Czech Economic Quarterly

September 17, 2019

A tale of two halves

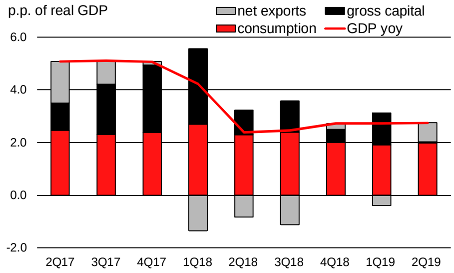
- In 2Q19, real GDP added 0.7% qoq, leaving the yoy dynamic unchanged at (an upwardly revised) 2.7% yoy. Private consumption expanded at the same pace, whereas government consumption slightly accelerated to 3.4% yoy. Fixed capital formation further slowed to 0.9% yoy. The inventory change was slightly negative, causing the contribution of gross capital to stay flat yoy. Net exports edged in a surplus proportionate to 0.7% of GDP.

- Signals about 3Q19 remain mixed. July industrial and construction output rose on a yoy basis, helped by a working-day effect. Retail sales performed the best among the short-term indicators, serving as a clear sign of an ongoing expansion of private consumption. In total, we expect 3Q19 GDP slowing to 0.2% qoq and 2.5% yoy.

- The resilience in the face of external headwinds, which helped the economy in 1H19, is expected to be fading. We expect GDP growth to ease below 2% yoy in 4Q19, reaching 2.4% for the full year. For 2020, we stick to our GDP forecast of 2.0% but stress that a recovery in global demand is probably needed to achieve that.

- Inflation appears to be rather sticky. We expect the ČNB to hesitate on cutting the repo rate even after the ECB has committed to more policy easing. ČNB rates are very likely to remain on hold until mid-2020, while even thereafter, cutting them would look as an emergency rather than baseline scenario.

Breakdown of GDP growth by demand*



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

Gross capital formation stopped contributing to GDP growth yoy in 2Q19, as fixed capital was marginally up but the level of inventories fell by the same token. Lower investment-related imports helped reverse the net exports' negative input to GDP. In line with recent trends, consumption accounted for three-quarters of total GDP growth.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	2Q19		1Q19 revised	
	YoY change	**% of change in GDP***	**YoY change**	**% of change in GDP***
GDP total	**2.7**	**2.7**	**2.7**	**2.7**
Household consumption (%)	2.7	1.3	2.7	1.3
Government consumption (%)	3.4	0.7	3.0	0.6
Fixed capital formation (%)	0.9	0.2	3.3	0.8
Change in inventories	-	-0.2	-	0.4
Net exports	-	0.7	-	-0.4

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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2Q19: STABLE GROWTH ON CHANGING STRUCTURE

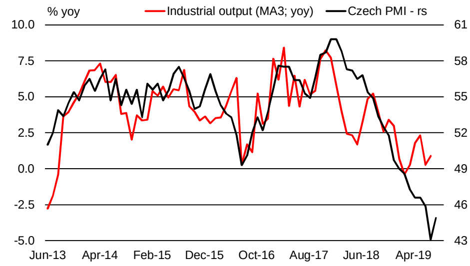
In 2Q19, real GDP added 0.7% qoq, leaving the yoy dynamic unchanged at (an upwardly revised) 2.7% yoy. Private consumption expanded at the same pace, also maintaining its momentum from the last period, whereas government consumption slightly accelerated to 3.4% yoy. Fixed capital formation further slowed to 0.9% yoy, as dynamics eased for all investment categories but infrastructure, while for machinery and transport equipment the volume slipped into an outright yoy fall. The inventory change was also slightly negative, causing the contribution of gross capital to stay flat yoy. Exports moderately accelerated to 2.2% yoy, which was partly the result of a seasonal adjustment (without which growth would record 1.5% yoy). Imports rose 1.4% yoy, leaving net exports in a surplus proportionate to 0.7% of GDP. Nominal GDP expanded by 6.4% yoy (6.1% in unadjusted terms), as GDP deflator hit yet another decade high of 3.5% yoy. From the production side, growth was seen across sectors but in information and communication, its pace stood out with 8.9% yoy. Gross operating surplus and mixed income recorded a solid 5.1% yoy growth despite compensation of employees easing the momentum only marginally to 7.6% yoy (from previous 8.0%). Total employment was higher by 0.8% yoy, posting the lowest increment since 3Q14.

In the light of GDP contraction in Germany and sluggish growth elsewhere in Europe, the Czech economy showed up once again much resilience. This is attributed mainly to an ongoing demand for Czech-made cars in Europe, bolstering exports. Yet, the structure of 2Q19 GDP growth, with fixed capital and employment easing, has provided a strong signal that a slowdown in GDP will follow before long.

3Q19: AT A START OF A SLOWDOWN

Signals remained mixed. July industrial output increased by (unadjusted) 5.6% yoy, helped by two more working days against the base month and a shift in the Škoda Auto company-wide holidays (car manufacturing added 22.6% yoy in July). In August, manufacturing PMI posted its first uptick after 13 months of a decline. However, neither the index level (44.9) nor its breakdown into components looked particularly promising. What improved were current output and backlogs of work, while new orders remained depressed. July foreign trade painted a similar picture, with the balance improving yoy by CZK 8 billion but finished cars being the only systemically growing product in exports. Construction output rose in July by (unadjusted) 6.5% yoy but the momentum remained solid only for infrastructure, while it seemed to be slowing for buildings. New car (passenger+LUV) registrations stabilized in July (+1.6% yoy) but resumed its long-term fall in August (-8.3% yoy). Retail sales (ex-auto, unadjusted 7.0% yoy in July) performed the best among the short-term indicators, serving as a clear sign of an ongoing expansion of private consumption. In total, we expect 3Q19 GDP slowing to 0.2% qoq and 2.5% yoy. In the structure of growth, net exports may contribute less and fixed capital more than in 2Q19, the latter being the result of completing the first phase of Nexen Tire's EUR 900m greenfield investment.

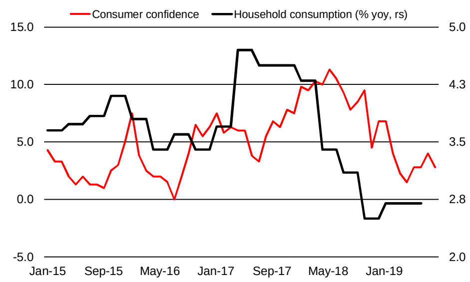
Manufacturing PMI and industrial output



Sources: Markit, CZSO, UniCredit Research.

Manufacturing PMI showed first signs of stabilizaton in August after a long and deep fall. The index level looks consistent with a sizeable contraction in industrial output. We regard PMI a useful signal for changing trends in industry. To what extent it will prove precise to forecast a magnitude of output contraction, is yet to be seen.

Consumer confidence and private consumption



Sources: Macrobond, CZSO, UniCredit Research.

The slowdown of real private consumption from its peak above 4% yoy looks consistent with the consumer confidence deteriorating. Unless the confidence deteriorates further, however, household spending should keep expanding at a dynamic close to recent ones.

4Q19 AND 2020: WEAK SPOTS TO EXTEND

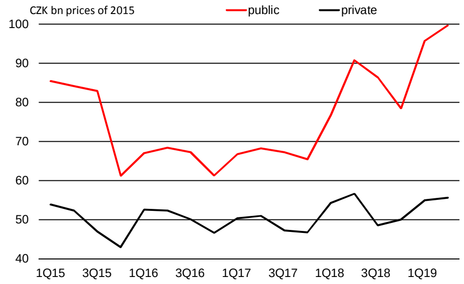
The resilience in the face of external headwinds, which helped the economy in 1H19, is expected to be fading. Exports will be losing momentum, as global value chains may start de-stocking after keeping high levels of inventories in the run-up to the 31 October Brexit deadline. Weaker exports are set to affect manufacturers' performance, turning them less generous towards their employees from 2020 onwards. Subsequently, private consumption may slow in 2020, following with some delay the other demand-side components of GDP in their reaction to a downbeat global sentiment. We expect GDP growth to ease below 2% yoy in 4Q19, reaching 2.4% for the full year. For 2020, we stick to our GDP forecast of 2.0% but stress that a recovery in global demand is probably needed to achieve that.

What may bolster GDP growth is the pipeline for construction-related investment. The value of pending orders has been on the rise since the start of 2018 and now exceeds the previous cyclical peak from 2015, measured in constant prices. Admittedly, future growth in the construction sector stands only on one leg, as the value of public orders is sharply up but private orders stagnate. We see restrictions in the sector affecting supply more than demand. In order to overcome those, companies are gradually getting rid of their foreign orders for the benefit of domestic ones. While in mid-2015, foreign orders accounted for 16% of the total, their weight fell to 6.5% in 2Q19. The shift from foreign to domestic projects is set to make the overall construction output look worse than its contribution to GDP. We expect the sector's domestic value added to grow by 5% yoy in 2H19 and by 4% in 2020.

Compared to construction, there are fewer reasons to be optimistic about industrial output. This is not only due to Brexit or US-China trade conflicts but also because of a mature phase in the global investment cycle. As a bright spot in a generally gloomy outlook, Škoda Auto may still give a boost to industrial output. Unlike its sales in China, which are less relevant from the domestic value-added viewpoint, its EU sales have been on the rise despite the overall market moderately contracting. Considering waiting lists for its new models, the output of Škoda Auto could expand until at least mid-2020. Admittedly, car manufacturing is one of the sectors to be potentially hit the most by a hard Brexit.

Household consumption is likely to remain strong for several quarters. Lower demand for labor in the sectors most exposed to external woes has been offset by firing agency workers who were mostly foreigners. Some companies in services continue to increase employment. Unless industrial output plummets, the unemployment rate is unlikely to face more than a mild correction. Wage growth has barely started to slow, as corporate financial results looked solid until 2Q19. We expect a deterioration for the latter in 2H19 but it will take a while for a knock-on effect on wages to emerge. In addition, the Finance Ministry has retreated from its initial stringent proposal of a 2% hike for public sector salary bill. We see this as a reason to slightly revise upwards our former 5% estimate of 2020 nominal wage growth. Real wages are thus likely to add 3%, allowing for a solid consumption growth in 2020.

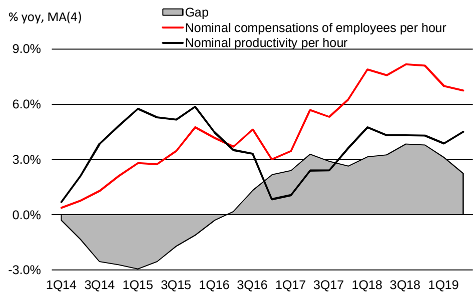
Value of construction orders (end of each period)



Sources: CZSO, UniCredit Research.

Looking at the overall value of construction orders, the sector might seem to have a relatively bright future. However, orders in constant prices are higher than a year ago only from public, not private investors. Hence, in 2020, the infrastructure segment will remain a driving force for construction output, while the same cannot be said about the building segment.

Labor productivity and wages



Sources: CZSO, UniCredit Research.

Poor productivity gains remain a challenge for (not only) the Czech economy. While growth in the product per hour worked has been fluctuating around 4% yoy, compensation of employees grew 3 p.p. faster until recently. The gap has slightly narrowed in 1H19 but is still seen as unsustainably high.

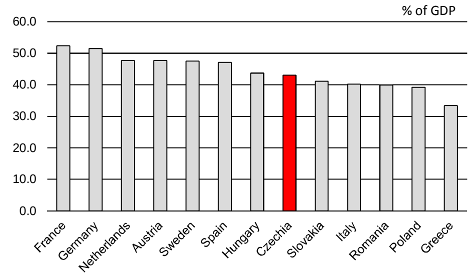
CNB POLICY: RATE CUTS ONLY IN EMERGENCY

Inflation appears to be rather sticky, which is apparent not only from CPI. In 2Q19, GDP deflator hit 3.5% yoy with only a minor contribution from the terms of trade. A similar situation has not been observed since 2004. Under the circumstance, we expect the ČNB to hesitate on cutting the repo rate even after the ECB has committed to more policy easing. In this vein, a weaker-than-projected koruna serves as yet another argument for the monetary policy inaction. A lower EUR-USD FX rate than previously expected (by the ČNB and by us) means that the koruna may not strengthen in effective terms either. For those reasons, several ČNB board members have lately indicated a longer period ahead with the rates on hold and we think their call is credible. In our view, this is very likely to remain the case until mid-2020, while even thereafter, cutting rates would look as an emergency rather than baseline scenario.

FOCUS: WAGES VERSUS CORPORATE PROFITS

One way to look at a structure of GDP in an economy is through the breakdown between the part which companies and institutions pay out as compensation to their employees (gross wages and mandatory contributions) and the part which they book as their income (gross operating surplus). In 2013, employee compensation in Czechia accounted for 40.9% of GDP, which was well below that of gross operating surplus at 49.3% (technically, income of the self-employed, so called mixed income, is also shown as part of that figure). This served as an argument for left-wing economists and trade unionists to push for higher wages. Meanwhile, the share of compensation in GDP rose to the all-time high of 43%, reaching a middle ground in the EU-28 between France and Denmark (52.4% each) and Ireland (28.8%). Does it however make sense to argue that wages are low just because gross operating surplus (linked to corporate profits) accounts for a higher share in GDP? We point out that a sustainable share of wage compensation in GDP is not the same for each economy. It derives from at least two major factors. First, capital-intensive economies need a higher share of profits to GDP in order to replace their depreciated capital. Second, an economy with a higher share of self-employed workers in total employment will tend to have the share of compensation in GDP lower. The latter makes the breakdown biased, since part of entrepreneurs' income is used to cover their basic needs, serving the same purpose as employees' wages. In Czechia, with the structure of the economy oriented on capital-intensive manufacturing, a "natural" level of gross operating surplus in GDP should be higher than for a more service-based economy. As to the second factor, mixed income of the self-employed, its influence on Czech data remains less clear-cut. On the one hand, the self-employed account for an above-EU-average 14% of total employment, their average income is on the other hand rather low. Anyway, 2019 will see yet another hike in the share of employee compensation, which may pressure on structural changes in the Czech economy. We expect similar changes in other countries (such as Romania, and Slovakia) where employee compensation rose enormously in 2013-2018.

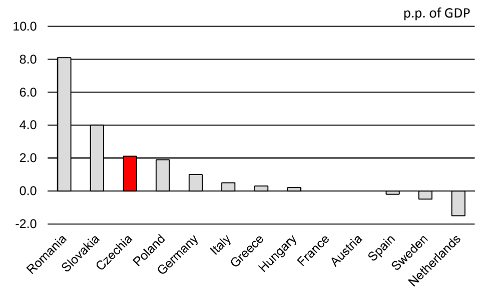
Compensation of employees (2018)



Sources: Eurostat, UniCredit Research.

At 43% of GDP, compensation of employees in Czechia is in the middle of the EU spectrum. Importantly, cross-county differences are not driven just by a level of GDP or the "old-EU" versus "new-EU" attribute. An important role is played by a structure of an economy.

Change in compensation of employees (2018-2013)



Sources: CZSO, UniCredit Research

The share of employee compensation on GDP has been a relatively stable indicator over time, with larger swings between 2013-2018 occurring solely in the CEE region. Notably, Romania has experienced a convergence leap to the others in the region. The open question is what implications the fast convergence will have for an economic structure.

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	3.3	2.6	2.2
Gross fixed capital formation (real yoy change, %)	-3.2	4.0	7.1	1.4	1.0
Industrial output (real yoy change, %)	3.4	6.5	3.0	0.3	1.5
Unemployment rate (average, %)	5.5	4.2	3.2	2.8	3.1
Inflation rate (CPI yoy change, average, %)	0.7	2.5	2.1	2.8	2.2
Average wages (nominal yoy change, %)	4.4	6.8	7.5	6.8	5.2
Interest rates (3-M PRIBOR, end of period, %)	0.28	0.75	2.01	2.14	2.14
Interest rates (3-M PRIBOR, average, %)	0.29	0.41	1.27	2.11	2.14
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	0.9	1.1
FDI net inflow (% of GDP)	3.9	0.9	1.7	1.2	1.4
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	31.2	30.8

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