Czech Economic Quarterly

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Stronger Headwinds

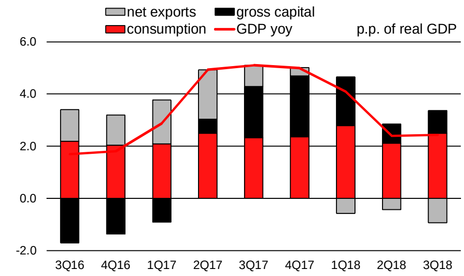
- In 3Q18, real GDP growth eased to 0.6% qoq from a previous 0.7%, remaining stable in yoy terms at 2.4%. Nominal GDP growth eased further to 4.6% yoy. From the production side, construction was the sector to display the highest dynamic in gross value added at current prices (12.7% yoy), while expansion of manufacturing ground to a halt (0.2% yoy).

- High-frequency data came in solid in October. In unadjusted terms, industrial output rose 6.7% yoy, construction output expanded by 10.4% yoy, whereas retail sales (ex-car) added 6.4% yoy. Recent data have not signaled an acute problem in the economy, confirming that GDP could accelerate moderately to 0.9% qoq and 2.7% yoy. Full-2018 GDP growth would likely reach 2.9%.

- We expect economic growth to slow a tad to 2.6% in 2019. Exports could rise at the slowest pace since 2009 due to weak global trade and the cyclical slowdown in the US and Europe. Private as well as capital spending will hold up well.

- A persistently weak CZK, driven by a downside pressure on EUR-USD in 1Q19 assumed by UniCredit Group, may encourage the CNB to deliver two 25bp hikes by mid-2019. We expect the rates on hold thereafter.

Breakdown of GDP growth by demand*



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

In 3Q18, consumption contributed more to GDP growth while net exports subtracted more from it than in the previous period. With an input of gross capital remaining broadly unchanged, the overall GDP growth was stable.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	3Q18		2Q18 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**2.4**	**2.4**	**2.4**	**2.4**
Household consumption (%)	3.1	1.5	3.2	1.5
Government consumption (%)	5.3	1.0	2.9	0.6
Fixed capital formation (%)	9.3	2.3	8.5	2.1
Change in inventories	-	-1.5	-	-1.4
Net exports	-	-0.9	-	-0.4

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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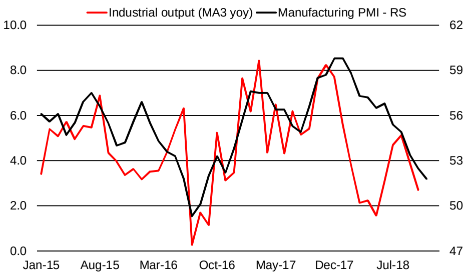
3Q18: A TYPICAL LATE-CYCLE PICTURE PREVAILS

In 3Q18, real GDP growth eased to 0.6% qoq from a previous 0.7%, remaining stable in yoy terms at 2.4%. Private consumption slowed further to 3.1% yoy, whereas government consumption jumped by 5.3% yoy. Fixed capital formation posted a three-year high dynamic of 9.3% yoy. With the level of inventories facing a sizeable rundown (-1.5 pp of GDP) total gross capital expanded by only 3.3% yoy, not much more than in the previous period. Net exports subtracted from GDP 0.9 pp, of which an overwhelming part was due to higher imports of services. Nominal GDP growth eased further to 4.6% yoy. From the production side, construction was the sector to display the highest dynamic in gross value added at current prices (12.7% yoy), while expansion of manufacturing ground to a halt (0.2% yoy). Total employment added (non-adjusted) 1.1% yoy, slowing sharply from a previous 1.9%. This eased the dynamic of wage compensation to 9.3% yoy from double-digit figures seen in the previous two quarters. Yet, gross operating surplus and mixed income grew by only 0.4% yoy, further deteriorating from 1H18.

The acceleration in government consumption and the rise in imports of services were probably inter-related, triggered by a government contract with a one-off booking. Importantly, the two changes were mutually offsetting, not affecting the 3Q18 GDP growth or GDP outlook. Apart from that peculiarity, we find the picture as typically late-cycle. A number of investment projects were probably being finalized, causing significant shifts from inventories into fixed capital formation.

Manufacturing PMI and industrial output



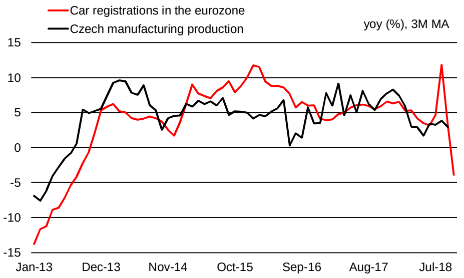
Sources: CZSO, UniCredit Research.

Manufacturing PMI is for industrial activity an indicator without much lead. The slowdown in industrial output from early-2018 was not quite supported by PMI values. Following a sharp reduction, the latest PMI level seems consistent with a slow industrial output expansion, This is also what we currently expect for industry.

4Q18: A TEMPORARY REBOUND

Following their volatile performance, high-frequency data came in solid in October. Industrial output rose (unadjusted) 6.7% yoy, stabilizing its adjusted pace at 3.3% yoy. Importantly, manufacture of motor vehicles rose by 8.4% yoy, recovering from the previous two-month decline. New orders in the particular sector as well as in the whole industry looked set to keep the expansion going. Construction output expanded by 10.4% yoy, extending the period of double-digit growth to four months. Retail sales (ex-car, unadjusted) added 6.4% yoy, with car sales and repairs contracting by 3.1% yoy, however. Car registrations (passenger+LUV) saw a sharp drop not only in October (-12.8% yoy) but also in November (-13.3% yoy), suggesting that some units, pre-registered in the summer, were still on sale. October foreign trade looked firm in terms of dynamics (exports 9.0% yoy, imports 10.3% yoy in CZK terms) but its surplus shrank to CZK 5.7bn from last October's CZK 9.1bn. In our assessment, the deterioration was largely associated with a rise in inventories and capital expenditure. All in all, recent data have not signaled an acute problem in the economy, confirming our view that GDP could accelerate moderately to 0.9% qoq and 2.7% yoy. Full-2018 GDP growth would likely reach 2.9%.

Eurozone car registrations and Czech manufacturing production



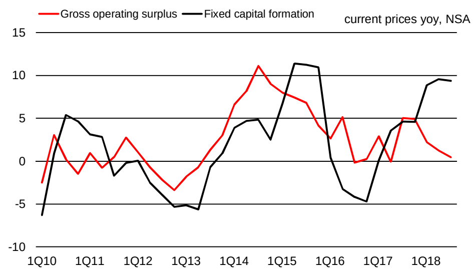
Sources: CZSO, Markit, UniCredit Research.

Demand for cars in Europe, measured by their new registered units, is a key determinant for Czech manufacturing dynamic. Volatility in car registrations in the summer, related to the new emission norm implementation (WLTP), blurred the outlook for Czech manufacturing. We believe the output will recover for short term but has turned more uncertain for 2019.

2019: STRONGER HEADWINDS FROM ABROAD

We expect **economic growth** to slow a tad to 2.6% in 2019. Some headwinds, such as the tight labor market and a housing price bubble, may be broadly offset in terms of GDP growth by productivity gains and more infrastructure investment. However, external demand could be a more important risk due to weak **global trade** and the cyclical slowdown in the US and Europe. As a result, **exports** could rise in 2019 at the slowest pace since 2009. **Real wage growth** may slow to 4.5% in 2019 from 6.0% in 2018, as many companies will resist their employees' wage claims in light of deteriorating fundamentals. The envisaged 2019 wage dynamic would still be the second highest in 15 years after 2018. **Employment** is projected to rise 0.8% (versus the 1.6% expected for 2018), with the improvement coming from the growing participation rate of people aged 60+ and from worker immigration, rather than from a fall in the unemployment rate. However, even the availability of guest workers will be more uncertain, as the labor market turns tighter in many countries. Rising interest rates could eat up to 0.25pp of **households' disposable income** growth due to higher mortgage payments. However, private consumption may be supported by pent-up demand from 2018, when households spending rose significantly less than income. In the business sector, we expect 2019 to be the year of structural shifts on both the demand and the supply side. From the demand side, slower global trade will leave fewer opportunities for Czech exporters. In addition, Brexit, a cyclical saturation of demand for passenger cars in Europe and a risk of the US administration imposing new import tariffs on cars could also affect Czech manufacturing activity. From the supply side, labor shortages and growing labor (as well as other) costs will influence business strategy, resulting in a changing focus on products and markets. Along with the **capital spending** that has been under way for some time, we believe that this will lead to a **productivity gain** of slightly over 2% in 2019, above the 1.4% increment estimated for 2018. **Capex** is set to keep growing in 2019, although surveys in manufacturing show that the pace will not exceed that of 2018 and the aim will be to make production more efficient rather than expand capacity. Outside the group of machinery and equipment, we expect a decline in spending on transport vehicles and stagnation in residential construction. In regard to the latter, causes for the slowdown include a strong increase in house prices from the past and a lack of new projects in the pipeline. Total **construction output** may nevertheless expand by 6% in 2019, as some longer-term infrastructure projects, finance by the public sector move (finally) into full swing after multi-year delays. With significant parts of the economy overheating, we expect **inflation** above 2% yoy over the whole of 2019 despite oil prices staying below their 2018 peaks. Cost-push inflation could remain high in business services and even in manufacturing, despite strong external competition in tradables. In addition, volatile prices for energy and food may keep inflation moderately above target in 2019. In 2020, we expect the economy to slow further to 2.2%, with domestic demand likely to be affected by external factors.

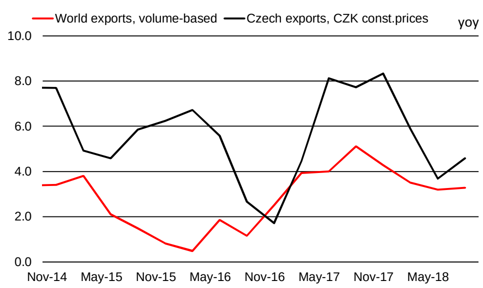
Fixed capital formation and gross operating surplus



Sources: CZSO, MPSV, UniCredit Research.

An investment cycle in the Czech economy typically lags behind the cycle of gross operating surplus by one or two quarters. At the end of 2015, the delay grew higher by last-minute spending of EU funds. For 2019, we expect a slower but positive growth of investment despite a likely stagnation in gross operating surplus, as public infrastructure spending will give a boost to investment.

Global and Czech exports



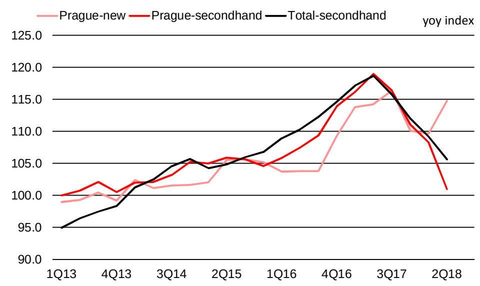
Sources: CZSO, UniCredit Research.

In recent years, Czech exports managed to grow faster than global exports, with cars and car components being the key sort of goods outperforming in Czech exports. There are few arguments, though, for the outperformance to persist in the long run.

CNB POLICY: TWO MORE HIKES LIKELY IN 2019

Our forecast of headline inflation is marginally higher than the CNB's for 2019, while being broadly similar for 2020. The CNB regards its outlook to be consistent with an equivalent of 200bp tightening in 2019-20 (interest rate plus exchange rate), of which about 125bp should arrive in 2019. Given the CZK appreciation path assumed by the CNB, only two to three 25bp repo rate hikes are included in its scenario, all of them in 2020. That is where our scenario differs. First, the CZK may not appreciate in early-2019, encouraging the CNB to increase rates in February. Assuming EUR-CZK stays elevated consistently with downward pressure on EUR-USD in 1Q19, the probability of one more repo rate hike by mid-2019 may be high. With some appreciation of CZK versus EUR later in the year, the overall tightening would reach an equivalent of 100bp over 2019, in our view. Regarding 2020, we remain cautious at the moment due to our projected GDP expansion lagging behind CNB assumptions and the pace of ECB tightening likely falling below what the CNB considered in its forecast.

House prices



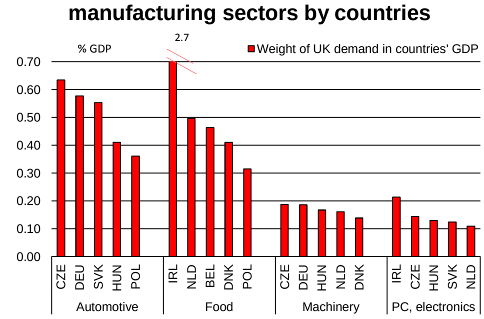
Sources: ČNB, UniCredit Research.

The house price boom may be coming to an end. With the price dynamic peaking around mid-2017, it has been slowing down since. Only for new units in Prague the price growth in 2Q18 remained double-digit but that was related to an insufficient supply.

FOCUS: HOW MUCH STRESS WILL BREXIT CAUSE?

Brexit is currently seen as one of the most serious external risks for the Czech economy. As future arrangements of Brexit are unknown, we have tried to capture the worst-case scenario of a total disruption of trade in goods between the UK and the EU, other things staying unchanged. In the model example, we take into account neither how fast import cuts would be replaced on each side, nor an impact on the long-term potential of the economies. The UK is more dependent on exports to the EU than the EU is on exports to the UK. In 2017, the share of UK's exports of goods to the EU accounted for 8.0% of UK's GDP, while UK imports of EU goods were "only" 2.3% of the rest of EU's GDP. However, a direct impact of a trade disruption would be mitigated to 5.3% of UK's GDP by the exports to the EU having on average a 34.5% share of imports. An impact on the EU would also be mitigated but probably not much below 2% of GDP. Brexit will affect individual EU countries and individual economic sectors differently, depending on the intensity of international supply chains. Within manufacturing, automotive and food may come as the two most affected sectors. Czechia would be the most affected by a disruption in automotive trade, having a 0.63% GDP weight of the total UK's final and intermediate consumption. Other most affected countries would be Germany and Slovakia. For food industry, Ireland would really feel the pinch, with its weight at 2.73% of GDP being a multiple of the other affected countries such as the Netherlands and Belgium. For Czechia we estimate an impact at 0.22% GDP. Czechia also ranks among the most affected countries in other sectors such as mechanical engineering and electronics, although their overall impacts should stay much smaller than those of automotive or food. Importantly, the sector effects cannot be added up because of their overlap. For Czechia we nevertheless estimate the total effect of a complete trade disruption at close to 3% GDP, which is well above the EU average. In general, Brexit has the potential to affect the North of Europe and the CE region than the European South.

Impact of potential EU-UK disruption on manufacturing sectors by countries



Sources: Review of Intl. Economics, UniCredit Research

Automotive and food are the two manufacturing sectors most affected by a would-be disruption of EU-UK trade in goods. Czech GDP would be dragged the most by car trade barriers, while Ireland would suffer the most of all in case of food trade collapsing. Czechia also ranks among the most affected countries in many sectors of a lesser significance.

Czech Republic Macroeconomic Outlook

	2016	2017	2018 forecast	2019 forecast	2020 forecast
GDP growth (real yoy change, %)	2.4	4.5	2.9	2.6	2.2
Household consumption (real yoy change, %)	3.6	4.4	3.6	3.1	3.0
Gross fixed capital formation (real yoy change, %)	-3.3	3.7	8.0	2.5	1.8
Industrial output (real yoy change, %)	3.4	3.5	3.0	1.5	2.0
Unemployment rate (average, %)	5.5	4.2	3.2	3.2	3.5
Inflation rate (CPI yoy change, average, %)	0.7	2.5	2.2	2.4	2.1
Average wages (nominal yoy change, %)	4.4	6.2	8.3	6.8	5.0
Interest rates (3-M PRIBOR, end of period, %)	0.28	0.75	2.05	2.40	2.40
Interest rates (3-M PRIBOR, average, %)	0.29	0.41	1.27	2.30	2.40
EUR/CZK exchange rate (end of period)	27.02	25.54	26.10	25.40	24.80
EUR/CZK exchange rate (average)	27.03	26.33	25.65	25.90	25.10
Current account balance (% of GDP)	1.6	1.1	0.5	0.4	1.2
FDI net inflow (% of GDP)	3.9	2.7	1.9	1.8	1.6
General government balance (% of GDP)*	0.7	1.6	1.0	0.0	-0.5
Public debt (% of GDP)	36.8	34.7	31.9	30.4	29.7

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