Czech Economic Quarterly

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Facing headwinds from three directions

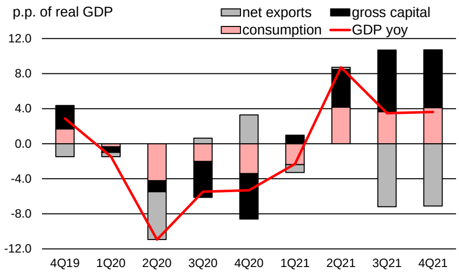
- In 4Q21, real GDP increased by (SA) 0.9% qoq, leaving the yoy dynamic (3.6%) little changed from the previous period. Private consumption powered ahead with growth of 9.3% yoy, while government consumption turned to a stagnation (0.1% yoy). Fixed capital formation advanced moderately (3.5% yoy), with investment in dwellings and transport equipment standing out. Inventories were again accummulated in a large scale, contributing to GDP by 5.7%. Net exports in contrast subtracted from yoy GDP a huge 7.1%. In 2021 as a whole, GDP rose by 3.3%, recovering just a bit more than half from the previous year's decline (-5.8%).
- The Russia's military aggression and the underlying economic sanctions stalled the fast post-covid normalization in spending of Czech households, observed until February. 1Q22 GDP growth may nevertheless still be close to 3% yoy, driven by private consumption.
- In the remainder of 2022, a loss in demand from Russia and Ukraine, supply chain disruptions and a fresh inflation shock are expected to drag the Czech economy on the brink of stagnation. Full-year GDP growth may post 1.2%, helped by a still solid 1Q22.
- The economic environment shifting towards stagflation creates a tricky situation for monetary policy. Following a 25bp or 50bp repo rate increase in March, hiking may not fully track the jump in expected inflation. That said, more persistent inflation will delay monetary easing in 2023.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	4Q21		3Q21 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**3.6**	**3.6**	**3.5**	**3.5**
Household consumption (%)	9.3	4.0	6.5	2.9
Government consumption (%)	0.1	0.0	3.0	0.6
Fixed capital formation (%)	3.5	0.9	2.2	0.6
Change in inventories	-	5.7	-	6.5
Net exports	-	-7.1	-	-7.2

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.

Breakdown of GDP growth by demand*



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

The structure of GDP in 4Q21 remained surprisingly stable from 3Q21 in terms of the key three demand-side components. Almost equally high – over 7% of GDP - was in both periods a negative input to growth from net exports, related to a sharp rise in inventory accumulation. Within consumption, whose increment was in total also stable, household spending accelerated while government's expenditures turned to a yoy stagnation.

Author:

Pavel Sobisek
Tel: +420 955 960 716
E-mail: pavel.sobisek@unicreditgroup.cz

UniCredit Bank Czech Republic and Slovakia
Internet:

4Q21: DOMESTIC DEMAND UP, EXPORTS FALLING

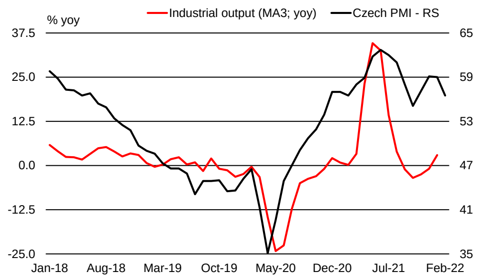
In 4Q21, real GDP increased by (SA) 0.9% qoq, leaving the yoy dynamic (3.6%) little changed from the previous period. Private consumption powered ahead with growth of 9.3% yoy, although decreasing by 1.1% in qoq terms after two strong periods. Government consumption turned to a stagnation (0.1% yoy). Fixed capital formation advanced moderately (3.5% yoy), with investment in dwellings and transport equipment standing out. Inventories were again accummulated in a large scale, contributing to GDP by 5.7%. Net exports in contrast subtracted from yoy GDP a huge 7.1%, as exports fell by 5.9% yoy (of which exports of goods being lower by 8.9% yoy), while imports grew by 3.5% yoy (of which imports of goods adding 4.0% yoy). Nominal GDP expanded by 7.0% yoy on GDP deflator easing to 3.3% yoy, the lowest level since 2018, due to distinctly negative terms of trade in goods. From the production side, gross value added grew slower (2.9% yoy) than GDP, as the tax collection returned to normal after relieves in the previous, pandemic year. The large sector of trade, transport, accommodation, food services was the only one to record a double-digit yoy increment (10.7%), while GVA in manufacturing contracted (-3.3% yoy). Real labor productivity expanded by 2.3% yoy per worker but declined by 3.3% yoy per hour. Nominal wages and salaries were higher by 7.6% yoy with gross operating surplus and mixed income adding 4.9% yoy.

In 2021 as a whole, GDP rose by 3.3%, recovering just a bit more than half from the previous year's decline (-5.8%). With business conditions abruptly changing from one quarter to another, the overall outcome was marked by private consumption and fixed capital formation staying well below pre-pandemic levels, while government consumption strengthening. The most staggering feature in the data was nevertheless an inventory run-up by 4.4% of GDP in current prices during 2021. Such a level of inventories will certainly have implications for businesses in future, with the trade-off existing between hedging against value chains disruptions and a burden of financing the inventory stock.

1Q22: THE WAR CAUSING AN ABRUPT TURN

The Russian military aggression and the underlying economic sanctions stalled the fast post-covid normalization in spending of Czech households, observed until February. Solid January retail sales (9.6% yoy) and signs of high February occupancy rates in local ski resorts suggest that households were ready to open their purses despite inflation at a twenty-year high (11.1% yoy in February). March spending was likely bolstered by stocking-up of motor fuels ahead of their price jump by a third. Industrial output was a bit disappointing with 1.0% yoy growth recorded in January and a similar dynamic estimated for February. In March, a swing to a yoy contraction of industrial output is envisaged from sentiment indicators. Those facts make us believe that 1Q22 GDP may be close to 3% growth yoy. Growth will be driven by private consumption that is projected to expand by more than 8% from the base period of 1Q21, affected by the pandemic.

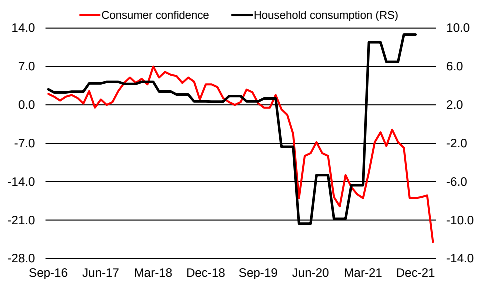
Industrial output and manufacturing PMI



Sources: CZSO, Markit, UniCredit Research.

Manufacturing PMI was spreading some optimism into industry until recently, but the Ukraine crisis is set to terminate this. Value-chain bottlenecks have already worsened, especially in the automotive sector. Even if March PMI, to be released on 1 April, does not look overly bad, it could be largely due to a not-so-good effect of suppliers' delivery times starting to extend again.

Consumer confidence and private consumption



Sources: CZSO, UniCredit Research.

Growth of private consumption remained much faster than indicated by surveys of consumer confidence in recent quarters, which is not sustainable. Nevertheless, the Ukraine crisis and the underlying inflation shock will initially cause both measures drop, with the gap probably remaining open for a while.

THE REST OF 2022: FACING STRONG HEADWINDS

Headwinds are currently blowing from three directions. Firstly, the military conflict will reduce demand from Russia and Ukraine, dragging on Czech exports. The world input-output tables show that demand from Russia accounted for 1.2% of Czech GDP, roughly twice the weight in the Eurozone, with demand from Ukraine adding roughly 0.3%. Our new scenario assumes exports to Russia and Ukraine to drop by 70% in the remainder of 2022, which may cut 2022 Czech GDP by 0.8pp.

Secondly, Ukraine has been part of European value chains, particularly in the automotive industry. The current problem involves above all wire harnesses, the shortage of which should not be as long-lasting as that of chips but may be still dragging on output for weeks or months. With that not being the only shortage in the car components segment, it is realistic to assume a decrease in the European car output for 2022. Considering the sector's significance for the Czech economy, a 10% drop (corresponding to 36% fewer cars being produced than in 2019) could reduce Czech GDP by 0.8pp.

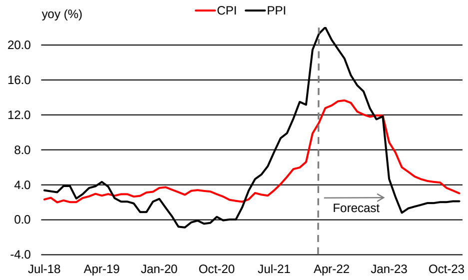
The third headwind derives from a fresh inflation shock. First, price hikes of electricity and gas from 2021 may wipe out a fraction of industrial output with the highest energy cost. Second, they will add to the impact of oil and other commodity price increases on inflation. CPI is now expected to peak in mid-2022, later than previously thought, and at a higher level of 13% to 14% yoy. It is set to bring 2022 average inflation above 12%, almost 4pp over our forecast from three months ago. Importantly, the rise in inflation will not be reflected in a similar spike in nominal wages this year (estimated at only 6.6%), as companies need to cope with other cost pressures first. Admittedly, the sources for boosting private income may still include higher employment and more working hours in the services sector due to a covid-related low base. The households' loss of purchasing power is on the other hand unlikely to be compensated by a drawdown from savings at the same pace as in late 2021. As a result, we count on a stagnation or a moderate annual drop in private consumption from 2Q22 onwards.

As to other 2022 key forecasts, the C/A is projected to end up in a deficit (-3.3% of GDP) for only the second time since 2013. The deficit should stem from expensive energy imports that will deteriorate trade balance by CZK 200 billion compared to 2021. With the cost being only gradually passed on to end-use consumers, we expect growth in fixed capital formation to moderate. GDP could get a small boost from the consumption of Ukrainian refugees. This is expected to be booked as exports of services and public consumption, financed by a deterioration in public sector finance and more EU-fund inflows. On balance, we are cutting our 2022 GDP growth outlook from 3% to 1.2%. The full-year figure is consistent with a stagnation in 2Q22-4Q22, meaning that we do not rule out a mild technical recession.

MONETARY POLICY: THE STAGFLATION DILEMMA

The economic environment shifting towards stagflation creates a tricky

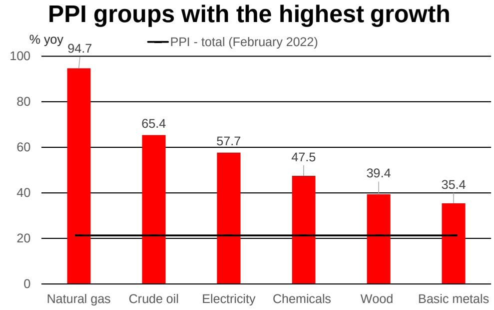
Consumer and producer prices



Sources: CZSO, UniCredit Research.

A fresh inflation shock is building up in energy prices. CPI is now expected to peak in mid-2022, later than previously thought, and at a higher level of 13% to 14% yoy. It is set to bring 2022 average inflation above 12%, almost 4pp over our forecast from three months ago.

PPI groups with the highest growth



Sources: CZSO, UniCredit Research.

In February 2022, producer prices grew by 21.3% yoy, pulled up mainly by energy prices. The Ukraine crisis is making additional inflation pressures, which will be seen in March figures.

situation for monetary policy. In our view, for now, the ČNB will continue with its strategy of tightening monetary conditions, hoping that the dust will settle soon enough to allow for tweaks ahead of its May policy meeting. There might be even chances for a 25bp or 50bp repo rate hike in March. Further down the road, hiking may not fully track the jump in expected inflation, as the environment is set to be much less prone to creating second-round inflationary effects than it was previously. That said, more persistent inflation will delay monetary easing. We expect rate cuts to start only in 2023, with the repo rate remaining above the neutral level, estimated by the ČNB at 3%.

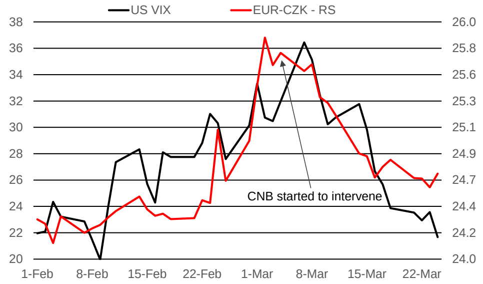
FOCUS: COULD ECONOMIC SANCTIONS BE A GAME CHANGER IN RUSSIA'S AGRESSION?

An economic war has become the West's response to the Russia's military conflict in Ukraine. From the demand side, the West has the upper hand, although Russia is a relatively closed economy, depending on foreign demand from only 25% of GDP (including indirect global links). Russia's most important trading partner is the EU+UK bloc where about 9.7 % of Russian GDP is finally used, while Russia finally demands only 0.6% of EU's GDP. By comparison, China's demand accounts for estimated 5.8% of Russian GDP, despite ongoing efforts to deepen economic links. As for the US, the Russian economy depends on demand from there by 2.4%, with a close-to-nil reliance in the opposite direction. If all trade links were cut off, it would undoubtedly be very painful for Russia, while from the West's side, it would be felt disproportionately more by CEE countries: the Baltics (2.2% of GDP), Bulgaria (1.8%), Slovenia (1.5%), Slovakia (1.3%), Czechia (1.2%).

On the supply side, however, the situation is different. A significant drag on the Russian GDP and employment will derive from Western companies' "self-sanctioning", or gradually terminating their activities in Russia. An official embargo on imports of Western technologies may rather be felt only in the long run via Russia's lower economic potential. The technologies may also be partially replaced by imports from China. Russia also has much more space to retaliate from the supply side, as its natural gas and oil account for 38% and 27%, respectively, of EU countries' consumption. According to a Bruegel think tank study, the share of Russian gas (direct or indirect) in total net energy consumption varies considerably across countries: Hungary 25%, Slovakia 21.5%, Germany 17.2%, Czechia 11.8% Italy 10.4%, but France only 1.6% and the UK 0%. Stopping the flow of Russian oil and gas suddenly would trigger an energy crisis in the EU's most exposed countries. For Russia itself, the situation would mean a drastic drop in foreign exchange earnings, which it can hardly afford.

Finally, what should be considered beyond pure macroeconomic thinking is the West's cutting off Russia from the global financial system. This is becoming very one-sided (with Russia hardly be able to respond) and the more painful, the longer it remains in place. However, while financial sanctions are undoubtedly a powerful tool, a game changer may look different.

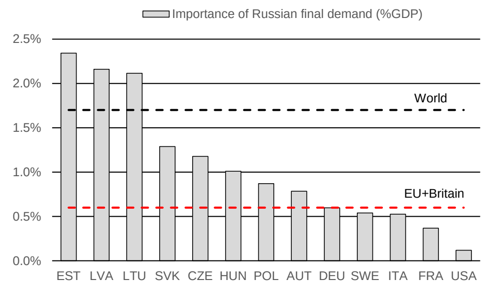
EUR-CZK and VIX since February



Sources: Macrobond, UniCredit Research

The koruna exchange rate is correlated with perceived risk in global markets, measured by the "fear index" VIX. However, even if the recent easing of perceived risk proved temporary, the koruna value may be supported by ČNB FX interventions. The ČNB showed its aim to keep EUR-CZK below 26.0 in first days of the Ukraine crisis and we believe it would remind its aim to the markets again, if needed.

Importance of Russian final demand in countries' GDP



Sources: OECD's TIVA, UniCredit Research.

Russia's final demand accounts for no more than 0.6% of EU's GDP. Eastern countries of the bloc, in particular the Baltic states, would nevertheless suffer more than the others, should exports to Russia be stopped. On the other hand, as much as 9.7 % of Russia's GDP is finally used in the EU+UK bloc, making the EU the biggest trading partner for Russia.

Czechia Macroeconomic Outlook

	2019	2020	2021	2022 forecast	2023 forecast
GDP growth (real yoy change, %)	3.0	-6.4	3.3	1.2	3.0
Household consumption (real yoy change, %)	2.6	-6.8	4.3	1.8	2.2
Gross fixed capital formation (real yoy change, %)	5.9	-7.5	0.9	6.5	5.0
Industrial output (real yoy change, %)	-0.2	-7.2	9.5	4.0	5.0
Unemployment rate (average, %)	2.8	3.6	3.8	3.2	3.0
Inflation rate (CPI yoy change, average, %)	2.8	3.2	3.8	12.3	5.0
Average wages (nominal yoy change, %)	7.9	3.1	6.1	6.6	7.8
Interest rates (3-M PRIBOR, end of period, %)	2.18	0.35	3.50	4.80	4.05
Interest rates (3-M PRIBOR, average, %)	2.12	0.86	1.13	4.75	4.50
EUR/CZK exchange rate (end of period)	25.41	26.25	24.86	24.90	24.60
EUR/CZK exchange rate (average)	25.67	26.44	25.65	25.00	24.70
Current account balance (% of GDP)	0.3	2.0	-0.8	-3.3	-1.6
FDI net inflow (% of GDP)	2.4	2.6	0.1	0.6	0.8
General government balance (% of GDP)*	0.3	-5.6	-7.0	-5.0	-4.0
Public debt (% of GDP)	30.0	37.7	42.1	44.4	44.7

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