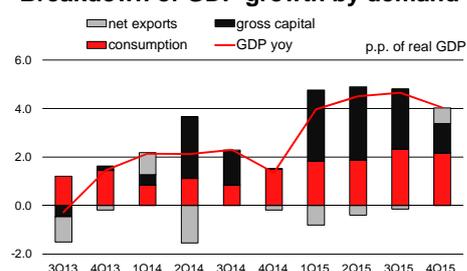


A slower lane but no congestion

- In 4Q15, real GDP posted a 4.0% yoy growth, bringing the full-2015 dynamic to an eight-year high of 4.3%. The qoq GDP was flat. Both private and government consumption continued powering ahead, while fixed capital formation proved again to be the most dynamic demand-side component in yoy terms. The inventory change, however, was negative for the first time since 1Q14.
- There is enough evidence that key positive trends in the economy have been transferred into 1Q16, which should keep boosting domestic consumption. In terms of fixed capital formation, though, the situation looks a bit less upbeat. The inventory rundown as well as pending construction orders from 4Q15 suggest that the stock of unfinished investment projects has gone sharply down.
- We are revising our 2016 GDP forecast one notch down to 2.2% solely due to the weaker carryover from the lower-than-expected GDP growth in 4Q15. We acknowledge that global risks have risen since the start of 2016. However, we find our standing local forecast conservative enough to stay consistent with a new global baseline scenario.
- As to the CNB policy, we argue that corporate flows rather than financial market speculations stand behind the current demand for CZK. This makes us believe that chance for imposing a negative rate by the CNB is slim.

Breakdown of GDP growth by demand*



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

In 4Q15, net exports swung into a positive contribution to GDP growth for the first time since 1Q14. This came as an input of gross capital narrowed. The narrowing was however brought about largely by an inventory adjustment, no sharp slowdown in fixed investments. Consumption continued to power ahead with both the government and households adding to it.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	4Q15		3Q15 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	4.0	4.0	4.7	4.7
Household consumption (%)	2.9	1.4	3.0	1.4
Government consumption (%)	3.9	0.8	4.7	0.9
Fixed capital formation (%)	7.9	2.0	9.6	2.4
Change in inventories	-	-0.7	-	0.1
Net exports	-	0.6	-	-0.1

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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4Q15: THE FIRST INVENTORY RUNDOWN SINCE 1Q14

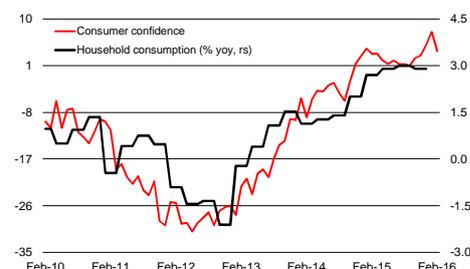
In 4Q15, real GDP posted a 4.0% yoy growth, bringing the full-2015 dynamic to an eight-year high of 4.3%. The qoq GDP was flat in 4Q15. From the demand side, private consumption continued powering ahead but its dynamic at 2.9% yoy meant a marginal slowdown from the previous period. Government consumption also slowed from the 3Q15's 4.7% yoy growth to a still very firm 3.9% yoy. Fixed capital formation proved again to be the most dynamic demand-side component, adding 7.5% yoy. The inventory change was negative for the first time since 1Q14 (subtracting 0.7 pp. from GDP growth) while, in the same vein, net exports added to growth (0.6 pp.) for the first time since 1Q14. Real export momentum (7.2% yoy in 4Q15) was stable throughout the year while imports slowed a bit to 7.0% yoy in 4Q15. Nominal GDP expanded 4.6% yoy, a bit less than previously, but the full-2015 growth (5.1%) recorded the best result since 2007.

Two interesting features have been spotted in the 4Q15 data. First, households boosted their consumption (in nominal terms) by 2.8%, i.e. distinctly less than would correspond to growth in their labor income (4.4%). The same-directional gap also existed for the whole of 2015 (3.0% versus 4.1%). Second, from the labor force viewpoint, GDP growth was driven primarily by a higher number of hours worked (3.3% yoy), with employment growth coming as a second factor (1.1% yoy). The figures resulted in a relatively poor gain in hourly productivity (0.7% yoy). Productivity per worker fared better (2.9% yoy), though.

1Q16: GEARING DOWN IN INVESTMENT

There is enough evidence that key positive trends in the economy have been transferred into 1Q16. The unemployment has resumed its decline in February. The purchasing power of households was boosted in February by a one-off cash transfer to pensioners above the normal, inflation- and real wage-linked indexation. Consumer confidence remains well above its long-term average and what caused its retreat from the January's all-time high were general macroeconomic concerns but no individual income worries. Depressed commodity prices are set to extend the spell of low inflation. All of that should keep boosting domestic consumption in 1Q16. In terms of fixed capital formation, though, the situation looks a bit less upbeat. The inventory rundown as well as pending construction orders from 4Q15 suggest that the stock of unfinished investment projects has gone sharply down, which we believe is linked primarily to scarcer EU fund inflows. That said, fixed capital formation unrelated to infrastructure construction may still be doing well. The residential construction is set to keep expanding, as suggested by the number of housing starts having risen by 15.5% yoy in 4Q15. New car registrations added 14.8% yoy in the first two months of 2016, proving that investment appetite of the corporate sector remains solid. Also external demand appears to be rather uncertain. In January, exports grew 2.4% yoy in CZK terms, which looked slow at face value but more reasonable if adjusted for working days and a more than 3% yoy appreciation of CZK. Overall, we expect GDP to expand 0.4% qoq, slowing to 2.0% yoy in 1Q16.

Consumer confidence and real growth of private consumption



Sources: CZSO, UniCredit Research.

Consumer confidence has retreated from its all-time high reached in January but still looks consistent with private consumption growth in excess of 3% yoy.

Industrial output and manufacturing PMI



Sources: Markit, UniCredit Research.

Manufacturing PMI has lately been showing more volatility but no systemic easing. This leaves chance for industrial output to regain momentum after its weaker data around the turn of the year.

2016: A SLOWER LANE BUT NO CONGESTION

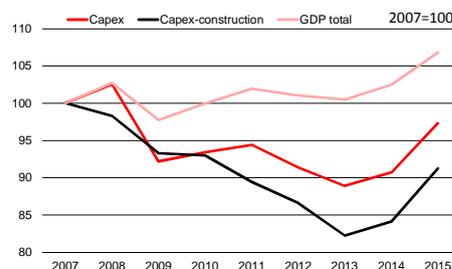
We are revising our 2016 **GDP forecast** one notch down to 2.2% solely due to the weaker carryover from a lower-than-expected GDP growth in 4Q15. We acknowledge that global risks have risen since the start of 2016. We are also aware that many institutions have subsequently decreased their global (and EU) economic forecasts. However, we find our standing local forecasts conservative enough to stay consistent with a new global baseline scenario.

The financial situation of households is set to improve further, reinforcing **private consumption**. Total employment will continue to rise but at a pace halved from 2015 when it hit 1.2%. That said, tighter labor market conditions may bring nominal wage growth to or even slightly above 4% yoy. **Inflation** may eat less into the **households' purchasing power** than expected three months ago. Inflationary pressures may start emerging only from mid-2016 onwards, stoked up by the ongoing boom in consumer spending and coupled with a renewed rise in food prices. Even so, headline inflation is unlikely to reach 2% yoy before early 2017. In contrast to private consumption, **fixed capital formation** may barely grow as infrastructure construction will be dragged by a high base from 2015. We also expect a technical slowdown for investments in dwellings but that may be overcome in the course of 2016. **Exports** are seen expanding by 6% in our baseline scenario, in which case **net exports** would contribute positively to GDP growth. Having in mind considerable external risks, we ran a sensitivity analysis based on a decade-long data series showing that GDP growth drops by 0.15 pp. if real export growth slows by 1 pp. From this viewpoint, the Czech economy remains vulnerable not only to a cyclical weakening in external demand but also to a potential break-up of the Schengen area (more on that see page 4).

THE CNB: A SLIM CHANCE FOR IMPOSING A NEGATIVE DEPOSIT RATE

The ECB's path towards further policy easing has made even more acute the question of whether the CNB should follow suit. From the viewpoint of monetary conditions, we argue that no need exists for the CNB to become more relaxed. From the market viewpoint, the key issue is whether the ECB steps will intensify the ongoing pressure on CZK to appreciate versus EUR. For Czech banks, the issue is of extreme importance given the amount of excess CZK liquidity (EUR 42bn, equivalent to a quarter of annual GDP) and the risk that a negative deposit rate for the excess liquidity could be imposed by the CNB. The CNB itself had to absorb in its FX reserves 1.7% to 1.8% of a rise in the excess liquidity of the Eurosystem occurring since the start of the ECB's asset purchasing program. Whether coincidentally or not, the percentage well corresponds to what the Czech GDP accounts for eurozone's GDP. This leads us to a hypothesis that natural diversification of liquidity reserves by corporations, rather than (or next to) foreign portfolio investor speculations on a CZK appreciation, may stand behind the pressure on CZK. If true, the corporate flow into CZK may rise by a third to just below EUR 1bn per month in connection with the asset purchases by the ECB increased from EUR 60bn to EUR 80bn per month. By the end of

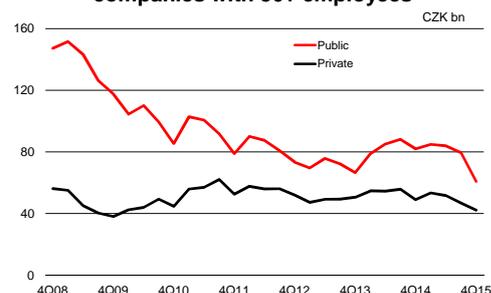
GDP and fixed capital formation based 2007 (CZK const. prices)



Sources: CZSO, UniCredit Research.

GDP structure has markedly changed since the pre-crisis period. While total GDP had troughed already in 2009, fixed capital formation continued to decline until 2013. The construction-based part of capex saw a more profound cut than fixed capital formation as a whole and its rebound over last two years still leaves it almost 10% below the level of 2007.

Pending construction orders for companies with 50+ employees



Sources: CZSO, UniCredit Research.

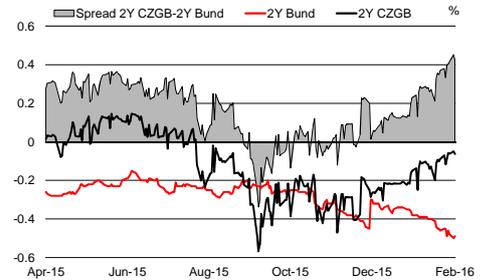
Pending construction orders by the public sector took a dive at the turn of 2015, as the EU funds drawdown from the previous budgetary period came to an end. The private order stock also looks far from promising. However, we believe the outlook for construction activity is a bit better than suggested by these figures.

2016, the CNB reserves should then rise to 43% from current 38% of GDP, which still looks as a manageable amount. The corporate flow differs from a foreign speculative flow in that it may not push on Czech government bond yields or FX swaps and may not cause as much FX volatility after the CNB exits its policy. Where both remain the same is that they have the potential to be followed by the opposite flow at some point in future. Hence, we continue to believe that chance for imposing a negative rate by the CNB is slim. Also, CZK is set to refrain from any strong appreciation and may even temporarily weaken after the exit. As a consequence, the CNB may start its repo rate hiking in 2017, well in advance from the ECB tightening.

FOCUS: THE SCHENGEN TREATY BREAK-UP WOULD HIT THE CZECH ECONOMY MORE THAN THE OTHERS

Since the Czech Republic joined the Schengen bloc in 2007 together with most other new EU members, free borders have become an integral part of the economy. Logistic centers located inside the Czech Republic serve to supply goods across Europe regardless of national borders, the only limit being the road distance of a destination. Many production units have been placed close to borders, benefiting from the free movement of labor and goods. Border-free areas thrive on tourism and shopping. Tens of thousands people are estimated to cross the Czech borders regularly for working abroad, with a similar number coming from abroad to work inside the country. However, the most profound implication is that cross-border transport intensity for goods has multiplied since 2007. The intensity is nowadays the highest in the Czech Republic and Slovakia in terms of GDP of all the Schengen members. Both countries belong at the same time to the top six within the Schengen area in terms of the share of foreign trade with other Schengen countries. This evidence points to the main risk of a Schengen break-up for the Czech economy. Border checks would be a barrier for daily commuters but would not ruin the economy. A slowdown in just-in-time deliveries of goods could in contrast damage the entire economic model of the country. Exports of sensitive items (for which we regard 100% of non-durable and 50% of semi-durable goods) account for an almost three times larger share of Czech and Slovak GDP than for an EU average. A drop by 10% in the trade of sensitive items would drag the Czech economy (based on historical links) by 0.5% of GDP. However, we do not see as the key risk the Schengen treaty break-up as such. The most serious risk is that the end of Schengen would be just one step in the process of an EU disintegration. An analysis of Unicredit has lately figured out a loss for the UK economy in case of Brexit as 6% of GDP. Given closer economic links of the Czech Republic to the EU than the UK has, the cost for Czechs in case of exiting or breaking up of the EU would be a multiple of the UK's.

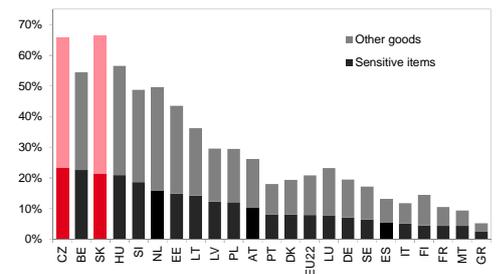
Yields on 2Y German Bunds and Czech government bonds



Sources: Macrobond, UniCredit Research.

Yields on 2Y CZGB are staying negative while the spreads versus German bunds have returned to 1H15 levels.

Exports to Schengen area as % of GDP (2015)



Remark: Sensitive items include 100% of non-durables and 50% of semi-durables. Sources: CZSO, UniCredit Research

The Czech Republic and Slovakia export an equivalent of two-thirds of their GDP to the Schengen area, more than any other country. At the same time, the two countries are more active in exporting the items sensitive to delays at border crossings. In case of the Schengen treaty break-up, the Czech and Slovak economies would be hit more than the others.

Czech Republic Macroeconomic Outlook

	2013	2014	2015	2016 forecast	2017 forecast
GDP growth (real yoy change, %)	-0.5	2.0	4.3	2.2	3.0
Household consumption (real yoy change, %)	0.7	1.5	2.8	3.3	2.7
Gross fixed capital formation (real yoy change, %)	-2.8	2.0	7.5	1.0	3.0
Industrial output (real yoy change, %)	-0.1	5.0	4.4	3.5	3.5
Unemployment rate (average, %)	7.7	7.7	6.5	5.6	5.5
Inflation rate (CPI yoy change, average, %)	1.4	0.4	0.3	0.7	2.2
Average wages (nominal yoy change, %)	-0.1	2.3	3.4	4.0	4.0
Interest rates (3-M PRIBOR, end of period, %)	0.38	0.34	0.29	0.30	0.80
Interest rates (3-M PRIBOR, average, %)	0.46	0.36	0.31	0.28	0.45
EUR/CZK exchange rate (end of period)	27.43	27.73	27.03	27.00	26.50
EUR/CZK exchange rate (average)	25.97	27.53	27.28	27.10	26.80
Current account balance (% of GDP)	-0.5	0.2	0.9	1.4	1.1
FDI net inflow (% of GDP)	-0.2	1.9	-0.6	1.1	1.1
General government balance (% of GDP)*	-1.3	-1.9	-1.5	-1.5	-1.7
Public debt (% of GDP)	45.2	42.7	40.8	41.1	40.9

Remarks:

*/ ESA 95 definition.

Sources: Czech National Bank, Czech Statistical Office.

Forecasts: UniCredit Bank CZ.

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