Czech Economic Quarterly

September 19, 2018

Signs of fatigue after rapid growth

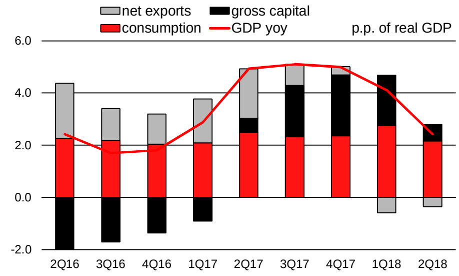
- In 2Q18, real GDP posted 0.7% qoq, slowing sharply in yoy terms to 2.4% from a previous 4.1%. Nominal GDP growth moderated to 4.8% yoy. From the production side, manufacturing slowed considerably and in current prices it added a mere 0.8% yoy.

- The third quarter of 2018 has started with relatively firm data on industrial output, construction output and retail sales. It remains to be seen, however, what effect the timing of company-wide holidays might have on full-quarter data. Car registrations skyrocketed in August, which might be an effect of frontloading. We remain cautious on 3Q18 GDP growth, predicting 0.8% qoq and 2.6% yoy.

- Barring a major disruption of business activities abroad, the Czech economy is seen growing at a pace close to its potential. Overall GDP growth for 2018 is projected a half percentage point lower at 3.0% than three months ago, which is more due to 1H18 downward revisions than to a changing outlook. We maintain our 2.8% forecast for 2019.

- Following the September's hike which is almost a deal done, another 25bp step this year is likely. For 2019, we assume two 25bp hikes to bring the repo rate to 2.25%. We stay a bit less upbeat on CZK appreciation than the CNB.

Breakdown of GDP growth by demand*



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

Consumption proved to be the main demand-side contributor to GDP growth in 2Q18, despite its momentum slightly easing. The input of fixed capital formation shrank radically due to a sharp inventory rundown. Net exports subtracted from GDP growth for the second quarter in a row.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	2Q18		1Q18 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**2.4**	**2.4**	**4.1**	**4.1**
Household consumption (%)	3.5	1.6	4.4	2.1
Government consumption (%)	2.6	0.5	3.3	0.6
Fixed capital formation (%)	7.8	1.9	10.3	2.5
Change in inventories	-	-1.3	-	-0.5
Net exports	-	-0.4	-	-0.6

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.

Authors:

Pavel Sobisek
Tel: +420 955 960 716
E-mail: pavel.sobisek@unicreditgroup.cz

Jiří Pour
Tel: +420 955 960 717
E-mail: jiri.pour@unicreditgroup.cz

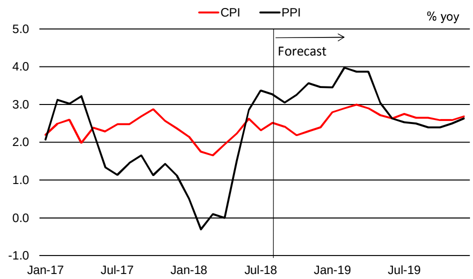
UniCredit Bank Czech Republic and Slovakia
Internet: www.unicreditbank.cz

2Q18: FEELING THE PINCH OF LABOR SHORTAGE

In 2Q18, real GDP posted 0.7% qoq, slowing sharply in yoy terms to 2.4% from a previous (revised) 4.1%. Private and government consumption eased moderately to 3.5% yoy and 2.6% yoy, respectively, whereas fixed capital formation added 7.8% yoy. Total gross capital, however, expanded only 2.4% yoy, as the stock of inventories shrank yoy in the equivalent of 1.3% of GDP. Net exports saw a negative contribution at 0.4% of GDP, as the momentum of exports and imports slowed to 3.5% yoy and 4.4% yoy respectively. Nominal GDP growth moderated to 4.8% yoy. From the production side, all major economic sectors expanded their gross value added, with construction turning out to be the most dynamic. In contrast, manufacturing slowed considerably and in current prices it added a mere 0.8% yoy. In the fixed capital formation breakdown, dwellings and transport infrastructure were the two most dynamic parts but other components did not fall much behind. The overall employment grew by 1.9% yoy, which must have been supported, under the diminishing downside potential of unemployment, by an increasing participation rate. Real productivity gained a disappointing 0.5% yoy.

Labor market imbalance is seen as the main characteristic of the latest national acocunts data. Gross operating surplus grew only by 1.5% yoy, comparing poorly with the employee compensation that rose by 9.8% yoy. The same gap was spotted in 1Q18 with only slightly smaller ones existing already in 2016-2017. A more technical remark to 2Q18 concerns private consumption. Its dynamic of 3.5% yoy may look disappointing with respect to real wages (expanding 6.2%). Our interpretation is twofold. Firstly, ongoing investment of households into housing with ever higher prices was taking a toll on their ability to boost spending. Secondly, however, we believe the Easter holiday timing inflated somewhat the 1Q18 consumption at an expense of 2Q18.

CPI and PPI – history and outlook



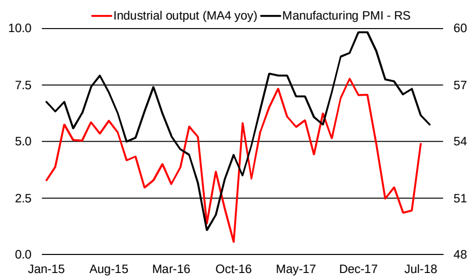
Sources: CZSO, UniCredit Research.

A combination of factors, with the rise in PPI being one of them, may lift CPI close to 3% yoy in 1H19. We do not expect CPI to ease to the ČNB-target 2% level before 2020.

3Q18: STRONG JULY DATA UNLIKELY TO PERSIST

The period has started with relatively firm data. July industrial output posted an unadjusted 10.3% yoy growth, with expansion seen across the sectors and being the highest in energy production. New orders of industrial producers reported a double-digit (11.2% yoy) growth as well. Double-digit were also yoy dynamics of exports and imports for July, with deficit reaching CZK 4.8bn, CZK 3bn wider than in July last year. Construction output surprised on the upside in July, showing an unadjusted 15.8% yoy rise. Dynamics were similar in both the infrastructure and building construction. July retail sales (without cars) expanded 5.6% yoy, whereas in the auto segment growth hit 10.4% yoy. July had one more working day than the same month of 2017 and hence, data pointed at a solid pace of business activity even after the adjustment. It remains to be seen, however, what effect the timing of company-wide holidays might have on 3Q18 data. The lesson learnt from the past suggests that it pays off to look at the July-August period as a whole rather than isolated July data. New car registrations serve as another source of uncertainty, being affected by WLTP (the new car emission standard) to apply from September.

Manufacturing PMI and industrial output



Sources: CZSO, Markit, UniCredit Research.

Manufacturing PMI has been declining from its cyclical high but remains firmly at levels consistent with growing industrial activity. Industrial output seemed recovering in July but the upturn is yet to be confirmed by next month's data.

The registrations skyrocketed in August to 24.2% yoy from the already elevated July 10.8% yoy dynamic. We suspect the rise to largely be a frontloading effect. The same effect may have masked a longer-term cyclical weakness in the July automotive production. All in all, we remain cautious on 3Q18 GDP growth, predicting only a marginal acceleration to 0.8% qoq and 2.6% yoy.

2H18 AND 2019: SIGNS OF FATIGUE SPREADING

Barring a major disruption of business activities abroad, the Czech economy is seen growing at a pace close to its potential. It may however be spreading signs of fatigue from the previous rapid growth. The signs will be mostly related to labor shortages and wage pressure.

Nominal wage growth in 3Q18 may hover at 8.6% yoy, its cyclical high from 1H18, and slow only marginally to 7.9% yoy in 4Q18 due to base effect. Full 2018 growth of 8.4% would mean a 17-year high in nominal and an all-time high in real terms. The rise in purchasing power should translate into real private consumption growth of 4.0% in 2H18 despite slightly higher inflation. In 2019, growth of purchasing power is set to slow a bit. First, nominal wages will slow, as the pace will become unsustainable for a growing number of companies in low-margin businesses. Second, inflation will offset income growth. Apart from the ongoing demand-pull price pressure on services, food prices are believed to spike following the extreme hot and dry weather conditions from 2018. Electricity and gas are other likely sources of inflation in 2019. All that leads us to raise our 2019 average inflation forecast to 2.7%. Private consumption could decelerate to 3.4% next year.

Despite somewhat lower employee compensation growth in 2019, corporate profits may start shrinking in absolute terms as soon as foreign demand slows. Among sectors, the most likely candidate for lower profits is manufacturing, which posted already in 2Q18 the worst outcome in five years.

As a natural reaction to more expensive and hardly available labor force, companies will keep boosting their investment in machinery and equipment (8% growth expected in 2018). However, productivity may accelerate with a delay to larger capex due to financial and human resource constraints. Machinery and equipment investments will continue boosting fixed capital formation in the period to come but the same is less likely about construction. While order books remain solid in infrastructure projects, fewer residential building projects may be in the pipelines. Therefore, we expect the overall fixed capital formation gradually weakening its yoy expansion to 4.0% in 2019 from 10.6% yoy in 1H18.

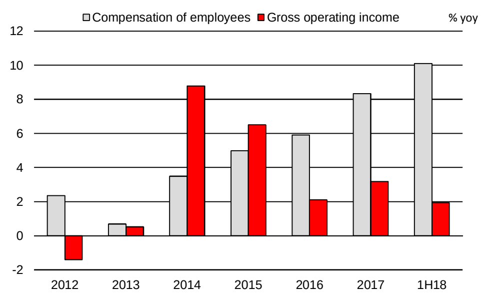
Overall GDP growth for 2018 is projected a half percentage point lower at 3.0% than three months ago, which is more due to 1H18 downward revisions than to a changing outlook. We maintain our 2.8% forecast for 2019.

Phillips curve for wages

Sources: CZSO, MPSV, UniCredit Research.

The Phillips curve showed no respite from wage pressure in 1H18 and we expect a similar picture for 2H18. The wage dynamic may ease somewhat in 2019 but not on the back of the labor shortage mitigating.

Compensation of employees and gross operating profit



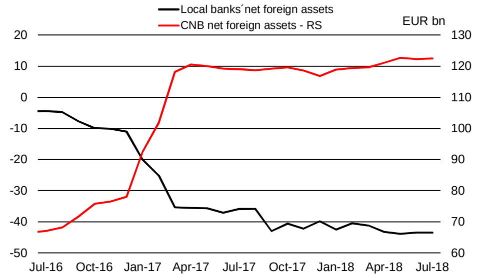
Sources: CZSO, UniCredit Research.

Employee compensation has been rising much faster than gross operation surplus for the third year in a row, putting strain on company financials.

CNB POLICY: SPACE FOR MORE TIGHTENING EXISTS

The recent limited reaction of EUR-CZK to a widening carry leaves the CNB space to continue tightening its monetary policy. Following the September's hike which is almost a deal done, another 25bp step this year is likely. For 2019, we assume two 25bp hikes to bring the repo rate to 2.25%. This would be a notch below our previous call but still above the CNB's assumed rate trajectory which looks consistent with pausing the hiking cycle at 1.75%. The reason for our expectation of more tightening is that we stay less upbeat on CZK appreciation than the CNB, which predicts 2019-end EUR-CZK value at 24.3. Risks to our interest rate call are probably symmetric, with an EU-wide economic outlook and ECB policy steps being the main factors. The CNB may adjust its monetary policy decisions depending on their impact on EUR-CZK.

CNB's and local bank's net foreign assets



Sources: ČNB, UniCredit Research.

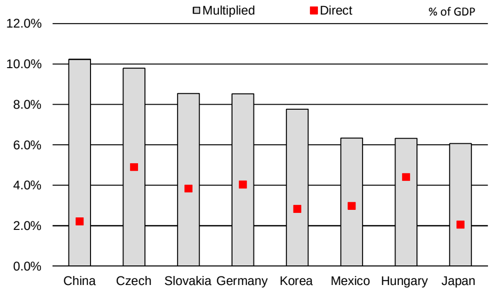
Net foreign position of local banks remains highly negative as a consequence of CNB FX interventions from 2013-2017. The economy does little to ease a relative lack of FX on the local market.

FOCUS: CZECHIA MAY HAVE THE MOST CAR-DEPENDENT ECONOMY IN THE WORLD

The share of automotive industry in the Czech GDP is known to be particularly high. Our aim was to identify other world's most car-dependent countries for comparison. In doing that, we decided not to limit ourselves to the automotive industry's simple share of value added in total GDP, as it omits the whole chain of suppliers and thus leaves the picture far from complete. Therefore, the chain of domestic subcomponents to the automotive industry's GVA was added using the country-specific multipliers. The approach forms the basis of an input-output analysis that could give an answer to the question "how would GDP of an economy be affected if the auto-industry disappeared, all else equal".

For the above-mentioned purpose we analyzed global value chains using the World Input-Output Database (WIOD) which covers 56 sectors for 43 countries with an estimated 86% share of global GDP. The data come from 2013, the latest available year. As observed, Czechia stands as the second most car-dependent country after China. Looking at direct shares of the automotive in GDP, Czechia ranked first in the world with a 4.9% share while China stayed far behind with 2.2%. Different multipliers explain the difference. Car industry in China uses much more inputs coming from the domestic economy, resulting in a much higher multiplication effect - GDP multiplier posts 0.85 as against 0.40 for Czechia. Hence, one additional car unit production brings 0.85 additional units of GDP in China but only 0.40 GDP units in Czechia. This provides the automotive industry with a 10.2% share in China GDP, with the Czech equivalent narrowly lagging at 9.8%.[1] However, 2017 data show a direct Czech share of 5.6%, bringing the likely multiplied share to 11%. Ignoring a potential shift in the GDP structure of China, this would possibly make Czechia the most car-dependent economy in the world.

Share of automotive industry in GDP



Sources: Review of Intl. Economics, UniCredit Research

Eight countries in the world – four European, three Asian and one American – saw their car industry accounting for (multiplied) 5% of GDP or more in 2013. The league was topped by China with a 10.2% share, while Czechia ranked second with 9.8%. For 2017, we estimate the Czech figure rising to 11%.

[1] The concept does not take into account one additional layer of multiplication. A change in production leads to changes in employment and the amount of wages, which affect the economy through consumption. In Czechia, this effect could boost the share of car manufacturing by 2-3pp. We do not have enough data from other countries to compare.

Czech Republic Macroeconomic Outlook

	2015	2016	2017	2018 forecast	2019 forecast
GDP growth (real yoy change, %)	5.4	2.4	4.5	3.0	2.8
Household consumption (real yoy change, %)	3.7	3.6	4.4	4.0	3.4
Gross fixed capital formation (real yoy change, %)	10.4	-3.3	3.7	6.4	4.0
Industrial output (real yoy change, %)	4.3	3.4	6.5	3.0	2.5
Unemployment rate (average, %)	6.5	5.5	4.2	3.2	3.2
Inflation rate (CPI yoy change, average, %)	0.3	0.7	2.5	2.2	2.7
Average wages (nominal yoy change, %)	3.2	4.4	6.2	8.4	6.8
Interest rates (3-M PRIBOR, end of period, %)	0.29	0.28	0.75	1.95	2.40
Interest rates (3-M PRIBOR, average, %)	0.31	0.29	0.41	1.25	2.20
EUR/CZK exchange rate (end of period)	27.03	27.02	25.54	25.40	24.80
EUR/CZK exchange rate (average)	27.28	27.03	26.33	25.50	25.00
Current account balance (% of GDP)	0.2	1.6	1.1	0.6	0.5
FDI net inflow (% of GDP)	-1.1	3.9	2.7	1.9	1.8
General government balance (% of GDP)*	-0.6	0.7	1.6	0.8	-0.2
Public debt (% of GDP)	40.0	36.8	34.6	32.0	30.7

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