UniCredit Bank

Economic Research

Czech Economic Quarterly

June 20, 2013

At a breaking point

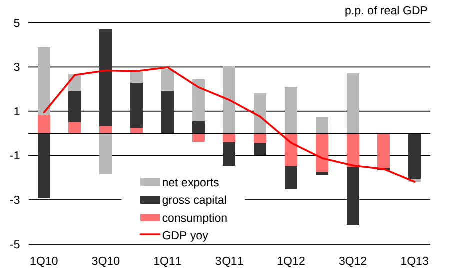
- Recession in the Czech economy extended to its sixth consequtive quarter in 1Q13, as real GDP slumped (seasonally adjusted) 1.1% qoq and 2.2% yoy. An inventory rundown dragged GDP by a considerable 1.1% yoy, explaining most of the GDP deterioration.
- For 2Q13, we expect to see a qoq upturn and a moderation of a yoy slump. Our confidence is supported by improvements in the industrial orders, resumption of export dynamic and ongoing stabilization in retail sales at the start of the period.
- Only a gradual improvement in economic conditions is envisaged for 2H13. The sequence of recovery will go from exports via private consumption to investments. The weak 1Q13 will keep full-2013 GDP still down, -0.8%.
- We continue to believe that a deeper-rooted recovery will set in next year. GDP growth projected at 2.1% should be supported evenly by all major demand-side components.
- Monetary conditions are set to stay neutral, with an fx intervention by the CNB still not expected in our baseline scenario. Fiscal policy will cease to be a drag on GDP this year and will turn sligtly stimulating in 2014.

REAL GDP (CONSTANT PRICES OF 2005, ADJUSTED)

	1Q13		4Q12 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**-2.2**	**-2.2**	**-1.6**	**-1.6**
Household consumption (%)	-0.5	-0.3	-3.5	-1.7
Government consumption (%)	1.1	0.2	0.7	0.2
Fixed capital formation (%)	-3.9	-0.9	-6.0	-1.5
Change in inventories	-	-1.1	-	1.4
Net exports	-	-0.1	-	0.0

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 1Q13, net exports failed to contribute positively to GDP growth yoy for the second quarter running. Private consumption eased its negative input whilst gross capital became a severe drag on GDP. Within the latter item, both fixed capital and an inventory change proved to be curbing GDP substantially.

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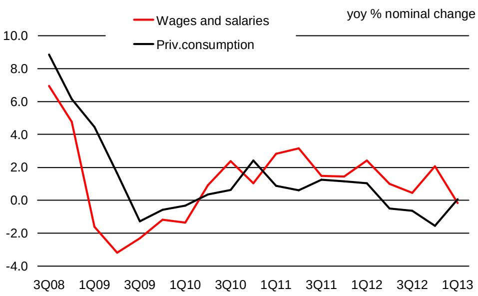
1Q13: CAPEX ALTERED CONSUMPTION AS GDP DRAG

Recession extended to its sixth consequtive quarter in 1Q13, as real GDP slumped (seasonally adjusted) 1.1% qoq and 2.2% yoy. The demand side structure displayed a much improved private consumption (-0.5% yoy, +1.6% qoq), weak external demand (with real exports shrinking 2.1% yoy and net exports taking away 0.1p.p. from GDP) and persistently poor fixed capital formation (-3.9% yoy). An inventory rundown dragged GDP by a considerable 1.1% yoy, explaining most of the GDP deterioration from 4Q12's -1.6% yoy. From the production side, all major sectors except for the financial saw yoy declines in real gross value added. Nominal GDP dipped 1.0% yoy, the same pace as in 4Q12.

At face value, the depth of recession looked indeed shocking, but we found the underlying picture a bit less bad. First, severe winter weather delayed the start of seasonal construction activity and slowed other economic activity. Second, the automotive industry – by far the most important manufacturing sector – took a combined hit from a reduction of oversupply across Europe and model upgrades at the local Skoda producer. Third, the scale of inventory adjustment was unprecedented for 1Q and probably left the inventory stock for many companies at their technological minima. All three facts suggest that a payback period has to start soon.

Work income and private consumption



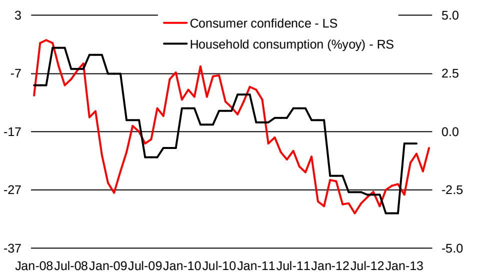
Source: CZSO, UCB CZ.

Household spending has ceased to decline in nominal yoy terms in 1Q13 despite nominal income from wages and salaries actually turning to a yoy stagnation. Apparently, former propensity to save has allowed households to become more upbeat on spending without their incomes improving.

2Q13: PAYBACK FROM 1Q13 MAY HELP GDP QOQ

We actually expect to see a qoq upturn and a moderation of a yoy slump already in 2Q13. Our confidence is supported by three factors. First, industrial output is heading to a faster track. The May manufacturing PMI has broken above the 50-mark. The April production posted a 0.5% yoy rise and new orders added 5.8% yoy in the same month. Second, exports have returned to growth in April, posting 6.4% yoy gain in CZK terms. Third, April retail sales were up 1.5% yoy, suggesting that a stabilization in household consumption is under way. Admittedly, April indices were helped by one additional working day against the base but even the adjusted yoy data looked better than in 1Q13. The early-June flooding caused some disruption but didn't seem to be a meaningful economic drag.

Consumer confidence and private consumption



Source: CZSO, UCB CZ.

A distinct moderation in the private consumption slump was adviced a couple of months ahead by improving consumer confidence. That said, the confidence would have to keep rising further from its May level in order to justify for the entire stabilization of private consumption.

2H13: ONLY A GRADUAL IMPROVEMENT

The poor economic outcome of 1Q has made us tame our optimism on the whole of 2013 but hasn't changed our view on the sequence of recovery by individual components. The sequence should go from exports via private consumption to investments.

With cross-border exports accounting for 78% of GDP (the figure as of 1Q13), GDP upturn is hardly conceivable without a revival of external demand. We do expect a partial upturn there in 2H13 but the optimism has also been scaled down, as UniCredit Group now predicts eurozone's 2013 GDP contraction at 0.6%, the same figure as for 2012. Czech exporters have been struggling to boost their focus on non-EU destinations (indeed, the share of non-EU on total exports for the first trimester of a year rose to 19.1% in 2013 from 15.2% in 2009) but the process surely has its limits.

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Despite imports set to remain depressed and despite exports expected to maintain (albeit slow) yoy growth in 2H13, we foresee net exports contributing to GDP growth mere 0.5 p.p. over the whole of 2013.

A yoy stagnation at best is projected for private consumption in 2H13. While on the one hand, inflation has been developing in favor of households' real purchasing power (the latest CPI came in at 1.4% yoy and we expect the same level on average for 2H13), nominal wages on the other hand are only seen rising around 1% yoy. Unemployment is still projected to head up, even though its highest momentum is probably over. On a more positive note, household spending behavior shouldn't be dragged by tax-induced inflation concerns, unlike in 2011-2012.

We remain downbeat on capital spending over the rest of 2013, predicting a 2.5% decline for the whole year. A moderate yoy growth may be restored for spending on machinery in 2H13, whilst transport equipment will likely continue to face a cyclical slowdown. No upturn is envisaged in construction-related investments where demand is missing from the side of both private investors and the public sector. Admittedly, the government has announced to release a couple of CZK billion to cover damage from the June flooding. This however appears to be only a marginal help for the construction sector which has been suffering for years from the lack of big projects.

On balance, we expect the qoq GDP growth will stay too weak to offset the deeply negative start of the year. We pencil in a full-2013 GDP contraction of 0.8%.

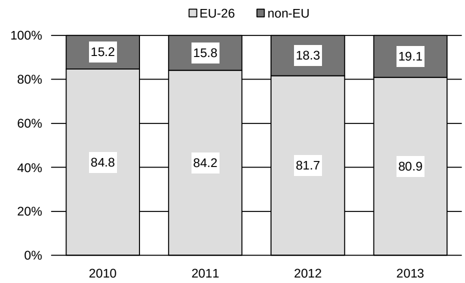
2014: ON COURSE TO NORMALIZATION

In spite of downgrading the 2013 outlook, we continue to believe that a deeper-rooted recovery will set in next year. GDP growth at projected 2.1% should be supported evenly by all demand side components. Within fixed capital formation, we expect growth for the segments of machinery and transport equipment, whilst construction-related investments may rather switch from falling to flat figures.

MONETARY CONDITIONS TO STAY NEUTRAL

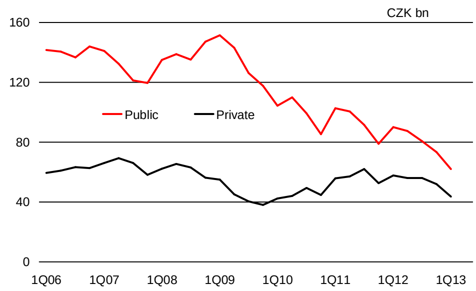
The CNB will keep its repo rate at zero at least until 2H14, maybe longer. It will also remind the markets from time to time its threat to weaken the CZK by intervention. Actual interventions are still not part of our baseline scenario but we admit a decline of headline CPI below 1% (the bottom of the CNB's target range for CPI) would boost chance for such a policy step. Another (not very likely) circumstance potentially leading to the CNB's intervention would be a continuous firming of CZK before economic recovery gets on a firmer ground. More detailed policy options will probably be disclosed in August when the CNB reviews its economic forcasts next time.

Czech exports destinations (% of total for Jan-Apr)



Source: CZSO, UCB CZ.

Export growth to non-EU countries has been much faster than to the EU since 2010, boosting the share of the non-EU on total exports to more than 19% by 2013. Yet, significance of the EU for Czech exporters stays overwhelming and chances to get much farther in export diversification are limited.



Stock of orders for construction work

Source: CZSO, UCB CZ.

The construction sector still doesn't see a light at the end of the tunnel, at least not in the form of long-term tendered contracts. The situation may be better in terms of ad-hoc work, chiefly but not only because of needed repairs after the recent flooding. The state is also increasing the funding of preparatory works for infrastructure projects, which will hopefully help the sector in 2014-2015.

FISCAL POLICY TURNING MODERATELY STIMULATING

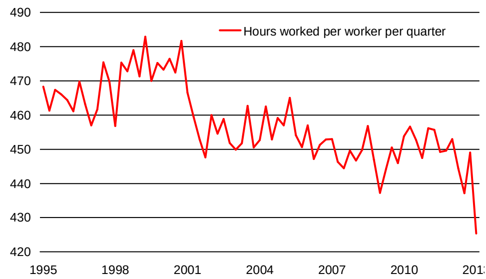
Fiscal policy should no longer drag on GDP growth this year. While the public sector deficit net of one-offs hit 2.5% of GDP in 2012 (against 2011's 3.3% of GDP), this year's deficit was forecast at 2.8% in the latest fiscal outlook as of May. Meanwhile, the government has set aside CZK 5.3bn for repairs after recent flooding. Our takeaway is that much of the spending boost is facilitated by improving VAT collection and would be triggered even had it not been for the flooding. An estimate of a change in the cyclically adjusted deficit makes fiscal policy marginally stimulating this year. For next two years, the government targets deficit to GDP ratio unchanged at at 2.8%-2.9% of GDP which, considering economic cycle, would make fiscal policy increasingly expansionary. That said, we wouldn't read much into medium-term fiscal goals, as these are prone to updating at a later stage. The current political crisis forms in the context yet another complication. Nevertheless, spending in the rest of 2013 will stay more or less unaffected, as a government's degrees of freedom to change an existing budget is strictly limited.

FOCUS: RECESSION BRINGS A LOWER NUMBER OF HOURS WORKED BUT HIGHER EMPLOYMENT

Recessions typically lead to a reduction in the number of hours worked and this one is no exception. On a yoy basis, hours worked shrank 1.1% in 2012 and as much as 5.2% in 1Q13. Interestingly, employment was at the same time on a yoy rise (0.4% in 2012 and 1.0% in 1Q13), bringing the average number of hours per worker down yoy 1.5% for 2012 and 6.3% for 1Q2013. The low labor utilization from 1Q13 was unprecedented. One explanation for more persons in the Czech economy working less is an increasing number of agency workers. At uncertain times companies prefer short-term contracts from creating permanent jobs and hiring workers through agencies appears to be an appropriate solution. Without precise statistics available, sources from the labor agencies estimate that as much as 250,000 agency workers may currently be available, the number having risen some 10% in 2012. Average utilization of an agency worker accounts for a quarter of a full-time contract. Hence, more agency workers may mean a distinct rise in total employment but only a minor change in the number of hours worked.

Whatever the explanation of increasing employment, the development is beneficial from the social and macroeconomic viewpoint. If employment followed the pattern of the 2009 recession, the number of jobless would be 120,000 higher now, burdening the state budget by extra social expenditures and causing more people to loose their work habits. A dark side of the current "more jobs – less utilization" mode is a declining labor productivity per worker. Nevertheless, with Czechs on average in 2011 having spent 10% more hours working than West Europeans according to the OECD statistics, the recent trend could prove to be part of a longer-term adjustment process.

Hours worked per worker



Source: CZSO, UCB CZ.

In 1Q13, the number of hours worked per worker dropped to an all-time low. While the slump can partially be explained by one-off factors (a lower number of working days, severe weather conditions), it may as well be part of a long-term adjustment process approaching labor utilization in the Czech economy to west-european standards.

Czech Republic Macroeconomic Outlook

	2010	2011	2012	2013 forecast	2014 forecast
GDP growth (real yoy change, %)	2.3	1.8	-1.2	-0.8	2.1
Household consumption (real yoy change, %)	0.8	0.5	-2.6	-0.1	1.5
Gross fixed capital formation (real yoy change, %)	0.7	0.4	-2.6	-2.5	2.5
Industrial output (real yoy change, %)	8.6	5.9	-0.7	0.0	3.5
Unemployment rate (average, %)	7.0	6.7	6.8	7.8	7.4
Inflation rate (CPI yoy change, average, %)	1.5	1.9	3.3	1.6	1.6
Average wages (nominal yoy change, %)	2.2	2.5	2.7	0.7	3.2
Interest rates (3-M PRIBOR, end of period, %)	1.22	1.17	0.50	0.50	0.95
Interest rates (3-M PRIBOR, average, %)	1.31	1.19	1.00	0.50	0.60
EUR/CZK exchange rate (end of period)	25.06	25.80	25.14	25.50	24.50
EUR/CZK exchange rate (average)	25.29	24.59	25.14	25.70	25.00
Current account balance (% of GDP)	-3.9	-2.7	-2.5	-1.2	-1.1
FDI net inflow (% of GDP)	2.5	1.2	4.7	3.4	3.6
General government balance (% of GDP)*	-4.8	-3.3	-4.4	-2.9	-3.0
Public debt (% of GDP)	37.8	40.8	45.8	47.9	48.9

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

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