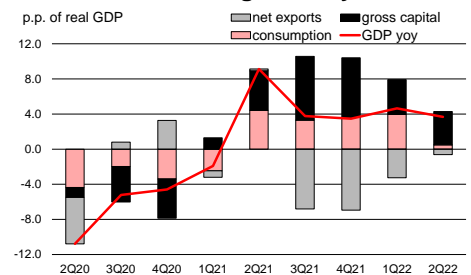


Past the turning point

- In 2Q22, real GDP slowed to (SA) 0.5% qoq and 3.7% yoy. Private consumption growth thinned to a mere 0.2% yoy, while government consumption expanded at a more stable pace of 1.8% yoy. The entire GDP growth was brought about by gross capital formation, of which the inventory change added a huge 2.2pp and fixed investment 1.6pp yoy. Net exports subtracted from GDP growth 0.6pp.
- Czechia's economy probably started to contract during the summer. Consumers have been cutting back their spending, while the investment cycle appears to be turning down. We expect the situation to get worse before it gets better. In total, we forecast 3Q22 GDP to contract by 0.8% qoq, slowing yoy growth to 1.1%.
- The economy is set to pass a recession, the depth of which looks uncertain now. Energy prices are obviously the crucial factor dragging down the economy. We expect sequential GDP to keep falling for three quarters between 3Q22 and 1Q23. Despite a resumption in activity thereafter, full-2023 GDP is seen down by 0.3% after 2022's projected growth at 2.2%.
- The recession should put a cap on demand-push inflationary factors. Disinflation and a change in drivers will remove one important item from the argument list of the ČNB hawks. We regard it as more likely than not that the hiking cycle has already ended. Less concern regarding inflation should also lead to the ČNB refocusing on its exit strategy from FX interventions.

Breakdown of GDP growth by demand*



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

in 2Q22, consumption almost stopped adding to GDP growth yoy, while net exports' balance was marginally negative. The entire GDP growth was brought about by gross capital formation, with inventory accumulation contributing more than fixed capital.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	2Q22		1Q22 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	3.7	3.7	4.6	4.6
Household consumption (%)	0.2	0.1	8.2	3.5
Government consumption (%)	1.8	0.4	2.2	0.5
Fixed capital formation (%)	6.2	1.6	6.9	1.8
Change in inventories	-	2.2	-	2.2
Net exports	-	-0.6	-	-3.3

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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2Q22: PRIVATE CONSUMPTION UNDER STRESS

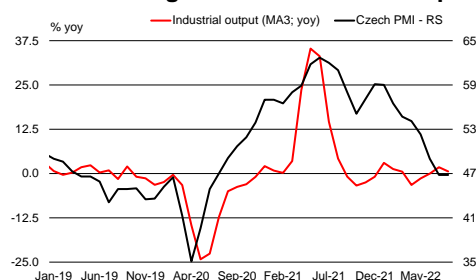
In 1Q22, real GDP growth slowed to (SA) 0.5% qoq and 3.7% yoy. Private consumption growth almost ground to a halt, adding a mere 0.2% yoy. Government consumption expanded at a more stable pace of 1.8% yoy. The entire GDP growth was brought about by gross capital formation, of which an inventory change added a huge 2.2pp and fixed investment 1.6pp. In yoy terms, fixed capital formation rose 6.2%, as all types of capital were on the rise. Net exports subtracted from GDP growth 0.6pp with exports and imports rising 1.8% yoy and 2.7% yoy, respectively. However, growth rates were positively influenced by high dynamics in services, whereas exports of goods were down 0.6% yoy and imports of goods only stagnated (0.1% yoy). Nominal GDP expanded by 10.5% yoy, as GDP deflator hit 6.6% yoy, the highest figure since 1998. From the production side, gross value added grew by 3.4% yoy, with 'other' (i.e. household-related) service activities being the only sector with a double-digit yoy increment. Manufacturing was on the brink of stagnation in terms of GVA (+0.8% yoy). Total employment accelerated to 2.5% yoy and working hours added 4.8% yoy, helped by the labor market recovering from the pandemic and, at the same time, absorbing refugees from Ukraine. Thus, per-worker productivity growth slowed to 1.2% yoy, while per-hour productivity decreased by 1.0% 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.

As a characteristic of 2Q22, the terms of trade came hugely negative. This stemmed from import prices of goods surging to 19.6% yoy, while export prices of goods expanding by a more moderate 11.4% yoy. Trading loss for the single quarter reached CZK 58bn, after the previous quarter's loss of CZK 34bn had been already the highest on record. The terms of trade largely contributed to a deterioration in the current account, although not being a single factor. In 1H22, C/A deficit hit 2.6% of GDP. This does not seem to be much in comparison with many medium-income economies, but for Czechia it was the worst outcome since 2010.

3Q22: AT A TURNING POINT

Czechia's economy probably started to contract during the summer. Demand destruction by the significant inflation spike and lagging wage growth are largely to blame, rather than supply-side issues. Consumers have been feeling the pinch for several months, gradually cutting back their spending. In July, retail sales fell by (WDA) 6.9% yoy and an even worse figure is expected for August. Corporates were able until recently to pass on increasing costs down the supply chain but now appear to be struggling as well. Industrial output rose (WDA) 0.8% yoy in July, driven largely by the automotive sector. Construction output dropped by (WDA) 2.7% yoy in July. The investment cycle appears to be turning down, which may add to economic woes initiated by the poor consumer appetite. We expect the situation to get worse before it gets better. In total, we forecast 3Q22 GDP to contract by 0.8% qoq, slowing yoy growth to 1.1%.

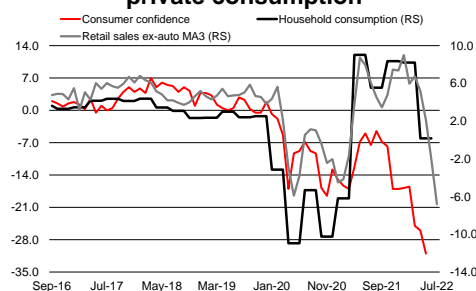
Manufacturing PMI and industrial output



Sources: CZSO, Markit, UniCredit Research.

The supply-chain disruption in the COVID-19 years distorted the delivery times sub-components of manufacturing PMI, blurring the link of PMI to industrial output growth. With the delivery times gradually normalizing, we expect manufacturing PMI to become a useful prediction tool again.

Consumer confidence, retail sales and private consumption



Sources: CZSO, UniCredit Research.

Both consumer confidence and retail sales suggest that private consumption experienced a free fall in 3Q22. This is also what we have incorporated into our GDP forecast.

4Q22 AND 2023: INTO AND OUT OF A RECESSION

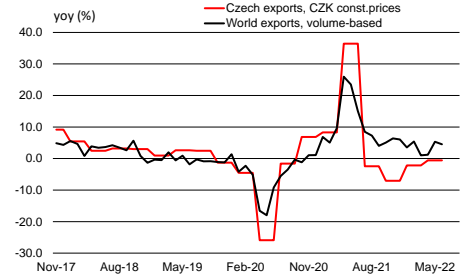
The economy is set to pass a recession, the depth of which looks uncertain now. Energy prices are obviously the crucial factor dragging down the economy. Prices of electricity for households currently vary by a factor of five, depending on the type of contract. The situation is similar with respect to natural gas, with the only material difference being that a smaller share of households consume gas. With the price ceiling installed at 6 CZK/kWh for baseload electricity and 3 CZK/kWh for gas, the average prices for households are still projected to go up by several tens of percent during 2023, keeping cost-side inflation elevated. Turning to manufacturing where energy price limits do not apply, our concern is that a decent chunk of output could be wiped out, being replaced by cheaper imports from outside Europe. Securing affordable-priced energy will therefore be key. If this cannot be accomplished, there is the risk of a severe shock in the economy at the turn of the year when companies typically renegotiate their energy contracts.

In 4Q22, households will have to cope with overall living costs rising by 17-18% yoy, with average wages adding only 8-9% yoy. This is set to pose an unprecedented drag on real disposable income, despite incomes other than labor mitigating the loss. Job losses will add to households' financial strain. With the first signs of a downturn in the labor market appearing in August, we see the average 2023 unemployment rate at 4.6%, still low by EU standards but up 1.1pp from 2022. We thus project private consumption to keep contracting yoy at least until 2Q23.

The recession will inevitably affect corporate capital spending, which is already impacted by rising borrowing costs. In 1H22, half of GDP growth was explained by inventory accumulation, coming largely as a reaction to supply-chain disruptions. Financing the excessive stock of material is not only expensive but, due to recession, also redundant. Bringing down the inventory level will likely pose a drag on GDP in 4Q22 and in 2023. In terms of fixed capital formation, we expect a cyclical drop in yoy terms starting from 4Q22. Ongoing projects will mostly aim at boosting energy resilience rather than production capacities or productivity. We already observe a reduced inflow of new construction orders, which is likely to cause lower construction activity in 2023. EU funds could help cover at least public infrastructure projects, but we are skeptical that these would bring a substantial impulse to overall capital outlays.

Unlike declining domestic demand, net exports may contribute anew to GDP from 4Q22 until the end of 2023. We see two major reasons for this. First, the assumed reversal in the inventory cycle lowers imports. Second, we expect the automotive industry to improve its performance, bolstering exports. Supply-side issues during COVID-19 knocked down car output, establishing a favorable base for future expansion of production. At the same time, waiting lists for some car models were extended to 12-18 months, which may protect manufacturers from a short-term drop in new orders. All in all, we project net exports to add 2.5pp to GDP in 4Q22 and 2.2pp in 2023. However, this is not expected to prevent sequential GDP from falling for three quarters between 3Q22 and 1Q23.

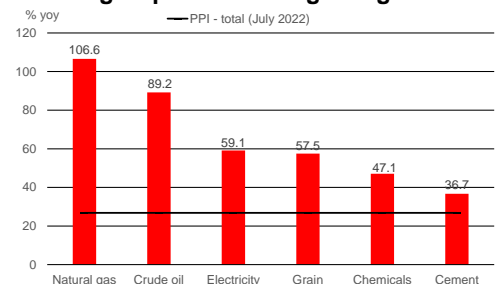
Global and Czech export dynamics



Sources: CZSO, Macrobond, UniCredit Research.

Czech exports are typically a stable part of global trade. Lately, however, Czech exports have been underperforming the global trade, which is attributable to a weakening position of car exports. We expect Czech exports to start catching up, as soon as a lack of chips cease to be a barrier for higher car production.

PPI groups with the highest growth



Sources: CZSO, UniCredit Research.

The role of energies as the key upside driver for producer prices has been on the rise. Apart from them, grain products moved up the ladder of main drivers lately, as did some non-food energy-intensive output. By contrast, oils and fats are no more in the list of top-6 products.

MONETARY POLICY: HIKING CYCLE MAY BE OVER

The recession should put a cap on demand-push inflationary factors, leading to a gradual deceleration in annual inflation from the start of 2023, Disinflation and a change in drivers will remove one important item from the argument list of the ČNB hawks. We regard it as more likely than not that the hiking cycle has already ended. That said, we continue to believe that first rate cuts will not arrive until 2Q23 or 3Q23. Less concern regarding inflation should also lead to the ČNB refocusing on its exit strategy from FX interventions. Our view is that few other options exist for the ČNB but to allow a controlled adjustment of EUR-CZK towards higher levels.

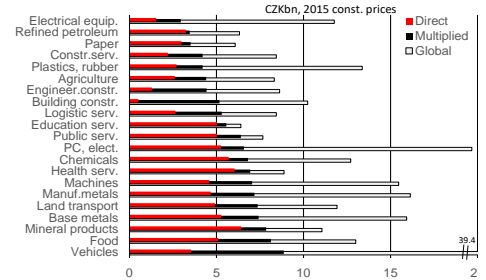
FOCUS: HOW TO DISTRIBUTE ENERGY SAVINGS AMONG BUSINESSES?

The energy crisis is expected to hit hard in the coming winter, possibly triggering the need to impose limits on energy consumption, in order to avoid blackouts or other critical scenarios. However, rationing on energies is a matter of politics that must be aimed to finding a balance between social coherence and macroeconomic costs. Let's leave aside a possible reduction of heating at homes and workplaces (which would be the best solution in a pure macroeconomic point of view) and let's merely focus on curbing production. How to distribute energy saving among business branches? What should be considered, are their shares in total energy consumption, as against their importance in the whole output.

Using input-output tables as of 2015, we estimated the shares of electricity and gas used in individual business sectors' output on Czechia's electricity and gas consumption. We include not only direct energy consumption, but also energy used to produce all incorporated parts across the production chain. This measure is compared with total (multiplied) shares of respective sectors in gross value added (GVA) of the Czech economy. Main idea is that the sectors with relatively high energy consumption and relatively low GVA (i.e. below a simple regression line and more to the right in the chart) are candidates for energy restrictions, if needed, as per unit of lost output one can save the highest amount of energy.

Those candidates appear to be producers of base metals, mineral products, chemicals, PC, electronics, machines, and food. By contrast, automotive industry is the third largest electricity and gas consumer in absolute terms (2.3% of total - just after trade and real-estate services), but its total multiplied GVA accounts for more than 10% of the Czech economy. On the other hand, base metals or mineral products mentioned above consume around 2% of energy as well, but their share of GVA in the economy is five times lower (around 2%). So, a 20% drop of base metals production could hypothetically save about 0.4% of total energy consumption at a cost of 0.4% drop in GDP, compared to a 2% drop of GDP when curbing automotive production. It must be noted, though, that the approach is based on the demand side only, ignoring limits of the supply side. In other words, it is assumed that important sub-components for domestic output or consumption (such as metals or food) may be easily imported. The outcomes must be therefore interpreted with caution.

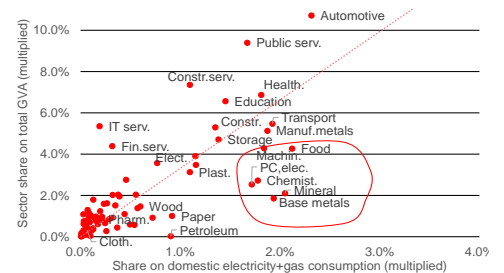
CZ business sectors' energy consumption in absolute terms



Sources: UniCredit Research, Macrobond, CZSO.

The "direct" effect in the chart shows electricity and gas directly consumed by respective branches in CZK as of 2015. The "multiplied" effect adds also the estimate of energy used by all other domestic branches across the production chain to ensure production of a given branch. This represents maximum potential energy savings, should the branch be turned off. The "global" effect adds a rough estimate of energy consumed all over the world to ensure production of a given domestic branch. Due to overlaps, multiplied or global effects cannot be summed-up across branches.

Importance of CZ business sectors in total GDP and total energy consumption



Sources: UniCredit Research, Macrobond, CZSO.

In the chart, the consumption of electricity and gas of a sector, multiplied across the whole domestic production chain, is compared to the sector's multiplied (direct and indirect) share of gross value added in the whole economy. The sectors of food, machinery, PC and electronics, chemistry, mineral products, and base metals are candidates for disproportionately higher energy savings, as per a lost unit of output one can save the highest amount of energy.

Czechia Macroeconomic Outlook

	2019	2020	2021	2022 forecast	2023 forecast
GDP growth (real yoy change, %)	3.0	-6.4	3.5	2.2	-0.3
Household consumption (real yoy change, %)	2.6	-7.2	4.0	1.6	-0.6
Gross fixed capital formation (real yoy change, %)	5.9	-6.0	0.6	3.9	-1.0
Industrial output (real yoy change, %)	-0.2	-7.2	6.9	-1.0	-2.0
Unemployment rate (average, %)	2.8	3.6	3.8	3.5	4.6
Inflation rate (CPI yoy change, average, %)	2.8	3.2	3.8	15.5	9.5
Average wages (nominal yoy change, %)	7.9	4.6	4.8	7.3	10.1
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	6.25	6.90
EUR/CZK exchange rate (end of period)	25.41	26.25	24.86	24.90	25.60
EUR/CZK exchange rate (average)	25.67	26.44	25.65	24.70	25.30
Current account balance (% of GDP)	0.3	2.0	-0.8	-3.7	-2.5
FDI net inflow (% of GDP)	2.4	2.6	0.1	0.7	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	42.0	43.1	44.4

Remarks:

*/ ESA 2010 definition.

Sources: Czech National Bank, Czech Statistical Office.

Forecasts: UniCredit Bank CZ.

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