

Czech Republic

Record annual drop in Czech GDP during Q2, but PMI signals impending recovery

Key findings

- **Czech economy shrank by 4.9% year-on-year in three months to June.**
- **PMI series points to recovery.**

PMI data from Markit covering the Czech Republic signalled that the manufacturing sector moved a step closer to recovery in July. Production, new orders, backlogs and purchases all fell more slowly during the month. Moreover, a ratio of the new orders and stocks of finished goods indices was at its highest for almost two years, pointing to the possibility of higher production in the second half of the year as firms replenish warehouses.

PMI survey data provide important signals to official series on both industrial production and gross domestic product (GDP). GDP figures for the second quarter were released by the Czech Statistical Office on 14 August. On a quarter-on-quarter basis, the economy grew by 0.3% but, measured against one year earlier, posted a record fall of 4.9%.

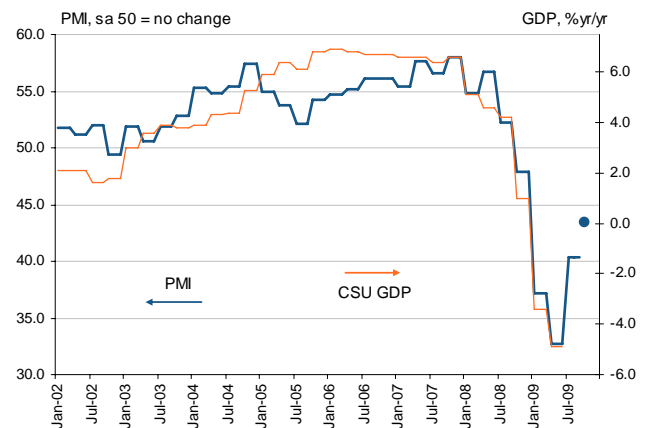
The PMI has a very good historical track record with official GDP data. A quarterly average of the PMI Output Index tracked against the annual rate of change in GDP since Q1 2002 produces a correlation of 0.84. This improves to **0.91** if the PMI series is advanced by one quarter, a relationship illustrated in Chart 1.

Over the past ten quarters (since Q1 2007), the advanced PMI quarterly series has correctly signalled the *direction of change* compared to the previous quarter in the annual rate of change of GDP for every quarter except Q2 2008.

On this basis, the strong upward movement in the PMI series over Q2 compared to Q1 suggests that the rate of economic contraction will ease significantly in Q3, as the chart shows. Furthermore, if July PMI data are used as a signal for Q4 (as shown by the blue circle),

then this trend is set to continue throughout the second half of 2009. Over time, an Output Index reading of 50.0 is consistent with annual growth in GDP of 2.8% (when advanced three months). The July figure of 43.4 is therefore consistent with a fall of around -0.3% in October.

Chart 1: PMI Output index (Q+1) vs GDP



The official year-on-year rate of decline in Q2 GDP was worse than expected by market analysts. But regression analysis applied to the Output PMI series (again advanced by three months) against an interpolated monthly GDP series suggests that PMI watchers would not have been caught out. PMI data for January, February and March – with the latter released on 1 April – were consistent with an annual fall in GDP over the second quarter of -5.4%, slightly worse than the actual first release of official data.

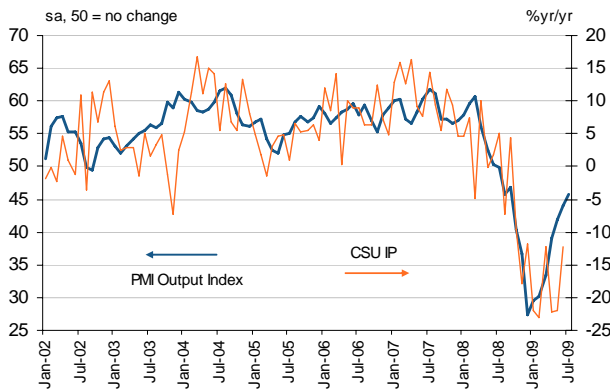
This illustrates a key strength of the PMI survey; it is released well in advance of official statistics, especially when leading indicator properties are accounted for. Another advantage of the PMI compared to official monthly industrial output figures is that the survey carries a high signal-to-noise ratio, as Chart 2 (overleaf) shows.

Although the Czech manufacturing sector only accounts for around 27% of total Czech value added,

the economy as a whole is highly export-driven. Total exports account for around 72% of GDP on the expenditure side, and principal exports include machinery and transport equipment, semi-manufactured goods and chemicals. Therefore, the manufacturing PMI is an important indicator of overall

economic performance in the EU newcomer. Recent PMI data, combined with the promising German GDP figures for the second quarter (Germany is the Czech Republic's biggest export market), bode well for Czech economic prospects in the second half of 2009.

Chart 2: PMI Output index vs IP



Forthcoming release dates:

Markit Czech Republic Manufacturing PMI (August): 1 September 2009

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