Czech Economic Quarterly

June 22, 2022

Crossing the pain threshold

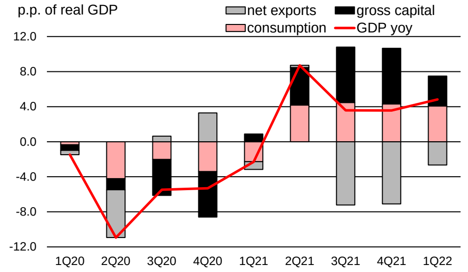
- In 1Q22, real GDP increased by (SA) 0.9% qoq, bringing the yoy dynamic up to 4.8%. Private consumption maintained a high dynamic (8.5% yoy), while government consumption was up 2.0% yoy. Fixed capital formation accelerated to 7.4% yoy on growth recorded in all types of investment. Inventories continued accummulating, adding to yoy GDP growth 1.5pp. Net exports subtracted from GDP growth 2.7pp, as exports dipped 0.1% yoy while imports grew by 3.7% yoy.

- Waning momentum of the post-pandemic recovery and a sharp adjustment in household spending due to an inflation spike characterize the current period of 2Q22. GDP is seen dropping more than 1pp qoq and yoy growth halving to 2.1%.

- GDP growth could weaken further in 2H22, as households are facing a considerable loss of real income and business investment is set to slow. Exports will be impeded from the supply side as well as the demand side. Furthermore, GDP will cease to receive support from inventory accumulation.

- A deterioration in 2023 GDP, a wider C/A deficit and a narrowing CZK-EUR interest rate spread would likely prevent the CZK from appreciating. Our revised view of CZK value is at odds with the ČNB's policy assumptions, questioning the timing of a reversal in monetary policy. Currently, we are calling for a first rate cut in 3Q23.

Breakdown of GDP growth by demand*



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

The structure of GDP did not change fundamentally in 1Q22, with spending and gross capital still contributing to growth positively while net exports subtracting from it. All the contributions, whether positive or negative, turned lower in size against 4Q21. We expect a sharp slowdown in consumption from 2Q22.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	1Q22		4Q21 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**4.8**	**4.8**	**3.6**	**3.6**
Household consumption (%)	8.5	3.6	9.3	4.0
Government consumption (%)	2.0	0.4	1.0	0.2
Fixed capital formation (%)	7.4	1.9	3.0	0.8
Change in inventories	-	1.5	-	5.6
Net exports	-	-2.7	-	-7.1

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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1Q22: RECOVERING FROM THE PANDEMIC

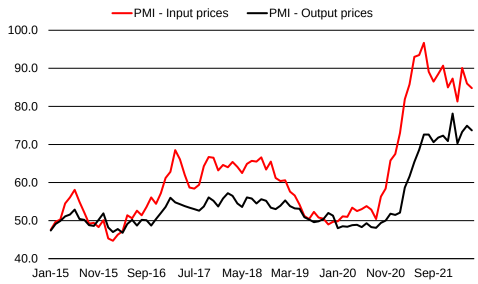
In 1Q22, real GDP increased by (SA) 0.9% qoq, bringing the yoy dynamic up to 4.8%. Private consumption maintained a high yoy dynamic (8.5%), although decreasing in qoq terms for the second time running (-1.0%). Government consumption was up 2.0% yoy. Fixed capital formation accelerated to 7.4% yoy on growth recorded in all types of investment, but a particularly high increment in transport equipment (31.1% yoy). Inventories continued accummulating, adding to yoy GDP growth 1.5pp. Net exports subtracted from GDP growth 2.7pp, as exports dipped (-0.1% yoy, of which exports of goods -2.6% yoy), while imports grew by 3.7% yoy (of which imports of goods 2.0% yoy). Nominal GDP added 10.9% yoy on GDP deflator rising 5.8% yoy. From the production side, gross value added grew by 4.4% yoy, as all major sectors saw increments except for industry (which was flat yoy) and agriculture (which fell in constant prices while growing in double-digit pace in current prices). The large sector of trade, transport, accommodation, food services expanded again the fastest (14.1% yoy) and was the only one to see a double-digit figure. Total employment was up 1.5% yoy, bringing per-worker productivity growth to a still solid 3.3%. However, real productivity per hour declined by 1.5% yoy. The volume of paid wages and salaries rose from a low base by 11.6% yoy, while average nominal wages added a more moderate 7.1% yoy.

Much of the observed yoy growth in individual GDP components is believed to have been driven by a low base from the period depressed by the pandemic. This factor probably more than offset households' discomfort from growing prices of basic needs. In addition, fast rising inflation may have frontloaded some purchases of consumer goods, temporarily boosting demand. The Russian military agression, starting in late February, resulted in a 76% yoy decrease of Czech exports to Russia in March, but did not manage to affect consumer behavior by the end of 1Q22.

2Q22: SIGNS OF SLOWING EVERYWHERE

Waning momentum of the post-pandemic recovery and a sharp adjustment in household spending due to an inflation spike characterize the current period. In April, industrial output fell by 3.8% yoy, deepening its contraction from -0.4% seen in 1Q22. The automotive sector was largely to blame. Leading indicators for industry are issuing conflicting signals, as May PMI recorded 52.3, i.e. 4.2 points down from February, whereas industrial confidence by the local statistical office increased by 8.6 points over the same period. Foreign trade swung to a CZK 28 billion deficit from a CZK 19 billion surplus in April 2021 due to lower car exports and imports of several times more expensive oil and gas. Construction output was in April up 2.6% yoy despite infrastructure building dropping. Retail sales increased by 5.0% yoy in April, but it is unclear how much the base was impacted by the pandemic. Consumer confidence fell in May to the lowest reading on record. We expect 2Q22 average inflation at 15.5% yoy, which may cause consumer sentiment to cool further down. GDP is seen dropping more than 1pp qoq and halving yoy growth to 2.1%.

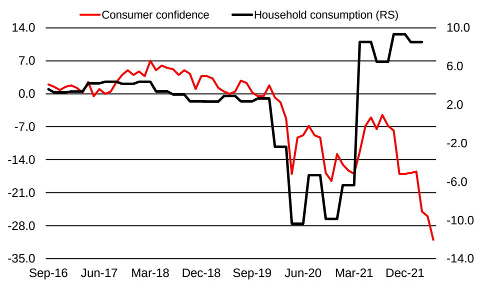
Manufacturing PMI – input and output prices



Sources: CZSO, Markit, UniCredit Research.

A rise in input prices was registered by 95% of businesses covered by PMI in 2021, while the latest share is still around 85%. Most businesses have been able to pass on the extra cost to their output prices, maintaining their price competitiveness.

Consumer confidence and private consumption



Sources: CZSO, UniCredit Research.

The yoy dynamic of private consumption has been driven by a forced reduction in the base period marked by covid restrictions. The end to that driver alongside the inflation spike means that the momentum stands in front of a sharp downward adjustment.

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2H22 AND 2023: CROSSING THE PAIN THRESHOLD

GDP growth could weaken further in 2H22. Households are facing a considerable loss of real income, as inflation rises and is likely to be stickier than previously hoped. Business investment is set to slow, as companies are hesitant to start new projects in an environment of weaker economic activity (except perhaps in residential building and energy saving). Exports will be impeded from the supply side by the ongoing value-chain disruption in the automotive industry and from the demand side by deteriorating business confidence in Europe. Czech exports to Russia are expected to remain depressed. Furthermore, GDP will cease to receive support from inventory accumulation. A drawdown of inventories seems inevitable as borrowing costs rise, although its pace remains uncertain.

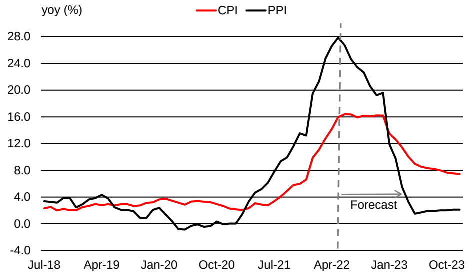
Inflation is viewed as by far the most important drag on economic growth. In the production sphere, price pressure is dominated by energy, but double-digit growth is being observed across the board. There are country-specific factors contributing to inflation, besides price pressure seen across Europe. Above all, these include the price categories clothing and footwear, and restaurants and hotels, which rose in May faster than anywhere else in the EU. What is also adding to current headline inflation, is a relatively muted government response compared to Czechia's peers. The government is nevertheless considering introducing a "savings" tariff on energies for households, which has the potential to become a more visible (and more costly) brake on inflation.

Meanwhile, we expect CPI to tick up further in June, peaking at between 16% and 17% yoy. While in 2H22, the base effect will start working against a further rise, its power may just be sufficient to stabilize annual inflation, rather than bring it down. We now believe that inflation will remain well above target in 2023, as second-round effects of past price changes could combine with fresh shocks. However, as a substantial change, 2023 inflation will no longer be driven by demand, which will lead to it becoming more of a burden on GDP growth.

Wage growth will react to higher inflation with a delay. First, a certain lag comes naturally from corporate policies. Second, the government seems to be actively slowing down wage bargaining in the public sector, pointing to the risk of a wage-inflation spiral. While the stance may come at a political cost, we think it will be effective in 2022, when we forecast real wages to fall by 6.6%. In 2023, real wage growth may turn marginally positive, as nominal wage growth is set to accelerate and inflation eases.

As a result, private consumption is facing a sharp loss of momentum. Pent-up household demand could wane by the end of 3Q22, with growth in spending on holidays abroad being stronger than that for the purchase of goods. However, on a sequential basis, we count on a decline in consumption starting already in 2Q22. We expect the influx of Ukrainian refugees, accounting for roughly 2% of Czech population, to have a minor impact on spending (statistically reflected as exports of services). Finally, we need to stress that our GDP forecasts for 2022 and 2023 assume that gas from Russia continues to flow in. Gas rationing, if implemented, could subtract up to several percentage points from economic growth.

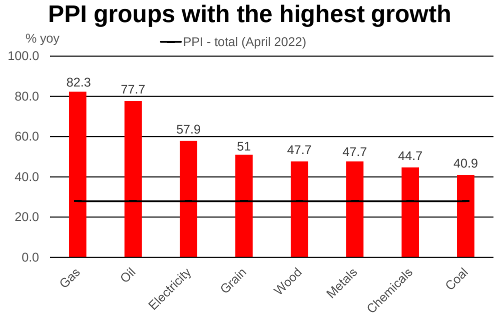
Consumer and producer prices



Sources: CZSO, UniCredit Research.

Despite PPI possibly already peaking off, a cumulation of shocks will hardly allow CPI to ease before the beginning of 2023. We have revised upwards both the assumed CPI peak (to 16.4% yoy for June and July 2022) and average CPI for 2023 (to 9.3%).

PPI groups with the highest growth



Sources: CZSO, UniCredit Research.

Energies continue to be the key upside driver for producer prices. Apart from them, wood and chemicals belong to the list of products with the highest price hikes. As regards agricultural commodities, oils and fats have fallen out of the same list in May, while grain has moved up the ladder with a yoy increase of over 50%.

MONETARY POLICY: A WEAKER KORUNA TO DELAY EASING

A deterioration in 2023 GDP, even under our baseline scenario, would likely prevent the CZK from appreciating. In the same vein, the value of the koruna will have to factor in a wider C/A deficit and a narrowing CZK-EUR interest rate spread when the ECB starts tightening. Our revised view of CZK value is at odds with the ČNB's policy assumptions, questioning the timing of a reversal in monetary policy. Currently, we are calling for a first rate cut in 3Q23. It is also uncertain whether the June 2022 repo rate level, at 7%, represents the peak. The ČNB's forecast assumptions will likely need to be tweaked to stop pointing to more tightening. Finally, we expect the ČNB to continue employing FX interventions in times of market stress but not as a long-term tool to tame inflation.

FOCUS: HOW CAN INFLATION AFFECT HOUSEHOLD CONSUMPTION?

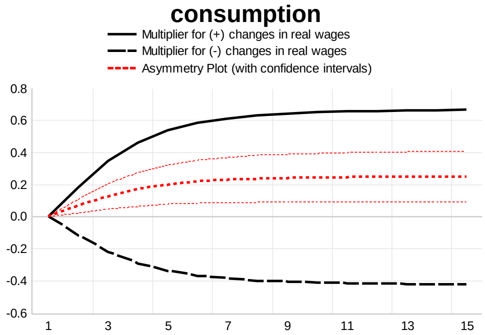
Inflation in Czechia is breaking long-term records, which heavily affects real wages. Their slowdown will be certainly reflected in the pace of private spending, the question is how much.

We investigated the effect of volume of real wages to real household consumption. Making it more complex, we tested the hypothesis that such effect is asymmetric as regards the sign of real wages' change. An intuition says that when real wages rise (or accelerate), households tend to increase (accelerate) spending more than they would cut (or decelerate) spending when wages decline (or decelerate). The asymmetry stems not only from the unwillingness of households to reduce consumption but also from the existence of social security network.

We estimated the relationships using a nonlinear autoregressive distributed lag model (NARDL) on Czech quarterly data between 2000 and 2019. We decided to ignore 2021-2022, as the Covid period could distort the results. The outcomes support our intuition. A 10% increase in the volume of real wages tends to increase private consumption by 4.6% within one year and by 6.6% within two years. On the other hand, a 10% decline in real wages would push down consumption "only" by 2.9% and 4.1% in one or two years, respectively. In other words, the willingness of households to reduce consumption under a negative shock of real wages is roughly 37% lower than their propensity to increase consumption under a favorable wage development.

Abstracting from all difficulties and uncertainties of such models, the outcome may be applicable for today's situation in Czechia. Considering expected growth of employment at 1.4% yoy, **an expected drop in real wages' volume by 5.2% this year may erase up to 1.5% from real private spending within one year and an additional 0.6% thereafter.** Of course, other factors are at play as well, so the outcome must be considered with caution when forecasting household consumption.

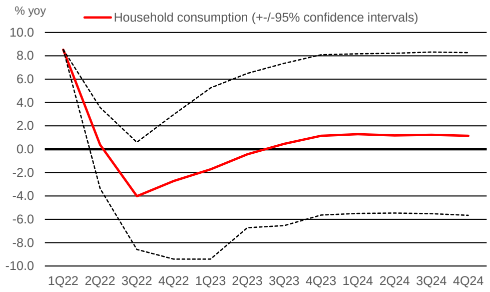
Asymmetric effect of wages on consumption



Sources: UniCredit Research, Macrobond

An impact of a change in the volume of real wages on real household consumption is spreading over six quarters and is asymmetric. A 10% increase in the volume tends to increase private consumption by estimated 4.6% within one year and by 6.6% within two years. On the other hand, a 10% decline in real wages would push down consumption "only" by 2.9% and 4.1% in one and in two years, respectively.

Modeled dynamics of household consumption



Sources: UniCredit Research, Macrobond

We also employed a model for forecasting private consumption from changes in the volume of real wages (which were calculated from our estimates of average nominal wages, inflation and employment). The model produced a 4% yoy slump in consumption for 3Q22, which would mean a larger hit into 2022 GDP than we expect in our baseline scenario.

Czechia Macroeconomic Outlook

	2019	2020	2021	2022 forecast	2023 forecast
GDP growth (real yoy change, %)	3.0	-6.4	3.3	1.5	0.9
Household consumption (real yoy change, %)	2.6	-6.8	4.3	1.8	-0.5
Gross fixed capital formation (real yoy change, %)	5.9	-7.5	0.6	3.6	2.5
Industrial output (real yoy change, %)	-0.2	-7.2	9.5	4.0	5.0
Unemployment rate (average, %)	2.8	3.6	3.8	3.3	3.5
Inflation rate (CPI yoy change, average, %)	2.8	3.2	3.8	14.8	9.3
Average wages (nominal yoy change, %)	7.9	4.6	4.8	7.1	9.8
Interest rates (3-M PRIBOR, end of period, %)	2.18	0.35	3.50	7.15	5.65
Interest rates (3-M PRIBOR, average, %)	2.12	0.86	1.13	6.20	6.90
EUR/CZK exchange rate (end of period)	25.41	26.25	24.86	24.90	25.00
EUR/CZK exchange rate (average)	25.67	26.44	25.65	24.70	25.20
Current account balance (% of GDP)	0.3	2.0	-0.8	-4.0	-3.3
FDI net inflow (% of GDP)	2.4	2.6	0.1	0.6	0.8
General government balance (% of GDP)*	0.3	-5.8	-5.9	-5.0	-4.0
Public debt (% of GDP)	30.1	37.7	41.9	43.3	44.1

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

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