Economic Research

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Facing a post-shock therapy

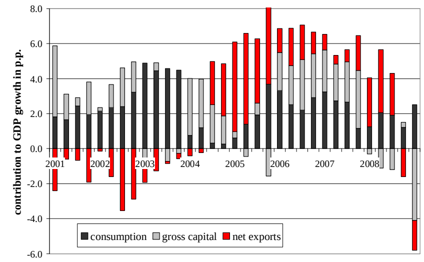
- In an unprecedented slump, the 1Q real GDP contracted by 3.4% in both the q-o-q and the y-o-y adjusted terms. The drags included the inventory adjustment, fixed capital formation and net exports, whilst both the household and the government consumption rose.

- The recession is believed to be past its trough but signs of the upturn are still unconvincing. Yet, we expect slightly positive increments in the q-o-q GDP for the remainder of 2009, as the industrial de-stocking may soon be over. The full-2009 GDP growth forecast has been revised to -3.2%.

- Budgetary constraints will affect the economy in 2010 via lower growth of social transfers and a reduction in publicly financed investment. Unless external demand picks up visibly, the economy is at risk of facing a double-dip recession. Our baseline GDP forecast calls for a 0.7% growth.

- The CNB repo rate is seen bottoming at 1.25%. Monetary conditions will be increasingly driven by CZK. The scenario of CZK resuming the appreciation path in 2010 is consistent with the CNB repo rate remaining at its bottom until 2H 2010. The fx rate outlook is however marked by a considerable uncertainty.

Breakdown of GDP growth by demand



Sources: UCB CZ, CZSO.

The sharp inventory adjustment along with the contraction in fixed capital formation and the ongoing drag of net exports brought the 1Q GDP into the most severe decline since 1993. The GDP drop was mitigated by consumption of both the households and the government.

REAL GDP (CONSTANT PRICES OF 2000, ADJUSTED)

	1Q 2009		4Q 2008 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**-3.4**	**-3.4**	**-0.1**	**-0.1**
Household consumption (%)	3.0	1.5	2.4	1.1
Government consumption (%)	5.2	1.0	0.5	0.1
Fixed capital formation (%)	-3.4	-0.8	-2.1	-0.5
Change in inventories (CZK bn)	-28.7	-3.3	6.7	0.8
Net exports (CZK bn)	-11.7	-1.7	-12.6	-1.6

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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1Q 2009: AN UNPRECEDENTED GDP CONTRACTION

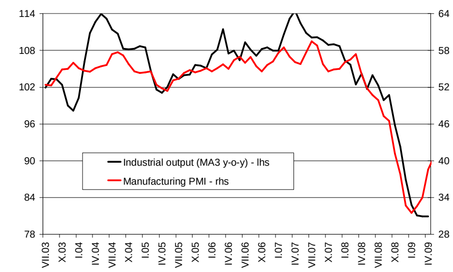
The economic slump, observed since 4Q 2008, developed into a free fall by 1Q. Real GDP contracted by 3.4% y-o-y (adjusted) or 3.3% y-o-y (unadjusted). At the same time, the 4Q's pace was downward revised to negative 0.1% y-o-y (adjusted) or negative 0.6% y-o-y (unadjusted). In the adjusted q-o-q terms, GDP posted 3.4% drop in 1Q after a revised 1.8% decline in 4Q. Breakdown on the demand side pointed to private consumption expanding 3.0% y-o-y, government consumption even adding 5.2% y-o-y, whilst in contrast fixed capital formation declining 3.4% y-o-y and real-term exports and imports down 20.5% and 19.6% y-o-y respectively. Gross capital formation proved to be the key contributor to GDP contraction, taking away 4.1pp from it, of which 3.3pp were attributable to an inventory rundown. Net exports shaved off 1.7pp from GDP. Nominal GDP growth maintained a positive 0.4% y-o-y change in 1Q thanks to favorable terms of trade, yet the increment hit the all-time low.

Severe declines in exports and gross capital formation came as no surprise. On the issue of the sharp inventory correction it is worth noting that, apart from manufacturers getting rid of their excessive stock, natural gas storage capacities are believed to have been almost emptied by 1Q. This should push gas imports higher in the remainder of 2009. The boost in government and private consumption were in contrast rather unexpected. While government spending was satisfactorily explained by an increased demand for healthcare covered by the public insurance (which makes sense in the context of political bickering over healthcare regulation fees), the private consumption boom deserves a deeper analysis. We attribute it largely to higher consumption on energies due to severe weather conditions, at least in comparison with the previous, extremely mild winter. The energy consumption was no immediate financial burden to household, as energy bills are paid ex post. Hence, the increase in the overall household consumption from 1Q may be altered by a slump in the remainder of 2009. A second, minor reason for solid spending appetite could be a shift of demand from new cars (the statistics showed investment on transport equipment down an unprecedented 16.7% y-o-y in 1Q) to various sorts of consumer goods.

ECONOMY IN 2Q 2009: PAST THE BOTTOM BUT WITHOUT CLEAR UPTURN

All available evidence suggests that the recession hit the bottom in 1Q. That said, signs of the economy picking up from the bottom still look unconvincing. Industrial output saw a 22.1% y-o-y decline in April, failing to deliver a positive reaction to a four-month unbroken rise in the manufacturing PMI. While the production slump has eased visibly in many light industries since the start of 2009, recession has got deeper in metal production and machinery. The construction output reversed to 2.1% growth y-o-y in April but we suspect that was largely weather-related. Nevertheless, the electricity consumption by large corporations has turned higher since May, promising some moderation in the y-o-y decrease in industry. In contrast, private consumption is no more likely to surprise on the upside in 2Q. We hence project a positive q-o-q GDP reading in 2Q, albeit not sufficiently to prevent the y-o-y figure from falling further.

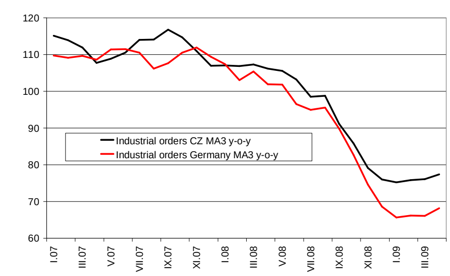
Czech industrial output and manufacturing PMI



Source: UCB CZ, CZSO.

Historically, PMI in manufacturing was closely correlated with the industrial output but its lead was minimal. Since the start of 2009, however, PMI has made four steps up without that translating into an adequate rise in the industrial output momentum. The issue is whether the PMI message is wrong or the output recovery arrives with delay. We are inclined to bet on the latter.

Orders in Czech and German industry



Source: UCB, CZSO.

Losses of industrial orders have been perfectly synchronized in the Czech and German industries. Troughs in both markets occurred in January and since then, the indices have been struggling to ease their declines. While in both cases the upturn looks equally unconvincing as yet, the fact remains that the Czech index is 9pp higher.

THE REMAINDER OF 2009: A POST-SHOCK THERAPY

Industrial output is set to further moderate its y-o-y decline in 3Q, as much of the de-stocking process will have been accomplished by then. Consumption-related types of production are seen outperforming those investment-related. **Exports of goods** in real terms are projected down about 15% y-o-y, with **net exports** still contributing negatively to GDP growth. The outlook for 4Q from the production and exports side looks however much brighter, with hopefully more signs of recovery in external demand and a huge positive base effect in a y-o-y comparison. In contrast to a milder y-o-y negative input to GDP from **net exports** and a neutral impact from the **inventory change** in 2H, we are however rather bearish on **fixed capital formation**. In 1Q, it was still bolstered by the deliveries of the formerly ordered machinery equipment but this support may no longer be in place by 3Q. Prospect for construction-related investment is not good either, with private businesses having little incentive to expand and the public infrastructure investment starting to feel the pinch of budgetary constraints. **Private consumption** will on the one hand be hit by increasing job losses, on the other hand the ongoing public social transfers are set to render it a meaningful stimulus. On balance, private consumption is projected to be more or less flat and the whole GDP may post slightly positive q-o-q changes. This would lead to the y-o-y dynamic of GDP reaching the bottom in 3Q around -4.0% before shooting up above -2.0% in 4Q.

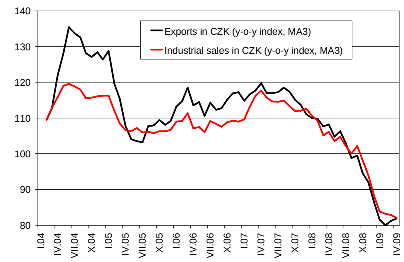
Of rather extensive changes in our macroeconomic forecasts for full-2009 since three months ago, the most noteworthy are:

- Downward revision to GDP growth from -1.8% to -3.2%
- Downward revision to industrial output from -5.0% to -10.5%
- Downward revision to fixed capital formation from -3.8% to -6.5%
- Upward revision to year-end unemployment rate from 8.2% to 9.3%
- Upward revision to trade balance from CZK 55bn to CZK 82bn.

2010: STAGNATION ON SLUGGISH PRIVATE SPENDING

With the public sector deficit likely to be capped at close to a 2009's level, fiscal incentives will no longer be in place. Exports are projected to resume a moderate growth on improving external demand, which may with some delay bolster also business investment activity. On the other hand, private demand is set to remain subdued, as unemployment will keep growing at least through 1H 2010, wage growth may stay around 2% only (with entire stagnation in the public sector) and the indexation of pensions should not exceed 2% either. Public sector investment will also suffer from the lack of funding. On balance, we expect GDP growth at mere 0.7% in 2010. Unless global economy recovers faster than we assume, GDP growth in some quarters of 2010 may grind to a halt with the risk of causing a double-dip recession.

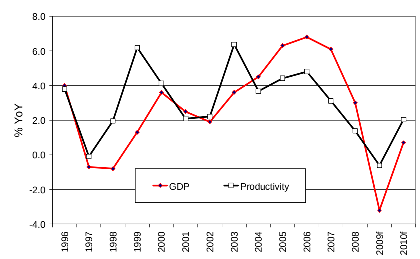
Industrial sales and exports



Source: UCB CZ, CZSO.

Global economic recession has broken the pattern of a rising share of exports in the sales of Czech manufacturers. Over the period of August 2008 to February 2009, the index of industrial sales at current prices was outperforming that of exports. Only March saw a reversal again, as a slight pick-up in export demand triggered an inventory rundown. We believe the spell of export underperformance to be over. This may however rather mean weak industrial output than strong exports in the pipelines.

GDP and productivity



Source: UCB CZ, CZSO.

The years of labor-extensive growth in the Czech economy are over. At its peak in 2007, the gap between GDP and productivity reached as much as 2.8 percentage points. For 2009, we predict the gap at negative 2.6 percentage points. On a positive note, flexible reaction of the corporate sphere in the area of employment will allow the productivity to drop only negligibly below nil despite severe recession. The other side of the coin is fast growing unemployment.

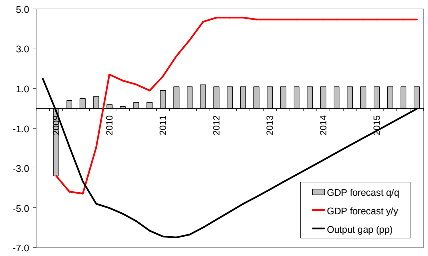
MONETARY CONDITIONS TO BE FX DRIVEN

On the backdrop of sinking GDP and subdued inflation, CNB is expected to cut the repo rate once more, possibly already in June, bringing it to the all-time low of 1.25%. Further down the road, the existing slack in the economy should prevent demand-side inflationary pressures from mounting any time soon. This will magnify the role of the exchange rate as a driver for monetary conditions. The exchange rate will hence decide on the scale of policy tightening by CNB. Our base scenario counts on EUR/CZK to stay within the current narrow 26.5-27.0 band until the end of 2009, while thereafter, improving exports should push CZK back on the appreciation track. Such a scenario would be consistent with the interest rate hiking cycle starting only in 2H 2010. That said, the move towards a firmer CZK looks far from certain. Taking into account the options of possible distress on the CEE FX markets and/or the carry trades evolving with CZK acting as a financing currency, CZK might as well turn rather weaker than firmer. Easier monetary conditions would in that case require tightening the monetary policy earlier and more extensively.

FOCUS: MODELLING THE OUTPUT GAP

The economic recession is set to be finally overcome some time in 2010 but its echoes may remain audible for as much as five years. Assuming that potential GDP growth (i.e. the pace of growth that would keep the labor market in equilibrium) declines to 2.5% in 2010 and converges towards 3.0% thereafter, the ongoing recession followed by a sluggish recovery are projected to open the negative output gap to as much as 6.5pp. If then GDP actually resumes growth peaking around 4.5% per annum, the output gap will sustain negative until 2015. Only at that time, the economy may start suffering from the acute shortage of labor like in 2007 and 1H 2008. Hence, wage and inflationary pressures are seen staying contained for an extended period.

GDP growth and the output gap



Source: UCB CZ.

Under conditions we regard likely, the negative output gap may keep opening until early 2011 to reach -6.5pp and may close no earlier than 2015.

Czech Republic Macroeconomic Outlook

	2006	2007	2008	2009 forecast	2010 forecast
GDP growth (real y/y change, %)	6.8	6.1	3.0	-3.2	0.7
Industrial output (real y/y change, %)	8.3	10.8	-1.5	-10.5	4.0
Gross fixed capital (real y/y change, %)	6.0	10.8	-0.1	-6.5	-3.5
Household consumption (real y/y change, %)	5.1	4.9	2.7	-0.2	-0.5
Unemployment rate (end of period, %)	7.7	6.0	6.0	9.3	9.5
Inflation rate (CPI y/y change, end of period, %)	1.7	5.4	3.6	1.7	1.8
Average wages (nominal y/y change, %)	6.5	7.3	8.5	2.7	2.2
External trade balance (CZK bn)	39.8	87.9	67.5	82.0	99.0
Current account balance (% of GDP)	-2.6	-3.1	-3.1	-2.6	-2.1
FDI net inflow (% of GDP)	2.8	5.1	4.1	2.2	2.1
Official foreign reserves (end of period, EUR bn)	23.9	23.7	26.6	28.0	29.0
General government balance (% of GDP)**	-2.6	-0.6	-1.5	-5.2	-4.8
Money supply (y/y change, end of period, %)	9.9	13.2	6.5	6.0	6.0
Interest rates (3-M PRIBOR, end of period, %)	2.55	4.11	3.63	1.80	2.00
EUR/CZK exchange rate (end of period)	27.50	26.62	26.93	27.00	25.50

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