Czech Economic Quarterly

March 21, 2017

High Demand, Low Productivity Growth

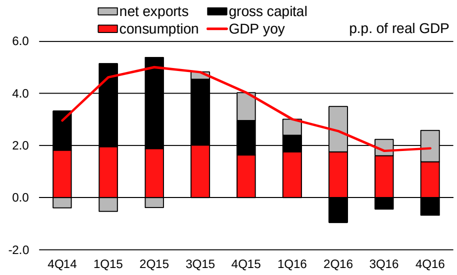
- In 4Q16, real GDP rebounded to 0.4% qoq, moving the yoy dynamic one notch up to 1.9%. Private consumption (0.9% qoq / 2.8% yoy) proved to be the major driving force of growth. Fixed capital formation (-6.1% yoy) further deepened its decline, whereas inventory accumulation added to GDP growth 0.9pp. The contribution of net exports to GDP growth doubled from 3Q16 to reach 1.2pp.
- January data came in relatively firm, offsetting poorer figures from the previous month. Industrial output headed the positive element in data, posting 9.6% yoy. There is every reason to believe that GDP growth will further strengthen in 1Q17. We have raised our forecasts to 0.8% qoq and 2.3% yoy.
- The cyclical recovery in the global economy is set to extend through the remainder of 2017, unless curbed by US protectionist policies or surging risks of the Eurozone breakup. Full-2017 GDP growth is projected at 2.6% with risk tilted towards a slightly higher reading.
- The EUR-CZK floor at 27.0 is likely to be removed after the next CNB forecast revision due in early May. Abandoning the EUR-CZK floor could push the cross initially below 27.00, but ensuing FX volatility could prevail in the weeks following the move to a managed float. We stick to our forecasts of EUR-CZK at 26.50 at the end of 2017 and 26.00 at the end of 2018.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	4Q16		3Q16 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**1.9**	**1.9**	**1.8**	**1.8**
Household consumption (%)	2.9	1.3	3.1	1.4
Government consumption (%)	0.0	0.0	1.0	0.2
Fixed capital formation (%)	-6.1	-1.6	-5.0	-1.3
Change in inventories	-	0.9	-	0.9
Net exports	-	1.2	-	0.6

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 growth changed little in 4Q16 from the previous quarter, with consumption being the key driver again. Net exports widened its contribution to growth, while gross capital widened its negative input. Within gross capital, the situation also remained unchanged in that fixed capital formation eased and the inventory stock accumulated.

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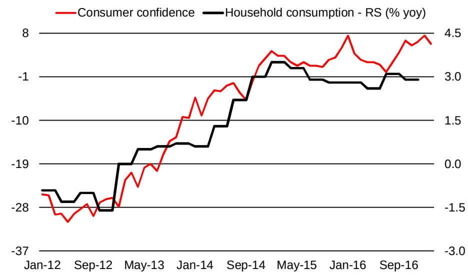
4Q16: PRIVATE CONSUMPTION HOLDING UP

In 4Q16, real GDP rebounded to 0.4% qoq, moving the yoy dynamic one notch up to 1.9%. Private consumption (0.7% qoq / 2.9% yoy) proved to be the major driving force of growth, while government consumption stalled after growing 1.0% yoy in 3Q16. Fixed capital formation (-6.1% yoy) further deepened its decline, whereas inventory accumulation added to GDP growth 0.9pp., an equal contribution to 3Q16. Exports grew 1.8% yoy, slowing further marginally from an already weak dynamic of 3Q16, but imports eased even more (0.4% yoy). As a result, the contribution of net exports to GDP growth doubled from 3Q16 to reach 1.2pp. Gross value added grew by 1.6% yoy, the same dynamic as in 3Q16. Nominal GDP slowed to 2.8% yoy.

In a quarterly comparison, the dynamic of exports picked up in 4Q16, suggesting that mid-year weakness from 2016 could be over. The same however cannot be said about fixed capital formation which posted a drop not only in yoy but also in qoq data. In the breakdown of fixed capital formation, the categories of non-residential construction and machinery equipment are to be blamed for the contraction. This stems from the base effect of hectic investment activity in 2015. We also expect that part of the inventory run-up will later be revised to become (mainly construction) investments. However, poor productivity gains of 2016 (in per-employee terms 0.5% for full year and -0.2% yoy for 4Q16) are believed to have links to shrinking machinery investments.

Consumer confidence and private spending



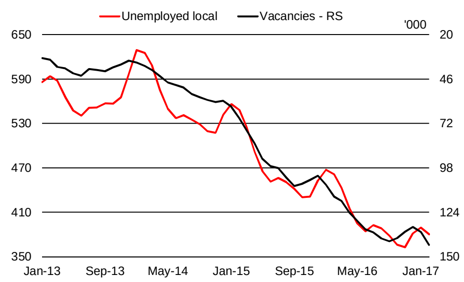
Sources: CZSO, UniCredit Research.

The consumer confidence at or close to all-time highs keeps supporting private consumption growth. The key issue for 2017 is how consumers will cope with the spike in inflation. Our assumption continues to be that nominal wages will grow fast enough to prevent derailing consumer confidence.

1Q17: IMPROVEMENT ON EXTERNAL FACTORS

January data came in relatively firm, offsetting poorer figures from the previous month. Industrial output grew 9.6% yoy, capturing not only two more working days against 2016 but in addition the timing of company-wide holidays at the turn of the year that were shifted more to December than in the 2015-2016 period. Exports in CZK terms were firmer by 6.7% yoy, continuing to expand slightly less than output in constant prices. Retail sales jumped 7.7% yoy on the core segment adding 5.6% yoy and the car sales and repairs growing 12.2% yoy. New car registrations posted 15.9% yoy rise in January and ticked up (1.4% yoy) even in February despite the leap year of 2016 forming a negative base effect. Construction output started 2017 with a minor, (unadjusted) 0.2% yoy dip in January, which looked as a solid outcome considering severe weather conditions. Building permits posted yoy increases in terms of total values as well as the number of housing units. Leading indicators in major EU countries suggest that the external environment will remain rather supportive, which makes us forecast real exports accelerate to 4.5% yoy in 1Q17. We also count on a reversal of fixed capital formation to (slightly) positive yoy figures, while private consumption growth will broadly maintain its 2016 momentum. All in all, there is every reason to believe that GDP growth will further strengthen in 1Q17. We have raised our forecasts to 0.8% qoq and 2.3% yoy.

Unemployment and job vacancies



Sources: MPSV, UniCredit Research.

The pace of new jobs creation remains high, as both the jobless and the vacancies statistics are approaching their record levels from 2008. The tight labor market is set to become a hindrance of faster GDP growth in 2017.

FULL-2017: CYCLICAL UPTURN, POLITICAL RISKS

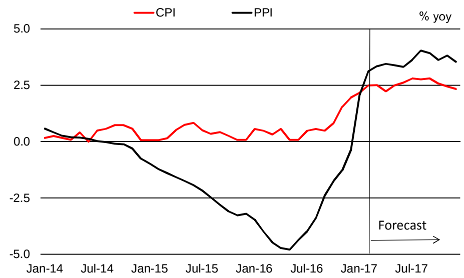
Global trade volumes are gaining momentum while leading indicators for **manufacturing** in Europe are hitting multi-year highs. This suggests that the cyclical recovery in the global economy is set to extend through the remainder of 2017, unless curbed by US protectionist policies or surging risks of the Eurozone breakup. Our view is that the latter will not materialize while the former will take more time to stage in. The Czech economy should hence benefit from the current situation via higher **external demand**, bolstering also **fixed capital formation**.

Real export growth is projected to reach 4.2% in 2017 despite the car market in Europe approaching the point of saturation after three years of expansion. The pace of export growth is seen sufficient for **net exports** to provide a positive contribution to GDP growth (estimated at 0.6 pp). The machinery part of **corporate investments** is set to resume expansion after the disappointing 2016, reacting not only to higher external demand but also seeking a shift to more efficiency. The shift is based on the need of higher productivity in the environment of scarce labor force and climbing personnel costs, exacerbated also by the approaching end to the EUR-CZK exchange rate floor.

As to factors affecting domestic demand, **headline CPI** has firmly settled above 2% yoy, the leap largely driven by motor fuels and food prices. On top of that, however, other price groups have powered ahead, bringing the Czech **core inflation** well above its Central European peers. As the most notable example, restaurant prices have been reported up 7.5% yoy in February. Technically, the rise is attributed to extra costs connected to the on-line sales registration system in place for catering since December, However, it is exactly the kind of demand-side-driven factors that the CNB would hope to see before abandoning the FX floor. Base effects are set to push inflation a bit higher before starting to fade away in late 2017. The tight labor market and pre-election salary generosity are nevertheless believed to represent an upside risk to the CNB inflation forecast which sees CPI drop below 2% yoy by 4Q18.

The rise in 2017 **average inflation** to estimated 2.5% will put a cap on real **household disposable income**, despite **nominal wages** seen accelerating to 4.7% and **total employment** adding 1.0% this year. However, **consumer sentiment** should not be derailed by inflation. What may also help is that lower incomes will grow faster than higher ones. On balance, **private consumption** is forecast to add 2.6% in 2017, only marginally less than in 2016. Where we see more optimism than a year ago in domestic demand is the construction-based part of **fixed capital formation**. While investments in dwellings will maintain its (slow but steady) growth from 2016, infrastructure investments are believed to benefit from a lower 2016 base and from new orders being taken. Fixed capital formation as a whole may expand by 2%, with the risk of an even higher growth in 2017. **Total GDP growth** is projected at 2.6% with risk tilted towards a slightly higher reading. That said, we remain more cautious on 2018, with infrastructure investments being the only component gaining sufficient momentum to avoid slowing down.

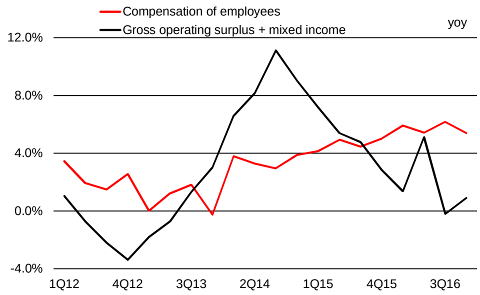
CPI and PPI – history and outlook



Sources: CZSO, UniCredit Research.

At February's 2.5% yoy, headline inflation got back above the CNB's 2.0% target for the first time since 2012. We predict CPI to stay around current levels for the rest of the year, easing towards the 2% yoy level thereafter.

Labor costs and company profits



Sources: CZSO, UniCredit Research.

The second half of 2016 saw gross operating surplus and mixed income ceasing to grow yoy. While the more costly commodity prices serve as an obvious reason, higher compensations on employees also represent a drag on corporate profitability. The latter factor is likely to remain in place through 2017.

THE END OF CNB'S FX FLOOR LIKELY FROM MAY

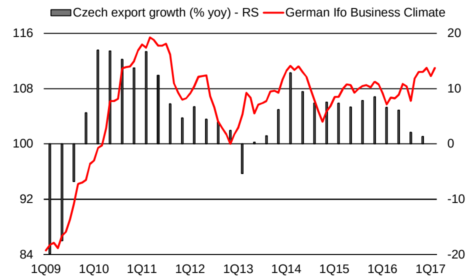
The CNB still appears to be concerned that inflation may not be robust enough on a monetary policy horizon. Despite a higher inflation forecast published in February, the CNB did not move forward its mid-2017 call for abandoning the FX floor. Some market participants interpreted this as CNB's aim to taking the markets by surprise on an early-April exit. Indeed, enormous euro amounts flowing into CNB reserves (EUR 14.5bn in January and over EUR 8bn estimated for February) speak in favor of an exit as soon as the CNB's hard commitment allows. However, taking into account the uniform communication of policy makers about mid-2017, we have come to the conclusion that the floor is more likely to be removed only after the next forecast revision due in early May. Abandoning the EUR-CZK floor could push the cross initially below 27.00, but ensuing FX volatility could prevail in the weeks following the move to a managed float. The investors mulling to open short EUR-CZK positions after the exit will need to take into account the volume of positions already open, which we estimate at EUR 30 billion. Admittedly, the volume has stabilized lately despite CNB interventions ongoing, as a larger share of CNB FX purchases is covering the hedging operations of domestic enterprises. We continue to stick to our forecasts of EUR-CZK at 26.50 at the end of 2017 and 26.00 at the end of 2018.

We also maintain our call of no rate increases in 2017, despite upside risks for inflation in 2018. Post-exit uncertainties over the trajectory of EUR-CZK and the ECB's ongoing asset purchases are the key arguments for the CNB to delay a first hike until early 2018. We keep two small repo rate increases in our forecast for 2018, with risks of tighter monetary policy rising.

FOCUS ON THE TERMS OF TRADE: NEGATIVE BUT WITH NO DRAMA

The terms of trade were stimulating GDP deflator in each of the last four years, the principal reason being a decline in global commodity prices. This year is set to be different. Higher crude oil as well as other commodity prices will bring about a trading loss, driving GDP deflator lower. Net imports of crude oil alone may cause trade balance to deteriorate by CZK 23 billion versus 2016 via the combination of the price factors and an increase of volume imports. Yet, we expect the 2017 trade surplus reduction versus 2016 to stay rather modest (CZK 7 billion), as exports (in particular in higher-value-added products) will benefit from growing external demand. The effect is hence unlikely to reverse the process of the current account improvements that has been going on without any break since 2011. Our preliminary thoughts foresee the current account surplus widening also in 2018, to 2.0% of GDP from 1.7% expected for 2017.

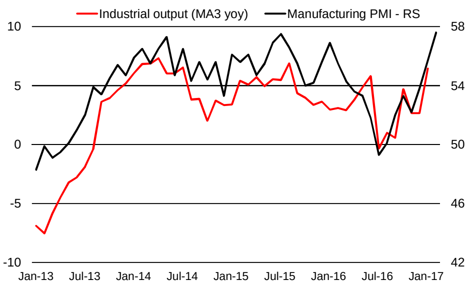
German Ifo and Czech exports of goods



Sources: Ifo, CZSO, UniCredit Research.

With the Ifo Business Confidence in Germany at a multi-year high, exports of goods from the Czech Republic appear to have space for a visible rise in dynamic. We expect this year's dynamic to be higher than in 2H16 but see the historical pattern unlikely to be precisely repeated.

Manufacturing PMI and industrial output



Sources: Markit, CZSO, UniCredit Research

Since mid-2016, industrial output growth has been mirroring ups and downs of manufacturing PMI. For January 2017, the leading indicator foresaw for industry a substantial upturn and indeed, industrial output expanded 9.6% yoy. The February PMI value looks consistent with an even stronger industrial output reading but other relevant signals for industry are less upbeat.

Czech Republic Macroeconomic Outlook

	2014	2015	2016	2017 forecast	2018 forecast
GDP growth (real yoy change, %)	2.7	4.6	2.3	2.6	2.5
Household consumption (real yoy change, %)	1.8	3.1	2.8	2.6	2.2
Gross fixed capital formation (real yoy change, %)	3.9	9.1	-3.6	2.0	3.0
Industrial output (real yoy change, %)	5.0	4.6	2.9	3.5	2.5
Unemployment rate (average, %)	7.7	6.5	5.5	4.5	4.4
Inflation rate (CPI yoy change, average, %)	0.4	0.3	0.7	2.5	2.1
Average wages (nominal yoy change, %)	2.9	2.7	4.2	4.7	4.2
Interest rates (3-M PRIBOR, end of period, %)	0.34	0.29	0.28	0.30	0.8
Interest rates (3-M PRIBOR, average, %)	0.36	0.31	0.29	0.30	0.4
EUR/CZK exchange rate (end of period)	27.73	27.03	27.02	26.50	26.00
EUR/CZK exchange rate (average)	27.53	27.28	27.03	26.50	26.30
Current account balance (% of GDP)	0.2	0.2	1.1	1.7	2.0
FDI net inflow (% of GDP)	1.9	-1.1	3.0	2.3	2.1
General government balance (% of GDP)*	-1.9	-0.6	0.5	-0.6	-0.5
Public debt (% of GDP)	42.2	40.3	38.5	37.5	36.5

Remarks:
**/ ESA 95 definition.*
Sources: Czech National Bank, Czech Statistical Office.
Forecasts: UniCredit Bank CZ.