Czech Economic Quarterly

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The taste of a shortage economy

- In 2Q21, real GDP jumped by (SA) 1.0% qoq, bringing the yoy dynamic to 8.2%, an all-time high. Private consumption grew by 7.4% yoy, also the highest dynamic on the record, while government consumption added 3.0% yoy. Fixed capital formation leapt by 1.5% yoy. Inventory building continued in its upward drift, contributing to yoy GDP by 3.2 pp. Net exports created a small positive contribution to GDP of 0.5 pp.

- The situation in 3Q21 is characterized by a strong demand, which is not fully matched from the supply side. Nevertheless, we believe that household spending optimism, coupled with a rebound in capital spending of businesses, should translate into an acceleration in qoq GDP to 2.0%. In yoy terms, GDP may expand 3.5% yoy.

- Household spending optimism and global supply-side constraints are shaping up changes in our forecasts versus the scenario made three months ago. Their mutual impacts may broadly offset for GDP growth but compound for inflation and trade balance. We are upgrading our GDP outlook marginally to 3.2% for 2021 and 4.1% for 2022, while lifting the outlook on average CPI substantially to 3.3% for 2021 and 3.6% for 2022.

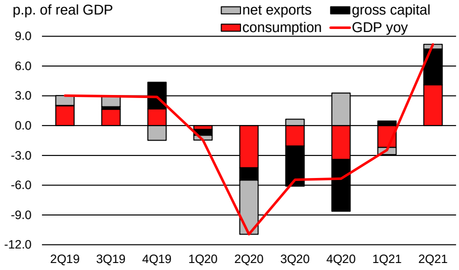
- If the ČNB opts to act in line with its legal mandate, it should hike the repo rate rather fast, in order to prevent second-round inflationary effects fully developing. We expect additional 50bp of hike(s) in 4Q21 to follow the September 50bp decision, while two more steps, delivered in 1H22, may bring the repo rate to 2.25%.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	2Q21		1Q21 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**8.2**	**8.2**	**-2.5**	**-2.5**
Household consumption (%)	7.4	3.4	-6.6	-3.0
Government consumption (%)	3.0	0.7	3.6	0.7
Fixed capital formation (%)	1.5	0.4	-4.2	-1.1
Change in inventories	-	3.2	-	1.6
Net exports	-	0.5	-	-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.

Breakdown of GDP growth by demand*



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

The resumption of yoy GDP growth in 2Q21 was driven by consumption and gross capital. Whereas higher consumption was brought about by both the household and the government spending, an overwhelming part of the capital contribution came from inventories.

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2Q21: PICTURE DIMMED BY STRONG BASE EFFECTS

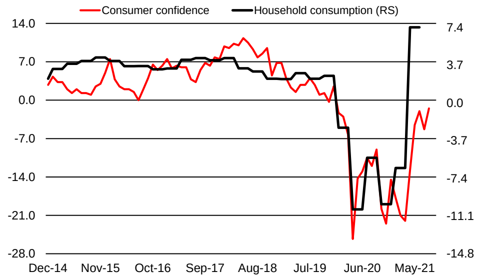
In 2Q21, real GDP jumped by (SA) 1.0% qoq, bringing the yoy dynamic against a low base to 8.2%, an all-time high. Private consumption grew by 7.4% yoy, also the highest dynamic on the record, while government consumption added 3.0% yoy. Fixed capital formation leapt by 1.5% yoy in its first yoy increase since the outbreak of the pandemic. Inventory building continued in its upward drift, contributing to yoy GDP by 3.2 pp. Net exports created a small positive contribution to GDP of 0.5 pp, as exports and imports grow by 30.6% and 31.3% yoy, respectively. Nominal GDP expanded by 12.8% yoy with the help of GDP deflator that accelerated to 4.3% yoy. From the production side, yoy growth was overwhelmingly driven by manufacturing (23.2% yoy), influenced by a low base. Construction, real estate activities and business services saw their GVA on the brink of stagnation, with all the other sectors posting single-digit growth. The employment was up 0.3% yoy with hours worked adding 6.6%. This implies productivity growth of 7.9% yoy per worker and 2.0% yoy per hour. Wages and salaries were higher by 17.7% yoy but employers' social contributions increased only by 5.5% yoy.

Huge fluctuations on the demand as well as supply side during the pandemic, caused by economic restrictions imposed locally and abroad, makes yoy comparisons of little use. Assuming that genuine recovery has been under way since 2Q21, it makes sense to compare the latest economic parameters against 4Q19, the period of economic activity peaking. In that perimeter, real GDP has stayed 4.8% below the peak in 2Q21, with private consumption short of 4.0% and fixed capital formation booking 5.8% less than in 4Q19. However, accummulation of inventories was worth a positive 1.0% of annual GDP. Hours worked fell by 3.9%, while employment was down 1.2%. In nominal terms, GDP expanded by 2.4%, the same pace as for gross operating surplus, but compensation of employees was up 7.5% over six quarters. Our takeaway is that the pandemic caused no fatal disruption on the macroeconomic level but going forward, hourly productivity will need to catch up and the output will need to grow faster than wages and salaries, in order for the economy to maintain its competitiveness.

3Q21: A CYCLICAL PEAK IN GDP QOQ GROWTH

The situation is characterized by a strong demand, which is not fully matched from the supply side. In July, retail sales rose (SA) 5.5% yoy, suggesting that pent-up demand of households is unwinding. We expect the process to gather a further momentum in the following months, although in August more households than last year probably spent their vacation abroad and inflation is eating up a larger share of income in 3Q21 compared to 2Q21. CPI hit 4.1% yoy in August, a 13-year high, with signs of an inflationary environment spreading. In contrast to the improving travelling appetite of local households, the incoming tourism remains depressed. In industry and construction, order books are full and delivery times extremely long due to bottleneck in the supply of materials as well as labor force. July industrial output saw a (SA) 7.0% yoy rise, driven by metal processing and electrical equipment production, whereas the

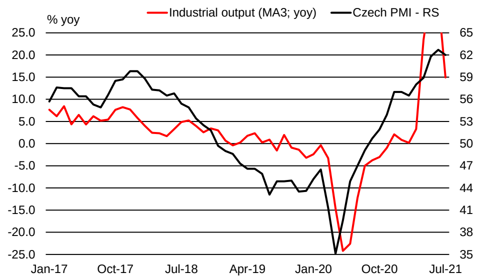
Consumer confidence and private consumption



Sources: CZSO, UniCredit Research.

In 2Q21, private consumption staged much faster growth than indicated by consumer confidence. This may suggest that a pent-up demand of households is unwinding.

Manufacturing PMI and industrial output



Sources: IHS Markit, CZSO, UniCredit Research.

The persistently high level of manufacturing PMI in recent months comes among other factors from all-time long delivery times. Considering the supply-side bottlenecks, the construction of PMI limits its predictive power for industrial output dynamics.

automotive production fell. The industrial activity is expected to be much weaker in August and September, as car makers have struggled with a shortage of key parts, cancelling shifts and extending company-wide holidays. Nevertheless, we believe that household spending optimism, coupled with a rebound in capital spending of businesses, should translate into an acceleration in qoq GDP in 3Q21. In yoy terms, GDP may expand 3.5% yoy.

4Q21 AND 2022: A TASTE OF A SHORTAGE ECONOMY

Two major factors, **household spending optimism** and global **supply-side constraints**, are shaping up changes in our forecasts versus the scenario made three months ago. Their mutual impacts may broadly offset for GDP growth but compound for inflation and trade balance.

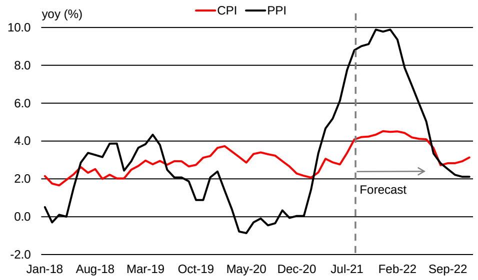
Since the start of the pandemic, households have been accumulating extra savings. Looking at just the dynamics of after-tax labor income versus household spending (ignoring a rise in social benefits), the **accumulated savings** have accounted for 10.5% of the 2019 household spending. This creates potential for a considerable **pent-up demand**. Going forward, **unemployment** (3.6% in August) is also expected to be lower and **wage growth** (11.3% yoy in 2Q21) higher than projected before. For 2022, the government has proposed an 18% hike in **minimum wages**, the step on which even trade unions were taken by surprise.

In contrast, global supply-side bottlenecks are set to sustain longer than previously thought. These are primarily transferred to output in Czechia via two channels – the **shortage of semiconductors** and skyrocketing **prices of freight sea transport**. The former channel is causing delays in the local output of a limited though crucial number of products, notably cars. The latter is causing delays and shortages in the supply of many intermediate as well as finished goods, driving up their prices (see also Focus on page 4). Importantly, we see none of the two channels related solely to the covid-19 pandemic, which leaves little hope for fast returning to business as usual if the pandemic subsides.

Only in a longer run, new strategies may emerge to cut short the **value chains**, creating new opportunities for local manufacturers. In 2022, however, inefficiencies in the transition process are believed to prevail, dragging **output and productivity growth**. The labor shortage is also seen as a constraint to developing more manufacturing capacities. This constraint is particularly relevant for Czechia as a country with one of the lowest unemployment rates in the EU. With over 13% of total workforce accounted for by non-residents, capacity for more labor immigration is also limited. Under circumstances, we also doubt that the NGEU subsidy (with the first tranche just approved at CZK 24 billion for Czechia) will help boost GDP growth materially in 2022.

On balance, we are upgrading our **GDP outlook** marginally to 3.2% for 2021 and 4.1% for 2022, while lifting the outlook on **average CPI** substantially to 3.3% for 2021 and 3.6% for 2022. In yoy terms, **CPI** may be peaking around 4.5% in late 2021 or early 2022, when most external cost factors will likely have been absorbed.

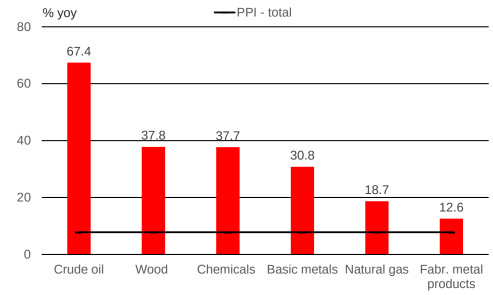
Czech consumer and producer prices



Sources: CZSO, UniCredit Research.

PPI is set to peak around the year turn at close to 10% yoy – a much higher level than previously expected. In the same vein – a peak in CPI is projected higher (about 4.5% yoy) and not much lagging behind PPI.

PPI groups with the highest growth in August 2021



Sources: Macrobond, UniCredit Research.

Within PPI, a rising number of price groups are showing double-digit yoy increments. This may gradually pass through to the entire output, delaying a subsidence of the PPI wave.

MONETARY POLICY: TIGHTENING TO SPEED UP

The ČNB has every reason to continue the policy tightening. If it opts to act in line with its legal mandate, it should hike the repo rate rather fast, in order to prevent second-round inflationary effects fully developing. We expect additional 50bp of hike(s) in 4Q21 to follow the September 50bp decision, while two more steps are assumed for 1H22. With the repo rate at 2.25% then, the ČNB may take a break for assessing impacts of its policy. A still open question is whether that will be the end of the hiking cycle.

FOCUS: SEA TRANSPORT PRICES ARE AN IMPORTANT COST FACTOR IN CZECH OUTPUT

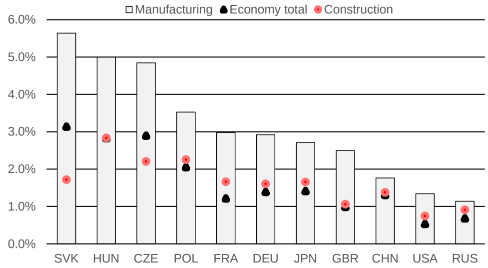
Many price indices have been lately hitting multi-year highs, but the global sea transport cost stands out. While the surface freight prices in 2Q21 were reported by Transport Intelligence higher by "only" 3.2% yoy, for global sea freight transport two different sources point to price hikes over the same period of 83% and 260% respectively. In case of the transport from China to Europe, sources say the price has even jumped sixfold.

More expensive freight transport must inevitably push on production prices in all industrial countries. By how much? The cost of global transport (including wholesalers' margins and insurance) as a share of industrial output prices cannot be directly measured. We estimate it from global input-output tables (WIOD 2016). In Czechia, international freight transport has the fifth highest share in the manufacturing output cost (4.8%) of all 43 countries surveyed. Higher than Czechia come only Slovakia, Taiwan, Lithuania and Hungary. Estimates tend to be lower for manufacturing in bigger countries: Poland 3.5%, Germany 2.9%, UK 2.5%, China 1.8%, USA 1.3% and Russia 1.1%. Output of the whole Czech economy (including services) stands in terms of the international transport share in costs at 2.9%, which ranks it third in the world.

What do the figures imply? Hypothetically, doubling the prices of international transport would boost PPI (all else equal) by almost 5% and should translate into (roughly) a 1.3pp hike of CPI. As it comes to extra-EU sea transport, the Eurostat puts its share in total international transport of imported goods at 22.5% in financial terms (or 39% if measured in tons) for 2019. Assuming the price impact of wholesale and insurance as 20% of total transport cost, we estimate that the 260% price hike of sea transport would boost PPI by 2.3pp, adding about 0.6pp to CPI.

Is that going to happen? Should we treat only an impact of the pandemic, we could possibly soon sigh a relief. However, the evolution might have deeper roots and new risks are emerging as well, such as the planned extension of the emission allowances system to surface, sea and air transport. Thus, higher prices of international transport may become a new norm.

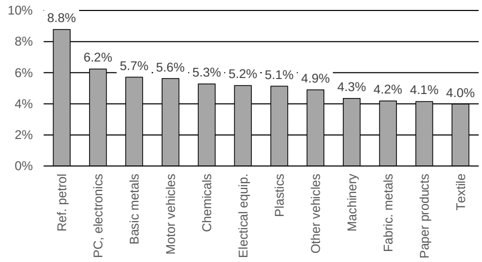
Share of international freight transport cost in total output and selected sectors



Sources: WIOD, UniCredit Research

Small open economies are marked by a higher share of international freight transport cost in their output than bigger ones. Of all 43 countries surveyed, Czechia ranks third in terms of that cost in the total economy and fifth in manufacturing.

Share of international freight transport cost in sectors of the Czech economy



Sources: WIOD, UniCredit Research.

With the share of 8.8%, oil refining appears to be the Czech manufacturing sector most sensitive to international freight transport cost. For most other sectors within Czech manufacturing, the shares are in the range of 4% to 6%.

Czechia Macroeconomic Outlook

	2018	2019	2020	2021 forecast	2022 forecast
GDP growth (real yoy change, %)	3.2	3.0	-6.4	3.2	4.1
Household consumption (real yoy change, %)	3.5	2.6	-6.8	2.8	4.2
Gross fixed capital formation (real yoy change, %)	10.0	5.9	-7.2	1.4	7.0
Industrial output (real yoy change, %)	3.0	-0.2	-7.2	9.5	5.0
Unemployment rate (average, %)	3.2	2.8	3.6	3.9	3.6
Inflation rate (CPI yoy change, average, %)	2.1	2.8	3.2	3.3	3.6
Average wages (nominal yoy change, %)	8.1	6.4	4.4	6.5	6.0
Interest rates (3-M PRIBOR, end of period, %)	2.01	2.18	0.35	1.90	2.35
Interest rates (3-M PRIBOR, average, %)	1.27	2.12	0.86	0.82	2.25
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	25.65	25.20
Current account balance (% of GDP)	0.4	0.3	3.6	2.2	1.0
FDI net inflow (% of GDP)	0.9	2.4	1.3	1.0	1.1
General government balance (% of GDP)*	0.9	0.3	-6.2	-7.3	-5.6
Public debt (% of GDP)	32.1	30.3	38.1	42.9	45.8

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

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