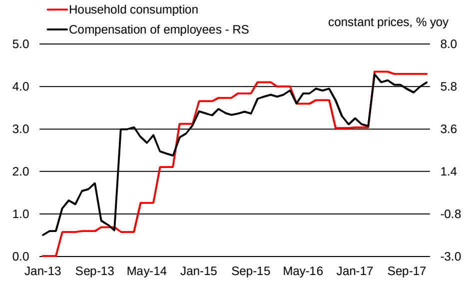
4Q17: PASSING THE CYCLICAL PEAK

In 4Q17, real GDP added 0.5% qoq, slowing from the 3Q17's revised 0.6% qoq pace. In yoy terms, GDP expanded 5.2%, inching up from the previous 5.1% dynamic. Growth rates of major demand-side components were remarkably stable: private consumption rose by 4.3% yoy in both 4Q17 and 3Q17, government spending grew by 1.1% yoy in 4Q17 after adding 1.3% yoy in 3Q17, whereas fixed capital formation was up 7.9% yoy in 4Q17 after growing 7.8% yoy in 3Q17. A major input to GDP growth, at 1.0 pp, was brought about by the inventory accumulation in 4Q17. This was broadly offset by net exports adding only 0.1 pp despite real exports expanding at a respectable 7.6% yoy. From the production side, business services became the most dynamic sector with GVA expanding 10.0% yoy, but all other major sectors saw positive figures too. The overall GVA grew by 5.4% yoy, which was a decade high. Similarly, nominal GDP at 7.5% yoy was highest since 2007. The dynamic of total employment slowed to 1.5% yoy, as the number of self-employed dropped while the number of employees grew steadily (1.9% yoy). The compensation of employees increased by 8.5% yoy, repeating the cyclical high from 3Q17. The dynamic of employee compensation was somewhat higher for large corporations versus small units. Full-2017 GDP saw a 4.5% growth in adjusted terms, but only 4.3% if unadjusted. Overall, the released data continue to suggest that the economy could be passing the cyclical peak in 4Q17.

Compensation of employees and private consumption



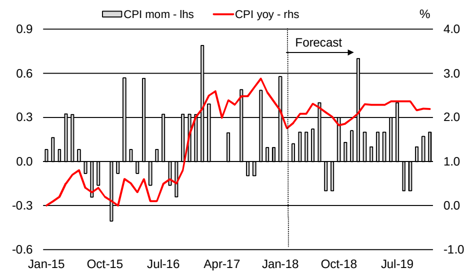
Sources: CZSO, UniCredit Research.

Labor income appears to be by far the most important driver for private consumption. With nominal wage growth expected to accelerate further and inflation to ease, private consumption is set to grow even faster in 2018 than in 2017.

1Q18: FIRM CONDITIONS TO PERSIST

At the start of 2018, economic situation continued to be firm both externally and inside the Czech economy, even as some leading indicators were retreating from their all-time highs. January industrial output recorded a 5.5% growth yoy, showing few signs of a slowdown versus its previous dynamics. The automotive sector's output ceased to outperform, but its 5.6% yoy growth compared well with a yoy stagnation in car unit production. More worryingly at a first sight, foreign trade surplus halved in January from the same month of 2017, with lower automotive exports revealed as the major cause. However, this is attributable to a slower start of production in early January, as the automotive producers made efforts to bring down their inventories. With demand for cars in Europe growing steadily (at about 5% yoy) and Škoda Auto reporting its all-time high unit sales in February, we believe that the overall manufacturing still has some space to grow in 1Q18. That said, the road ahead may be more bumpy, as suggested for instance by January industrial orders (they expanded 3.4% yoy in total but dipped 1.0% yoy in the automotive sector). Apart from industry, construction output surprised in January with its output expanding by a third yoy. Yet, the growth was seasonally adjusted to mere 5.4% yoy and, moreover, the prediction power of a January figure for a longer-term activity in construction is limited. January retail sales came in very strong, showing 5.7% yoy in total and 8.2% yoy ex-auto. Apparently, the momentum in purchasing power of households, driven by the accelerating wages (9.6% yoy for industry in January) and declining inflation (1.8% yoy for February) played a role. When estimating 1Q18 GDP growth, we are

CPI – history and outlook



Sources: CZSO, UniCredit Research.

Technical factors pushed CPI below 2% yoy in February. The decline in inflation is nevertheless expected to be short-lived. Inflationary pressures in the area of services are apparent and should maintain CPI at around 2% for foreseeable future.

however also taking into account technical aspects of the seasonal adjustment, which will be pushing a yoy figure slightly lower. We hence put our GDP forecasts at 0.7% qoq and 4.4% yoy.

2018-2019: A GRADUAL SLOWDOWN AHEAD

The economy is probably entering a slowing phase, which may translate into a soft landing rather than an abrupt downturn. **Private consumption** may smooth the slowdown, remaining the key growth driver and accelerating further compared to 2017. At the same time, **capital spending** may slow compared to 2017 in its machinery and transport equipment components, while public construction projects will provide a temporary boost in 2018.

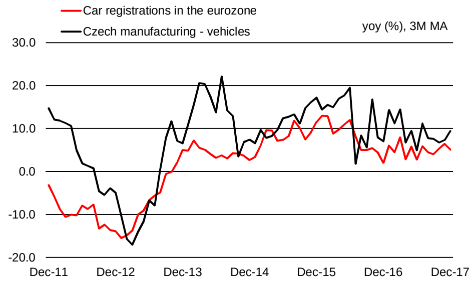
Nominal wage growth may approach 8% yoy in 2018, accelerating further on the back of extremely tight labor market conditions. The seasonally-adjusted **unemployment rate** has little room to fall from the 2.4% average registered in November – January, but its annual decline may contribute to an employment rise in 2018 by 0.8%, half its cyclical growth peak registered in 2017. Other sources of employment growth include more foreign workers and higher labor participation in the 60-65 age group. Employment growth could slow further in 2019.

The corporate sector **wage bill** may continue to expand by more than 8% yoy in CZK terms in 2018, exceeding by a wide margin the growth of gross operating surplus for a third year in a row. Two potential problems derive from the mounting imbalance. First, it raises the question of cost sustainability for Czech companies. In particular for manufacturing, faster future growth of employee compensation than in Slovakia and Hungary would affect the cost competitiveness of Czech companies. Second, poorer profitability bodes ill for **capital spending**. In 2018, however, a rise in public infrastructure investment may offset weaker private capex in total fixed capital formation.

On the production side, the automotive industry – the most important branch of manufacturing with the 13.3% combined direct and indirect share in total Czech GVA in 2016 – may face weaker demand from the eurozone after almost five years of unbroken expansion. A mild headwind may be withstood, however, if Škoda Auto manages to increase its market share in Europe. Overall, **industrial output** is forecast to add 3.5% in 2018, with the automotive sector growing at a similar pace. A further loss of IP dynamic is expected in 2019.

While our forecast for 2018 household nominal income remains broadly unchanged, we are revising **average inflation** a half percentage point lower to 2.0%. Lower inflation largely stems from a smaller contribution of food prices and an effect of the currency strengthening from 2H17. That said, demand-pull inflationary factors remain intact and we expect service prices to rise faster than those of goods in 2018-2019. Overall, households' higher purchasing power may allow for a 4.5% rise in **private consumption** in 2018 that would lift **GDP growth** to 3.7%. Private consumption is likely to rise strongly also in 2019, but external headwinds are expected to reduce

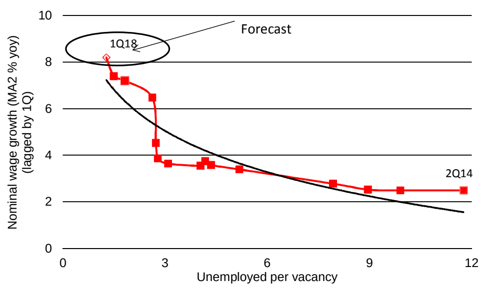
Car registrations in eurozone and Czech output of vehicles



Sources: Macrobond, CZSO, UniCredit Research.

The Czech production of vehicles is largely driven by car registration numbers in the eurozone. However, the yoy dynamic of Czech production is higher on average in the long run, suggesting that the production is moving up the value added chain.

Phillips curve for wages



Sources: CZSO, UniCredit Research.

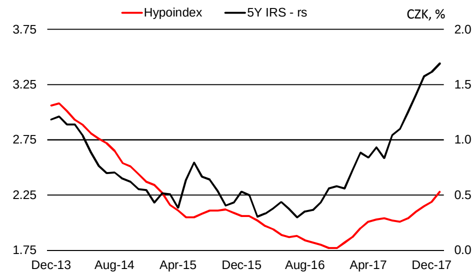
The Phillips curve for wages remains firmly in its exponential part. With the number of job vacancies almost reaching the number of unemployed, the wage pressure has more to go. In 1Q18, average wages may increase by more than 8% yoy.

GDP growth to 2.8% next year.

CNB POLICY: TWO REPO RATE HIKES LOOK LIKELY

Monetary conditions will continue to tighten at a moderate pace in 2018-2019, but the policy mix is unclear. The CNB's February forecast shows CZK appreciation accounting for most of the tightening in 2018, with interest rate increases taking over next year. We believe that the CZK will appreciate less and later than the CNB assumes, with existing long CZK positions not allowing the EUR-CZK exchange rate to break below the 25.0 level systematically before 2019. Compared to the central bank's forecast of EUR-CZK at 24.6 by the end of this year, this translates into a 25bp hike in 4Q18, endorsed publicly by some policy makers. Moreover, the CNB may deliver a mid-year hike if EUR-CZK deviates significantly from the central bank's forecast by late 2Q18. In 2019, weaker economic activity could slow, but not entirely stop, monetary tightening. We expect two more 25bp hikes, accompanied by modest CZK appreciation. Even with four additional rate increases from here, the central bank's proclaimed neutral level of interest rates at 2.6%-3.0% will remain far away at the end of 2019.

Hypoindex and 5Y interest rate swap



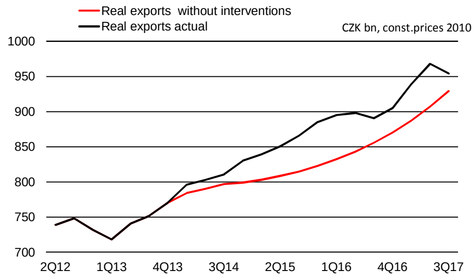
Sources: Macrobond, UniCredit Research.

Czech koruna interest rates have been on a continuous rise, capturing the (realized as well as upcoming) tightening policy of the CNB. Since its trough from the summer 2016, 5Y IRS has increased by 120bp. In contrast, new mortgage rates are moving up in a much slower pace, reflecting tough competition on the mortgage market..

FOCUS: DID CNB INTERVENTIONS FROM 2013-2017 BOLSTER CZECH EXPORTS?

At the end of 2013, the CNB devalued the Czech koruna by about 6% and was keeping EUR-CZK floored at 27.0 for 3.5 years. Making the currency weaker served the purpose of avoiding deflation in the Czech economy but, at the same time, it was hoped to give a boost to economic growth via higher exports. Did the reality meet such hopes? We used a simple ARDL model to estimate an effect of the FX move on export performance. The analysis was made in two steps: first, we modeled Czech export volumes as a function of GDP in the eurozone with four lags of the EUR-CZK exchange rate deviation from the linear trend (with CZK firming by 1.8% a year) and four lags of the auto-regressed exports in 2000-2017. We have found the model suitable for our purpose, with the exchange rate deviation positively and significantly correlated with exports. Next, we run a scenario showing how the model would have expected the exports to evolve, had there been no FX intervention.

Modeling exports as the function of EUR-CZK



Sources: CZSO, UniCredit Research

Without the 6% depreciation of CZK versus EUR, brought about by the CNB FX interventions in November 2013, Czech annual exports would have grown by 1.2 pp slower on average, our model shows.

The model shows that between 1Q 2014 – 3Q 2017, the CZK depreciation generated CZK 600bn worth of exports, adding 4.8% to their volumes. This means that annual exports grew on average by about 1.2% faster than they would have grown without FX interventions. It took almost a year for the effect to fully develop and then, the effect was staying at a 6% volume add-on for 2015 and 2016 before starting to diminish. In our view, the mean estimate presented here looks plausible but the analysis needs to be interpreted with caution. First, its dynamic forecast errors are high. Second, given that we dealt with one side of the foreign trade only, the model does not allow to draw any conclusion on net exports and, subsequently, a GDP dynamic.

Czech Republic Macroeconomic Outlook

	2015	2016	2017	2018 forecast	2019 forecast
GDP growth (real yoy change, %)	5.4	2.5	4.5	3.7	2.8
Household consumption (real yoy change, %)	3.7	3.5	4.0	4.5	3.8
Gross fixed capital formation (real yoy change, %)	10.4	-2.5	5.8	5.0	3.5
Industrial output (real yoy change, %)	4.6	3.5	6.5	3.5	2.5
Unemployment rate (average, %)	6.5	5.5	4.2	3.5	3.4
Inflation rate (CPI yoy change, average, %)	0.3	0.7	2.4	2.0	2.3
Average wages (nominal yoy change, %)	3.2	3.7	7.0	7.8	6.0
Interest rates (3-M PRIBOR, end of period, %)	0.29	0.28	0.75	1.45	1.95
Interest rates (3-M PRIBOR, average, %)	0.31	0.29	0.41	1.10	1.70
EUR/CZK exchange rate (end of period)	27.03	27.02	25.54	25.00	24.80
EUR/CZK exchange rate (average)	27.28	27.03	26.33	25.20	24.90
Current account balance (% of GDP)	0.2	1.6	1.1	1.0	0.9
FDI net inflow (% of GDP)	-1.1	3.9	2.7	2.8	2.5
General government balance (% of GDP)*	-0.6	0.7	0.7	0.2	-0.5
Public debt (% of GDP)	40.0	36.8	34.1	32.2	31.4

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

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