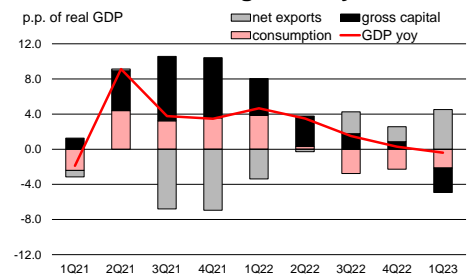


## In need of a game changer

- In 1Q23, real GDP stagnated (SA 0.0% qoq), turning to a contraction in yoy terms (-0.4%). Household consumption extended its losses, falling by 6.4% yoy, while government spending surprised on the upside with its dynamic of 3.9% yoy. Fixed capital formation broadly stagnated (0.3% yoy) and inventory destocking gathered momentum, reducing yoy GDP by 2.8pp. Net exports delivered a positive contribution worth 4.5pp of GDP.
- Convincing signals of business conditions bottoming out are still missing. In April, SA yoy data saw industrial output expanding (1.4%), while other major sectors shrinking (construction output -6.5%, retail sales -7.8%, sales in services -3.1%). Despite assuming that decelerating inflation will break some negative trends in June, we predict for 2Q23 GDP a contraction in both qoq (-0.2%) and yoy (-0.8%) terms.
- Disinflation will play an important role in boosting demand in 2H23. We expect business activity to improve, but not sufficiently for full-year GDP to expand by more than 0.4% 2023. A more solid momentum may be regained in 2024, with annual growth at around 2%.
- The risk that the hawks in the ČNB will prevail has been significantly reduced. The ČNB rhetoric may be slowly shifting to determining the moment of a first cut, which we do not expect until March 2024, when it becomes clear how extensive price adjustments were at the turn of the year.

### Breakdown of GDP growth by demand\*



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

In 1Q23, the long-awaited destocking has started, turning the gross capital formation's contribution to GDP negative yoy. With consumption sustaining a downward trend, a positive input to growth from net exports was not sufficient to save the overall GDP from yoy contraction.

### REAL GDP (CONSTANT PRICES OF 2015, ADJUSTED)

	1Q23		4Q22 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
<b>GDP total</b>	<b>-0.4</b>	<b>-0.4</b>	<b>0.3</b>	<b>0.3</b>
Household consumption (%)	-6.4	-2.9	-5.5	-2.4
Government consumption (%)	3.9	0.8	0.9	0.2
Fixed capital formation (%)	0.3	0.1	4.6	1.2
Change in inventories	-	-2.8	-	-0.3
Net exports	-	4.5	-	1.7

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.

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## 1Q23: STAGNATION ALTERING CONTRACTION

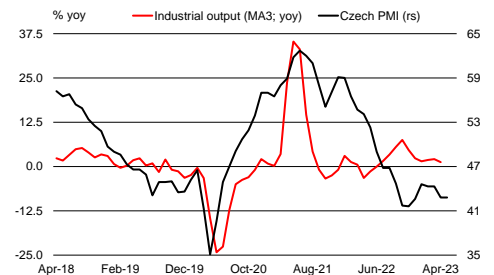
In 1Q23, real GDP stagnated (SA 0.0% qoq), turning to a contraction in yoy terms (-0.4%). Thus, the recession of previous two quarters was narrowly overcome, but only so via rounding the new GDP figure, which still came a bit lower against the previous quarter. In a yoy comparison, household consumption extended its losses, falling by 6.4% yoy, while government spending surprised on the upside with its dynamic of 3.9% yoy. Fixed capital formation broadly stagnated (0.3% yoy), as construction investment fell, while machinery and transport equipment continued to expand. The inventory destocking gathered momentum, reducing yoy GDP by 2.8pp. Net exports delivered a positive contribution worth 4.5pp of GDP, with real exports growth (9.5% yoy) outpacing imports growth (3.3% yoy). Nominal GDP added 11.8% yoy, with the pace that high being previously reached only once (in 4Q04). GDP deflator at 12.2% yoy hit an all-time high, which was not only due to the inflation wave but also improving terms of trade. From the production side, transport&trade and construction were the key sectors with GVA declining, while most other sectors maintained growth in GVA. Of those, manufacturing added 4.4% yoy but that figure consisted of the output increment by a quarter in automotive and an estimated 7% decline in the rest of manufacturing. Total employment rose by 1.4% yoy, with increments seen in almost all sectors, including those of declining GVA. Similarly, hours worked saw a 1.6% yoy increase spreading over most sectors. Employee compensations were higher by 11.0% yoy and gross operating surplus and mixed income expanded by 16.0% yoy, suggesting that businesses were still able to pass on their increasing costs to final production.

The 1Q23 GDP pace was better than we had predicted three months ago, the major reason being an unexpectedly strong performance of car producers. Assuming the automotive sector accounts for (directly and indirectly) 10% of Czech GDP, the output increase in the sector by a quarter yoy lifted GDP by 2.5%. The outperformance stemmed from an increase in the number of cars produced, while a longer-term comparison also captures a higher GVA per unit.

## 2Q23: NO SIGNS OF BUSINESS CONDITIONS UPTURN

Convincing signals of business conditions bottoming out are still missing. Industrial output added (SA) 1.4% yoy in April, driven once again exclusively by the automotive sector. In May, manufacturing PMI posted 42.8, unchanged from a depressed level of the previous month. Construction output was down by (SA) 6.5% yoy in April. Retail sales (ex-cars) fell by (SA) 7.8% yoy in April, with data from credit cards pointing to a similarly bad result in May. Car sales and repairs in contrast expanded by (SA) 6.0% yoy, consistently with an April rise in new car registrations, which also continued to grow yoy in May. The broad index of sales in services saw a (SA) 3.1% yoy drop in April, with only business services and accommodation managing to grow. All in all, despite assuming that the decelerating inflation will break some negative trends in June, we predict for 2Q23 GDP a contraction in both qoq (-0.2%) and yoy (-0.8%) terms.

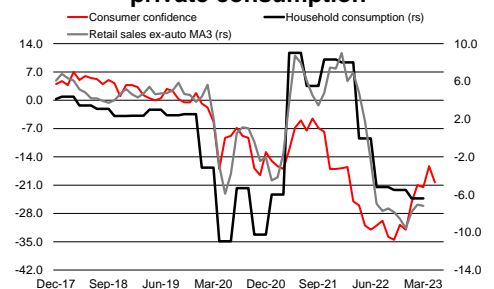
### Industrial output and manufacturing PMI



Sources: HIS Markit, UniCredit Research.

Manufacturing PMI has been signaling a distinct contraction in industrial output since June 2022. Actual figures are yet to display such a yoy decline, but we expect to see that happening already in 2Q23.

### Consumer confidence, retail sales and private consumption



Sources: CZSO, UniCredit Research.

Consumer confidence has bottomed out but has been staying far from levels consistent with a recovery in private consumption. Nevertheless, consumers are expected to react positively before long to the inflation deceleration that is just underway.

## 2H23: HOUSEHOLD CONSUMPTION RELIED UPON AS A GAME CHANGER

Looking at the demand side components of GDP, net exports are expected to be the only contributor to growth in each of the remaining quarters of 2023. This will be facilitated by a drop in imports due to the ongoing destocking after inventories declined in 1Q23 by only 15% of the amount accumulated since 2021. Fixed capital formation is set to deliver neutral inputs at best, as new investment projects are becoming scarcer given poor demand and high borrowing costs. Construction output has already started to decline, as growing interest rates hinder activity from both the demand side (via mortgages becoming less affordable) and the supply side (with developers delaying their plans). Capex may be less affected, but we suspect that most projects will aim to increase energy efficiency, rather than production capacity. Private consumption is relied upon as the key game changer in GDP momentum, but it remains uncertain when this boost will arrive. We expect real wages to start to grow from 3Q23 onwards, when it might also start to feed through to spending. However, to kick-start the entire economy, households would also need to employ their abundant cash reserves and to do that, sentiment would have to improve further.

Disinflation will play an important role in boosting demand. Inflation is very likely to fall to single digits from June, with base effects pushing it further down until October. Disinflation could stall in the last three months of 2023, only to resume next January. Further down the road, while inflation may approach the 3% ceiling of the ČNB's tolerance band, we think it will be challenging to keep inflation below this threshold due to both domestic and external risk.

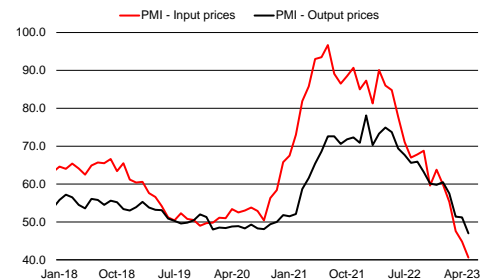
Overall, we expect business activity to improve in 2H23, but not sufficiently for full-year GDP to expand by more than 0.4%. That said, this means a marked upside revision to our former call of -0.4%, driven by a positive (but largely one-off) GDP surprise from 1Q23.

Despite a recent downward drift in consensus GDP forecasts for Germany and other large economies, we believe the Czech economy will be able to regain more solid momentum in 2024, with annual growth at around 2%. Lower inflation will lift real wages, allowing consumers to revive their spending. Foreign demand is forecast to remain strong enough to render support to exports and industrial production. Gross capital formation may contribute negatively to GDP growth, with ongoing inventory dissolution outweighing the effect of higher spending on fixed capital. Applying estimated multipliers, we assume fiscal restrictions worth 1.2% of GDP will drag on GDP growth by about 0.75pp in 2024.

## MONETARY POLICY: EASING TO START IN MARCH '24

The June release of single-digit wage growth in 1Q23 (8.6% yoy) could be a decisive piece of news in reaching a new balance between hawks and doves in the ČNB. The risk that the hawks will prevail has been significantly reduced. The ČNB rhetoric may be slowly shifting to determining the moment of a first cut, which we do not expect until March 2024, when it becomes clear how extensive price adjustments were at the

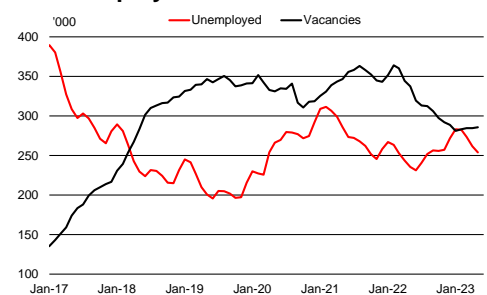
### Manufacturing PMI input and output prices



Sources: IHS Markit, UniCredit Research.

For the first time since 2010, manufacturers expect input prices to go down sharply. This may not only create space for cheapening their products, but also help them absorb in their margins higher staff costs.

### Unemployment and vacancies in CZ



Sources: Czech Ministry of Labor, UniCredit Research.

The Ukrainian refugees have cut the number of vacant job positions without causing the number of unemployed to rise. This confirms that the Czech labor market finds itself in a deeply imbalanced state.

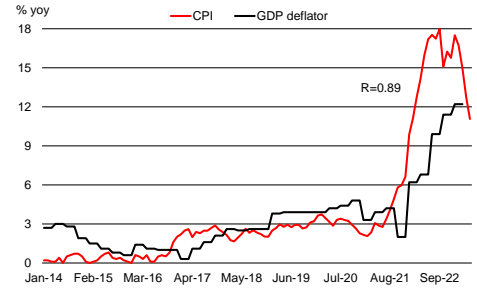
turn of the year. Overall, 2024 is set to be a year of monetary-policy easing, with the repo rate probably being lowered to 5.25%. It may nevertheless take until 2025 to see the repo rate drop to the new normal of around 3.5%. The trajectory means that rates will stay higher for longer than previously assumed, which will delay a rebound in bank credit, in particular mortgages, until 2024.

**FOCUS: STRUGGLE BETWEEN LABOR AND CAPITAL OVER THE COST OF INFLATION**

High inflation has many undesirable consequences, with one of them being wealth redistribution among different groups of economic subjects, such as debtors vs. creditors, poorer vs. richer people, exporters vs. importers, employees vs. employers, and so on. The last example tends to be the subject of numerous political debates. In this text, we attempt to assess whether a redistribution of inflation costs between labor and capital is underway.

Let us consider inflation in the broadest possible sense, namely in the form of the overall price level (GDP deflator), which considers not only consumer prices but also investment and export prices. According to the national accounts' identity, GDP is the sum of compensation of employees, gross profits (including self-employed individuals), and balance of net taxes (indirect taxes minus subsidies). The GDP deflator, or nominal GDP per unit of real GDP, can then be decomposed into unit profits (profits per unit of real GDP), unit labor costs, and net unit taxes. Subsequently, we can measure how the individual components of the GDP deflator contribute to its yoy growth, i.e., to the overall price level. This approach does not address the question of whether unit profits or labor costs were the original cause of domestic price pressures, or whether they were merely a response to price pressures from abroad. The approach only reflects the simple fact that the key to inflation always lies in the domestic economy. As we can see from the chart on the right, compensation to employees used to be the main component of inflation in 2017-2020, consistently with wages growing faster than labor productivity. However, the situation changed with the acceleration of inflation during the energy crisis in 2022, when the growth of prices was mainly driven by growing unit profits, with profit contributions and wage contributions standing in a ratio of 72:28. This indicates that firms were more successful in passing on their increased costs to their products than employees were in pushing through higher wages. Thus, after years of labor maintaining the lead, it seemed running out of steam, allowing capital to regain lost positions. However, wages typically respond to economic developments with a lag, so the labor factor is likely to reclaim a larger share of the ongoing inflation in the period to come. This trend may have already started, as in 1Q23, the ratio of profit and wage contributions decreased to a more balanced 40:60.

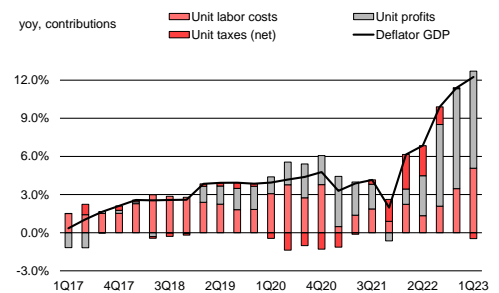
**Czech CPI and GDP deflator**



Sources: UniCredit Research, CZSO.

The consumer price index (CPI) is closely correlated with GDP deflator – the broadest price indicator in the economy. The deflator is set to peak at a lower level than CPI but stay elevated for longer.

**Breakdown of GDP deflator**



Sources: UniCredit Research, CZSO.

In recent quarters, gross operating surplus was the prevailing source of an upside pressure to GDP deflator. However, labor costs appear to be gathering momentum now.

# Czechia Macroeconomic Outlook

	2020	2021	2022	2023 forecast	2024 forecast
GDP growth (real yoy change, %)	-6.4	3.5	2.5	0.4	2.1
Household consumption (real yoy change, %)	-7.2	4.1	-0.9	-1.1	2.0
Gross fixed capital formation (real yoy change, %)	-6.0	0.8	6.2	0.0	2.4
Industrial output (real yoy change, %)	-7.2	6.9	2.5	-0.5	3.0
Unemployment rate (average, %)	3.6	3.8	3.4	3.7	3.6
Inflation rate (CPI yoy change, average, %)	3.2	3.8	15.1	11.0	3.7
Average wages (nominal yoy change, %)	4.6	4.8	6.5	8.8	7.0
Interest rates (3-M PRIBOR, end of period, %)	0.35	3.50	7.26	7.10	5.35
Interest rates (3-M PRIBOR, average, %)	0.86	1.13	6.28	7.17	6.40
EUR/CZK exchange rate (end of period)	26.25	24.86	24.12	24.00	24.50
EUR/CZK exchange rate (average)	26.44	25.65	24.57	23.70	24.30
Current account balance (% of GDP)	2.0	-2.8	-6.1	-1.4	0.0
FDI net inflow (% of GDP)	2.6	0.5	2.5	1.9	1.9
General government balance (% of GDP)*	-5.8	-5.1	-3.6	-4.8	-3.6
Public debt (% of GDP)	37.7	42.0	44.1	45.3	45.9

Remarks:

\*/ ESA 2010 definition.

Sources: Czech National Bank, Czech Statistical Office.

Forecasts: UniCredit Bank CZ.

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