Czech Economic Quarterly

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A two-speed economy

- In 3Q19, real GDP added 0.4% qoq, bringing the yoy dynamic two notches down to (adjusted) 2.5% yoy. Private and government consumption weakened slightly from 2Q19, while fixed capital formation ran into a contraction (-0.3% yoy). Net exports delivered a positive contribution to growth worth of 0.7% of GDP.

- In October, industrial and construction output dipped in yoy working-day-adjusted terms, whereas retail sales displayed a broadly stable dynamic from previous periods. For the whole of 4Q19 we expect a yoy contraction in industrial output but better performance in other economic sectors. 4Q19 GDP is projected at 0.1% qoq and 1.7% yoy. Full-2019 GDP may post 2.4%.

- 2020 will be a difficult year in economic terms. Industrial output and the volume of exports are only projected to stagnate, while the sectors of ICT, construction and services related to private consumption are relied upon as drivers of expansion. GDP growth is forecast at 1.9%.

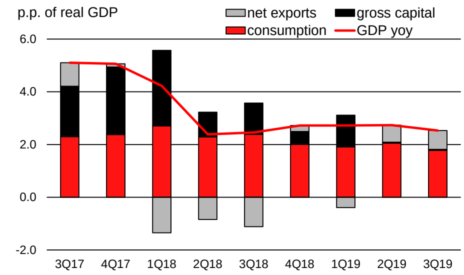
- CPI is set to stay close to 3% yoy until 2Q20 and ease only marginally thereafter. However, the bar for ČNB rate hikes remains high. A monetary policy easing may in contrast become the first option under consideration from late 2020. That would be needed in the case of a long-lasting slowdown in the eurozone, the situation that could derail consumer confidence also in Czechia. Our baseline scenario for 2021 is that of less upbeat private consumption but of a moderate recovery in investment and exports driving the economy to a new cycle.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	3Q19		2Q19 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**2.5**	**2.5**	**2.7**	**2.7**
Household consumption (%)	2.3	1.1	2.9	1.3
Government consumption (%)	3.3	0.7	3.5	0.7
Fixed capital formation (%)	-0.3	-0.1	1.4	0.3
Change in inventories	-	0.1	-	-0.3
Net exports	-	0.7	-	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.

Breakdown of GDP growth by demand*



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

For the second quarter in a row, gross capital formation was flat yoy in 3Q19. Net exports delivered the same contribution to GDP growth as in 2Q19. The overall (albeit marginal) GDP slowdown in 3Q19 versus 2Q19 was brought about by lower inputs from both private and government consumption.

Authors:

Pavel Sobisek
Tel: +420 955 960 716
E-mail: pavel.sobisek@unicreditgroup.cz

Jiří Pour
Tel: +420 955 960 717
E-mail: jiri.pour@unicreditgroup.cz

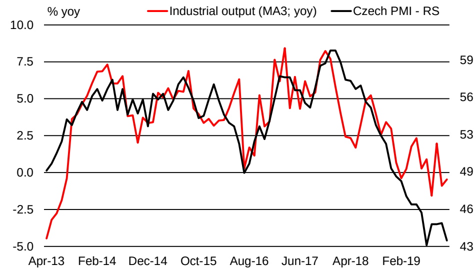
UniCredit Bank Czech Republic and Slovakia
Internet: www.unicreditbank.cz

3Q19: MORE SIGNS OF A SHIFT IN CYCLE

In 3Q19, real GDP added 0.4% qoq, bringing the yoy dynamic two notches down to (adjusted) 2.5% yoy. Private consumption slowed to 2.3% yoy, its lowest reading since 3Q14. Government consumption expanded by 3.3% yoy, also weakening slightly from 2Q19. Fixed capital formation ran into a contraction (-0.3% yoy) for the first time since 1Q17, as growing investment into dwellings failed to outweigh falling machinery outlays. The volume of exports rose by 1.8% yoy, outperforming the global trade dynamic which posted a 1% yoy dip. With the volume of imports up only 1.0% yoy, net exports delivered a positive contribution to growth worth of 0.7% of GDP. Nominal GDP expanded by 6.2% yoy (6.4% in 2Q19), as the GDP deflator remained at a decade-high 3.6% yoy reached for the first time in 2Q19. From the production side, growth was again seen across sectors, was again the highest in information and communication (8.1% yoy), whereas in industry it slowed to mere 0.5% yoy. Gross operating surplus and mixed income surprised on the upside, posting 7.8% yoy and outpacing compensation of employees (6.8% yoy) for the first time since 3Q15. Total employment growth eased to 0.6% yoy with the number of employees up 0.8% yoy, maintaining the productivity gain per employee at 1.9% yoy (and higher than the 1.6% in the whole of 2018).

Two findings in the 3Q19 data are worth pointing out. First, from the production side, variance in gross value added among sectors was on the rise. Second, fixed capital formation stopped supporting GDP growth from the demand side. Both findings are typical for a phase changening in economic cycle and their apperance now comes as no surprise.

Manufacturing PMI and industrial output



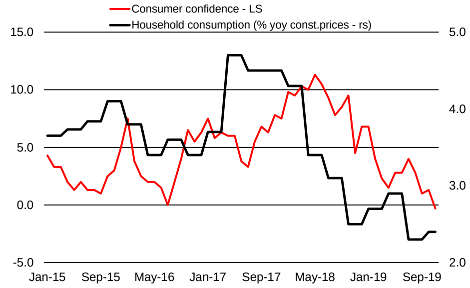
Sources: IHS Markit, CZSO, UniCredit Research.

Recent months brought a lot of volatility and some signs of stabilization at low levels to both the industrial output and manufacturing PMI. The gap between the two series, in place since early 2019, has nevertheless remained unchanged. Our interpretation of the persisting gap is that demand in industry is probably set to get worse before it gets better.

4Q19: SEEING FIRST DROP IN INDUSTRY SINCE 2Q13

Working-day-adjusted industrial output dropped by 0.4% yoy in October (-3.0% yoy without adjustment) and is probably on course of posting a yoy decline in the final quarter of 2019, the first one since 2Q13. The outlook is consistent with PMI and new orders for manufacturing, as well as a negative base effect in the production of motor vehicles. Similarly, (adjusted) construction output was down 0.3% yoy in October. We nevertheless expect construction to maintain moderate yoy growth in 4Q19, as public infrastructure projects will provide it some support. October retail sales posted 4.6% yoy adjusted growth, with the dynamic broadly stable from previous periods. We expect marginally weaker yoy growth for the whole of 4Q19, caused by an uptick in CPI. With unemployment rate remaining at 2.6%, the all-time low, until November, we expect a rise in private consumption to be broadly unaffected in 4Q19. New passenger cars added 1.2% and 4.6% more registrations yoy in October and November, respectively. However, registrations of trucks and LUVs tumbled in the same period, suggesting that companies have turned cautious on their capital spending. In total, 4Q19 GDP is projected to add only 0.1% qoq, bringing the yoy dynamic sharply down to 1.7%. Full-2019 growth would thus post 2.4%, with 3Q19 likely to be revised slightly down due to a revision in trade balance.

Consumer confidence and private consumption



Sources: CZSO, UniCredit Research.

The consumer confidence has been slowing since one and half years ago. Its level, however, is still above the decade-long average (-9.4) and consistent with decent growth of private consumption.

2020: ENTERING A TWO-SPEED ECONOMY

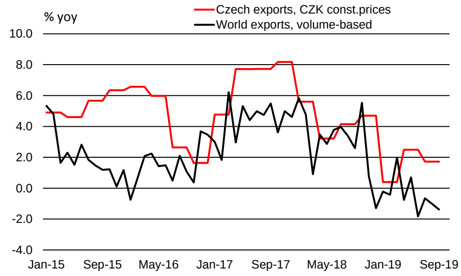
There is every reason to believe that 2020 will be a difficult year in economic terms. The slowdown in economic activity, observed since 2Q19, is set to deepen. **Manufacturing** faces a weakness in at least first several months of 2020 based on November PMI that returned to a sub-44.0 band, the lowest level since 2009. In the same vein, a different market research sees a 2% drop in production and a substantial decrease in profits for machinery companies. With the EU being a dominant export market and all major producers being part of global value chains, a full-fledged global recovery and not just that in niche markets would be needed to turn around the depressed outlook. Thus, the full-2020 manufacturing output is seen stagnating, as are export volumes. In addition, the outperformance of **Czech exports** over global trade dynamics is about to fade away, as the flagship automotive sector will no longer be able to rely on a positive base effect, unlike 2019. **Capital spending** of manufacturers may be posting outright contraction until signs of a rebound in global demand are spotted.

That said, the picture remains more upbeat outside manufacturing. First, we foresee an ongoing expansion in the **ICT sector** which may benefit from the corporate focus on digital economy. Apart from domestic sales, the sector will also add to exports of services. Second, **construction** is believed to continue boosting production, but by just a couple of percent in 2020. We expect solid demand in residential construction, a small rise in infrastructure projects but a decline in non-residential buildings. Whereas a lack of human resources was the key problem for the sector until recently, the barrier has been shifting towards insufficient future demand. With deflator reaching 8.5% yoy, the most of all sectors, pricing of new contracts may become more difficult for investors to accept. Third, **service sectors** directly related to household demand should maintain a good performance.

Unless the slowdown in external demand turns more severe than we predict, **private consumption** may not be affected much. Admittedly, consumer sentiment has dropped to a five-year low but its level still looks consistent with decent growth in consumption. Furthermore, manufacturers may keep controlling their labor needs primarily via reducing foreign employment, in which case unemployment rate will have a limited upside. As is usual, a slowdown in nominal wages will be gradual and well lagging the output cycle. Salary negotiations in public institutions will bolster 2020 government consumption. We expect **household and government consumption** to add 2.3% and 2.7%, respectively, in 2020. A further deteriorating consumer sentiment is seen as the key risk for the scenario.

Fixed capital formation is projected to dip in 2020, with residential construction still on the rise but not enough to offset decreasing investment in machinery and transport equipment. State budget sees capital spending of public institutions to jump 19.5% above the 2019 budget thanks to a sizeable hike in EU funds inflow. This should make public infrastructure keep growing, although part of the hike will be eaten up by fast growing prices in the construction sector.

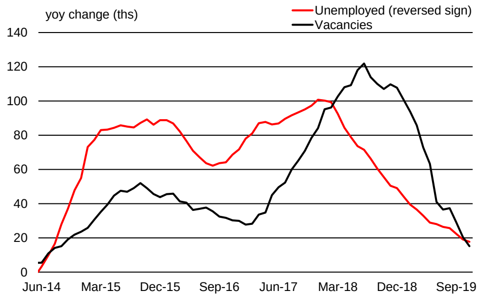
Dynamics of Czech and global exports



Sources: Macrobond, UniCredit Research.

Czech exports follow trends in global trade but are, at times, able to achieve higher dynamics. The spells of above-average growth in Czech exports derive largely from gains in the market share of Czech automakers. One such spell is just under way but may come to an end soon.

Number of the unemployed and job vacancies



Sources: MPSV, UniCredit Research.

Labor market pressures hit the peak in 2018 when in yoy terms the number of unemployed shrank by 100 thousand and a half year later the number of job vacancies rose by 120 thousand. By early 2020, the former yoy indicator is set to turn positive while the latter one negative. This is not to say, however, that the pressures would disappear entirely.

LASTING SLOWDOWN MAY URGE FOR RATE CUTS

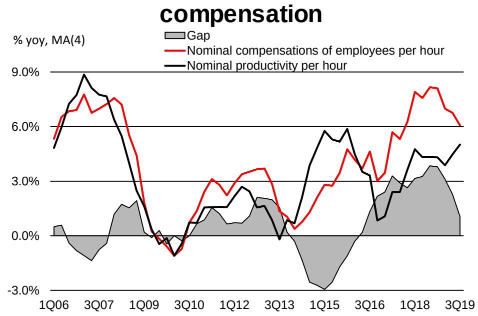
CPI is set to stay close to 3% yoy until 2Q20 and ease only marginally thereafter, which explains a hawkish rhetoric of some ČNB policy makers. However, the bar for actual rate hikes remains high, in our view. First, the ČNB staff model assuming two rate hikes followed by two cuts within 2020 creates a natural option for cautious central bankers to take decisions on neither side. Second, the model's 2020 GDP forecast (2.4%) is in our view prone to downward revisions. A monetary policy easing may in contrast become the first option under consideration from late 2020. That would be needed in the case of a long-lasting slowdown in the eurozone, the situation that could derail consumer confidence also in Czechia, turning poorer the outlook for private consumption and GDP growth in 2021. Our baseline scenario for 2021 is indeed that of less upbeat private consumption but of a moderate recovery in investment and exports driving the economy to a new cycle.

FOCUS: FOREIGN DEMAND ACCOUNTS FOR 10% TO 58% OF GDP ACROSS COUNTRIES

Recent months have shown that barriers to international trade are affecting economies disproportionally. This is not surprising, as economies differ in the degree of reliance on foreign demand. A simple ratio of exports to GDP (almost 80% for Czechia) is misleading, however, as it does not take into account imported inputs contained in exports. Based on the world input-output database (WIOD), we have therefore quantified the importance of foreign demand for 43 countries, taking into account only their own domestic value added. Czechia is one of the most export-dependent economies in the world, as its complete cut-off from foreign demand would cause a 43% drop in GDP, all else being equal. Hungary and Slovakia look similar, while Poland and Germany are slightly less reliant on exports (34%). The least dependent appear to be the USA (9.7%), Brazil (10%), India and Japan (just below 14% each). In the context of "trade wars", exports account for 19.5% of China's GDP, which is below the world average but still more than twice that of the US. The low export reliance of the US therefore gives D. Trump quite a legitimate confidence that the US economy would stay more resilient than the others in case of global trade tensions.

We could argue, however, that countries such as Czechia are naturally more dependent on foreign trade than large countries, as for a small country it is more difficult and less efficient to maintain both production and demand self-sufficiency. Using a simple cross-country OLS regression model, we have therefore estimated for each country the export reliance "justified" by a population size. The model explains 50% of export variance across countries, the other half being deviations from the "implied equilibrium". In this optic, Czechia's export reliance turns out to be well above its model value, with a deviation of 6.7pp. Ireland (18.4pp), Germany and Russia (10.4pp each) deviate even more. In contrast, countries with lower-than-modelled reliance include Greece (-19pp), Australia (-15.7pp) and Portugal (-13pp). The US and UK are by 5.6pp and 4.2pp less export-dependent, respectively, than their population size would suggest.

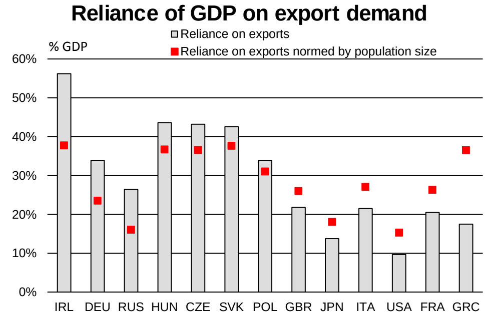
Labor productivity and employee compensation



Sources: CZSO, UniCredit Research.

Labor productivity and the compensation of employees used to be developing in tandem, with gaps staying relatively modest. Over the last three years, however, employee compensation were overtaking productivity by a margin not experienced before. The latest period, 3Q19, has further added to the cumulated imbalance. It is yet to be seen how the economy will cope with that.

Reliance of GDP on export demand



Sources: WIOD, UniCredit Research.

Ireland, Germany and Russia are the countries whose GDP is more driven by external demand than would correspond to a size of their population. The USA, France and Greece are examples of the opposite deviation between the reliance on exports in GDP and the number of inhabitants. Czechia is somewhat more export-dependent than its population size would suggest.

Czech Republic Macroeconomic Outlook

	2017	2018	2019 forecast	2020 forecast	2021 forecast
GDP growth (real yoy change, %)	4.5	2.9	2.4	1.9	2.1
Household consumption (real yoy change, %)	4.4	3.3	2.6	2.3	2.0
Gross fixed capital formation (real yoy change, %)	4.0	7.1	0.8	-0.5	1.5
Industrial output (real yoy change, %)	6.5	3.0	0.3	0.0	1.5
Unemployment rate (average, %)	4.2	3.2	2.8	3.2	3.5
Inflation rate (CPI yoy change, average, %)	2.5	2.1	2.8	2.6	2.1
Average wages (nominal yoy change, %)	6.8	7.5	7.0	5.7	4.8
Interest rates (3-M PRIBOR, end of period, %)	0.75	2.01	2.18	1.90	1.65
Interest rates (3-M PRIBOR, average, %)	0.41	1.27	2.11	2.08	1.77
EUR/CZK exchange rate (end of period)	25.54	25.73	25.70	25.40	25.30
EUR/CZK exchange rate (average)	26.33	25.64	25.70	25.50	25.30
Current account balance (% of GDP)	1.7	0.3	1.0	1.4	1.5
FDI net inflow (% of GDP)	0.9	1.7	1.1	1.2	1.1
General government balance (% of GDP)*	1.6	1.1	0.0	-0.7	-1.2
Public debt (% of GDP)	34.7	32.6	30.8	30.1	30.1

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