Czech Economic Quarterly

September 26, 2016

Summertime weakness

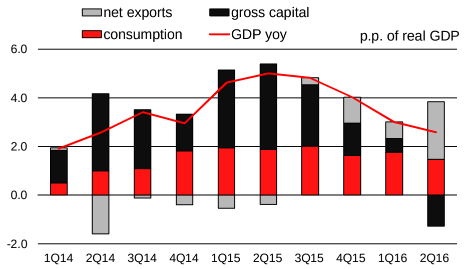
- In 2Q16, real GDP rebounded to 0.9% qoq but slowed to 2.6% yoy in yoy terms. A contraction of fixed capital formation (-4.4% yoy) came as the most remarkable change in the structure of growth, while private spending also posted a slight slowdown to 2.2% yoy. The slower domestic demand was partially offset by higher net exports.

- The July industrial output came in with a shocking 14.1% drop yoy. We expect the sector figures resuming growth already in August but a slowdown in external demand and the ongoing weakness in other components of fixed capital formation are projected to leave (seasonally adjusted) 3Q16 GDP flat qoq. With GDP resuming qoq growth in 4Q16, the full-2016 growth is seen at 2.3%.

- In 2017, the corporate investment appetite will remain depressed by post-Brexit uncertainties. Construction-related investment projects are believed to grow modestly from their low base of 2016. The consumption, both household and government, is set to be the most reliable contributor to GDP growth. GDP is projected to expand 2.1% in the whole of 2017.

- The central bank will prefer abandoning the EUR-CZK floor in 2017. That said, getting rid of the floor may not mean the end of interventions. Under the managed-float regime, interventions would aim to prevent EUR/CZK from falling back to pre-intervention levels of 25.0-25.5.

Breakdown of GDP growth by demand*



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

The shift of fixed capital formation into a yoy contraction came as the most remarkable change in the structure of GDP in 2Q16. This was counter-balanced by net exports bringing a higher input to GDP – in fact even higher than that of final consumption.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	2Q16		1Q16 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**2.6**	**2.6**	**3.0**	**3.0**
Household consumption (%)	2.2	1.0	2.7	1.3
Government consumption (%)	2.5	0.5	2.5	0.5
Fixed capital formation (%)	-4.4	-1.2	2.6	0.7
Change in inventories	-	-0.1	-	-0.1
Net exports	-	2.4	-	0.7

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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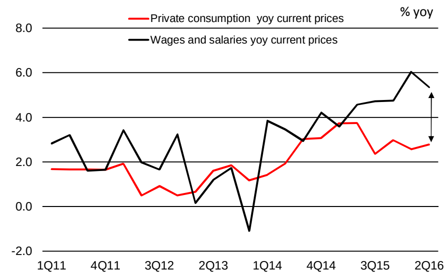
2Q16: WEAKER DOMESTIC, FIRMER EXTERNAL DEMAND

In 2Q16, real GDP rebounded to 0.9% qoq but slowed in contrast to 2.6% yoy in yoy terms. The contraction of fixed capital formation (-4.4% yoy) came as the most remarkable change in the structure of growth. Private spending also posted a slight slowdown to 2.2% yoy while government consumption maintained the previous dynamic of 2.5% yoy. In all, slower domestic demand was partially offset by higher net exports (contributing 2.4 p.p. to GDP growth) on the backdrop of export volumes boosted by 5.7% yoy and import volumes only by 3.1% yoy. Nominal GDP rose 3.5% yoy, slowing more profoundly from a 1Q16 dynamic than real GDP.

The contraction of fixed capital formation was clearly an element of surprise in 2Q16 GDP data. A slowdown was to be expected alongside troublesome results of construction output (which was down 11% yoy volume-wise in the first seven months of the year). However, capex saw a yoy decline not only for non-residential building but also for machinery equipment, suggesting that not only the EU funds but also cyclical factors could be in the game as well. Additionally, the question is why the pace of private consumption has been underperforming that of household labor income persistently since early 2015. We attribute the gap to households preferring to satisfy their housing needs, rather than spend on consumption. Finally, we suspect that the firm industrial output in 2Q16 (5.7% yoy, the highest pace since 2Q14) might capture building an inventory stock in the automotive sector ahead of the July scheduled company-wide holidays. If so, a consequent inventory adjustment may render GDP growth a negative impulse in 3Q16.

Compensation of employees and private consumption



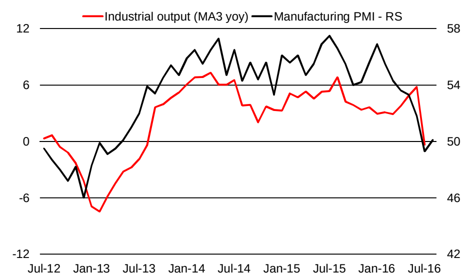
Sources: CZSO, UniCredit Research.

Since early 2015, households have been boosting their consumption less than justified by the growth of their labor income. Households' preference for investment into housing may serve as an explanation.

3Q16: THE INDUSTRIAL OUTPUT DOWNTURN BELIEVED TO BE TEMPORARY

The July industrial output came in with a shocking 14.1% drop yoy. While part of the decline was due to a working-day effect (with three days missing versus the 2015 base), timing of the company-wide holidays in the car manufacturing sector served as the key explanation. Indeed, production was down 35% yoy in the automotive sector alone. We expect the sector figures resuming growth yoy already in August. Yet, boosting production in the run-up for the summer break probably had a positive impact on a June dynamic and may by the same token knock down industrial output data for the whole of 3Q16. Apart from the industry, construction output continued to display disappointing data in July (-16.3% yoy), while retail sales including cars also posted a slight yoy contraction (-0.4%). We remain positive about retail sales for August-September and, subsequently, for 3Q16 private consumption as part of GDP. In addition, new car registrations in August (17.1% yoy) suggest that at least one component of fixed capital formation has resumed its former momentum. Nevertheless, a slowdown in external demand and the ongoing weakness in other components of fixed capital formation are projected to leave (seasonally adjusted) GDP flat qoq, slowing its yoy growth to 1.6%.

Manufacturing PMI and industrial output



Sources: Markit, UniCredit Research.

For the first time in more than three years, manufacturing PMI dropped below the 50 level in July. This coincided with a sharp yoy contraction of industrial output in July. With PMI partially recovering in August, the industrial output downturn may prove temporary.

4Q16: RESUMING A QOQ GROWTH

There are more reasons to believe that a GDP dynamic will improve a bit in 4Q16, although not abandoning a low-speed territory. First, private consumption may get a boost from accelerating wages. Most of public sector workers will see a salary hike in November, while teachers have already reached for their deal in September. Wages in the private sector are believed to respond to growing shortages of labor in many professions. Second, new infrastructure projects, delayed by administrative barriers in the ecological audit procedure, may hopefully go ahead. Third, export dynamics will no longer be dragged by the summer break in car (and related) production. In terms of demand for cars in Europe, the situation appears to remain stable rather than subject to a sharp slowdown. Finally, industrial output may leap by a percentage point after a year (or more) of supply-side problems in electricity and chemical production will have been over. In total, we bet on GDP rising 0.7% qoq, accelerating yoy growth to 2.0%. Full-2016 GDP growth is thus seen at 2.3%, with the structure versus 2015 shifted considerably away from fixed capital formation towards net exports.

2017: A MIXED BAG

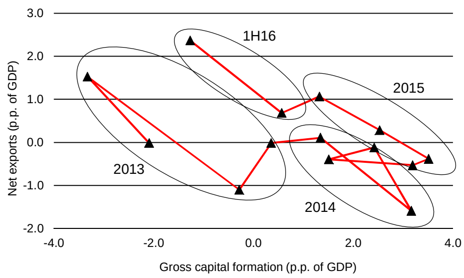
From today's perspective, the external environment will fail to provide the economy a strong boost but should not bring any catastrophe either. The key risk is political, related to upcoming elections in the USA as well as major eurozone countries and the underlying adoption of would-be anti-market reforms. A similar risk stemming from the Czech Republic general elections to be held in autumn 2017 appears to be smaller.

The corporate investment appetite will remain depressed by post-Brexit uncertainties. With a significant part of Czech exports driven by a demand for investment goods, export dynamic will be affected as well. As to car and related exports, we assume demand in Europe to hold better, allowing the automotive industry to expand moderately. Overall, real exports may post a 3.5% growth, the lowest dynamic since 2013.

Construction-related investment projects are believed to grow modestly from their low base of 2016. This may apply to commercial real estate, infrastructure as well as residential building. However, the trend may not be smooth in the last mentioned part, as housing starts have tumbled for administrative reasons in Prague. Thus, bureaucratic blockages may slow the growth in residential fixed investment in 2017, despite strong demand. On balance, however, construction may contribute more than machinery and transport equipment to the projected rise of fixed capital formation by 1.5%.

Consumption, both household and government, is set to be the most reliable contributor to GDP growth. Nominal wages may grow 4.5%, allowing for higher real spending despite inflation creeping up. The state budget, driven by pre-election populism, will boost spending on public sector wages (8.2% more yoy has been allocated for that purpose) as well as household

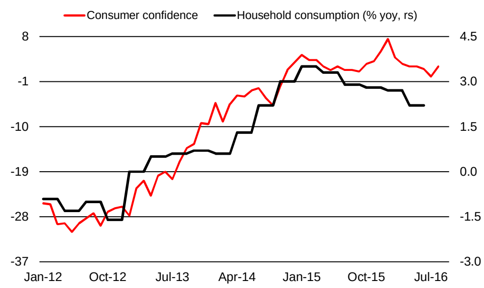
Gross capital formation and net exports



Sources: CZSO, UniCredit Research.

With gross capital formation easing and (as of 2Q16) even contracting yoy, the economy cycle is getting back to where it was in 2013. However, as a significant difference from then, exports have turned more intensive, which is demonstrated by this year's line in the chart staying well above the 2013 level.

Consumer confidence and private consumption



Sources: CZSO, UniCredit Research.

Consumer confidence remains high by historical standards, while private consumption growth has been constantly easing from its early-2015 peak. In our interpretation, the inconsistency reflects an inclination of households to invest into housing rather than spend on consumption.

transfers. The fiscal impulse is forecast at 1% of GDP. Consumption may account for three-quarters of the full-2017 GDP growth of 2.1%.

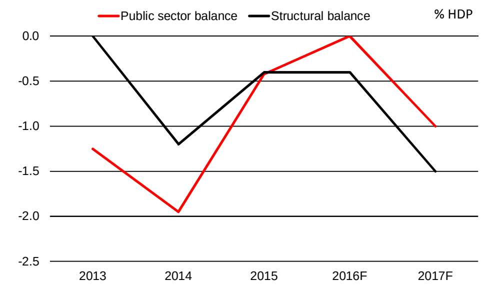
THE CNB POLICY: THE AIM REMAINS TO ABANDON THE EUR/CZK FLOOR IN 2017

After an early-summer lull, market speculation on the CNB exiting the intervention regime and the subsequent CZK appreciation has picked up again. The CNB may maintain its narrative of abandoning the current intervention policy around mid-2017. The exit could happen earlier in 2017 if inflation exceeds 2% yoy (we expect the level to be reached in July), if growth recovers in the eurozone and the CZK is not under strong appreciation pressure. While, on the other hand, poor data could compel the CNB to extend forward guidance, we believe the central bank prefers abandoning the EUR-CZK floor in 2017, since the current FX regime stretches its mandate. That said, getting rid of the floor may not mean the end of interventions. Under the managed-float regime, interventions will aim to prevent EUR-CZK from falling back to pre-intervention levels of EUR/CZK 25.0-25.5.

FOCUS: AGING OF POPULATION WILL DRAG PRODUCTIVITY GROWTH

With the unemployment hitting a long-term low and the demand for new labor not abating, it is worth looking beyond the economic cycle and see if the labor supply will facilitate the economy to keep growing. Analyzing demographic trends through 2030, we conclude that the overall labor force in the Czech Republic may not shrink, suppose the participate rates (percentage of population working) for certain age groups go up. However, gains in the participation rate are mostly feasible in the age group of 55+. More specifically, gains are set to be the result of a gradual shift in the retirement age, occurring predominantly in the 55-59 age group for women and the 60-64 age group for men. As a result, the overall work force will be aging, raising the need for new approaches on the part of employers as well as economic policy of the government. One inevitable aspect of the greyer labor force is set to be a lower productivity growth. While older employees tend to be more experienced and more loyal to their employers, their cognitive skills and their flexibility turn lower. Economic research from abroad suggests that productivity gains are getting smaller with the share of employees aged 55+ over the whole employment growing. Although data constraints prevent us from applying the same research to the Czech labor market, we find the conclusion plausible also here. With other sources of productivity growth difficult to attain and net labor immigration having at best a limited positive impact on the labor supply, the clear conclusion is that potential growth of the Czech economy will go lower. This should be taken into account in the public finances long-term planning. Mandatory expenditures in particular need to be based on conservative macroeconomic assumptions.

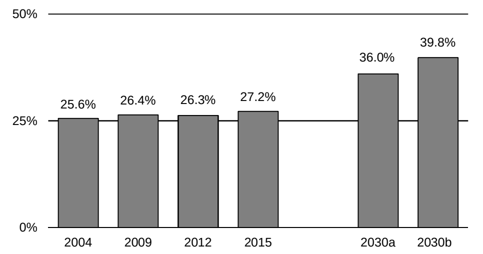
Public sector and structural balance



Sources: MoF, OECD, UniCredit Research.

Public finance may end up in entire balance for 2016 but is likely to deteriorate in 2017 amid higher government spending on wages and transfers. In terms of structural balance which takes into account an economic cycle and certain one-off transactions, the 2017 deficit may reach as much as 1.5% of GDP in our assessment.

Share of work force aged 50-64 on total



Remark: 2030a assumes no change in participation rates, 2030b assumes a shift in participation rates that we regard likely.
Sources: UN, CZSO, UniCredit Research

The Czech Republic labor force has been getting older. The 50-64 age group, which currently accounts for 27.2% of total working population, may boost its share to 36.0% if pure demographic trends are considered. If in addition a likely shift in the participation rate is taken into account, the share may approach 40%.

Czech Republic Macroeconomic Outlook

	2013	2014	2015	2016 forecast	2017 forecast
GDP growth (real yoy change, %)	-0.5	2.7	4.6	2.3	2.1
Household consumption (real yoy change, %)	0.5	1.8	3.1	2.6	2.4
Gross fixed capital formation (real yoy change, %)	-2.5	3.9	9.1	-1.5	1.5
Industrial output (real yoy change, %)	-0.1	5.0	4.6	2.7	1.5
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	0.6	1.9
Average wages (nominal yoy change, %)	-0.1	2.9	2.7	4.2	4.5
Interest rates (3-M PRIBOR, end of period, %)	0.38	0.34	0.29	0.30	0.35
Interest rates (3-M PRIBOR, average, %)	0.46	0.36	0.31	0.28	0.30
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	1.7	1.6
FDI net inflow (% of GDP)	-0.2	1.9	-0.6	1.3	1.3
General government balance (% of GDP)*	-1.3	-2.0	-0.4	0.0	-1.0
Public debt (% of GDP)	45.1	42.7	41.1	39.2	39.0

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