Quarterly report

Czech Economic Outlook

Investments: the driver last year, the brake this year


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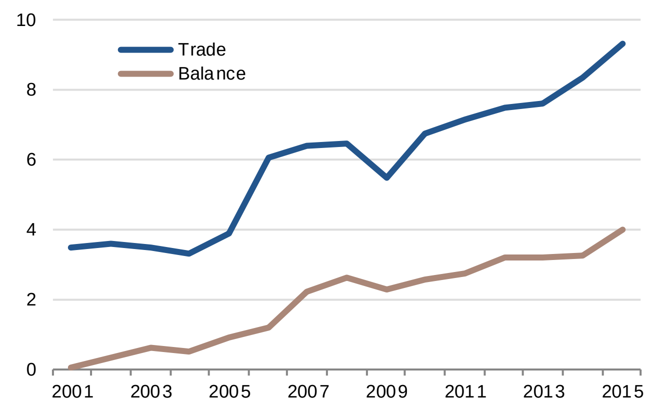
Looking back at the last few issues of our *Czech Economic Outlook* quarterly we find headlines like '*Households not about to lose their spending appetite*'; '*2016: Third year with no inflation*'; and '*Pay raises: later, but happening after all*'. Although they were released a year ago, nothing fundamental has changed regarding these conclusions. Economic growth is so robust that the record employment rate continues to rise and the labour market is reaching its limits. The result is continuously increasing pressure on nominal wage growth, expected to reach 4% this year. The low inflation scenario is also turning out to be true, which also means strong growth in real wages.

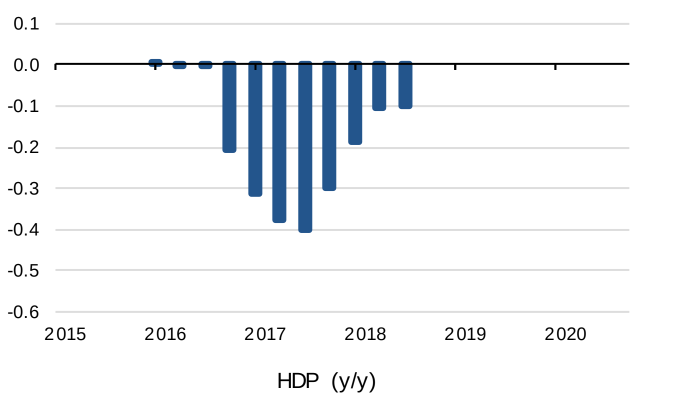
We have already mentioned several times that the Czech economy's growth in excess of 4% in 2015 was attributable to the coincidence of a number of non-recurring factors. Once this effect wanes, we expect the Czech economy will grow at approximately one half of last year's growth rate. While investments were the driving force behind the economy last year, this year we expect them to act as a brake. Developments to-date have confirmed our concerns that last year's boom in public investment co-financed with EU funds was significantly, but temporarily, underpinned by tapping the last of the EU money from the preceding programming period. Yes, we do have a new programming period and, as we noted in the February issue of the *Czech Economic Outlook*, the amount of available funds is not significantly smaller. However, the public sector is again facing a slow start to calls for proposals financed with money from the new programme. Still worse, complications have arisen because the environmental assessments (EIA) for some construction projects are too old to be eligible for EU financing. Unfortunately, this will have quite a major impact on the investment process in the public sector this year. The effect is already visible in the volume of public construction contracts being put up for tender. In short, civil engineering is facing a difficult 2016. In addition, the building sector is hampered by problems with regional development plans which frequently prevent projects, including those in Prague, from being launched.

Trade between the UK and CR, €bn



Source: International Trade Center, Economic & Strategy Research, Komerční banka

Simulation of Brexit impact on Czech GDP: how much could Czech GDP drop?



Source: Economic & Strategy Research, Komerční banka

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But it is not only the Czech economy that is suffering from the rather sluggish start to 2016. Global financial markets had a chaotic start to the year and, on the macroeconomic side, the global economic picture was not very upbeat. Indeed, US central bankers have revised significantly downwards their expectations for dollar rate hikes. While the spring months show some signs of stabilisation, there is still one major risk ahead: Brexit. SG Economic's team assign a 45% probability of the UK leaving the EU. The event would be so fundamental that it would generate global impacts. In the light of this, special boxes offer our views of what such a development could mean for the Czech economy and its financial markets. The globally low-inflation environment—deferring dollar rate hikes and vindicating the ECB's continued QE—has not stopped at the Czech national borders. Due to the revised inflation outlook we see an exit from the FX floor mode as happening no earlier than in Q3 17, providing the central bank actively intervenes in the forex market for at least another two quarters, limiting increased volatility in both directions. Because of the expected inflow of arbitrage capital, we expect negative rates for bank deposits over a set ceiling, specifically -0.5%, at the time of the exit.

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Mid-term macroeconomic forecasts for the Czech Republic

External environment: Brexit represents a risk

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Compared to our last prognosis, the growth prospects for the United States and the Euro area have worsened slightly. The common feature is that GDP growth in the US, the euro area as well as in the CEE region is driven by domestic demand. The risks remained virtually unchanged, chiefly: the potential exit of the United Kingdom from the EU, a slowdown of the Chinese economy, commodity price changes and refugee crises.

External factor assumptions (average values)

	Q1 15	Q2 15	Q3 15	Q4 15	Q1 16	Q2 16	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17
Brent crude oil prices (USD/brl)	54.9	62.9	51.3	44.7	35.2	40.0	40.0	40.0	45.0	50.0	55.0
GDP yoy - Euro area (SG)	1.3	1.6	1.6	1.6	1.3	1.2	1.3	1.4	1.5	1.5	1.5
CPI yoy - Euro area	1.1	1.0	1.1	1.0	1.2	1.1	1.2	1.3	1.4	1.4	1.4
EUR/USD	1.13	1.11	1.11	1.10	1.1	1.08	1.07	1.05	1.05	1.06	1.06
1Y EURIBOR	0.3	0.2	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Economic & Strategy Research, Komerční banka, SG Economic Research, Bloomberg

United States: expectations of rate hikes are gradually scaled down

GDP is expected to grow 1.8% this year.

Domestic demand remains the key driver of the US economy. Household consumption is positively affected by the situation on the labour market, which has already reached full employment (NAIRU). This creates pressures on wage growth and raises the purchasing power of households. Unit labour costs are already growing well above 2%. Moreover, lower energy prices improved household balance sheets as well, while the debt service burden remains the lowest in the past few decades. The situation on the housing market is also developing positively. Mortgage rates remain at historical lows, while undersupply on the market promises further investment growth. The factors creating downward pressure on US GDP remained roughly unchanged, namely the strong dollar, lower investment in the energy sector and tighter financial conditions. According to SG economists, the cumulative 22% appreciation of the US dollar, which began in summer 2014, wiped 0.9% off 2016 GDP growth. Lower investment in the energy sector is likely to cut an additional 0.4% of GDP. In sum, GDP is likely to grow 1.8%, while next year it should accelerate slightly to 2.2%.

Rate hike expectations have been reduced substantially.

Consumer prices are likely to rise this year. Given the continued tightness on the labour and housing markets, core prices have exceeded market expectations in recent months. Headline inflation is likely to return to 2% by the end of the year. Regarding inflation, the Fed is particularly concerned by the inflationary expectations. Fears of their further decline, a slowdown of the world economy and tighter financial conditions have led the Fed to remove two hikes from its dot plot. The Fed is now counting on just two rate hikes this year, while the previous median implied four rate hikes. SG economists expect just one rate hike in the second half of this year. SG economists expect there will be four increases next year.

Euro area: Inflation target still not in sight

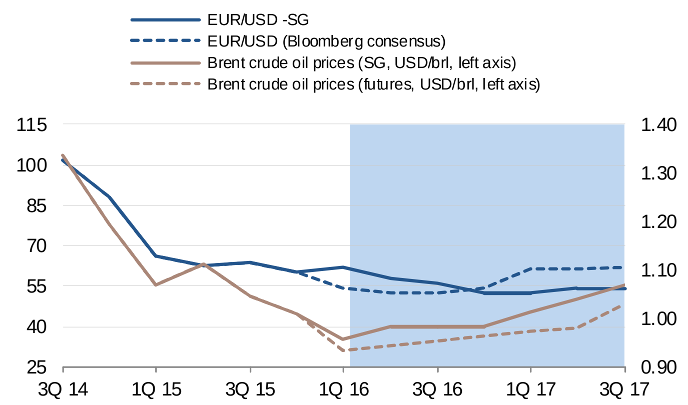
Euro area's inflation target still not in sight.

SG economists revised the 2016 GDP forecast down from 1.6% to 1.5%. A lower contribution from net exports and tighter financial conditions were the main reasons for the revision. Inflation in the euro area is at a persistently low level. According to SG economists, inflation is likely to hover around zero through the summer, but in H2 16 it is likely to accelerate given the base effects. Nevertheless, inflation is unlikely to exceed 0.4% on average this year. At the beginning of 2017, inflation is likely to rise temporarily to close to 2%. For 2016-20, it is likely to average around 1.6%, still substantially below the ECB's inflationary target of 2%.

President Draghi sees no room for further rate cuts.

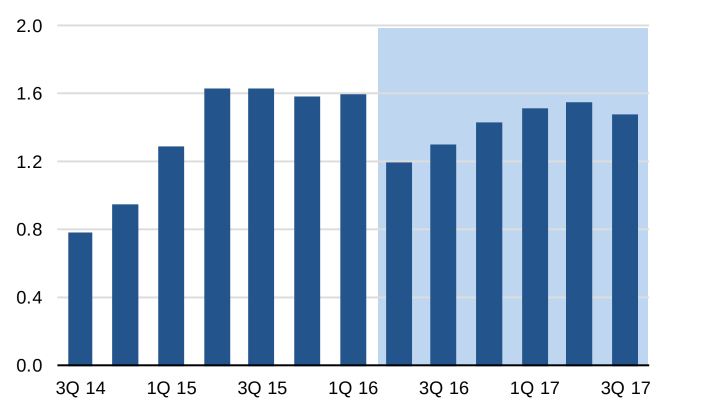
The European Central Bank delivered another package of measures in March to push inflation closer to the inflation target. The ECB lowered all interest rates, with the deposit rate cut by another 10bb to -0.4%. At the same time, ECB President Draghi stated that he doesn't see scope for further rate cuts. The amount of purchased assets will be raised by €20bn to €80bn starting in April. In addition, investment-grade corporate bonds have now been added to the programme. From June, a new TLTRO II programme will start. The interest rate for this programme will move within a range of -0.4% to 0%, according to the amount of lending provided by individual banks. As inflation is likely to rise given the base effects, we cannot expect a great deal of action from the ECB this year. The main question is what the ECB will do in 2017 and beyond if inflation persists below the central bank's target. Currently, the ECB's appetite for buying bank bonds or equities is low. According to SG economists, the most likely scenario is an extension of the asset purchase programme through the end of 2017, extending the TLTRO and possibly including mortgage loans.

Oil prices and EUR/USD



Source: Economic & Strategy Research, Komerční banka,SG Cross Asset Research/Economics

Euro area GDP



Source: Economic & Strategy Research, Komerční banka,SG Cross Asset Research/Economics

The German economy is expected to rise by just 1.4% this year and next. Private consumption is likely to remain the key source of GDP growth, while investment is likely to remain sluggish and exports will probably wipe out part of the growth. Household consumption is well supported by the positive situation on the labour market. A number of vacancies are at record highs and the slow inflation growth is boosting the real disposable income of households Inflation persists at low levels. This year, it is likely to reach 0.5% on average according to SG economists and 1.8% next year. In their view, the risks are balanced. Inflation is expected to be pushed higher by oil prices in H2 16. On the other hand, there is a risk on wage growth, which could be lower as a consequence of lower external demand and higher labour supply (refugees).

CEE: growth driven by domestic demand

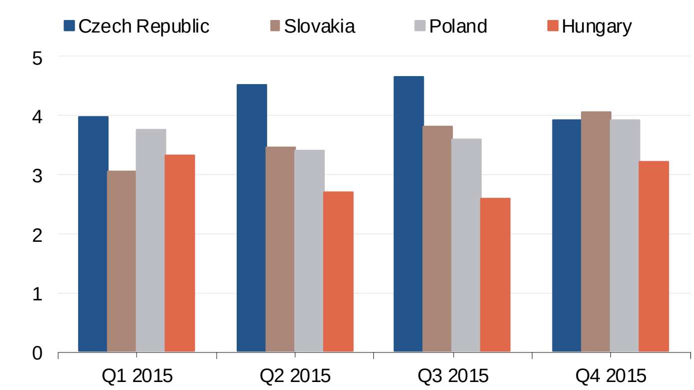
The prospect of individual central banks meeting inflationary targets is still not within sight.

Inflation in the CEE region (the Czech Republic, Poland, Hungary and Slovakia) persists at low levels. Only in the Czech Republic is inflation in positive territory (+0.3% yoy in March). In Hungary, inflation is back in red figures after six months of growth. Poland is no better, as consumer prices are already negative there since July 2014 (-0.9% yoy in March). Slovakia sank into deflation in 2014 and is not able to improve the inflationary picture of the CEE region either. Although consumer prices in the region are likely to rise gradually, the prospect of individual central banks meeting inflationary targets is still not within sight. In the Czech Republic, inflation should reach the central bank's target next year. For Slovakia and Poland, it would be a success to break out of deflation by the end of this year (SG economists expect the exit from deflation in Q3 16 at the earliest). Hungary is not faring any better. According to the Hungarian central bank, the country should achieve the target in H1 18 at the earliest. Finally, Poland will probably not be able to hit its inflationary target sooner than in 2018 either.

Hungarian CB might cut rates further, Polish CB likely to stay on hold.

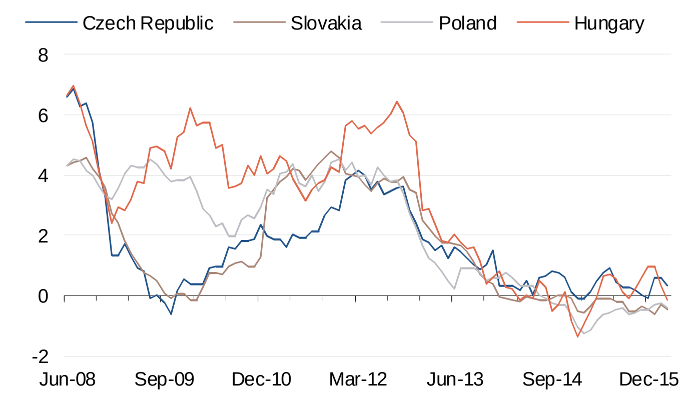
Inflationary in the region determines the monetary policy settings of the central banks. While the Czech central bank is maintaining its FX commitment at 27EUR/CZK and, according to our assumptions, is unlikely to scrap it before Q3 17, the Hungarian central bank renewed its cycle of rate cuts. First off, it surprised with a 15bp rate cut to 1.2% in March, while in April it lowered rates by another 15bp to 1.05%. In the statement released after the meeting, the central bank also mentioned that another negligible rate cut might be needed to meet the inflationary target. This is in line with SG strategists' view that the key interest rate will fall to 0.9%. The Polish central bank is likely to leave rates unchanged at the current level of 1.5% over the coming months, in SG's view. Any change could undermine the inflationary target, which currently stands at 2.5% +/- 1%. According to SG, the Polish central bank could address this question during discussions about the Monetary Policy strategy for 2017, which will take place soon. The best solution, according to SG, would be an asymmetric inflation target, i.e. inflation no higher than 2.5%.

CEE GDP (%, yoy)



Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

Harmonised inflation (%, yoy)



Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

There is limited room for strengthening regional currencies.

After the surprising rate cut in March's, the Hungarian forint gradually weakened towards 315EUR/HUF. Later, however, it gradually wiped out its losses and rallied back to below 310EUR/HUF. Reaction to the latest rate cut was less clear and currently the EUR/HUF is trading around 312EUR/HUF. SG economists expect the EUR/HUF to hover around this level over the coming months, while in H2 16 it should weaken slightly towards 316EUR/HUF. The Polish zloty has seen losses from mid-January when Standard & Poor's lowered Poland's rating from A- with a positive outlook to BBB+ with a negative outlook. Currently, the EUR/PLN stands close to 4.4 EUR/PLN and domestic factors don't hold much promise of strengthening the currency. As early as May, there is a risk that Moody's may revise its rating to A2 with a negative outlook (the current rating is A2 with a stable outlook). The reason would be fears from a worsening public finance situation following steps taken by the new government. In addition, there is no solution in sight to the conversion of household loans denominated in Swiss francs (PLN137bn, 7.8% of GDP) into PLN. The new presidential draft bill should be discussed in the parliament in June; the costs for the banking sector are unlikely to exceed PLN10bn. As a result, despite the positive macroeconomic situation of Poland, the prospects of the polish zloty strengthening are limited. According to SG economists, the EUR/PLN will trade at 4.38EUR/PLN at the end of H1 16, while at the end of this year the forecast is 4.3EUR/PLN.

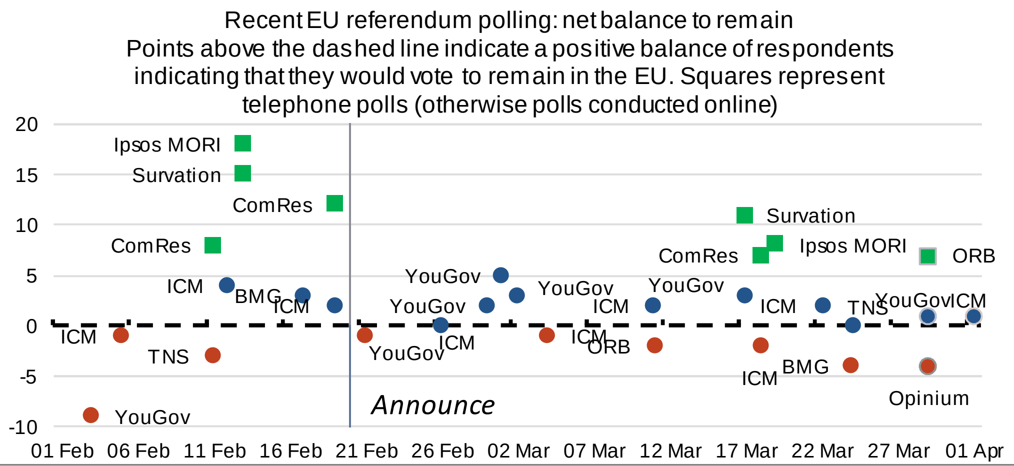
Fiscal policy stimulates GDP growth in the CEE region.

The main source of GDP growth in the region remains domestic demand. The appetite of households to spend is well supported, not just by a positive dynamic on the labour market but also by government measures, which improve household budgets. The Hungarian government reduced personal income tax by 1 percentage point, increased the family tax allowance for families with two children and the minimum wage was raised by 5.7%. The real wages of employees at budgetary institutions rose in real terms by 10.8% in January, while unemployment is at its lowest since 2014 (6.1% in March). Poland is in a similar situation, where government measures are also stimulating consumption. From 1 April, the 500+ child benefit program came into operation. The program provides a subsidy for the second child and every subsequent child thereafter, regardless of household income. According to SG economists, this could raise private consumption by 1.0-1.3pp over the coming quarters and GDP growth by 0.2-0.3pp. Although the fiscal policy supports growth in the region, the deceleration in investment resulting from the new programming period for EU funding will be a drag. In Poland, GDP is expected to grow by 3.6% this year, by 2.7% in Slovakia, by 2.8% in Hungary and by 2.1% in the Czech Republic.

BOX 1: Brexit – The referendum is just the beginning…

The British government declared that the referendum on whether the United Kingdom will remain in the European Union will take place on 23 June. The campaign itself was started on 15 April, 10 weeks in advance. What is the likelihood that the UK will leave the EU? What would such a result mean for the United Kingdom? Which steps would follow? We answer these questions in the following paragraphs (you can find more information in SG's report – *What if….? The Brexit Briefing*[1]).

Results of current Brexit referendum polls



Source: SG Cross Asset Research/Economics

[1] https://doc.sgmarkets.com/en/3/0/393691/177502.html?sid=4c80899876cea82e5ac543ff379a52bc

SG economists have set the probability of Brexit at 45%. According to opinion polls, the number of voters in both the yes and no camps hovers around 40%. Bookmakers, which for example in assessment of the result of the UK general election in May 2015 were more accurate than opinion polls, see the probability of Brexit at just 30%.

If British voters, however, do decide to leave the EU, they would start a very long and complicated process. The exit from the EU follows Article 50 of the Treaty on the European Union. Firstly, the leaving state has to announce its intention to leave the EU to the European Council. For the withdrawal process, Article 50 sets down the period of two years. During this time, UK will follow the same rules as it has, but it would not participate in the Council of Ministers or the European Council. If the UK were not able to reach all necessary agreements, it could get stuck in a certain vacuum. The extension of the withdrawal period would require the approval of all 27 EU member states, which is not by a long sight the matter of course. If the withdrawal period is not prolonged and at the same time not all of the necessary agreements are made, the United Kingdom would then be governed by the rules of the World Trade Organization (WTO). This, however, would mean an imposition of sizeable tariffs on UK goods, which until now have moved freely within the single market. Nevertheless, even the UK's membership in the WTO could not be without problems. The UK would have to negotiate with all 161 members of the WTO as the UK's access to WTO member markets was guided by rules for the whole EU. The UK would have to negotiate not only its withdrawal from the EU but also rules for further cooperation with EU states and non-EU countries, so negotiations would likely be demanding and long. According to the document published by the British government (HM Treasury), the process could take a decade or even longer. The complexity of the negotiations is apparent in the case of free trade between Canada and the EU (EU-Canada Trade Agreement, CETA), which started in 2008 and has still not been ratified.

Apart from WTO rules, several other scenarios could be considered, but all of them involve some disadvantages:

1. Membership in the European Economic Area (EEA) and the European Free Trade Association (EFTA). Thanks to the agreement between EFTA and the EU, EEA members (Norway, Iceland, and Liechtenstein) enjoy the benefits of free movement of goods, services, people and capital within the EU and the EEA. A disadvantage is that EEA member states remain the subject of most EU legislation (Norway takes up more than 75% of the EU's legislation) but they cannot participate in the negotiations for such laws. In addition, they still have to contribute to the EU budget (Norway contributes a similar amount per capita as the UK). According to SG economists, this scenario would cost the UK 0.5 pp to 1.0 pp of GDP for 10 years.

2. Bilateral agreements and European Free Trade Association (EFTA) membership. This is the path chosen by Switzerland, which after refusing EEA membership concluded 120 bilateral agreements with the EU. At the same time, it does not automatically adopt EU legislation. Unfortunately, the EU of course has the stronger bargaining position. In the process of concluding bilateral agreements, the EU requires the full adoption of relevant laws, including all future amendments. Breaking free from EU legislation is therefore to a large extent just illusory. There is also the question of which terms and within what time frame the UK would be able to make all these agreements.

3. Customs Union. The Customs Union of Turkey and the EU might be an example. In the Customs Union, the country is obligated to follow common trade policy and joint customs tariff scaled with third countries. The problem is that the country cannot participate in negotiations with third countries but is obligated to implement the conditions agreed upon by the EU. In this case, the UK could also loose the advantage of so-called passporting, which allows financial institutions to open branches without the approval of the regulator of the relevant country. The costs of this variant would be naturally higher than those of scenarios 1 and 2.

4. Free trade association within the EU and the UK. The UK could try to negotiate a comprehensive free trade agreement with the EU.

The problem is not, however, just the UK's access to the single market. The status of UK citizens living and working in other EU countries (around 2 million people) and EU citizens in the UK would have to be addressed. The position of London as the centre of financial services would also have to be reconsidered. Everything would depend on agreements negotiated during the two-year withdrawal period and the willingness of EU member state to reach agreements.

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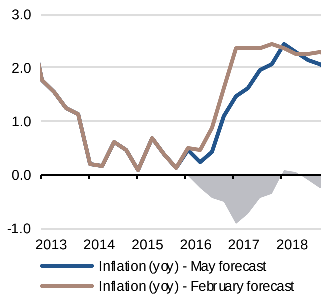
Main changes

GDP:
GDP will decelerate this year due to a considerable slump in investment activity. We have revised GDP growth from 2.3% to 2.1%.

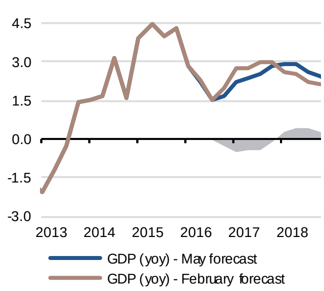
Inflation:
We have revised our inflation outlook down from 0.9% to 0.6% mainly on the back of lower imported prices and food prices.

Change in our inflation outlook



Source: Economic & Strategy Research, Komerční banka, CZSO

Change in our GDP outlook



Source: Economic & Strategy Research, Komerční banka, CZSO

Macroeconomic outlook

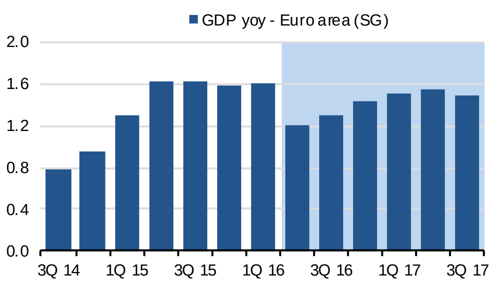
Consumers to drive growth; investment to impede it

Although GDP growth in the euro area has eased only mildly, Czech economic growth slowed significantly in the fourth quarter of last year. An earlier-than-expected decline in investment is to blame. Fixed capital formation is also expected to weigh on economic growth in the first quarter of the year. Growth should be driven by strong domestic consumption and sound external trade underpinned by growing demand on the export side and lower investment on the import side. Overall, GDP growth should slow to 2.1% this year while inflation will remain muted, printing 0.6% on average.

Volatility on financial markets at the turn of the year filtered into the real economy and the euro area saw an economic slowdown at the end of 2015. However, SG economists expect this slowdown to be only temporary as consumer demand remains sound. **Growth in the euro area should repeat last year's result of 1.5%.** Governments' austerity programmes continue to hinder the realization of big infrastructure projects which translates into muted development of fixed capital formation. To boost its growth and potential, the euro area including Germany desperately needs reform and deregulation. Otherwise we cannot expect much from fixed capital formation, and growth will be driven only by consumption. Consumption growth is supported by low oil prices and weak inflation overall. In Germany, the wage bill benefits from record high employment figures while wage growth remains modest. **The recent influx of refugees will keep the increase in salaries muted, but might trigger some fiscal easing, which would further boost household consumption.** The risk is that spending on the refugee crisis will cut into much-needed infrastructure investment.

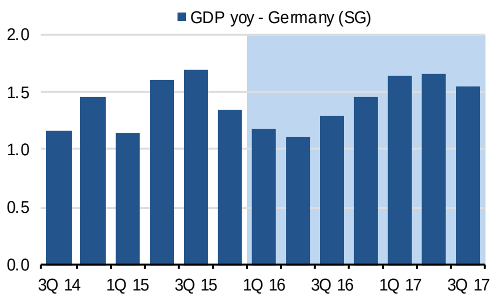
Inflation in the euro area will remain low this year at 0.5%, according to SG economists, though they expect a strong acceleration towards the end of the year when inflation should temporarily attack the 2% inflationary target due to strong base effects. Afterwards, inflation should ease again and remain at approximately 1.6%. Thus, **we do not expect any significant inflationary pressure stemming from the external environment.**

SG expects slowdown in the euro area …



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

… as well as in Germany

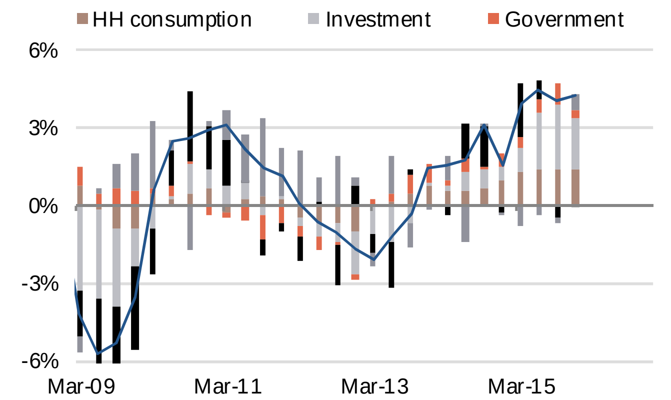


Source: SG Cross Asset Research, Economic & Strategy Research, Komerční banka

GDP to decelerate sharply due to slump in investment

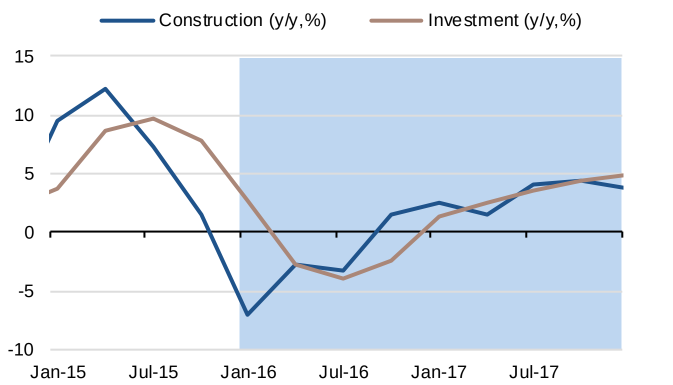
GDP growth in 2015 was boosted by a massive increase in fixed capital formation, which rose 7.4%, boost overall GDP growth by 1.9pp and became the biggest GDP contributor. This year should see the exact opposite. Fixed capital formation is expected to become the biggest impediment to economic progress as it should fall by 1.6% depressing overall GDP growth down 0.4pp. Last year, investments were inflated by public spending funded via EU funds, as it was the last opportunity to tap the money from the 2007-2013 programming period. **This year, the EU funds will dry up as tapping the new programming period is usually sluggish. And that is not the only reason for the expected slump in investment. The neglected issue of the Environmental Impact Assessment (EIA) will hit back this year, as the European Union is not going to finance projects where the assessment based on new rules is missing.** This is the case for infrastructure construction projects valued at CZK130bn. It will take at least one year until the new EIA will be ready for the older projects. The government will fully finance some of the projects (these projects will not need new EIA) to mitigate part of the drop in public investment, but it will offset only a small part of planned construction. To quantify the impact of the reduction in public investment, we have looked at the public procurement registry. There is a significant decline in government demand for construction works. Our analysis shows that this decreased roughly 25% at the end of the year. Given public investment creates approximately 20% of fixed capital formation, we forecast that in H1 the public sector will cut a cumulative 5pp from overall investment activity. Conversely, the situation of the private sphere remains sound. Interest rates remain at record lows, the main trading partners are reporting growth, and the CNB is maintaining its policy of a weak CZK. Thus, **non-financial corporations have all the conditions required to invest.** However, some of them will wait until the Czech Republic sets in motion its operating programs and EU funds start flowing into the country.

Investment drove growth last year



Source: Economic & Strategy Research, Komerční banka, CZSO

Investment to drop, depressing construction



Source: Economic & Strategy Research, Komerční banka, CZSO

Low investment hurts industry, construction to suffer considerably

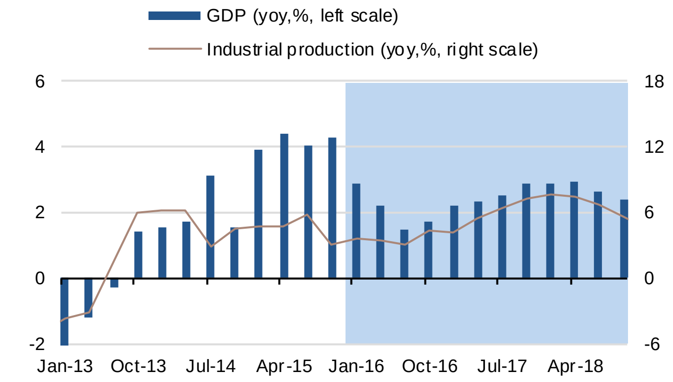
Drop in investment activity will weigh on development of the construction sector and industrial output.

Over the past year, investment activity also supported industrial production and especially construction. This year's decline in investment activity will weigh on these sectors. **Our rough estimates indicate that a 1% drop in investment dynamics translates into a 0.2% slowdown in industrial production and 0.8% in construction output.** We believe that in the event of a drop in public infrastructure investment, the damage to the construction sector is even higher. The lack of infrastructure projects puts the engineering construction sector in jeopardy as it will probably require restructuring. Building construction should do significantly better. The improvement in households' financial situation and low interest rates create demand for housing which is already apparent in the offer prices that have accelerated in the past few quarters. The only drag on new building construction is the lack of suitable building plots in Prague. The absence of metropolitan land use creates uncertainty for developers. **The situation in the construction sector is severe as we expect that it will see a drop of 2.8% while the summer months in particular will be critical.**

Industry benefits from strong external demand for cars.

Although industry is also partly dependent on investment activity, public investment expenditure does not play as big a role as in the case of construction. Companies in the industrial sector benefit from firming external demand. In particular, the automotive industry is underpinned by strengthening demand for cars in the euro area. Last year was also marked by problems in energy production and the chemicals sector. The shutdown of the Litvinov refinery substantially cut into the chemicals sector output. Energy production normalized at the beginning of this year and new production should start in Litvinov during the summer. **These factors more than offset the drop caused by public investment. Industrial output will slow from 4.6% (WDA) last year to 3.6% (WDA) in 2016.**

Industrial production growth to ease



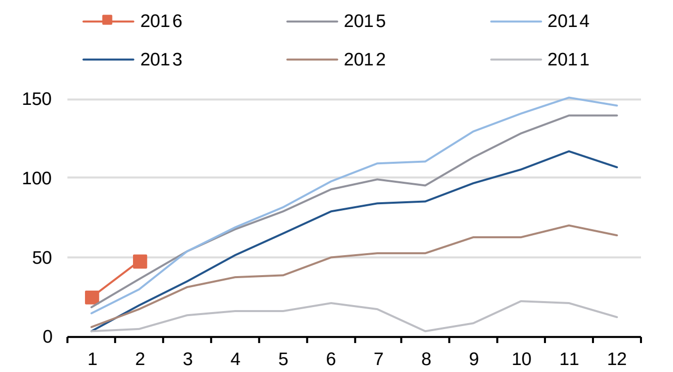
Source: Economic & Strategy Research, Komerční banka, CZSO

Net exports to strengthen

Import growth to be muted due to lower investment. Exports flourishing thanks to external demand.

External trade will increase its surplus this year. On the import side, lower investment will support easing as it is very import intensive. Moreover, subdued commodity prices will still act in favour of lower nominal imports. On the other hand, growing consumption will increase the volume of imported goods this year. Even though personal consumption is less import intensive than investment, slightly less than half of consumed goods are imported. Moreover, higher export activity will boost imports.

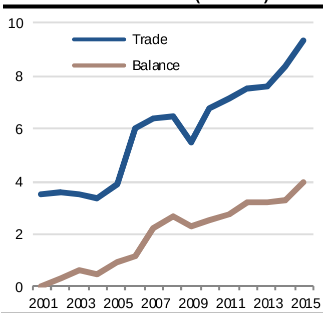
Net exports heading to record surplus



Source: Economic & Strategy Research, Komerční banka, CZSO

The monthly indicators of exports have been surprisingly positive. Consumers in the euro area are demanding cars and Czech industrial producers are delivering. Economic dynamics in the euro area and Germany remains sound. Thus, we expect that external trade is going to perform this year. **The trade balance should print a record surplus and contribute 0.8pp to overall GDP growth. The external position of the Czech economy will thus remain sound. The current account is set to print a surplus of 1.4% of GDP.**

UK-CZ mutual trade (EURbn)



Source: International Trade Center

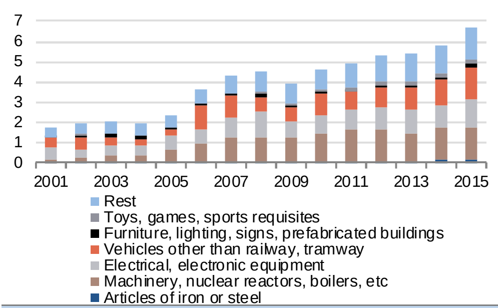
BOX 2: Economic linkages between CR and UK

The possible confirmation in referendum by British voters of leaving the EU structures will be only a beginning of process which will spread across two years as defined by the Article 50 of Treaty of EU. UK will be rightful member of the EU at least regarding the trading linkages. Hence, in the short term no changes regarding the common trade might be expected. However, approaching end of this period the trade relationship will adjust to the conditions under which the UK will have the access to the single EU market. Individual possibilities of the future access of UK on the single market are commented in the preceding part together with their pros and cons.

However, any restriction of trade between UK and EU would negatively impact the trade between UK and CZ (direct and indirect as well) and the resulting implications for the Czech economy. Bilateral trade is with the exception of crisis year 2009 gradually increasing and Czech economy is able to realize ever growing surplus from the trade with goods. It is the second largest trade surplus following Germany in the country ranking according to the goods trade surplus. In general the British economy is the ninth most important trading partner counted by the trade turnover.

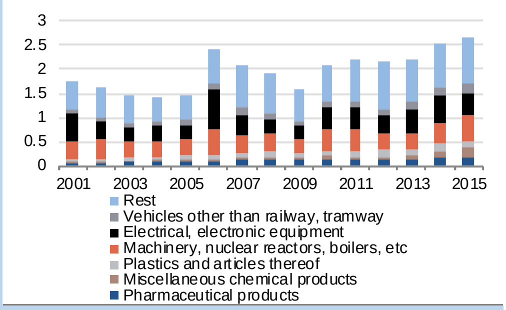
The structure of trade shows that the trade is concentrated in to several commodities. Figures below reveal the sectors with highest weight on imports and exports according to the commodity structure. Machinery, electrical items and production transport equipment are represented both on import as well as export side. These commodities contribute most heavily to the trade surplus. Manufacturing sector in general contributes by a quarter of valued added in the Czech economy and its limited business opportunities would bring decreasing sales to companies in this sector, since the trade surplus in this sector accounts for 2% of GDP, when the overall trade surplus is 2,8 % GDP. The share of UK goods trade on GDP is with the exception of Slovak republic the biggest in the central European region which illustrates the importance of UK market for the Czech economy.

Structure of UK imports from CZ (bn EUR)



Source: International Trade Center, Economic and Strategy Research, Komerční banka

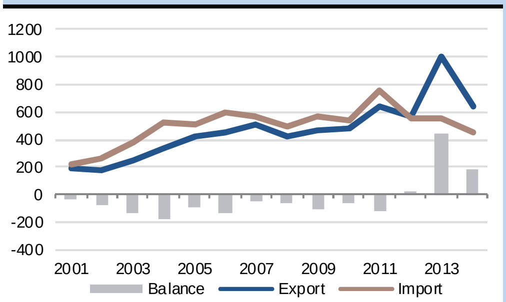
Structure of UK exports to CZ (bn EUR)



Source: International Trade Center, Economic and Strategy Research, Komerční banka

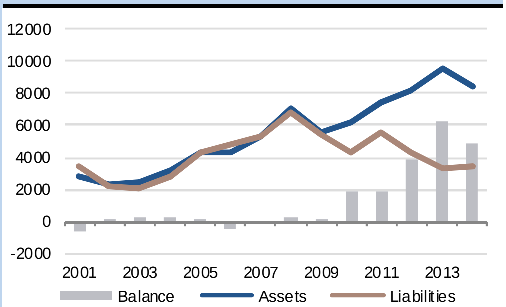
Trade surplus was historically present even in the trade with services which balance has turned in the favour of UK only recently which would decrease the total trade of goods by 1.3bn EUR and the total surplus of trade and services is then 2.7bn EUR.

Development of service balance (mil GBP)



Source: Office for National Statistics, Economic and Strategy Research, Komerční banka

Stock of foreign direct investment (mil GBP)



Source: Office for National Statistics, Economic and Strategy Research, Komerční banka

Hence, if in the worst case scenario the total fall out of the mutual trade would be concentrated to a single point of time then it would have potential to decrease the GDP growth by 1.9pp. However, we attach only marginal probability to this scenario based on two reasons. Firstly, the possible negotiations of UK with European business partners about the conditions under which they will grant the access to the markets will be pursued on the European level as access to the single European market. Thus, it will be of a very important interest of the UK to allow as smooth flow of goods across the borders since the trade flows with rest of EU accounts for a half the EU trade. Hence, we do not expect any large obstacles to arise. Moreover, if in any case the process might not finished within the two months, the Article 50 of Treaty of EU includes possibility of extending this period of time when the partners agrees. This agreement would be easily created since in the case of emerging fall out of trade with UK. Secondly, if the possibility of any trade restriction might arise then the politicians would communicate this to markets well advance. The possible one-off effect then would be spread across the time, which would allow price setting to adjust and include the tariffs barriers or preparation of reexport measurement via countries which might already have a form of free trade agreement established.

Last real economy transmission channel (below in the text are discussed financial and equity markets channels) which transmits the negative shock in the case of EU leaving the EU are the foreign direct investment. UK is an important investor to the Czech economy, which has assets of almost 12bn EUR in the CR. This investment position in CR might even in the optimistic scenario strengthen since activities of British companies might use these assets to provide the access to the single EU market, although even this is not without risk either.

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Fiscal policy – capital spending binge of 2015 is over

Last year's public sector deficit strongly surprised on the positive side, printing at just 0.4% of GDP – the best figure in the Czech Republic's history. All subsectors beat our expectation. Notably, local governments reported a surplus of 0.5% of GDP, due mostly to a slowdown in investment expenditures (as stated by the Finance Ministry), with the city of Prague accounting to a half of this amount due to the paralysed city assembly. The central government shortfall (in the ESA2010 methodology) narrowed on ever-higher accrued tax collections and an inflow of EU funds. Also, government-owned financial institutions reported a surplus of 0.3% of GDP, according to the Czech Statistical Office, in contrast to our call for a deficit (during 2015, news emerged that export-financing government agencies faced issues with bad-debt write-downs).

Following the EU-funded capital spending binge of 2015, fiscal policy enters considerably calmer waters this year.

Following the EU-funded capital spending binge of 2015, fiscal policy enters considerably calmer waters this year. As we stated in the previous *Czech Economic Outlook*, the government has focused on rising wages and payrolls within the public sector, increasing pension benefits and tax allowances on children. On the other hand, taxes on gambling and tobacco have been scaled up, and the Finance Ministry hopes for improvement in (mainly) VAT revenues on the back of the new invoice-matching system (effective since January) and electronic sales reporting system (starting in December 2016).

However, it seems that the hottest topic in 2016 will be the looming shutdown in EU-sponsored infrastructure construction. Due to the lack of updated environmental impact assessment (EIA), the EU will likely refuse to co-finance dozens of projects worth a total of CZK130bn (to be spread over several years). Obtaining a new EIA is a lengthy process of around one year or longer, resulting in a considerable risk of postponement for almost a hundred projects. Meanwhile, the government can instead focus on other projects funded by national sources (having a full impact on domestic public finances). However, these issues bring some uncertainty and will be definitely subject to scrutiny over the remainder of 2016. We assume that the government will only partly offset the drop in EU-funded projects.

Due to the very favourable Q1 revenues (mainly the remaining portion of the 2007-13 EU funds), solid macroeconomic developments (notably in domestic consumption and the labour market) and the probable lack of large investment projects with EU co-funding**, we expect the central cash budget deficit to print at just CZK35bn**, compared with the original government plan of CZK70bn.

Public finance dynamics

	2015	2016f	2017f	2018f	2019f	2020f
Public deficit (% GDP)	-0.4	-0.7	-0.8	-0.3	-0.4	-0.5
Fiscal impulse (pp GDP growth)	0.5	-0.2	-0.6	0.0	0.0	0.0
Public debt (CZKbn)	1,836	1,846	1,886	1,901	1,921	1,946
Debt ratio (% GDP)	41.1	40.1	39.3	37.7	36.7	35.9

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

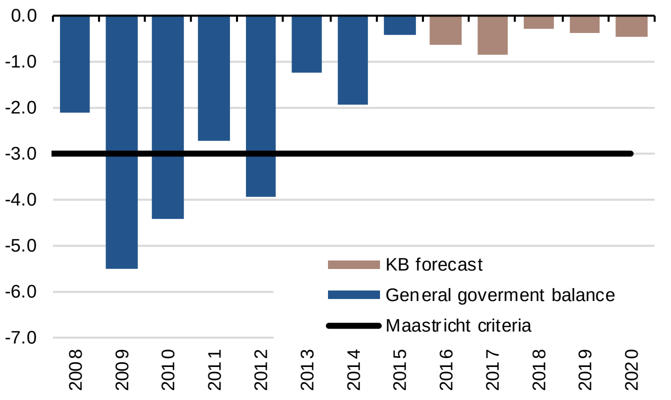
Under the ESA2010 methodology, we expect the public sector deficit to reach 0.7% of GDP in 2016.

Under the ESA2010 methodology, we expect the public sector deficit to reach 0.7% of GDP, due mainly to the low central government shortfall (accrued), which explains the majority of our revision (our previous forecast was for a 1.5% deficit). Also, we expect a moderate surplus from regional governments and municipalities, as tapping the EU funding programme for the 2014-20 period is only slowly starting. We assume that the factors mentioned above will result in a minor fiscal stimulus of 0.2pp.

The debt/GDP ratio is set to fall to 40.1% this year.

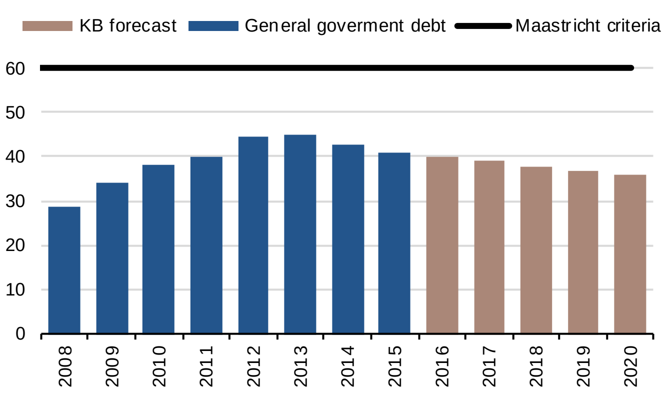
Public debt increased by a modest CZK17bn in 2015, of which around CZK10bn is attributable to the renewed lease of the Czech army's fighter jets (see previous *Czech Economic Outlooks*). The Finance Ministry again tapped the liquidity reserve to cover a significant part of the central government's deficit. Due to the dynamic economic growth, the debt/GDP ratio declined by 1.6pp to 41.1%. In 2016, we expect public debt to increase by a minor CZK10bn, as we look for another tap of the liquidity reserve. **The debt/GDP ratio is then set to fall to 40.1%**. However, there is a risk that the Finance Ministry will utilise the current environment of extremely low yields to pre-finance a part its 2017 borrowing needs (see the *Czech Government Bond and IRS Markets* section), which would result in a worse (but still favourable) debt trajectory this year.

Public finance deficits (% of GDP)



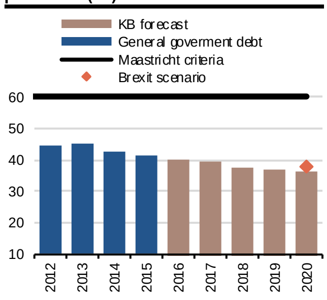
Source: CZSO, Economic & Strategy Research, Komerční banka

Public debt (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

Debt-do-GDP developments: Brexit scenario not a significant problem (%)



Source: CZSO, Economic & Strategy Research, Komerční banka

BOX 3: Impact of Brexit on fiscal policy and tapping of EU funds

As a worst-case scenario, we consider a total halting of UK contributions to the EU budget, and a resulting (possible) proportional cut in EU funds allocation for the Czech Republic. Assuming there are no UK payments starting in 2017, the EU budget would fall short of the baseline by roughly EUR 65bn cumulatively through 2020 (the end of the current budgetary framework). A proportional cut in EU funds (totalling EUR 454bn in the 2014-20 programming period) would then reach some EU 27bn. The Czech Republic can tap up to EUR 24.2bn (CZK 654bn) in the baseline scenario. The lack of UK funding would result in this sum being shorter by roughly 6%, i.e. **the Czech Republic would lose some CZK 38bn cumulatively in 2017-20. Per year, the sum is less than CZK 9.5bn**. Put into perspective, this yearly amount is just 0.8% of the planned budget revenues in 2016. Moreover, due to the N+3 rule applicable in the current programming period, such a possible loss of EU money would be spread out until 2023, making the yearly drop even less. As a result, **we assume the direct impact of Brexit on tapping of EU funds would be negligible**.

On the other hand, the stress related to Brexit would likely hamper the economic performance in Europe (via plummeting confidence and probably a shock to investments), including the Czech Republic. In response, **the government can embark on fiscal expansion to counter the negative effects of the shock**. In our February forecast, we expected fiscal stance (the change in the cyclically adjusted primary balance) of -0.2pp (expansion) in 2016 and 2017, respectively, with zero stance on the remaining forecast horizon. The sound state of public finances and relatively low debt burden offer the government quite a lot of space to manoeuver. The drop in EU funding in 2017-20 could be offset by an easily achievable 0.1-0.2pp negative fiscal stance for the respective years. This expansion would widen the public finance deficit to 1.3% of GDP by 2020 compared with the 0.5% shortfall in our baseline. A resulting increase in government debt by some CZK 105bn would bring the debt-to-GDP level to just 37.9% of GDP.

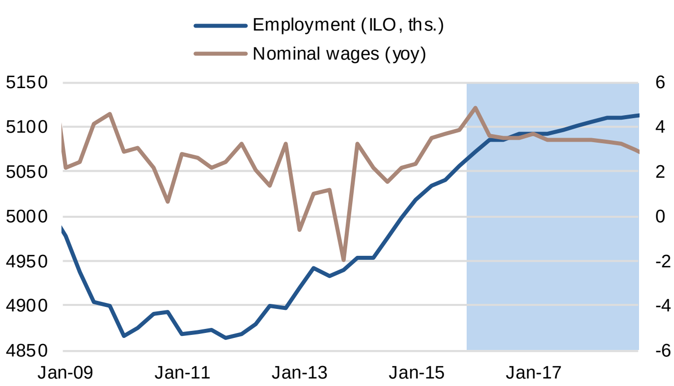
In conclusion, **we assume that even such a negative shock from Brexit would be manageable**. Moreover, **note that this scenario of a total cut in UK payments to the EU budget is highly unlikely**, as new agreements between the EU and UK regarding mutual trade would likely result in the UK paying fees to access the common EU market. On a different note, the tail risk would stem from rising uncertainty in the EU as a whole, or mounting speculation of Czexit.

Consumers to drive GDP

Consumers' conditions improved rapidly last year. Employment figures have been breaking records, while the unemployment rate is approaching the lows of 2008. The number of vacancies is high so it is relatively easy to find a job. In some professions, it is already difficult for employers to find a qualified work force. Unsurprisingly, wages are growing in this environment. And this is necessary if employers want to attract new workers. Competition on the labour market is getting stiffer, and so trends on the labour market will continue moving in the same direction. The unemployment rate is set to resume decreasing, but the pace will decelerate. There are two reasons for this. Economic growth will slow and the pool of capable workers is shrinking. Nominal wages will accelerate to 3.9% and given the sluggish price growth in real wages will speed up as well.

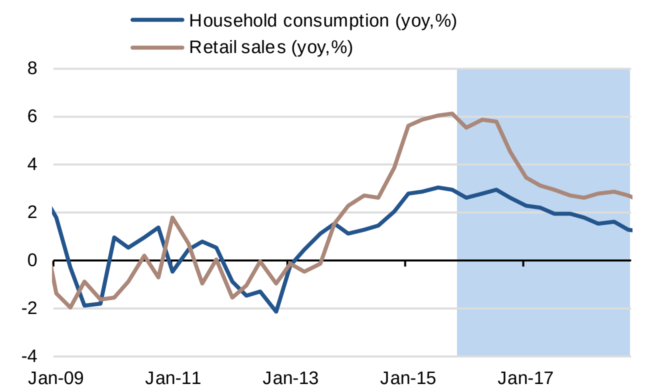
Although consumer confidence has decreased from its historical high in January, it remains robust. Households are not worried about future economic development, suggesting that more of their income will be spent and less saved. Retail sales were very strong at the turn of the year and should remain on this trend over all of 2016. **Household consumption is set to be strong this year. It will become the main GDP growth driver as it should increase 2.7% contributing 1.3pp to overall growth.**

Low unemployment drives wages up



Source: Economic & Strategy Research, Komerční banka, CZSO

Household consumption to remain the growth driver



Source: Economic & Strategy Research, Komerční banka, CZSO

Expected inflation trajectory revised down again

Inflation to remain very low this year. Administered prices should decrease once this year and at the beginning of 2017.

Although the headline inflation rate in the first quarter of the year was fully in line with our forecast, the structure differed from our estimates. We had expected stagnation of administered prices due to lower gas and electricity prices; however, the decline in electricity prices has not materialized and gas prices decreased only marginally. Fuel and food prices remained weaker than we expected, pulling the overall index down.

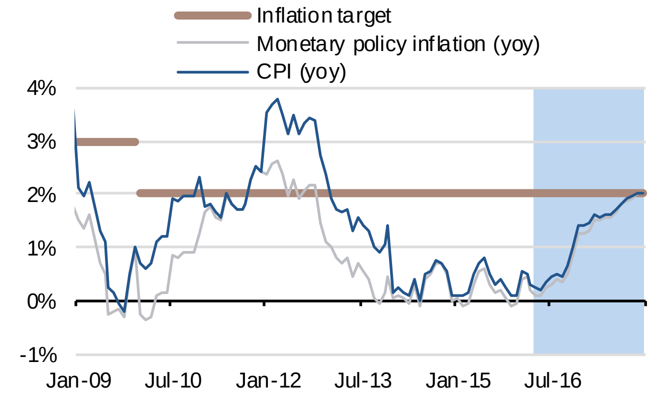
Core prices remained resilient in the first quarter when they grew 1.5% yoy again. Core inflation is supported by good wage growth and growing employment which increases the purchasing power of households. These developments are set to continue. The unemployment rate will continue decreasing although at slower pace. In contrast, wage growth will accelerate this year given the tightness on the labour market. Conversely, the USD/CZK exchange rate has started moving towards stronger koruna levels. This might cause the cheapening of some imported goods especially from Asia pushing core prices down.

Thus, we expect core inflation to rise only very slowly as it should print 1.6% on average this year while we expect only a mild acceleration next year.

Fuel prices bottomed out, but their growth to remain sluggish.

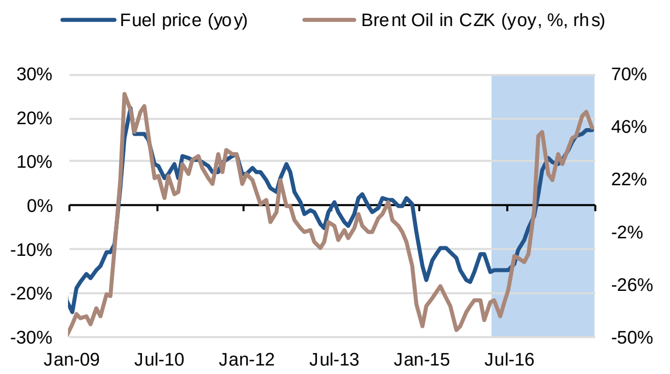
Fuel prices have bottomed out in the first quarter when they printed 2.5% qoq growth after three consecutive quarters of decline. Yet, we expected a more pronounced increase. Fuel prices were still 12.4% lower than last year. Since our last quarterly report, SG economists revised down their forecasts for oil prices. We do not expect fuel prices to grow significantly this year; however, the base effect will ensure that yoy fuel price inflation will continuously move into positive territory.

Inflation to remain subdued this year…



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

…as oil prices will remain low



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

Food prices have been surprising on the downside. Cheap fuel is partly to blame.

Food prices have continued surprising on the downside. In the first quarter, they slumped 1.2% and compared to the last year they are already 2.1% lower. Food prices are partly depressed by low transportation prices due to low fuel prices. We expect fuel prices to grow in the coming months while the same is true for food prices. The statistical base effect should ensure that yoy inflation will become positive at the turn of the year.

Administered prices have surprised by their relatively strong increase at the beginning of the year. The increase in electricity prices and very mild decrease in gas prices are to blame. Low commodity prices filter through to consumer prices only slowly. The main gas distributors promised that they would decrease their prices by about 10% in May. We take this information with a grain of salt as the biggest distributor reportedly cut prices at the beginning of the year by 10%, but the consumer prices showed only a 0.5% decrease. **Thus, we project a decline of only 1% in gas prices. We expect gas prices to fall further at the beginning of 2017.**

We expect the overall price index to grow continuously this year and yoy inflation to pick up at the end of the year thanks to base effects. However, the inflation target will not be hit this year. We will have to wait until autumn 2017 before inflation reaches the 2% target.

Brexit to dominate risks

We see risks from both external and domestic environments.

We have identified a bulk of risks to our forecast. **A prominent risk is Brexit.** We have devoted five special boxes to Brexit in this *Quarterly report*. At the end of this section, you will find a description of the full scale scenario for the Czech Republic in the event Britain leaves the EU. However, there are also positive risks stemming from the external environment. **Flash**

estimates of euro area GDP dynamics showed surprisingly strong growth at the beginning of the year. We are still waiting for the German figures, but if the dynamics keep surprising on the upside in the coming quarters as well, it would be a boost for the Czech economy. Risks are still stemming from the commodity markets. A sharp increase in commodity prices would be bad news for the Czech industrial sector, while they would provide a boost to inflation. The opposite is true for continuous weakness of commodity prices.

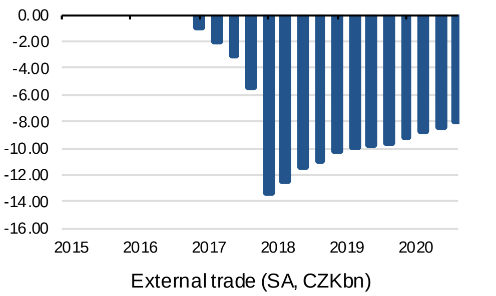
On the domestic front, there is a risk on both sides regarding investment. An early start to tapping EU funds from the new programming period would help the investment activity and create upside risk for the economic growth. Conversely, problems with EU funds are not rare in the Czech Republic, they may not get off to a full start right away. There is a lot of uncertainty regarding infrastructure projects given the problems with EIA. The risk again is on both sides. It is highly improbable, but the government might reach an agreement with the EU which could start funding projects with the former EIA, or the government could invest more from the budget. However, new assessments could also be delayed and the start of infrastructure projects could be delayed even more than we expect now.

BOX 4: Simulation of economic impact of Brexit on the Czech economy

In the Boxes above, we have discussed the direct effect of Brexit on the Czech economy through trade linkages. We have also described the indirect effect taking shape of a smaller inflow of EU funds, translating into lower investment. **Brexit does not influence only the Czech economy, but SG economists expect a resulting slowdown in the euro area amounting to 0.15-0.25pp over 10 years.** Thus external trade will suffer not only through its direct links to the UK but also from a slowdown in the euro area. We have summarised the effects in a simulation capturing all of the above-mentioned factors. The magnitudes of shocks used are rather high-end estimates, so the overall impact in our simulation describes the worst-case scenario.

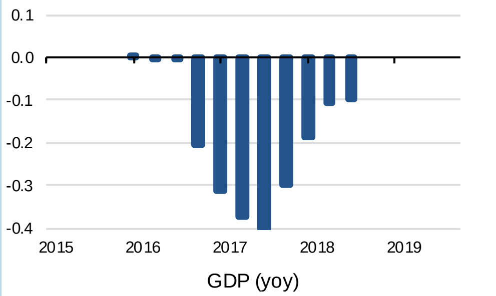
The initial and most severe shock would hit external trade, not only by limiting trade with the UK, but also a slowdown of the euro area would be to blame. The magnitude of the drop in the trade surplus roughly corresponds with the current positive balance the Czech Republic currently maintains in its trade with the UK. A decrease in trade, a slowdown of the main trading partners within the euro area and an overall decline in confidence would also drag down Czech GDP growth. GDP growth could be impeded by up to 0.4pp.

Significant drop in external trade …



Source: Economic & Strategy research, Komerční banka

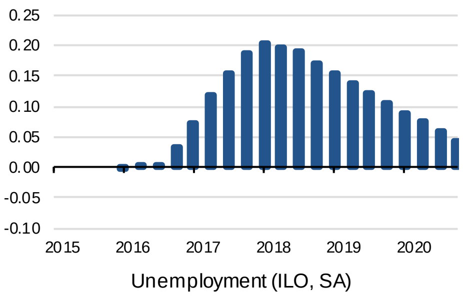
… contributes among other factors to GDP decline



Source: Economic & Strategy research, Komerční banka

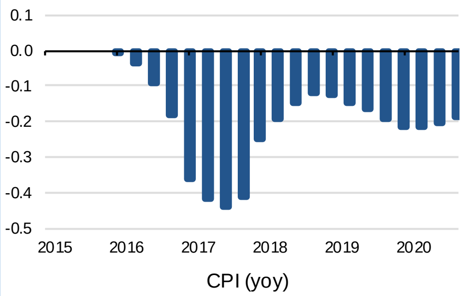
Lower economic growth would translate into milder job creation, which would be apparent in the unemployment rate dynamics. We expect companies would be cautious in hiring after uncertainty mounts during the exit. The effect on unemployment could amount up to 0.2pp. The economic slowdown, higher unemployment and lower external price pressures would also impact inflationary developments. Our projections show that inflation might decrease up to 0.4pp. **This would significantly influence the decisions of the CNB. Lower inflation would translate into postponement of the FX floor exit. Our alternative scenario suggests that if the worst-case scenario materialises, the bank board would not scrap the floor sooner than 2018.**

Economic slowdown to increase unemployment rate



Source: Economic & Strategy research, Komerční banka

Weaker inflationary pressures to dampen inflation



Source: Economic & Strategy research, Komerční banka

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Key economic indicators

	Q1 16	Q2 16	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17	2015	2016	2017	2018	2019	2020
GDP and its breakdown														
GDP (real, yoy)	2.9	2.2	1.5	1.7	2.2	2.4	2.5	2.9	**4.2**	**2.1**	**2.5**	**2.7**	**1.9**	**1.7**
Household consumption (real, yoy)	2.6	2.8	2.9	2.6	2.3	2.2	2.0	1.9	**2.9**	**2.7**	**2.1**	**1.5**	**1.1**	**1.3**
Government consumption (real, yoy)	4.2	3.2	2.4	3.9	2.5	3.0	2.0	1.8	**2.8**	**3.4**	**2.3**	**1.6**	**2.0**	**2.2**
Fixed investments (real, yoy)	2.7	-2.8	-3.9	-2.4	1.3	2.5	3.5	4.3	**7.4**	**-1.6**	**2.9**	**4.7**	**2.5**	**2.7**
Net exports (contribution to yoy)	0.9	1.5	1.0	0.1	-0.3	0.0	0.4	1.0	**-0.2**	**0.8**	**0.3**	**0.6**	**0.1**	**0.0**
Inventories (contribution to yoy)	-0.7	-0.6	-0.4	0.1	0.5	0.3	0.0	-0.2	**0.6**	**-0.4**	**0.2**	**-0.1**	**-0.1**	**-0.5**
Monthly data from the real economy														
Foreign trade (CZK bn) (*) (***)	132.0	129.0	116.0	103.4	112.1	112.4	116.2	112.4	**426.3**	**473.5**	**446.2**	**431.7**	**430.1**	**430.1**
Exports (nominal, yoy) (*)	4.0	6.3	4.8	3.2	7.6	4.5	8.1	10.1	**7.5**	**4.6**	**7.6**	**8.0**	**3.5**	**1.0**
Imports (nominal, yoy) (*)	1.0	5.0	3.9	5.1	10.9	6.9	9.0	10.1	**8.6**	**3.7**	**9.2**	**9.2**	**3.8**	**1.1**
Industrial production (real, yoy)	2.7	5.7	2.3	4.3	6.3	2.6	5.7	7.4	**4.4**	**3.7**	**5.5**	**6.9**	**2.8**	**0.4**
Construction output (real, yoy)	-7.0	-2.7	-3.2	1.6	2.5	1.5	4.0	4.4	**7.7**	**-2.8**	**3.1**	**4.1**	**2.6**	**1.7**
Retail sales (real, yoy)	6.8	5.8	5.7	4.5	3.4	3.1	2.9	2.7	**5.8**	**5.7**	**3.0**	**2.7**	**2.3**	**2.1**
Labour market														
Wages (nominal, yoy)	4.9	3.6	3.5	3.5	3.7	3.5	3.4	3.4	**3.3**	**3.9**	**3.5**	**3.2**	**2.5**	**2.9**
Wages (real, yoy)	4.4	3.3	3.1	2.4	2.2	1.8	1.4	1.3	**3.0**	**3.3**	**1.7**	**1.0**	**0.7**	**1.2**
Unemployment rate (MLSA)	6.1	5.0	5.0	5.4	5.6	4.8	4.8	5.3	**6.4**	**5.4**	**5.1**	**4.8**	**4.6**	**4.5**
Unemployment rate (ILO 15+)	4.6	4.2	4.3	4.1	4.3	4.0	4.0	3.9	**5.1**	**4.3**	**4.1**	**3.8**	**3.6**	**3.5**
Employment (ILO 15+, yoy)	1.1	1.0	0.9	0.7	0.4	0.1	0.2	0.2	**1.4**	**0.9**	**0.2**	**0.3**	**0.2**	**0.1**
Consumer and producer prices														
CPI Inflation (yoy)	0.5	0.2	0.4	1.1	1.5	1.6	1.9	2.1	**0.3**	**0.6**	**1.8**	**2.2**	**1.8**	**1.6**
Taxes (contribution to yoy inflation)	0.1	0.2	0.2	0.2	0.1	0.0	0.0	0.0	**0.2**	**0.2**	**0.0**	**0.0**	**0.0**	**0.0**
Core inflation (yoy) (**)	1.5	1.6	1.5	1.6	1.6	1.7	1.8	2.0	**1.3**	**1.6**	**1.8**	**2.2**	**1.9**	**1.6**
Food prices (yoy) (**)	-1.7	-2.1	-1.4	-0.2	1.6	1.9	2.1	2.1	**-1.1**	**-1.3**	**1.9**	**1.6**	**1.6**	**1.5**
Fuel prices (yoy) (**)	-12.4	-14.4	-13.1	-4.9	6.3	8.1	12.7	16.5	**-13.3**	**-11.2**	**10.9**	**5.9**	**-3.8**	**-1.0**
Regulated prices (yoy) (**)	0.7	0.4	0.4	0.5	-1.2	-1.0	-0.3	-0.4	**0.2**	**0.5**	**-0.7**	**2.5**	**2.6**	**2.5**
Producer prices (yoy)	-4.0	-4.6	-2.8	-1.1	2.3	3.2	3.7	4.3	**-3.2**	**-3.1**	**3.4**	**3.9**	**1.6**	**1.7**
Financial variables														
2W Repo (average)	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	**0.05**	**0.05**	**0.05**	**0.20**	**0.97**	**1.58**
3M PRIBOR (average)	0.29	0.29	0.29	0.29	0.29	0.29	0.14	0.29	**0.31**	**0.29**	**0.25**	**0.44**	**1.22**	**1.83**
EUR/CZK (average)	27.04	27.02	27.00	27.00	27.11	27.11	26.88	26.75	**27.3**	**27.0**	**27.0**	**25.7**	**24.7**	**24.1**
USD/CZK (average)	24.50	25.02	25.23	25.71	25.82	25.57	25.36	25.00	**24.6**	**25.1**	**25.4**	**23.8**	**21.0**	**19.8**
External environment														
GDP in EMU (real, yoy)	1.3	1.2	1.3	1.4	1.5	1.6	1.5	1.4	**1.5**	**1.3**	**1.5**	**1.4**	**1.0**	**1.0**
GDP in Germany (real, yoy)	1.2	1.1	1.3	1.5	1.6	1.7	1.6	1.5	**1.5**	**1.3**	**1.6**	**1.4**	**1.0**	**0.6**
CPI in EMU (real, yoy)	0.9	0.8	1.2	1.4	1.5	1.5	1.5	1.5	**0.1**	**1.1**	**1.5**	**1.4**	**1.5**	**1.6**
Brent oil price (USD/brl, average)	35.2	40.0	40.0	40.0	45.0	50.0	55.0	60.0	**53.4**	**38.8**	**52.5**	**65.0**	**70.0**	**75.0**
EURIBOR 1Y (average)	0.01	-0.01	-0.01	-0.01	-0.01	-0.01	-0.01	-0.01	**0.17**	**0.00**	**-0.01**	**-0.01**	**0.00**	**0.16**
EUR/USD (average)	1.10	1.08	1.07	1.05	1.05	1.06	1.06	1.07	**1.11**	**1.08**	**1.06**	**1.08**	**1.18**	**1.22**

Source: Economic & Strategy Research, Komerční banka
Note: (*) foreign trade according to cross border statistics;
(**) these parts of inflation are adjusted for the primary effect of indirect tax changes;
(***) the quarterly data are seasonally adjusted.

CNB Focus

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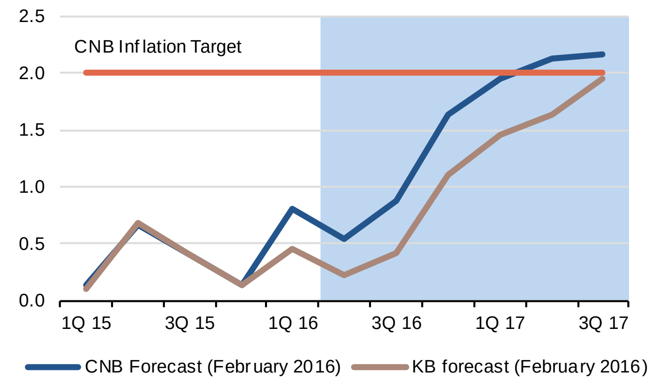
Low inflation to lead to exit postponement

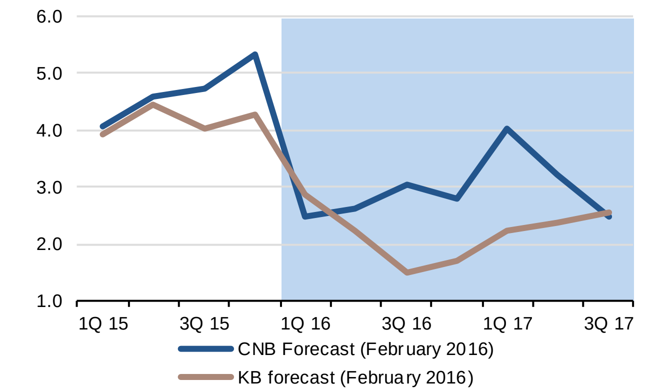
We have revised our inflationary outlook downwards as we expect further pressures on price dynamics. As a result, we have also revised our call on the FX commitment. We believe it will be scrapped in Q3 17. Our call has now moved beyond the CNB's board guidance which sees the probable end of the FX commitment "nearer to mid-2017". Although we see a minor risk that the floor will be scrapped earlier, the risks are tilted toward an even later exit. Moreover, the intervention regime will not end when the floor is scrapped. CNB will remain present on the market to limit exchange rate volatility.

Inflation outlook



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

GDP outlook



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

At its last meeting, the CNB board made its view on the timing of the FX commitment more precise. Originally, the bank board saw the end of the FX commitment in the first half of next year, whereas the last statement sees the probable exit closer to mid-2017. Central bankers made this clarification based on the downside risks to their forecasts:

- lower observed domestic and foreign inflation
- slower observed wage growth
- the short-term outlook for food prices

Moreover, the hot candidate for the governor's seat, Jiří Rusnok, recently mentioned that the odds for an exit later than Q2 17 are, in his personal view, 60-40. On this occasion, we have to agree as our revised inflationary outlook assumes the price dynamic to hit the target later than previously expected. Thus, we have changed our call and we see the end of the FX commitment in Q3 17.

Exit risks on both sides

We consider the scenario that the FX commitment would be scrapped this year as virtually impossible, although according to a Reuters poll, there are analysts who still expect the end of the FX floor by December. Most analysts are sticking to the current CNB view. We consider the risk of exit in H1 17 as only minor (20% probability). This is partly due to changes in the bank board, with four new members (including the governor) to be appointed at the beginning of 2017 by the current president who is known for his aversion to the artificial devaluation of EUR/CZK. Another factor now feeding into our analysis is commodity prices, which may increase more sharply pulling overall inflation up and pushing the CNB into action.

We consider the risk of a later exit to be more pronounced, at 30%. Low commodity prices are only slowly being passed onto final consumers and so the inflation rate is to remain under pressure next year also. In addition, if the weakness in oil prices unexpectedly persists through 2017, the inflation rate would remain muted and the FX floor would remain in place longer.

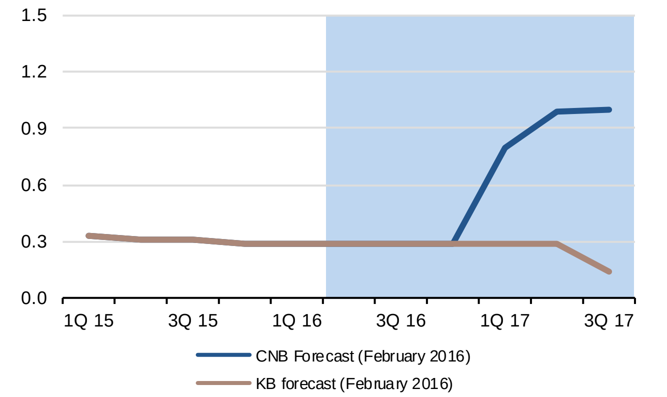
Intervention regime will survive the end of FX floor

We believe that even after the CNB stops defending the EURCZK 27 level, it will stay on the FX market do defend excessive volatility. Our view is in line with the bank board members' statements that the CNB will not allow either a strong appreciation of the currency nor will it stand idly by when the currency is at risk of depreciating, for example. The interventions should decline progressively as most of the speculative positions are closed. We expect that in 2018 the CNB will withdraw from the market and the exchange rate will fully reflect market forces

CNB to intervene rather than heading into negative territory; the exit time is an exception

Negative rates were given plenty of discussion time at the last two monetary policy meetings. We have outlined the case for negative rates in a special report[2]. The bottom line is that we believe the bank board sees more costs to this measure than benefits when used over a longer period. We believe therefore that the CNB will opt to absorb liquidity with outright interventions rather than deter the flows with negative rates. Moreover, the recent volumes the EUR CNB was forced to buy with new liquidity were rather small. According to Governor Singer, they came mostly from real economic flows rather than as a result of speculation on exit. As stated by the bank board members, the CNB is prepared to accumulate an unlimited volume of reserves. This is a clearly exaggerated statement and **we assume therefore that to limit volatility and ensure a smooth exit process, the CNB will actually cut the rates into the negative for a short term period around the end of the FX floor.** So that the cut is effective, the CNB will have to cut the rates deep into negative territory (-0.5%) to deter the hot money inflow. To avoid collateral damage to the banking sector, the CNB will adopt a two-tier system. Thus, the banks would be allowed to put certain volumes of liquidity into a facility with non-negative rates.

The rates should decrease during exit



Source: Economic & Strategy Research, Komercni banka, CNB, Bloomberg

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[2] http://trading.kb.cz//api/file/147049?hash=3104d635f74f6acd2ff4cc3b4dd523c7

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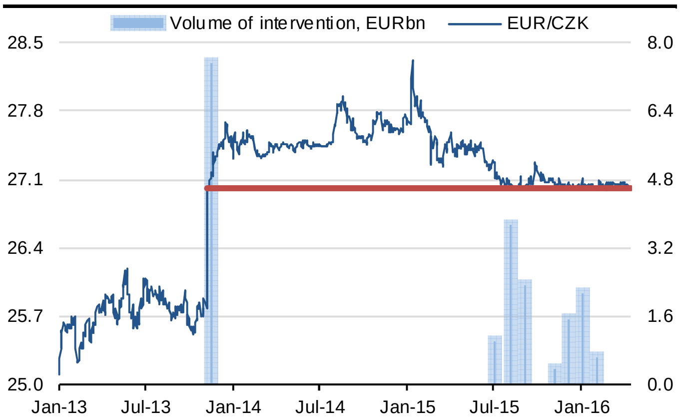
Czech FX Market

FX floor to be removed in Q317 and intervention regime in Q118

EUR/CZK has been close to the floor since the middle of last year

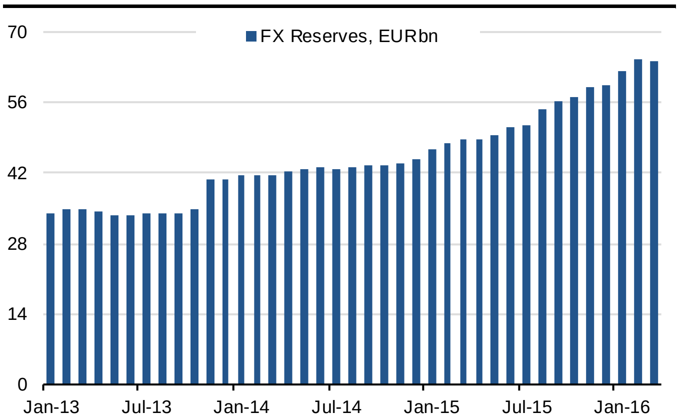
With the CNB automatically intervening in the FX market to prevent the koruna from appreciating below the EUR/CZK 27 floor, official FX reserves have been increasing, reaching EUR64.2bn in March (38.4% of GDP). The volume of FX reserves does not limit the Czech central bank in its intervention activity, and it bought almost EUR12bn from July 2015 to February 2016.

EUR/CZK exchange rate development and intervention volumes



Source: Economic & Strategy research, Komerční banka, CNB, Datastream

CNB FX reserves development

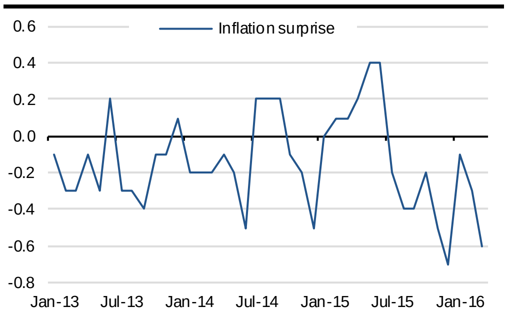


Source: Economic & Strategy research, Komerční banka, CNB

Export performance of Czech economy supports the koruna

Favourable macroeconomic indicators and real economic flows favour the Czech currency. The Czech economy has been growing, driven by industrial production. Export activity is solid, and the current account of the balance of payments is in very good shape. The 12-month cumulative current account surplus reached 1.2% of GDP in February, and part of the EUR volumes generated by the economy have finally ended up in the CNB's FX reserves. Nevertheless, central bank intervention has been gradually diminishing since the start of this year. While the bank bought EUR1.5bn in January, the figure fell to just EUR0.6bn in February. Figures for March are not yet available, but intervention was almost non-existent in the month, according to our estimates. So, how can we explain the contradiction between the increasing current account surplus and decreasing central bank intervention? We think there has been a squeeze of speculative positions since the CNB changed its view at the start of the year and envisaged removing the FX floor in H117. According to some central bankers, it could happen toward mid-2017. In addition, with inflation lower than expected, central bankers are not motivated to remove the floor.

Inflation surprises from CNB perspective



Note: Inflation surprise id defined as realized inflation minus inflation forecasted by CNB
Source: Economic & Strategy research, Komerční banka, CNB, CSO

We push our forecast for FX floor exit out to Q317

Koruna appreciation pressure should ease in the next few months, but pronounced depreciation is unlikely

Only moderate appreciation pressure on the Czech currency is likely in the upcoming months. Our short-term inflation outlook shows that year-on-year consumer price growth will decelerate further. For May, we expect a print of just 0.2% yoy. In addition, the second quarter is typically influenced by dividend outflows. Last but not least, the upcoming UK referendum on whether or not to leave the EU will also reduce CZK appreciation pressures . We discuss the consequences of Brexit on the FX market in the box below.

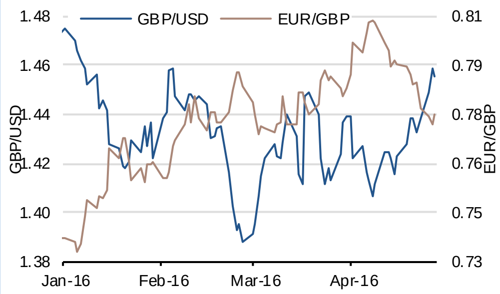
BOX 5: Possible impact of Brexit on exchange rates

The period surrounding the referendum will see dramatically increased volatility in FX markets. The direction of FX movements will strictly depend on the outcome of the vote. Stronger swings can be expected as the referendum approaches. 3M GBP/USD exchange rate volatility has been increasing since mid-December 2015, jumping dramatically in the second half of March given that the three-month period starting then encompasses the referendum date.

GBP/USD 3M implied volatility

Source: Bloomberg, Economic & Strategy research, Komerční banka

GBP/USD and EUR/GBP performance YTD



Source: Bloomberg, Economic & Strategy research, Komerční banka

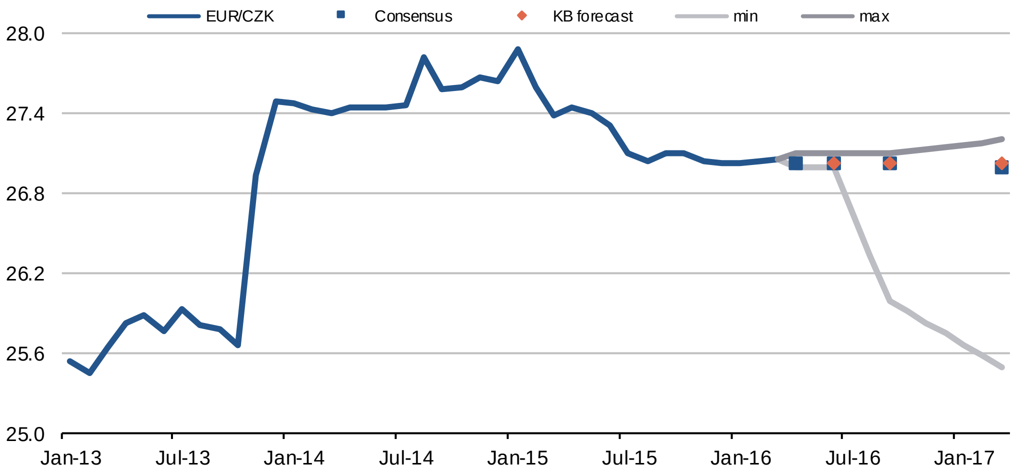
As the risk of Brexit is not insignificant, the British currency has come under selling pressure. Sterling has lost 6.5% against the euro since the start of the year to mid-April. The loss was not as pronounced against the greenback thanks mainly to euro strength against the dollar after the ECB and Fed meetings in March. Given that the impact in terms of reducing long-term growth potential would be considerable not only for the UK but also the EU, the winner in the event of Brexit would be the US dollar. As a consequence, GBP/USD could fall toward 1.30 and EUR/USD to below parity. On the other hand, if the UK stays in the EU, it would be reasonable to expect the GBP to largely reverse its accumulated losses since the beginning of the year.

Brexit would be negative for Central European FX markets. This is due to direct trade links between Central European countries and the UK as well as indirect links, mainly via Germany. The financial markets channel would also play a role, with regional financial markets influenced by volatility on global financial markets. As a result, CE currencies would probably temporarily lose their regional safe-haven status. The most vulnerable currency is the Polish zloty, while conversely the Czech koruna probably wouldn't depreciate significantly against the euro. The move of the exit from the intervention regime far beyond Q3 17 would be a more likely scenario in the event of Brexit. Central European currencies would be more affected vis-à-vis the USD. If EUR/USD were to fall below parity, it would mean a rise in USD/CZK above 27.00.

Low inflation will not allow an exit earlier than Q317

A downward revision to our long-term inflation outlook has led us to see exit from the FX floor delayed to Q317. it seems unlikely that the Czech currency will significantly depreciate before exit from the FX floor. Significant depreciation would happen only in the event of a significant negative shock from abroad translating into strong deflationary pressure. The other potential trigger is an increase in risk aversion on global financial markets.

EUR/CZK – market consensus, April 2016



Source: Economic & Strategy research, Komerční banka, CNB, Reuters

Greater FX volatility possible after floor exit due to speculative flows

CNB will aim to prevent elevated exchange rate volatility after floor exit

The exit from the FX floor will not mean the end of the intervention regime. As Czech central bankers have repeated several times, they will not allow quick CZK appreciation after the exit. Thus, we expect the CNB to continue intervening to eliminate the risk of increased FX volatility. However, the evolution of the exchange rate will depend on speculative flows. In the event of huge speculation on CZK appreciation, the koruna could finally depreciate as a result of profit-taking and squeezing of positions. The CNB undoubtedly has almost unlimited ammunition to prevent excessive appreciation, and thanks to robust and rising FX reserves, it also has enough power to prevent depreciation above EUR/CZK 28.00). In our opinion, the central bank will not allow EUR/CZK to fall below 26.50 in the quarter after the exit or below 26.00 in the subsequent quarter. As soon as the situation calms down, after two quarters in our view, the CNB will retreat from interventions.

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EUR/CZK technical analysis

Sideways configuration persists, 27 is a key support

EUR/CZK has been undergoing a steady retracement after forming shooting star at multiyear channel resistance, which is currently at (28.80). The pair is close to support levels of 27.00, the 50% retracement from October 2013 lows. Monthly MACD is closing in on the zero mark suggesting 27.00 as a key level which will dictate if next level of down move unfolds.

If we drop down to weekly chart, the pair is evolving within a sideways configuration. A break below 27.00 will lead to a deeper correction towards 26.63 and even towards 2011 highs of 26.15. Short term recovery, if any, should find resistance near September highs and graphical levels of 27.25. Only a move beyond this will signal possibility of a meaningful pullback.

EUR/CZK, monthly chart.

EUR/CZK, weekly chart.

Source: SG Cross Asset Research/Technical Analysis

Important Disclaimer: The recommendations in the part Technical analysis is based only on analytical methods of technical analysis and may be different from the fundamental opinion of KB (or SG) presented in other part s of this documents or of other documents of KB (or SG).

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Czech Government Bond and IRS Markets

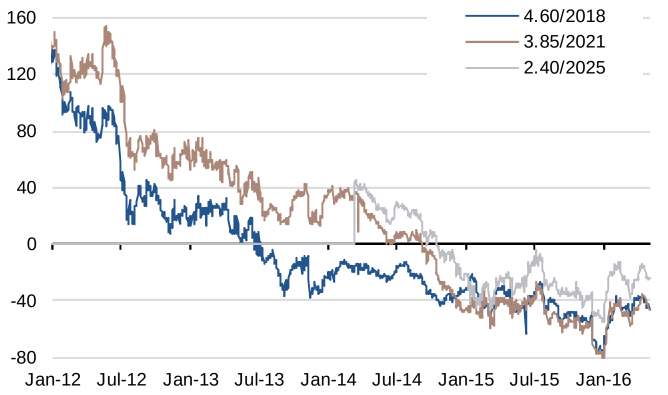
Low-yield environment to prevail in 2016

The Czech government bond curve bull-flattened in mid-March to levels not seen in a year, on the back of global risk-off trends and a dropout of supply in February and March (as the government enjoyed surplus liquidity and feared the a potential CNB rate cut into negative territory). In mid-March, however, CZGB yields started to rise led by the long end of the curve, with renewed primary market auctions and a swing in global market developments.

CZGB yields, Bloomberg generic (%)

Source: Bloomberg, Economic & Strategy Research, Komerční banka

ASW spreads (bp)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

Revising 2016 supply: lower borrowing needs but higher primary issuance

As stated in the subsection on fiscal policy, we have cut the outlook for this year's central government budget deficit from CZK70bn (as per February's *Czech Economic Outlook*) to just CZK35bn. **Mechanically, the gross borrowing needs are thus set to reach CZK308.3bn in 2016**. In year-on-year terms, borrowing needs are to decline by roughly CZK3bn.

On the financing side, we have reduced our forecast for T-bill sales but have increased our expectations for CZGB issuance. The Finance Ministry is likely to focus on placing the short-end zero-coupon bonds, which attract sizeable demand from EUR-funded investors. Year-to-date, the MoF has sold 62% of bonds in 1-5 year maturities. The limit for issuance of CZGBs with a remaining maturity of up to 5Y was set at CZK150bn for 2016, which would constitute 68% of CZK220bn – our call for total CZGB issuance this year. We thus expect the MoF to continue focusing on short-end paper, utilising the maximum CZK150bn limit.

2016 gross borrowing needs and financing, CZKbn

	MinFin Dec	KB Apr
Borrowing needs		
Budget deficit	70.0	35.0
Buybacks of CZGBs	-	0.0
Redemption of CZGBs	155.8	142.6
Redemption of Eurobonds		12.5
Redemption of retail bonds	30.0	30.0
Redemption of T-bills	84.4	84.4
Redemption of other money market instruments	-	2.2
Redemption of EIB loans	1.7	1.7
Total	**342.0**	**308.3**

Financing	
Gross T-bill issuance	50.0
Other money market instruments	0.0
Gross CZGB issuance (in auctions)	220.0
Tap sales	13.3
Gross issuance of eurobonds	0.0
Gross issuance of retail bonds	0.0
EIB loans	0.0
Tapping of financial reserve	25.0
Others	0.0
Total financing	**308.3**
Net CZGB issuance	*77.5*

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

Also, we assume the MoF will again tap its liquidity reserve, but only by a minor amount of CZK25bn.

Since the start of the year, the MoF has covered around 31% of the expected gross borrowing needs net of the liquidity tap, according to our calculations.

Czech government bond yields

The CZGB yield curve is set to remain low and flat for the remainder of the year, according to our outlook.

The CZGB yield curve is set to remain low and flat for the remainder of the year, according to our outlook. The SG strategists expect Bund yields to remain close to zero until Q3 16, with only a slight increase in the final months of the year. We expect inflation to remain muted for longer vis-á-vis our previous forecast, resulting in lower pressures from the real-yield perspective. Finally, demand by EUR-funded investors (who benefit from the negative XCCY swaps) for short-end bonds should sufficiently cover their supply, while domestic buyers are set to concentrate only on the belly and mainly the long end. This should result in excess demand, and we thus look for a richening of bonds in relative terms versus swaps. Also, Q4 is set to see higher demand from domestic financial institutions diverting deposits (subject to annual contributions into the new crisis-resolution fund) into bonds and other instruments.

CZGB yield forecast

	Q2 16f	Q3 16f	Q4 16f	Q1 17f	Q2 17f	Q3 17f
2y CZGB yield (%)	-0.15	-0.10	-0.05	-0.15	-0.15	0.00
10y CZGB yield (%)	0.35	0.45	0.60	0.70	0.80	1.05
10y CZGB ASW (bp)	-25	-30	-40	-40	-45	-30

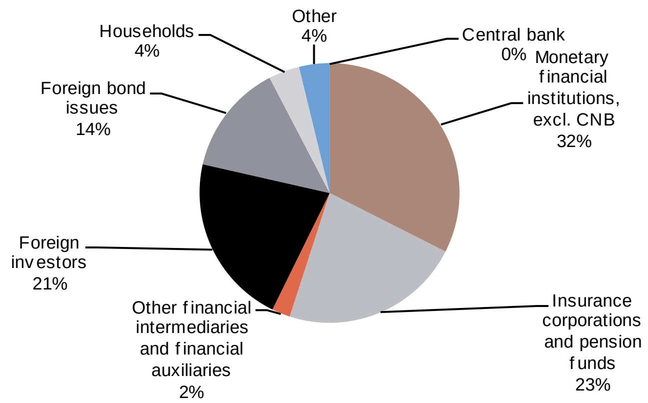
Source: Economic & Strategy Research, Komerční banka

Non-resident holdings at new maximum

As we noted in the previous *Czech Economic Outlook*, non-resident holdings have been on a massive upward trend since mid-2015. As of end-March, non-residents possessed 24.7% of CZK-denominated debt securities (T-bills and bonds), up from 17.1% one year earlier. With the expected supply on the short-end of the curve aiming to satisfy non-resident demand, foreign holdings are set to expand further in the remainder of 2016, likely reaching as much as 30% of CZK-denominated debt.

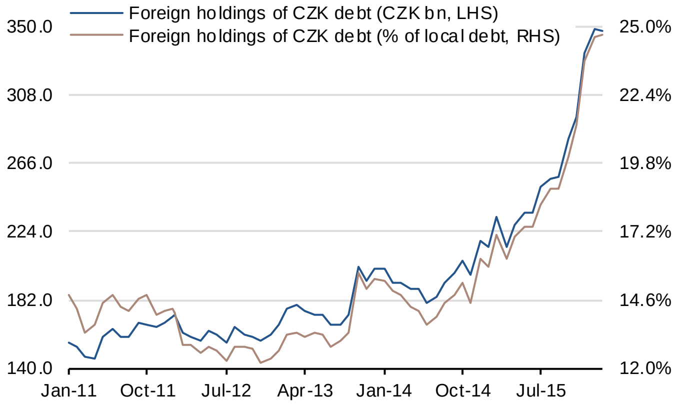
As we stated in the February's report and above, non-resident holdings concentrate on the short end of the curve. At the turn of 2017/2018, zero-coupon bonds worth a total CZK130bn will mature, together with almost CZK50bn (as of today) of another paper. **The need to roll over the maturing debt will result in a cheapening of bonds during the period, in our view**, but we expect no major market stress.

Holdings of Czech Republic's debt securities, end-March 2016



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

Share of foreign holdings at highest levels in data series history

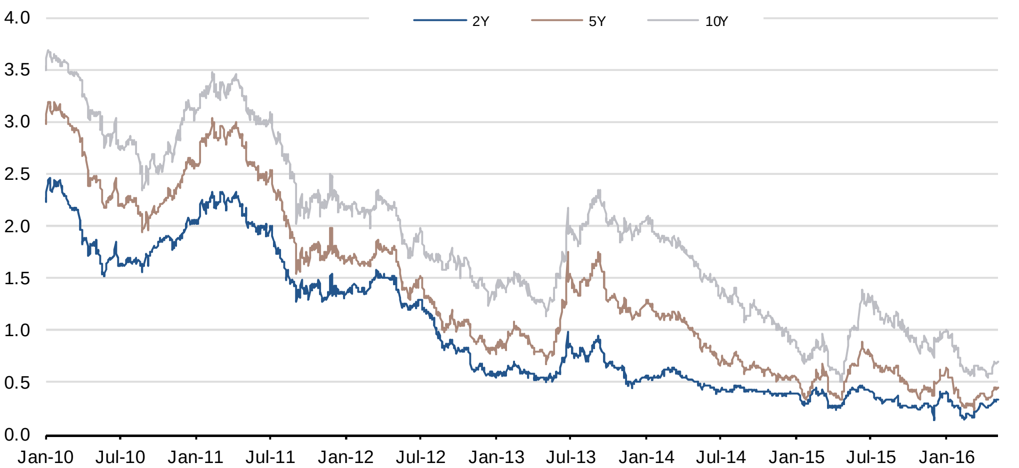


Source: Finance Ministry, Economic & Strategy Research, Komerční banka

Risks: pre-financing for 2017 – a risk of faster steepening

The Finance Ministry has stated that it is considering utilising the current low-yield environment for pre-financing 2017 borrowing needs. In our core scenario, we view this as unlikely due to the relatively large needs and level of supply in the year 2016 alone. However, if the MoF decides to boost supply further, it would probably place more bonds in the belly and the long end of the curve, in our view, which would most likely lead to **faster bear-steepening of the curve**.

Recent developments of CZK IRS (%)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

CZK interest rate swaps

Koruna interest rates swaps fell to their lowest levels in a year during Q1 16, driven by risk-off global developments, low domestic inflation, and the threat of a CNB cut into negative territory. Since the start of April, however, the curve started to re-steepen slowly, driven by developments on its EUR counterpart.

We keep our forecast that the short end of the curve should remain at or near the currently very low levels until at least the exit from the FX floor (Q3 17 in our view). **The long end of the curve is expected to stay virtually flat through Q3 16**, with an increase in Q4 16 and thereafter on the back of rising inflation. However, based on the very modest expectations for the EUR curve, our call is for only a relatively mild increase in CZK swaps with the 10Y tenor not reaching 1.50% before end-2017.

CZK IRS outlook (%)

	Q2 16f	Q3 16f	Q4 16f	Q1 17f	Q2 17f	Q3 17f
2Y	0.25	0.30	0.35	0.35	0.45	0.40
10Y	0.75	1.00	1.10	1.25	1.35	1.45

Source: Economic & Strategy Research, Komerční banka

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Key Economic Indicators

Macroeconomic indicators – long-term outlook

		2013	2014	2015	2016	2017	2018	2019	2020
GDP	real, %	-0.5	2.0	4.2	2.1	2.5	2.7	1.9	1.7
Inflation	average, %	1.4	0.4	0.3	0.6	1.8	2.2	1.8	1.6
Current account	% of GDP	-0.5	0.2	0.9	1.4	-0.4	-0.1	-0.1	-0.2
3M PRIBOR	average, %	0.5	0.4	0.3	0.3	0.3	0.4	1.2	1.8
EUR/CZK	average	25.98	27.53	27.28	27.01	26.91	25.67	24.74	24.07
USD/CZK	average	19.56	20.75	24.59	25.12	25.44	23.83	21.04	19.82

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

FX & interest-rate outlook

		2-Mar-2016	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
EUR/CZK	end of period	27.04	27.0	27.0	27.0	27.0	27.0
USD/EUR	end of period	1.153	1.08	1.07	1.05	1.05	1.06
CZK/USD	end of period	23.44	25.0	25.2	25.7	25.7	25.5
3M PRIBOR	end of period	0.29	0.29	0.29	0.29	0.29	0.29
10Y IRS	end of period	0.69	0.60	0.75	1.00	1.25	1.45

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

Monthly macroeconomic data

		VII-15	VIII-15	IX-15	X-15	XI-15	XII-15	I-16	II-16	III-16
Inflation (CPI)	%, m/m	-0.1	-0.2	-0.2	0.0	-0.4	-0.1	0.6	0.1	-0.1
Inflation (CPI)	%, yoy	0.5	0.3	0.4	0.2	0.1	0.1	0.6	0.5	0.3
Producer prices (PPI)	%, m/m	-0.4	-0.8	-0.7	-0.2	-0.4	-0.4	-1.6	-0.6	0.0
Producer prices (PPI)	%, yoy	-3.0	-3.7	-4.2	-3.9	-3.7	-2.9	-3.4	-4.0	-4.5
Unemployment rate	% (MLSA)	6.3	6.2	6.1	5.9	5.9	6.2	6.4	6.3	6.1
Industrial sales	%, yoy, s.p.	2.3	1.4	-0.7	2.0	1.7	-1.4	-1.7	2.8	n.a.
Industrial production	%, yoy, s.p.	4.7	7.0	1.0	3.8	5.7	0.7	1.3	5.6	n.a.
Construction output	%, yoy, s.p.	12.8	6.6	3.5	-0.8	2.4	3.3	-10.6	-2.3	n.a.
Retail sales	%, yoy, s.p.	6.0	4.5	7.0	7.4	8.7	8.7	5.4	10.5	n.a.
External trade	CZK bn (national met.)	5.6	-2.8	16.9	15.8	11.2	0.4	25.1	22.0	n.a.
Current account	CZK bn	-28.1	-4.5	-3.0	5.8	4.9	3.9	32.4	44.0	n.a.
Financial account	CZK bn	-5.2	-0.1	-1.6	-13.3	14.7	40.8	26.5	54.4	n.a.
M2 growth	%. yoy	6.5	6.4	7.7	8.2	8.6	6.9	7.9	7.6	n.a.
State budget	CZK bn (YTD cum.)	25.7	19.0	-2.8	-29.1	-29.5	-62.8	45.9	27.7	43.6
PRIBOR 3M	%, average	0.31	0.31	0.30	0.29	0.29	0.29	0.29	0.28	0.29
EUR/CZK	average	27.10	27.04	27.11	27.11	27.04	27.03	27.03	27.04	27.05
USD/CZK	average	24.64	24.27	24.13	24.16	25.21	24.80	24.88	24.35	24.28

Source: CSO, CNB, MF, MLSA. Economic & Strategy Research, Komerční banka

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