Czech Economic Quarterly

March 21, 2013

Headwinds starting to fade

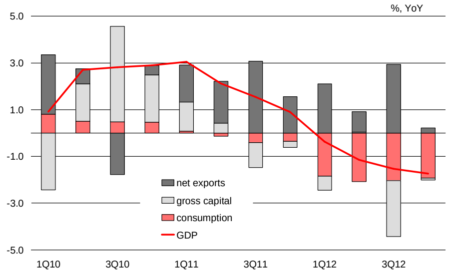
- In 4Q12, recession was going on for the fourth quarter in a row. Real GDP came in at -0.2% qoq and -1.7% yoy. Private consumption, slumping 4.1% yoy, was largely to blame for the GDP contraction, whereas other components turned to be only marginal (positive or negative) contributors to GDP.
- For 1Q13, we see industrial output stabilizing and private consumption easing its yoy decline to 1%. Capital expenditure may in contrast extend its decline. On external demand, recovery is in the pipeline but uncertainty over its timing makes us stay conservative. On balance, this brings us to a call of GDP flat qoq and declining 1.2% yoy.
- 2013 is hoped to bring a reversal in the Czech economy's performance lagging behind the euro area. The sequence of GDP recovery should go from net exports to private consumption.
- In 2014, accelerating wage growth and higher investment activity are forecast to bring GDP growth to 2.2%, making growth largely domestically driven.
- For the time being, the CNB will stick to its policy of keeping monetary conditions accomodative by preventing CZK from appreciation. That said, the CNB seems happy with the current EUR/CZK rate and no interventions are being considered for now.

REAL GDP (CONSTANT PRICES OF 2005, ADJUSTED)

	4Q12		3Q12 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**-1.7**	**-1.7**	**-1.5**	**-1.5**
Household consumption (%)	-4.1	-2.1	-3.9	-2.0
Government consumption (%)	0.8	0.2	-0.4	-0.1
Fixed capital formation (%)	-5.0	-1.2	-3.0	-0.7
Change in inventories	-	1.1	-	-1.7
Net exports	-	0.2	-	2.9

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.

Breakdown of GDP growth by demand*



*/ Contributions to real GDP growth in percentage points
Sources: UCB CZ, CZSO.

In 4Q12, net exports displayed the smallest contribution to GDP growth yoy since 3Q10. The deterioration in net exports from the previous quarter was nevertheless offset by an improvement in gross capital formation, in particular inventory building. Consumption has remained the key drag to GDP, with lower private spending fully responsible, whereas government spending ticking up yoy.

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4Q12: A SLUMP IN CONSUMPTION EXTENDED

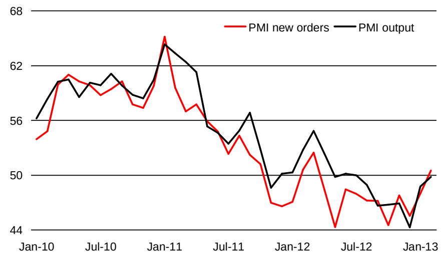
In 4Q12 recession was going on for the fourth quarter in a row. Real GDP for 4Q12 came in at -0.2% qoq and -1.7% yoy. Revisions were also made to previous quarters, deepening the full-2012 GDP decline to -1.2% (from the preliminary announced -1.1%) and putting the bottom of qoq recession to 2Q12 (from the previously reported 1Q12). Private consumption was largely to blame for the GDP contraction throughout 2012, with the 4Q12's reading of -4.1% yoy looking particularly worrisome. Private spending thus took away 2.1 p.p. from 4Q's GDP, whereas other components turned to be only marginal (positive or negative) contributors to it (government consumption +0.2 p.p., gross capital -0.1 p.p., net exports +0.2 p.p.). The gross capital component saw a 5.0% yoy drop in fixed investments but a solid (partially base-effect-induced) boost in the inventory stock. The real export dynamic at 1.4% yoy was the weakest since 3Q09. In nominal terms GDP contracted 1.2% yoy in 4Q12 and posted mere 0.1% yoy growth for full-2012.

Interestingly, the depth of private consumption decline was highly inconsistent with households' work income dynamic in 4Q12. Wages and salaries rose 2.6% yoy, which adjusted by inflation at 2.8% yoy should have allowed real spending broadly stable. Hence, it was a big change in household spending pattern what drove consumption lower (for analysis of its causes for Focus on page 4).

1Q13: STABILIZATION AT A LOW LEVEL

Industrial output shrank 4.1% yoy in January after a sharp, 11.6% yoy contraction in December. On a working days adjusted terms the output fall has been moderating for the second month running. Encouragingly, an ongoing improvement is promised by February's manufacturing PMI values of 49.8 for output and 50.5 for new orders. This is also in line with our assumption that around the year turn the output was hit by extended holiday breaks but not by a collapse of demand. We hence see industrial output stabilizing in 1Q13, even though a recovery may take longer to arrive in the automotive sector where model upgrades at Skoda Auto are just under way. Signals seem mixed on consumer demand. Retail sales dipped 0.5% yoy in January solely on a 3.5% yoy decline in the auto segment, whereas ex-auto sales added 0.7% yoy. The uptick may just reflect stronger post-Christmas sales reacting to poorer pre-Christmas sales. Two facts are more positive, however. First, inflation fell deeper than expected to 1.7% yoy by February, allowing households to fund more real spending. Second, consumer confidence, although still remaining low by historical standards, hit a 15-month high in February. Our conclusion is that private consumption will markedly ease its contraction to -1% yoy in 1Q13. Capital expenditure may in contrast extend its decline (to estimated -4% yoy), as construction output as well as car registration remain poor. On external demand, recovery is in the pipeline, as suggested by the relationship between the German Ifo index and the Czech export dynamic. However, uncertainty on timing of the stimulus

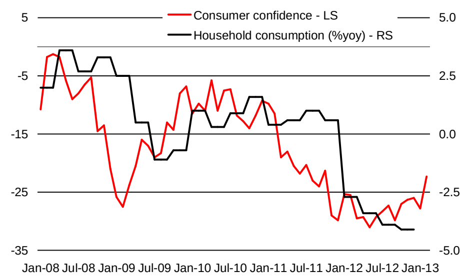
Manufacturing PMI – output and new orders



Source: Markit, UCB CZ.

The new orders component of manufacturing PMI was remaining below the output component over the most of 2012. However, the situation has reversed in recent months and in February new orders have broken above the 50-mark again. This entails moderate optimism about industrial output going forward.

Consumer confidence and private consumption



Source: CZSO, UCB CZ.

Consumer confidence has been picking up from its long-term bottom, as inflation goes down and households are facing no more indirect tax hikes. Subsequently, private spending should moderate its yoy contraction soon. However, neither employment nor nominal wages are set to accelerate any time soon, leaving the upturn in private consumption rather limited.

for Czech exports makes us stay conservative about 1Q13 and expect only a 2% yoy growth. Imports are projected to grow similarly slow at 1.5% yoy. On balance, this brings us to a call of GDP flat qoq and declining 1.2% yoy for 1Q13.

REST OF 2013: SLOW IMPROVEMENT

The year is hoped to bring a reversal in the Czech economy's lagging behind the euro area seen in 2012. From the external side, an upturn in global demand, albeit small, should benefit more the Czech economy due to its openness and the orientation of industry on capital goods. From the domestic side, improving consumer confidence signals more willingness of households to spend even if their income situation does not change much. Headwinds should not come from the local financial markets which remain sound or fiscal policy that is seen acting neutral in the economy. That said, sluggish economy in the euro area (where UniCredit Group projects the 2013 GDP at negative 0.1%), the target for 63% of Czech exports, will allow only contained improvement in the Czech GDP.

The sequence of GDP recovery should go from net exports to private consumption. Improvement in net exports should be facilitated by an acceleration of real export growth up to 5% yoy from 2Q13 onwards, as suggested by the recent pick up in German Ifo business confidence. Private consumption may partially benefit from stabilization of real wages (to 0.2% yoy) on the backdrop of declining inflation (1.9% on 2013 average) but even more so from normalization in household spending pattern (for details see Focus on page 4). With other demand side components (notably fixed capital formation and government consumption) retaining their weak momentum from 2012, real GDP is forecast to expand 0.4% in 2013. The figure would mean a somewhat faster pickup in dynamic from 2012 (when GDP was down 1.2%) than in the euro area (where the momentum is only seen improving from -0.4% to -0.1%).

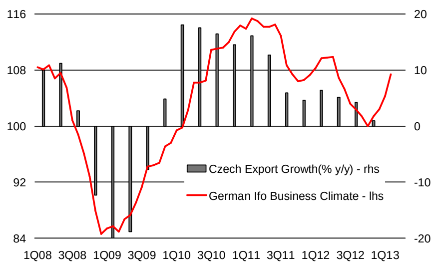
INSIGHT INTO 2014: DOMESTICALLY DRIVEN GROWTH

Restoring economic confidence through 2013 may give rise to investment activity in 2014. Wage growth is also seen accelerating to about 3.5% which combined with contained inflation will boost private consumption. GDP growth is forecast to hit 2.2%, being largely domestically driven. While export growth is hoped to accelerate further (to 7% yoy), growing imports will prevent external demand from adding much to GDP growth. Apparently, the optimistic picture is contingent to recovery in Europe turning broader-based by late 2013 – in line with UCG's outlook.

CNB POLICY: NO FX INTERVENTIONS FOR NOW

The zero interest rate policy is almost certain to remain in place for the remainder of 2013. For the time being, the CNB will also stick to its policy of keeping monetary conditions accomodative by preventing CZK from appreciation. Fx interventions may stay in the CNB's policy toolbox fairly long. Willingness of the CNB to actually intervening against CZK would

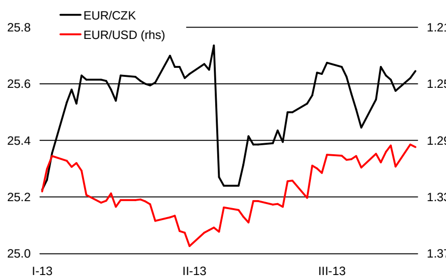
German Ifo index and Czech export growth



Source: CZSO, UCB CZ.

The Czech export growth stalled in 4Q12, as business confidence in Germany hit the cyclical bottom in October. Recovery in the Ifo index since then raises hope for an upturn in Czech exports by 2Q13 at the latest.

EUR/USD and EUR/CZK



Source: UCB CZ.

Being influenced by verbal interventions of the CNB, EUR/CZK ignored the January spike of EUR/USD. This shortly made CZK 2.5% weaker versus EUR than would correspond to the EUR/USD course. Since then the gap has narrowed to 1%, driven largely by a downward drift in EUR/USD. Despite the CNB policy becoming a distinct factor in CZK behavior, the correlation between EUR/CZK and EUR/USD has remained intact.

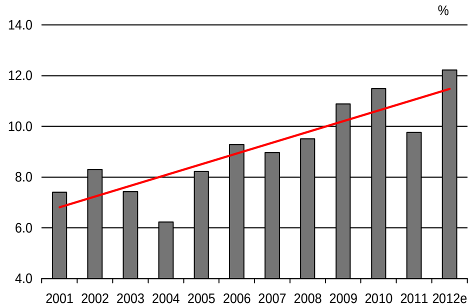
nevertheless soften alongside growing signs of economic recovery. The CNB is also set to carefully structure its communication policy, in order to avoid misinterpretations similar to early February when EUR/CZK adjusted by almost 2% after the CNB meeting. Ahead of the March policy meeting, CNB's signals are clear. Central bankers are happy with the exchange rate and no interventions are being considered for now. We expect EUR/CZK to remain stuck in the 25.0-26.0 band over most of 2013. Only late in the year a drop of EUR/CZK below 25.0 could stay free of any reaction from the CNB. As for interest rates, normalization is seen starting some time in 2014, depending on exchange rate pressures.

FOCUS: WILL HOUSEHOLDS EASE THEIR RELUCTANCE TO SPEND?

With average nominal wages rising 2.7% and average inflation hitting 3.3%, real wage growth was negative by 0.6% in 2012. Wages and salaries shown in the national accounts (capturing also small units) expanded in nominal terms 2.0% in 2012, leaving real growth of work income negative by 1.3%. Yet, even the latter figure does not explain fully the depth of household spending decline which posted in real terms 3.5% over the whole of 2012. The gap came even wider in 4Q12, as nominal wages accelerateed to 3.7% yoy (+0.8% yoy in real terms), the national accounts' wages and salaries grew 2.6% yoy (-0.3% yoy in real terms) but households' real expenditure was down 4.1% yoy. Subsequently, household saving ratio in our estimate for 2012 jumped over 12% - a decade high. What restricted the spending appetite? It could be dragged by several factors, such as a hike in the lower VAT rate from 10% to 14%, pension reform (which has boosted awarness of the need for long-term private savings) and uncertainty about an upcoming tax regime in late 2012. Also importantly, the wage acceleration in 4Q12 was of little help to spending. It was solely driven by advanced bonuses paid before the year-end particularly in the financial sector (this sector accounted for one-third of wage increase in the whole economy). However, bankers probably spent only a fraction of their extra income in 4Q12.

Nominal wage growth will hardly turn higher in 2013 versus 2012. Nevertheless, we expect households' spending reluctance to ease substantially. First, average inflation (estimated at 1.9%) is set to go lower, reverting real wages to marginal growth (0.2% yoy). Second, no tax uncertainty lies ahead of households for 2013 or 2014. And last but not least, the consumer cycle may help, as it is known that postponement in renewal of durables in one year leads to a higher need for renewal in another year. In all, we expect real wages broadly flat and private consumption down by mere 0.5% in 2013.

Household saving ratio



Source: CNB, UCB CZ.

Household saving ratio is estimated to hit a decade high over 12% in 2012. At the beginning of the century the typical level was 8%, growing by a half since. The process was not continuous, with temporary declines in the ratio tracking the spells of unexpected inflation easing with a one-year lag. Lower inflation in 2013 hence bodes well for a dip in household saving ratio in 2014.

Czech Republic Macroeconomic Outlook

	2010	2011	2012	2013 forecast	2014 forecast
GDP growth (real yoy change, %)	2.3	1.9	-1.2	0.4	2.2
Household consumption (real yoy change, %)	0.9	0.7	-3.5	-0.5	1.5
Gross fixed capital formation (real yoy change, %)	0.6	-0.7	-1.6	-1.0	2.5
Industrial output (real yoy change, %)	8.6	5.9	-0.7	1.0	3.5
Unemployment rate (average, %)	7.0	6.7	6.8	7.5	7.0
Inflation rate (CPI yoy change, average, %)	1.5	1.9	3.3	1.9	2.1
Average wages (nominal yoy change, %)	2.2	2.4	2.7	2.1	3.5
Interest rates (3-M PRIBOR, end of period, %)	1.22	1.17	0.50	0.55	1.50
Interest rates (3-M PRIBOR, average, %)	1.31	1.19	1.00	0.50	0.85
EUR/CZK exchange rate (end of period)	25.06	25.80	25.14	25.30	24.50
EUR/CZK exchange rate (average)	25.29	24.59	25.14	25.40	24.90
Current account balance (% of GDP)	-3.9	-2.7	-2.4	-2.2	-1.8
FDI net inflow (% of GDP)	2.5	1.2	4.7	3.6	3.5
General government balance (% of GDP)*	-4.8	-3.3	-5.2	-3.1	-3.0
Public debt (% of GDP)	37.8	40.8	45.7	47.8	48.9

Remarks:
**/ ESA 95 definition.*
Sources: Czech National Bank, Czech Statistical Office.
Forecasts: UniCredit Bank CZ.