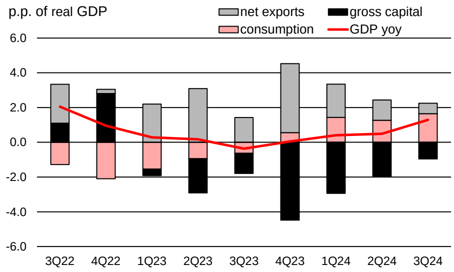
Czech Economic Quarterly

December 11, 2024

Staying in the slow lane

- In 3Q24, real GDP expanded by 0.4% qoq and in yoy terms, growth accelerated to 1.3%. Private consumption picked up to 2.2% yoy, while government spending slowed to 3.0% yoy. Fixed capital formation edged in a -0.8% yoy contraction. Inventory building slowed GDP growth by 0.8 pp. Net exports boosted GDP by 0.6 pp, as export volumes added 4.0% yoy while import volumes grew by 3.4% yoy.
- The GDP momentum is not expected to pick up in 4Q24. We predict GDP at 0.4% qoq again, which should bring the yoy index a notch up from 3Q24's to 1.4%. As to a full-2024 figure, we are revising our outlook further down from 1.0% to 0.9% due to a downward revision in official 2Q24 data.
- Economic growth in 2025 will be less manufacturing-driven than is typical for an initial phase of economic cycle. We expect GDP to add 2.2% next year, broadly maintaining its pace also in 2026 (2.4%). Considering major threats, such as US and other trade barriers, military conflicts on the outskirts of the EU and political crises in some major EU countries, we find the risk of our GDP outlook to be downwardly biased.
- We expect persistence of inflation at levels above the 2% ČNB's target. The reason for our moderate upward forecast shift for inflation in 2025 is an expectation of a weaker koruna, particularly against the US dollar. The ČNB may deliver two more 25bp repo rate cuts by mid-2025 before turning to an on-hold stance. If cost pressures do not result in a second-round inflation hike, the ČNB may then add one more rate cut in late 2025, bringing the repo to a terminal level of 3.25%.

Breakdown of GDP growth by demand*



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

3Q24 was the seventh quarter in a row with a negative yoy input of gross capital to GDP growth. That said, the drag significantly diminished versus previous periods, allowing GDP to gain some momentum. Furthermore, the GDP dynamic was helped by rising consumption, while net exports also kept contributing positively to growth.

REAL GDP (CONSTANT PRICES OF 2015, ADJUSTED)

	3Q24		2Q23 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**1.3**	**1.3**	**0.5**	**0.5**
Household consumption (%)	2.2	1.0	0.8	0.4
Government consumption (%)	3.0	0.6	4.3	0.8
Fixed capital formation (%)	-0.8	-0.2	0.3	0.1
Change in inventories	-	-0.8	-	-2.0
Net exports	-	0.6	-	1.2

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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3Q24: Sluggish growth was ongoing

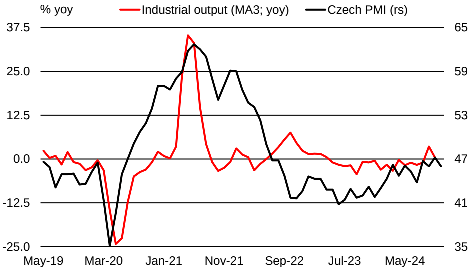
In 3Q24, real GDP expanded by 0.4% qoq, firming from the 2Q24 downwardly revised dynamic of 0.2%. In yoy terms, growth accelerated to 1.3%. Private consumption picked up to 2.2% yoy, while government spending remained the fastest-growing demand-side component, albeit slowing to 3.0% yoy. Fixed capital formation edged in a -0.8% yoy contraction with machinery and equipment being the only type of capital declining, but sharply so (-11.6% yoy). Inventory building once again slowed GDP growth, this time by 0.8 pp. Net exports boosted GDP by 0.6 pp, as export volumes added 4.0% yoy while import volumes grew by 3.4% yoy. Year-on-year growth was recorded on exports and imports in goods as well as services. From the production side, gross value added (GVA) in constant prices dropped yoy in agriculture, was almost flat (-0.1%) in industry and construction, while growing modestly in most service sectors. Nominal GDP expanded by 5.2% yoy on the GDP deflator slowing to 3.9% yoy. Total employment added 0.4% yoy with hours worked expanding by (SA) 1.4% yoy. Thus, labor productivity inched up (0.9% yoy) per worker, remaining almost flat per hour (-0.1% yoy). Gross operating surplus and mixed income in current prices slowed to 2.4% yoy, while compensation of employees sped up to 6.5% yoy.

As one element of surprise in the latest data, we observe the decent pace of exports of goods (3.5% yoy), which contrasts with sluggish demand in the eurozone – Czechia's largest trade partner. Diving deeper into the data, we conclude that the latest export growth comes as a combination of an extraordinarily weak base from 3Q23 for the eurozone and recent double-digit yoy increments in a variety of countries outside the EU. The UK stands out in that group in terms of the overall amount of exports, suggesting that the drag of brexit on mutual trade has been overcome. But smaller trade partners surpass the UK in terms of dynamics, with their list covering large parts of Asia and the Arab world. Our takeaway is that despite all economic hardship of Czech exporters, they are able to deliver more where sufficient demand arises.

4H24: No pick-up in GDP momentum

The GDP momentum is not expected to pick up in 4Q24. Households are set to continue spending more in yoy comparison (October seasonal and calendar- adjusted retail sales posted +5.2%), leaving private consumption a major role in GDP growth. That said, our November payment card data point to a lower yoy increment in spending versus October and market research surveys show only a limited (4%) yoy increase in households' intended Christmas-related spending. Output and sales in services displayed a moderate expansion in October and are hoped to render GDP a push from the production side. In contrast, industrial output may stagnate at best in 4Q24, as October reading (-2.1% yoy) was disappointing and S&P PMI manufacturing index fell to 46.0 in November. All in all, we predict 4Q24 GDP at 0.4% qoq again, which should bring the yoy index a notch up from 3Q24's to 1.4%. As to a full-2024 figure, we are revising our outlook further down from 1.0% to 0.9% due to a downward revision in official 2Q24 data.

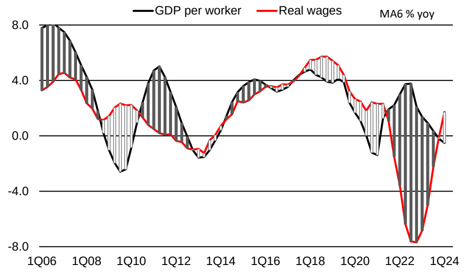
Czech industrial output and S&P manufacturing PMI



Sources: CZSO, UniCredit Research.

The S&P manufacturing PMI has lately stabilized at levels between 46 and 47. This is well below the breakeven point of 50 but historically, 47 rather than 50 appears to be consistent with stagnation of industrial output. Indeed, stagnation is an appropriate characteristic for the current situation in industry.

Czech productivity and real wages



Sources: MPSV, UniCredit Research.

A decline in real wages during the inflation wave of 2022-2023 shifted dramatically the relationship between productivity and wages. Since 2024, we have been back in a situation where wage growth outpaces productivity. However, the legacy from 2022-2023 makes sure that wages may now still go up without too much loss in competitiveness.

2025: On the eve of a household-driven rebound?

Private spending is set to maintain its momentum running into 2025, as salaries in the public sector are projected to accelerate to 6% yoy. Additionally, tax hikes effective from the start of 2024 will no longer be eating up to households' disposable income in a year-on-year comparison. That said, two factors may somewhat temper the spending boost. One is marginally higher unemployment (estimated at 4.2% on 2025-average), the other being an inflation uptick (with CPI projected on average at 2.9% for 2025 against 2.5% for 2024). On balance, private consumption growth is expected to slightly exceed 2% in 2025.

Less good news is seen coming from the area of **capital spending**. While financial situation of the corporate sector will remain solid, its motivation to invest into fixed capital could be dwarfed by business uncertainties. This applies to all sectors but particularly to manufacturing. In general, we rely on a pick-up in machinery and equipment investment from 2H25 in the hope that some uncertainties will have been removed by then. As for the public sector projects, we expect in 2025 more drawdown from EU funds of both the Next Generation Europe and the ordinary multi-year perspective. In terms of privately financed construction activity, a boost in residential housing projects is conceivable in 2025, but that may initially translate into an inventory run-up, helping fixed capital formation only with a delay.

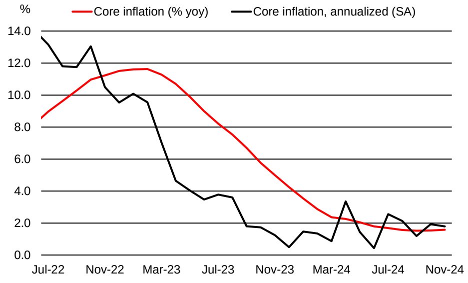
By contrast, **real exports** are expected to broadly stagnate in 2025, as demand in Europe and notably Germany will remain subdued. Moreover, there are signs that a cyclical recovery in high energy-intensive parts of manufacturing will not arrive until 2H25. Thus, fortunes of the manufacturing will largely depend on the automotive production where Czechia is probably somewhat better positioned than Germany thanks to its prevailing orientation on the output of fossil fuel cars. However, the advantage is deemed temporary and contingent to a relaxation in EU regulations, just under consideration.

Anyway, economic growth in 2025 will be less manufacturing-driven than is typical for an initial phase of economic cycle. We expect **GDP** to add 2.2% in 2025, broadly maintaining its pace also in 2026 (2.4%). Considering major threats, such as US and other trade barriers, military conflicts on the outskirts of the EU and political crises in some major EU countries, we find the risk of our GDP outlook to be downwardly biased.

ČNB policy: Fighting inflation stays incomplete

On inflation, we do not expect any new wave but rather its persistence at levels above the 2% ČNB's target. The reason for our upward forecast shift for 2025 is an expectation of a weaker koruna, particularly against the dollar. This is projected to push PPI towards 5% yoy during 2025, translating into a cost-side pressure on CPI. While total inflation is thus set to remain broadly at levels seen in 2H24, its character may shift from the dominance of service prices towards more balance between goods and services. The changing character of inflation may ease an urgency of the

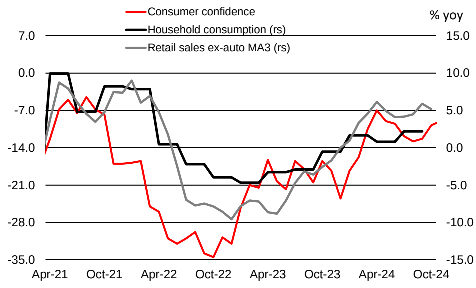
Czech yoy core inflation versus annualized core inflation



Sources: CZSO, UniCredit Research.

In November, both of our closely monitored core inflation measures stabilized at levels just below 2%. Next, they are more likely to go up than down.

Consumer confidence, retail sales and private consumption in Czechia



Sources: Macrobond, UniCredit Research.

Since early 2024, consumer confidence and retail sales have been pushing up household consumption growth. The expansion of retail sales by close to 5% yoy should bring overall private spending up around 2.5%. We expect a similar pace for private spending over the whole of 2025.

ČNB to keep restrictive monetary policy, but the CPI level nearing the upper bound of the target band will not allow for much policy easing. As a result, we expect from the ČNB two 25bp repo rate cuts in 1H25, followed by an on-hold spell. If the cost pressure does not result in a second-round inflation hike, the ČNB may then add one more rate cut in late 2025, bringing the repo to a terminal level of 3.25%.

Focus: US import tariffs would hurt but not kill

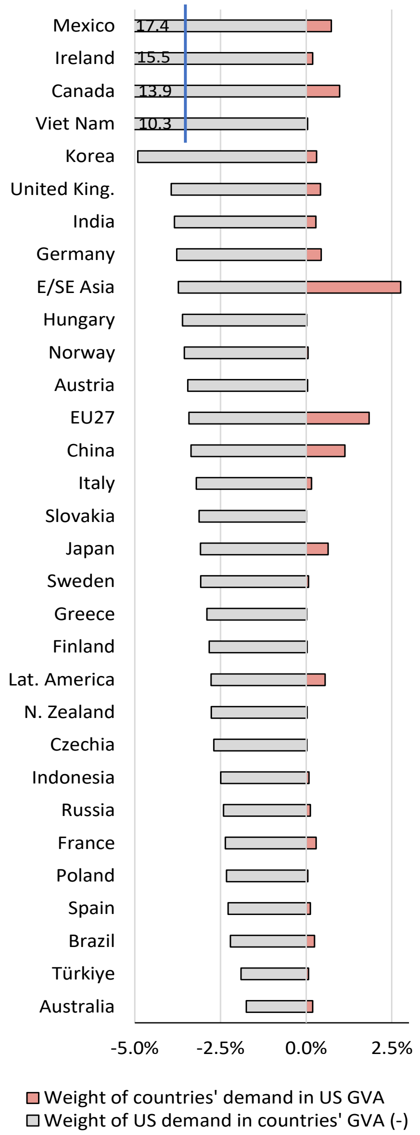
Europe is worried about the looming tariff battles with the USA following D. Trump's inauguration. He has promised to impose a 10% tariff on imports from the EU and 60% on imports from China. What burden would this be for the EU or the Czech economy?

Let's first examine how important the US is as an export destination for individual players, considering both direct and indirect flows across the world supply chains. According to global input-output tables, 3.4% of EU gross value added (GVA), or 2.7% of Czechia's and 3.4% of China's, respectively, find its final destinations in the US. Meanwhile, the US exports about 1.8% of its GVA to the EU and 1.1% to China. It is obvious that in potential trade wars, the US holds a significantly stronger position as its trade restrictions may hurt other countries more than vice versa.

Economic theory suggests that import tariffs lead to higher import prices, reduced profit margins for importers or exporters, and lower import volumes. Estimating the magnitude of these effects is challenging. For European goods, a simplified assumption might not be far off: a 10% tariff may result in a 5% increase in US import prices and a 5% drop in US importers' (or EU producers') margins. A 5% price hike would also likely reduce US real (volume-based) imports by 5%. Given the EU's reliance on exports to the US, this suggests a potential 0.2% GDP contraction for the EU. Retaliatory measures on the EU part would surely follow but would be carefully calibrated to limit the negative impact on its own producers.

A more significant drag on GDP might come from indirect effects. Chinese manufacturers, partially excluded from the US market, could divert discounted goods to the EU. This would bring not only a welcome deflationary pressure but also uncomfortable competition for European producers. Attention was drawn by a study estimating total real GDP losses of as much as 2.5% for the EU and 3.5% for Czechia due to tariff wars. However, these vague-explained results based on questionable assumptions lack credibility, in our opinion. The scale of an impact from Chinese goods flooding the EU market also seems exaggerated. China's exports to the US amounted to $448bn in 2023, representing 1.5% of US GDP and 2.4% of EU GDP. Even if the entire export to the US was redirected exclusively to the EU (an unlikely scenario), entirely replacing goods from local producers (also unlikely, as some would replace other imports), the overall GDP impact would be lower because estimated 25% of EU producers' inputs are imports, not influencing GDP. Moreover, cheaper components from China would benefit EU manufacturers. Thus, the above-mentioned GDP loss appears greatly overstated, even though the effect cannot be ignored.

Weight of US demand in countries' GVA and vice versa



Sources: OECD's TIVA (capturing the year of 2018), UniCredit Research

The USA has the upper hand in trade disputes, as dependency of countries on the US final demand (i.e. consumption and investment) is much higher than vice versa. The most vulnerable country is Mexico, followed by Ireland and Canada. The US's potential to damage by trade barriers the EU is twice as large and the potential to damage China three times as large as those countries' ability to hit the US economy.

Czechia Macroeconomic Outlook

	2022	2023	2024 forecast	2025 forecast	2026 forecast
GDP growth (real yoy change, %)	2.9	0.0	0.9	2.2	2.4
Household consumption (real yoy change, %)	0.5	-2.7	1.5	2.1	2.5
Gross fixed capital formation (real yoy change, %)	6.3	2.7	-0.4	-0.3	3.0
Industrial output (real yoy change, %)	2.1	-1.3	-0.3	1.0	3.0
Unemployment rate (average, %)	3.4	3.6	3.8	4.2	4.0
Inflation rate (CPI yoy change, average, %)	15.1	10.7	2.5	2.9	2.5
Average wages (nominal yoy change, %)	4.3	8.0	6.9	6.5	5.4
Interest rates (3-M PRIBOR, end of period, %)	7.26	6.97	3.93	3.30	3.35
Interest rates (3-M PRIBOR, average, %)	6.28	7.13	4.98	3.57	3.35
EUR/CZK exchange rate (end of period)	24.12	24.73	25.30	25.20	25.00
EUR/CZK exchange rate (average)	24.57	24.01	25.20	25.30	25.00
Current account balance (% of GDP)	-4.7	0.3	1.4	2.2	2.3
FDI net inflow (% of GDP)	1.2	0.2	0.6	0.9	1.0
General government balance (% of GDP)*	-3.1	-3.5	-2.8	-2.7	-3.0
Public debt (% of GDP)	42.5	44.0	43.2	43.5	44.4

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