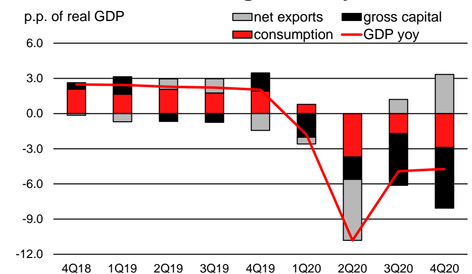
A worst-in-covid stigma

- In 4Q20, real GDP rose 0.6% qoq, easing the yoy decline to 4.7% from a previous 4.9%. Private consumption fell yoy by 8.3%, whereas government consumption was higher by 4.9%. Fixed capital formation further lost the momentum to -12.3%. The inventory change subtracted from GDP an additional 1.9pp. Net exports contributed to GDP a hugely positive 3.3pp, all of which came from the trade in goods.
- Additional limits for physical mobility, put in place in early March, were at odds with our assumption in December that there would be a gradual relaxation of COVID-19 restrictions from 1Q21 onwards. Thus, we now expect a 4% quarterly fall in 1Q21 GDP, which would put the yoy dynamic to -5.5%.
- A delaying economic recovery makes us lower our 2021 GDP outlook by half a percentage point to 1.5%. We are upgrading the 2022 growth forecast by the same amount to 5.4%.
- We predict fiscal imbalance at 7.8% of GDP in 2021, which would be consistent with a fiscal impulse larger than 1% of GDP and a deterioration in the structural balance. Nevertheless, poor economic performance may discourage the central bank from talking about monetary policy tightening as soon as June. We still view one 25bp hike in 4Q21 as most likely, but now envisage at least two more hikes in 2022.

Breakdown of GDP growth by demand*



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

In 4Q20, the overall yoy dynamic of GDP changed little from 3Q20 but there was more dispersion among demand-side components. While net exports contributed to the GDP dynamic by 3.3pp, the most since 1Q06, gross capital took away from it 5.2pp, an amount only comparable with 1Q09. Consumption subtracted from the GDP dynamic 2.9pp, which was the all-time second worst outcome, only overtaken in 2Q20.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	4Q20		3Q20 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**-4.7**	**-4.7**	**-4.9**	**-4.9**
Household consumption (%)	-8.3	-3.9	-3.6	-1.7
Government consumption (%)	4.9	1.0	0.1	0.0
Fixed capital formation (%)	-12.3	-3.3	-10.3	-2.7
Change in inventories	-	-1.9	-	-1.7
Net exports	-	3.3	-	1.2

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.

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4Q20: A TEMPORARY RELIEF

In 4Q20, real GDP rose 0.6% qoq, easing the yoy decline to 4.7% from a previous 4.9%. In yoy terms, private consumption fell by 8.3%, almost as deep as in 2Q20, whereas government consumption was higher by 4.9%. Fixed capital formation further lost the momentum to -12.3% on double-digit declines for investment in machinery, transport equipment and dwellings. The inventory change subtracted from GDP an additional 1.9 pp. Net exports contributed to GDP a hugely positive 3.3 pp, all of which came from the trade in goods. Real exports were higher by 4.7% yoy, of which visible exports expanded by 8.9% yoy. Real imports ticked up by 0.2% yoy. Nominal GDP was down 0.7%, easing the yoy decline from 3Q20 by the same pace as real GDP. From the production side, the only sectors avoiding a yoy decline in gross value added were ITC; agriculture; and public administration. A substantial change in the overall GVA yoy dynamic was nevertheless brought about by manufacturing, which posted -1.1% in 4Q20 as against -4.6% in 3Q20 and -18.8% in 2Q20. The employment fell by 1.9% yoy with the pace of decline remaining broadly stable since 2Q20. Hours worked came down by 7.2% yoy, lifting real-term hourly productivity by 2.7% yoy but leaving productivity per worker lower by 2.9% yoy. Compensation of employees was higher by 2.3% yoy, whereas gross operating surplus and mixed income ticked up 0.7% yoy, being bolstered by a 52% yoy rise in government subsidies on production. GDP deflator continued to be high (4.2% yoy), as the terms of trade kept improving and prices in public consumption soared (5.6% yoy).

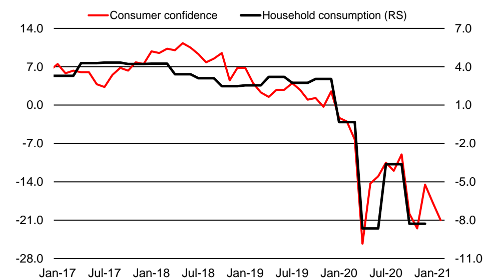
Notwithstanding an easing of a yoy decline in 4Q20, full-2020 GDP contracted by 5.6%, marking the worst recession in the Czech economy since 1993. What made the outcome worse than in the epizode from 2009 when GDP fell by 4.5% was a much deeper contraction in private consumption. Fixed capital formation was evolving similarly, while exports saw a milder decline in 2020 than in 2009.

1Q21: DOWN THE SLOPE AGAIN

Economic restrictions to tackle the current Czechia's worst-in-covid position in Europe have left services accounting for an estimated 12% of GDP switched off since the start of 2021. Additional limits for physical mobility, put in place in early March, keep the Google Mobility Index as low as during the last spring's trough for all components except 'workplaces' that displays the second lowest monthly level. The evolution is at odds with our assumption in December that there would be a gradual relaxation of COVID-19 restrictions from 1Q21 onwards. Thus, we expect a 4% quarterly fall in 1Q21 GDP, which would put the yoy dynamic to -5.5%. From the demand side, almost the whole yoy decline in GDP would be proportionate to lower private consumption. Gross capital is expected to continue shrinking but the pace will moderate due to the lower base. Net exports are seen to add positively to GDP.

Indeed, high-frequency data stayed on a weaker side in early 2021. Manufacturing PMI (at 56.5 in February) looked as a positive outlier but that was largely due to an unprecedented lengthening of suppliers´

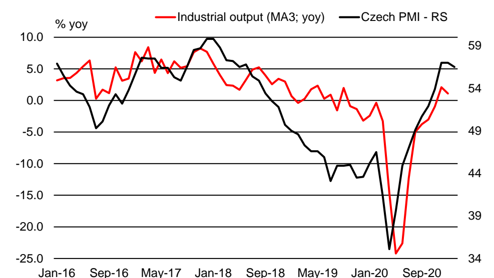
Consumer confidence and private consumption



Sources: CZSO, UniCredit Research.

Consumer confidence is having a solid predictive power on household consumption also during the pandemic. The latest slump in consumer confidence points to a decline in consumption by 8% yoy. Assuming a further deterioration of confidence in March, we project a 1Q21 consumption figure even a tad lower.

Manufacturing PMI and industrial output



Sources: IHS Markit, CZSO, UniCredit Research.

Manufacturing PMI has lately been promising a solid recovery in industrial output. However, this is largely due to a sharp lengthening of suppliers' delivery times. These are normally regarded as a sign of an excessive demand, positive for future output. This time around, however, the same lengthening is rather a function of supply-side constraints.

delivery times, hardly a promising signal in the context of supply-side deficiencies. January industrial output posted adjusted growth of 0.9% yoy, as producers benefitted from a larger order intake from December. However, new orders plunged by (adjusted) 4.6% yoy in January. New car registrations dropped by 18.8% yoy in the first two months of 2021, a deeper fall than the 12% in the whole of 2020. January construction output was down by (adjusted) 6.1% yoy, while January retail sales plummeted by (adjusted) 6.5% yoy.

FIRST SIGNS OF A REBOUND TO BE SEEN IN 2Q21, FULL-SCALE RECOVERY ONLY IN 2022

Industrial output is unlikely to be much of a support to economic growth in 1H21. Order books have thinned lately. Car sales in Europe remain depressed, which captures not only a lower demand but also longer waiting lists for some models, affected by a global shortage of chip. As an additional negative supply-side factor in the local manufacturing, just-in-time deliveries of goods across the borders face frequent delays. Furthermore, producers are facing labor shortages due to a sharp rise in sick and quarantine days.

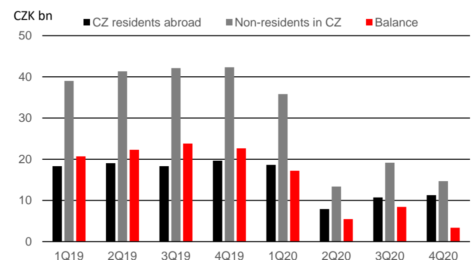
In financial terms, the corporate sector has been coping with the pandemic-related constraints reasonably well. Cash reserves have been on the rise, while bank loans of the same sector were down by 1.2% yoy in January, as companies have been delaying outlays. Indeed, investment in machinery and transport equipment fell by 20% yoy in 4Q20 and we expect further contractions in 1H21. That said, when business sentiment improves, companies should be able to employ their reserves to kickstart a new investment cycle. We hope to see that in 2H21.

Regarding the household sector, restrictions in physical mobility will continue to be a drag on GDP in 2Q21. In addition, tourism ceased completely in 1Q21 and we also remain pessimistic regarding a normalization in visitor arrivals for the following quarters. As a related issue, spending on goods was down by 3.9% but on services by as much as 11.1% in 2020. Apart from the tourism effect, the gap was largely due to a change in the structure of household spending, forced by the unavailability of some services. Nevertheless, surveys show that the pandemic has affected household incomes unevenly, with 20% of them being severely constrained while 50% not feeling the pinch at all. Therefore, most households are set to resume spending once the supply-side hurdles are removed. In annual terms, we expect private consumption to start growing from 2Q21, helped also by the low base.

However, with some services being frequently closed since last spring, their providers are financially in the doldrums and probably unable to respond adequately to a termination of the lockdown once it arrives. The short supply may cause prices of services to tick up in 2H21, adding to inflationary pressures from global commodity price hikes. While we do not expect CPI to overshoot 3% yoy, the top of the target range, any time soon, we do believe that inflation has already bottomed out.

The circumstances make us lower our 2021 GDP outlook by half a p.p. to 1.5%. We are upgrading the 2022 forecast by the same amount to 5.4%.

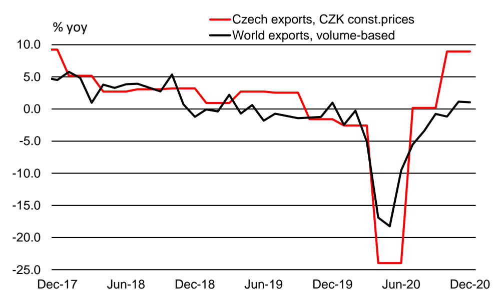
Spending of non-residents in Czechia and residents abroad



Sources: CZSO, UniCredit Research.

The pandemic has caused the number of foreigners living and spending in Czechia to plunge. While also fewer Czechs stay abroad, the deterioration in yoy balance between the two items was responsible for a cut in household consumption by 2% in the whole of 2020 and by as much as 2.7% yoy in 4Q20. A return to pre-pandemic levels is not conceivable in a short run.

Global exports and Czechia exports



Sources: Labor Ministry, UniCredit Research.

Czech exports have long been an integral part of global trends in the exchange of goods. In 2020, however, Czech exports first strongly underperformed the global momentum and were catching up thereafter. We believe the situation will not be repeated in 2021 and Czech exports growth will remain more in line with that in the rest of world.

POLICIES: FISCAL EASING, MONETARY TIGHTENING

Less than two months after the state budget had been approved with a CZK 320bn deficit, the government increased it to CZK 500bn. Our forecast for the full-year public-sector imbalance of 7.8% of GDP is based on the government programs being phased out from mid-2021. Such a deficit is consistent with a fiscal impulse larger than 1% of GDP and a deterioration in the structural balance. Unless countermeasures are taken, public debt will double within four years, hitting the debt brake of 55% of GDP by 2024.

The fiscal easing continues to urge the ČNB to consider raising interest rates. That said, the prospect of Czechia lagging behind its peers in economic recovery and the underlying CZK weakness are likely to discourage the central bank from talking about monetary policy tightening as soon as June. On balance, we still view one 25bp hike in 4Q21 as most likely, but now envisage at least two more hikes in 2022, when the economic recovery gathers pace.

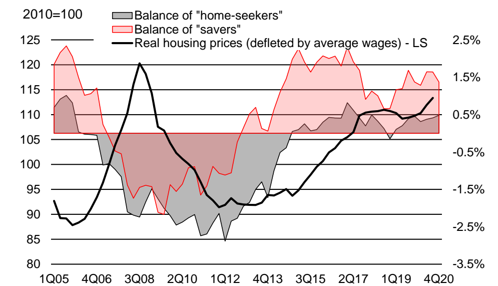
FOCUS: ARE CZECH HOUSES OVERPRICED?

House prices in Czechia, likewise elsewhere in Europe, have been a hot topic lately. Are they overvalued? In order to answer the question, we would have to adopt strong assumptions for the equilibrium long-term interest rates. We hence take an easier approach and only check whether house prices are in line with actual market conditions.

As the housing market's supply side is typically non-elastic, let's consider a simple arbitrage model focusing on the demand side. There are two types of players – those who choose between buying their own apartment on mortgage or paying a rent ("home-seekers") and those who choose between buying a house as an investment alternative to other forms of safe cash savings ("savers"). The home-seekers compare "adjusted rental yield", i.e. annual rent-to-price ratio minus amortization, risk premium and other costs plus expected growth of property prices, with long-term mortgage fixed interest rate. When adjusted rental yield exceeds mortgage fixed rate, they will tend to prefer buying their own house. The savers compare the same adjusted rental yield with long-term government bond yield. Lower bond yields relative to adjusted rental yield motivate them to buy a house.

Conditions for both arbitragers vary in time. However, since 2014, their home purchases would be constantly "in the money" despite house prices rising sharply (in contrast to 2008). The reason is that both mortgage rates and bond yields fell substantially. To restore the equilibrium and diminish a demand pressure of home buyers in 4Q20, mortgage rates would need to grow by 0.4pp and bond yields by 1.4pp, all else being equal. Even the actual rise in bond yields by about 0.8pp, seen in 1Q21, (with mortgage rates broadly flat) has not been big enough to change the balance. Further down the road, house prices in this optic could become overvalued if long-term interest rates turned much higher than today. Indeed, the CNB estimates house prices to be overvalued by 15-25%, assuming equilibrium mortgage rate at 5% p.a. However, we find that assumption questionable in the light of low interest rates becoming a "new normal" globally.

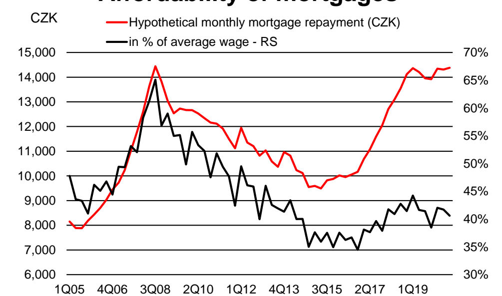
Czechia house prices in decision-making of home seekers and savers



Sources: CZSO, Numbeo, Realitymix, IRI, UniCredit Research

House prices in Czechia still looked attractive in 4Q20 if adjusted rental yield was compared to 5Y-10Y fixed mortgage interest rates or 10Y government bond yields. To eliminate the "arbitrage" opportunity, mortgage rates would then need to grow by 0.4pp or bond yields by 1.4pp, all else being equal. The arbitrage model also suggests that mortgage rates and bond yields, if increased substantially, should start pushing house prices lower.

Affordability of mortgages



Sources: CZSO, Realitymix, UniCredit Research.

House prices in Czechia are deemed high, but this does not apply to all metrics. If we consider a hypothetical 100% mortgage for 30 years with 5Y-10Y fixation, buying a 60m2 flat would make the monthly burden as high as in 2008 in absolute terms, but this would be by one-third lower compared to average wages. Admittedly, a significant rise in interest rates would change the picture, but such a change might in turn put a downside pressure on house prices.

Czechia Macroeconomic Outlook

	2018	2019	2020	2021 forecast	2022 forecast
GDP growth (real yoy change, %)	3.2	2.2	-5.6	1.5	5.4
Household consumption (real yoy change, %)	3.5	3.0	-5.2	0.6	4.8
Gross fixed capital formation (real yoy change, %)	10.0	2.2	-8.5	-2.7	10.0
Industrial output (real yoy change, %)	3.0	-0.2	-7.2	7.0	4.0
Unemployment rate (average, %)	3.2	2.8	3.6	4.4	4.1
Inflation rate (CPI yoy change, average, %)	2.1	2.8	3.2	2.3	2.5
Average wages (nominal yoy change, %)	8.1	6.4	4.4	2.9	4.2
Interest rates (3-M PRIBOR, end of period, %)	2.01	2.18	0.35	0.60	1.10
Interest rates (3-M PRIBOR, average, %)	1.27	2.12	0.86	0.40	0.85
EUR/CZK exchange rate (end of period)	25.73	25.41	26.25	25.60	25.00
EUR/CZK exchange rate (average)	25.64	25.67	26.44	25.90	25.20
Current account balance (% of GDP)	0.4	0.3	3.6	3.1	1.7
FDI net inflow (% of GDP)	0.9	4.3	2.6	3.1	3.5
General government balance (% of GDP)*	0.9	0.3	-6.3	-7.8	-6.0
Public debt (% of GDP)	32.1	30.2	37.1	43.5	46.3

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

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