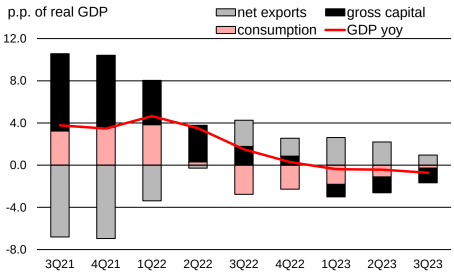
Czech Economic Quarterly

December 19, 2023

The tide is turning

- In 3Q23, real GDP contracted by 0.5% qoq and 0.7% yoy on private consumption easing its yoy slump to 2.3% and government consumption expanding sharply (3.9% yoy). Fixed capital formation maintained its pace of growth at 3.3% yoy, while the inventory accummulation slowed sharply, posting a negative contribution to GDP growth of 2.2pp. Net exports added 1.0pp to GDP growth.
- In 4Q23, headwinds eased but fundamentals remained weak. October saw in yearly comparison a rise in industrial output and an easing of retail sales contraction, but sales in services remained deeply negative. Households have been probably piling their savings in anticipation of economic hardship in early 2024, caused by the government's consolidation package. The situation allows for projecting only marginal sequential GDP growth (0.2%), with an ongoing annual decline (-0.1%). Full-2024 GDP is heading for -0.4%.
- Looking into 2024, household spending prospects are turning cautiously optimistic, as real wages are projected to resume growth thanks to declining inflation. On the other hand, the external environment does not bode well for capex in Czechia. GDP is projected to expand by 1.5% on private consumption and fixed capital formation growing by 2.5% and 2.0%, respectively.
- We expect the ČNB to cut the repo rate at most of its 2024 meetings, with some steps larger than 25bp. We estimate the repo rate will reach 4.5% by the end of 2024. As to government policies, we expect the fiscal consolidation package to push the government deficit below 3% of GDP in 2024. However, more difficult reforms are yet to be implemented and the political window of opportunity will start to close soon.

Breakdown of GDP growth by demand*



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

In 3Q23, the consumption slump moderated, net exports eased its positive input to GDP, while gross capital continued to subtract from GDP in an undiminished manner. Such a structure in GDP momentum suggests that the economy is waiting for a new impulse.

REAL GDP (CONSTANT PRICES OF 2015, ADJUSTED)

	3Q23		2Q23 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**-0.7**	**-0.7**	**-0.4**	**-0.4**
Household consumption (%)	-2.3	-1.1	-4.0	-1.8
Government consumption (%)	3.9	0.8	3.6	0.7
Fixed capital formation (%)	3.3	0.9	3.5	0.9
Change in inventories	-	-2.2	-	-2.4
Net exports	-	1.0	-	2.2

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.

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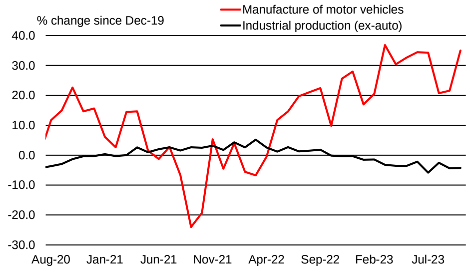
3Q23: PRIVATE CONSUMPTION KEEPS DECLINING

In 3Q23, real GDP contracted by 0.5% qoq, deepening the yoy contraction to 0.7%. Private consumption eased the yoy contraction to 2.3% from previous 4.0%, while government consumption in contrast expanded sharply (3.9% yoy). Fixed capital formation maintained its pace of growth little changed at 3.3% yoy, with all the expansion brought about by machinery and transport equipment. The inventory accummulation slowed sharply, posting a negative contribution to GDP growth at of 2.2%. Foreign trade dynamics turned negative in yoy terms for the first time since 4Q21 (exports) and 4Q20 (imports), while the net exports‘ contribution to GDP growth halved from 2Q23 to reach 1.0pp. From the production side, gross value added fell marginally (-0.1% yoy), while taxes on products were largely behind the loss in GDP. Sector-wise, gross value added by industry turned to a decline (-1.6% yoy), adding to the already contracting sectors of transport&trade and construction. ICT posted the highest, albeit also a bit reduced growth rate of 4.4% yoy. Nominal GDP slowed to 6.6% yoy on GDP deflator recording 7.4% yoy. Total employment rose by 0.4% yoy, while hours worked dipped by 0.1% yoy. Both measures point to productivity losses (1.1% yoy per worker, 0.8% per hour worked). Gross operating surplus and mixed income expanded by 7.1% yoy, exactly the same pace as compensation to employees.

Industrial output in the breakdown to the automotive and ex-auto sectors



Sources: CZSO, UniCredit Research.

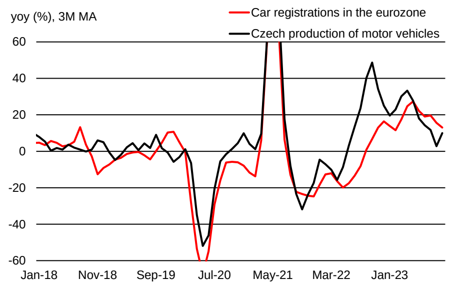
The automotive sector saves the industrial output from a decent decline. While the input in ex-auto sectors has been lately down versus December 2019, the automotive sector has been showing growth of 30% plus. Car production will also likely help the overall GDP performance in 4Q23, although it is uncertain how much longer this support will last.

4Q23: WEAK FUNDAMENTALS PERSISTED

In 4Q23, headwinds eased but fundamentals remained weak. October industrial output posted working-day-adjusted 1.9% yoy growth, driven largely by a 22% yoy increment in the auto segment. November PMI ticked up for the second month running but stayed deep in the contractionary area (43.2). December flash manufacturing PMI for Germany and the Eurozone dashed any hope for an improvement in sentiment among Czech producers before the year-end. October retail sales (ex-auto) was down by 1.4% yoy, the mildest decline so far this year. October sales in services kept declining in October by 4%-5% yoy, showing stagnation from September.

One point to consider is that the fiscal consolidation package comes into force from the start of 2024. The package consists of dozens of individual measures that will create a combined negative fiscal impulse of 1.1% of GDP in 2024, according to the ČNB. While the measures did not eat into household purchasing power in 4Q23, they probably dampened consumer expectations, as the legal process was underway while inflation remained high. As a result, some households probably increased their savings further in anticipation of economic hardship in early 2024. On balance, we believe the situation allows for only marginal sequential GDP growth (0.2%), with an ongoing annual decline (-0.1%). Full-2024 GDP is heading for -0.4%.

Eurozone car registrations and Czech automotive production



Sources: Macrobond, UniCredit Research.

Where does the resilience of the Czech automotive output come from? There is a strong and long-term link to Eurozone's car registrations. The question to be answered is whether the current rise in the number of new car registrations only comes as a legacy of the former, covid-related downturn or is part of a new longer-term pattern.

2024: THE TIDE IS TURNING

Looking into 2024, household spending prospects are turning cautiously optimistic. First, real wages are set to grow more quickly from 1Q24 onwards, after nine poor quarters. Second, projected monetary easing by the ČNB may drive households to spend some of their extra savings or at least the interest earned on their savings over past two years, the latter worth 1.6% of GDP. Third, VAT on food is set to drop in Czechia from 15% to 12%, while it will return to 5% from 0% in Poland, probably from 2Q24, which may bring some Czechs back to local stores. All in all, we expect private consumption to expand by 2.5% in 2024, speeding up to 3.0% in 2025.

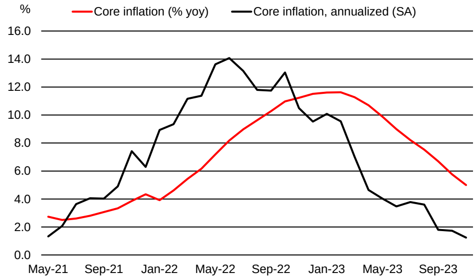
With expected nominal wage growth of 6-7% in 2024, it is crucial that inflation drops meaningfully for households to boost real spending. We do expect it to fall but not necessarily as low as the upper bound of the ČNB's 1-3% target range. On the one hand, little external price pressure is assumed. On the other hand, we are concerned about turn-of-the-year price adjustments for services and, to a lesser extent, food, in response to cost increases from 2023. In addition, service providers could take the opportunity of the expected improvement in household purchasing power to pass on more of the cost increases to households. Government policies will also add to consumer price growth, mainly due to the hike in energy prices (the distribution component up 67% for electricity and 39% for gas). It is uncertain how much this will influence inflation, as the consumer basket is set to undergo its biennial reweighting in January 2024. In 2025, the year of next general elections, we expect external inflationary shocks to be stronger than domestic ones.

The external environment, with GDP projections for Germany in 2024 deteriorating lately, does not bode well for capex in Czechia. We forecast fixed capital formation to grow by only 2.0% in 2024. The efficiency and security of energy and input supply, as well as the availability of labor, will continue to be the key topics for private projects. On a negative note, no major greenfield investment appears to be in the pipeline after the government failed to convince Volkswagen to build one of its gigafactories in Czechia. On a more positive note, we expect some previously delayed residential building projects to go ahead in 2H24 once interest rates are on a clear downward path. Public investment may remain broadly stable. Projects co-financed by the 2021-27 EU budget are still not out of their initial stages, but RRF-funded projects could gather momentum slowly despite a limited pipeline. By 2025, production-capacity-related private projects may become more frequent, giving fixed capital formation an additional boost.

POLICIES: ČNB TO DELIVER 250BP WORTH OF EASING IN 2024, MORE TO COME IN 2025

We expect the ČNB to cut the repo rate at most of its 2024 meetings, with some steps larger than 25bp. We estimate the repo rate will reach 4.5% by the end of 2024, which would be a full percentage point above the level forecast by the ČNB itself. Our more cautious view is consistent with inflation remaining above the ČNB's tolerance band. The rate cutting may then continue in 2025 to approach a neutral level of 3.25-3.50%.

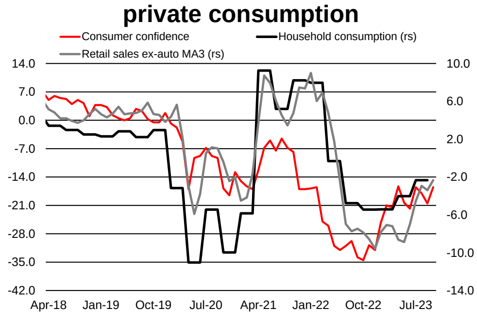
Czech core CPI – year-on-year versus monthly annualized



Sources: CZSO, Macrobond, UniCredit Research.

A traditional view of inflation via the year-on-year price comparison may delay spotting abrupt changes in the price development, as those could be masked by a previous year's base. Our alternative indicator – monthly annualized CPI – removes the disadvantage. November core inflation demonstrates the difference. It posted 5.0% in yoy terms but dropped as low as 1.24% in the annualized metric.

Consumer confidence, retail sales and private consumption



Sources: CZSO, UniCredit Research.

A moderation of the consumption slump in 2Q23 and 3Q23 was nicely predicted by the consumer confidence index. Meanwhile, however, consumer confidence has stopped increasing, which bodes ill for a further improvement of household consumption in 4Q23.

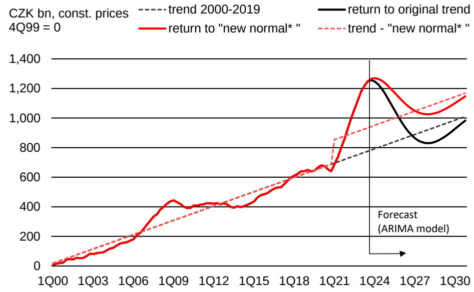
As to government policies, we expect the fiscal consolidation package to push the government deficit below 3% of GDP in 2024. However, more difficult reforms are yet to be implemented and the political window of opportunity will start to close soon. Higher energy prices may continue to be a contentious issue, angering both households and businesses. The healthcare system will need urgent savings, not least because hospital doctors have won the promise of considerable salary hikes. The government is also set to introduce the most important changes to the pay-as-you-go pension system for decades, probably raising the retirement age beyond 65, which may trigger public resistance. Thus, the scope for more good news on the fiscal side is small, while the risk of political instability will rise ahead of the 2025 general elections.

FOCUS: ANALYZING THE EXCESSIVE INVENTORIES

The Covid-19 pandemic and the related shocks in global supply chains showed that the business model based on low inventories and "just in time" deliveries is not sustainable under volatile business conditions. After emptying of warehouses in 2020, Czech firms started to pile inventories in historically unprecedented amounts. We estimate that in 1Q21-3Q23, firms accumulated by CZK 475bn more inventories in constant 2015 prices (9% of GDP) than the long-term "normal" path would suggest. That resulted in huge contributions to real GDP growth (4.7pp in 2021, 0.8pp in 2022). However, as about 80% of inventories consist of both direct and indirect imports (see below), this effect was largely offset by negative contributions to GDP growth from net exports. In 1Q23-3Q23, a sharp deceleration of inventory accumulation weighed negatively on GDP growth (1.9pp), being offset by lower imports. Now the question emerges, important for the future structure as well as the dynamic of GDP: will firms start to truly dissolve inventories, or will they consider their higher levels a new normal?

There are two conflicting factors at play. Keeping a high level of inventories is expensive, especially when interest rates are high. On the other hand, full warehouses are often welcome, as supply chain problems are not fully banished due to global security issues and the related process of deglobalization. Our working assumption is that one-third of excessive inventories has become a new normal, and the rest will be gradually dissolved. We estimate the pace of adjustment by the ARIMA regression model on quarterly data of 2000-2023. Our model implies an ongoing deceleration of the inventory run-up in 4Q23-1Q24, followed by its gradual decumulation, reaching the new-normal level in 1Q27. It would mean a strong negative contribution to GDP in 2024 (-3.2pp) and 2025 (-1.2pp). How much will lower imports will mitigate the effect.? Inventories consist of unfinished domestic production (34.6% in 2022), commercial goods (31.6%), material (23.0%), finished products (10.4%) and military equipment (0.5%). Using input-output tables we estimate that average unit of domestically produced goods contains 49% of imports. Furthermore, part of inventories (we estimate 60%) comes completely from direct imports. Putting the two pieces together gives us an estimated 80% import content in accumulated inventories. It implies that "true" impact of an inventory change to GDP growth in 2024 and 2025 should be only -0.6pb and -0.2pb, respectively.

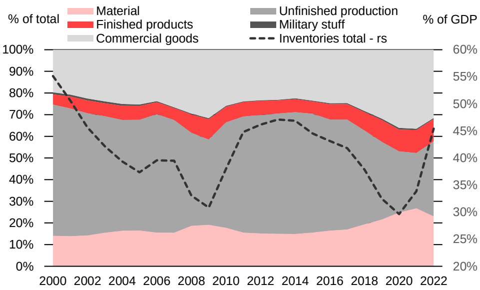
Evolution of inventories in the Czech economy – history and forecast



*/ new normal assumes a rise by one-third of the excess
Sources: UniCredit Research, CZSO

Accumulated investments into inventories in constant prices show a rising trend over time. In 3Q23, however, the trend was overshot by 9% of GDP, dominantly driven by inventories hoarding in the corporate sector. If 1/3 of this overshoot is assumed to be a "new normal", then our model suggests a gradual dissolution of inventories lasting until 1Q27.

Breakdown of inventories in the Czech economy by different categories



Sources: UniCredit Research, CZSO

Unlike the inventory flows above, the level of Inventories as a percentage of GDP in this chart shows a sharp increase in 2021-2022 but no long-term trend. That is because this statistics in current prices is historically driven more by repricing effects of the whole batch of inventories than by inventory accumulation itself.

Czechia Macroeconomic Outlook

	2021	2022	2023 forecast	2024 forecast	2025 forecast
GDP growth (real yoy change, %)	3.5	2.4	-0.4	1.5	2.5
Household consumption (real yoy change, %)	4.1	-0.7	-3.2	2.5	3.0
Gross fixed capital formation (real yoy change, %)	0.7	3.0	2.1	2.0	3.5
Industrial output (real yoy change, %)	6.9	2.5	-1.0	3.0	2.5
Unemployment rate (average, %)	3.8	3.4	3.6	3.6	3.5
Inflation rate (CPI yoy change, average, %)	3.8	15.1	10.7	3.5	3.0
Average wages (nominal yoy change, %)	5.8	5.3	7.8	6.7	6.5
Interest rates (3-M PRIBOR, end of period, %)	3.50	7.26	6.85	4.55	3.60
Interest rates (3-M PRIBOR, average, %)	1.13	6.28	7.12	5.70	3.80
EUR/CZK exchange rate (end of period)	24.86	24.12	24.70	25.00	25.00
EUR/CZK exchange rate (average)	25.65	24.57	24.00	24.90	25.00
Current account balance (% of GDP)	-2.8	-6.1	-0.3	1.2	1.4
FDI net inflow (% of GDP)	0.5	2.5	0.7	1.7	1.8
General government balance (% of GDP)*	-5.1	-3.2	-3.5	-2.8	-3.0
Public debt (% of GDP)	42.0	44.2	44.3	44.9	45.4

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