Czech Economic Quarterly

June 22, 2021

A recovery amid inflation concerns

- In 1Q21, real GDP dropped by (SA) 0.3% qoq, easing the yoy decline to 2.1% from previous 4.8%. Private consumption fell by 6.1% yoy, whereas government consumption added 1.3% yoy. Fixed capital formation contracted by 3.6% yoy, while inventory building staged a huge rebound, contributing to GDP yoy by 1.9 pp. Net exports subtracted from GDP 0.5 pp, with all of the negative input coming from the trade in services.

- Private spending from the demand side and the sector of trade and transport from the production side should be the main drivers of GDP in 2Q21. We predict GDP to expand roughly by 1.0% qoq, bringing the yoy growth, thanks to a base effect, above 8% to a 15-year high.

- Headwinds observed now will be slow to dissipate. Travel restrictions, rising prices and changes in consumer habits may struggle to prevail over a low base, facilitating full-2021 GDP growth of 2.8%. In 2022, growth is seen accelerating to 3.8%, supported by stronger private consumption and fixed capital formation.

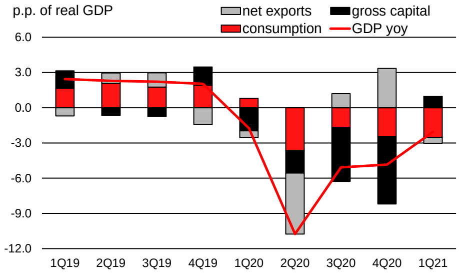
- The CZK 390bn gap in public finance, drafted for 2022, means that almost no fiscal effort is planned. Loose fiscal policy could be a major reason for monetary policy tightening in 2022. We expect the ČNB to deliver two more 25bp hikes beyond the June one by the end of 2021. Tightening should continue in 2022 with two or more hikes, the number depending on fiscal plans of a new government.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	1Q21		4Q20 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**-2.1**	**-2.1**	**-4.8**	**-4.8**
Household consumption (%)	-6.1	-2.8	-8.3	-3.9
Government consumption (%)	1.3	0.3	7.0	1.4
Fixed capital formation (%)	-3.6	-0.9	-12.8	-3.4
Change in inventories	-	1.9	-	-2.3
Net exports	-	-0.5	-	3.4

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 structure of GDP staged a substantial change in 1Q21. Gross capital turned up after three consecutive declines and contributed to GDP yoy momentum positively thanks to a huge inventory accumulation. This was counter-balanced by a slight negative input from net exports. Consumption continued to shrink at a stable pace, as growth of public consumption eased but so did a decline in private spending.

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1Q21: RE-STOCKING TEMPERED GDP DECLINE

In 1Q21, real GDP dropped by (SA) 0.3% qoq, easing the yoy decline to 2.1% from previous 4.8%. Private consumption fell by 6.1% yoy, slightly less than in 4Q20, whereas government consumption added 1.3% yoy. Fixed capital formation contracted by 3.6% yoy, as all types of investment except for intellectual property continued to shrink. Inventory building staged a huge rebound, contributing to GDP yoy by 1.9 pp. Net exports subtracted from GDP 0.5 pp, with all of the negative input coming from the trade in services. Real exports were higher by 4.3% yoy and real imports by 5.6% yoy, despite dynamics for services on both sides falling. Nominal GDP picked up to 1.3% yoy after contracting in each of the three previous quarters. From the production side, manufacturing switched to growth (3.0% yoy) after four quarters of a decline. Another sector newly posting growth was financial (6.1% yoy). The deepest decline in gross value added came from Trade and transport (-12.2% yoy) and Other services (-23% yoy). The employment fell by 1.6% yoy, as only the sectors of ICT, public administration and agriculture employed more workers than a year ago. Hours worked were lower by (SA) 1.9% yoy, bringing the productivity per worker down by 0.5% yoy and the hourly productivity down by 0.2% yoy. The volume of wages and salaries fell by 1.0% yoy, while compensation of employees rose by 1.8% yoy. A dominating part of the gap was found in Trade and transportation and Other sevices, the sectors most severely hit by lockdowns in the economy. By far the highest yoy dynamic of both compensation (6.8% yoy) and salaries (6.7% yoy) was recorded by the sector of public administration (also comprising education and health).

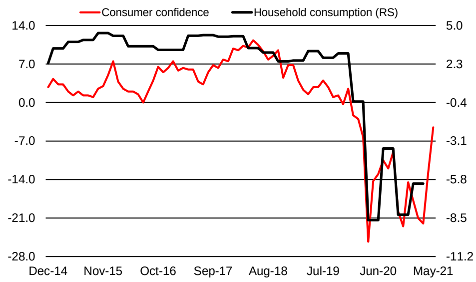
Business uncertainties due to the pandemic have inflated employment in the sector of public administration. The number of employees in the sector exceeded one million first time in 3Q20 and have continued to grow since. In 1Q21, its share of total number of employees in the economy hit 22.1%, almost 2 pp above a typical pre-pandemic level. With salaries in the sector surpassing a national average and rising faster than in the rest of the economy, the sector accounted for 25.6% of total wages and salaries paid in the economy, 4 pp more than in 2016-2017. While there is a general acceptance that good public services cannot be attained without costs, we find the trend highly excessive and unsustainable.

2Q21: SURGE IN ACTIVITY MAGNIFIED BY LOW BASE

Opening-up of the economy from the start of 2Q21 after a severe lockdown makes high-frequency data looking good. April industrial output posted (SA) 1.9% growth mom and 55% yoy, the latter being largely magnified by a low base. New industrial orders were up 90% yoy in April. New car registrations added 65% yoy for April-May, also benefiting from the low base. Retail sales (NSA, ex-car) rose by 7.5% yoy in April. Construction output, by contrast, continued to shrink in April, down (SA) 4.6% yoy.

The last year's base effect is set to continue boosting industrial output also in the following months. Yet, under the observed supply chain disruptions

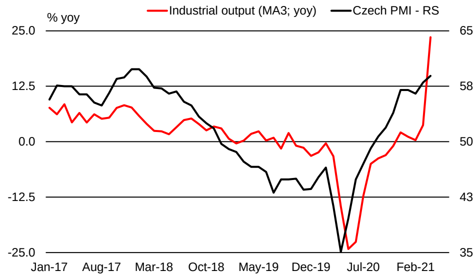
Consumer confidence and private consumption



Sources: CZSO, UniCredit Research.

Consumer confidence has risen after restrictions were eased but its recent level may be underestimating the pace of recovery in private consumption in 2Q21.

Manufacturing PMI and industrial output



Sources: IHS Markit, CZSO, UniCredit Research.

As a result of a huge base effect, industrial output added 55% yoy in April. This was well above the dynamic predicted by manufacturing PMI. We expect industrial output growth to be more gradual in next months.

and mounting input price pressures, we expect it to become increasingly difficult to boost production further. Construction output is facing similar hurdles already now. Therefore, private spending from the demand side and the sector of trade and transport from the production side should rather be the main drivers for GDP in 2Q21. We predict GDP to reach roughly 1.0% qoq, bringing the yoy growth above 8% to a 15-year high.

2H21 AND 2022: RECOVERY ACCOMPANIED BY AN UNUSUAL COMBINATION OF RISKS

Headwinds observed now will be slow to dissipate. Travel restrictions may keep business in Prague hotels just at or even below last year's level during the summer. The situation may start improving from 4Q21, unless a new COVID wave urges for more restrictions. In the area of household spending, only a fraction of pent-up demand, mostly that related to consumer durables, may be realized. Sports and cultural events are facing a slow restart. It appears that spending is not primarily inhibited by a loss in household income or a higher propensity to save. Rather, in our view, 234 days of lockdowns may have changed consumer habits, and it will likely take time for these to return to normal.

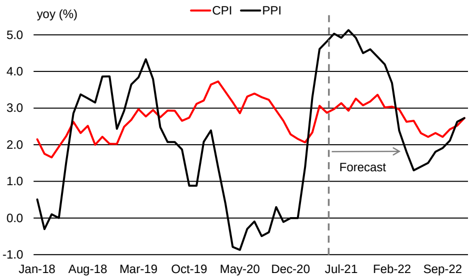
Industrial output may expand in 2021 just enough to cover the 2020 contraction of 7.2%. On the one hand, the order books remain solid. On the other hand, companies processing metals and plastics have reported frequent supply-chain disruptions, which may slow their output and/or raise their costs. The construction activity too appears to be hit by a double-digit rise in input prices. Wages have slowed markedly, but with the unemployment rate dropping below 4% and with companies facing more difficulties to employ foreigners since the outbreak of the pandemic, we assume wage pressures to restore in 2022.

The rising prices, with May PPI at 5.1% yoy, resemble a bit the situation in 2011, which was followed by a shallow but lengthy recession. This time around, there seem to be even more intermediate products with an elevated price level but the passthrough to consumer prices has so far been limited. Nevertheless, we expect pressures from multiple sides to keep CPI above 3% yoy at least during 3Q21.

Even if consumers stay affected by inflation to a limited extent, the producer price spike is a complication for capex. The risk is that not only a slow pick-up in demand, but also extra costs could cause new projects to delay until 2022. Admittedly, what we have observed already in 1Q21 and what may continue is an inventory run-up, stemming from the efforts of businesses to mitigate disruptions in deliveries by holding a larger stock of materials and intermediate products. This could boost GDP in the short run (as was the case in 1Q21), but slow growth subsequently.

While we perceive an unusual combination of risks to economic growth, our baseline scenario is based on the assumption that the supply chains functioning will normalize. This should facilitate accelerating **GDP growth** from 2021's estimated **2.8%** to **3.8%** in 2022. Both private consumption and capital formation should turn stronger next year.

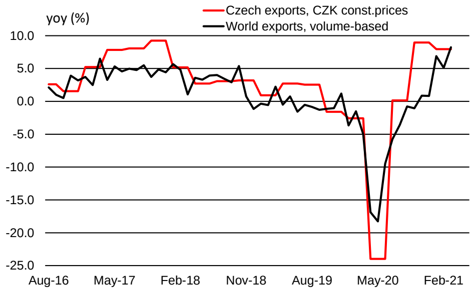
Czech consumer and producer prices



Sources: CZSO, UniCredit Research.

PPI is spiking just now and will probably remain elevated for the rest of 2021. CPI values look more moderate but are seen at the upper limit of the ČNB's 1%-3% tolerance band in next months. Monetary policy tightening is about to start.

Global exports and Czechia exports



Sources: Macrobond, UniCredit Research.

Czech exports have long been an integral part of global exchange of goods. In 1Q21, too, the dynamic of Czech exports appeared to be in line with that in the rest of world.

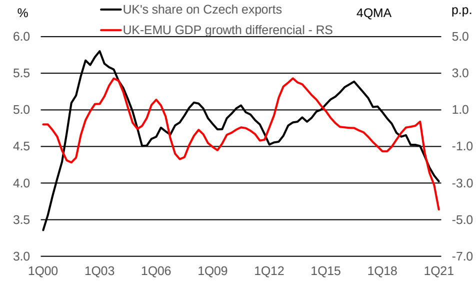
POLICIES: LOOSE FISCAL, TIGHTENING MONETARY

Following the 2021 state budget targeting a CZK 500 billion deficit, the government is drafting a CZK 390 billion gap for 2022. Considering higher projected GDP growth and a reduction in spending directly related to fighting the pandemic, the indicated deficit means that there will be almost no fiscal efforts in 2022. We hence project public sector deficit to reach 6% of GDP in 2022 after an estimated 8% of GDP for 2021. Loose fiscal policy could be a major reason for monetary policy tightening in 2022. We expect the ČNB to deliver two more 25bp hikes beyond the June one by the end of 2021, bringing the repo rate to 1.0%. Tightening should continue in 1H21, but we project a pause at the 1.5% level if the fiscal policy tightens meaningfully. Whether this happens, depends on the September parliamentary election results and a new government's agenda. Without a change in the fiscal stance, the ČNB would be forced to extend monetary tightening, running into a sub-optimal policy mix.

FOCUS: NOT ONLY BREXIT DRAGS UK-CZECH TRADE

After the final Brexit at the start of this year and with the 1Q21 foreign trade data released, we have tried to assess an impact of Brexit on the UK-Czech foreign trade. In the period between the referendum in 2016 and 1Q21, we observed a systematic decline in the UK's share on Czech foreign trade. Exports dropped from 5.2% in 2016 to 4.0% and imports from 2.7% to 1.4%, respectively. On the export side, these changes were mainly due to machinery and transport equipment and industrial consumer goods, which together accounted for over 80% of Czech exports to the UK in 2020, worth almost CZK 180bn. However, historical movements of the share of exports to the UK in total Czech exports since 2007 can be explained quite well by a gap in UK's GDP growth rates against the eurozone. The declining trend in recent years may thus not be directly attributable to restrictions or even changes in the foreign trade orientation of business entities due to Brexit. Rather, Brexit probably contributed to UK's GDP growth (perhaps temporary) lagging behind the eurozone, affecting Czech exports to the UK indirectly. Employing other assumptions, we estimate that the weakness of the UK economy rid Czech GDP of about CZK 44bn in 2020 (0.8% of GDP), with other factors than Brexit also playing a role. Focusing just on the most recent data, it is positive that no significant changes in UK's share in Czech total exports or imports can be observed in 1Q21 compared to the "pre-Brexit" period of 4Q20. This points to the ability of companies on both sides to deal with extra bureaucracy, brought about by Brexit. A deeper look however reveals sharp declines in imports of food with a short expiration such as meat, milk or dairy products. Those are surely attributable to border complications. Furthermore, imports of cereals, feed, chemicals, pharmaceuticals and plastics fell sharply as well. It is uncertain which of these declines will prove temporary and which will become more permanent. Anyway, the changes in mutual trade look minor on the macroeconomic level.

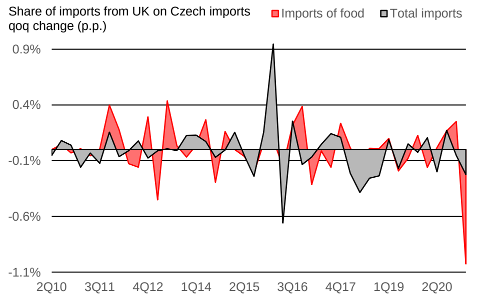
The UK-EA GDP growth differential and the UK's share on Czech exports



Sources: CZSO, Macrobond, UniCredit Research

The UK's share on Czech exports has been on a continuous slide since 2016 and in 1Q21 it hit a long-term low. The share appears to be reasonably correlated with the growth differential between the UK and the Eurozone. Hence, not only Brexit as an isolated phenomenon stood behind the UK's underperformance.

The UK's share on Czech imports of food and total imports



Sources: CZSO, Macrobond, UniCredit Research.

The share of the UK on total imports in Czechia was systematically falling just after the voting on Brexit in 2016. Brexit itself at the start of 2021 did not affect total imports much but did cause imports of food to slump.

Czechia Macroeconomic Outlook

	2018	2019	2020	2021 forecast	2022 forecast
GDP growth (real yoy change, %)	3.2	2.2	-5.6	2.8	3.8
Household consumption (real yoy change, %)	3.5	3.0	-5.2	2.3	4.2
Gross fixed capital formation (real yoy change, %)	10.0	2.2	-8.1	-0.7	7.0
Industrial output (real yoy change, %)	3.0	-0.2	-7.2	8.5	4.0
Unemployment rate (average, %)	3.2	2.8	3.6	4.1	3.7
Inflation rate (CPI yoy change, average, %)	2.1	2.8	3.2	2.9	2.6
Average wages (nominal yoy change, %)	8.1	6.4	4.4	3.8	4.2
Interest rates (3-M PRIBOR, end of period, %)	2.01	2.18	0.35	1.20	1.65
Interest rates (3-M PRIBOR, average, %)	1.27	2.12	0.86	0.65	1.30
EUR/CZK exchange rate (end of period)	25.73	25.41	26.25	25.40	25.00
EUR/CZK exchange rate (average)	25.64	25.67	26.44	25.70	25.20
Current account balance (% of GDP)	0.4	0.3	3.6	3.9	2.5
FDI net inflow (% of GDP)	0.9	4.3	2.6	3.0	3.5
General government balance (% of GDP)*	0.9	0.3	-6.2	-8.0	-6.0
Public debt (% of GDP)	32.1	30.2	38.1	44.2	47.6

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

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