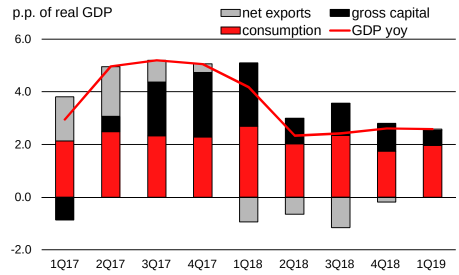
Czech Economic Quarterly

June 18, 2019

Resilience testing

- In 1Q19, real GDP added 0.6% qoq, leaving the yoy dynamic unchanged at 2.6% yoy. Consumption remained the key driver of growth. Fixed capital formation experienced a rather dramatic slowdown to 3.4% yoy, with gross capital including inventories slowing even more sharply to 2.2% yoy. The contribution of net exports to GDP was flat.
- All of the industrial output, construction output, exports and retail sales displayed solid April data and a reasonable short-term outlook. The question remains how the positive hard economic data fare with a depressed level of manufacturing PMI. For 2Q19 at least, we currently estimate a stable pace at 0.5% qoq and 2.6% yoy.
- Economic activity remains resilient in front of external headwinds, helped by private spending, construction activity and the automotive sector. However, GDP growth is likely to ease gradually, to 2.4% in 2019 and 2.0% in 2020, due to a slowdown in eurozone, trade conflicts and Brexit.
- The CNB is probably at a start of a gradual retreat from its tightening bias. We maintain our view that no policy move will be on the CNB agenda for the remainder of 2019. Also in 2020, CNB rates on hold look consistent with our baseline scenario for GDP and inflation.

Breakdown of GDP growth by demand*



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

In 1Q19, GDP growth remained stable and contributions of its main components changed only little. Consumption continued to be the key driver. Gross fixed capital slowed sharply but gross capital (including inventory change) eased more moderately. Net exports' input was nil after four previous quarters of negative figures.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	1Q19		4Q18 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**2.6**	**2.6**	**2.6**	**2.6**
Household consumption (%)	2.7	1.3	2.2	1.0
Government consumption (%)	3.4	0.7	3.6	0.7
Fixed capital formation (%)	3.4	0.9	10.4	2.6
Change in inventories	-	-0.3	-	-1.6
Net exports	-	0.0	-	-0.2

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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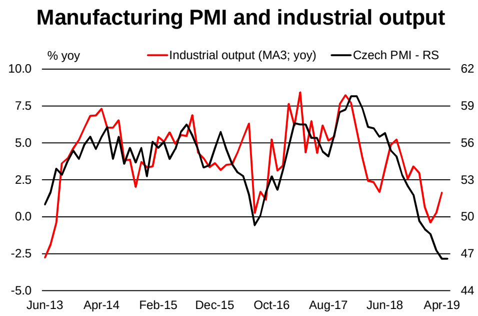
1Q19: LIMITED RESPONSE TO GLOBAL WOES AS YET

In 1Q19, real GDP added 0.6% qoq, leaving the yoy dynamic unchanged at 2.6% yoy. Private consumption partially recovered its momentum to 2.7% yoy, whereas government consumption eased to 3.4% yoy. Fixed capital formation experienced a rather dramatic slowdown from previous double-digit growth to 3.4% yoy, with all investment-related categories of capital maintaining growth which however turned slim for transport equipment and intangibles. The inventory level was lower than a year ago, causing gross capital slow even more sharply to 2.2% yoy. Exports rose by 2.0% yoy, posting the slowest pace since 3Q13. With imports showing a similarly weak figure (2.1% yoy), the contribution of net exports to GDP remained flat. Nominal GDP expanded by a solid 5.8% yoy, as GDP deflator reached a decade-high growth (3.1% yoy). From the production side, growth was very balanced across sectors with only agriculture being an exception with a yoy decline. The compensation of employees grew by 8.1% yoy, the same pace as in 4Q18, while gross operating surplus and mixed income accelerated to 4.6% yoy. Faster growth of the fomer than the latter parameter nevertheless brought the share of compensation to GDP to an all-time high (45.3%). Total employment in the national accounts was higher by 1.4% yoy, of which the number of employees rose 1.6% yoy. However, the full-time-employee-based statistics displayed only a 0.8% yoy rise of employment, suggesting that part of the employees worked substantially less on average than a year ago. We attribute this primarily to manufacturers contracting fewer agency workers.

In general, the economic situation looked solid in 1Q19, with a limited response observed as yet to global woes such as foreign trade disruptions caused by the US policy or Brexit.

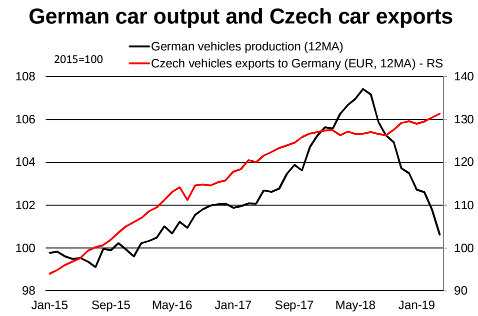


Sources: Markit, CZSO, UniCredit Research.

With manufacturing PMI dropping to the lowest level since 2012, industrial output was expected to stagnate or even shrink. In April, the industry rebounded instead, defying the contracting signal. A short-term outlook for industry remains rather positive, as indicated by new orders.

2Q19: INDUSTRY HELPS TO KEEP GDP MOMENTUM

Industrial output rebounded in April (3.3% yoy) after a weak start in 2019, with car manufacturing even posting 5.4%. April order books (9.0% yoy in CZK nominal terms) suggest that a couple of more solid months may follow in industry. In the same vein, exports surprised in April by its fast dynamic (7.4% yoy). The structure of exports shows that car and car-component demand from Germany has returned to a pre-WLTP (i.e. new emission standards) mode, with monthly volumes comparable with 2017 rather than 2018. Retail sales (ex-auto) posted 6.9% yoy, the strongest figure so far this year, although helped by the Easter holidays' timing. Construction output in April also expanded firmly (8.9% yoy). Out of the high-frequency data, only new car registrations were poorer (April: -5.6%, May: -5.9% yoy). Hence, the question comes how the prevailing positive hard economic data fare with a depressed level of manufacturing PMI (46.6 in May, unchanged from April). In our view, this is a general problem of soft indicators which tend to be correct trend-wise but inaccurate time-wise. As to 2Q19 GDP, we currently estimate a stable pace at 0.5% qoq and 2.6% yoy.



Sources: Macrobond, CZSO, UniCredit Research.

For many years, fortunes of Czech automotive exporters seemed to be closely linked to an expansion of German vehicles production. Since mid-2018, however, German output has been falling while Czech car exports have resumed growth after a brief stagnation. This is partly related to a higher share of finished cars versus parts and accessories in the overall exports to Germany. We nevertheless suspect that the gap will not keep open for too long.

THE OUTLOOK: RESILIENCE TESTING

Economic activity remains resilient in front of external headwinds, helped by several factors. First, private spending continues to benefit from tight labor market and fast wage growth. Second, construction activity remains in a full swing, driven by optimism in the corporate sector and the upswing of public infrastructure projects. Third, the automotive sector appears to have overcome the WLTP (new emissions standard) shock which affected car output for the most of 2018 and in early 2019.

However, growth is likely to ease gradually, to 2.4% in 2019 and 2.0% in 2020, due to a slowdown in eurozone, trade conflicts and Brexit. That said, we have stepped back a bit in our pessimism from three months ago on both 2019 and 2020.

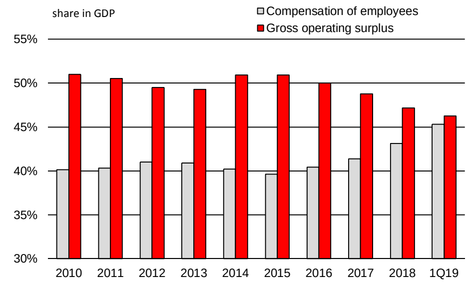
Private consumption is set to be the most stable component of GDP growth. The labor market remains very tight, with unemployment rate at 2.6% having very little space to go further down. Employment in industry, admittedly, has already started to decline (-0.4% yoy in April). Also, the increment of job vacancies in the whole economy in 5M19 slowed to a third of those from 5M18. With employment (in national accounts) expected to add 0.6% in 2019, wage growth may keep the current momentum until late 2019, turning slightly weaker thereafter. This bodes well for real private consumption expanding 2.5% in 2019, slowing (along with a tad lower inflation) towards 2.0% by 2020. In fact, real wages alone would leave a bit more space for private spending growth but the double-digit house price growth takes too much money out of the buyers' pockets. Due to a demand overhand that is unlikely to be covered soon, housing market may take time to cool off, despite the CNB's efforts.

We have turned somewhat more upbeat on housing construction. It appears that stricter rules on mortgage lending in place since October 2018 have not slowed developers' new projects. In the first four months of 2019, housing starts added more than a quarter yoy. Along with other construction segments, notably the EU-co-financed public infrastructure projects, the order stock for construction output hit the highest level since 2010. This fact is unlikely to add much to GDP growth in 2019 but it may act as a welcome stabilizer for the sector thereafter, when an order intake weakens.

We expect total fixed investment to grow by 2.4% in 2019 and 1.0% in 2020, driven by private capex, housing and infrastructure projects. The companies' gross operating surplus accelerated in 1Q19 to 4.6% yoy despite employee compensation increasing their share in gross value added. As a result, we expect companies to continue to invest into machinery and equipment, with transport vehicles turning to be the weakest capex component in 2019.

Industrial output is projected to add only 1.5% in 2019, despite its solid outlook for 2Q19. The same sub-standard dynamic is expected for 2020. Exports in constant prices may expand 2.0% in each of 2019 and 2020, with external demand bringing a limited support to GDP growth.

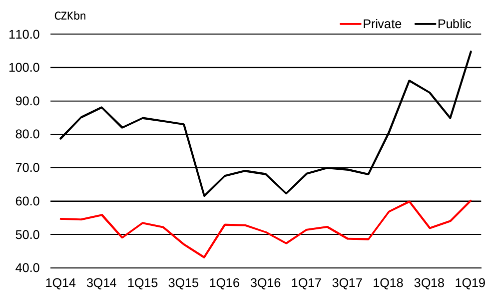
Gross operating surplus and compensation of employee



Sources: CZSO, UniCredit Research.

The compensation of employees as a share of GDP has been on a constant rise since 2016, further sharply accelerating in 2018. in 1Q19, it reached an all-time high at 45.3%, almost balancing the share of gross operating surplus and mixed income. While still lower than in some other countries, the rising share of compensation could become a problem for many companies when GDP growth slows.

Stock of construction orders



Sources: CZSO, UniCredit Research.

The stock of construction orders hit the highest level since 2010 for both the building and the infrastructure segments. This could keep momentum of the construction activity high if it were not be for supply-side constraints, notably labor shortage.

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CNB POLICY: ON HOLD UNTIL 2020-END

By raising the repo rate to 2.0% in May, the CNB delivered the amount of policy tightening suggested in its inflation report. Since the May inflation report, momentum seems to be moving away from the central bank's tightening bias. Tomáš Holub, an influential member of the MPC, considers that hikes and cuts carry equal probabilities as a next policy move. We regard this to be a game changer. Indeed, additional tightening steps may also be prevented by (our as well as ČNB's) expectation of CPI slowing in 2020. We maintain our view that no policy move will be on the CNB agenda for the remainder of 2019. Also in 2020, CNB rates on hold look consistent with our baseline scenario for GDP and inflation. Policy easing might materialize only if the economic outlook deteriorated beyond our baseline view.

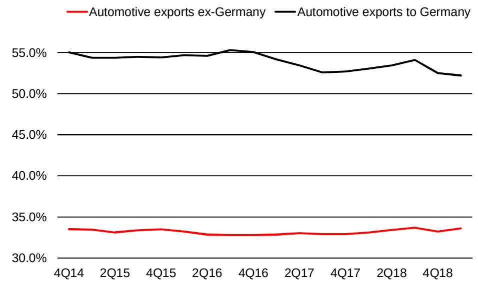
FOCUS: WHAT STANDS BEHIND CZECH EXPORTS' RECENT OUTPERFORMANCE?

Exports are the key driver of the Czech economy, with Germany being its key trading partner. The Czech as well as German industrial production form an integral part of global value chains and both tend to be sensitive to changes in global business sentiment, as measured by various leading indicators. Lately, however, Czech exports have been doing better than suggested by leading indicators.

We have tried to model yoy changes of Czech exports by one of the available sentiment indicators for exports, i.e. #1 the CZSO's new non-domestic industrial orders; or #2 export orders in the German manufacturing PMI. The model was tested with up to a seven-month lag and completed by other parameters such as German Ifo manufacturing expectations (with no lag), EUR-CZK, number of working days and autoregressive terms. All the variables showed some statistical significance on the 2003-2019 data sample. As the leading indicators started to slump since half-2018, we have made a dynamic forecast from that moment onwards. As can be seen from the chart on the right, historical discrepancies of the forecast were typically being quickly corrected in our preferred model #1. However, since February 2019, the exports dynamic has been deviating from the model quite persistently. In April, exports grew by 7.4% yoy, while (#1) only pointed at 2.0% yoy and #2 even predicting -4.6%.

Thus, the international sentiment data has lost some of their forecasting power on Czech exports recently. A tempting conclusion could be that the Czech economy has been successful in cutting its dependency on global value chains. If true, this would be demonstrated by an increasing share of final products in the structure of exports. This has indeed been observed in automotive segment but only to a small extent and only in exports to Germany. Anyway, we expect the discrepancy to disappear before long. Either export sentiment indicators will improve, or the Czech exports' performance will deteriorate. The latter looks more likely indeed.

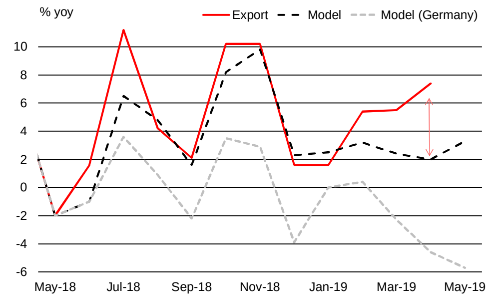
Share of parts and accessories in total automotive exports (quarterly data MA4)



Sources: CZSO, UniCredit Research.

Almost a half of Czech automotive exports is made of parts and accessories, as opposed to finished cars. In exports to Germany, the share even exceeds 50% but has been sinking lately. It remains stable at one-third for other markets.

Czech exports dynamics – actual and modelled



Sources: CZSO, UniCredit Research

Since mid-2018, German PMI export orders have completely lost their forecasting power on Czech exports. The CZSO's non-domestic industrial orders sentiment provided a good fit until January but has started to underestimate Czech exports since. We expect the exports' outperformance not to sustain long.

Czech Republic Macroeconomic Outlook

	2016	2017	2018	2019 forecast	2020 forecast
GDP growth (real yoy change, %)	2.4	4.5	2.9	2.4	2.0
Household consumption (real yoy change, %)	3.6	4.4	3.2	2.5	2.0
Gross fixed capital formation (real yoy change, %)	-3.3	4.1	10.4	2.4	1.0
Industrial output (real yoy change, %)	3.4	6.5	3.0	1.5	1.5
Unemployment rate (average, %)	5.5	4.2	3.2	2.9	3.2
Inflation rate (CPI yoy change, average, %)	0.7	2.5	2.1	2.6	1.9
Average wages (nominal yoy change, %)	4.4	6.8	7.5	6.6	5.0
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	25.60	25.10
Current account balance (% of GDP)	1.6	1.7	0.3	0.6	0.9
FDI net inflow (% of GDP)	3.9	0.9	1.7	1.3	1.5
General government balance (% of GDP)*	0.7	1.6	0.9	-0.4	-1.0
Public debt (% of GDP)	36.8	34.7	32.7	31.5	31.3

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