Czech Economic Quarterly

September 29, 2020

The time of reckoning

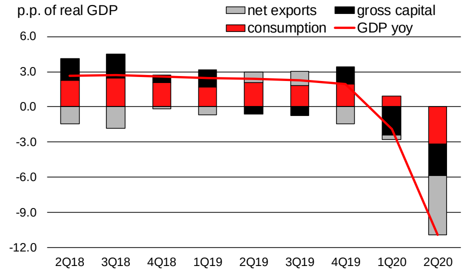
- In 2Q20, real GDP contracted by 8.7% qoq, bringing the yoy dynamic to -11.0%, the lowest figure on the record. All GDP components but government consumption contributed to the slump. From the production side, ITC and agriculture remained the only sectors to avoid a contraction. Hours worked declined by 10.6% yoy but total employment fell only by 1.9% yoy.
- The recovery, started in 2Q20, was ongoing in July and August but has lost part of its momentum in September, with the number of Covid-19 cases recording a steep rise. We expect GDP in our baseline scenario to rise 6% qoq in 3Q20, regaining about half of losses from the previous two quarters. The estimate leads to GDP at -6% yoy in 3Q20.
- Our baseline forecast has shifted to include a more-moderate GDP decline in 2020 (-6.4%), followed by more-moderate growth in 2021 (4.7%), in comparison to three months ago. Alternative scenarios see the figures slightly worse. Anyway, GDP is set to return to yoy growth from 2Q21.
- The government seemed to be taking uncontroversial measures at a start of the pandemic but has been moving towards more populist policies. It looks unable to reasonably boost other spending aside from social outlays. Absent is public debate on the utilization of the EU's recovery fund. The CNB policy is expected to remain on hold at least until late-2021, when a hike is conceivable.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	2Q20		1Q20 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**-11.0**	**-11.0**	**-1.9**	**-1.9**
Household consumption (%)	-7.6	-3.5	-0.2	-0.1
Government consumption (%)	1.8	0.4	4.9	0.9
Fixed capital formation (%)	-4.8	-1.2	-5.2	-1.4
Change in inventories	-	-1.4	-	-1.0
Net exports	-	-5.1	-	-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.

Breakdown of GDP growth by demand*



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

The all-time-deep yoy contraction of GDP in 2Q20 was brought about by all the three major demand-side components. Almost a half of it came from net exports. Consumption accounted for close to 30%, with gross capital being responsible for the remainder.

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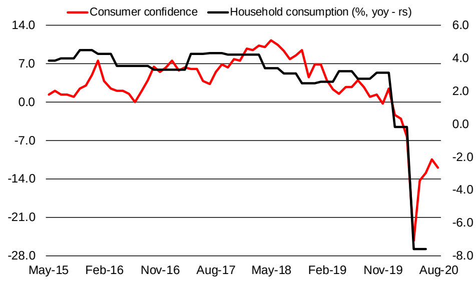
2Q20: RECORD-BREAKING DATA

In 2Q20, real GDP contracted by 8.7% qoq, bringing the yoy dynamic to -11.0%, the lowest figure on the record. Private consumption fell by 7.6% yoy, also the all-time low dynamic. Government consumption moderated the overall GDP slump by rising 1.8% yoy. Fixed capital formation was down by 4.8% yoy, slightly less than in 1Q20. Nevertheless, the inventory change was negative at 1.4% of GDP, a larger rundown than in 1Q20, which suggests that an additional contraction in fixed investment lies ahead. Real exports fell by 23.3% yoy, displaying another all-time low figure. With imports contracting distinctly less (18.2% yoy), net exports provided a negative contribution to growth worth a huge 5.1% of GDP. Nominal GDP dropped by 7.2% yoy, recording the first negative figure since 1Q13. From the production side, ITC and agriculture remained the only sectors to avoid a contraction. In contrast, gross value added in the sector of trade and transport declined by as much as 20.5% yoy. Hours worked declined by 10.6% yoy but total employment fell only by 1.9% yoy. Compensation of employees dropped by 2.3% yoy, whereas gross operating surplus and mixed income fell by 8.5% yoy.

The 2Q20 figures came as a result of highly uneven business development in individual months. After troughing in April, the economy set in a V-shaped recovery during May and June. Such a shape was facilitated by lifting most restrictions from the supply side and the fact that social transfers replaced a big chunk of households' income loss caused by the pandemic.

Consumer confidence and private consumption



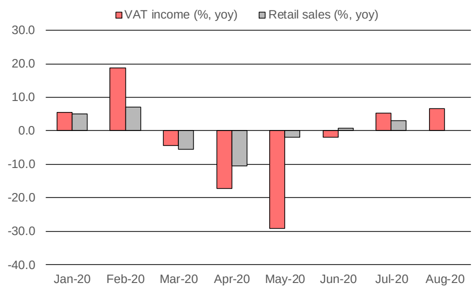
Sources: IHS Markit, CZSO, UniCredit Research.

Consumer confidence drifted upwards in June and July but has flattened the trend thereafter. This nevertheless looks consistent with household consumption to ease its yoy decline markedly in 3Q20.

3Q20: THE RECOVERY TO LOSE MOMENTUM

The recovery was ongoing in July and August but has lost part of its momentum in September. Industrial output eased its yoy contraction to (NSA) 4.9% in July and, judged by leading indicators as well as the highway toll collection, a similar pace may have been recorded in August. Construction output was nevertheless down by (SA) 9.8% yoy in July and we do not see any upturn for the coming months there. July sales in restaurants and hotels dropped by 23.3% yoy, as the number of visitors from abroad may have fallen by two-thirds this summer against the previous one. Retail (ex-car) sales expanded by 3.0% yoy in July, but we expect a bit worse figure for August when more Czech people were taking their vacations abroad. New (passenger + LUV) car registrations eased by 10% yoy in July but extended their losses to more than a third in August (although measured against a base elevated by the run-up to a new emission norm). Economic trends are set to deteriorate again in September, with the number of Covid-19 cases recording a steep rise. All in all, we expect GDP in our baseline scenario to rise 6% qoq in 3Q20, recovering about half of losses from the previous two quarters. The estimate leads to GDP at -6% yoy in 3Q20. Component-wise, household consumption is set to narrow the yoy slump to less than 3%, whereas fixed capital formation may deepen the yoy contraction to double-digit terms. Uncertainties surrounding the estimates remain considerable.

Retail sales and VAT collection



Sources: MoF, CZSO, UniCredit Research.

The dynamics of retail sales and a VAT collection are closely linked, with the latter lagging behind the former by one month. Indeed, the June upturn in retail sales was followed by a first positive yoy change in VAT collection in July.

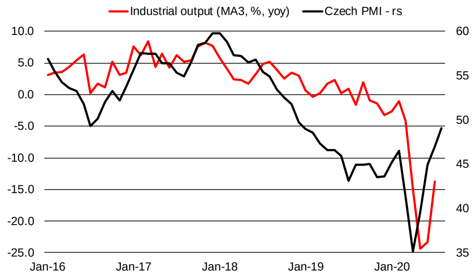
4Q20 AND 2021: THE TIME OF RECKONING

In comparison to three months ago, our baseline forecast has shifted to include a more-moderate GDP decline in 2020 (-6.4%), followed by more-moderate growth in 2021 (4.7%). The shift is set to occur, even if the economic recovery from 3Q20 is reversed in 4Q20 (our baseline scenario counts on a flat sequential GDP in 4Q20; alternative scenarios point to a shrinking GDP in 4Q20 and a marginally worse full-year figure – for detail see page 4). In terms of the GDP structure in 4Q20, we expect household consumption to post a slightly deeper yoy contraction than in 3Q20, while fixed capital formation is projected to maintain a double-digit yoy decline. In 2021, GDP is set to return to yoy growth from the second quarter. Whether this will be driven by improving consumer and business confidence in reaction to reaching a breaking point in fighting the pandemic or just by a technical aspect of the worst performing period falling out of the calculation base, remains to be seen. Anyway, we foresee private consumption to recover in advance of fixed capital formation. The recovery is set to be aligned with the rest of Europe, as almost half of Czech GDP is driven by demand from abroad, of which Europe accounts for more than two-thirds. Our view remains unchanged in that the GDP level of 2019 will be attained in 2022.

FISCAL POLICY:NEARING THE STIMULUS OVERDOSE

The government seemed to be taking uncontroversial measures at a start of the pandemic but has been moving towards more populist policies. First, maintaining the furlough scheme, which gives support even to employees who do not work at all, is driven by the political cycle rather than by macroeconomic needs. Second, the government has approved a one-off transfer to pensioners (in addition to their rather-generous pension indexation) at a cost of CZK 15bn. Finally, and most importantly, political leaders have proposed a permanent personal-income-tax cut worth CZK 80-90bn from 2021 onwards – this was done without any discussion about offsets on the revenue or expenditure sides of the budget. If implemented, the tax cut would lead to a positive fiscal impulse in 2021 for the second year running. To avoid threatening the long-term stability of Czechia's public finances, the government would probably have to tighten fiscal policy sharply in 2022, curbing GDP growth. The loosening of Czechia's traditionally solid fiscal discipline was facilitated by the smooth and inexpensive financing of this year's deficit, which was legally amended to gigantic proportions (CZK 500bn, 9% of GDP). We actually see the deficit significantly lower (7.3% of GDP for the whole public sector), as the government is unable to reasonably boost other spending aside from social outlays. Also absent, unlike in other EU countries, is public debate on the utilization of the EU's recovery fund (the CNB estimates an investment impulse from EU money at just 0.1% of GDP for 2021 and 2022). Nevertheless, this fits the perception that the government lacks ideas for an investment plan but does not lack money.

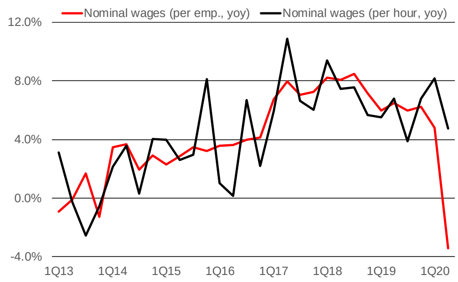
Manufacturing PMI and industrial output



Sources: CZSO, Markit, UniCredit Research.

Manufacturing PMI points to a mitigation of the slump, but not yet a recovery, of industrial output.

Nominal wages per employee and per hour



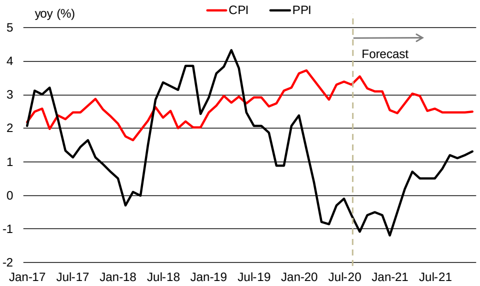
Sources: CZSO, Macrobond, UniCredit Research.

In 2Q20, an average employee worked a lower number of hours than previously due to sickness, quarantine or obstacles on his/her employer's part. The employee's nominal wages were sharply down, although the impact was partially mitigated by higher social incomes. In contrast, wages per hour stayed unaffected by the crisis.

MONETARY POLICY: A HIKE IS CONCEIVABLE IN LATE 2021

In a rare move, the CNB joined other institutions in criticizing the government's policy objectives. Indeed, headline inflation's persistently overshooting the 3% upper bound of its target range puts the CNB in a policy dilemma. The reasons behind higher inflation in Czechia relative to that of many other EU countries do not include just one-offs but probably also less slack in Czechia's economy. With the government supporting household consumption instead of dealing with structural deficiencies, there is a risk that the CNB will need to tighten monetary policy before economic recovery can be set on a sustainable path. Unlike three months ago, we now admit that a first repo-rate hike could be delivered already in 2021.

Consumer and producer prices



Sources: ČSÚ, UniCredit Research

CPI is projected to stay above the CNB's 1% to 3% tolerance band until the end of 2020, settling in its upper half from 2021. There is no apparent upside pressure on CPI from producer prices.

FOCUS: HOW MUCH DAMAGE MAY BE CAUSED BY NEW ECONOMIC RESTRICTIONS?

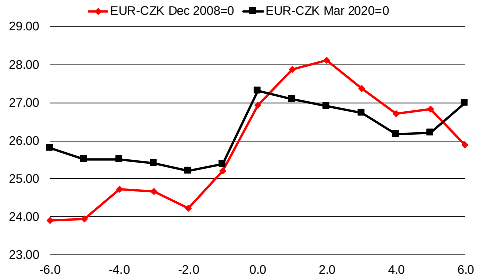
Political leaders in Czechia are repeatedly ensuring that an economic lockdown of the same extent as in the spring is no option, despite the number of Covid-19 cases sharply rising. Nevertheless, measures of a smaller scale are mounting and even those may be a drag on economic performance via both the supply-side restrictions and the consumers´ changing preferences. This makes us have a look at what impact on GDP they might have if lasting over the whole of 4Q20.

Our approach is to identify the economic sectors that might be hit by the new restrictions. For each of those sectors we estimate a percentage loss in gross value added (GVA) in 4Q20 versus 3Q20, as against our baseline scenario. To calculate the overall impact to GDP, we use multiplied shares of individual sectors in total GVA from 2018. The multiplied shares should make sure that indirect effects on GDP are also taken into account.

The identified restricted sectors fall in general into the categories of foreign tourism or leisure activities. GVA losses (qoq, seasonal adjusted) are estimated as follows: Air transportation (30%), accommodation (10%), restaurants and bars (25%), travel agencies (20%), healthcare (3%), entertainment, cultural, sporting activities (20% each). In an interpretation of the estimated losses, we have to bear in mind that even the baseline scenario is not particularly upbeat on the same sectors.

Under the assumptions, the overall loss in GVA shaves off 1.7% from GDP in 4Q20, leaving GDP at -1.7% qoq. The impact to full-2020 GDP remains minor (-0.4pp versus the baseline), as only the final quarter of a year is assumed to be hit. Importantly, however, the GVA losses are deemed permanent. The reason of not making this scenario part of our baseline one is that we see a chance for an actual drag on GDP to stay smaller, as some restrictions are hoped to be lifted before the end of 4Q20. That said, even scenarios with more dramatic supply-side restrictions are conceivable, if the pandemic gets out of control.

EUR-CZK before and after economic shocks (end-of-month data)



Sources: UniCredit Research.

In March, the koruna staged a sharp weakening versus EUR in reaction to the Covid-19 economic shock. The extent of weakening was nevertheless smaller than in the shock to the financial crisis in 2008. A recovery in the CZK value between April and August corresponded to that in post-shock months of 2009. However, the September weakness of CZK has no parallel in 2009.

Czechia Macroeconomic Outlook

	2017	2018	2019	2020 forecast	2021 forecast
GDP growth (real yoy change, %)	5.4	3.2	2.3	-6.4	4.7
Household consumption (real yoy change, %)	4.1	3.5	3.0	-3.2	3.8
Gross fixed capital formation (real yoy change, %)	5.1	10.0	2.1	-8.5	4.5
Industrial output (real yoy change, %)	6.5	3.0	-0.2	-9.5	7.5
Unemployment rate (average, %)	4.2	3.2	2.8	3.7	4.7
Inflation rate (CPI yoy change, average, %)	2.5	2.1	2.8	3.3	2.6
Average wages (nominal yoy change, %)	6.8	8.1	6.4	3.1	3.3
Interest rates (3-M PRIBOR, end of period, %)	0.75	2.01	2.18	0.35	0.60
Interest rates (3-M PRIBOR, average, %)	0.41	1.27	2.12	0.84	0.40
EUR/CZK exchange rate (end of period)	25.54	25.73	25.41	26.50	25.60
EUR/CZK exchange rate (average)	26.33	25.64	25.67	26.35	26.00
Current account balance (% of GDP)	1.5	0.4	-0.3	1.4	0.5
FDI net inflow (% of GDP)	0.9	0.9	1.1	0.7	0.8
General government balance (% of GDP)*	1.5	0.9	0.3	-7.3	-6.0
Public debt (% of GDP)	34.7	32.6	30.8	38.5	41.9

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