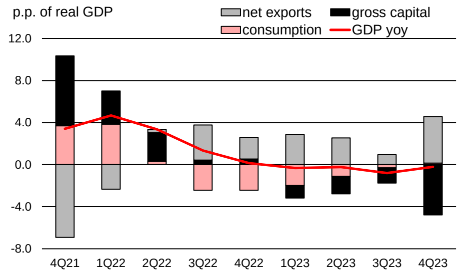
Czech Economic Quarterly

March 21, 2024

Households to become a game changer

- In 4Q23, real GDP expanded by 0.2% qoq, moderating the yoy contraction to -0.2%. Private consumption stood largely behind the improvement, adding 0.5% qoq and bringing the yoy change to -0.5%. Government consumption added 1.9% yoy and fixed capital formation rose by 4.7% yoy. The level of inventories contracted in 4Q23, posting a hugely negative, -6.0pp contribution to GDP. This was partially offset by net exports showing a 4.4pp positive contribution to GDP.
- Signals on an economic activity since the start of 2024 have been mixed. On the one hand, retail sales added yoy 1.4% (ex-auto) and 3.4% (the auto segment) in January. More on the downside, January construction output dropped by 5.9% yoy and January industrial output was only flat yoy. With partial improvement in data expected for February and March, 1Q24 GDP may increase by 0.4% qoq, turning the yoy figure to a positive 0.1%.
- In the remainder of 2024, private consumption has every reason to strengthen. Fixed capital formation could benefit in the first part of 2024 from investment in transport equipment, while in 2H24 we expect an upturn in construction-related activity. As for exports, an outright annual decline is conceivable in 1H24, whereas an upturn envisaged later in the year could help provide further support to GDP. We are maintaining our GDP forecasts of 1.5% for 2024 and 2.5% for 2025.
- Following 100bp in rate cuts by the ČNB in 1Q24, we expect the same amount to be delivered in 2Q24, but much less in the second half of the year due to a weaker koruna than projected by the ČNB and to supply-side inflationary risks. We expect the repo rate to be at 4.0% in December 2024 and at 3.5% a year later.

Breakdown of GDP growth by demand*



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

In 4Q23, consumption continued be a neutral factor for GDP growth. Net exports were the key contributor to it for the fifth period in a row, while gross capital was subtracting from growth for the past four quarters. Within gross capital, it was solely an inventory change to shift GDP growth lower, whereas fixed capital kept growing and gathering momentum.

REAL GDP (CONSTANT PRICES OF 2015, ADJUSTED)

	4Q23		3Q23 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**-0.2**	**-0.2**	**-0.8**	**-0.8**
Household consumption (%)	-0.5	-0.3	-2.3	-1.1
Government consumption (%)	1.9	0.4	3.7	0.8
Fixed capital formation (%)	4.7	1.3	4.4	1.2
Change in inventories	-	-6.0	-	-2.6
Net exports	-	4.4	-	0.9

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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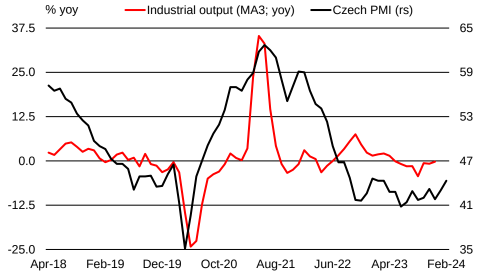
4Q23: Inventories turned sharply lower

In 4Q23, real GDP expanded by 0.2% qoq, moderating the yoy contraction to -0.2% from a previous -0.8%. Private consumption stood largely behind the improvement, adding 0.5% qoq and bringing the yoy change to -0.5%, the best outcome since the outset of the inflation wave. Government consumption added 1.9% yoy. Fixed capital formation rose by 4.7% yoy, maintaining an above-4% pace for a third period running. Similar to previous quarters, the growth was brought about by double-digit increments of machinery and transport equipment, while the construction and intellectual property-related investment stalled. The level of inventories contracted in 4Q23, posting a hugely negative, -6.0pp contribution to GDP. This was partially offset by net exports showing a 4.4pp positive contribution to GDP on exports rising (+1.0% yoy) while imports declining (-4.7% yoy). From the production side, gross value added (GVA) rose 0.3% yoy, helped by a 40% yoy increase in subsidies on products. Sector-wise, GVA contracted in yoy terms in the sectors of transport&trade, financials and construction, similar to previous quarters. Nominal GDP further slowed to 5.8% yoy on GDP deflator displaying 6.0% yoy. Total employment rose by 0.4% yoy largely due to a sharp increase in the number of self-employed persons from 1H23, whereas hours worked expanded by 0.6% yoy. Both measures point to productivity losses (-0.6% yoy per worker, -0.8% per hour worked). Gross operating surplus and mixed income was shown expanding 7.1% yoy, while compensation of employees grew by a bit slower 6.0% yoy.

Manufacturing PMI and industrial output



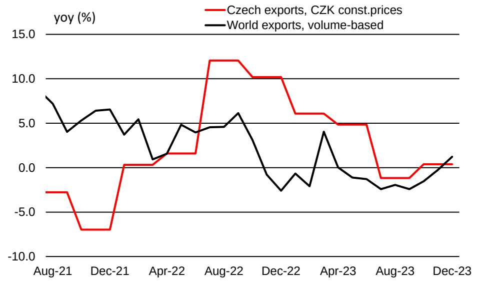
Sources: Macrobond, CZSO, UniCredit Research.

Manufacturing PMI is yet to confirm its bottoming out. Its latest value 44.3 is the highest in 11 months but fails to translate into industrial output growth. In fact, the industry performance would have been much worse if it had not been for solid growth in the car manufacturing (up 16.6% in 2023).

1Q24: Mixed data with an encouraging sign

Signals on an economic activity since the start of 2024 have been mixed. On the one hand, adjusted retail sales added yoy 1.4% (ex-auto) and 3.4% (the auto segment) in January. The expansion may have also extended through February, as indicated by bank card payment and new car registration statistics. As a mixed bag, January sales in services eased by 1.4% yoy but grew by 0.8% mom. More on the downside, January construction output dropped by (adjusted) 5.9% yoy and January industrial output was only flat yoy. In month-on-month terms, industrial output fell by 2.3% in January after having risen by 2.8% a month earlier. New industrial orders in current prices were down by 2.2% yoy for the same month. Poor industrial activity data contrasts with car unit production expanding by 17% yoy. This only confirms that activity trends around a year-turn tend to be unstable. Manufacturing PMI hit 44.3 in February, an 11-month high, while still staying well below the 50 level that would herald an industrial expansion. Nevertheless, we regard as an encouraging sign a month-on-month upturn of output in the sectors of non-metallic products and base metals after many months of a decline. The data makes us believe that a gradual economic recovery is underway. With partial improvement in data expected for February and March, 1Q24 GDP may increase by 0.4% qoq, turning the yoy figure to a positive 0.1%.

Czech export and global trade volumes



Sources: Macrobond, UniCredit Research.

Czech export volumes copy long-term trends of global trade, which does not exclude that the dynamics deviate in certain periods. The Czechia's outperformance stopped in December 2023, as global trade picked up from its previous contraction.

Rest of 2024: Households to become a game changer

Private consumption has every reason to strengthen. First, consumer confidence improved in February to -15.8, a level still well below the long-term average but the highest it has been in 28 months. Second, headline inflation dropped to 2.0% yoy in February, a deeper fall than expected, allowing real wages to expand by almost 4% yoy in 1Q24. Finally, with financial stress abating, households may become more willing to employ part of their long-term savings in purchasing durable goods. Later in 2024, the real-wage dynamic may ease slightly as stable nominal wage growth runs into higher inflation. That said, we project a full-2024 real wage rise of 3.5%, which would be the best since 2019 and should allow consumer spending to grow by 2.5%.

We believe that headline inflation bottomed out at 2% in February. More expensive crude oil, CZK weakness and sticky service prices may gradually outweigh disinflation stemming from weak domestic demand. Later in 2024, an adverse base effect in food prices will push annual inflation higher. Thus, we forecast headline inflation will reach 3.2% yoy in December 2024, with the annual average at 2.5%.

Labor market's trends are unlikely to deter consumer spending. We expect the unemployment rate to change little in 2024-25. One negative aspect of persistently low unemployment is a limited potential for productivity gains. Even worse, healthcare and education, the sectors where measuring productivity is problematic, have been experiencing continuous rises in employment without adequate funding for wages.

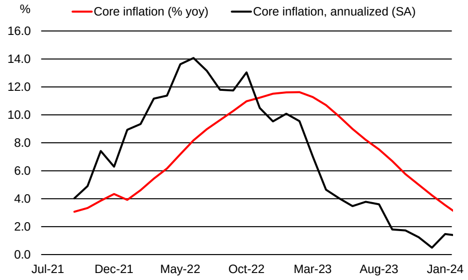
We are maintaining our GDP forecasts of 1.5% for 2024 and 2.5% for 2025. Fixed capital formation could benefit in the first part of 2024 from investment in transport equipment, with new car registrations rising in January and February. we expect an upturn in construction-related activity later in 2024 for two reasons: first, previously stalled residential building projects may restart, helped by a decline in mortgage rates, and second, real estate experts point to surging demand for industrial parks and a lack of new ESG-compliant office space in Prague. Thus, we expect fixed capital formation to grow by 2% in 2024 and 3.5% in 2025.

We expect almost no GDP growth impulse from external demand in 2024, given the poor economic outlook for Germany. As a result, Czech export volume is predicted to increase by only 0.5%, which would boost GDP by just 0.3%. In fact, an outright annual decline in exports is conceivable in 1H24. An upturn envisaged later in the year could nevertheless help provide further support to GDP. Net exports, as shown in the national accounts, may offer a rosier picture, as destocking will continue to affect import dynamics.

ČNB: Monetary policy easing to slow in 2H24

Following 100bp in rate cuts by the ČNB in 1Q24, we expect the same amount to be delivered in 2Q24, but much less in the second half of the year. If the koruna is weaker in 4Q24 than the ČNB is predicting (EUR-CZK at 25.00 in our forecast compared to 24.43 in the CNB's) this would remove

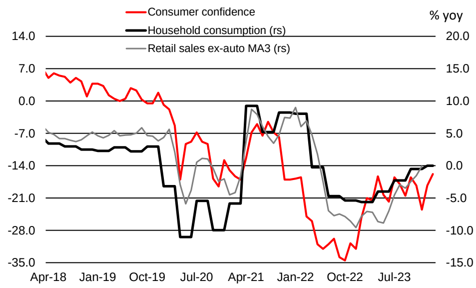
Czech core CPI – year-on-year versus monthly annualized



Sources: CZSO, Macrobond, UniCredit Research.

We continue to look at monthly annualized core CPI as a measure of inflationary pressures. The measure hit the bottom in December at just 0.5%, slightly picking up to 1.4% since. Core inflation in standard yoy terms has been declining, recording 2.8% lately.

Consumer confidence, retail sales and private consumption



Sources: CZSO, UniCredit Research.

Consumer confidence, retail sales and private consumption from national accounts seem having potential to pick up further. Indeed, private spending is expected to be the key driver of GDP growth in 2024.

about 50bp of rate cuts in the standard framework from the ČNB's projection, which has the repo rate at 3.0% at the end of 2024. An additional 25-50bp in cuts may not materialize due to inflationary risks related to supply-side constraints (e.g. higher transport costs). As a result, we expect the repo rate to be at 4.0% in December 2024 and at 3.5% a year later.

Focus: CEE currencies and economic convergence

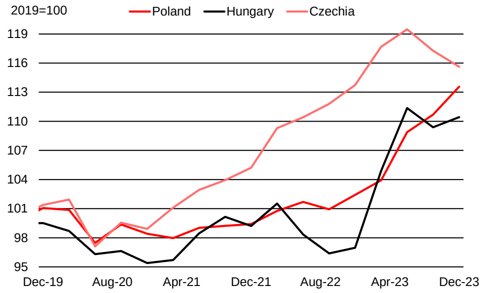
The koruna lost about 8% of value against the euro since April 2023, staying around EUR-CZK 25.3 in March. This may lead to a perception that the koruna is currently too weak and prone to rebounding to stronger levels. However, the koruna's real effective exchange rate (REER) is fully in line with the Czechia's current state of macroeconomic convergence, which limits the currency's potential for nominal appreciation.

REER measures real purchasing power of a domestic currency against a relevant group of foreign currencies and its appreciation may be driven by the currency's nominal appreciation and/or by slower foreign inflation compared to the domestic one. The chart on the top right shows quarterly data of REER against eurozone countries with "inflation" based on GDP deflator. The koruna showed the most dynamic real appreciation of the CE-3 currencies over last 3 years, exceeding the pre-covid 2019 level by 15.6% in 4Q23.

To evaluate whether REER climbed "too high" one must consider the macroeconomic convergence process to developed eurozone countries. Textbooks distinguish nominal and real convergence. The nominal convergence can be illustrated as a ratio of domestic price level to the eurozone's (comparative price level, CPL) while the real convergence is usually measured as ratio of domestic GDP per capita in purchasing power parity compared eurozone's. The chart on the bottom right shows that nominal and real convergence typically stay in a close relationship. In our benchmark year 2019, the price level in Czechia (GDP deflator-based) was almost at 67% of EU-15, while GDP per capita stayed at relatively much higher 87%. That laid foundations for a massive rise in the Czech comparative price level, or in other words strong REER appreciation, as movements in REER should be equal to changes in CPL. Indeed, that was really happening over last years, with Czech prices moving up to 81% of the EU-15 average. However, Czechia performed the worst in its peer group in terms of real measures, showing real divergence by 2pp to estimated 85% in 2023. To compare, Poland moved up by 7pp to 75% and Hungary by 4pp to 72%.

What are the implications for future development? Both Czechia and Hungary have their price levels currently fully in line with their states of real economic convergence, so further REER appreciation would require catching-up in terms of GDP. In Czechia, we find this unlikely to happen in the following years. Slow real convergence would likely be accompanied by a bit higher inflation compared to the eurozone, leaving no space for the koruna's systematic nominal appreciation. Poland is positioned below the regression line, having more space for further REER appreciation, but may close it rather via higher inflation than nominal appreciation of the zloty.

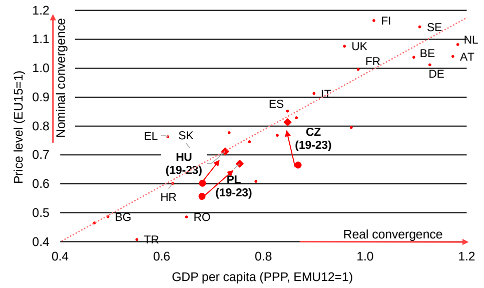
Real effective exchange rates*



*/ GDP deflator based, only against eurozone countries
Sources: European Commission, UniCredit Research

Of the CE-3 currencies, the koruna appreciated the most in real terms over the last 3 years, with its 4Q23 REER level surpassing the average of 2019 by 15.6%. The Polish zloty and the Hungarian forint gained 13.6% and 10.4%, respectively. High inflation was the major force behind in all countries, with the koruna appreciating nominally by 4.6% against the euro, while the zloty and the forint losing 0.7% and 19.4%, respectively.

Nominal and real economic convergence



Sources: Eurostat, OECD, UniCredit Research
Remark: 2023 data were computed using available GDP deflators from the Eurostat and monthly comparative price levels from OECD.

Nominal and real convergence stay in a close relationship with a unit elasticity. Since our benchmark year 2019, high inflation in Czechia (as well as Hungary) has led to adjustments in comparative price levels, which were previously too low compared to the state of real economic convergence. In the chart, this is demonstrated by an upward shift closer to the regression line.

Czechia Macroeconomic Outlook

	2021	2022	2023	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	-0.6	-3.0	2.5	3.0
Gross fixed capital formation (real yoy change, %)	0.7	3.1	3.3	2.0	3.5
Industrial output (real yoy change, %)	6.9	2.5	-0.8	0.8	2.5
Unemployment rate (average, %)	3.8	3.4	3.6	3.7	3.5
Inflation rate (CPI yoy change, average, %)	3.8	15.1	10.7	2.5	2.3
Average wages (nominal yoy change, %)	5.8	5.3	7.5	6.0	5.4
Interest rates (3-M PRIBOR, end of period, %)	3.50	7.26	6.97	4.05	3.60
Interest rates (3-M PRIBOR, average, %)	1.13	6.28	7.13	5.00	3.72
EUR/CZK exchange rate (end of period)	24.86	24.12	24.73	25.00	25.00
EUR/CZK exchange rate (average)	25.65	24.57	24.01	25.20	25.00
Current account balance (% of GDP)	-2.8	-6.1	1.2	1.4	1.4
FDI net inflow (% of GDP)	0.5	2.5	0.1	1.0	1.2
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	45.2	45.8

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