Quarterly report

Czech Economic Outlook

Looking for growth impetus

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- **We do not expect the economy to recover this year** Instead, we are looking for a 0.3% contraction in 2023 due to ongoing anaemic household consumption and problems in industry. GDP growth should pick up in 2024, but to a still-modest 1.6%.

- **Inflation set to ease towards 2% in 2024** After hitting 10.8% this year, we expect inflation to fall to an average of 1.9% in 2024. Cheaper energy for households should contribute to this, but the removal of government subsidies will nevertheless be a hindrance. Nonetheless, inflation is likely to accelerate to 2.4% in 2025 due to a persistently high core component as demand recovers.

- **CNB close to cutting rates** We expect the weak economy and decline in inflation to contribute to a rapid reduction in the repo rate from the current 7% to 4% by the end of next year. However, the policy-neutral level of 3% is unlikely to be reached before end-2025.

- **Cautious decline in CZK interest rates** The steepening in the yield curve should continue next year, in tandem with the easing of CNB's monetary policy. The decline in longer-term rates will be hampered by high interest rates abroad.

- **Koruna no longer supported** Without the CNB's presence in the FX market, the koruna is likely to weaken slightly further vs the euro. We expect it to start to appreciate again as the domestic economy recovers and the US dollar weakens, only from 2H24.

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Consumer confidence recovery crucial


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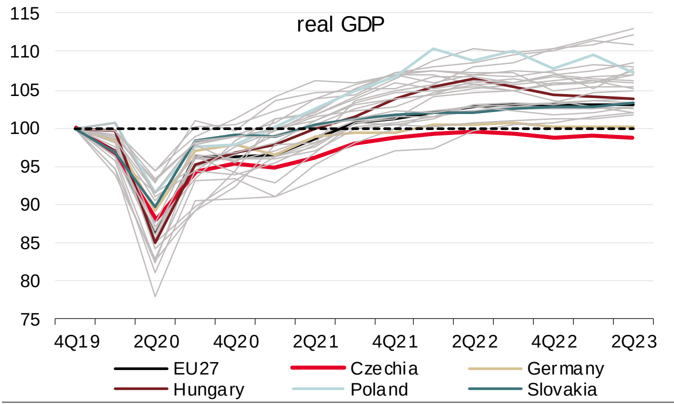
The economic recovery that we had expected for the second half of this year has not materialised. Following a shallow recession in the second half of 2022 and economic stagnation in the first half of 2023, in the last edition of the *Czech Economic Outlook* we argued that fresh growth impetus would emerge over the summer, together with renewed growth in real wages. However, in the third quarter, real GDP actually declined slightly qoq, according to our current estimates (by 0.1%), in part due to recurring supply chain issues that have hit the automotive industry again.

Recovery delayed, most likely to 2024.

The Czech economy is plodding along in the slow lane, mainly due to unprecedentedly weak household consumption.

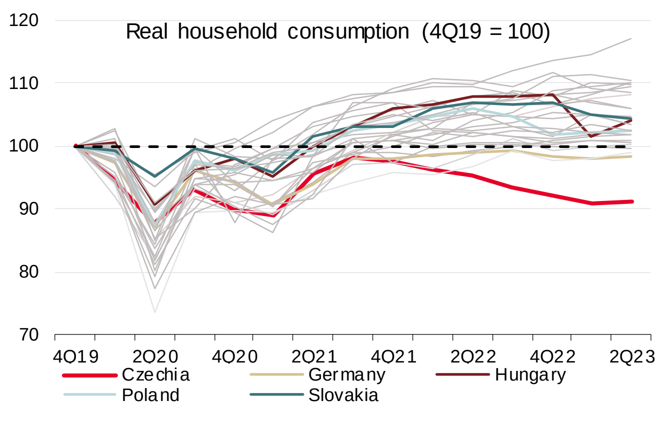
The Czech Republic remains the only EU country to have not yet returned to its pre-pandemic level of economic performance. Taking into account the information that has emerged since our last *Czech Economic Outlook*, the return to pre-pandemic GDP has been delayed by one quarter, i.e. to mid-2024. Looking at the development of the various GDP expenditure items we can clearly see that the main reason why the Czech economy is still plodding along in the slow lane is the dramatic drop in real household consumption. This drop is unique, even from the European perspective. As late as mid-2023, household consumption was still almost 9% below the pre-pandemic level. For comparison, the second-worst performer in Europe is Germany, where household consumption is only 1.7% below its end-2019 level. Consumption is also slightly below pre-pandemic levels in Spain (-1.0%) and France (-0.6%). However, in all other EU countries real household consumption expenditure is now higher.

Czechia is the only EU country where real GDP remains below the pre-pandemic level (4Q19 = 100)



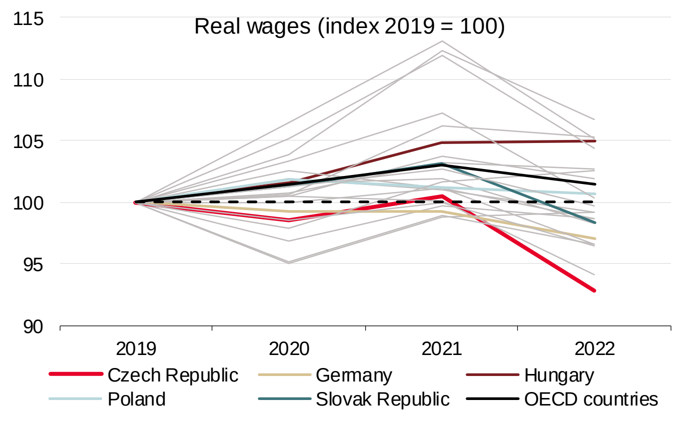
Source: Eurostat, Economic and Strategy Research, Komerční banka

The sharp drop in Czech household consumption is in a class of itself in the European context …



Source: Eurostat, Economic and Strategic Research, Komerční banka
Note: excluding Ireland

… but it is no wonder given that the country also recorded the steepest drop in real wages among OECD countries

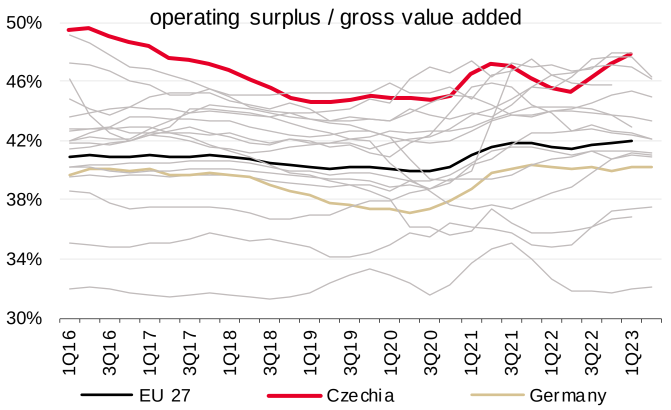


Source: OECD, Economic and Strategic Research, Komerční banka
Note: in the international dollar, PPP, 2022 constant prices

The decline in real wages is the main reason for the drop in Czech households' real consumption.

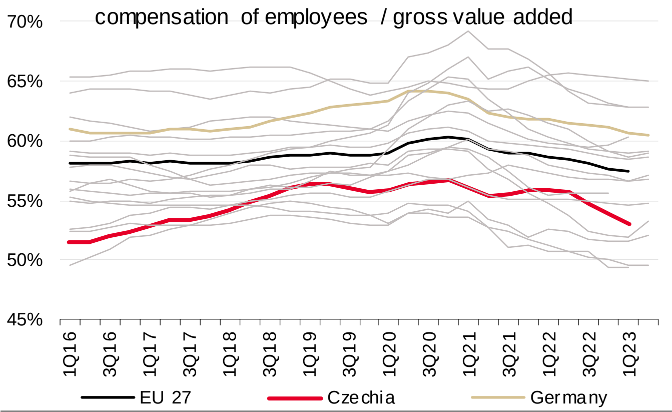
There are a large number of factors behind the sharp drop in Czech household consumption, the dramatic decline in real wages being the strongest. In mid-2023, real wages were down to levels last seen in 2H17, i.e. six years ago. This, combined with one of the highest levels of inflation in Europe, which the Czech Republic has been struggling with for almost two years now, has eroded household purchasing power. Low-income households have hit their budgetary limits while high-income households have been increasing their emergency savings, i.e. migrating their money to long-tenor savings products or riskier investment instruments with a view to achieving higher returns and offsetting the losses caused by inflation.

Czech company profit margins are among the highest in Europe and have even expanded significantly in the past few quarters…



Source: Eurostat, Economic and Strategic Research, Komerční banka
Note: rolling average for the last four quarters

… at the expense of employee compensation



Source: Eurostat, Economic and Strategic Research, Komerční banka
Note: rolling average for the last four quarters

It is not just households, companies are economising too.

In recent quarters, non-financial companies and financial institutions have been expanding their share of value added while keeping employee compensation costs on a leash. Due to the high level of uncertainty, investment activity remains weaker and businesses are therefore accumulating savings as well. The generated gross operating surplus exceeds companies' current capex needs in the high interest rate environment. However, they can allocate their own abundant resources to capex. The above charts show that the allocation of value added between labour and capital in the European context looks even worse from the employees' perspective. Profit margins in the Czech business sector are some of the fattest in Europe, whereas the share of employee compensation is at the opposite end of the spectrum, despite the high labour intensity of the Czech economy.

Households' interest income outpaces their debt service costs.

Czech households are benefiting from high interest rates. As analysed in detail by our colleague Kevin Tran in this *Czech Economic Outlook* (see *Box 1*), the central bank's tight monetary policy is also bringing certain benefits to Czech households at large. Although lending activity has been dwindling, higher rates on deposits are helping households to profit from the current high-interest-rate environment. Given current monetary conditions, which already call for a certain amount of easing in the light of not only declining inflation but also economic stagnation, we believe a weaker Czech currency makes more sense. And indeed, we have actually observed a depreciation trend for several months. We believe a rate cut is fast approaching. From a macroeconomic perspective, it matters less whether this happens this year or in early 2024. Nevertheless, rates will be visibly lower by the end of next year.

No economic growth without real consumption recovering.

Whether or not the real economy will pick up in 2024 and the country will manage to move on from its current economic lethargy will depend on whether it can find that all-elusive fresh growth impetus. But it is clear that this will not be possible without a recovery in real household consumption. And this, in turn, will not happen unless households' real disposable income grows. The key therefore is to beat down inflation on the one hand, and, on the other, promote a recovery in employee purchasing power, even if this is at the expense of a temporary decline in company profits. In the light of the persistent labour market tension due to labour shortages, and high profit margins, employees have a unique chance to improve their standing next year and achieve growth in real wages.

Although this edition of Komerční banka's *Czech Economic Outlook* is not exactly optimistic, we firmly believe that the Czech economy will pick up in 2024. Inflation is expected to return to the target level and the economy as a whole should finally return to its pre-pandemic level. Enjoy the read!

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External environment and assumptions

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The central banks' mantra: higher for longer

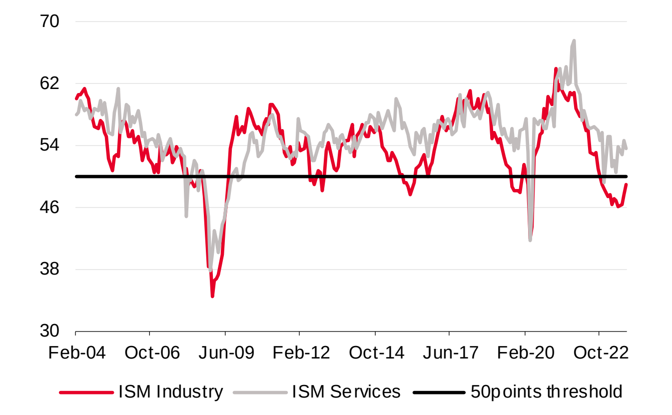
In our view, the US and European central banks will not raise interest rates any further. Although the risks are skewed toward a hike, they should now increasingly stress a 'higher for longer' stance. This is likely to be especially true for the ECB, which we forecast will not cut rates until 2025 due to relatively favourable economic developments and persistent core inflation, which will probably not return to the 2% target until 2026. In the US, we expect a recession in the second and third quarters of next year, which although likely shallow and short-lived should kick-start a cycle of rate cuts.

US: Economy starting to slow after strong 3Q

We have revised our estimate of GDP growth for 3Q substantially higher.

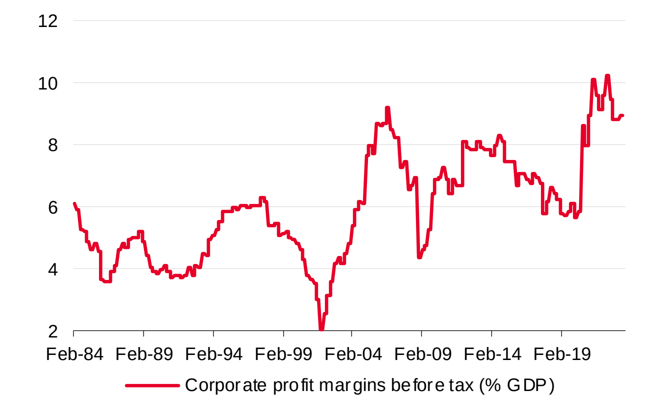
Good third quarter for the US economy. The labour market data were very strong, with the number of new jobs created in September (336 ths.) reaching double market expectations, while the figure for August was revised up significantly (to 227 ths.). Consumer spending was also strong, rising in real terms in July (however, its growth rate slowed down in August). Although the ISM index in industry remained below the 50-point threshold, indicating contraction, it increased in September from 47.6 to 49. Retail sales and foreign trade also brought positive surprises. At the same time, companies' profit margins remained high in 2Q and so did not indicate a significant slowdown in the economy. We thus revised up our estimate of GDP growth for 3Q from 3.6% qoq annualised to 4.8% qoq annualised. However, GDP growth will likely not be nearly as strong in the coming quarters. Vehicle sales are losing momentum, and nonfarm payrolls have already reached pre-pandemic levels in many sectors, so job creation should rapidly decline. Moreover, amid weaker consumer demand (also due to renewed student loan repayments) and the impact of high interest rates on the housing market and corporate investment, the US economy will likely see recession in 2Q/3Q24, in our view. However, it should be shallow and short-lived.

US economic activity improves slightly



Source: Macrobond, SG Cross Asset Research/Economics

Corporate profit margins still high



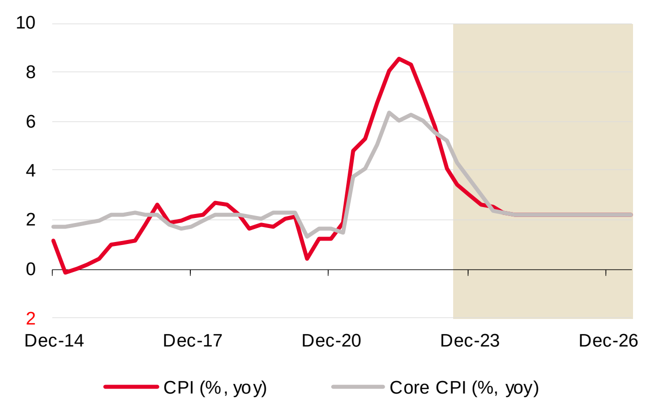
Source: Macrobond, SG Cross Asset Research/Economics

First FED rate cut likely in 2Q24.

Macroeconomic situation and statements by US central bankers suggest 'higher for longer' Fed monetary policy. The key interest rate is at 5.25%-5.50%, and we think it will remain there until the second quarter of next year. While the dot plot assumes one more hike this year, we do not see it materialising given expected economic developments. September inflation surprised slightly to the upside (3.7% yoy). The core component (which was in line with expectations at 4.1% yoy) in particular is holding higher. A slowdown in growth in rental prices, which account for almost a third of the US consumer basket, is needed for it to fall.

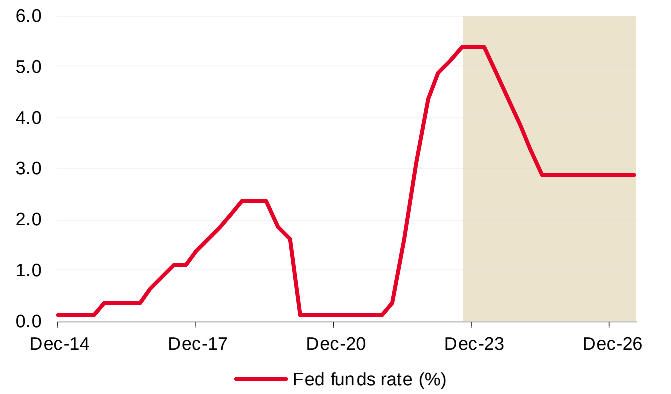
This is already happening and should be further boosted by an easing in the labour market. Next year, the dot plot envisages a double easing of monetary conditions. Our SG colleagues' forecast sees rates at 3.75%-4.00% at the end of next year and 3% in mid-2025, when rate cuts should come to an end.

US inflation slows



Source: Macrobond, SG Cross Asset Research/Economics

We expect the Fed to cut rates in 2Q24



Source: Macrobond, SG Cross Asset Research/Economics

Euro area: higher for longer

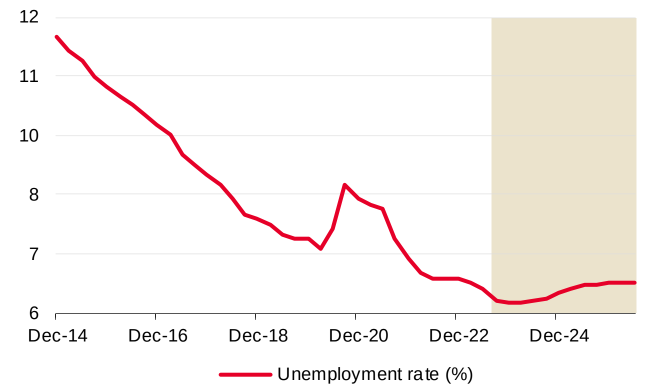
Euro area's problem is more on the supply side than demand side.

Euro area has so far avoided recession. While preliminary estimates had pointed to a double-dip contraction in the final quarter of last year and first quarter of this year, refined estimates has brought GDP qoq stagnation for 1Q23 and 0.2% qoq growth in 2Q23. We do not expect a recession in the coming quarters either despite continued weakness in the sentiment indicators (PMI, Ifo, ESI). Our optimism is based on the high profit margins of corporates, which continue to benefit from pricing power in an environment of robust demand. Moreover, they have a stockpile of liquidity from the Covid days enabling them to continue to invest despite tighter monetary conditions. Firms are reporting a shortage of equipment and skilled labour as barriers to output more than a lack of new orders. All this suggests that the euro area's problem is insufficient supply rather than demand. This is particularly evident in the automotive industry, although here the demand overhang is gradually normalising. Even so, European industry should remain subdued in the third and final quarter of this year, dragged down by the drive for energy savings, the weaker performance of energy-intensive industries and weak external demand. However, European industry should slowly revive next year.

Consumption should be the engine of the European economy.

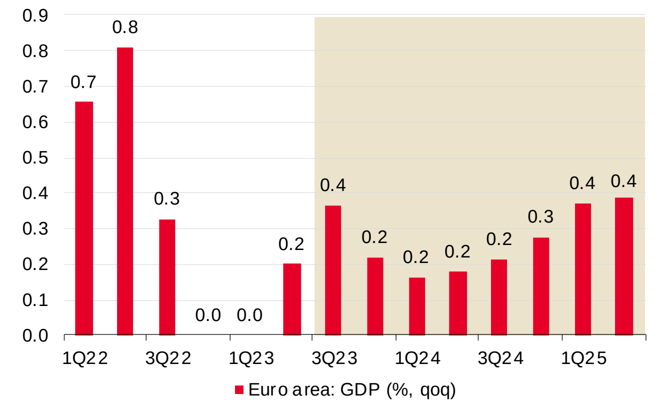
Household consumption should be supported by a high savings rate, historically low unemployment and thus a solid position for wage negotiations. In addition, real disposable income has been improved by rising interest rates and strong fiscal support. Household consumption should thus be the main driver of the European economy. If this were not to happen, it would be due to households starting to save even more. But we do not foresee this happening. We see GDP growth of 0.7% this year and 0.9% next year. The significant risk to our forecast is fiscal retrenchment next year, which may be more pronounced in individual countries than we assume.

Euro area labour market remains tight



Source: Macrobond, SG Cross Asset Research/Economics

GDP likely to grow moderately

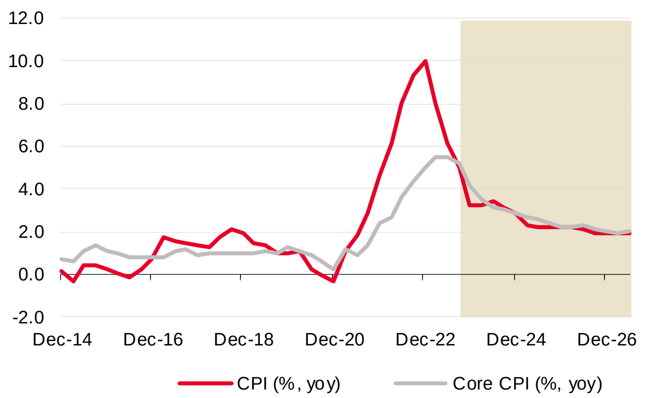


Source: Macrobond, SG Cross Asset Research/Economics

Interest rates likely stable until 2025.

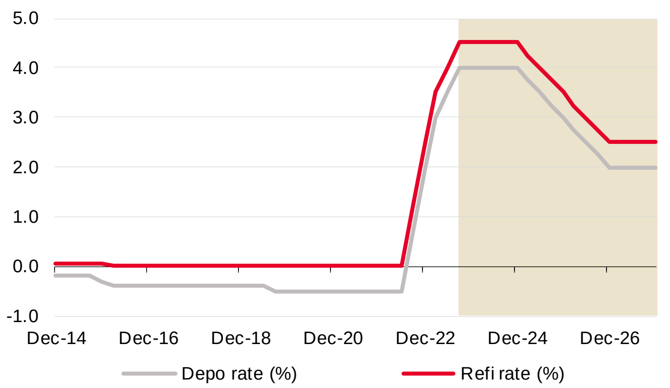
Although euro area inflation has already slowed, it will likely not return to the ECB's 2% target next year. The problem is mainly core inflation, which will probably be held at higher levels by strong wage growth. We estimate it at around 4% at the end of this year, 2.6% at the end of next year and above 2% in 2025. This is the main reason we believe the ECB will have to leave interest rates at their current level for an extended period. Further interest rate hikes cannot be fully ruled out, but this is not our main scenario. We do not expect the first rate cut until 1H25. The deposit rate should reach 2% from the current 4% at the end of 2026.

Core inflation still high



Source: SG Cross Asset Research/Economics

ECB rates: no change likely until 2025



Source: SG Cross Asset Research/Economics

Quantitative tapering should intensify.

ECB to step up balance sheet reduction. This has been running since March and will average EUR23bn per month in 3Q (from the APP programme) and should be extended to EUR26bn in 4Q. In February next year, we estimate that the ECB will increase this to EUR30bn per month and will start to reduce reinvestments from the pandemic programme (PEPP) by EUR15-20bn per month, or it may start selling APP bonds directly. Repayments from TLTRO programmes, i.e. cheap money provided to commercial banks, are also contributing significantly to reducing the balance sheet. Of these, around EUR1.7tn had been repaid by the end of September. The ECB is likely to continue reducing the balance sheet when it starts to cut interest rates. The spring review of the central bank's strategic tools could hint at how the central bank will approach these issues.

CEE: monetary policy easing has started

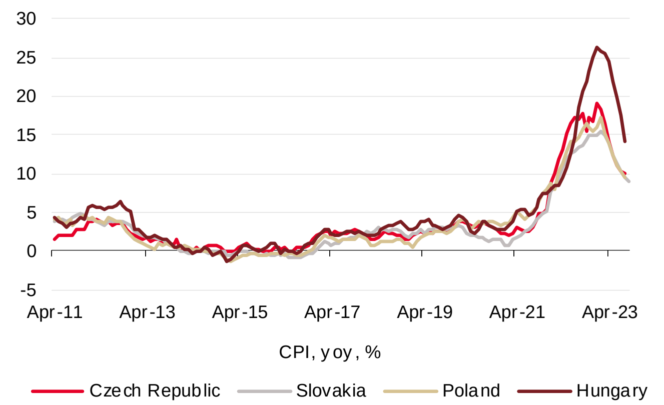
Polish interest rates likely to remain stable for longer.

The Polish central bank surprised financial markets in September by cutting its key rate by 75bp, following up with a 25bp cut to 5.75% in October. But that was the last one for a while, in our view. Poland's labour market remains tight (unemployment 5% in August), with wages rising at a double-digit pace (minimum wage was raised by 18%, year-on-year wage growth was 10.3% in September). This should keep core inflation high, while the removal of support measures (0% VAT on food, energy subsidies) will likely also prevent a significant fall in inflation. This argues for keeping rates at current levels until 2Q24, with rates expected to be at 5.25% by the end of 2024 on SGe.

Hungarian central bank cut the key 3M rate in October.

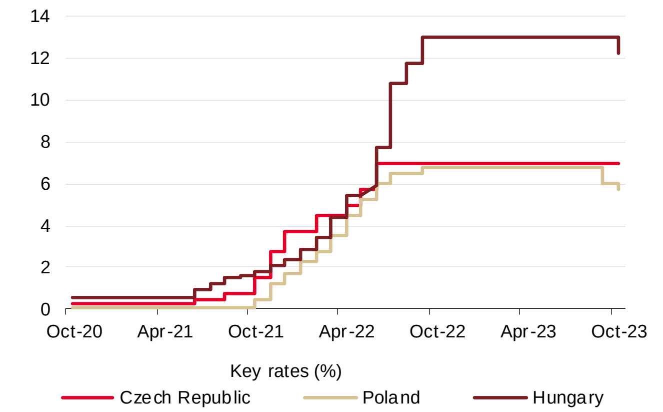
Hungary's central bank continues to cut the overnight deposit rate, which has already reached the 13% level of the key 3M deposit rate in September. In October, it cut the 3M deposit rate to 12.25 %. Key rate would stand at 11.5% at end-2023 and to hit 5 % in 4Q24.

Inflation in the region is falling



Source: Macrobond, Economic & Strategy Research, Komerční banka

Central banks cut key interest rate



Source: Macrobond, Economic & Strategy Research, Komerční banka

Macroeconomic forecast

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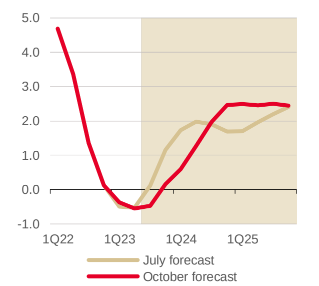
Major changes

GDP:
We expect the economy to contract by 0.3% this year and to grow by 1.6% next year. Compared with our previous forecast, the outlook for both years has worsened due to continued very weak household demand and a lack of production inputs in industry. We expect economic stagnation to continue in 2H23. Thereafter, we expect the economy to pick up as the high level of excess savings is reduced and real wage growth resumes.

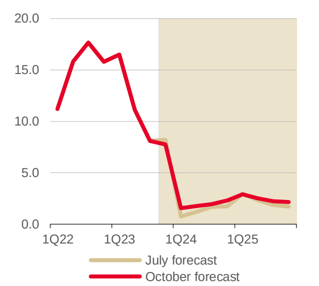
Inflation:
We have lowered our inflation estimate for this year from 11.0% to 10.8% and raised it for 2024 from 1.3% to 1.9%. The downward revision this year is driven by the earlier decline in household energy prices. Next year, the administrative measures related to the austerity package and the withdrawal of state support for energy are likely to have an impact on inflation. We expect core inflation to remain above 2% next year, driven by the expected recovery in household consumption.

Changes to GDP forecast (%, yoy)



Source: CZSO, Economic & Strategy Research, Komerční banka

Changes to CPI forecast (%, yoy)

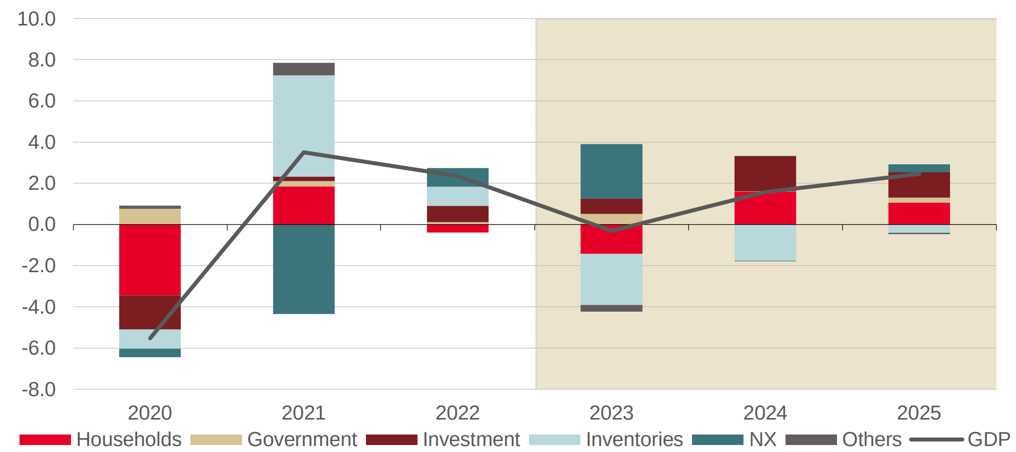


Source: CZSO, Economic & Strategy Research, Komerční banka

The economy becomes a bigger problem than inflation

The Czech economy is stagnating and this is unlikely to change in the second half of the year. There has been no recovery in household consumption or in the economy as a whole. Households have seen their purchasing power eroded by high inflation and have cut back on spending as a result. The labour market remains tight and corporate profitability continues to rise. Higher nominal wage growth should therefore continue next year and contribute to a resumption of real wage growth in the context of a rapid decline in inflation towards the central bank's 2% target. This, together with the high level of excess savings, should help revive consumer spending, which is now the main drag on economic growth. However, tight monetary policy and fiscal consolidation are likely to weigh on the economy in 2024.

We expect GDP to fall by 0.3% this year and rise by 1.6% next year (%, yoy)

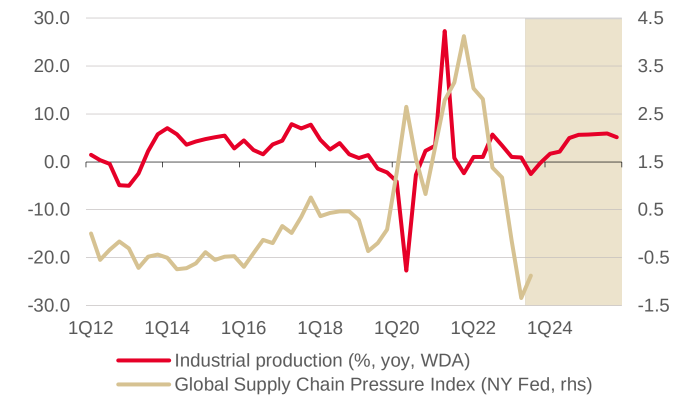


Source: CZSO, Economic & Strategy Research, Komerční banka

An economic rebound in the second half of this year is unlikely

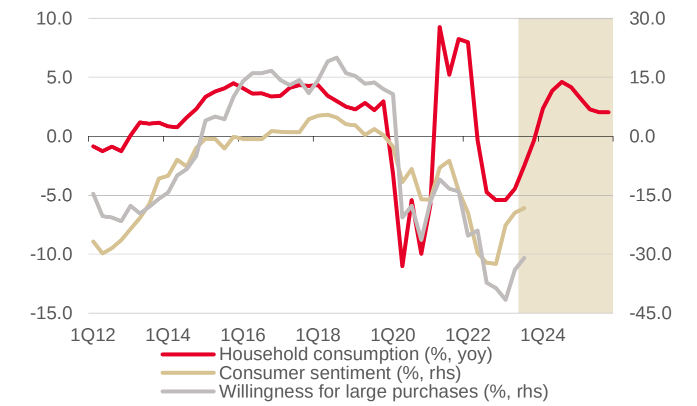
The Czech economy remained flat in 2Q23. While GDP was unchanged qoq, in our previous forecast we had expected slight growth of 0.1% qoq. The economy thus stagnated in 1H23 after the mild recession in 2H22. The good news is that household consumption has stopped declining after a year and a half (+0.2% qoq in 2Q23). However, the previous long and deep contraction has had a significant impact, leaving real household spending 9% lower than in the pre-pandemic period. This is also the main reason why the overall economy is the only one in the EU to be below pre-pandemic levels. In terms of structure, the slight qoq growth in household consumption in 2Q was mainly driven by spending on non-durable goods such as food, with a small increase in spending on services. In contrast, spending on semi-durable and durable consumer goods continued to fall rapidly. The continued reluctance to spend on unnecessary items was confirmed by the CZSO survey, which shows that the willingness to make large purchases remains low, as does overall consumer sentiment. The main support for the economy in 2Q23 came from rising fixed investment (+3.4% qoq). This was related to purchases of transport equipment, most likely in the form of replacements for corporate fleets, which have recently been constrained by shortages of car components. Higher government spending on defence is also likely to have had a positive impact. Net exports continued to make a positive contribution to qoq GDP growth. The only drag on the economy in 2Q23 was inventories, which made a large negative contribution. This confirms that the economy is now partly supported by previously unfinished production that could only be completed and exported once supply chains resumed. At the same time, the manufacturing PMI survey reported a reduction in inventories in response to weak demand.

Shortage of production inputs is currently local-based



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

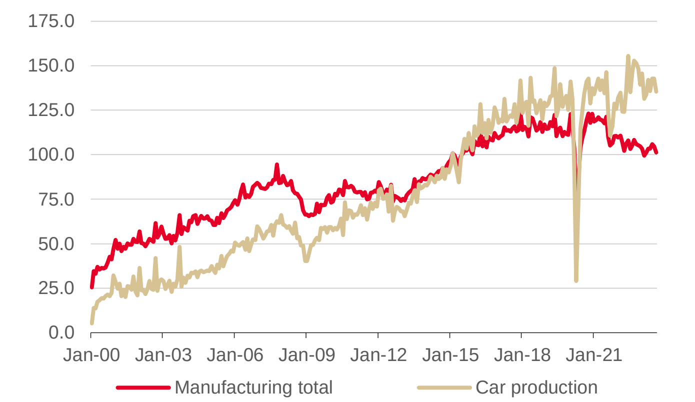
Household consumption should gradually recover



Source: CZSO, Economic & Strategy Research, Komerční banka

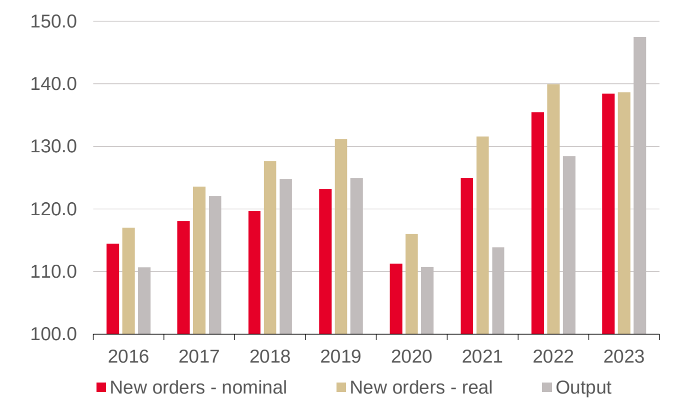
The economy is unlikely to recover this year. We expect GDP to contract by 0.1% qoq in 3Q23, followed by modest growth of 0.2% qoq in 4Q23. This is a downward revision from our July forecast, where we expected GDP to grow by 1% in total in 2H23. The continued depression in household consumption, which we estimate to have been flat qoq in 3Q23, is a major contributor to this revision. The ongoing weakness in household spending is reflected by the leading monthly indicators for retail and services sales, low consumer sentiment and lower-than-expected nominal wage growth. The situation on the industrial production side does not look good either. Lower demand for industrial goods has been compounded by renewed problems with the supply of production parts in the car industry, mainly due to the floods in Slovenia. As a result, manufacturing output is likely to have fallen sharply qoq in 3Q. The contribution of net exports to qoq GDP growth is therefore likely to have declined. Nevertheless, it should remain positive, as monthly foreign trade data continues to point to further exports of previously unfinished goods. In line with this, the contribution from inventories should have remained negative. We expect fixed investment growth to continue in 2H23, with a similar structure as in 2Q23. Car sales continue to rise and the government's emphasis on the importance of defence investment has not changed.

The real volume of new orders is falling, but less so in car production than in the rest of manufacturing (SA, 2015=100)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Deflated by the corresponding producer price index (PPI).

The automotive industry should still have some of the order backlog from the previous two years (2015=100)

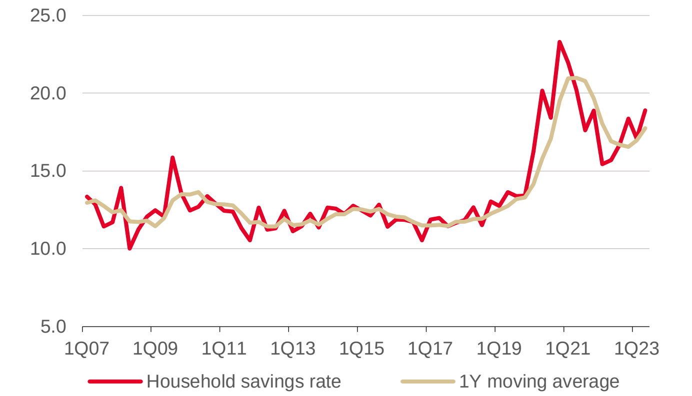


Source: CZSO, Economic & Strategy Research, Komerční banka
Note: All three indicators refer to car production. The average for this year is calculated from available data from January to August.

Economic activity will not return to the 4Q19 pre-pandemic level until 2Q24, according to our forecast.

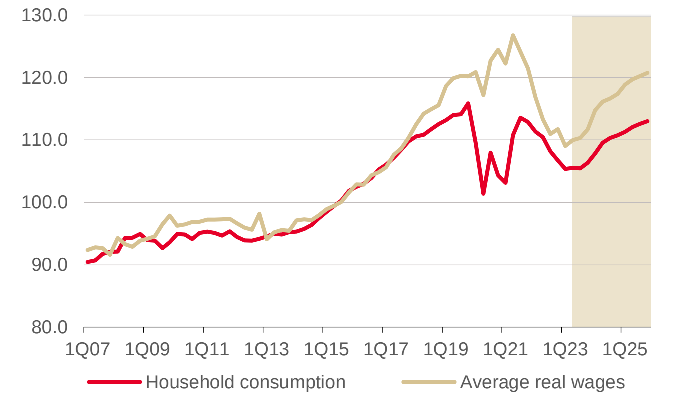
We expect the Czech economy to shrink by 0.3% this year and grow by 1.6% next year. This is a deterioration from our previous forecast of 0.1% growth this year and 1.8% next year. The main reasons for this are continued weak demand and problems in industry. However, we believe that economic growth should gradually recover, although the economy is likely to remain below its potential for some time. In our view, the car industry still has some of the order backlog from the previous two years, which should offset the current weaker demand for industrial goods. In addition, recent data from China and the US have surprised to the upside, raising hopes for a pick-up in external demand. As in our previous forecast, we expect to see a gradual recovery in household consumption. This should be supported by a reduction in the high and still rising level of excess savings and a resumption of real wage growth. However, given that a significant part of savings is held in less liquid savings and investment instruments and that real wage growth has not yet been convincing, the recovery in household consumption is likely to be gradual. In line with this, we do not expect consumption to return to pre-pandemic levels until 1Q27, while the economy as a whole should reach these levels already in 2Q24. By contrast, monetary tightening and fiscal consolidation are likely to slow economic growth next year. We have written more about the impact of the austerity package on GDP here: https://bit.ly/3BUnVcG.

Savings rate remains high (% of disposable income, SA)



Source: CZSO, Economic & Strategy Research, Komerční banka

Decline in consumption is linked to a fall in real wages (2015=100)



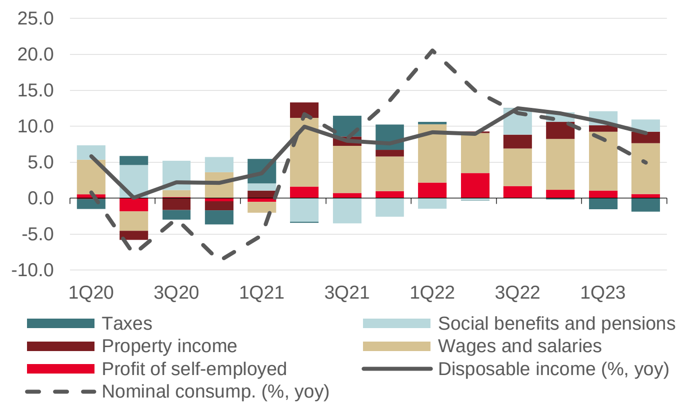
Source: CZSO, Economic & Strategy Research, Komerční banka

Despite a tight labour market, purchasing power of wages not yet improved

We expect the ongoing labour shortage, the compensation for the sharp decline in household purchasing power and the strong financial position of companies to contribute to continued higher nominal wage growth next year.

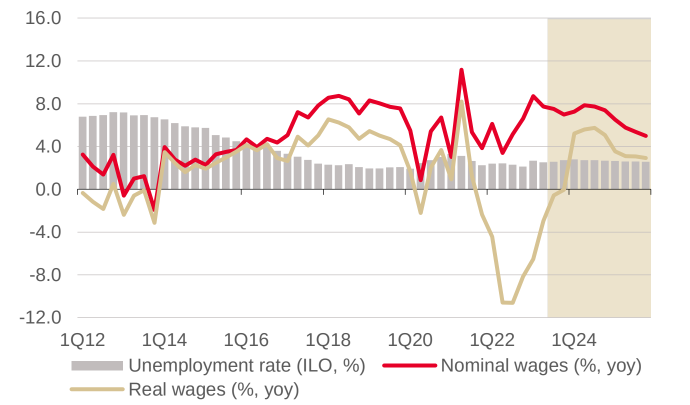
Nominal wages are set to grow by 7.7% this year, well below our previous estimate, and by 7.6% next year. In our July forecast, we had estimated growth of 9.4% for this year, followed by a slowdown to 7.3% in 2024. The figure for 2Q23 was already below our expectations, with average wages rising by just 7.7% yoy, compared to 9.5% in our July forecast. Real wages rose slightly qoq due to the fall in inflation, but were still 3% lower yoy. Compared with the pre-pandemic period, the purchasing power of wages has fallen by a substantial 9%, i.e. by the same amount as household consumption. The sharp decline in household purchasing power is likely to be the main reason for lower spending, especially among the more heavily weighted low-income households with a higher propensity to consume. We expect real wages to continue to grow on a qoq basis in 2H23. However, for the year as a whole, real wages are likely to fall by 2.5%, following a decline of 8.4% in 2022. While the share of wages in country's gross value added has been falling, the share of corporate profits has been rising (see *Box 1*). In our view, this should be reflected in next year's wage negotiations. Continued higher nominal wage growth and the decline in inflation should help to at least partially offset the earlier decline in purchasing power and contribute to a revival in household consumption. A recovery in demand, which is currently very weak, should also be in the interest of companies, as it is a necessary condition for the long-term sustainability of higher profit margins. Moreover, significant labour shortages are likely to continue to push up wages over the forecast horizon. We expect the ILO unemployment rate to remain below 3% and the share of unemployed persons to remain below 4%. Employment growth is likely to resume this year and next, after declining over the past three years.

Pensions and social benefits boosted disposable income growth



Source: CZSO, Economic & Strategy Research, Komerční banka

Annual real wage growth set to resume next year



Source: CZSO, Economic & Strategy Research, Komerční banka

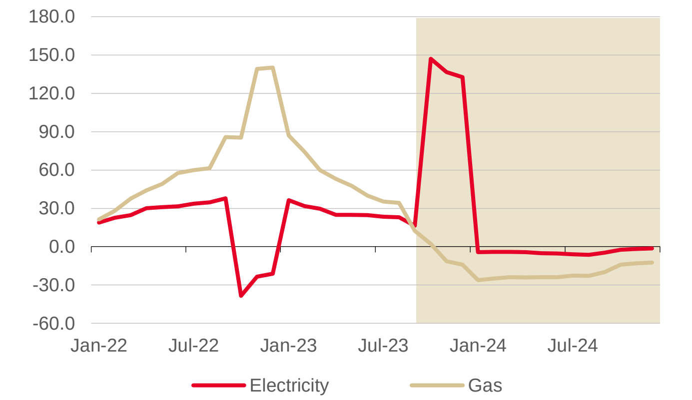
Inflation set to reach central bank's 2% target next year

Inflation continued its rapid decline. While headline inflation slowed from an average of 11.1% yoy in 2Q23 to 8.1% in 3Q23, its core component fell from 8.7% yoy to 5.9%. In both cases, this was fully in line with our July forecast. Annual food price growth was slightly above our expectations, but this was offset by lower regulated prices. These reflected the earlier decline in household energy prices, which started in September and is expected to continue for the rest of the year. In contrast, in our previous forecast we had expected energy prices to fall at the beginning of next year. The decline in policy-relevant core inflation is not only due to the impact of the higher comparison base; in our view, the effect of very subdued demand is becoming increasingly apparent. We estimate that core inflation eased from 1.1% qoq in 2Q23 to 0.6% in 3Q23 in seasonally adjusted terms, which would imply that it was only slightly above the central bank's 2% target on an annualised basis. We expect that core inflation will reach 2% qoq annualised in 4Q23 as consumer demand remains weak.

The reduction in household energy prices will help bring inflation down to the CNB's target next year, but the fall in energy prices is set to be milder than we originally assumed due to the removal of government subsidies.

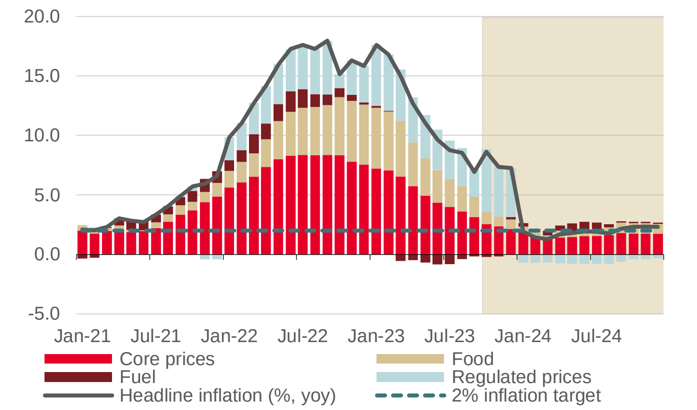
Inflation is likely to temporarily accelerate towards the end of the year due to the statistical effect, but we expect it to fall to an average of 1.9% next year due to lower energy prices. In September, inflation reached 6.9% yoy. From October, the lower comparison base should be reflected in the annual inflation trend due to the introduction of the special energy tariff in 4Q22, which significantly lowered energy prices for final consumers (we wrote more about this here: https://bit.ly/3rJTT66). As a result, we expect inflation to accelerate to 8-9% yoy in October and to not fall below 7% yoy before the end of the year. Without the statistical effect, we estimate that annual inflation would have been around 2-3pp lower in 4Q23. The base effect is likely to be partly offset by the reduction in consumer energy prices announced by energy suppliers, which follows an earlier drop in wholesale energy prices. The first wave of major energy price cuts took place in September and a second wave is likely to follow in October, according to available information published by energy suppliers. We expect the last wave of major energy price cuts to take place early next year. According to our forecast, this should lead to a reduction in the market component of the consumer price of around 20% yoy for electricity and around 30% yoy for gas at the beginning of next year. Subsequently, we also expect a reduction in heating prices. As regards the overall size of the projected decline in the market component of household energy prices, our forecast remains broadly unchanged. The only change is in the timing. This is because in our July forecast we had assumed that a more significant reduction in household energy prices would not occur until the beginning of next year.

The fall in electricity prices next year will be slowed by the removal of government subsidies (%, yoy)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Average consumer prices for electricity and gas.

October's acceleration in yoy inflation is related to the introduction of a special energy tariff last year



Source: CZSO, CNB, Economic & Strategy Research, Komerční banka

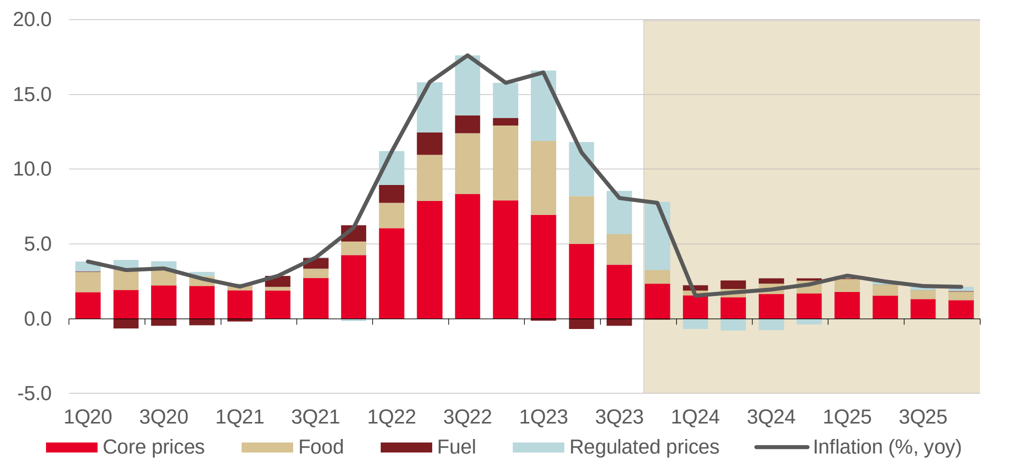
As a result of the administrative measures related to the austerity package, we have raised our inflation forecast for next year to 1.9% from 1.3%. The austerity package has already been approved by the lower house of parliament and, given the current distribution of political power, is likely to be approved by the Senate and signed by the President before the end of the year. Most of the measures contained in the austerity package should therefore come into force early next year. Our July forecast only included the impact of the VAT changes, which at the time already had a concrete outline and clear political support. We continue to believe that the VAT changes will contribute to a reduction in inflation of around 0.4pp in 2024 (we discuss this estimate in more detail here: https://bit.ly/VAT_changes_EN). In particular, the reduction in the VAT rate from 15% to 12% on food and construction work is set to have a significant impact. The pass-through of lower VAT rates into consumer prices should be supported by the current very subdued demand. However, this is likely to be offset by an increase in excise duties on tobacco and alcohol. We estimate that this will add around 0.4pp to headline inflation next year and around 0.2pp each year between 2025 and 2027. The cumulative impact of the indirect tax changes on inflation should therefore be broadly neutral next year and slightly inflationary in 2025-2027, in our view.

The removal of government support for energy, including the reintroduction of renewable energy payments, should lead to an increase in the regulated component of energy prices and therefore mitigate the fall in final consumer prices.

The fiscal consolidation includes the reintroduction of renewable energy payments, which we estimate will increase the regulated component of electricity prices by around 30%. These payments have been suspended since October last year. However, the government also plans to remove subsidies for electricity transmission. We therefore expect the increase in the regulated component of electricity prices to be higher next year, at a total of 40%. For gas, we expect the regulated component to rise by 10%. As a result, the removal of government support for energy should lead to a smaller reduction in household energy prices next year than we had originally expected, especially for electricity. According to our new forecast, household electricity prices should fall by an average of 4% next year, while gas prices should fall by around 20%. However, these are still estimates with a higher degree of uncertainty, as the energy regulator is expected to publish its price decisions for 2024 in November. Nevertheless, the increase in the regulated component of energy prices is likely to partly offset the decrease in the market component. As a result, we expect total regulated prices to fall by 4.6% in 2024, compared with -10.8% in our previous forecast.

Our forecast of a recovery in consumer demand is likely to hinder the return of core inflation to the central bank's 2% target. We expect core inflation to fall to 2.9% in 2024 and 2.4% in 2025 from 7.6% this year. This trajectory is lower than in our July forecast, reflecting the deterioration in the economic and wage outlook. However, we still expect a recovery in demand, supported by high excess savings and a tight labour market, to lead to renewed upward pressure on core prices. However, consumer demand trends and the related development of core inflation are the main uncertainties in this forecast.

After 10.8% this year, we expect inflation to fall sharply to 1.9% next year on the back of lower energy prices, before reaccelerating to 2.4% in 2025 on renewed demand pressures (%, yoy)



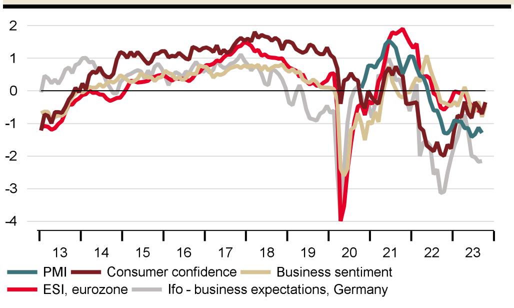
Source: CZSO, CNB, Economic & Strategy Research, Komerční banka

Box 1: Domestic economy fundamentals remain resilient

The Czech economy has not bounced back yet from the shallow recession at the end of 2022. This is mainly due to ongoing subdued household demand, which is no longer offset by a large positive net trade balance. Hereafter in this Box, we show that despite the current adverse developments, the economic fundamentals of households and businesses are strong and they should thus lay a solid foundation for the more tenacious recovery in the domestic economy we expect next year.

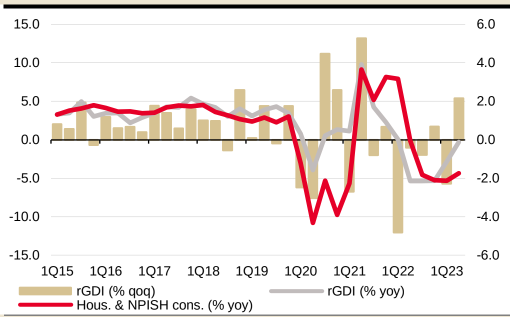
The mood in the economy remained downbeat in 3Q this year. While consumer confidence improved slightly on average qoq, despite a decline in both August and September, business confidence deteriorated markedly. Optimism is not abundant abroad either, especially in Germany, the key market for the Czech export sector. Lower external demand combined with weak domestic consumer demand bodes poorly for domestic industry, which in 3Q also faced renewed supply chain issues. However, despite the prevailing gloomy mood, we believe that there are robust fundamentals in the domestic economy that should help fuel the economic rebound. Furthermore, the overwhelmingly bleak sentiment surveys in both Czechia and in the euro area since last year largely overstated the weakness compared to the only slight decline actually observed in economic activity.

Sentiment surveys (Z-scores)



Source: CZSO, EC, ifo Institute, S&P Global, Macrobond, Economic & Strategy Research, Komerční banka.

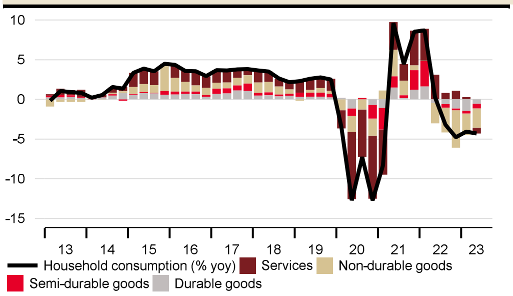
Households spending and disposable income



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Real disposable income (rGDI) is adjusted using the household consumption deflator. NPISH = non-profit institutions serving households.

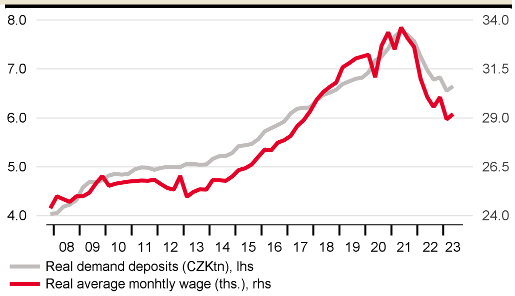
Given the significant decline in real disposable income, households have reduced spending accordingly. Inflation has also taken its toll on the high level of excess savings accumulated by households since the pandemic. The purchasing power of their demand deposits held within banks this August at 2015 prices was equivalent to the level at the beginning of 2018. That was partly also due to the shift of funds towards higher-yielding instruments and non-bank solutions.[1] Regarding the weak spending, in addition to the erosion of purchasing power, the precautionary approach of households is also evident as they continue to put money aside.

Household goods consumption by durability



Source: CZSO, Economic & Strategy Research, Komerční banka

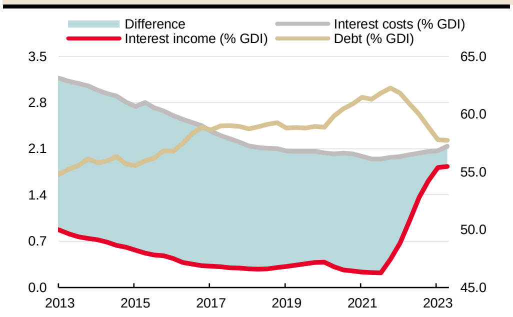
Decline in household purchasing power



Source: CNB, CZSO, Economic & Strategy Research, Komerční banka
Note: Adjusted at 2015 constant prices, using the CPI.

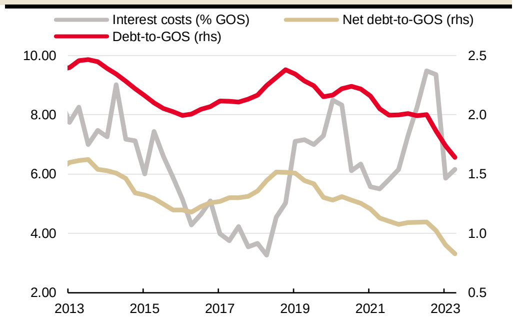
The prevailing high-interest-rate environment also provides households with significant benefits in the near term due to the maturity profile of bank deposits and loans. Given the position of households as net lenders within the banking sector – determined by the excess of deposits over loans – and the positive effect of deposits repricing more quickly than fixed-rate loans, households are currently reaping the benefits of interest rates remaining at higher levels. In other words, the rise in interest income significantly offsets the increasing interest cost burden. This can be inferred from average interest rates and the stocks of deposits and loans in the banking sector as well as the national sector accounts. Higher savings and cooling credit activity are also contributing to the increase in household net interest income. On the latter, the mortgage and real estate market are already showing signs of recovery, possibly indicating improved consumer sentiment, despite surveys implying the contrary. Such factors will logically have an inverse effect as interest rates fall and credit activity rebounds.

Households & NPISH interest income and cost



Source: CNB, CZSO, Economic & Strategy Research, Komerční banka
Note: Annual interest costs (income) are approximated using average interest rates from the stock of bank loans (deposits) to households and NPISH.

Interest costs and indebtedness of NFC

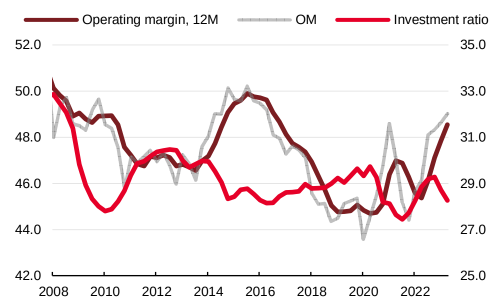


Source: CNB, CZSO, Economic & Strategy Research, Komerční banka
Note: Interest costs of NFCs from sectoral accounts are used. Net debt is adjusted for currency and deposits on financial accounts. GOS = gross operating surplus

[1] The purchasing power of households deposits (including term deposits) corresponds to the level of beginning of 2019.

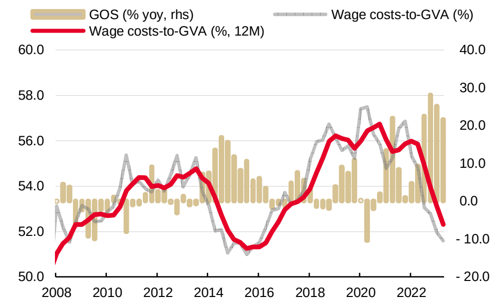
For net-borrower households, such as middle-income percentiles with mortgage loans, the redistribution of wealth due to inflation from lenders to borrowers may be of some comfort too.[2] However, this effect only slightly offsets the direct impact of inflation on the decline in purchasing power, which wage growth has so far not made up for, even though sound businesses' financial health undeniably leaves some room for wage increases. The share of employees' compensation in the gross value added (GVA) of non-financial corporations (NFCs) continued to fall below 52% this year and reached levels similar to those of 2015-2016. Across the entire economy, the labour share of GDP was 50.5% in 2Q23, after having fallen by 2.3pp since the start of 2021. Despite the high increase in input prices, firms managed to improve operating margins (OM), which reached 49% in 2Q23. This, coupled with declining debt and a lower interest cost burden – further mitigated by the overhang of high interest yielding deposits over loans[3] – speaks to the sound financial health of NFCs. At the same time, it opens the way to a possible acceleration in wage growth, helping households recoup some of the lost purchasing power.

Strong financial footing of NFCs (%)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: OM = operating margin

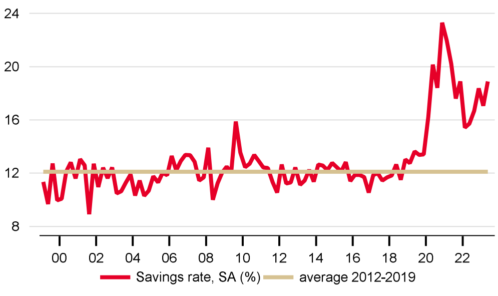
Declining share of labour costs on NFC's GVA



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: GOS = gross operating surplus, GVA = gross value added, 12M denotes trailing twelve-month average.

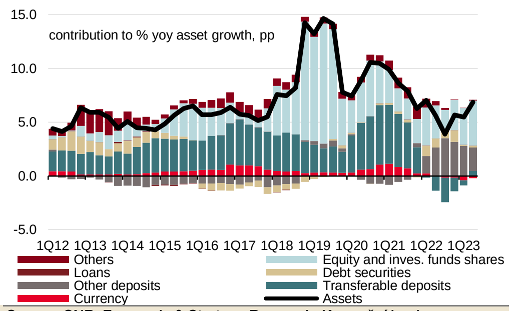
Households can enter the wage bargaining process in a fairly strong position given the tight labour market and firms' currently resilient financial positions. This should support employees' efforts to at least in part offset the fall in purchasing power and, through wage growth, effectively lead to a redistribution of output in the economy partially back to employees. Consequently, that would also fuel a stronger rebound in domestic demand.

Savings rate (%)



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Financial assets of households and NPISH



Source: CNB, Economic & Strategy Research, Komerční banka

[2] For more you can refer to: International Monetary Fund (IMF). 2023. Fiscal Monitor: On the Path to Policy Normalization. Washington, DC: IMF, April (https://www.imf.org/en/Publications/FM/Issues/2023/04/03/fiscal-monitor-april-2023

[3] The overhang of deposits of loans in the NFC sector is mainly due to the large volume of public NFC's deposits, although even within the private sector the leverage ratio (loans-to-deposits) fell significantly.

We believe that the fundamentals argue for a more robust economic recovery next year. Consumption should be driven by rising household real disposable income, on the back of wage growth and returns on savings, as well as the high level of accumulated savings itself. However, the recovery is likely to be only gradual, given the less liquid structure of the savings, which, moreover, are mainly accumulated by higher income percentiles, which have a lower marginal propensity to consume. Robust household and firm balance sheets, aided by the declining (net) debt burdens, provide a staunch springboard for economic growth next year. The prevailing dark cloud of gloomy sentiment hanging over the economy may seem precarious in the near term, but strong fundamentals suggest otherwise.

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Monetary policy

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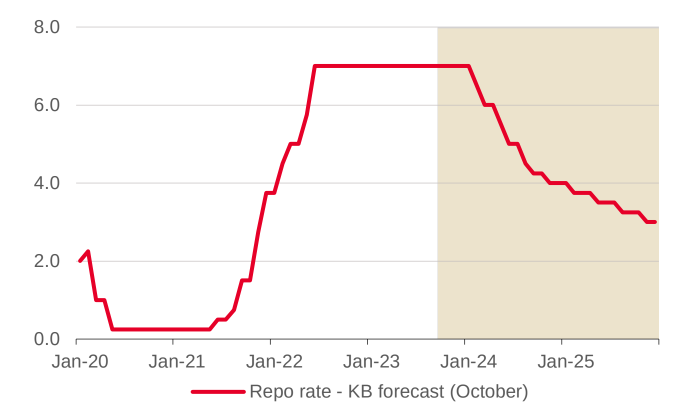
CNB to cut interest rates next year

We expect the Czech National Bank to keep interest rates on hold until the end of the year. Economic developments and inflation are already arguing for an easing of monetary conditions, but this has been partly achieved by the recent weakening of the koruna. The risks to the inflation outlook are still intact. As a result, we think the cautious bank board will wait until the February meeting to cut interest rates for the first time. It is also possible that the meeting will be postponed until after the January inflation figure has been published, to give the central bankers the certainty they need to go ahead with a rate cut. Cutting before the end of this year remains a significant risk to our forecast, which could be signalled by a close vote at the board in November or December. Next year, interest rates are likely to fall rapidly, as we expect the repo rate to be 4% at the end of the year. However, we do not expect the policy neutral level of 3% to be reached until the end of 2025.

The Czech koruna was 1.3% weaker than CNB forecast in 3Q23 and contributed to the easing of monetary conditions, although interest rates remained unchanged.

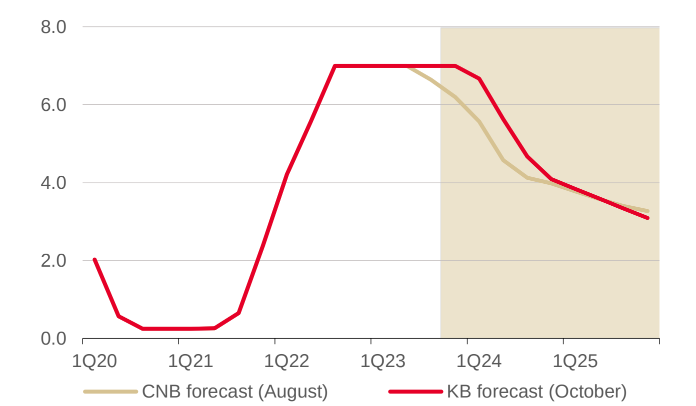
Weak demand and the overall economy, as well as currently subdued core inflation, are arguing for an immediate rate cut; however, the weakening of the Czech koruna has contributed to easing monetary conditions. The CNB's August forecast recommended a rate cut of around 75bp by the end of the year, with the first cut expected as early as 3Q23. Compared with the CNB forecast, the latest data can be seen as slightly less inflationary. Although the yoy decline in household consumption in 2Q23 was milder than the CNB forecast, private spending was only flat qoq. On the other hand, nominal wage growth was well below the CNB forecast (+8.6% yoy vs actual +7.7% in 2Q23). Headline inflation and its core component were only slightly lower than the CNB forecast in 3Q23. While interest rates remained unchanged in 3Q23, the easing of monetary conditions was achieved through a significantly weaker exchange rate of the koruna. The CNB had forecast EURCZK23.8 in 3Q23 after EURCZK23.6 in 2Q23, but the koruna weakened more significantly to an average of EURCZK24.1, which was 1.3% weaker than the CNB forecast. Moreover, the trend towards a weaker koruna has continued.

We expect the repo rate to remain unchanged until end-2023 (%)



Source: CNB, Economic & Strategy Research, Komerční banka

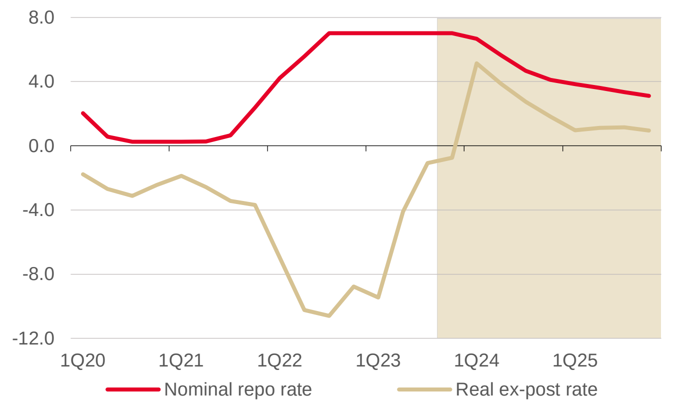
CNB forecast shows a decline in the repo rate in 2H23 (%)



Source: CNB, Economic & Strategy Research, Komerční banka

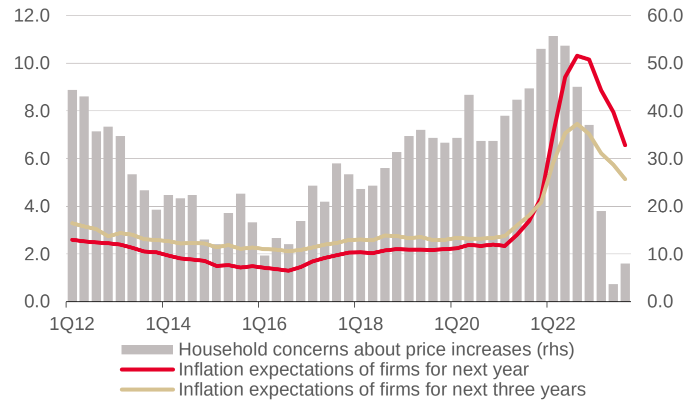
Although the CNB has already started talking about easing policy, we still think that it will wait until early next year before cutting interest rates. Compared with our July forecast, our call for the CNB's rate path remains unchanged. The next meeting is due to take place on 2 November, before the release of October inflation. This is expected to show a marked acceleration in annual consumer price growth. The question is by how much. In its communications, the bank board has put a lot of emphasis on yoy inflation and has made the start of rate cuts conditional on a clear trend towards the 2% target. An acceleration in inflation announced shortly after a possible rate cut in November could therefore be problematic for the board in terms of communicating this decision to the public. High yoy inflation above the latest September print is likely to persist until the end of the year, so this argument remains valid for the December meeting. Moreover, the meeting will take place just before the Christmas holidays, on 21 December, at a time of reduced liquidity in financial markets. The first rate cut in December, which would also signal the start of the monetary easing cycle, could trigger a stronger reaction in the koruna. For this reason, we still think the board will wait until February to cut rates for the first time. The beginning of next year is associated with considerable inflation uncertainty regarding the size of the traditional price adjustment in January. The bank board has communicated extensively on this uncertainty. Equally, we should also highlight that the CNB has not yet published its schedule of monetary policy meetings for next year. This is usually done at the end of the year. January inflation is traditionally published shortly after the February meeting. However, in our view, there is nothing to prevent the central bank from postponing the February meeting until after the January inflation data. Our expectation of a sharp fall in annual inflation in January should give the cautious board the confidence to cut rates for the first time.

Real ex-post interest rates to turn positive in 2024 and be very restrictive in the first half of the year (%)



Source: CZSO, CNB, Economic & Strategy Research, Komerční banka

Household concerns about rising prices have eased significantly, but firms' inflation expectations remain elevated (%)



Source: CZSO, CNB, Economic & Strategy Research, Komerční banka

We expect the repo rate to remain at the current level of 7% until the end of this year, fall to 4% at the end of next year and reach a policy-neutral level of 3% at the end of 2025.

In our view, the stability of the repo rate at the current level of 7% until the end of the year means that it will fall rapidly in 2024, but monetary policy should remain restrictive. We expect the first rate cut in February to be 50bp, and for the same amount to be cut at each subsequent meeting until August. The board has expressed a preference for gradual policy easing, so we think a cut of more than 50bp at one meeting is less likely. Conversely, the weakness of the economy and the later policy response will likely require the board to move faster than the standard 25bp. Around the middle of next year, the mismatch between tight monetary policy and a still relatively weak economy is likely to diminish. Based on this, we expect a standard 25bp cut at the September and November meetings and no change in December. By the end of next year, we expect the repo rate to be 4%. In 2025, we expect a 25bp cut only at each meeting when the board has a new CNB forecast. We expect the repo rate to reach the policy-neutral level of 3% by the end of 2025. A gradual decline towards the policy-neutral level would be consistent with our expectation of a recovery in consumer demand.

Uncertainty about the CNB's rate path remains high and we see the risks to our forecast as tilted towards an earlier cut. Recent statements from central bankers suggest a willingness to at least consider a rate cut by the end of this year. It is therefore possible that the vote in November or December will be close, perhaps the closest possible. However, our baseline scenario is that a first cut will not secure majority support before the February meeting.

Fiscal policy

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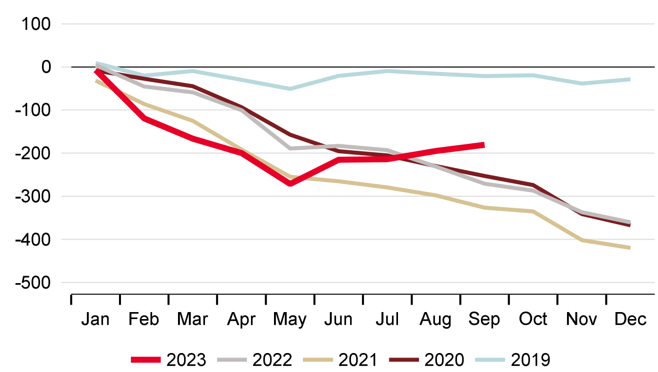
On a more sustainable path

The year-to-date fulfilment of this year's state budget so far suggests that the approved deficit of CZK295bn could eventually be met. The consolidation package, combined with the unwinding of some extraordinary measures and the recovery of the domestic economy, should bring the public finance deficit markedly below 3% of GDP in the coming years, according to our estimates. The structural deficit, however, remains close to 2% of GDP. Total public debt will continue to rise, but only slowly relative to nominal GDP.

This year's state budget plan is likely to be fulfilled after all

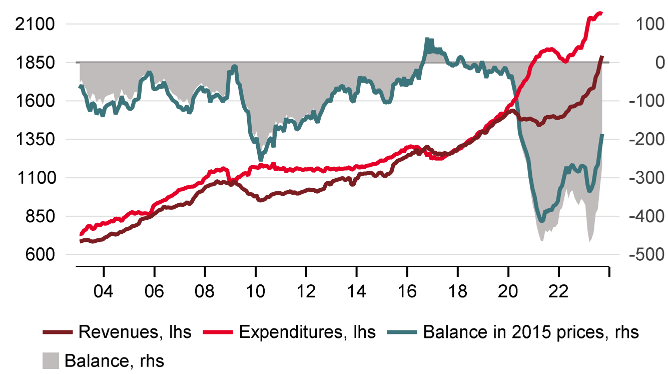
By the end of September, the state had run a deficit of CZK180.7bn. This meant the state budget gap had eased for a fourth consecutive month. In September, the first advance payment of the so-called windfall tax (WFT) was a significant contributor to this. In the previous months, EU revenues, the dividend from the state-owned company CEZ, and corporate income tax takings all improved the state's budget. In a year-on-year comparison, the September ytd deficit was lower by CZK90.2bn.

State budget balance (CZKbn, ytd cumulative)



Source: Ministry of Finance, Macrobond, Economic & Strategy Research, Komerční banka

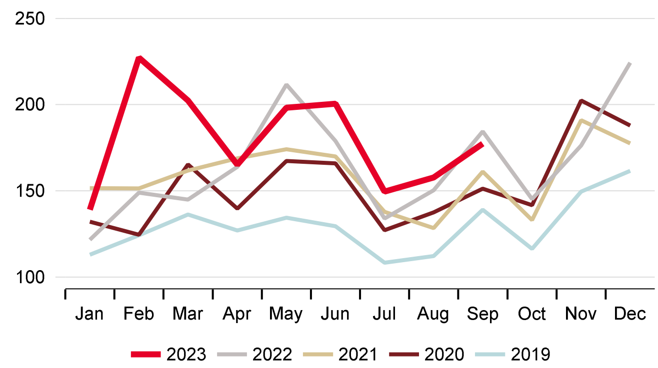
Budget revenues and expenditures (CZKbn, 12m cumulative)



Source: Ministry of Finance, CZSO, Macrobond, Economic & Strategy Research, Komerční banka

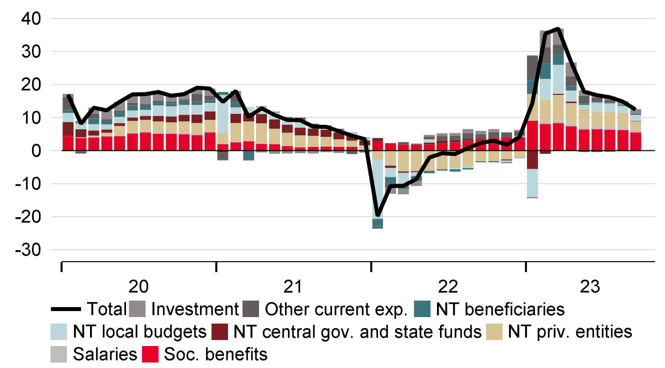
Expenditures rose by CZK178.6bn (12.4%) year-on-year by the end of September. This was mainly due to an increase in social spending, support to households and firms in response to high energy prices, higher investment, transfers to local budgets in the area of education and more expensive servicing of the public debt.

State budget expenditure (CZKbn, non-cumulative)



Source: Ministry of Finance, Macrobond, Economic & Strategy Research, Komerční banka

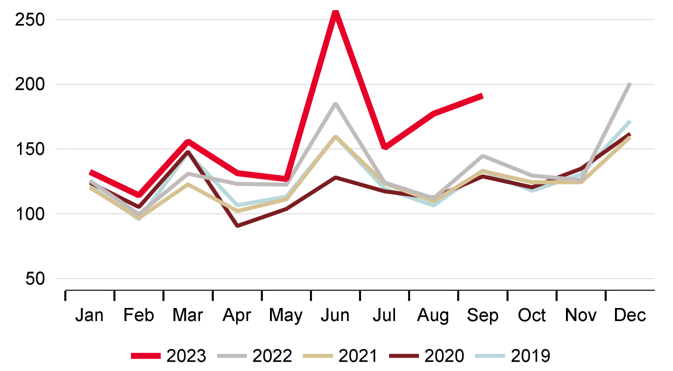
State budget expenditure (%, pp, yoy, ytd cumulative)



Source: Ministry of Finance, Macrobond, Economic & Strategy Research, Komerční banka
NT – non-investment transfers

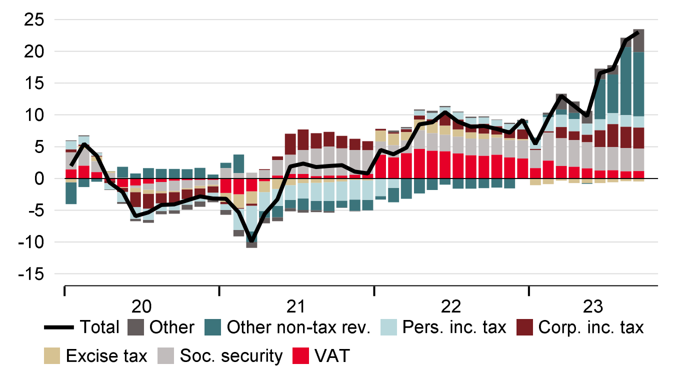
The year-on-year growth on the revenue side is driven by EU funds, social contributions, corporate income tax, as well as other extraordinary revenues. Total revenues in September were CZK268.8bn higher year-on-year (23.0% higher in relative terms). The main contributors to the increase in revenues were EU funds (CZK59.1bn), social contributions (CZK40.9bn), corporate income tax (CZK39.1bn), WFT (CZK25.6bn), individual income tax (CZK20.1bn) and the tax on excess revenues of electricity producers (CZK16.7bn). In our view, the VAT collection (up only 5.5% yoy) indicates that real household consumption remained relatively subdued, which is probably related to the previous fall in real wages and the persistently high savings rate. On the other hand, the 32.5% year-on-year increase in corporate income tax collections (excluding WFT) confirms the solid corporate profitability.

State budget revenue (CZKbn, non-cumulative)



Source: Ministry of Finance, Macrobond, Economic & Strategy Research, Komerční banka

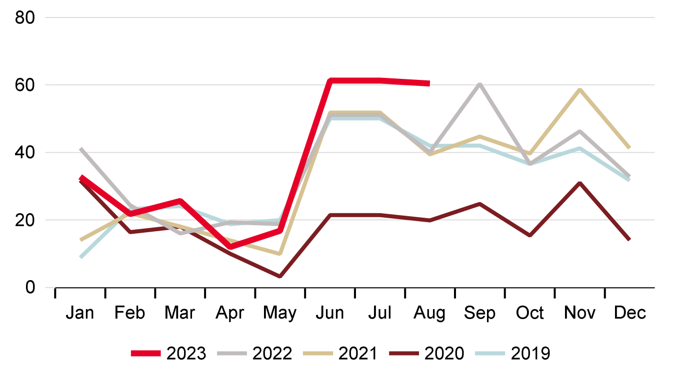
State budget revenue (%, pp, yoy, ytd cumulative)



Source: Ministry of Finance, Macrobond, Economic & Strategy Research, Komerční banka
Other revenue includes EU funds for example

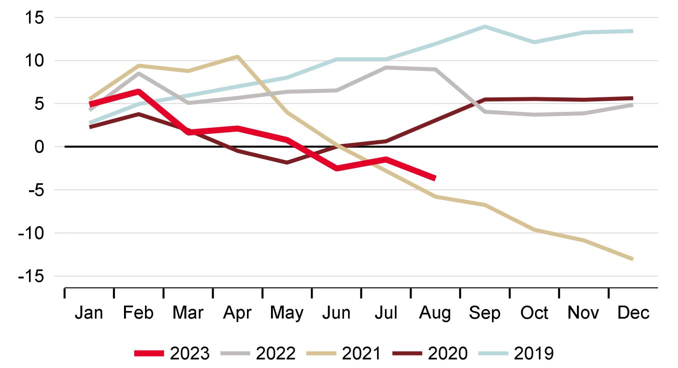
By the end of August, the budgets of municipalities had run a surplus of CZK60.4bn. Year-on-year higher revenues (by CZK75.8bn, 15.7%) exceeded the increase in expenditures (by CZK55.4bn, 12.5%), which resulted in a year-on-year increase in the positive balance by CZK20.4bn. The accumulation of local government funds in bank accounts continued. At the end of June, according to the Ministry of Finance, municipalities and regions had a total of CZK474.3bn in their accounts, while their debt amounted to CZK93.8bn.

Municipal finances (CZKbn, ytd cumulative)



Source: Ministry of Finance, Macrobond, Economic & Strategy Research, Komerční banka

Health insurers' finances (CZKbn, ytd cumulative)



Source: Ministry of Finance, Macrobond, Economic & Strategy Research, Komerční banka

The planned state budget deficit for this year of CZK295bn could be met, in our view. Although the deficit is likely to increase in the final quarter due to the seasonality of spending and the previous realisation of most of the extraordinary revenues, meeting the approved target no longer seems unrealistic in light of the data for the first three quarters of this year.

Moreover, the Ministry of Finance has repeatedly assured that additional savings of CZK15-20bn will be realised by the end of the year.

State budget deficit to fall to CZK250bn next year

The approved consolidation package will contribute to easing the state budget deficit. In addition, the expected recovery of the domestic economy and the abolition of energy price caps (including the planned end of state support for the electricity transmission and distribution network) should also play a role. According to the government-approved budget, these factors will be partly offset next year by an increase in spending on defence (2% of GDP), education (teachers' salaries), servicing the national debt, and payments for state-insured persons to the public health insurance.

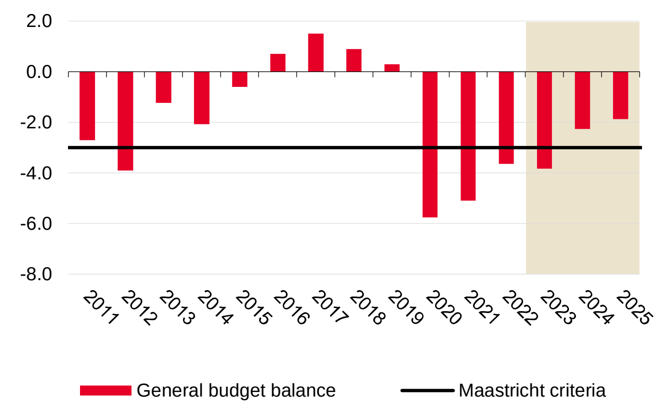
We expect a slight reduction in the state budget deficit in line with the Ministry of Finance's medium-term outlook in future years. Thus, the deficit should reach CZK235bn in 2025 and CZK220bn in 2026.

Public finance forecasts

	2021	2022	2023f	2024f	2025f	2026f
Balance (% GDP)	-5.1	-3.2	-3.6	-2.4	-2.2	-2.0
Fiscal effort* (pp GDP)	-0.8	1.1	0.0	0.1	0.1	0.1
Public debt (CZKbn)	2 566.7	2 997.6	3 292.1	3 542.1	3 777.1	3 997.1
Debt ratio (% GDP)	42.0	44.2	44.7	45.7	46.5	47.0

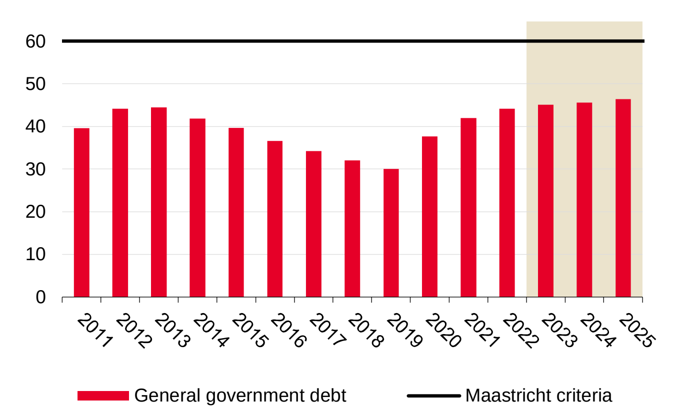
Source: CZSO, Macrobond, MinFin for published data, Economic & Strategy Research, Komerční banka
Note: Fiscal effort is measured as the year-on-year change in the public finance balance, adjusted for the economic cycle and one-off operations on GDP in pp.

Public finance balance (% of nominal GDP)



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Public debt (% of nominal GDP)



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

We expect this year's public finances to end with a slightly deeper deficit relative to GDP than last year (3.6% of GDP after 3.2% of GDP). The consolidation package should contribute to a marked deficit reduction in 2024 and 2025.

Public finance deficit to return to below 3% of GDP in 2024 after four years

The overall public finance deficit is likely to reach 3.6% of GDP this year. The narrowing of the deficit compared to our original forecast (3.8% of GDP) mainly reflects the newly expected fulfilment of this year's planned government budget deficit (CZK295bn). Compared to last year, we expect a slight deterioration, mainly due to the revision of last year's deficit to 3.2% of GDP from 3.6% of GDP as a result of higher corporate income tax takings. This is accounted for in accrual terms to 2022, although it is only reflected in the cash statistics of the state budget this year. Next year, we estimate that the public finance deficit as a whole should again be lower compared to the state budget. However, the traditionally surplus performance of municipalities is likely to be partly offset by the deficit performance of The State Fund for Transport Infrastructure. **As a share of GDP, the public finance deficit is expected to return below 3% of GDP next year for the first time since 2019, specifically to 2.4% of**

GDP. We expect public sector debt as a share of GDP to grow by an average of 0.7pp per year over the 2023-2026 period to reach 47% of GDP in 2026.

Structural imbalances in public finances persist. Although the consolidation package is a welcome contribution to reducing the gap between public revenues and expenditures, it is, in our view, only the first necessary step towards a correction. This is because these efforts are largely offset by new spending in the most important chapters, which will also be automatically indexed (pensions, education, defence, health). As a result, the structural deficit still remains around 2% of GDP (we estimate that it will fall to 2.2% of GDP next year from 2.3% of GDP this year). The medium-term imbalances due to unfavourable demographic developments, which will start to become pronounced from the 2030s onwards, will also require a change in the parameters of the pension system (e.g. linking the retirement age to life expectancy beyond 2030).

Summary forecast table

	Q1 23	Q2 23	Q3 23	Q4 23	Q1 24	Q2 24	Q3 24	Q4 24	2022	2023	2024	2025	2026	2027
GDP and its breakdown														
GDP (real, yoy, %)	-0.4	-0.6	-0.5	0.1	0.6	1.3	2.0	2.5	2.4	-0.3	1.6	2.5	2.5	2.7
Household consumption (real, yoy, %)	-5.4	-4.5	-2.5	-0.4	2.3	3.8	4.6	4.1	-0.8	-3.2	3.7	2.4	1.9	2.0
Government consumption (real, yoy, %)	3.2	3.2	2.7	1.5	1.0	0.1	-0.6	-0.2	0.6	2.7	0.1	1.3	1.9	2.0
Fixed investments (real, yoy, %)	-0.8	2.5	3.7	5.8	7.6	5.4	5.9	5.8	3.0	2.8	6.1	4.3	2.8	3.1
Net exports (contribution to yoy)	3.0	3.1	2.3	2.2	0.7	0.0	-0.4	-0.1	0.9	2.7	0.0	0.4	0.5	0.7
Inventories (contribution to yoy)	-1.0	-2.6	-2.9	-3.4	-3.2	-1.8	-1.1	-0.9	0.9	-2.5	-1.8	-0.4	-0.2	-0.3
Monthly data from the real economy														
Foreign trade (CZK bn)	38.7	37.5	4.3	19.7	52.8	25.6	2.1	32.2	-204.8	100.3	112.7	131.7	184.6	256.7
Exports (nominal, yoy, %)	10.1	0.4	-6.5	0.5	0.6	2.0	11.6	7.7	13.6	1.0	5.3	8.5	6.4	6.8
Imports (nominal, yoy, %)	5.1	-8.9	-12.1	-5.7	-0.6	3.1	11.9	6.7	18.5	-5.7	5.1	8.3	5.5	5.7
Industrial production (real, WDA, yoy, %)	1.0	0.8	-2.6	-0.2	1.7	2.1	5.0	5.6	2.8	-0.2	3.6	5.6	3.9	3.8
Construction output (real, yoy, %)	-0.6	-4.1	-0.5	-1.2	-2.5	3.9	7.4	9.6	3.6	-1.6	4.6	6.1	3.5	3.8
Retail sales (real, WDA, yoy, %)	-7.4	-6.1	-3.3	-1.0	1.8	4.6	5.1	4.5	-3.1	-4.4	4.0	2.3	2.0	2.0
Labour market														
Wages (nominal, yoy, %)	8.7	7.7	7.5	7.0	7.3	7.9	7.7	7.4	5.3	7.7	7.6	5.7	4.6	4.2
Wages (real, yoy, %)	-6.5	-3.0	-0.6	0.0	5.2	5.6	5.7	5.1	-8.4	-2.5	5.4	3.2	2.4	2.2
Unemployment rate (MLSA, %)	3.8	3.5	3.6	3.7	4.1	3.7	3.7	3.6	3.4	3.7	3.8	3.7	3.6	3.7
Unemployment rate (ILO 15+, %)	2.6	2.6	2.5	2.8	2.7	2.8	2.6	2.7	2.3	2.6	2.7	2.6	2.6	2.6
Employment (ILO 15+, yoy, %)	0.8	1.1	0.9	0.3	0.6	0.2	0.7	0.8	-0.5	0.8	0.6	0.5	0.2	0.2
Consumer and producer prices														
CPI Inflation (yoy, %)	16.5	11.1	8.1	7.7	1.5	1.8	1.9	2.3	15.1	10.8	1.9	2.4	2.1	2.0
Taxes (contribution to yoy inflation)	0.0	0.2	0.2	0.1	0.0	0.0	0.0	0.0	0.6	0.1	0.0	0.2	0.2	0.2
Core inflation (yoy, %) (*)	11.9	8.7	5.9	3.9	2.9	2.7	3.0	3.1	13.2	7.6	2.9	2.4	2.1	2.0
Food prices (yoy, %) (*)	18.2	11.8	7.3	3.1	1.2	2.2	2.7	3.2	12.8	10.1	2.4	2.4	2.1	1.8
Fuel prices (yoy, %) (*)	-5.0	-21.8	-15.5	-2.4	11.9	17.9	11.3	5.1	34.1	-11.1	11.6	0.4	-3.1	-4.1
Regulated prices (yoy, %)	32.8	25.2	19.9	31.8	-4.9	-5.4	-5.2	-2.7	20.9	27.4	-4.6	1.5	2.0	2.0
Producer prices (yoy, %)	15.0	3.9	1.3	1.7	0.9	4.2	4.5	3.7	24.3	5.5	3.3	2.2	0.9	0.3
Financial variables														
2W Repo (%, average)	7.0	7.0	7.0	7.0	6.7	5.6	4.7	4.1	6.0	7.0	5.3	3.5	3.0	3.0
3M PRIBOR (%, average)	7.2	7.2	7.1	7.1	6.9	5.9	4.9	4.3	6.3	7.1	5.5	3.7	3.3	3.3
EUR/CZK (average)	23.8	23.6	24.1	24.6	24.8	24.8	24.8	24.7	24.6	24.0	24.7	24.3	24.0	23.8
External environment														
GDP in EMU (real, yoy, %)	1.2	0.5	0.5	0.8	0.9	0.9	0.8	0.8	3.4	0.7	0.9	1.3	1.5	1.5
GDP in Germany (real, yoy, %)	-0.3	-0.1	-0.3	0.2	0.3	0.5	0.6	0.9	1.9	-0.1	0.6	1.3	1.3	1.3
CPI in EMU (yoy, %)	8.0	6.1	5.0	3.2	3.3	3.4	3.0	2.9	8.4	5.6	3.1	2.2	2.1	1.9
Brent oil price (USD/bbl, average)	84.2	77.3	82.4	90.0	95.0	95.0	100.0	100.0	101.0	83.5	97.5	106.3	92.5	77.6
EUR/USD (quarter eop, year average)	1.07	1.09	1.09	1.08	1.10	1.12	1.15	1.17	1.05	1.08	1.14	1.21	1.25	1.26

Source: CZSO, MLSA, Bloomberg, Macrobond, Economic & Strategy Research, Komerční banka
Note: (*) these parts of inflation are adjusted for the primary effect of indirect tax changes

Czech IRS market and government bonds

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Cautious decline in CZK market interest rates

The inversion of the market interest rate curve has eased markedly in the past quarter. Short rates are still pricing in an early start of domestic monetary policy rate cuts, while the rise in longer maturities has been driven mainly by developments in global markets. We estimate that the decline in the short end of the curve will temporarily stall due to the later start of domestic monetary policy easing than the market expects and will resume towards the turn of the year. The decline in longer-maturity rates should be partly hampered by high interest rates abroad. Government bond yields should also decline gradually next year, helped by a year-on-year reduction in gross CZGB issuance.

Czech IRS market: long rates follow foreign developments

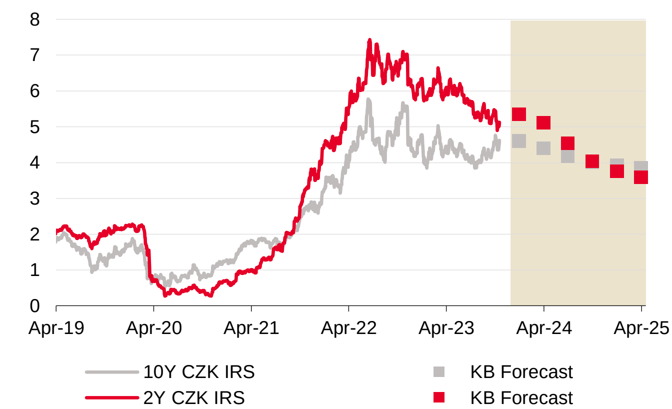
The downward trend in domestic market interest rates should continue in 2024. The inverse shape of the koruna curve is likely to be maintained throughout next year.

The CZK IRS curve inversion has eased significantly since the start of 3Q. The decline in shorter maturities was probably related to market bets on an early start of domestic monetary policy easing. Longer rates, on the other hand, have been dominated by a global rise in market interest rates following surprisingly favourable data from the US economy (see more in the *External environment* chapter) and concerns about the health of the US public finances, which were fuelled by Fitch's downgrade of the US credit rating in August. Newly published domestic data confirming the fading of inflationary pressures and the continuing stagnation of the economy should, on the contrary, push for a reduction in longer-term koruna yields.

In our view, the decline in domestic monetary policy rates will be somewhat slower than markets expect. According to market contracts, the CNB's repo rate will fall in aggregate by 50-75bp by the end of the year. This is too aggressive in our view. Rather, we are counting on a more cautious approach by the CNB, which should be consistent with monetary policy rate stability by the end of this year. Its subsequent decline from the beginning of next year remains unchanged compared with our July forecast. Relative to the market, we continue to expect slightly higher monetary policy rates than currently targeted, especially in the first half of next year.

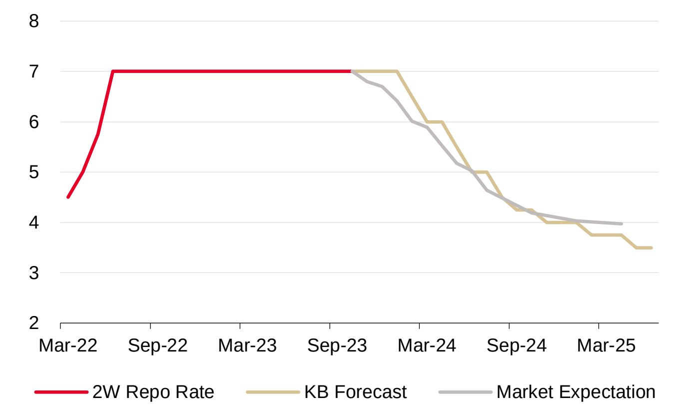
Market interest rates with shorter maturities should roughly stabilise by the end of the year. Compared to the market, we believe that the decline in yields will be more gradual and will start at the turn of the year. We see more limited scope for a more significant decline in longer-term koruna rates, as the effects of the fading high inflation and the mild recession in the US economy during 2Q-3Q24 on the one hand and the recovery in domestic economic activity combined with high euro market rates on the other should roughly compensate.

IRS forecast (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Expected CNB key interest rate path as of 23 October 2023 (%)



Source: Bloomberg, CNB, Economic and Strategy Research, Komerční banka

The start of the CNB's rate-cutting cycle next year will help to gradually normalise the shape of the domestic yield curve. Given that the equilibrium repo rate of 3% will not be reached until the end of 2025 according to our forecast, we expect the inverse shape of the curve to be maintained throughout next year.

CZK IRS outlook (end of period, %)

	4Q23f	1Q24f	2Q24f	3Q24f
2y	5.35	5.10	4.55	4.05
5y	4.75	4.50	4.15	3.90
10y	4.60	4.40	4.20	4.00

Source: Economic & Strategy Research, Komerční banka

Euro market still offers lower interest rates

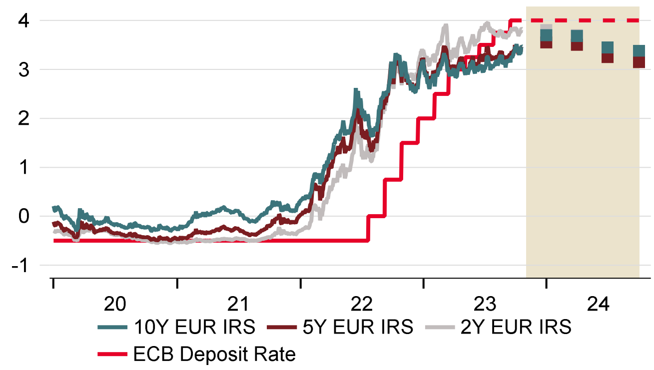
With the global rise in longer-term market interest rates, fixing conditions have stopped improving. While the forward market has lower rates compared to spot IRS, its profitability from our perspective has been exhausted at longer maturities. Indeed, with inflation falling and a shallow recession in the US next year, we expect long-dated rates to fall more significantly than is achievable in the forward market. **Noticeably lower interest rates compared to the koruna continue to prevail in the euro area**. The ECB deposit rate is already at its peak, in our view, where it should remain for an extended period, and the room for euro swaps to rise is also likely to run out soon.

Forward interest rate swaps (%, p.a., vs 6M PRIBOR)

Forward \ Maturity	1Y	2Y	3Y	5Y	10Y
Spot	6.05	5.21	4.85	4.63	4.67
3M	5.51	4.87	4.63	4.53	4.62
6M	4.91	4.52	4.40	4.40	4.54
9M	3.94	4.02	4.08	4.21	4.45
1Y	4.17	4.13	4.18	4.29	4.49
2Y	4.10	4.18	4.25	4.39	4.57
3Y	4.27	4.33	4.40	4.51	4.67

Source: Bloomberg, Economic & Strategy Research, Komerční banka, as of 23 October 2023

Euro area rates (%)



Source: Bloomberg, SG Cross Asset Research/Economics

The supply of CZGBs will decrease next year

The likely achievement of the planned deficit this year leaves the Ministry of Finance in a comfortable position. We assume that the state budget this year will aim for the planned deficit of CZK295bn, as we write in the '*Fiscal policy*' chapter. Since the beginning of this year, the Ministry of Finance (MinFin) covered its financing needs not only through primary auctions of domestic government bonds, but also through secondary market activity. By 20 October, CZK357.2bn worth of bonds had been sold in auctions this year, while the MinFin carried out secondary market operations (in the form of switches and direct sales) in the amount of CZK72.6bn. From this point of view, it is thus so far possible to fulfil the set plan, which envisages the issuance of CZK400-500 billion of koruna bonds this year, with a margin. For 4Q23, the MinFin has lowered the indicative volume to up to CZK70.0bn of offered CZGBs, while in October it has already issued bonds worth CZK27.3bn. **Overall, we expect financing needs to reach CZK645.8bn this year (8.8% of GDP), compared to CZK635.6bn last year (9.4% of GDP).**

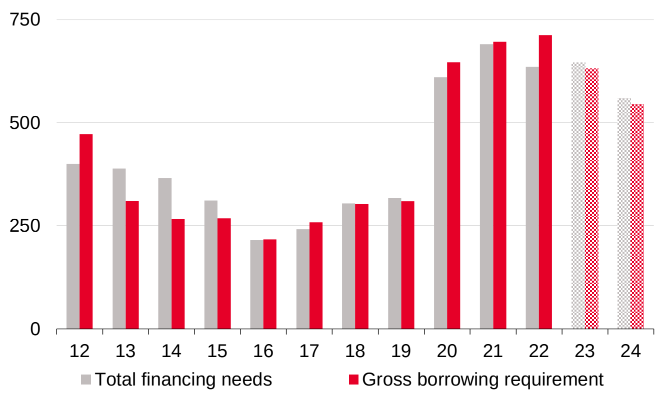
Issuance activity will decrease next year. This will reflect lower maturing debt repayments, but also a noticeable decline in the government budget deficit. We estimate total financing needs for 2024 at CZK558.9bn (7.2% of GDP).

Funding programme and issuance activity (CZKbn)

	2023		2024	
	MinFin	KB	MinFin	KB
State budget deficit	295.0	295.0	235.0	250.0
Transfers and other operations of state financial assets	1.4	1.4	2.4	2.4
T-bonds denominated in local currency redemptions	200.2	200.2	156.7	148.8
T-bonds denominated in foreign currency redemptions	0.0	0.0	24.5	24.8
Redemptions and early redemptions on savings bonds	1.0	1.0	0.0	10.0
Money market instrument redemptions	145.2	145.2	0.0	122.3
Redemption of T-bills		0.0		22.3
Redemption of other money market instruments		145.2		100.0
Repayments on credits and loans	3.0	3.1	0.6	0.6
Total financing needs	**645.7**	**645.8**	**419.2**	**558.9**
Money market instruments		122.3		80.0
T-bills		22.3		20.0
Other money market instruments		100.0		60.0
Gross issuance of CZK T-bonds on domestic market	Min. 400-500	474.5		415.3
Gross issuance of EUR T-bonds on domestic market/eurobond		0.0		24.8
Gross issuance of government savings bonds		10.0		5.8
Received credits and loans		24.0		18.0
Financial asset and liquidity management		15.0		15.0
Total financing sources		**645.8**		**558.9**
Gross borrowing requirement		**630.8**		**543.9**
Net CZGB issuance		**274.3**		**266.5**

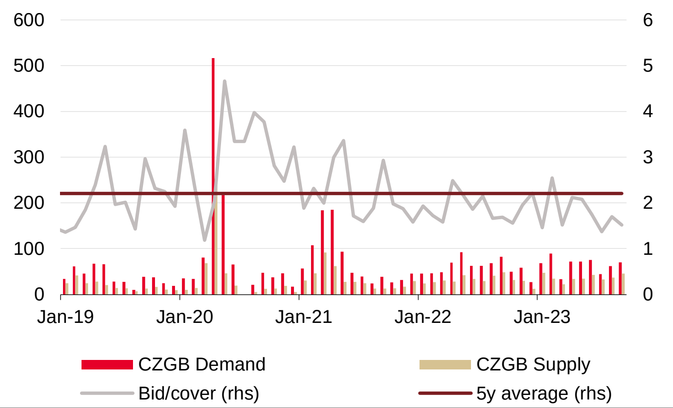
Source: Economic and Strategy Research, Komerční banka, MinFin

Financing needs (CZKbn)



Source: Economic and Strategy Research, Komerční banka, MinFin

CZGB primary market (CZKbn)



Source: Economic and Strategy Research, Komerční banka, MinFin, CNB

CZGB yield forecast (end of period)

	4Q23f	1Q24f	2Q24f	3Q24f
2y CZGB yield (%)	5.45	5.15	4.55	4.05
5y CZGB yield (%)	4.85	4.60	4.20	3.80
10y CZGB yield (%)	4.75	4.55	4.30	4.15
10y CZGB ASW (bp)	15	15	15	15

Source: Economic & Strategy Research, Komerční banka

Reduced supply will support the decline in CZGB yields next year

Similarly to the koruna IRS, the CZGB yield curve inversion has also eased significantly compared to the beginning of 3Q. The movement in yields during this period has been similar to that of market interest rates. A significant difference is only evident for the 2-year maturity, where the bond yield has fallen relatively less than the 2y IRS. In ASW terms, it has thus cheapened by around 25bp. Overall, as with market interest rates, bonds with shorter maturities should have more room to fall next year. The decline in yields on longer maturities should be more gradual due to higher yields abroad. However, global factors will still be outweighed by a decline in CZGB supply next year, on our estimates.

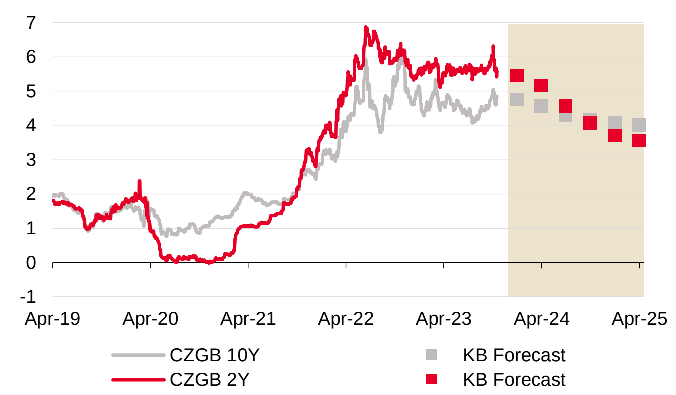
The rating of the Czech Republic remains unchanged. In August, Fitch confirmed the current rating and its negative outlook. According to agency, the consolidation package has eased concerns about the public finances in 2024-2025, but uncertainty about medium-term structural imbalances remains. In October, S&P published its periodic assessment, which also maintained the rating at its current level while keeping its outlook stable. It highlighted in particular the relatively low debt, high foreign exchange reserves and improved energy security. At the same time, it noted that the government's consolidation measures may not sufficiently improve structural budget deficits due to increased defence and social spending.

Sovereign rating overview

	Local currency	Outlook	Foreign currency	Outlook	Next rating review
S&P	AA	STABLE	AA-	STABLE	
Moody's	Aa3	NEGATIVE	Aa3	NEGATIVE	24 November 2023
Fitch	AA-	NEGATIVE	AA-	NEGATIVE	

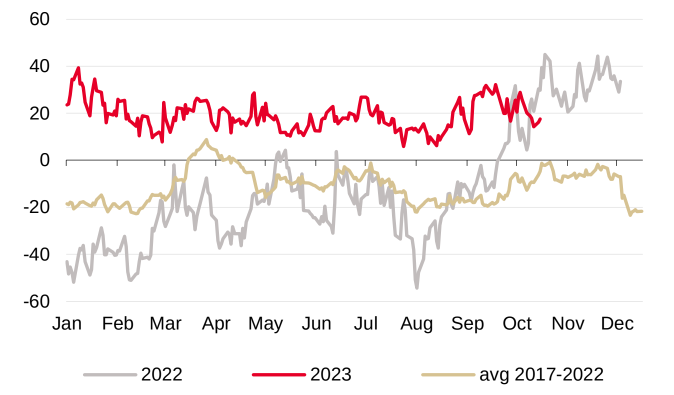
Source: Economic and Strategy Research, Komerční banka, Bloomberg

CZGB yield forecast (%)



Source: Economic and Strategy Research, Komerční banka, Bloomberg

10y CZGB ASW (bp)



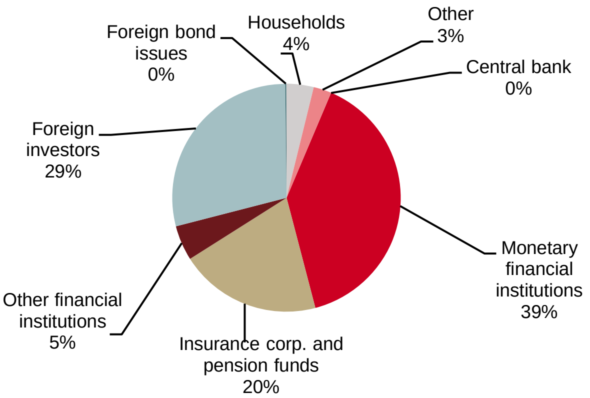
Source: Economic and Strategy Research, Komerční banka, Bloomberg

Government bond overview

Government bond overview									Rich-cheap analysis											
Bond		Dur.	Issued last 90D	Issuance limit	Yield	Δ1W	Δ1M	FX hedged	ASW	Δ1W	Δ1M	Min	90D	Max	Z-Score	Rank	Spline spread	Rank	Carry Roll 90D	Rank
5.70	May-24	0.6	0.0	100%	5.05	3	-8	2.89	-163	28	29	-220		-105	-0.4	16	8.5	19	-165.2	24
0.00	Dec-24	1.1	0.0	34%	5.19	8	-32	3.79	-83	0	-12	-86		-27	-1.5	21	-15.5	2	-64.0	23
1.25	Feb-25	1.2	0.0	100%	5.32	-6	-19	4.06	-47	-4	5	-72		-9	-0.1	11	-30.7	1	-50.7	22
2.40	Sep-25	1.8	0.0	85%	4.93	13	-8	3.93	-40	-2	-10	-50		-10	-1.1	20	0.4	14	-39.3	21
6.00	Feb-26	2.1	0.0	67%	4.57	15	-7	3.59	-54	3	-4	-67		-33	-0.9	18	31.3	24	-37.5	20
1.00	Jun-26	2.5	0.0	100%	4.73	19	-9	3.78	-27	6	-7	-33		1	-1.8	22	12.2	23	-29.0	19
0.25	Feb-27	3.1	0.0	90%	4.68	15	-5	3.74	-15	1	-11	-19		15	-1.8	23	11.9	22	-23.0	18
2.50	Aug-28	4.4	0.0	94%	4.72	20	12	3.73	2	5	-6	-9		20	-0.3	15	1.2	16	-15.3	16
5.50	Dec-28	4.2	0.0	68%	4.62	19	7	3.63	-7	1	-9	-24		15	0.2	8	11.1	21	-15.8	17
5.75	Mar-29 *	4.5	42.3	110%	4.78	26	14	3.79	9	3	-8	-12		27	0.2	9	-4.5	8	-13.9	15
2.75	Jul-29	5.1	0.0	100%	4.76	27	16	3.72	7	7	-2	-4		20	-0.1	13	-3.5	10	-12.2	14
0.05	Nov-29	5.8	0.0	57%	4.75	26	17	3.66	5	7	-3	-3		19	-0.5	17	-1.7	12	-10.5	13
0.95	May-30	6.0	0.0	100%	4.82	31	20	3.72	11	8	-1	-3		21	0.3	6	-7.8	4	-9.5	11
5.00	Sep-30	5.7	8.5	101%	4.83	29	23	3.79	14	8	-1	-9		22	1.1	2	-7.2	6	-9.9	12
1.20	Mar-31	6.7	0.0	100%	4.85	30	26	3.73	11	8	-1	-2		20	0.3	7	-8.3	3	-8.1	9
6.20	Jun-31	6.0	5.3	72%	4.83	28	27	3.81	15	7	3	-5		22	1.4	1	-5.2	7	-9.2	10
1.75	Jun-32	7.6	0.0	100%	4.87	34	33	3.76	10	11	4	-6		17	0.7	3	-4.2	9	-6.6	7
4.50	Nov-32 *	7.2	28.2	20%	4.86	29	26	3.83	15	6	-1	-3		24	0.6	4	-1.7	11	-7.0	8
2.00	Oct-33	8.6	0.0	100%	4.89	33	30	3.80	9	9	-1	-4		23	-0.1	12	-0.5	13	-5.6	3
4.90	Apr-34	7.8	15.1	42%	4.90	30	24	3.91	15	13	-5	-2		27	0.5	5	0.8	15	-6.2	5
3.50	May-35	9.0	4.2	48%	4.91	32	29	3.90	11	7	-7	-3		23	0.1	10	5.3	17	-5.5	2
4.20	Dec-36	9.4	0.0	100%	4.93	30	28	3.98	13	6	-10	0		27	-0.2	14	7.0	18	-5.7	4
1.95	Jul-37	11.2	0.0	34%	4.91	31	27	3.90	5	6	-12	0		25	-1.1	19	9.0	20	-5.1	1
1.50	Apr-40	13.3	0.0	44%	4.96	29	24	3.92	4	5	-16	4		30	-2.3	24	-7.7	5	-6.4	6

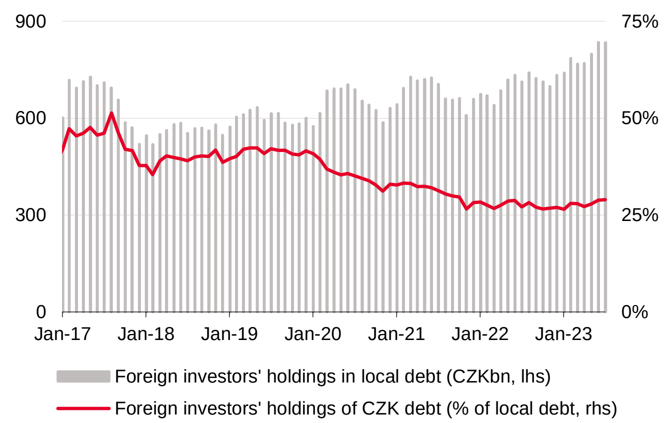
Source: Economic & Strategy Research, Komerční banka; Note: more details in CZGB Auction Alerts

Holdings of CZK government debt (August 2023)



Source: MinFin, Economic & Strategy Research, Komerční banka

The share of non-resident bondholders has stabilised



Source: MinFin, Economic & Strategy Research, Komerční banka

Czech FX market

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The koruna no longer supported

The formal ending of the intervention regime by the central bank at its August meeting, against a backdrop of continuing slowdown in the domestic economy, and the strength of the US dollar has resulted in a marked weakening of the koruna. We estimate that this development has erased most of the currency's overvaluation vs the euro. In the short term, factors on the depreciation side could still prevail, but they will, in our view, be dampened by, among other things, the overly aggressive market pricing of pace of domestic monetary policy rate cuts. We expect a resumption of the trend appreciation of the koruna against the euro on the back of a recovery in the domestic economy and a weakening of the US dollar in the second half of next year.

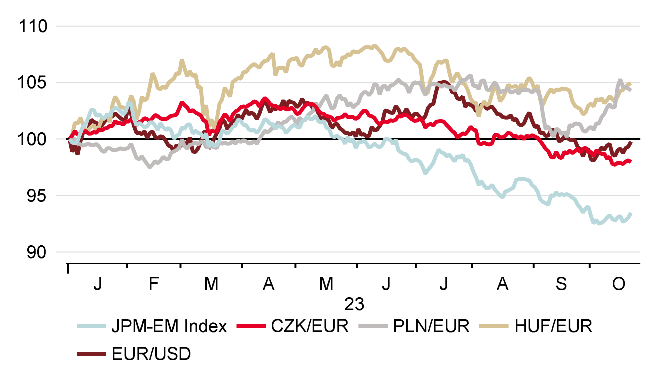
CZK overvaluation has eased significantly

The koruna has been weakening against the euro since its April peak. In an environment of narrowing interest rate differentials, other emerging market currencies generally did not perform well either. On the global FX markets, in contrast, the US dollar in particular continued to strengthen in the context of the surprising resilience of the US economy. In addition to global influences, weaker data from the domestic economy in general and, on our estimation, the persistent overvaluation of the currency relative to fundamentals probably contributed to the weakening of the koruna after the CNB ended its intervention regime (at its August meeting). Overall, the koruna lost almost 4% against the euro since the beginning of 3Q23.

CZK exchange rates

Source: Bloomberg, Economic and Strategy Research, Komerční banka

Performance of CE currencies (1. 1. 2023 = 100)



Source: Bloomberg, Economic and Strategy Research, Komerční banka
Note: A value above 100 indicates an appreciation of the CZK, PLN or HUF against the EUR, or an appreciation of the EUR against the USD from 1 January 2023.

We have shifted our forecast for the koruna-euro exchange rate to weaker levels. The revision mainly reflects the end of the CNB's intervention regime, a stronger US dollar and continued stagnation in the Czech economy.

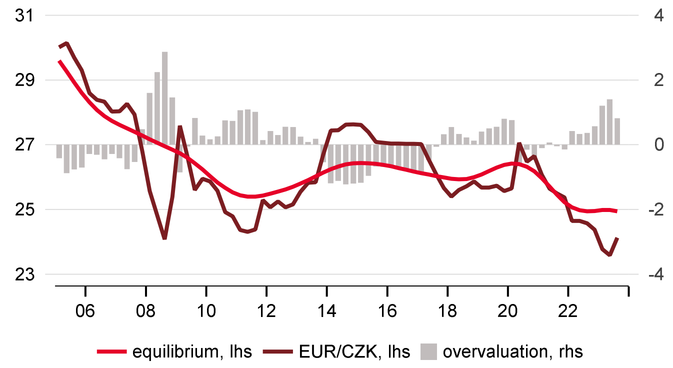
In our view, factors in favour of a weaker koruna will prevail until about the middle of next year. The koruna's advantage in the form of the interest rate differential (measured by the difference between 2y market interest rates in the Czech Republic and the euro area) has already fallen by around four-fifths (from 6pp to 1.3pp) from its peak last July, amid tightening monetary policy abroad and the end of the CNB's rate-hike cycle. However, we do not expect any further narrowing until 2024, given the current overly aggressive market pricing of the pace of domestic monetary policy rate cuts (a drop in the repo rate of around 50-75bp by the end of the year). According to the available statements, the CNB is not planning to return to the foreign exchange market. Our assessment is that the overvaluation of the koruna persists, but that it has eased significantly with the recent depreciation. For

3Q, we estimate the equilibrium level[4] of the exchange rate at EURCZK 24.9. However, the equilibrium should start to decline in the following quarters, which would essentially eliminate the overvaluation – in combination with a slight depreciation of the spot exchange rate.

EUR/CZK and interest rate differential

Source: Bloomberg, Economic and Strategy Research, Komerční banka

Equilibrium EUR/CZK exchange rate



Source: Macrobond, Economic and Strategy Research, Komerční banka
Note: The estimated equilibrium exchange rate is based on a model of the economy's internal (output gap) and external (net export-to-GDP gap) equilibrium.

Depreciation pressures should be outweighed by a weakening of the US dollar and a recovery in the domestic economy next year. On our forecasts, the dollar could move to USDEUR 1.15 by the end of 3Q24. Slowing domestic inflation should contribute to closing the inflation gap of the domestic economy vs the euro area. This, combined with a recovery in the domestic economy, could help the nominal exchange rate to resume appreciation. In the short term, the CNB repo rate cuts priced in by the markets, which are earlier and more pronounced than our expectation, should partially counteract further depreciation. In contrast, given the current volumes (€105m in August), we do not expect a significant impact from the resumption of the programme of selling off part of the proceeds of foreign exchange reserves, which was announced at the same time as the CNB ended the intervention regime in August. Overall, we expect the koruna to reach its weakest levels in the first half of next year before gradually resuming its appreciation. We expect the koruna to be at EURCZK 24.80 in the annual horizon.

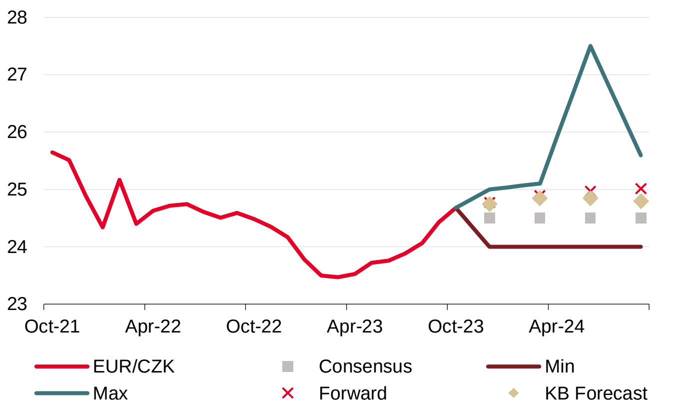
Koruna exchange rate forecast (end of period)

	4Q23f	1Q24f	2Q24f	3Q24f
EUR/CZK	24.75	24.85	24.85	24.80
USD/CZK	22.90	22.60	22.20	21.55
EUR/USD	1.08	1.10	1.12	1.15

Source: Economic and Strategy Research, Komerční banka, SG Cross Asset Research

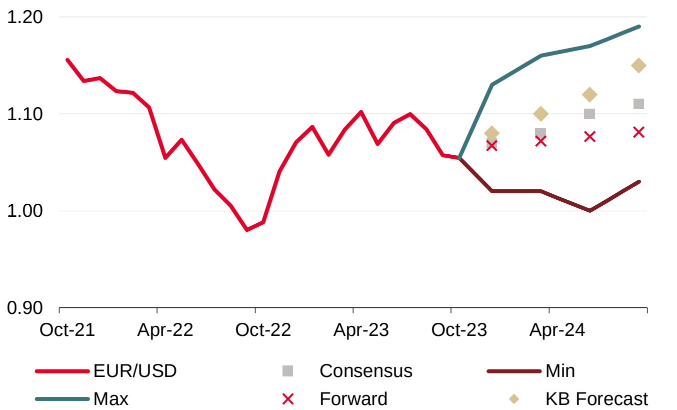
[4] The hypothetical equilibrium value is based on the average of model filtrations of real bilateral exchange rates against the euro that are consistent with the internal and external equilibrium of the economy. Real exchange rates are deflated using the CPI, PPI and GDP deflator.

Expected EUR/CZK path, Bloomberg market consensus (as of 23 October 2023)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Expected EUR/USD path, Bloomberg market consensus (as of 23 October 2023)

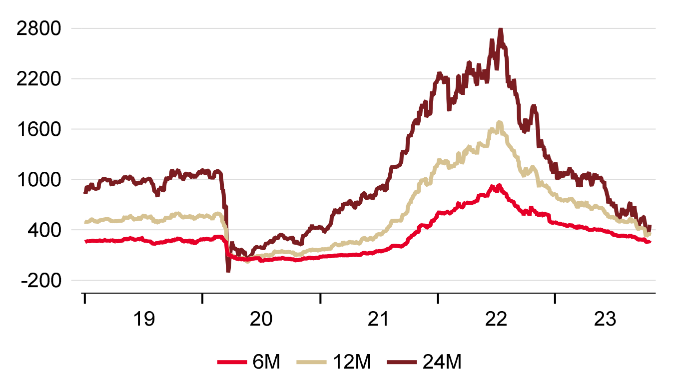


Source: Bloomberg, Economic and Strategy Research, Komerční banka, SG Cross Asset Research

The balance of risks is skewed towards a weaker koruna

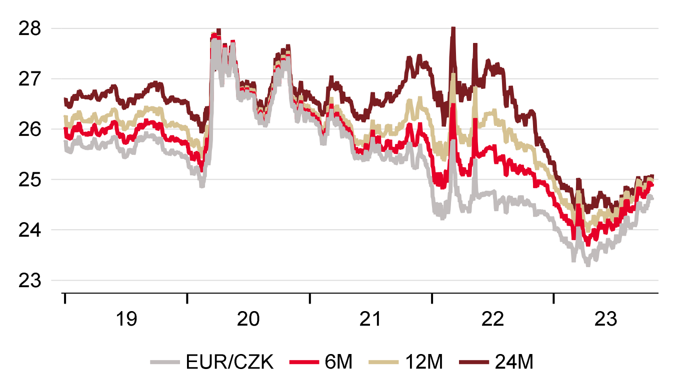
As regards domestic factors, the main risks to our scenario are a slower recovery in the Czech economy than we expect and the CNB starting to cut interest rates as early as this year. A possible escalation of the geopolitical situation could also disrupt global sentiment towards emerging markets. With regard to external factors, the main risk is the trend in the US dollar, which could hold its strong positions for a longer period of time in a scenario other than a soft landing or only a mild recession in the US next year.

Forward points



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Forward vs spot exchange rate EUR/CZK



Source: Bloomberg, Economic and Strategy Research, Komerční banka

The weakening of the koruna has improved hedging conditions for exporters. We do not expect further significant narrowing of the interest rate differential over the rest of the year, and therefore no decline in forward points. A weakening of the spot exchange rate could thus skew forward exchange rates towards even slightly weaker values.

Banking sector

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Credit impulse to only boost the economy from next year

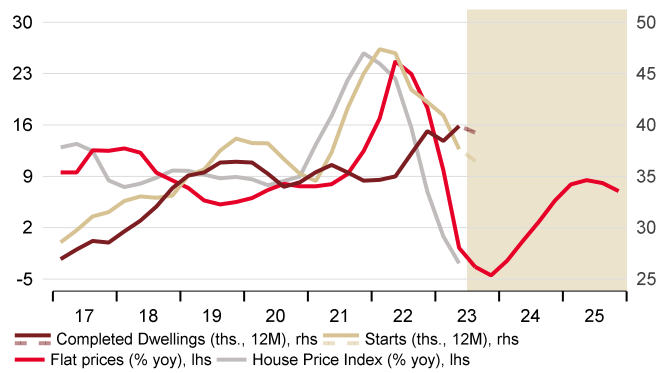
Credit demand is likely to remain subdued this year in view of tight monetary policy and the weak performance of the domestic economy. Less urgent financing needs are also likely to continue to contribute to that, thanks to the sizable amount of own funds held by firms and households. We only expect the credit impulse to boost economic growth from next year as interest rates begin to decline. We also expect the gradual recovery in mortgage lending to continue and strengthen more tangibly next year. This should also help to resume growth in house prices following a meagre price correction this year, on our estimates. Owing to the high appreciation of savings, we estimate that deposits growth will outpace loan growth once again this year, before slowing markedly next year. Tight monetary conditions and the lacklustre economic performance are likely to result in only a modest increase in the share of non-performing loans, which remains near historical lows. This also supports our view on strong household and corporate balance sheets.

Thawing of the mortgage and real estate markets set to accelerate next year

Mortgage lending is set to continue to gain momentum. However, we expect a more tangible recovery to take place next year, when house price growth should also resume.

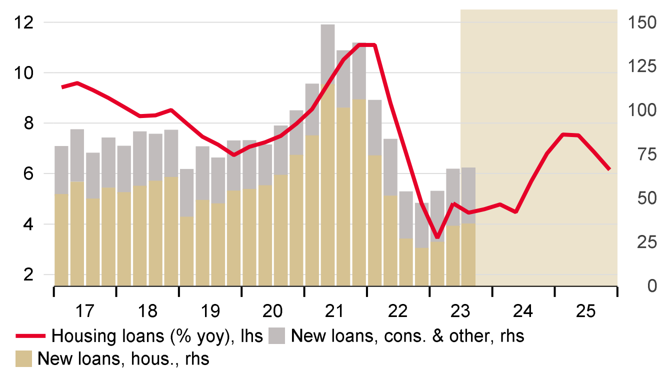
Residential house prices continued to fall in 3Q, although the qoq rate of decline moderated significantly compared to 2Q. The qoq decline in flat offer prices slowed to 0.7% in 3Q, following a 1.7% decline in the previous two quarters. In yoy terms, prices were down 3.3% in 3Q, while the house price index (HPI, published with a greater lag) showed a decline of 2.8% in 2Q, while the qoq decline already eased to 0.6% (vs -1.4% in 1Q23). We expect the moderate correction in house prices to continue this year and reach 4.5% yoy by the end of this year. Starting from next year, we expect house prices to resume growth as the real estate market activity rebounds. This should be supported by lower mortgage interest rates and deferred household demand, which is likely to be boosted by excess savings. Moreover, from the supply side, we expect the limited residential construction over the past two years to exert upward pressure on prices. Nonetheless, a mild price correction combined with a solid wage growth is likely to further improve housing affordability, which has deteriorated since 2015 at one of the highest rates in the EU or OECD. However, the weaker wage growth compared to our previous forecasts is likely to limit the pace of improvement. We have covered the residential market in a previously published report *Seedbed for a resurgence of strong house price growth* available here: https://bit.ly/Spec_Res_RealEstate_EN.

The supply and demand imbalance should contribute to renewed house price growth next year



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Data on dwelling completions and starts (last available data from August) is extrapolated for September and purely indicative for 3Q23. 12M denotes twelve-month trailing sum.

We expect mortgage lending to bounce back more tangibly next year



Source: CNB, Economic & Strategy Research, Komerční banka
Note: Data on new loans are not seasonally adjusted.

Mortgage lending continued to recover in 3Q. However, the volume of pure new loans remained low from a historical perspective. In fact, year-to-date (January-August) they are 45% lower, which mainly reflects the strong performance in 1H22. We expect the gradual rise in mortgage lending to continue this year, although the increased volumes are likely to have a lagged impact on loan stock growth due to later drawdowns. This is also the main factor contributing to the downward revision of our 2023 (end of period) growth forecasts of 1.1pp to 4.6% yoy. We expect a more tangible recovery to take place next year, driven by the fall in interest rates, deferred household demand, aided by accumulated savings, and the previous easing of DSTI mortgage limits. We estimate that the housing loan market will grow by 7.0% on average next year, following an estimated 5.4% (KBe) growth in 2023.

Bank loans and deposits (%, yoy)

	Q1 23	Q2 23	Q3 23	Q4 23	Q1 24	Q2 24	Q3 24	Q4 24	2022	2023	2024	2025	2026	2027
Bank loans														
Total	4.9	6.3	5.3	5.1	6.0	5.4	6.1	6.8	6.2	5.4	6.1	7.0	6.0	5.7
Households - real estate loans	3.4	4.8	4.5	4.6	4.8	4.5	5.7	6.8	7.9	4.3	5.4	7.0	5.3	5.0
Households - consumer loans	7.0	9.8	10.2	8.6	6.9	5.8	5.9	6.5	7.3	8.9	6.3	7.5	6.5	6.1
Corporate loans	2.8	5.9	4.6	6.8	7.5	6.4	7.1	7.3	6.8	5.0	7.1	6.9	6.2	6.0
Deposits														
Total	7.3	7.7	5.9	7.1	6.3	5.0	5.3	5.5	6.8	7.0	5.5	4.7	5.2	4.9
Households	5.8	6.0	6.7	6.2	7.0	6.7	6.1	5.7	4.2	6.2	6.4	4.9	5.3	4.7
Non-financial corporations	9.9	13.7	3.0	7.1	1.6	0.2	4.6	4.6	7.3	8.4	2.7	3.3	4.2	4.7
Others	8.0	6.5	6.7	9.5	8.6	6.0	4.3	5.9	11.7	7.7	6.2	5.4	5.7	5.6
Ratios														
Loans/GDP	59.1	59.0	59.1	58.1	58.6	58.8	59.5	59.0	61.4	58.8	59.0	59.9	60.7	61.2
Deposits/GDP	95.2	95.9	93.8	85.2	94.5	95.1	93.7	85.5	95.2	92.5	92.2	91.8	92.2	92.3
Loans/deposits	62.1	61.6	63.0	68.2	62.0	61.8	63.5	69.0	64.7	63.7	64.1	65.4	65.9	66.4
Interest rates														
Real estate loans	5.2	5.4	5.5	5.5	5.4	5.1	4.9	4.7	4.5	5.4	5.0	4.6	4.5	4.5
Consumer loans	9.5	9.5	9.6	10.0	10.1	10.2	9.8	9.3	9.1	9.6	9.9	8.7	8.3	8.6
Corporate loans	8.9	8.7	8.5	8.5	8.3	7.2	6.2	5.6	7.9	8.6	6.9	5.0	4.5	4.5
Share of NPL														
Real estate loans	0.7	0.7	0.7	0.8	1.0	1.0	1.1	1.2	0.7	0.7	1.0	1.3	1.4	1.6
Consumer loans	3.9	3.9	4.1	4.5	4.8	5.7	6.0	6.5	4.1	4.1	5.8	7.2	7.4	8.1
Corporate loans	3.2	3.0	2.8	2.8	3.0	3.2	3.4	3.5	3.5	3.0	3.3	3.8	3.8	4.2

Source: CNB, CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Moderate consumer finance growth against a backdrop of high savings

We expect the recovery in consumer demand to be accompanied by only moderate growth in consumer finance due to accumulated savings.

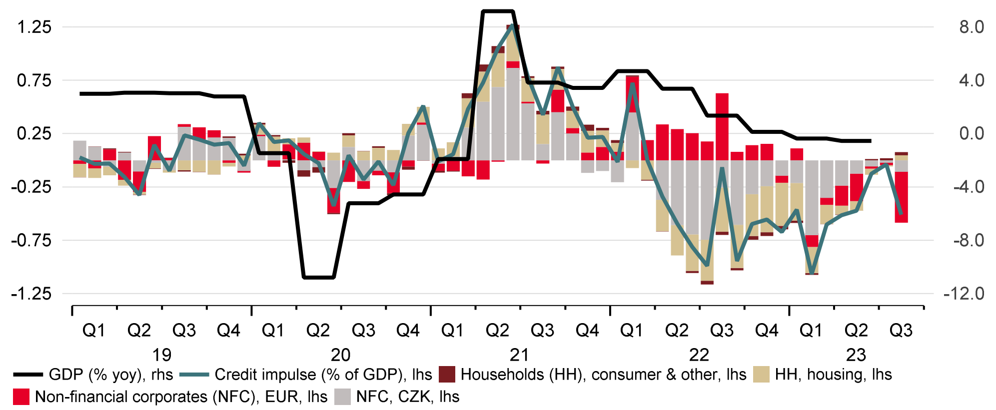
The higher consumer loan volume this year mainly reflects the increased price level. In real terms, the volume of new consumer credit remains very low compared to 1H22, although it has steadily increased since the start of the year. However, this is not reflected in the still-subdued household consumption, despite the household credit impulse reaching positive levels in 3Q. The increased volume of consumer credit paired with gradual rebound in mortgage lending suggests that consumer sentiment has improved, albeit sentiment surveys paint a slightly different picture. We expect an increased impetus for consumer loans to come with a stronger recovery in mortgage lending and a more tenacious rebound in aggregate demand next year. Nevertheless, given that the recovery in consumption could be fuelled by excess savings, we do not expect a large increase in consumer debt. We estimate 8.9% average growth in the consumer loan market this year and 6.3% in 2024.

Non-financial firms' credit impulse set to strengthen next year

Given the ample liquidity and lower funding needs, we expect the NFC credit demand to remain weak this year. However, the fall in interest rates next year will strengthen the credit impulse.

Loan activity of non-financial corporates (NFCs) remains very subdued. Tight monetary conditions both domestic and abroad are contributing to this, as is the sizable amount of own funds with which firms are able to finance less capital-intensive investments and operations. The volume of koruna loans extended to NFCs is down by more than 41% ytd, while euro-denominated loans fell by 27% ytd. However, the largely negative credit impulse, although gradually improving, does not necessarily reflect corporates' weakness, but rather sufficient liquidity and lower financing needs due to the unwinding of supply chain issues and strong disinflation in production sectors. We expect the credit impulse to strengthen more materially next year as interest rates fall and stronger investment activity ensues. However, despite weak credit activity, growth in loans to NFCs has been fairly strong this year. That may be partly due to the technical factor of exchange rate revaluation, which has gained in significance given the current 50% share of foreign currency denominated loans in total NFC loans. Overall, the growth in NFC loans is set to average 5.0% (vs 4.3% from our July forecast) this year and accelerate to 7.1% next year, on our estimates.

The credit impulse remains weak, although it is slowly turning positive



Source: CNB, CZSO, Macrobond, Economic & Strategy Research, Komerční banka
Note: Credit impulse is defined as the change in the volume of new borrowing, often given as a % of annual GDP. The presented credit impulse represents the yoy change in new borrowing of the non-financial private sector to trailing 12M nominal GDP. It is further broken down according to the use of the loan for households and currency denomination for firms. As opposed to monthly credit indicators (last data point from August 2023), GDP (as of 2Q23) is a quarterly indicator.

Deposit expansion to remain strong and outpace loan growth this year

Despite the slowdown, we expect deposit expansion next year to be supported by interest income and increased lending activity.

Deposit growth continues to be supported by household savings and solid corporate profitability this year. Still, outflows to non-bank solutions in search of higher yields represent a significant factor diluting this year's growth, which, however, is strong as is. The high level of liquidity in the banking sector also reflects the appeal of the Czech koruna thanks to high interest rates. We expect household deposits growth to slow next year as consumer spending recovers. However, increased lending activity and high interest yields on previously placed deposits are likely to mitigate the slowdown in deposit growth next year. According to our estimates, total deposit growth is likely to slow to 5.5% next year, after growing 7.0% on average this year.

Limited defaults demonstrate strong fundamentals in the economy

The share of non-performing loans is set to remain low in historical terms despite a slight increase.

Default rates remained near historic lows in 3Q, reflecting the sound financial situation of both households and firms. However, tight monetary policy and the lacklustre performance of the domestic economy this year is likely to result in a gradual increase in the non-performing loan (NPL) ratio, on our estimates. Although the rise in risk on bank portfolios is set to be fairly limited. The risk tilted towards a higher rise in NPLs is the increased volume of foreign currency denominated loans or the refixing of mortgage rates at higher levels. Nevertheless, as we have shown in *Box 1* above, the debt service for firms and households does not yet pose a significant risk. As interest rates fall next year, the risk is set to gradually diminish, especially for firms given the maturity and interest rate profile of their loans.

Key economic indicators

Macroeconomic indicators – long-term outlook

		2020	2021	2022	2023	2024	2025	2026	2027
GDP	real, %	-5.5	3.5	2.4	-0.3	1.6	2.5	2.5	2.7
Inflation	average, %	3.3	3.8	15.1	10.8	1.9	2.4	2.1	2.0
Current account	% of GDP	2.0	-2.8	-6.1	-0.9	-0.1	0.2	0.6	1.1
3M PRIBOR	average, %	0.9	1.1	6.3	7.1	5.5	3.7	3.3	3.3
EUR/CZK	average	26.5	25.6	24.6	24.0	24.7	24.3	24.0	23.8
USD/CZK	average	23.2	21.7	23.4	22.2	21.8	20.2	19.3	18.9

Source: CZSO, CNB, Macrobond, Economic & Strategy Research, Komerční banka
Note: KB forecasts are in red

FX & interest-rate outlook

		24-10-2023	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
EUR/CZK	end of period	24.6	24.75	24.85	24.85	24.80	24.65
USD/EUR	end of period	1.06	1.08	1.10	1.12	1.15	1.17
CZK/USD	end of period	23.2	22.90	22.60	22.20	21.55	21.05
3M PRIBOR	end of period, %	7.03	7.15	6.25	5.30	4.50	4.20
10Y IRS	end of period, %	4.57	4.60	4.40	4.20	4.00	3.90

Source: CNB, Macrobond, Economic & Strategy Research, Komerční banka, SG Economic Research
Note: KB forecasts are in red

Monthly macroeconomic data

		I-23	II-23	III-23	IV-23	V-23	VI-23	VII-23	VIII-23	IX-23
Inflation (CPI)	%, yoy	17.5	16.7	15.0	12.7	11.1	9.7	8.8	8.5	6.9
Inflation (CPI)	%, mom	6.0	0.6	0.1	-0.2	0.3	0.3	0.5	0.2	-0.7
Producer prices (PPI)	%, yoy	19.0	16.0	10.2	6.4	3.6	1.9	1.4	1.8	0.8
Producer prices (PPI)	%, mom	5.8	-0.3	-1.0	-1.2	-0.8	-0.3	-0.1	0.2	0.3
Unemployment rate	% (MLSA)	3.9	3.9	3.7	3.6	3.5	3.4	3.5	3.6	3.6
Industrial production	%, yoy, c.p.	0.8	2.4	3.1	-1.2	-2.3	0.9	-2.9	-1.7	n.a.
Industrial sales	%, yoy, c.p.	9.1	12.9	13.5	6.8	1.4	2.5	-2.2	-3.1	n.a.
Construction output	%, yoy, c.p.	7.3	-4.6	-2.6	-8.9	-5.0	0.9	-2.1	-0.2	n.a.
External trade	CZKbn (national met.)	7.9	14.3	16.6	9.2	9.9	18.4	-7.2	-3.8	n.a.
Current account	CZKbn	12.1	17.6	4.3	33.4	-11.9	-52.0	-16.5	-26.3	n.a.
Financial account	CZKbn	25.9	15.6	32.5	30.7	-22.7	-5.4	-20.3	-27.7	n.a.
M2 growth	%, yoy	6.3	7.0	6.7	7.5	7.3	8.1	9.3	8.5	n.a.
State budget	CZKbn (YTD cum.)	-6.8	-119.7	-166.2	-200.0	-271.4	-215.4	-214.1	-194.6	-180.7
PRIBOR 3M	%, average	7.22	7.20	7.19	7.18	7.18	7.15	7.11	7.10	7.09
EUR/CZK	average	23.9	23.7	23.7	23.4	23.6	23.7	23.9	24.1	24.4
USD/CZK	average	22.2	22.2	22.1	21.4	21.7	21.9	21.6	22.1	22.9

Source: CZSO, CNB, MF, MLSA, Macrobond, Economic & Strategy Research, Komerční banka

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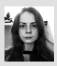

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