Czech Economic Quarterly

December 20, 2016

Heading for policy shifts

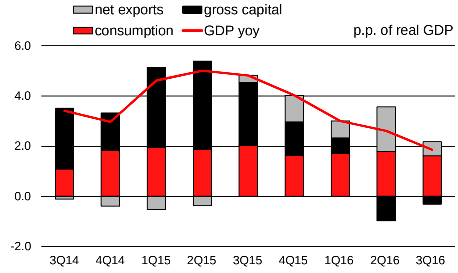
- In 3Q16, real GDP slowed sharply to 0.2% qoq and 1.9% yoy, the weakest readings since early 2014. Private consumption proved to be the major driving force of growth. Fixed capital formation (-2.3% yoy) was staying negative but the inventory accumulation helped ease a negative momentum of gross capital. Net exports made a positive contribution to growth by 0.6 p.p.
- High-frequency macroeconomic data for October lacked optimism, while the November manufacturing PMI also failed to impress. Private spending may nonetheless leverage on projected nominal wage acceleration to 4.8% yoy and fixed capital formation is seen to almost stop falling yoy in 4Q16. GDP growth will marginally accelerate to 0.4% qoq and 2.0% yoy.
- 2017 is seen as the year of policy shifts. This is set to be so in both the private sphere (reacting by capital spending to bottlenecks of the labor market) and the public sector (with slightly tighter monetary conditions being offset by fiscal easing).
- The CNB may discontinue its intervention policy in 2Q17 but would re-enter the FX market, should EUR-CZK drop to 25.0. In a scenario we regard more likely, though, market forces will bring EUR-CZK towards 26.5 after an initial post-exit volatile trading. This would be consistent with a couple of CNB repo rate hikes in 2017 but we do not rule out a delay in policy tightening until 2018.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	3Q16		2Q16 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**1.9**	**1.9**	**2.6**	**2.6**
Household consumption (%)	2.8	1.3	2.5	1.2
Government consumption (%)	1.5	0.3	3.1	0.6
Fixed capital formation (%)	-2.3	-0.6	-3.4	-0.9
Change in inventories	-	0.3	-	-0.1
Net exports	-	0.6	-	1.8

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: CZSO, UniCredit Research.

In 3Q16, gross capital formation kept subtracting from yoy GDP growth but to a lesser extent than in 2Q16. By the same token, net exports turned less positive than previously. Consumption was again the biggest contributor to GDP growth, with its input staying fairly robust since 4Q14.

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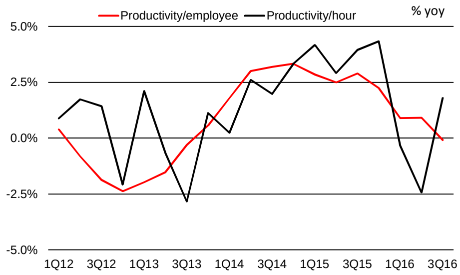
3Q16: PRIVATE CONSUMPTION HOLDING UP

In 3Q16, real GDP slowed sharply to 0.2% qoq and 1.9% yoy, the weakest readings since early 2014. Private consumption (0.9% qoq and 2.8% yoy) proved to be the major driving force of growth, while government consumption slowed to 1.5% yoy on a high base effect from 3Q15. Fixed capital formation (-2.3% yoy) was staying negative for the second quarter running but the inventory accumulation helped ease a negative momentum of gross capital to -1.1% yoy. Exports grew by mere 2.0% yoy, the weakest dynamic since 2013, whereas slowdown in imports to 1.4% yoy made net exports a positive contributor to growth by 0.6 p.p. A rise in taxes on production made gross value added performing worse than GDP as such, displaing 0.1% qoq and 1.6% yoy. Nominal GDP slowed as well, posting 3.2% yoy.

The structure of 3Q16 GDP stayed without any major surprise. Economic growth has proved to be increasingly labor-demanding. Productivity, measured as GDP at constant prices per person employed, has been growing at a pace lower than 1% this year, while productivity per hour worked has even been stagnating. The situation has been pushing up wage costs (5.7% yoy for 3Q16 , the second highest reading since 3Q08).

Labor productivity per worker and per hour



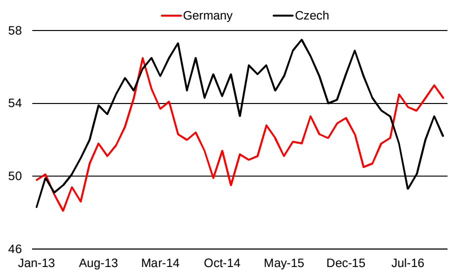
Sources: CZSO, UniCredit Research.

The growth of productivity per employee ground to a halt in 3Q16, as GDP slowed but the employment grew by 1.7% yoy. Poor productivity gains are no specific problem of the current period. Economic recession in 2012-2013 was marked by an ongoing demand for more labor, bringing a loss in productivity as deep as 2.5% yoy.

4Q16: A MODERATE UPTURN IN MOMENTUM

High-frequency non-adjusted data for October lacked optimism, as industrial output saw a 1.7% yoy decline, exports in CZK terms dropped 4.9% yoy and retail sales including the auto segment added mere 0.5% yoy. The data would look only moderately better if adjusted for one fewer working day against the base period. In a similar vein, the November manufacturing PMI failed to impress with a reading of 52.2 and a drop from the previous month's value of 53.3. As a result, industrial output and exports may generate only a modest growth at best in 4Q16. From the domestic demand side, private spending may leverage on projected nominal wage acceleration to 4.8% yoy but an expected inflation spike (to 1.3% yoy versus previous quarter's 0.5% yoy) could be a burden. Two aspects should be considered for fixed capital formation. First, with the EU funding spree having come to an end in 4Q15, the negative base effect is turning less intense in 4Q16. Second, part of the inventory accumulation from 3Q16 may give a boost to fixed capital formation in 4Q16. In terms of its structure, positive inputs to yoy growth are expected from residential construction and transport equipment, while infrastructure investment will surely continue to post negative inputs and so will probably machinery equipment. On balance, we expect fixed capital formation to almost stop falling yoy, which makes us foresee 4Q16 GDP marginally accelerating to 0.4% qoq and 2.0% yoy, bringing full-2016 growth to 2.4%.

Czech and Germany manufacturing PMI



Sources: Markit.

Despite recovering from its July sub-50 level, Czech manufacturing PMI has been staying below Germany's. While Germany PMI staged a quantum leap in 2Q16, its Czech peer experienced the opposite move. We do not observe any fatal problem in the Czech industry. Having said that, its heavy reliance on car manufacturing tends to be a burden at some phases of a cycle.

2017: THE YEAR OF POLICY SHIFTS

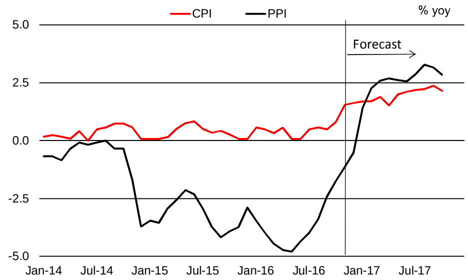
After several years of relative stability in economic policies, the economy is heading for policy shifts in 2017 on several fronts. With the **unemployment rate** sinking below 5% (4.9% for November 2016), the mounting labor shortage is pushing up wages and may boost **corporate investment**, leading, in turn, to **productivity gains**. **Inflation** is seen moving up as a result of not only wage pressure but also a cyclical upturn in prices of food and fuels. The on-line reporting system for restaurants and retail sales - the key policy measure introduced to fight tax avoidance - may contribute a bit to higher inflation as well. The inflation uptick will fulfill the CNB's key condition to exit its **FX intervention policy**. The underlying tightening of monetary conditions will be offset by **fiscal easing**, as public-funded investment is set to recover from a low level in 2016. In addition, the Social Democrats are expected to push for generous social policies in the run-up to general elections to be held in autumn 2017, which may ease fiscal policy in 2018.

Nominal wage growth at close to 5% yoy is believed to be sufficient for private consumption to avoid a slowdown despite higher inflation in 2017. Thus, **private consumption growth** (+3% yoy) could remain the key contributor on the demand side to a GDP expansion of 2.4%. **Fixed capital formation** is projected to resume growing in 2017, although the pace is uncertain. On the one hand, manufacturers are optimistic about their investment in modernization and cost-saving measures (albeit less so in extending their production base) and some infrastructure projects are also expected to proceed. On the other hand, investment in transport equipment may slow after two solid years, and so will housing projects (where both demand and supply constraints could emerge).

Exports will contribute less to GDP growth in 2017 and in 2018, despite receiving support from the expected rebound in global trade. Demand for new cars in Europe provided a big boost to Czech exports in recent years. With that demand getting close to saturation after more than three years of uninterrupted growth in the number of **car registrations** in Europe, we believe that Czech exports may only grow marginally above the pace of global trade. The situation reminds us a bit of 2013, when Czech exports stagnated. Our conservative export growth forecast of 2.7% for 2017 means net exports would cease to contribute to GDP growth.

On the production side, **industrial output growth** could slow down further to 2.5% in 2017 before picking up slightly to 3% in 2018. GDP growth will rely more than in 2016 on construction, trade (probably helped by potential currency appreciation) as well as business services (ICT in particular should continue expanding).

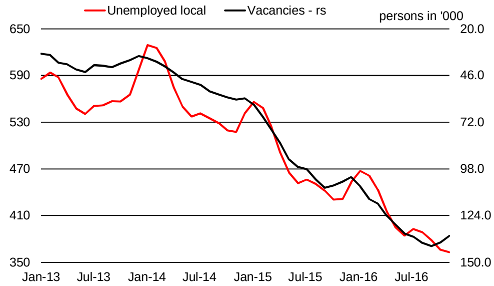
CPI and PPI – history and outlook



Sources: CZSO, UniCredit Research.

The close-to-zero-inflation environment is apparently coming to an end. Our forecast for CPI aims above 2% yoy from 2Q17 and PPI is projected to be even higher.

Unemployment and job vacancies



Sources: MPSV, UniCredit Research.

The number of unemployed approached an eight-year low in November, while the number of vacancies recorded an eight-year high. The labor market situation may turn out to be a bottle-neck for faster GDP growth in 2017.

CNB INTERVENTIONS TO BE DISCONTINUED IN 2Q17

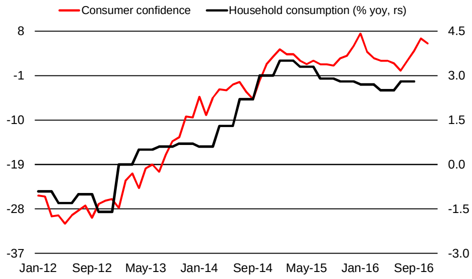
The key policy event of the year is set to be the end of the CNB's EUR-CZK floor of 27.0. Of the two potential obstacles to the CNB's exit, i.e. low inflation and the ECB's QE, the former is probably almost gone. We expect headline inflation to reach 2% yoy before mid-2017, with higher core inflation adding to food and fuel price inflation. As to the ECB, the issue is how its QE extension will be interpreted by the CNB's MPC. Comments made ahead of the extension nevertheless tended to play down the ECB as a factor for CNB policy. This makes us believe that the exit from interventions is more likely to come in 2Q17 than in 3Q17. More specifically, our preferred scenario is that of an early April exit, which would minimize the spell of uncertainty after expiration of the CNB hard commitment at the end of 1Q17. The decision would be based on the inflation outlook to be released in early February, with inflation data for January and February expected to support the decision.

For the post-exit initial period, considerable uncertainty is seen as to a direction and a magnitude of change for EUR-CZK. If CZK appreciates, we expect verbal interventions below EUR-CZK 25.50 and actual interventions if EUR-CZK drops to 25.00. In the logic of the CNB model, the EUR-CZK at 25.00 would correspond to five 25bp repo rate hikes, which appears to be significant tightening. The CNB may nevertheless prefer not to intervene during the initial market reaction and wait for a significant portion of investors to take profits before correcting a potential excessive appreciation of the CZK. Moreover, fine-tuning real monetary conditions using a managed float may prove a difficult task. Once investors start taking profits on their positions, we expect EUR-CZK to return towards 26.5, given the shallow local market and the lack of euros. After that, a gradual appreciation trend could take EUR-CZK towards 26.00 sometime in 2018, an appreciation equivalent to approximately 60bp in interest rate increases. This would leave monetary conditions still laxer than at the time when the EUR-CZK floor was introduced.

CNB REPO RATE HIKES BY 2017-END POSSIBLE BUT NOT CERTAIN

We do not expect any rate hike in 2017 if the CZK appreciates by more than 5%. The current CNB model assumes 3M Pribor a full percentage point above its current level by end-2017 on the condition that there would be no CZK appreciation. In reality, our envisaged EUR-CZK path would be consistent with a couple of 25bp repo rate hikes by the end of 2017. However, the CNB may delay the start of rate increases, taking into account both the ECB's easing and the risk of CZK firming later. Hence, our baseline projection of the CNB repo rate counts on hikes arriving only from the start of 2018.

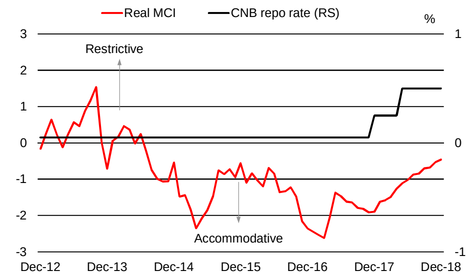
Consumer confidence and private spending



Sources: CZSO, UniCredit Research.

The consumer confidence remains close to an all-time high, while private spending has been growing at a pace distinctly below that of early 2015. Apparently, households prefer housing investment to boosting consumption.

Monetary conditions index and CNB repo rate



Sources: UniCredit Research

Real monetary conditions (consisting of interest rate and exchange rate changes) have been staying accommodative since the CNB introduced its FX intervention policy in 2013. Even the envisaged end of interventions next year may not mean an ultimate end to relaxed monetary conditions.

Czech Republic Macroeconomic Outlook

	2014	2015	2016 forecast	2017 forecast	2018 forecast
GDP growth (real yoy change, %)	2.7	4.6	2.4	2.4	2.5
Household consumption (real yoy change, %)	1.8	3.1	2.7	3.0	2.2
Gross fixed capital formation (real yoy change, %)	3.9	9.1	-0.8	2.0	3.0
Industrial output (real yoy change, %)	5.0	4.6	2.6	2.5	2.5
Unemployment rate (average, %)	7.7	6.5	5.5	5.2	5.1
Inflation rate (CPI yoy change, average, %)	0.4	0.3	0.6	2.0	2.2
Average wages (nominal yoy change, %)	2.9	2.7	4.4	4.7	4.0
Interest rates (3-M PRIBOR, end of period, %)	0.34	0.29	0.29	0.30	0.8
Interest rates (3-M PRIBOR, average, %)	0.36	0.31	0.29	0.30	0.4
EUR/CZK exchange rate (end of period)	27.73	27.03	27.05	26.50	26.00
EUR/CZK exchange rate (average)	27.53	27.28	27.10	26.50	26.30
Current account balance (% of GDP)	0.2	0.9	2.3	1.8	1.8
FDI net inflow (% of GDP)	1.9	-0.6	2.9	2.3	2.2
General government balance (% of GDP)*	-1.9	-0.6	0.3	-0.4	-0.5
Public debt (% of GDP)	42.2	40.3	38.6	37.9	36.8

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

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