Czech Economic Quarterly

June 16, 2015

The Growth Quantum Leap

- In 1Q15, GDP surprised sharply on the upside, rising 3.1% qoq and 4.2% yoy. Gross value added posted growth of 1.6% qoq and 3.8% yoy. Our takeaway from the figures is overall positive. One-offs had a little impact on the 1Q15 acceleration. Rather, the growth quantum leap came as a pay-back from the uneven tax collection on tobacco which masked genuine improvements in the economy during 2014.

- We are revising substantially upwards our full 2015 forecast to 3.8% amid a rare combination of tailwinds for the economy, both from the external and the domestic demand side. Improving growth prospects for the eurozone are key via trade links. Private consumption is bolstered by low inflation and growing employment. A survey among manufacturers suggests that their capex growth may reach 9% this year.

- Policies are set to contribute positively to growth as well. The positive fiscal impulse is estimated at 0.5% of GDP in 2015. EUR/CZK is projected to trade trendless and range-bound over the next few months. On the backdrop of faster GDP and higher inflation, the CNB may consider exiting its FX intervention regime before mid-2016, though.

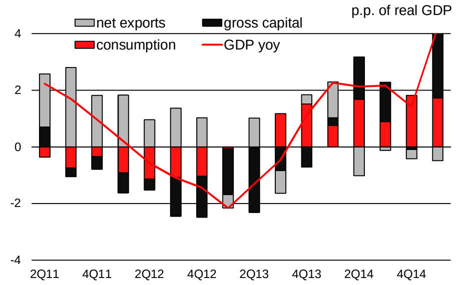
- The sharp rise in our 2015 GDP forecast comes with greater downside risks. The growth momentum may be vulnerable to a premature end to any of the numerous supporting factors.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	1Q15		4Q14 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**4.2**	**4.2**	**1.4**	**1.4**
Household consumption (%)	3.0	1.4	2.0	1.0
Government consumption (%)	1.5	0.3	4.2	0.8
Fixed capital formation (%)	3.2	0.8	4.3	1.1
Change in inventories	-	2.2	-	-1.2
Net exports	-	-0.5	-	-0.3

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.

Breakdown of GDP growth by demand*



*/ Contributions to real GDP growth in percentage points
Sources: UCB CZ, CZSO.

Comparing the 1Q15 structure of GDP with that of 4Q14, the acceleration was brought about exclusively by gross capital and, more specifically, by inventory accumulation. However, the structure of 4Q14 was rather untypical, with gross capital not contributing to growth at all. A more appropriate conclusion about 1Q15 hence is that improvements in both consumption and investments rendered the economy a stronger momentum.

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1Q15: EXPERIENCING THE QUANTUM LEAP

In 1Q15, GDP surprised sharply on the upside, displaying growth of 3.1% qoq and 4.2% yoy. From the demand side, growth was brought about by private as well as government consumption (3.0% and 1.5% yoy respectively), fixed capital formation (3.2% yoy) and, notably, a huge jump in investories (accounting for 2.2 p.p. of GDP). Net exports was reported to subtract 0.5 p.p. from GDP despite a solid 7.7% yoy growth in exports, as the import dynamic reached 9.0% yoy. Gross value added posted growth of 1.6% qoq and 3.8% yoy, with manufacturing taking care of the highest contribution to yoy growth but all other major sectors also contributing. Nominal GDP was up a respectable 5.4% yoy, as the terms of trade benefited from cheaper crude oil.

Our takeaway from the latest figures is overall positive. First, the comparison of the GVA dynamic with that of GDP suggests that one-offs had a little impact on the 1Q15 acceleration. Rather, the quantum leap in GDP growth came as a pay-back from the uneven tax collection on tobacco which masked genuine improvements in the economy during 2014. Second, at this phase of economic cycle, the inventory accumulation tends to be associated with unfinished investments projects, which are later set to translate into a rise of fixed capital formation.

Manufacturing PMI – Germany and Czech

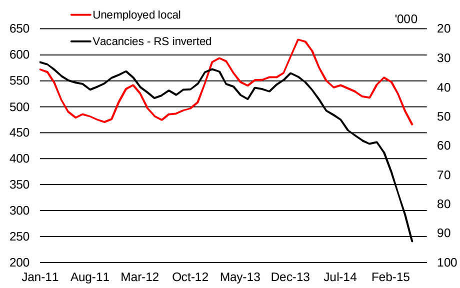
Sources: Markit, UniCredit Research.

The gap between the Czech and German manufacturing PMI has been intact since early 2014 – an unusually long spell. This bodes well for the Czech industrial output, which has been growing by 4%-5% yoy against the German pace of just 1%.

2Q15: MAINTAINING THE MOMENTUM

No major change in economic conditions was spotted in high-frequency data for April. Industrial output added 4.3% yoy after growing 4.8% yoy in 1Q15, with none of the figures affected by a working day adjustment. Retail sales were particularly firm in April, posting 6.4% yoy including the auto segment and 6.0% yoy excluding it. Construction output was up 10.2% yoy in April, the second double-digit monthly increment running. All in all, we see a good chance for the 2Q15 GDP figure in the range of 3.5% to 4.0% yoy, even though we would be cautious about the qoq figure following its 1Q jump.

Unemployment and vacancies



Sources: CZSO, UniCredit Research.

2015: THE FORECAST UPGRADE

We are revising substantially upwards our full 2015 forecast to 3.8% amid a rare combination of tailwinds for the economy, both from the external and the domestic demand side. Policies are set to contribute positively as well, with a moderate fiscal impulse underway and an accommodating monetary stance.

Improving growth prospects for the eurozone are set to act as the key tailwind via trade links. In particular, the 20-month streak of annual growth in new car registrations in Western Europe pushed the estimated share of **car manufacturing** in total Czech GVA for 2014 to 5%, the highest in the EU. All three passenger car manufacturers will continue to expand production throughout 2015, benefiting from past investment and changes in production lines.

Faster GDP growth is reflected in the signs of tension on the labor market. While the number of jobless has been falling moderately, the number of vacancies has doubled over last 12 months. Businesses are reporting growing difficulties in meeting their workforce needs.

Despite **exports** growing at a fast pace, the contribution of **net exports** to GDP growth will continue to be rather neutral due to strong import demand related to both investment and consumption. As to the former, **capital spending** on machinery and transport equipment has been on the rise since 3Q13 and a survey among manufacturers suggests that their capex growth may reach 9% this year. Confidence has also improved among **construction** companies, although signals are more mixed there. It appears that their order books were filling last year while the intake has been stumbling since the start of 2015, which leaves some risk of output gradually losing steam.

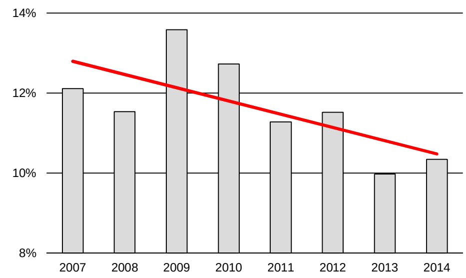
Private consumption is boosted by households' real income growth as well as pent-up demand for durables. **Consumer confidence** hit a seven-year high in January, before inflation bottomed out, and its current level is consistent with private consumption growth of 2-3%. Over the rest of 2015, low inflation will compensate for weak **nominal wage growth** in supporting private spending. With most of new hiring targeting low-qualified job seekers, wage gains will remain modest. In 2016, we expect an acceleration in nominal wage growth to play a bigger role in driving private consumption, despite higher inflation. **Government consumption** will also expand in 2015, at least via healthcare spending. Looser regulation will generate additional demand for health services in the short term but poses a medium-term risk for public spending.

NEUTRAL MONETARY, MORE RELAXED FISCAL POLICY

The positive **fiscal impulse** is estimated at 0.5% of GDP in 2015, despite an expected fall in the share of government revenues and current expenditures in GDP. In contrast, capital spending could rise amid a stronger focus on public infrastructure projects financed from government and/or EU funds. The fiscal policy stance in 2016 is difficult to gauge at the moment. The central government **budget deficit** proposed by Finance Minister Andrej Babiš for next year stands at CZK 70bn, CZK 30bn less than the planned deficit for 2015, with **tax income** targeting a rather ambitious 6% rise yoy. We would count on a broadly neutral stance for fiscal policy in 2016.

As an immediate reaction to the GDP quantum leap and stronger reflation, the CNB is expected to move from downside to balanced risks to its inflation forecast, abandoning the idea of an upward shift of its EUR-CZK floor at the same time. Faster GDP growth could lead to a faster closing of the **output gap**, now expected by the CNB in 2H16. As a result, the CNB may additionally consider exiting its **FX intervention regime** before mid-2016. The option is set to be on the table first time at the August policy meeting. Whatever the outcome, we are convinced that the CNB will communicate in a timely manner any shift in its policy stance in order to prevent market volatility and to maintain its reputation for transparency and accountability. As a result, **EUR/CZK** is projected to trade trendless and range-bound over the next few months. The market could start positioning itself for a stronger CZK from late 2015 or early 2016 onwards if the exchange rate floor is to be abandoned around mid-2016.

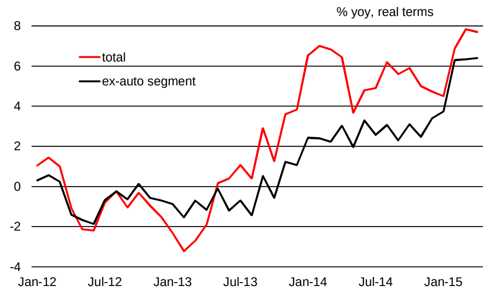
Household saving ratio



Sources: CZSO, UniCredit Research.

The household saving ratio ticked up to 10.3% in 2014 but this failed to alter the declining trend in place since 2009. We expect the ratio to reverse again in 2015, edging below 10%.

Retail sales total and ex-auto (3M MA)



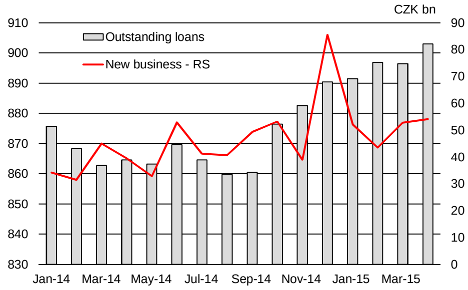
Sources: CZSO, UniCredit Research.

Retail sales have geared up in early 2015. Unlike the previous acceleration from 2014, the core segment, no car sales and repairs, is responsible for the latest leap.

2016: GREATER DOWNSIDE RISKS

The sharp rise in our 2015 GDP forecast comes with greater downside risks, in particular for 2016. The growth momentum may be vulnerable to a premature end to any of the numerous supporting factors. Among external drivers, weaker car sales in the eurozone would affect Czech exports significantly. On the domestic side, the labor market is expected to further tighten by 2016, resulting in labour shortages for new projects in some regions. Having said that, risks are related to GDP momentum, with macroeconomic imbalances contained or eliminated. The C/A is set to remain close to equilibrium this year and next, while a widening of the general government deficit will become an issue beyond 2016 if an economic slowdown is coupled with a lack of structural reforms.

Corporate loans – outstanding and new



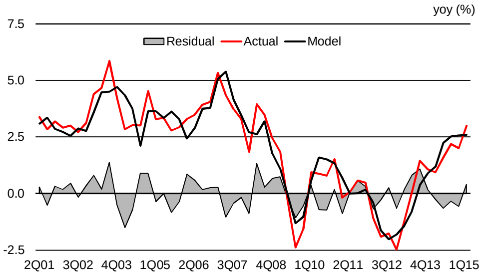
Sources: CNB, UniCredit Research.

Since 4Q14, corporate loans have been on a steady rise as the average monthly volume of new bank lending got CZK 10bn higher than a year ago. More bank business corresponds to an increased investment activity of non-financial corporations.

FOCUS: WAGES AND JOBS KEY FOR CONSUMPTION

Growing significance of household consumption as a factor of GDP growth has made us to take a closer look at factors that may influence the behavior of consumers. Household consumption is undoubtedly driven by many economic variables connected to each other but a big chunk of its variance (74%) can be explained by a simple model using just two of them – real wages and total employment. Unsurprisingly, real wages are the more important factor of the two. According to the model, households tend to spend two-thirds of their real extra income within two quarters. One percentage point hike in real wages yoy results in 0.23 p.p. increase of yoy real consumption in the same quarter and a 0.42 p.p. increase in the following one. More interestingly, employment plays a very significant role as well. Our model estimates that one-percent yoy increase of employment leads (all else equal) to a 0.49% rise in consumption with the lag of one quarter. A plausible explanation could be that a person newly employed turns more confident about his/her future financial situation and decides to realize part of his/her deferred consumption. In addition, the transition from the state of economic inactivity into the state of employment surely triggers forced spending on transportation, meals outside home and perhaps as well on clothing. Other variables, such as consumer confidence, hours worked and social payments, have less explanatory power for household consumption but are also statistically significant, boosting an explained part of the overall variance to 82%. Consumer confidence appears to be particularly useful, as it is highly correlated with many other variables and can be used as a proxy, given that it is published in advance of hard data releases. For the purpose of forecasting private consumption, we have modified the model utilizing real-time consumer confidence and one-quarter lagged real wages, employment, hours worked and social payments. For 1Q15, the model produced the estimate of real private consumption growth at 2.6% yoy, slightly understating the actual figure. This followed the spell of systemic overvaluation of private consumption by the model lasting since 1Q13. Looking at the chart, it is apparent that the directions of deviation between modelled and actual data alternate fairly regularly. Going forward, private consumption may still surprise on the upside.

Household consumption model



The pace of household consumption growth is dominantly influenced by changes in real wages and employment. 1Q15 was the first period since 1Q14 to see the actual consumption higher than forecast. A similar deviation may be repeated in 2Q15.

Source: UniCredit Research.

Czech Republic Macroeconomic Outlook

	2012	2013	2014	2015 forecast	2016 forecast
GDP growth (real yoy change, %)	-0.7	-0.7	2.0	3.8	2.7
Household consumption (real yoy change, %)	-1.7	0.4	1.7	2.8	2.4
Gross fixed capital formation (real yoy change, %)	-2.8	-4.4	4.5	5.5	4.0
Industrial output (real yoy change, %)	-0.8	-0.1	5.0	4.0	3.5
Unemployment rate (average, %)	6.8	7.7	7.7	6.6	6.2
Inflation rate (CPI yoy change, average, %)	3.3	1.4	0.4	0.5	1.4
Average wages (nominal yoy change, %)	2.5	-0.1	2.3	2.9	3.4
Interest rates (3-M PRIBOR, end of period, %)	0.50	0.38	0.34	0.30	0.30
Interest rates (3-M PRIBOR, average, %)	1.00	0.46	0.36	0.30	0.30
EUR/CZK exchange rate (end of period)	25.14	27.43	27.73	27.40	26.80
EUR/CZK exchange rate (average)	25.14	25.97	27.53	27.60	27.10
Current account balance (% of GDP)	-1.6	-0.5	0.6	0.1	0.0
FDI net inflow (% of GDP)	3.0	-0.2	3.1	2.6	2.8
General government balance (% of GDP)*	-3.9	-1.2	-2.0	-2.0	-2.0
Public debt (% of GDP)	44.6	45.0	42.6	41.8	42.2

Remarks:
**/ ESA 95 definition.*
Sources: Czech National Bank, Czech Statistical Office.
Forecasts: UniCredit Bank CZ.