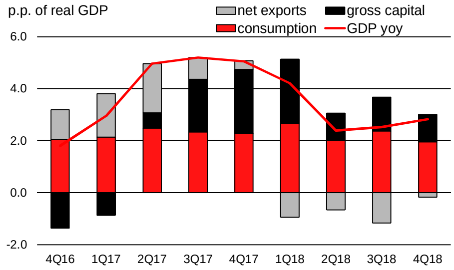
Czech Economic Quarterly

March 21, 2019

Controlled descent

- In 4Q18, real GDP growth accelerated to 0.9% qoq and 2.8% yoy from 3Q18's dynamics of 0.7% qoq and 2.5% yoy. Nominal GDP grew by a solid 5.2% yoy. From the production side, all sectors but agriculture recorded yoy increases of gross value added. With GDP in previous quarters revised marginaly upwards, full-2018 real growth maintained 3.0%.
- Clear signs of the weakness spreading through external sectors affected Czech early-2019 data. Manufacturing PMI, at 48.5, touched a six-year low. January industrial output and employment declined 1.1% and 0.5% yoy, respectively. January retail sales grew (ex-auto) 4.7% yoy, suggesting than private spending has remained unhurt. On balance, we estimate 1Q19 GDP growth at 0.4% qoq and 2.6% yoy.
- Global slowdown is set to drag on the Czech economy in 2019 and 2020. Robust domestic demand is expected to mitigate the drag in 2019 but less so in 2020. Economic growth may slow only slightly to 2.1% in 2019 before easing to 1.4% in 2020.
- Whereas central bankers hint at up to three 25bp repo rate hikes to be delivered in 2019, we incorporate into our baseline scenario just one hike, which could already occur on 28 March. Our call is consistent with expectations of very modest CZK appreciation of around 1% by the end of 2019.

Breakdown of GDP growth by demand*



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

In 4Q18, GDP growth accelerated on net exports sharply reducing their negative input. Both consumption and gross capital eased their momentum marginally. Within the consumption component, government displayed a yoy pace twice as high as households. In gross capital, a sizeable inventory rundown occurred again.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	4Q18		3Q18 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**2.8**	**2.8**	**2.5**	**2.5**
Household consumption (%)	2.2	1.0	2.8	1.3
Government consumption (%)	4.7	0.9	5.3	1.0
Fixed capital formation (%)	10.1	2.5	11.0	2.8
Change in inventories	-	-1.5	-	-1.5
Net exports	-	-0.2	-	-1.2

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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4Q18: A TEMPORARY REBOUND ON INVESTMENT

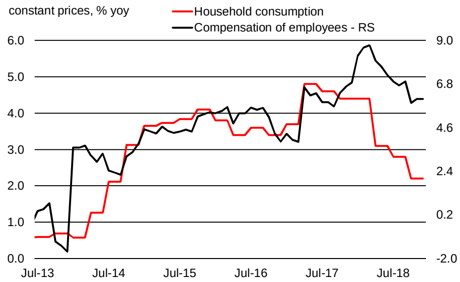
In 4Q18, real GDP growth accelerated to 0.9% qoq and 2.8% yoy from 3Q18's dynamics of 0.7% qoq and 2.5% yoy. Private consumption slowed again to 2.2% yoy, the lowest pace since 3Q14. Government consumption in contrast maintained a high momentum, expanding 4.7% yoy. Fixed capital formation posted another double-digit growth (10.1% yoy), remaining a decisive demand-side component of GDP growth. All the investment-related categories of capital, i.e. machinery, transport equipment, construction and intangibles, displayed solid increments. The level of inventories, however, extended the spell of adjustment to a third quarter in a row, which was last seen in 2013. Exports grew faster than in the previous quarter (5.0% yoy), easing a negative contribution of net exports to 0.2% of GDP. Nominal GDP grew by a solid 5.2% yoy. From the production side, all sectors but agriculture recorded yoy increases of gross value added, the highest being seen for construction (7.9% yoy) and ICT (7.1% yoy). The number of employees added (non-adjusted) 1.6% yoy while compensation grew in nominal terms by 8.2% yoy, in line with a slowdown in average nominal wages to 6.9% yoy from a previous 8.5% yoy. With GDP in previous quarters revised marginaly upwards, full-2018 real growth maintained 3.0%.

Many investment projects were probably being finalized, causing significant shifts from inventories into fixed capital formation. Apart from this typical late-cycle feature, few warning signs of economic slowdown were spotted in hard data yet. We nevertheless believe that the risk of foreign trade disruptions caused by the US policy and Brexit could have made global manufacturers stock up, improving Czech exports temporarily.

1Q19: A SLOWER START OF THE YEAR

Clear signs of the weakness spreading through external sectors affected Czech early-2019 data. Manufacturing PMI extended its streak of monthly declines to eight in February, with the level of 48.5 touching a six-year low. Also hard data from industry surprised on the downside with January output and employment declining 1.1% and 0.5% yoy, respectively. Car manufacturing accounted for the full scale of the decline on its contraction by 6.9%. On a somewhat more positive note, industrial orders from abroad rose 2.7% yoy, reversing the previous month's decline. Car registrations for January-February saw an ongoing sharp slide in Czechia (-10.5% yoy), but a more moderate decline in the Eurozone (-2.4% yoy). Trade surplus came in lower at CZK 12bn versus last January's CZK 19bn, as imports probably reacted to local manufacturers' efforts to normalize their inventory stock after a year-end reduction. Construction output was down 13.2% yoy in January but we largely attribute the poor performance to more severe weather conditions. January retail sales grew (ex-auto) 4.7% yoy, suggesting than private spending has remained unhurt. For 1Q19 as a whole, we expect external demand broadly stagnating and domestic demand moderately growing, which on balance brings our GDP forecasts to 0.4% qoq and 2.6% yoy.

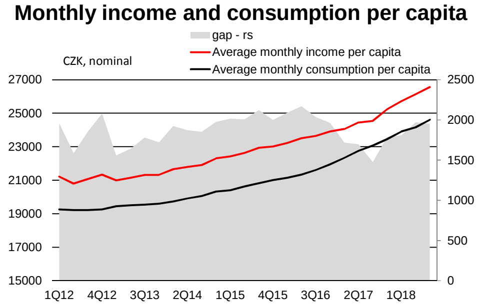
Compensation of employees and household consumption



Sources: CZSO, UniCredit Research.

The dynamic of employee compensation used to be a reliable determinant for household consumption growth. Since early 2018, however, a spending pattern of households has changed towards their greater cautiousness.

Monthly income and consumption per capita



Sources: CZSO, UniCredit Research.

In 1-3Q18, households also boosted their spending less than allowed by their growing total (not just employment) income. We attribute the current higher savings propensity to cyclical factors related to replacement needs of durable goods. We expect the saving rate to remain elevated in 2019 but starting to decline naturally in 2020, unless derailed by an income shock.

2019: CONTROLLED DESCENT

Global slowdown is set to drag on the Czech economy in 2019 and 2020. Robust domestic demand is expected to mitigate the drag in 2019 but less so in 2020. On exports, we continue to see in 2019 the poorest performance in six years. Importantly, car exports are unlikely to be the only weak spot. Weakness will rather stem from a downturn in the global investment cycle, affecting a majority of branches in the Czech manufacturing. For the automotive specifically, we do not expect any fall of the cliff but rather a stagnation brought about by the ability of local producers to boost their share on a slightly decreasing European market.

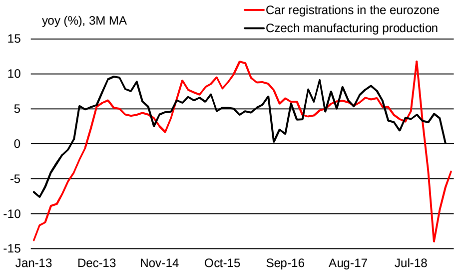
Despite net exports subtracting from GDP again, economic growth may slow only slightly to 2.1% in 2019. Private consumption and fixed capital formation may hold up well, the former due to solid real income growth and the latter because of a pipeline full of investment projects, both public and private. In 2020, GDP growth is seen slowing further to 1.4% despite exports slightly picking up from the low base. Domestic demand will then need to cope with lower corporate profits and a cyclical downturn in investment.

Labor market conditions will remain tight but may show a more nuanced picture than in 2018. First, slower export growth along with investment in increasing productivity will reduce demand for additional workers and the number of vacancies may start to shrink in 2019. Second, small-scale layoffs will occur among less successful manufacturers. Third, the government has extended its guest worker program. All these factors could bring the labor market closer to balance. Nevertheless, labor shortages are unlikely to disappear entirely and may turn out to be more acute in services than in industry. As a result, we expect only a slight rise in the unemployment rate to 3.8% by the end of 2020, despite the cyclical slowdown.

Less pressure on the labor market may slow real wage growth to 3.5% in 2019 and below 3% in 2020. This may ease private consumption growth to 2.3% in 2019 and 1.8% in 2020. In fact, signs of a slowdown in household spending have been apparent since 3Q18 when household income was still growing at a record high pace. We attribute that to a changing pattern in consumer behavior, brought about by a sharp rise in housing prices and a cyclical slowdown of spending on durables. In 2020, consumption growth may stabilize at lower levels, with demand for durables rising slightly.

Fixed capital formation set a high base for an additional increase in 2019. Indeed, we project an outright reduction in investment in transport equipment and dwellings. For other categories, however, there is still scope for growth. The pipeline for infrastructure projects financed by the public sector appears to be sufficient to maintain an expansion at least in 2019. The same is valid for machinery, with companies focused on boosting productivity. Investment in intangibles, reinforcing a structural shift of the economy away from manufacturing, is also set to remain on its long-term steady growth path. All in all, a small rise in fixed capital formation is expected in 2019, before the trend is reversed in 2020.

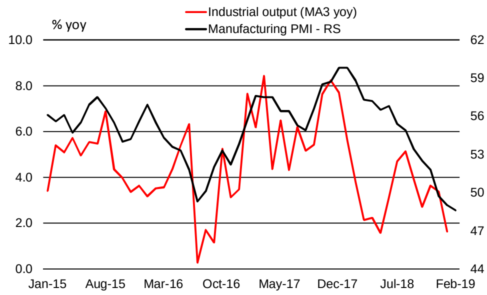
Eurozone car registrations and Czech manufacturing output



Sources: Macrobond, 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 2018 related to the new emission norm implementation (WLTP). The situation seems to be normalizing since then, suggesting that a cyclical slowdown rather than a one-off drop in car registrations stands behind the poorer performance of Czech manufacturing.

Manufacturing PMI and industrial output



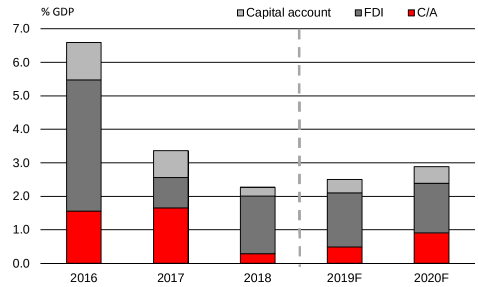
Sources: CZSO, Markit, UniCredit Research.

While the slowdown in industrial output from early-2018 was not quite supported by manufacturing PMI values, the eight-month streak of declines has lately brought PMI to a level consistent with a stagnation rather than expansion of industrial output. Indeed, we expect industrial output flat on 2019.

CNB POLICY: ONE FINAL HIKE TO BE DELIVERED?

The tight labor market is the key factor for the ČNB to stay in a policy-tightening mode despite signs of the economy cooling. As seen in the February ČNB forecast, tightening should be delivered by a downward shift in EUR-CZK to 24.5 by the end of 2019, equivalent to five 25bp rate hikes. However, ČNB officials also signal that their model tools are subject to recalibration, which may alter the EUR-CZK assumed path or even change the proportion between the interest rate and the FX in real monetary conditions. Whereas central bankers hint at up to three hikes to be delivered in 2019, we incorporate into our baseline scenario just one hike, which could already occur on 28 March. Our call is consistent with expectations of very modest CZK appreciation of around 1% by the end of 2019. Thereafter, weaker economic growth could translate into the rates being kept on hold until the end of 2020 despite a limited appreciation of CZK.

Balance of payments' selected components



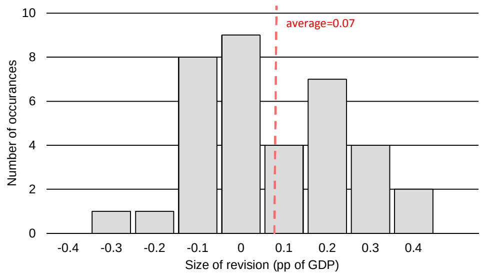
Sources: ČNB, UniCredit Research.

Surpluses in the components of the balance of payments that are key for longer-term movements in the exchange rate – the current account, the capital account and FDI – have all shrunk since 2016. For 2019-2020, we expect them to start growing only very slowly – insufficiently to create a downside pressure on EUR-CZK.

FOCUS: HOW RELIABLE ARE FLASH ESTIMATES OF GDP IN CZECHIA?

Flash GDP estimates have been published since 2010 and are available approximately six weeks after the end of a quarter. Each quarter they form a market-relevant piece of information. However, flash estimates are based on incomplete data, with promptness of their release being at an expense of accuracy. We focused in our analysis on revisions between the flash and the second "reading" of GDP. It appears that the average revision of qoq GDP growth over 2010-2018 was positive at 0.07pp with the mean error of 0.17pp. The spectrum ranged from a negative -0.3pp to a positive 0.4pp. In total, we counted 17 positive revisions, 10 negative and 9 nil. The test confirmed that with a 98% probability average revision is different from zero, i.e. the disparity is no coincidence. How to explain that flash estimates tend to underestimate real GDP growth? Estimating an inventory change appears to be the key problem. Higher growth of gross capital tends to be associated with a positive revision of flash GDP, while growth of fixed capital (excl. inventories) does not show this pattern. In a 10-quarter sample with the fastest growth of gross capital, we see an average revision of positive 0.15pp, while the 10 worst quarters showed a zero average revision. A similar feature showed up in the sample of the 10 worst quarters in terms of net exports contribution. Negative net exports may be due to, among other things, a decline in external demand or a local investment boom. In both cases, inventories usually increase first. While data on foreign trade or investment is available relatively early, estimating inventory changes at a time of constructing flash estimates is difficult. This means that negative net exports may first lead to a more pessimistic estimate of GDP, but growth of inventories may later show it in a better light. We should add that the finding does not mean any harm to a good reputation of Czech statistics. Flash estimates are definitely seen as a useful tool despite their minor bias.

Histogram of flash GDP revisions



Sources: CZSO, UniCredit Research

Flash GDP releases underestimate GDP dynamics published later on average by 0.07 pp with the mean error reaching 0.17 pp. The key shortcoming is in our view a lack of knowledge on inventory changes.

Czech Republic Macroeconomic Outlook

	2016	2017	2018	2019 forecast	2020 forecast
GDP growth (real yoy change, %)	2.4	4.5	3.0	2.1	1.4
Household consumption (real yoy change, %)	3.6	4.4	3.2	2.3	1.8
Gross fixed capital formation (real yoy change, %)	-3.3	4.1	10.1	2.2	-1.0
Industrial output (real yoy change, %)	3.4	6.5	3.2	0.0	1.5
Unemployment rate (average, %)	5.5	4.2	3.2	3.0	3.2
Inflation rate (CPI yoy change, average, %)	0.7	2.5	2.1	2.5	1.9
Average wages (nominal yoy change, %)	4.4	6.2	8.1	6.1	4.8
Interest rates (3-M PRIBOR, end of period, %)	0.28	0.75	2.01	2.15	2.15
Interest rates (3-M PRIBOR, average, %)	0.29	0.41	1.27	2.12	2.15
EUR/CZK exchange rate (end of period)	27.02	25.54	25.73	25.40	24.80
EUR/CZK exchange rate (average)	27.03	26.33	25.64	25.50	25.10
Current account balance (% of GDP)	1.6	1.7	0.3	0.5	0.9
FDI net inflow (% of GDP)	3.9	0.9	1.7	1.6	1.5
General government balance (% of GDP)*	0.7	1.6	1.0e	-0.4	-1.0
Public debt (% of GDP)	36.8	34.7	31.9e	30.9	31.0

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