Czech Economic Quarterly

December 14, 2020

Getting ready for fiscal avalanche

- In 3Q20, real GDP expanded by 6.9% qoq, the all-time high, easing the yoy contraction to -5.0%. Private consumption moderated its decline to -3.9% yoy, whereas government consumption saw only a marginal change of 0.1% yoy. Fixed capital formation deepened its slump to -10.7% yoy. Net exports were in contrast a positive contributor to GDP growth by 1.2 pp.

- The second lockdown, in place since October, is taking its toll on economic activity in 4Q20. Weaker household demand, supply-side restrictions and a close-to-100% fall of income from foreign tourism are projected to cause GDP post -2.6% qoq and -7.8% yoy. This would lead to full-2020 GDP at -6.4%.

- In 2021, things are expected to get worse before getting better. Real wages are projected to stay flat in gross terms. The corporate sector's ability to invest in 2021 will be reduced. Prospects for economic sectors are varying in a wide range. The sectors linked to social mobility will be heading back to normal only slowly and of those, services related to foreign tourism will stay in the deepest trouble. On balance, we expect real GDP to rise by 2.0% in 2021.

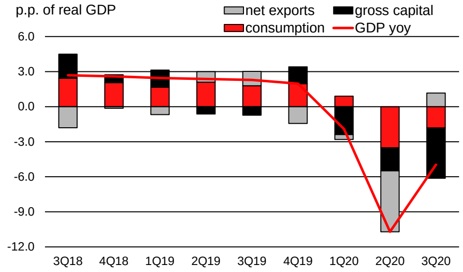
- The pandemic has given the government an excuse to a sharp loosening of the traditionally solid fiscal discipline. After a huge fiscal impulse from 2020, an additional one will be delivered in 2021. Having the form of a permanent measure, it is set to damage the public finance stability in the long run. On the monetary policy front, we continue to include into our 2021 baseline scenario a single, 25bp late-year hike.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	3Q20		2Q20 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**-5.0**	**-5.0**	**-10,7**	**-10.7**
Household consumption (%)	-3.9	-1.8	-8.3	-3.8
Government consumption (%)	0.1	0.0	1.7	0.3
Fixed capital formation (%)	-10.7	-2.8	-5.1	-1.3
Change in inventories	-	-1.5	-	-0.7
Net exports	-	1.2	-	-5.2

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.

Breakdown of GDP growth by demand*



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

In 3Q20, slightly more than half of the all-time-deep yoy contraction of GDP from 2Q20 was recovered. Net exports saw the most important change, switching into a positive contribution to GDP, while a negative contribution of consumption eased. Gross capital, in contrast, deepened its negative input.

Author:

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

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

3Q20: HALF OF THE PREVIOUS SLUMP TAKEN BACK

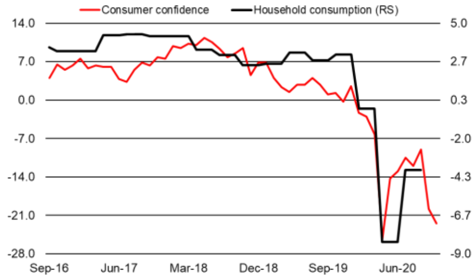
In 3Q20, real GDP expanded by 6.9% qoq, the all-time high, taking back half of the the previous two quarters‘ slump. In yoy terms, GDP eased the contraction to -5.0%. Private consumption moderated its decline to -3.9% yoy, whereas government consumption saw only a marginal change of 0.1% yoy. Fixed capital formation deepened its contraction to double-digit terms (-10.7% yoy) on substantial rates of decline in all types of investment and the deepest one (-22.9% yoy) in transport equipment. The inventory change, as part of gross capital formation, subtracted from GDP 1.5 pp, showing that a turnaround in investment activity is not within sight. Net exports were in contrast a positive contributor to GDP growth by 1.2 pp, as real exports fell by 3.1% yoy but real imports declined by 5.1% yoy. Unlike trade in goods, trade in services remained in deep yoy contraction (exports -20.8%, imports -26.3%). Nominal GDP dropped by 1.0% yoy. From the production side, ITC and agriculture were, similar to 2Q20, the sectors avoiding a yoy contraction, but public administration newly joined them. In general, GVA declines were less severe than in 2Q20. The employment declined by 1.7% yoy but, as another deviation from 2Q19, hours worked remained flat, causing real-term hourly productivity to plunge by 5.0% (in 2Q20 it was flat). Compensation of employees ticked up (0.1% yoy), whereas gross operating surplus and mixed income dipped (-0.5% yoy). Solid GDP deflator (4.1% yoy), related to a decline in global energy prices, saved gross operating surplus from a deeper cut.

3Q20 was the fourth quarter in a row with compensation of employees growing faster than gross operating surplus and mixed income. In fact 3Q19, the last period with the opposite ratio, was quite exceptional in the recent years‘ history. Compensation of employees for full-2020 is heading towards 46% of GDP, the figure that would be record high and by 5pp above that of 2015. Such a rapid growth of employers‘ costs eats into their competitiveness, which is seen as a particular problem at a crisis time such as now. There is nevertheless a chance to stop the drift next year, when nominal wages will slow sharply.

4Q20: TESTING A SECOND TROUGH

The second lockdown, in place since October, is set to take its toll on economic activity. Mobility of the population troughed in November at a higher level than a 2Q20 trough but is expected to peak in December at a lower level than a peak from 2Q20, making the whole quarter comparable to 2Q20 in that aspect. Industrial activity represents a marked difference from 2Q20. In seasonal-adjusted terms, October industrial output was higher by 1.3% yoy, with PMI index as well as new orders promising also solid data for November. However, growth appears to be heavily reliant on the automotive sector. With new car registrations facing a double-digit yoy slump in November on major EU markets, sustainability of the output growth looks difficult. Construction output was down by 10.1% yoy (SA) in October and similar results are expected in the following two months. Retail sales (ex-cars, NSA) were down by 0.9% yoy in October, suggesting some resilience of household

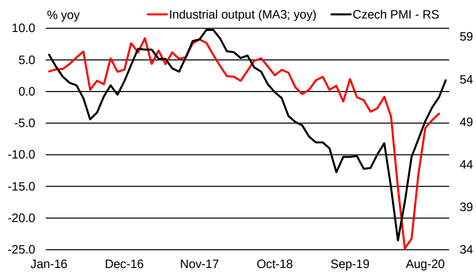
Consumer confidence and private consumption



Sources: CZSO, UniCredit Research.

The lockdown in October sent consumer confidence sharply down, with November further adding to consumers' pessimism. Private consumption is seen losing momentum in 4Q20, although its yoy decline may not go as deep as in 2Q20.

Manufacturing PMI and industrial output



Sources: IHS Markit, CZSO, UniCredit Research.

For the first time in two years, manufacturing PMI clearly points to a halt in industrial output's yoy decline. In fact, October working-day-adjusted output was already marginally higher in yoy terms but a turnaround is yet to be confirmed in the unadjusted, MA-3 metric.

consumption in the lockdown in terms of goods. Considering in addition supply-side restrictions in individual grades of the five-grade alert system for an epidemiological situation introduced by the government, and a close-to-100% fall of income from foreign tourism, we expect GDP to post -2.6% qoq and -7.8% yoy. This would lead to full-2020 GDP at -6.4%.

2021: SLOW AND UNEVEN RECOVERY TO START

The pandemic will continue to steer the economic outlook in 2021, albeit differently than in 2020. Regarding the supply side of the economy, we assume grade 3 of the government's five-grade alert system to persist through most of the 1Q21 and be then eased to grade 2. An evolution worse than that would clearly make a downside risk to our forecast.

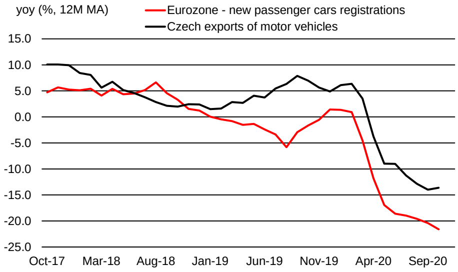
Regarding the demand side, things are expected to get worse before getting better. Despite the financial markets' optimism about the start of vaccination, neither the household nor the corporate sector appear to be in a shape to boost their spending substantially. Government subsidies were structured in 2020 to cushion primarily the former group. With much of the government measures coming to an end, we expect the unemployment rate to add 1pp in 1Q21 and to hover at the new level for much of the rest of 2021. Additionally, real wages are projected to stay flat in gross terms in 2021, with a higher purchasing power of households only stemming from 1) higher number of hours actually worked, and 2) income tax cut that, however, favors wealthier households more in absolute terms. Pent-up demand is also projected to be lifting household consumption somewhat from 2Q20 onwards.

Financials of the corporate sector have deteriorated sharply, with one reason being the reluctance of companies to shed their labor force in the hope that shutdowns and the slow-business environment would soon be over. As a legacy of the approach, the corporate sector's ability to invest in 2021 will be reduced. Indeed, a survey made in November showed that non-financial corporations expect to cut their capital spending by 10%, the worst survey outcome ever. We expect fixed capital formation to start 2021 with an ongoing double-digit slump, resuming yoy growth only in late 2021.

Prospects for economic sectors are varying in a wide range. Within manufacturing, metal processing is feeling more optimism, which we however largely attribute to a short-term factor of tariffs on imports from China. The outlook for automotive has sharply improved, which makes us a bit skeptical. New car registrations in Europe have returned to double-digit yoy declines and even if demand for Škoda cars outperforms the other brands, it may not secure sustained growth in 2021. Machinery will probably be the last to recover.

Outside industry, the sectors linked to social mobility will be heading back to normal only slowly. Of those, services related to foreign tourism will stay in the deepest trouble. On balance, we expect real GDP to resume sequential growth in 2Q20 and full-2020 GDP to rise by 2.0%.

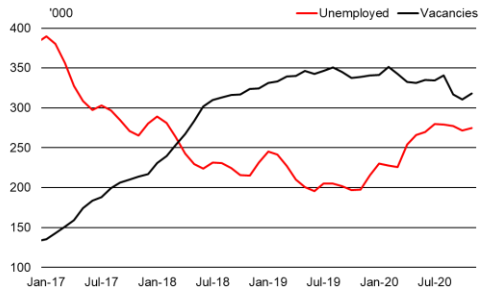
Eurozone new car registrations and Czech exports of motor vehicles (EUR)



Sources: CZSO, Macrobond, UniCredit Research.

Czech exports of motor vehicles have been showing remarkable resilience to a fall of demand for cars in Europe. Nevertheless, yoy declines in new car registrations are too steep to stay without any response on the production and export side.

Number of unemployed and vacancies



Sources: Labor Ministry, UniCredit Research.

The labor market saw only a marginal reaction to the pandemic-induced recession in 2020. By November, the ratio of unemployed per vacancy rose to 0.86 from its all-time low of 0.57 seen in 2019. We expect more normalization on the labor market in 2021.

POLICIES: FISCAL AVALANCHE

The pandemic has given the government an excuse for sharp loosening of the traditionally solid fiscal discipline in the run-up for the autumn 2021 general elections. While widening of public sector deficit in 2020 versus 2019 by an estimated 7% of GDP may be close to an EU average, Czechia's likely positive fiscal impulse in 2021 may be quite unique. The main source will be a huge, CZK 100bn personal income tax cut that may however boost household spending by no more than CZK 60bn. As a permanent measure, it is set to damage the public finance stability in the long run. While the impulse may theoretically be an inflation booster bringing the ČNB on alert, we expect the slow economic recovery to ease the urgency to tighten monetary policy. We continue to include into our 2021 baseline scenario a single, 25bp late-year hike.

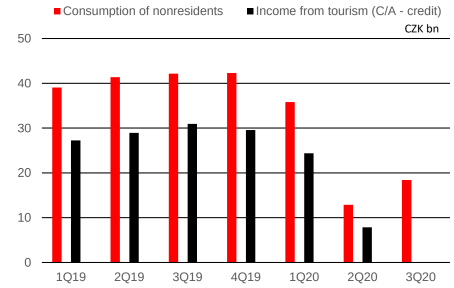
FOCUS: CZECH GDP IS MISSING FOREIGNERS' CASH

Despite Czechia having a highly industrialized economy with the share of manufacturing in GDP being one of the highest in the EU, foreign tourism does matter there. The pandemic cut non-residents' hotel stays in the spring months by as much as 96% yoy, with the summer showing a limited improvement to -68%. The second country lockdown occurring since early October appears to be for tourism-related businesses equally detrimental as in the spring, unlike for some other segments of the economy. Importantly, foreign tourism in Czechia is dominated by city sightseeing in Prague, which brings little seasonality to incomes. Missing tourists are therefore a considerable drag on GDP even now in 4Q20, unlike off-seasons in the Mediterranean or in the Alps.

Additionally, over 600,000 foreigners are registered in Czechia for a permanent or a long-term stay, with most of them working or running business there. The number is slowly but steadily growing over time, as is consumption of non-residents, i.e. foreigners without permanent residence, in the national accounts. However, the arrival of the pandemic has reduced spending of non-residents considerably. This is hardly explainable by their rising propensity to save. Rather, many foreigners left Czechia at a start of the first lockdown and have not come back yet.

Two data sources are available to figure out a loss in GDP stemming from the missing income from foreigners. For non-residents' spending, the national accounts point to CZK -28bn (-69%) yoy in 2Q20, followed by CZK -24bn (-56%) yoy in 3Q20. Spending of non-residents is dominated by spending of tourists that has its reflection on the current account's credit side of the balance of payments. The item of income from travelling showed a yoy reduction of CZK 22bn (-75%) in 2Q20, while 3Q20 data is not yet available. A direct drag on yoy GDP hence stood at 2.1% in 2Q20 and 1.7% in 3Q20 and had the form of a deterioration in net exports of services. For 4Q20, we estimate the drag to approach 2% of GDP again. Missing income from foreigners has thus been directly responsible for a quarter of total yoy GDP decline in 2020.

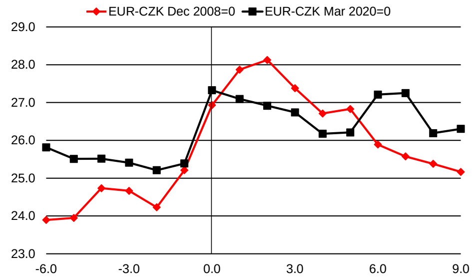
Spending of non-residents in Czechia



Sources: ČSÚ, ČNB, UniCredit Research

In 2019, both the non-residents' consumption in the national accounts and the item on the balance of payment's current account credit side called spending of tourists displayed a moderate growth with limited volatility. In 2020, the pandemic has caused the figures plunge. Missing consumption of non-residents may be responsible for a quarter of the total GDP decline in 2020.

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



Remark: Dec 2020 as of 11th Dec
Source: UniCredit Research.

In March, the koruna staged a sharp weakening versus EUR in reaction to the Covid-19 economic shock. Despite the extent of weakening smaller than after the financial crisis of 2008, parallels to the previous episode are obvious. During nine months after an initial shock, half of the CZK loss from a peak in EUR-CZK has been recovered in 2020, as against three-quarters in 2009.

Czechia Macroeconomic Outlook

	2018	2019	2020 forecast	2021 forecast	2022 forecast
GDP growth (real yoy change, %)	3.2	2.3	-6.4	2.0	4.9
Household consumption (real yoy change, %)	3.5	3.0	-4.6	2.2	3.0
Gross fixed capital formation (real yoy change, %)	10.0	2.1	-8.9	-3.0	8.0
Industrial output (real yoy change, %)	3.0	-0.2	-8.1	3.0	6.0
Unemployment rate (average, %)	3.2	2.8	3.6	4.6	4.0
Inflation rate (CPI yoy change, average, %)	2.1	2.8	3.2	2.1	2.6
Average wages (nominal yoy change, %)	8.1	6.4	2.4	2.8	4.0
Interest rates (3-M PRIBOR, end of period, %)	2.01	2.18	0.35	0.60	0.90
Interest rates (3-M PRIBOR, average, %)	1.27	2.12	0.84	0.40	0.80
EUR/CZK exchange rate (end of period)	25.73	25.41	26.50	25.60	25.00
EUR/CZK exchange rate (average)	25.64	25.67	26.45	26.00	25.20
Current account balance (% of GDP)	0.4	-0.3	3.6	2.7	1.2
FDI net inflow (% of GDP)	0.9	1.1	0.4	1.0	1.1
General government balance (% of GDP)*	0.9	0.3	-7.0	-7.8	-6.0
Public debt (% of GDP)	32.1	30.2	38.1	44.4	47.3

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