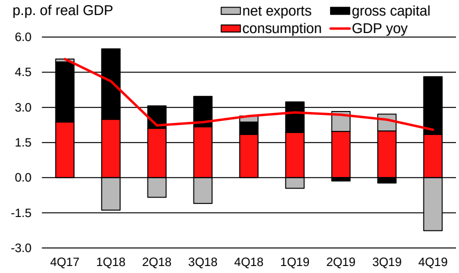
**Czech Economic Quarterly**

April 8, 2020

# Shocking times

- In 4Q19, real GDP added 0.5% qoq, bringing the yoy dynamic down to (adjusted) 2.0% yoy. Full-2019 GDP growth posted 2.5%, slowing from the previous year's 2.8%.
- In 1Q20, what was formerly supposed to be an ongoing moderate slowdown, occurring mostly via manufacturing and exports, has turned into an unprecedented economic shock. We estimate that the economy was running at 60% of its capacity at the end of March.
- GDP took a substantial hit already in 1Q20, in which we expect a decline of 4.9% qoq. Nevertheless, the sharpest sequential loss of output is expected in 2Q20, when GDP could plummet by 15% qoq. 3Q20 looks fairly likely to be the first quarter of sequential growth. However, huge uncertainty surrounds the outlook.
- The CNB cut its repo rate by 125bp within a single month and we expect more easing to come. Our only uncertainty is whether cuts will stop at 0.25% or will dip to the previous cycle's bottom of 0.05%. We have cut back our expectations for an early correction in EUR-CZK. We continue to see its long-term equilibrium at 25.0, but acknowledge the koruna may remain undervalued for an extended period.

**Breakdown of GDP growth by demand***




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

In 4Q19 GDP structure was subject to a larger change, as gross capital contributed by 2.5pp to GDP growth while net exports subtracted 2.3pp from it. Consumption proved more stable with its input to growth at 1.8pp on government consumption easing but private spending strengthening.

**REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)**

| | 4Q19 | | 3Q19 revised | |
|---|---|---|---|---|
| | YoY change | % of change in GDP* | YoY change | % of change in GDP* |
| **GDP total** | **2.0** | **2.0** | **2.5** | **2.5** |
| Household consumption (%) | 3.2 | 1.5 | 2.7 | 1.3 |
| Government consumption (%) | 1.7 | 0.3 | 3.5 | 0.7 |
| Fixed capital formation (%) | 4.6 | 1.2 | 1.1 | 0.3 |
| Change in inventories | - | 1.3 | - | -0.5 |
| Net exports | - | -2.3 | - | 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.*

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## 4Q19: MANUFACURING AS A SINGLE WEAK SPOT

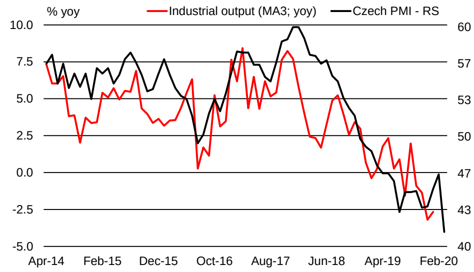
In 4Q19, real GDP added 0.5% qoq, bringing the yoy dynamic down to (adjusted) 2.0% yoy. Private consumption accelerated to 3.2% yoy, its best performance since 2Q18. Government consumption in contrast slowed to 1.7% yoy, the weakest outcome since 4Q17. Fixed capital formation added 4.6% yoy on growth in all components except for the transport equipment, while (above all corporate) inventories expanded sharply, contributing 1.3pp to yoy growth. The volume of exports declined by 1.5% yoy, breaking the streak of expansion lasting since 2Q13. With the volume of imports up 1.4% yoy due to a 14.4% rise in services imports, net exports took away a significant 2.3pp from GDP growth. Nominal GDP was higher by 5.8% yoy on GDP deflator at 3.7% yoy. From the production side, GVA expansion moderated in most sectors but only for manufacturing, growth turned negative (-0.3% yoy). The momentum for wages and salaries eased slightly to 6.5% yoy with the number of employees higher by 0.3% yoy (but total employment including the self-employed was flat yoy). Full-2019 GDP growth posted 2.5%, slowing from the previous year's 2.8%.

## 1Q20: AN UNPRECEDENTED SHOCK

Monthly figures for the first two months of 2020 still looked very similar to last year's final quarter. In January and February, industrial output dipped yoy (NSA) by 1.2% and 0.9%, respectively, whereas construction output was bolstered by a mild winter to add yoy (NSA) 6.0% and 5.3% respectively. Retail sales rose yoy (SA) 4.7% and 3.9%, respectively. In March, however, manufacturing PMI posted 41.3, the level corresponding to late-2008, or just ahead of the financial crisis. We estimate March industrial output at roughly -10% yoy. New car registrations in 1Q20 (passenger + LUV) tumbled by 16.7% yoy, contracting by almost 37% yoy in March alone.

What was formerly supposed to be an ongoing moderate slowdown, occurring mostly via manufacturing and exports, has turned into an unprecedented economic shock. In March, the Czech economy was overwhelmed by the COVID-19 pandemic. The lockdown in place since 12 March halted services such as travel and hospitality and hampered others. Just a few days later, major car producers discontinued operations in anticipation of a severe drop in European car sales (we estimate a 20% decline in 2020). A number of industrial plants from other sectors, as well as some construction companies, have reported disruptions in their activity due to the limited flow of supplies, an inability to access their logistics capacities abroad and labor shortages. Many foreign workers, who accounted for 11% of total labor force in early 2020, left the country prior to the border being closed. Tens of thousands local employees have remained quarantined, while an even larger number of them have been at home taking care of their children affected by temporary school shutdowns. We estimate that the economy was running at 60% of its capacity at the end of March.

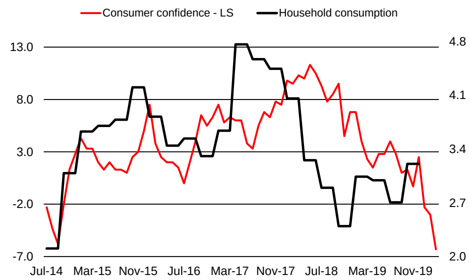
**Manufacturing PMI and industrial output**




Sources: IHS Markit, CZSO, UniCredit Research.

Manufacturing PMI tumbled in March after signs of stabilization seen in a couple of previous months. Its level looks consistent with an industrial output decline by around 10% yoy. Even worse figures are probably yet to come.

**Consumer confidence and private consumption**




Sources: CZSO, UniCredit Research.

Consumer confidence hit a six-year low in March. Despite that, the indicator probably did not capture fully the problem ahead. A deep spending cut is in the pipeline particularly for 2Q20.

## 2020: AT RISK OF A DOUBLE-DIGIT DECLINE IN GDP

Much of the economic shock comes from the supply side. Together with Hungary, Czechia tops the CEE ranking in terms of how deeply global value chains are integrated into the local economy. The share of inputs from the euro area to Czech GDP is 12.5%, while those from China account for 1.5% of GDP. While China's share looks rather small, it is heavily skewed towards the manufacture of electronics (value-added [VA] share of 14%) and manufacture of other transport vehicles (5.5% VA share). We expect supply constraints to persist throughout 2Q20 due to large inventories and long shipment times.

With the lockdown imposed slightly earlier than in most other EU economies, GDP took a substantial hit already in 1Q20, in which we expect a decline of 4.9% qoq. Nevertheless, the sharpest sequential loss of output is expected in 2Q20, when GDP could plummet by 15% qoq in a scenario of a slow but steady easing of restrictions from May onwards. As a result, 3Q20 looks fairly likely to be the first quarter of sequential growth. However, huge uncertainty surrounds the outlook. The critical aspect of our forecast is whether currently inactive companies manage to withstand the shock and restore business links. For many of them, the breaking point may be around three months.

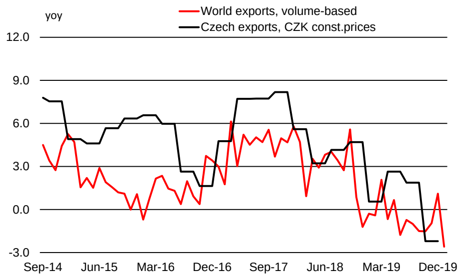
While most households are currently restricting their consumption involuntarily and their saving ratios are strongly up, they will start to feel the pinch of missing income before long. The government's support programs are largely aimed at preserving jobs. The share of subsidized workers may amount to more than a quarter. Despite that, the loss of household income will be severe and is projected to bring real consumption down by 4.5% in 2020 as a whole. That said, the key victim of recession on the demand side will be business investment. Construction activities may slow only moderately, unless the recession extends to 3Q20. Spending on machinery and transport equipment is nevertheless forecast to fall by more than a third in 2020. Altogether, domestic demand should account for two-thirds of the 2020 GDP decline. One-third may be attributable to net exports, which are likely to be hit by a 20% contraction in export volumes.

## POLICIES: SHARP EASING ALREADY UNDER WAY

Monetary policy has been quick in response to the economic shock. The CNB cut its repo rate by 125bp within a single month and we expect more easing to come. Our only uncertainty is whether cuts will stop at 0.25% or will dip to the previous cycle's bottom of 0.05%. In any case, the FX channel will dominate in the overall adjustment of monetary conditions which may reach the equivalent of 400bp in rate cuts. We have cut back our expectations for an early correction in EUR-CZK. We continue to see its long-term equilibrium at 25.0, but acknowledge the koruna may remain undervalued for an extended period.

Fiscal policy will need to bear the brunt of a response to the COVID-19 crisis. The government has introduced a number of support programs for

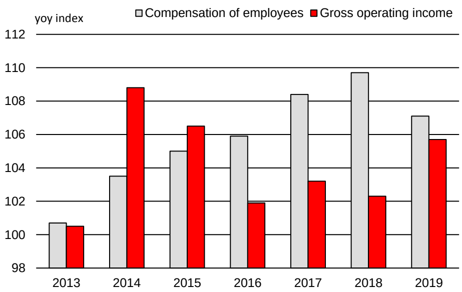
**Dynamics of Czech and global exports**




Sources: Macrobond, UniCredit Research.

Historically, Czech exports often managed to grow moderately faster than global exports. The outperformance was terminated in 4Q19 and we do not expect it to re-emerge until 2H20.

**Compensation of employees and gross operating surplus**




Sources: CZSO, UniCredit Research.

2019 proved to be a good year for employee compensation as well as corporate profits. Unlike in previous three years, characterized by companies boosting wages at an expense of their profits, a more balanced picture set in last year.

households and companies in the form of direct subsidies, tax and bank loan deferrals, and interest-free loans and guarantees. We regard the overall government response appropriate in size, although coordination between individual measures appears to be lacking in some cases. The overall cost for the state budget will be huge. This year's official deficit has already been raised from CZK 40bn to CZK 200bn but we estimate that this increase will have been consumed by the end of April. We currently see the budget shortfall coming in at 5.5% of expected GDP. The amount does not seem to be beyond the country's means, given the country starts from a good debt position (at just 30.8% GDP).

## FOCUS: HOW SENSITIVE ARE ECONOMIES TO THE SHOCK FROM COVID-19?

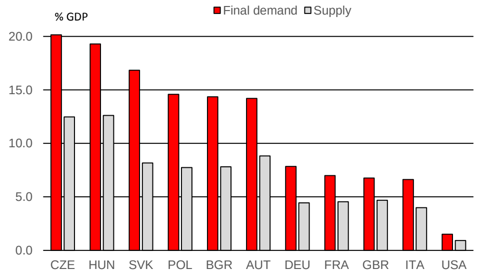
The COVID-19 epidemic has resulted in a severe shock to the global economy from both the demand and the supply side. Our aim is to measure the shock through the whole value-added chain using the World Input Output Database (WIOD) and OECD's TiVA. We are focusing on the sensitivity of various European countries on demand or supply from China and the eurozone.

In terms of China and its final demand, our data show that Germany tops the league of selected countries with 2.8% of its total value added directly or indirectly consumed or invested in China. Then follow Slovakia and Czechia (1.8% each), Austria and Hungary (1.7% each) and Bulgaria (1.5%). Big economies such as France, Poland and Italy are dependent much less with about 1.0%, while the USA comes at the bottom of the ranking (0.7%). From the supply side, we measure China's inputs in individual countries' domestic production. The supply chain exposure is defined in a pure accounting sense, disregarding its technical parameters or substitutability. Czechia and Hungary are exposed the most with 1.5% and 1.4% share of China inputs, respectively, with electronics (14.0% and 14.7%, respectively) hugely surpassing inputs to other sectors. No other country is exposed more than at 1.0%.

As regards the eurozone and the dependence on foreign final demand from it, Czechia comes as the most exposed with the weight of 20.2% GDP. Next are Hungary (19.3%), Slovakia* (16.8%) and Poland (14.6%). The biggest European economies are dependent on foreign EMU demand far less: Germany* (7.8%), France* (7.0%), the UK (6.8%), Italy* (6.6%). From the supply side, production of Hungary and Czechia incorporates directly or indirectly about 12.5% of eurozone's value added, Austria* 8.8% and Slovakia* 8.2%. The UK, France* and Germany* each stands at about 4.5%, while the USA at only 0.9%. One clear conclusion from the figures is that small open economies are set to suffer severely from the eurozone's economic slump. With the COVID-19 shock almost synchronized over the globe, equally synchronized should however be a reaction of individual economies in the sum of their domestic and external effects. The exercise could nevertheless be more useful in a subsequent recovery which could turn more diverse.

**/ EMU countries adjusted for their own share*

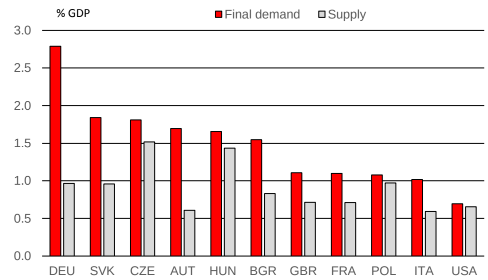
**Dependence of GDP on links to eurozone**




Remark: EMU countries adjusted for their own share
Sources: WIOD, UniCredit Research

As much as 20% of some countries' GDP is directly or indirectly attached to final demand from the eurozone. Conversely, countries use up to 12.5% of their direct and indirect inputs from the eurozone.

**Dependence of GDP on links to China**




Sources: WIOD, UniCredit Research.

2.8% of Germany's GDP and as much as 1.8% of other countries' GDP are directly or indirectly attached to final demand from China. Conversely, countries use up to 1.5% of their direct and indirect inputs from China.

# Czechia Macroeconomic Outlook

| | 2017 | 2018 | 2019 | 2020 forecast | 2021 forecast |
|---|---|---|---|---|---|
| GDP growth (real yoy change, %) | 4.5 | 2.8 | 2.5 | -11.0 | 8.4 |
| Household consumption (real yoy change, %) | 4.4 | 3.2 | 3.0 | -4.5 | 5.0 |
| Gross fixed capital formation (real yoy change, %) | 4.0 | 7.5 | 2.7 | -20.0 | 8.0 |
| Industrial output (real yoy change, %) | 6.5 | 3.0 | -0.2 | -8.5 | 8.0 |
| Unemployment rate (average, %) | 4.2 | 3.2 | 2.8 | 3.6 | 4.4 |
| Inflation rate (CPI yoy change, average, %) | 2.5 | 2.1 | 2.8 | 2.6 | 1.8 |
| Average wages (nominal yoy change, %) | 6.8 | 7.5 | 7.1 | 3.5 | 4.0 |
| Interest rates (3-M PRIBOR, end of period, %) | 0.75 | 2.01 | 2.18 | 0.40 | 0.70 |
| Interest rates (3-M PRIBOR, average, %) | 0.41 | 1.27 | 2.12 | 0.90 | 0.50 |
| EUR/CZK exchange rate (end of period) | 25.54 | 25.73 | 25.41 | 26.20 | 25.30 |
| EUR/CZK exchange rate (average) | 26.33 | 25.64 | 25.67 | 26.80 | 25.80 |
| Current account balance (% of GDP) | 1.7 | 0.4 | -0.4 | -2.5 | -1.0 |
| FDI net inflow (% of GDP) | 0.9 | 1.0 | 1.1 | 0.5 | 0.7 |
| General government balance (% of GDP)* | 1.5 | 0.9 | 0.3 | -5.5 | -4.0 |
| Public debt (% of GDP) | 34.7 | 32.6 | 30.8 | 39.0 | 39.4 |

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