CZECH REPUBLIC

AN ACCUMULATION OF SHOCKS HAS HIT GROWTH

Economic growth experienced several short-lived boom-bust wild swings in 2020, amplified by trade openness and the severity of the second wave of Covid-19 in the fall. However, the recovery in the 3rd quarter proved strong. Industrial production and exports both performed well, boosted by a stable exchange rate (and substantial foreign currency reserves). In addition, thanks to very modest debt levels, the government was able to offer rapid and substantial support to the economy.

AMONG THE WORST SECOND WAVES

The Czech Republic was one of the European countries hit earliest (the beginning of October) and hardest (75,000 active cases per million people) by the second wave of the Covid-19 pandemic. New lockdown measures were introduced, although these were less restrictive than in the spring of 2020 as industry continued to operate.

After improving slightly, the infection curve worsened again at the turn of the year, prompting the continuation of restrictions on movement and access to public spaces (as evidenced by the latest closure of restaurants on 18 December, after they had been allowed to reopen on 3 December). A vaccination programme has been announced, with the aim of vaccinating front-line health staff and the over-80s by the end of March. Once this phase is completed, anyone else will be able to register for vaccination and priority will be warranted along with the risk profile of each person.

The Czech lockdown strategy is relatively flexible. It is designed to limit contact between individuals whilst allowing the economy to continue to operate. It has several alert levels, allowing regular adjustment of the severity of restrictions, which so far has helped limit the number of businesses closed. However, the scale of the current 3rd wave suggests that restrictions in the 1st quarter of this year will be tough.

FURTHER SHOCKS AHEAD IN 2021

Industrial activity was therefore able to continue to grow in the 4th quarter, and the sector even saw its manufacturing PMI climb to 57 in December 2020, its highest level since early 2018. The size of the automotive sector has been a fairly positive factor, as this sector saw both production and order books rise. This was a visible difference with the situation in the spring of 2020, when factories had to close their doors. Thus, manufacturing production in November 2020 was close to its pre-Covid level (up 3% in the case of the automotive sector).

Export growth was one of the engines of this performance: exports grew by 5% y/y in October and as much as 9.5% in November. Conversely, household consumption had to cope with stronger impacts from the resurgence of the Covid-19, with retail sales falling by 1.9% (month-on-month) in October and by 5.6% in November. As a result, consumption, which had regained its pre-Covid level in August, is now 8% lower, pointing to a very likely sizeable fall in GDP in the 4th quarter, under the effects of this resurgence.

Nonetheless, the Czech industry saw upward pressure on costs increase at the end of the year, a phenomenon driven by delays created by restrictions on transport, but also linked to high capacity utilisation rates. This has come on top of an increase in unit labour costs that had to be absorbed in the first half (9.5% y/y in the 2nd quarter), linked to the closure of factories and the fact that partial unemployment compensation did not fully offset the loss of activity.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	2.4	-6.5	4.5	4.4
Inflation (CPI, year average, %)	2.8	3.2	2.5	2.4
Gen. Gov. balance / GDP (%)	0.3	-7.5	-6.5	-3.1
Gen. Gov. debt / GDP (%)	30.2	40.0	42.0	41.5
Current account balance / GDP (%)	0.0	1.4	0.5	0.6
External debt / GDP (%)	77.3	78.3	68.5	64.4
Forex reserves (EUR bn)	113.0	132.0	138.0	142.0
Forex reserves, in months of imports	10.3	11.4	11.0	10.9
Exchange rate EURCZK (year end)	25.4	26.3	26.3	26.3

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

MANUFACTURING PRODUCTION AND RETAIL SALES (LEVELS)

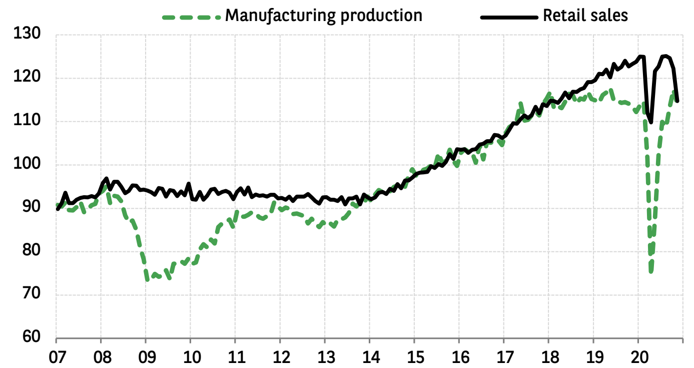

CHART 1

SOURCE: CEIC

Overall, the volatile pattern of growth in 2020 is likely to continue into 2021, although variations should be less extreme. This will delay the return to pre-Covid GDP levels to 2022, with growth over the whole of 2021 expected to be 4.5% (after a 6.5% contraction in 2020). The prospect of a global shortage of semiconductors will weigh on the automotive industry in early 2021. Given the size of the sector, it should have an impact on overall GDP growth.

A SUBSTANTIAL LEEWAY TO EASE ECONOMIC POLICY

The Czech Republic has one of the lowest levels of government debt in Europe, at 30.2% of GDP in 2019. In 2020, automatic stabilisers and the implementation of a stimulus package worth 5.5 points of GDP did not threaten this situation, with debt still well below the 60% limit (40% at end-2020).

The stimulus package focused primarily on employment, through two mechanisms, one based on the payment of wages to workers exposed to partial unemployment (extended to the end of February 2021), the other (implemented in the 3rd quarter of 2020) on the suspension of payment of social security contributions by SMEs. Other measures were also introduced, including cuts in VAT on the most impacted sectors by Covid-19 and a mechanism for accelerated write-downs on investments made in 2020 and 2021, thus allowing a reduction in business tax bills. The European stimulus package is likely to help these efforts to support economic activity, with an expected initial payment of EUR 3.3 billion in grants (according to European Commission calculations). The government has issued 9 percentage points of GDP worth of potential guarantees on loans to the private sector in 2020 (a programme to be continued in 2021), whilst the period for which this guarantee will remain in force has been extended to April 2026.

Given the relatively low level of government debt, the central bank did not have to buy sovereign bonds, as there was no pressure on yields. The 10-year yield remained roughly around 1.25% in early 2021, slightly below the pre-Covid level. Monetary stimulus has therefore been concentrated on conventional measures, with cuts in the policy rate in the spring of 2020 (from 2.25% to 0.25%). The other pillar of the central bank's strategy has been to ease macroprudential ratios in a bid to support lending (increase in the loan to value ratio and a suspension of the debt to income ratio for households).

Indicators of debt (government and external) and liquidity (foreign currency reserves) have remained at comfortable levels despite last year's health crisis, which has helped limit financial tensions. The increase of the current account surplus and continued net capital inflows thus helped support foreign currency reserves. The decrease in the external debt ratio, interrupted in 2020 by the fall in nominal GDP, is likely to resume in 2021. All of this argues for a quite stable exchange rate for the koruna against the euro.

BANKS ARE WELL CAPITALISED RELATIVELY TO THE FORESEEABLE INCREASE IN CREDIT RISK

Growth in banking sector lending to households held steady in 2020 at a rate of 6%, close to the 2019 level, whilst growth in lending to companies slowed to 3% (with relative stagnation from May).

The Czech authorities gave a 6-month moratorium on repayments on loans to the private sector (this expired in October 2020). In the end, this affected 16% of loans to non-financial companies, and 15% of loans to households. The authorities have not so far adopted a new moratorium, given the scale of those already granted in 2020.

Banks estimate that a share of the loans that benefited from this moratorium will become non-performing loans over the coming months, with an impact of 2 points on the non-performing loan ratio, which stood at 2.7% of total loans at end-September 2020. The greatest risk is related to non-financial companies, for which the central bank expects a non-performing loan ratio of 8.7% by end-2021. In addition, the central bank has observed that the households that made use of the moratorium were those with the highest debt and interest expenditure to income ratios. The expected increase in credit risk has resulted in a rise in provisions and a fall in profitability (in ROA terms) from 1.2% at end-2019 to 0.6% in the 3rd quarter of 2020.

At the same time, banks' capital has grown further, with a CET1 ratio of 20.7% in the 3rd quarter of 2020, demonstrating ample resources to deal with any shock.

FOREIGN CURRENCY RESERVES (EUR BN)

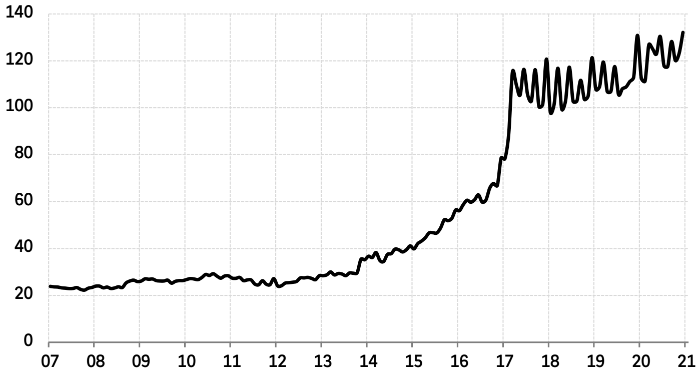

CHART 2 SOURCE: REFINITIV

Completed on 11 January 2021

Stéphane COLLIAC
stephane.colliac@bnpparibas.com