CZECH REPUBLIC

WEAK CONSUMPTION

The last two quarters have been marked by slower growth in economic activity. This is mainly attributed to weaker levels of consumer spending. Furthermore, the country is still very exposed to supply chain disruptions in the automotive sector to a great extent, which adversely impacts both industrial activity and exports. The expected slowdown in the global economy in 2022 will also affect growth given the country's high exposure to trade. Inflation has probably not yet peaked, which means that monetary tightening is likely to continue in the short term.

SOFT CONSUMPTION IS WEIGHING ON GROWTH

In Q1 2022, real GDP growth reached 0.9% q/q versus 0.8% q/q in Q4 2021 and 1.7% q/q in Q3 2021. Consumer spending contracted over the last two quarters. The sharp rise in the inflation rate resulted in a loss of purchasing power for households despite government measures (energy price cap, increase in pensions and an allowance of 5,000 Czech crowns (200 euros) per child, subject to income criteria). The most affected segments were vehicles, capital goods and food products. Retail sales indices for these sectors are still below their pre-Covid levels. IT and communication equipment was the only sector whereby demand has continued to be very dynamic since the start of the year (+16.9% above pre-Covid levels in April).

Consumer spending is likely to remain subdued in the coming months. However, its future trajectory will depend on saving dynamics. In 2021, households have already drawn on savings accumulated during the Covid crisis without however returning to 2019 levels. The savings rate fell to 15.2% last year after rising sharply to 21.6% in 2020. It was 13.3% in 2019.

TOWARDS A WEAKER SUPPORT FROM INVESTMENT AND EXPORTS

First quarter growth was supported by investment and net exports, with respective contributions of 1.2 points and 0.6 points. However, both engines of growth may dampen in the short term.

Exports will undoubtedly be less dynamic in the coming months. Over the recent period, new export orders fell significantly, judging by the underlying manufacturing PMI index. As the country has a high exposure to foreign trade, it will be adversely affected by the slowdown in demand from the EU, the main trading partner, including Germany, which alone accounts for 32% of total exports. By contrast, the consequences of the Russian-Ukrainian conflict should have only a very limited impact on exports to Russia. They account for only 2.3% of total exports.

Investment may be dragged down by supply constraints and the squeeze on margins resulting from rising production costs. Similarly, the uncertainties caused by the geopolitical situation will result in the postponement of investment projects.

Ultimately, we expect a slowdown in activity to 2.9% in 2022 and 2.4% in 2023, down from 3.3% in 2021.

SUPPLY SHOCKS IN INDUSTRY

Industrial activity returned to its pre-Covid level at the end of 2020, but has made little progress since then, mainly due to supply disruptions. More recently, these have been exacerbated by the lockdowns in China, leading to plant closures at the start of the year. The war in Ukraine is also feeding through supply shocks.

The automotive sector, which plays an important role in the economy (22% of value added in manufacturing activity and 20% of total exports), was significantly impacted. Reflecting these constraints, car production in volume terms fell by 14% in total from January to April compared to the same period last year. Sales of vehicles abroad have also been struggling to gain momentum since 2019. This pattern is comparable to that of most countries in the region, which are also highly exposed to the automotive sector.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	3.0	-5.8	3.3	2.9	2.4
Inflation, CPI, year average, %	2.6	3.3	3.3	14.7	8.4
Gen. Gov. balance / GDP (%)	0.3	-5.8	-5.9	-4.4	-3.5
Gen. Gov. debt / GDP (%)	30.3	38.1	41.9	39.9	39.4
Current account balance / GDP, %	0.3	2.0	-0.9	-1.2	-0.7
External debt / GDP, %	76.5	76.5	75.3	64.6	59.0
Forex reserves, EUR bn	133.4	135.4	153.3	158.9	164.4
Forex reserves, in months of imports	10.4	11.7	11.1	9.4	9.4

TABLE 1 e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CZECH REPUBLIC: CONTRIBUTION TO GDP GROWTH

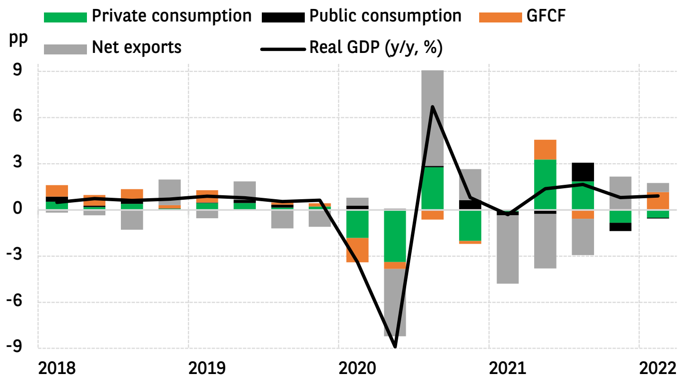

CHART 1 SOURCE: EUROSTAT, BNP PARIBAS

MONETARY TIGHTENING

Since last autumn, central banks in the countries of the region have been implementing a round of monetary tightening to curb inflation. In the Czech Republic, the key benchmark rate has been raised by 675 basis points (bps) since April 2021 to 7%. The appointment of the new governor, Aleš Michl, viewed as more dovish compared to the members of the Monetary Board, should however not affect the current tightening judging by the size of the last policy rate hike (+125 bps).

Inflationary pressures have intensified in recent months. The Harmonised Index of Consumer Prices (HICP) rose by 15.2% year-on-year in May. Food and energy items added 3.7 points and 4.3 points respectively. Supply disruptions also contributed to the rise in durable goods' prices. Inflationary pressures may ease in 2023 as a result of a relative easing of both agricultural and energy commodity prices and supply constraints. Furthermore, the wage-price spiral remains contained for the time being, given that salaries are rising at a slower pace than inflation. Nonetheless, the rate of inflation is likely to be well above the Central Bank's target of 1–3%.

LIMITED DETERIORATION IN PUBLIC AND EXTERNAL ACCOUNTS

The current account balance turned negative in 2021 at -0.9% of GDP. This can be explained by a sharp drop in the trade surplus to EUR 2.8 billion last year compared to EUR 10.6 billion in 2020. The trade balance was insufficient to compensate for the structural deficit in the income balance, which amounted to EUR 9.1 billion. As for the services account, it remained close to its four-year average at a surplus of EUR 4.3 billion.

The current account deficit is likely to persist over the next two years due to an increase in energy costs and a slowdown in exports. Energy imports from Russia are relatively high, at 42% of the total. This dependence is significant in terms of gas supply (71% of imports). For the time being, the Czech Republic, Hungary and Slovakia have obtained an exemption from the EU embargo on Russian oil imports.

Nevertheless, FDI flows and funds from the EU will still largely finance external needs, and foreign exchange reserves will likely increase. These will cover 9.4 months of imports in 2022, a very comfortable ratio.

The consolidation of the public finances will probably be delayed again this year. In this scenario, the budget deficit would remain high over the short term. The authorities anticipate a deficit of 4.5% of GDP for 2022 compared to the initial predictions of 3.3% last February. This revision aims to take account of the new government support measures. In addition to those in favour of households, guarantees on SME borrowings and deadlines for VAT payments are aimed at supporting businesses. Government debt would remain close to 40% of GDP by 2023, or about 10 points above 2019 level.

Importantly, the government's debt service burden will increase due to the rise in 5-year or 10-year rates on the local bond market. However, compared to revenues which have steadily increased over the past 10 years, the increase is likely to remain limited.

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CZECH REPUBLIC: INDUSTRIAL PRODUCTION AND VEHICLES PRODUCTION

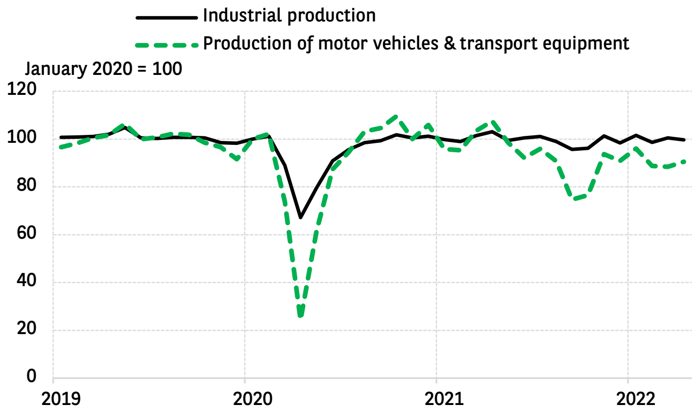

CHART 2 SOURCE: EUROSTAT, BNP PARIBAS