

Quarterly report

Czech Economic Outlook

The Bogey of Stagflation



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■ **Shallow recession in base-case scenario** We expect the Czech economy to go through a mild recession in 2022 due to the war in Ukraine. Reaching the pre-pandemic GDP level is thus likely to be postponed by about a year until 1H23.

■ **Inflation should be close to peak** Inflation is showing no signs of slowing, but we think it will soon do so. We expect inflation to average 12.6% this year and remain high at 7.2% next year.

■ **CNB likely to raise interest rates to 5.5%** We expect this peak to be reached in May. Monetary policy risks are now more balanced. We do not expect the CNB to start cutting rates back to the policy neutral level of 3% before the start of 2023.

■ **Yields close to peak** The shorter end of the curve in particular may soon begin to gradually decline given the prospect of CNB rates starting to return to neutral levels over the next year and this year's slowdown in economic growth.

■ **Koruna likely to appreciate slightly in 2022** The interest rate differential will support the koruna in the short term, partly offset by the US dollar strength and deteriorating exports. Overall, we expect EURCZK to reach 24.20 at end-2022.



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The stagflation bogeyman is here

When preparing the last edition of the *Czech Economic Outlook* none of us could have imagined what was to take place just a few weeks later. Our January report waxed lyrical about the *Taming the Inflation Shrew* and the recovery of the Czech economy to pre-pandemic levels. Unfortunately, **the war in Ukraine has changed everything**. First of all, it has brought immeasurable suffering that none of us had ever expected to see in Europe in the 21st century. However, the war is of course also having economic consequences.

Basically, all the risks flagged in our January macroeconomic forecast have materialised

Right up until the last moment we did not believe that the geopolitical situation would escalate to the point of arms being fired and human lives being lost. **The war has caused the materialisation of most of the economic risks** we warned against in the January edition of the *Czech Economic Outlook*, although we did not expect warfare as such. The first signs of improvement in the supply chain situation have vanished, as Russia and Ukraine were mainly part of the initial stages of the global production chain. While problems with the supply of chips to the automotive industry have subsided, a new problem has emerged in the form of a shortage of cable assemblies, of which Ukraine is a major producer. Consequently, an additional inflation shock, i.e. a massive hike in prices of energy and agrarian commodities, has exacerbated the inflationary pressures that first arose in the autumn of 2021 as a result of the production chain disruption. The risk of significant dollar rate hikes and dollar strengthening is also materialising, while the war in Ukraine is undermining the Czech cabinet's determination to work on fiscal consolidation. Equally importantly, the pandemic risk is returning, not in Czech Republic or Europe, but in China and other Asian economies. For European producers (among others), the zero tolerance policy and lockdowns imposed across whole Chinese cities and regions complete the picture in terms of component shortages.

Commodity prices are skyrocketing

Commodity	Price hikes since the beginning of 2022 (in CZK)
Oil (Brent)	+36.1%
Gas	+33.0%
Electricity	+71.6%
Nickel	+65.7%
Wheat	+43.1%

Source: Bloomberg, Economic & Strategy Research, Komerční banka
Note: as of 25 April 2022

Commodity...



... and food prices are rising globally



Supply chain issues remain ongoing

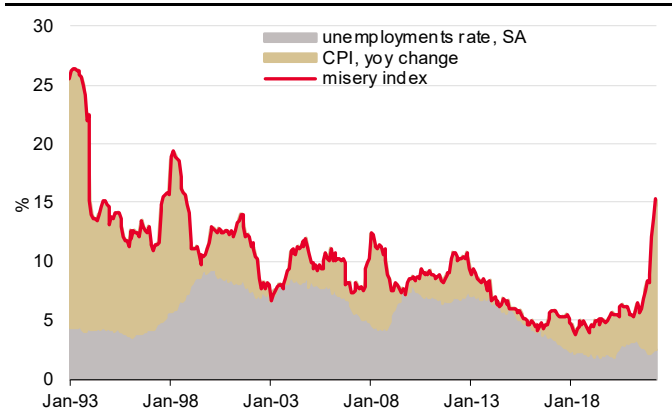


Source: Bloomberg, FAO, Macrobond, Economic & Strategy Research, Komerční banka

Stagflation is here but fortunately, the labour market is strong

The war in Ukraine has raised the spectre of stagflation as a result of high inflation and economic stagnation. Typical demand-pull inflation is driven by the rapid growth and overheating of the economy. In the case of stagflation, a rapid surge in consumer prices is caused by a supply shock, typically higher prices of key commodities, such as crude oil. It is no coincidence that

Only the inflation component of the misery index is deteriorating



Source: Economic & Strategy Research, Komerční banka, Macrobond

the term 'stagflation' dates back to the oil crisis of the 1970s. Weakening purchasing power significantly limits aggregate demand and the economy falls into stagnation or, in the worst case scenario, recession. This may result in a dramatic rise in the unemployment rate, which would further exacerbate the situation in the real economy. The combination of a high unemployment rate and inflation is what impacts households. The misery index, which in fact also originates from the 1970s stagflation episode, shows the overall negative effect in a simplified manner.

Inflation is not demand-pull only; it also has a cost-push component

Nevertheless, from the perspective of both the global economy and the Czech economy, we would not describe the current situation as genuine stagflation. While the origins of the Czech inflation certainly lie on the supply side, i.e. imports of expensive energy, demand-pull inflation makes up a considerable portion, as described in more detail in our previous *Czech Economic Outlook* editorials. And so the country's high rate of inflation is jeopardising households' and firms' real purchasing power while rising prices of essential goods, such as energy and food, are undermining demand for less essential products. This will, naturally, slow down the country's economic growth. We therefore forecast the Czech economy to continue to grow, but at a much slower rate this year. We expect the economy to grow by 1.8% this year and 2.8% next year, which implies that the Czech Republic won't return to its pre-pandemic level of growth until mid-2023.

There are enough vacancies, including for Ukrainian refugees

The situation is completely different in the labour market which has clearly returned to its overheated pre-pandemic situation. In addition to difficulties caused by shortages and/or prices of materials, companies in various sectors are citing scarcity of labour as one of the main barriers to further growth. From this perspective we therefore do not expect the inflow of Ukrainian refugees to present a major issue for the Czech labour market. In addition, Czech employers have considerable experience with Ukrainian employees, who for many years made up the second-largest group of foreign employees in the country, after Slovak employees. The immigration wave triggered by the war has already catapulted them into first place. The major influx of refugees will probably weaken public finances but, according to our estimates, the impact should be manageable at a few tens of billions of koruna. The reason for this is that when inflation is factored in, the high nominal growth in the Czech economy should underpin tax revenue.

Persistent vacancy overhang in the Czech labour market



Source: MLSA, Economic & Strategic research, Komerční banka

Inflation expectations are rising dramatically



Source: CNB, Economic & Strategy Research, Komerční banka

The CR's dependence on Russian gas imports is a huge problem

From the perspective of the Czech economy, the skyrocketing gas prices and the reliability of gas supply have the most dramatic impact. As one of the most industrialised countries in Europe, the Czech Republic is extremely dependent on Russian gas. Furthermore, end consumers are yet to experience the heaviest impact on prices. The war in Ukraine and the stagflation environment have created a dilemma on the monetary policy front. On the one

hand, it is clear that the upward pressure on prices is extreme and the central bank must respond. The risk that higher inflation will be built into inflation expectations is more than real. On the other, the real economic impacts are also clear. Full-year economic growth will be significantly weaker, with 2Q and 3Q22 the economy going through a shallow recession.

While still reeling from the COVID pandemic we find ourselves facing another shock. The degree of uncertainty in any economic forecasts has clearly risen again. Economic life continues to be determined not only by market forces but increasingly also by the situation on the battlefield and in politicians' minds. While this does not make our work easy, we hope that this updated edition of the *Czech Economic Outlook* will help you to navigate the currently rough economic seas.

Table of Contents

External environment and assumptions	6
Macroeconomic outlook	9
Box: Risks of gas supply shutdown.....	21
Summary forecast table	22
CNB Focus.....	23
Czech IRS market and government bonds.....	26
Czech FX market.....	31
Banking sector	34
Key economic indicators.....	36
Disclaimer	37

External environment and assumptions



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Central banks to tighten monetary policy substantially

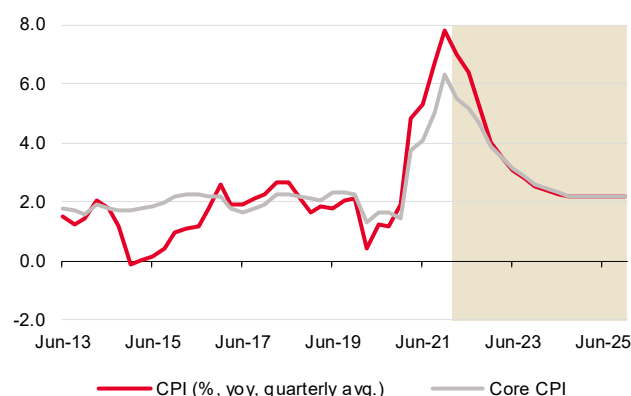
Inflation in the US and euro area has exceeded expectations in the last couple of months, triggering a change in our calls on key central bank policies. Our view is that the Fed will hike rates by 50bp in May and start to reduce its balance sheet, possibly by as much as \$1.0trn a year. This in itself is a sharp tightening of monetary conditions, so we expect the hikes to stop when the rate reaches its neutral level, which the Fed estimates at 2.5%. We expect the ECB to raise the deposit rate twice this year (by 25bp), in September and December. Next year, we expect it to hike all three policy rates by 75bp. Regional central banks will likely continue monetary tightening this year too.

US: Fed balance sheet might decline by \$1.0trn a year

Inflation likely close to its peak

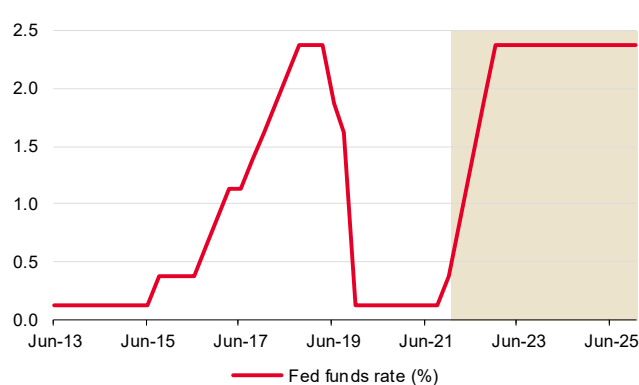
US inflation reached its highest level in more than 40 years at 8.5% yoy in March. In the coming months, however, it should begin to decline. For full-year 2022, we expect it to average 6.6%. Next year, we see the inflation averaging 3.3%, and in the coming years it should return back to the Fed's target. Given the significant acceleration in inflation, we have raised our expectation for the May rate hike from 25bp to 50bp. By the end of this year, key rates should exceed 2%.

US: inflation at a peak (% , yoy, quarterly avg.)



Source: SG Cross Asset Research/Economics

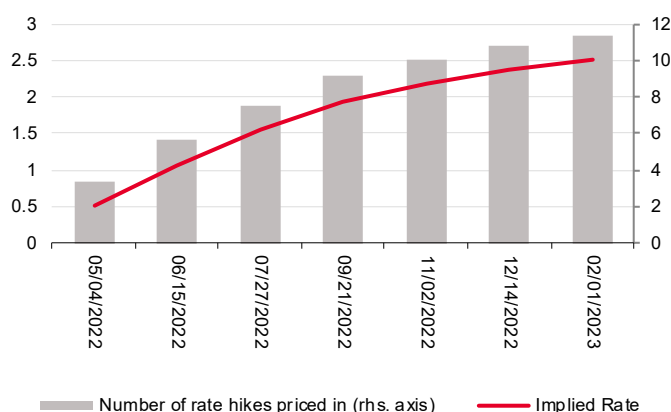
Interest rate rise will likely stop at 2.5%



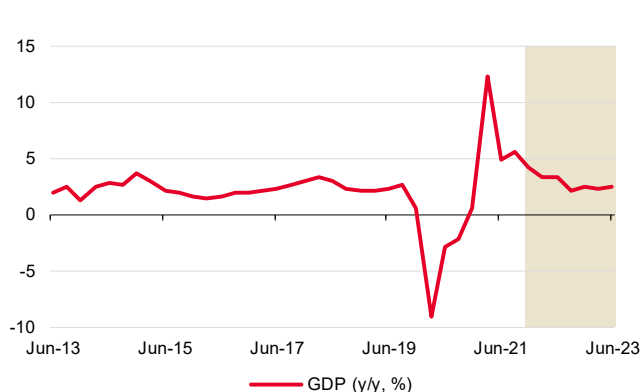
Source: SG Cross Asset Research/Economics

Fed's balance sheet could decline by \$1.0trn a year

Along with the rate hike, the Fed will likely announce a plan to reduce the balance sheet in May. According to preliminary discussions, the Fed's portfolio could shrink by as much as \$95bn per month (\$60bn for government bonds, \$35bn for mortgage-backed securities). That would mean a drop in the balance sheet of about \$1.0trn a year. This in itself would represent a sharp tightening of monetary conditions, which is why we expect rate hikes to stop at a neutral level of 2.5% (Fed estimate) early next year. The Fed was in a similar situation in 2017-2018, when it was also reducing the balance sheet while raising interest rates. However, it underestimated the impact of tapering and in 2019 had to cut rates three times. In our opinion, it will want to avoid this, even if the 'dot plot' see rates rising to 2.8%. But the risks are indeed skewed toward rates going higher than 2.5%, in our view.

Market more aggressive in rate hike pricing


Source: Bloomberg, Economic & Strategy Research, Komerční banka

GDP likely to grow by 3.2% this year


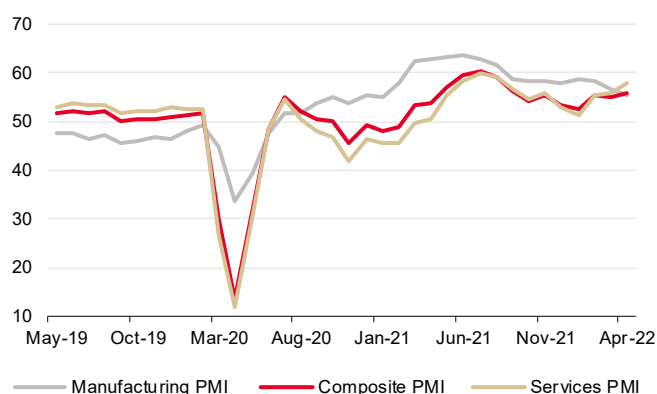
Source: SG Cross Asset Research/Economics

Euro area: ECB will likely hike rates twice this year

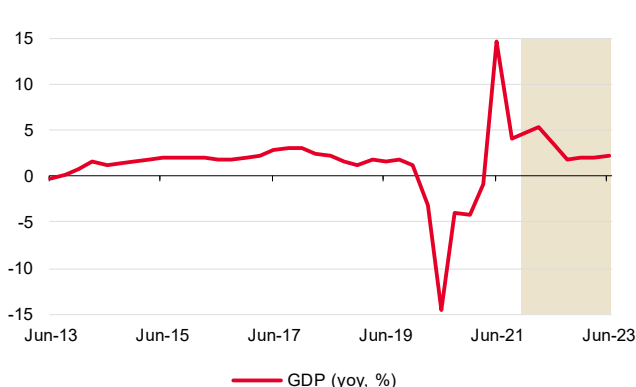
SG, April 2022	2022	2023	2024
GDP (%)	3,1	2,1	1,9
Inflation (%)	6,5	2,0	1,9
Core inflation (%)	2,7	1,9	1,9

Source: SG Cross Asset Research/Economics

The eurozone economy is dealing relatively well with the shock of the war in Ukraine so far. Although the PMI leading indicators deteriorated slightly in March, they're still at around 56 points in both industry and services, suggesting further expansion. Although inflation has significantly cut real household income, households accumulated a large amount of savings during the COVID crisis (7% of GDP), which should cushion spending. In the coming months, households will likely also catch up on spending in services where they could not spend during the pandemic (travel, restaurants). Car sales are also due a catch-up after dropping significantly recently (2021 sales were 25% below 2019 sales) due to insufficient supply. The willingness to spend should also be supported by labour-market strength: the unemployment rate is at a historical low of 6.8%. For further growth in household consumption, wage growth will be key, and we expect a rise of 3.3% this year and 3.4% in 2023, which is relatively subdued. In addition, the corporate sector emerged from the pandemic relatively strongly, and given the need to invest – due to the green transition, among other things – we also see positive developments in this area. Overall, we expect the euro area economy to grow by 3.1% this year and 2.1% next year.

PMI down recently but still over 50


Source: SG Cross Asset Research/Economics

Eurozone GDP to grow by solid 3.1% this year


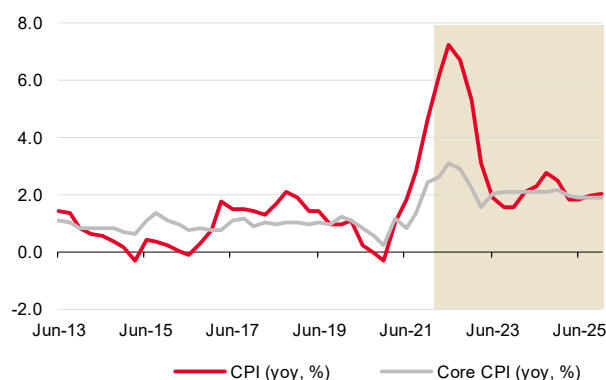
Source: SG Cross Asset Research/Economics

Inflation should return to an average of 2% next year

Euro area inflation reached a record 7.5% in March. This was mainly due to energy prices, which were up 45% yoy. We see inflation peaking in April at around 8%. Due to the high comparison base, the rate should gradually decline in the subsequent months to fall below 5% at the end of this year. We see it averaging 2% next year. Given that inflation is well above

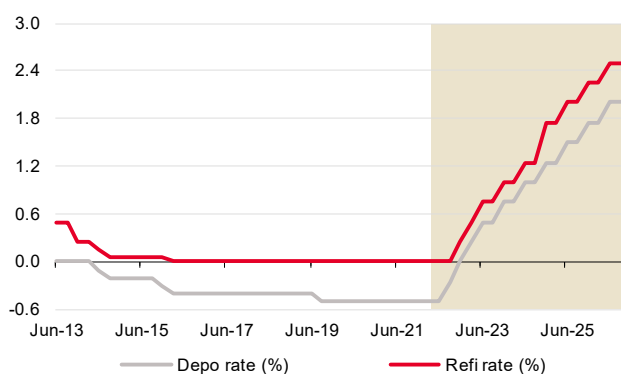
the target, we expect the ECB to end its asset purchase program by the end of June this year. Purchasing is expected to run at a pace of €40bn in April, €30bn in May and €20bn in June. The ECB may need time over the summer to assess the impact of the end of favourable conditions on TLTRO. Thus, we expect a first 25bp hike in the deposit rate in September and the next in December. In 2023, we see a 75bp increase in all policy rates. The euro should benefit from tightening monetary conditions, and we see it bouncing from the current lows and strengthening to EUR/USD 1.16 over a one-year horizon.

Inflation likely to peak in April (% , yoy, quarterly avg.)



Source: SG Cross Asset Research/Economics

ECB likely to start hiking rates in September (%)



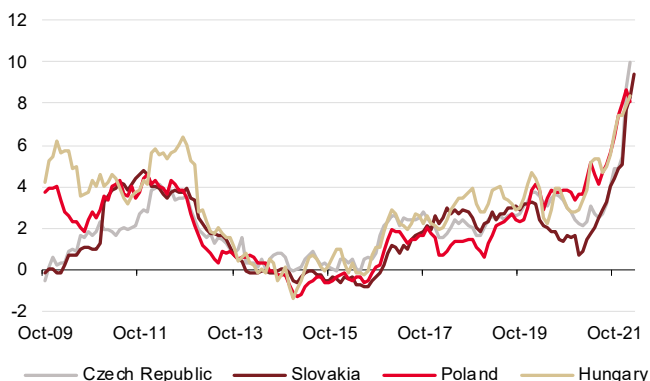
Source: SG Cross Asset Research/Economics

CEE region: central banks likely to hike rates further

Monetary policy tightening, as well as the good health of CEE economies, should allow for further strengthening of regional currencies

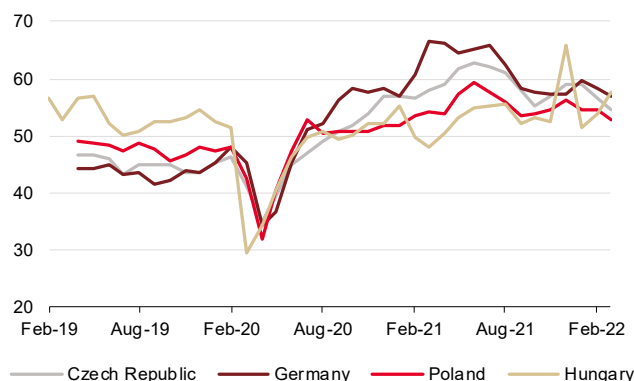
Inflation in the region hit further highs in March at 8.5% yoy in Hungary and 10.9% yoy in Poland. This was mainly due to energy prices, but food and other items also rose. Central banks thus continued to tighten monetary conditions. The Polish central bank surprised by raising the key rate by 100bp to 4.5%. According to its estimates, inflation will continue to rise, peaking in the middle of this year. We see monetary conditions continuing to tighten, with the key rate hitting 5.5% this year. Hungary's central bank has also been tightening, gradually raising the weekly deposit rate to 6.15% and the three-month deposit rate to 4.4%. Due to high inflation, we expect the bank to increase the 3M deposit rate by 100bp in April and May and 50bp in June, with the weekly deposit rate lifted to the same level (6.9%). This should help the forint to strengthen, and at the end of this year, we see it at EURHUF355. We see the Polish zloty strengthening to EURPLN4.53.

Inflation in CEE at historical highs (HICP, %, yoy)



Source: Macrobond, Economic & Strategy Research, Komerční banka

PMIs worsen in CEE (points)



Source: Macrobond, Economic & Strategy Research, Komerční banka

Macroeconomic outlook



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Main changes

GDP:

For 2022, due to the war in Ukraine, we have decreased our GDP forecast to 1.8% from the previous estimate of 4.9%. In 2023, we expect the economy to grow by 2.8%.

Inflation:

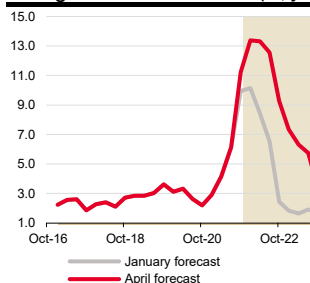
For this year, we have raised our inflation forecast to 12.6% from the January estimate of 8.8%. We expect it to average 7.2% next year.

Change to GDP outlook (% yoy)



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

Change in inflation outlook (% yoy)

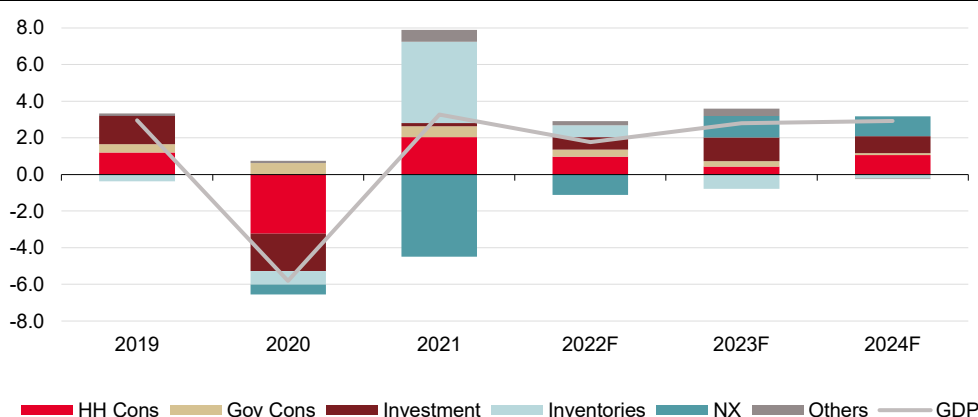


Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

The economic recovery is being postponed

The economy entered this year with the hope of an end to the pandemic and a significant easing of the supply chain disruption, which was a key brake on the economy in 2021. Unfortunately, this did not materialise. On the contrary, the escalation of the conflict in Ukraine has led to renewed delays in the supply of components and materials for production and a further sharp rise in energy prices, especially for gas. The pace of price increases thus seems to be weakening more slowly than we estimated in the January forecast. We expect a slight recession this year.

A more significant recovery in exports and investment is postponed to 2023 (% yoy)



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

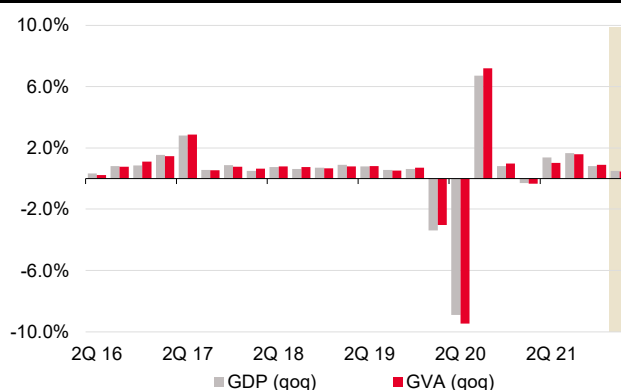
The economy grew at the beginning of this year

Economic growth slowed to 0.8% qoq in the fourth quarter of last year.

In terms of structure, the real decline in household consumption of 1.8% qoq was particularly significant. This can be attributed to a decline in consumer confidence, mainly related to the sharp rise in energy prices, accompanied by the collapse of some suppliers. Recall that at the same time, there were

growing concerns about the impact of another wave of the pandemic. On the other hand, net exports were the driving force of the economy, which was related to a partial improvement in supply chains. Stock-building contributed less positively to quarter-on-quarter GDP growth. Fixed capital formation grew by just 0.2% qoq. Industrial expansion also reached only 0.1% qoq on the supply side of GDP. Here, the trade and services sectors was once again the

GDP probably expanded slightly further in Q1 22



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

driving force, escaping the pandemic's grip and contributing 0.6pp to quarter-on-quarter GDP growth of 0.8%.

Monthly data from the beginning of this year give a mixed picture of the development of the economy, but, in summary, they still indicate an economic expansion. We expect GDP growth to slow to 0.5% qoq in Q1. Due to the low comparative base, this would mean an increase in the year-on-year rate to 4.4% from the previous 3.6%. Again, we expect a significant contribution from the services sector, while in the case of industry as a whole, we expect a slight decline. While manufacturing has likely increased qoq due to improved supply of inputs, we estimate a drop in the other industrial sectors. On the demand side, after a previous decline in household consumption of 1.8%, we estimate growth of 0.5% and the acceleration of fixed investment growth to 0.9% qoq. It is possible that quarterly GDP averages mask the course of economic performance, which probably strengthened in January and February, while in March it may have weakened due to the war in Ukraine. The effects of the war in the form of supply constraints, current and expected increases in energy prices and a general increase in uncertainty are now a key determinants of the forecast for the coming quarter. **At the same time, the ongoing impact of the pandemic cannot be overlooked, with trade and production being curtailed, and subcontracting being delayed again, especially in the case of Asian economies.** Leading indicators have not yet been able to fully absorb the negative impact of the conflict in Ukraine, and PMI in March was still in the zone of expansion. In the coming months, however, we will probably see a descent into the contraction zone here as well. For the time being, however, the preliminary level of these indices in the euro area is still indicating expansion.

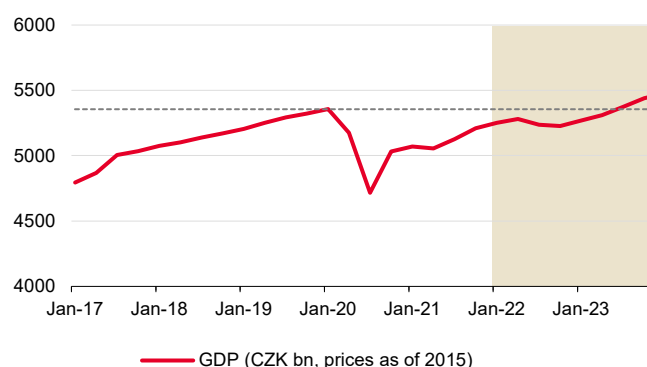
During Q2 and Q3, we expect the economy to decline by a total of around 1%.

We expect subcontracting problems to persist until the end of the year. Another assumption of this forecast is no significant improvement of the situation in Ukraine, but also no deterioration in terms of a strong reduction or complete abolition of gas supplies from Russia. In our view, the shock caused by the war will lead to a total decline of the Czech economy over Q2 and Q3 of approximately 1% (compared to Q1). This can be described as a shallow recession. The economy will be hampered by a lack of subcontracting, declining economic confidence, accelerating inflation and related tighter monetary policy. We expect a significant improvement in the situation of subcontracting only next year. This assumption remains one of the most significant risks to the forecast.

Return of GDP to pre-crisis level in the middle of next year

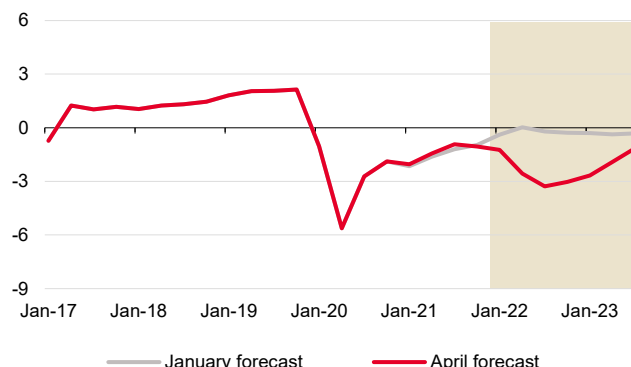
In the January forecast, we expected the pre-pandemic level of real GDP to be reached in the second quarter of this year. According to our forecast, the war in Ukraine and its implications will delay this return by approximately one year, i.e. into H123. We estimate GDP growth of 1.8% for this year, with a qoq decline in GDP during Q2 and Q3. Due to the low base effect, the full-year GDP growth rate is not dramatic, but the estimated negative impact of the war is significant. To illustrate that, even if economic growth came to a complete halt at the end of 2021, the average annual growth rate would still be just 1.8% this year, thanks to the base effect. In the previous forecast, we also assumed that the negative output gap would close during the first half of this year. We now estimate the reopening of the negative output gap and its closing with a one-year delay. The position of the economy within the cycle is thus one of the reasons why we expect a slowdown in inflation in the medium term.

GDP to return to pre-crisis level in 1H23 (CZKbn)



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

Output gap will widen again (% from potential)



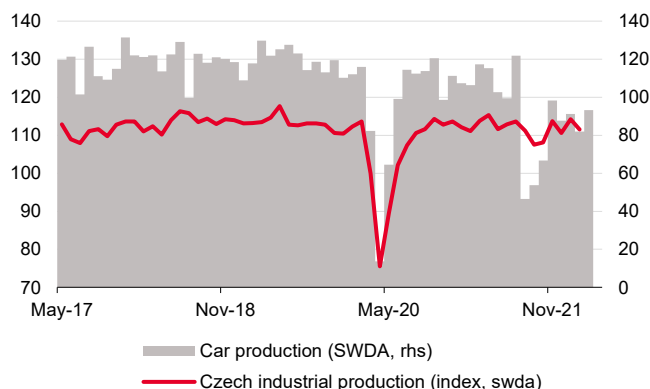
Source: Economic & Strategy Research, Komerční banka

Delayed subcontracting and rising energy prices are putting further upward pressure on producer prices.

Manufacturing still faces supply chain disruptions

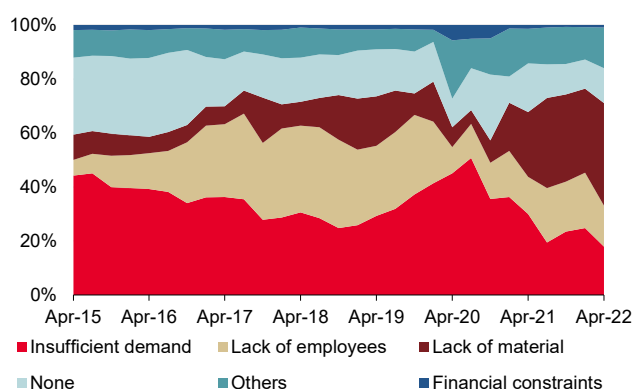
Signs of improved supply chains emerged during the fourth quarter. Hopes for better industrial performance have grown, especially for car production this year. Although data from industry for January showed significant growth of 3.3% mom (SA), in February production fell again by 2.4% mom. The main driver was the still volatile production of cars. Data on their production for March then showed growth of 11% mom (SA). This would still mean a year-on-year decrease of more than 20%. But the question is mainly the performance in the coming months. The carmakers spoke about dramatic supply disruptions in connection with the war in Ukraine. However, problems in subcontracting also affect many other manufacturers. The result is accelerating growth in input prices. The year-on-year increase in industrial producer prices was almost 25% in March. Of course, this also reflects rising energy prices, which lead to declining margins, upward pressure on prices and often lower output.

Car production remains limited



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

Barriers of growth in industry

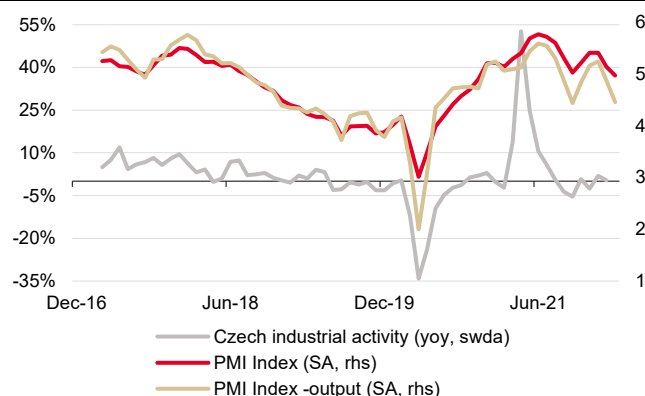


Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

In summary, after last year's growth of 8%, we expect an average decline of 1% for industrial production this year. Lack of subcontracting to production remains a key barrier and main growth uncertainty. **We expect its improvement only from next year, when we expect industrial production to grow by around 2%. We expect a further acceleration to above 4% in 2024. In addition to problematic subcontracting, the industry will be hampered this year and next by rising energy prices and tight monetary policy.** The overall performance of the industry in February was less than 2% below the pre-pandemic level. However, the industry reached its local peak in the spring of 2019, with more than 5% still to rise to that point from the current level. From the point of view of our forecast, this level could be reached

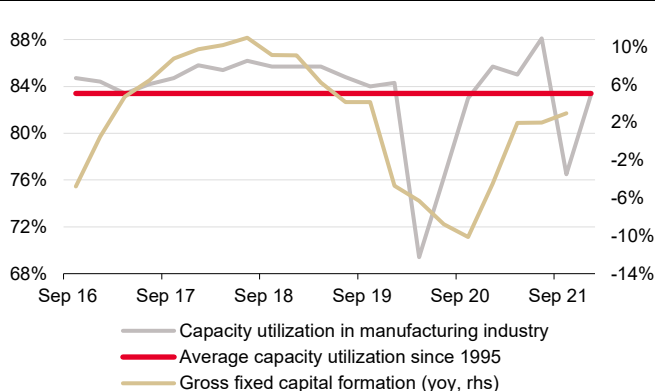
in 2024-2025. However, the uncertainty of such distant forecasts is, by default, very high even in normal times.

Leading indicators started to decrease



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

Capacity utilization back to average levels

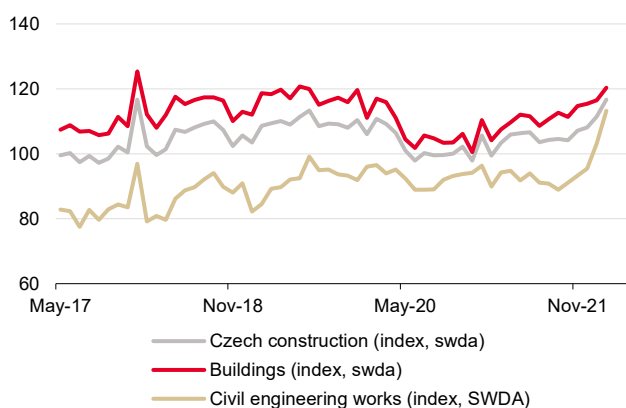


Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

The construction industry should be significantly supported by EU funds this year.

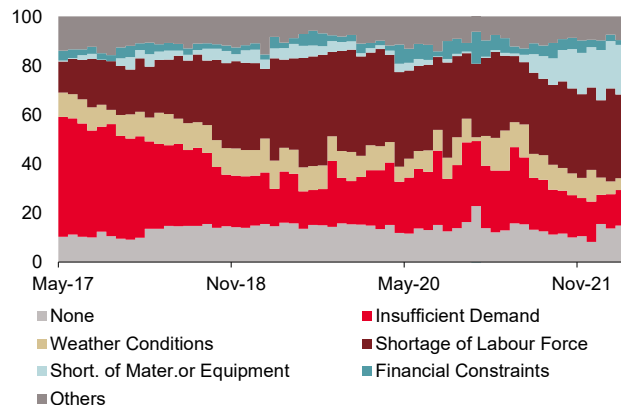
Due to the lack of production materials, we saw declines in construction production last summer. The whole sector is still burdened by labour shortages. Nevertheless, there was a decent increase in production here in the autumn. For the whole of 2021, the construction industry in the methodology of national accounts increased by 0.9% in real terms. At the end of last year, civil engineering works related to public investment added to the growth of building construction. This trend intensified at the beginning of this year, when production in civil engineering expanded by more than 17% (SA) in the first two months. A similar trend is likely to continue. This is despite the fact that the construction industry will continue to be limited by a shortage of employees and materials, which are becoming more expensive and, together with rising interest rates, will increasingly affect demand. Year-on-year growth in construction material prices was 23% in March and 10.4% in the case of construction work. On the contrary, what will increase the activity of the construction industry is public investment in line with the planned use of EU programmes. This should be a record this year (we discussed this topic in the Czech Economic Outlook in July 2021). After last year's increase of 2%, we expect the construction industry to expand by 11.1% this year.

The construction started to expand again (2010 = 100)



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

Barriers to growth in the construction industry



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

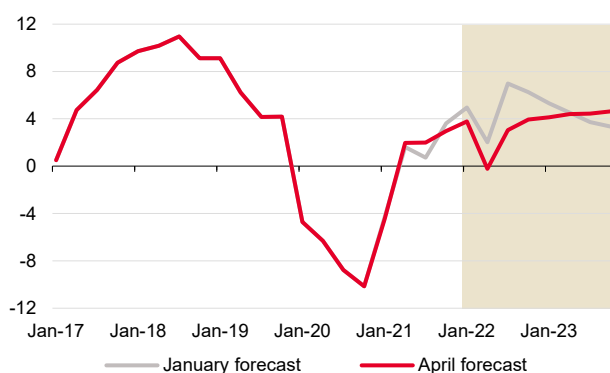
Household consumption is likely to fall from the second quarter of this year.

Household consumption will probably decline

Due to the fading of the pandemic, household consumption was the second strongest driver of GDP in 2021, growing by 3.3%. In line with our expectations, inventories contributed the most to growth last year. This was due to the lack of materials and

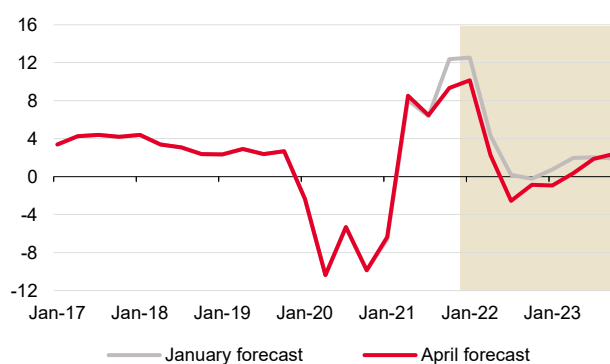
components in production, which caused companies to accumulate unfinished products and also tried to pre-supply where possible. For this year, we expect household consumption to be the main driver of the economy. But it will be a false victory, as it will be due to a comparison with last year's low statistical base. Regarding further rapid growth in consumer prices and a fall in consumer confidence and given the fall in real wages, we expect a gradual decline in real spending by Czech households from the second quarter to the end of this year. In the case of the already mentioned investments in inventories, we originally expected a significant negative contribution to growth this year due to improved subcontracting and the completion of work in progress. However, we are postponing this scenario to 2023, and for this year we still expect a slight but still positive contribution from the creation of inventories. We expect investment in fixed capital due to events in Ukraine, increased uncertainty, and tight monetary policy to expand more slowly this year, but with increasing support from EU funds, without which total investment would probably weaken this year.

Investment expansion will be slow (% , yoy)



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

Inflation slowing down household consumption (% , yoy)



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

Thanks to the expected improvement in the situation of subcontracting, net exports were originally intended to be the main driver of the economy this year. The situation described above in the new forecast led to a 180-degree turn in this direction. The level of net exports at the turn of last year and this year indicates this trend and we do not see a strong reason for a turnaround, so we expect a negative contribution from this demand component of GDP this year. In 2023, we expect an improvement, when net exports together with fixed investments should be the main drivers of the economy.

However, the post-COVID shock of the war in Ukraine is so significant that the outlook for economic growth remains rather cautious in the coming years, even though GDP is still very low in terms of level and therefore has considerable potential for growth. The impact on economic sentiment can theoretically last several years. We expect GDP growth of 1.8% this year and an acceleration to 2.8% next year.



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Fiscal policy: cumbersome consolidation

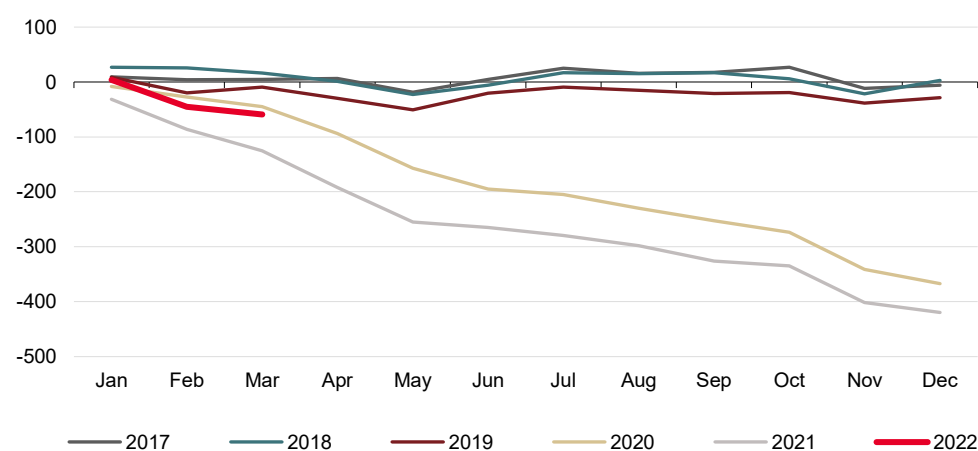
The state budget fulfilment year to date has been significantly affected by the provisional nature of the budget. Although the new budget has brought additional savings vs the previous forecast, aiming for medium-term sustainability of public finances, the war in Ukraine, high inflation and associated additional expenditures are likely to again slow the process of consolidating the state budget. For now, we expect this year's state budget deficit to be CZK310bn. The social security funds system is also likely to end in a slight deficit this year. Municipal budgets, on the other hand, will probably be in surplus again. Overall, we expect the general government deficit to decrease to 4.5% of GDP (from 5.9%

last year), thanks to a significant contribution from nominal GDP growth on the back of high inflation. At the same time, we expect public debt to increase more slowly, until it stabilises in 2025 at the level of 46.4% of GDP. Further developments, especially this year, are strongly conditioned by the course of the war in Ukraine, as well as the government's new discretionary measures and the source of their financing.

This year's budget will undergo further changes due to the war

At end-March this year, the state budget deficit had run to CZK59.1bn. This represents a CZK66.1bn contraction vs March last year, mainly reflecting lower expenditure related to the specifics of the provisional budget regime. However, this year-on-year reduction also stemmed from economic recovery and higher inflation, both of which contributed to higher tax collection.

The state budget (CZKbn)



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

The reduction in expenditure was linked mainly to the budget being provisional. Until 21 March, the government had been operating under a provisional budget, which significantly limited the possibilities for pre-financing some expenditures that are normally concentrated in the first months of the year. However, lower expenditure on COVID-related compensation to companies also brought significant savings. In contrast, expenditure increased on social benefits, especially due to a rise in the old-age pension. With the increase in both the debt itself and interest rates, there has also been a rise in interest expenses for servicing the state debt, on which, we estimate, the government could pay an additional CZK10bn compared to last year.

The strong domestic labour market coupled with higher inflation has led to an increase in budget tax revenues. The still-strong demand for labour was reflected in a further decline in unemployment and growth in employment. This, together with higher prices, which also increase tax revenue, supported higher year-on-year income from VAT, excise duties and social security contributions.

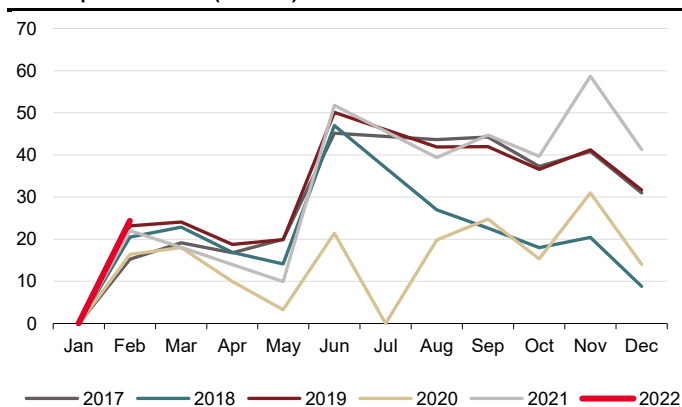
For the time being, we expect a state budget deficit of CZK310bn this year. The government has already announced that it will probably amend the current budget, which envisages a deficit of CZK280bn, around the middle of this year. The current estimate of the amount of additional funds that will be spent to help war refugees, planned increased defence spending, additional discretionary government measures (reduction of fuel excise tax and abolition of road tax) and an increase in the 'subsistence minimum' together total almost CZK80bn, which this year's budget does not yet take into account. However, at least the part

of the additional expenditure that is directly related to the refugee crisis (about CZK54bn) should be largely financed from EU resources (REACT-EU fund, or unused funds from operational programmes). In our opinion, the state budget deficit is set to worsen this year, due also to lower-than-expected economic growth. For the time being, we have reduced our estimate of this year's GDP growth to 1.8% (from the previous 4.9%). On the other hand, there will visually be a slight improvement in budget management due to higher inflation, the full-year forecast for which we raise from the original 8.8% to 12.6% mostly as a result of the war in Ukraine.

Municipalities still in surplus

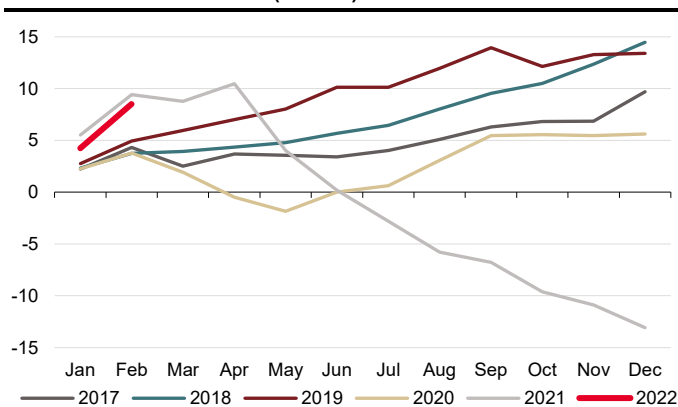
Municipalities ended up with a surplus of CZK41.3bn last year. The adjustment of the budget allocation of taxes in favour of regions and municipalities in particular contributed significantly to this. This year, we expect the surplus to decrease to CZK30bn. Last year, health insurers' finances ended in significant deficit despite increased transfers from the state budget. In our opinion, keeping the payment unchanged for a state-insured person this year will lead to a slight deficit in 2022 as well.

Municipal finances (CZKbn)



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

Health insurers' finances (CZKbn)



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

Public finance forecasts

	2021	2022f	2023f	2024f	2025f	2026f
Balance (% GDP)	-5.9	-4.5	-3.5	-2.7	-2.1	-1.6
Fiscal effort (pp GDP)	-0.9	1.8	0.8	0.6	0.7	0.4
Public debt (CZKbn)	2 566.6	2 876.6	3 136.6	3 356.6	3 536.6	3 686.6
Debt ratio (% GDP)	41.9	44.3	45.1	45.9	46.4	46.4

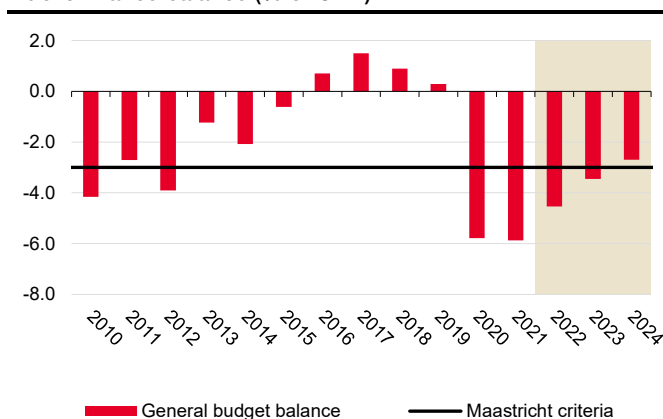
Source: CZSO, Macrobond, MinFin for published data, Economic & Strategy Research, Komerční banka

The negative shock of the war should slow consolidation of public finances

We expect the general government deficit to reach 4.5% of GDP this year, i.e. a 1.4pp year-on-year decrease. In our view, higher growth of nominal GDP and significantly greater fiscal efforts will contribute to reducing the deficit this year, compared to last year. Municipalities' 'traditional' surplus should continue to help lower the public finance deficit this year as well. We expect the gradual consolidation of public finances to continue in 2023, when the deficit could be reduced to 3.5% of GDP, even with the contribution of drawing on EU funds. We expect public sector debt to increase to 44.3% of GDP this year and to reach 45.1% of GDP in 2023. Overall, however, the development, especially this year, is strongly dependent on how the war in Ukraine develops, the government's possible new discretionary measures and the source of their financing.

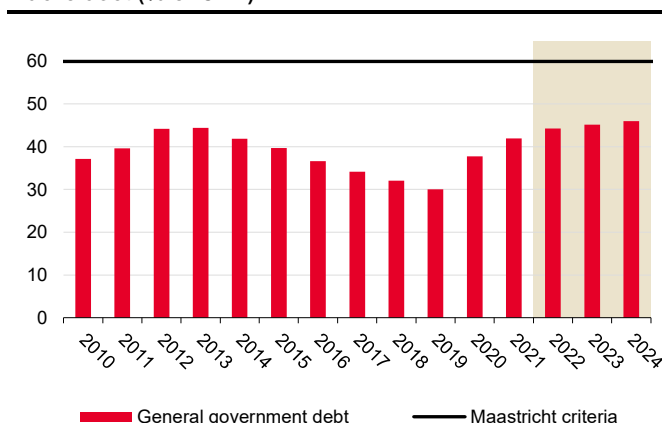
In our opinion, this year's public finances will end with a significantly smaller deficit than last year. The consolidation of the government's budget should continue at a gradual pace in the years to come. At the same time, we expect public debt to peak in 2025.

Public finance balance (% of GDP)



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

Public debt (% of GDP)



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



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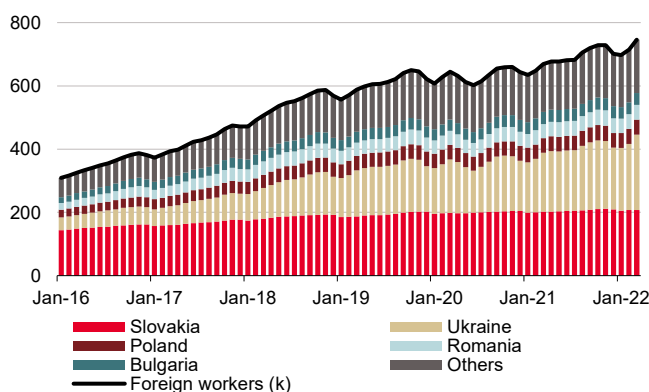
Labour market remains very tight

The Czech labour market continues to show signs of overheating. Unemployment remained low in 1Q22 and was below its equilibrium level. The number of vacancies is still at a record high and significantly exceeds the number of registered jobseekers. In our view, the labour market will remain tight over the whole forecast horizon. The influx of refugees from Ukraine is not likely to change this much. The labour shortage will contribute to higher nominal wage growth, which, according to our forecast, should increase by an average of 6.7% this year. However, due to high inflation, this would be a drop of 5.3% in real terms. We expect the growth in real wages to resume next year.

The number of vacancies remained at a historical high and exceeded the number of registered jobseekers by about 100k. The influx of refugees from Ukraine will not solve the labour market tightness.

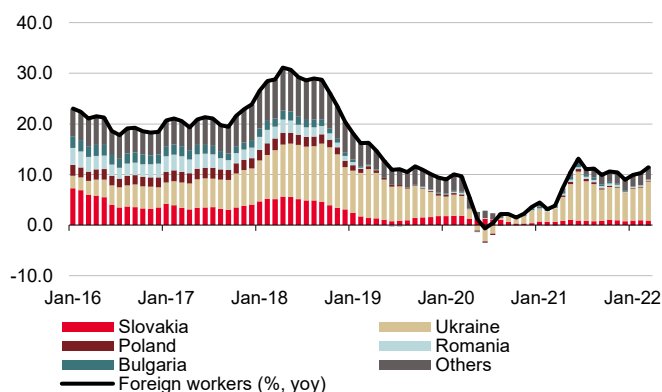
The unemployment rate remained below its equilibrium level in 1Q22, which only proves a persistent labour shortage. The ILO unemployment rate remained slightly above 2%, while we estimate its equilibrium at around 3%. The seasonally adjusted share of unemployed persons (Ministry of Labour and Social Affairs (MLSA) methodology) further decreased from 3.4% in 4Q21 to 3.2% in 1Q22. Therefore, it is gradually approaching the pre-pandemic level of slightly below 3%. The number of vacancies continued to be at a historical high, reaching around 350k in 1Q, which is about 100k more than the number of registered job seekers. In our view, the labour market will remain tight over the whole forecast horizon but space for a further decline in the unemployment rate from current levels is limited. This year, we expect a reduction in the ILO unemployment rate from an average of 2.8% in 2021 to 2.1%, with only a slight increase to 2.2% next year. Regarding the share of unemployed persons, we envisage a decrease from 3.7% to 3.3% this year, with an increase to 3.5% in 2023.

Due to the influx of war refugees, Ukrainians have become the largest group of foreign workers in the Czech Republic



Source: MLSA, Economic & Strategy Research, Komerční banka

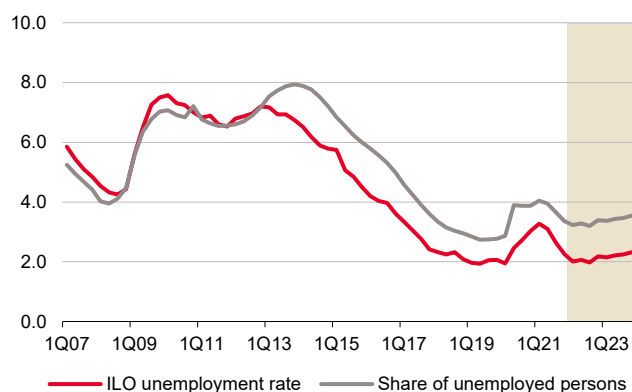
From start-2022, the number of workers from Ukraine increased by 40k, which is not enough to ease labour market tightness



Source: MLSA, Economic & Strategy Research, Komerční banka

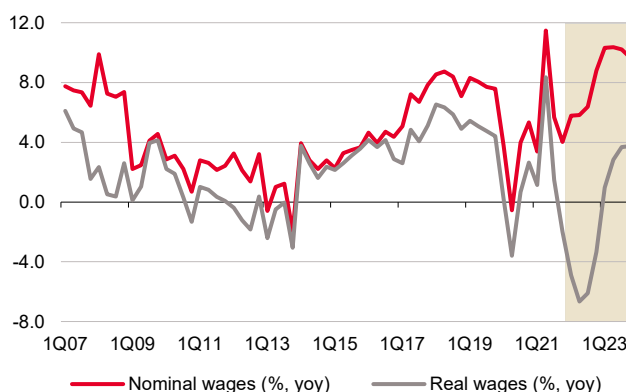
The influx of war refugees from Ukraine represents only slight relief for the Czech labour market. According to data from the MLSA, almost 240k Ukrainians worked in the Czech Republic in March, which was about 40k more than in January. In 1Q22, Ukrainians became the largest group of workers from abroad in the Czech Republic. They even exceeded the number of workers from Slovakia, which represented the largest group for a long time. When comparing the total number of Ukrainians working in the Czech Republic (the vast majority of whom worked there before the outbreak of the war in Ukraine) with the number of vacancies, it is clear that this represents only very slight relief for a tight labour market. As of mid-April, approximately 150k Ukrainian refugees of working age (15-64 years) had obtained a visa in the Czech Republic, with women accounting for about an 80% share. Thus, the potential for further growth in terms of employment still exists, but it is unlikely to change the aforementioned situation.

Unemployment rate is close to pre-pandemic levels and indicates strong labour market tightness (% , SA)



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

Despite nominal growth of 6.7%, real wages are likely to decrease by 5.3% this year due to high inflation



Source: CZSO, Economic & Strategy Research, Komerční banka

This year's nominal wage growth of 6.7% will be supported by a tight labour market. Due to high inflation, however, wages will fall sharply in real terms.

The tight labour market should be reflected in rapid nominal wage growth, but its pace this year will not exceed double-digit inflation. In 4Q21, nominal wage growth slowed to 4.0% yoy from 5.7% yoy in 3Q. This was mainly due to the effect of a high base in healthcare, where wages had been boosted by extraordinary COVID bonuses in 4Q20. As a result, the average wage there fell by 8.1% yoy. We estimate that average wages have stagnated across the whole of the public sector. In the private sector, on the other hand, rapid wage growth of 5.7% yoy continued in 4Q. Wage developments should be similar in 1Q22, for which we estimate that private wages will have grown by an average of 6.8% yoy, with public wages

up by only 3.2% yoy. This reflects the new government's efforts to reduce budget expenditures. As a result, stronger wage growth in the public sector can be expected only in healthcare this year. In summary, we expect the average nominal wage to increase by 5.9% yoy in 1Q.

For FY22, we forecast nominal wage growth of 6.7%. Due to high inflation, however, this would mean a decrease of 5.3% in real terms. Next year, we assume higher pressure on wage growth from employees, which should accelerate nominal wage growth to 10.1% and to 2.8% in real terms.

Inflation is heading to 14%



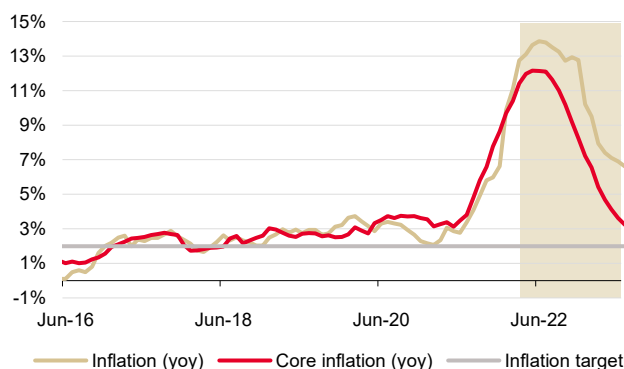
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The growth rate of consumer prices has not yet shown significant signs of a slowdown; on the contrary, its acceleration at the beginning of the year exceeded already-high estimates. The biggest drivers of rising prices are energy and housing, transport and, increasingly, food. However, price growth affects the entire spectrum of the consumer basket. We estimate that inflation will start to slow due to weaker demand and tighter monetary policy. On the contrary, due to the deferred expectation of an improvement in the situation for subcontracting, a slower decline in inflation in terms of its cost component can be expected. Energy prices are likely to continue to rise. We expect year-on-year inflation to peak at around 14% in the middle of this year. However, we do not expect it to return to single-digit territory until the beginning of next year.

Core inflation is close to 15% mom annualized. We expect this to decelerate to 2% by the end of next year.

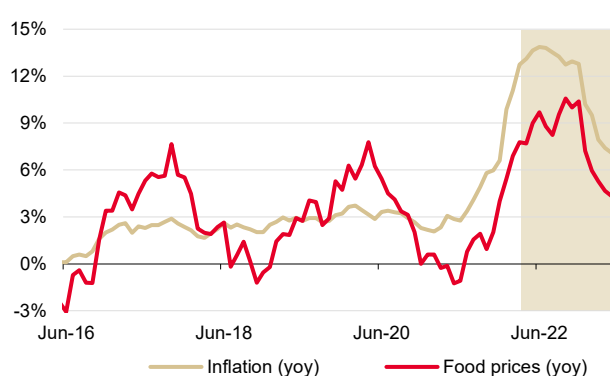
Inflation accelerated significantly at the beginning of this year. In year-on-year terms, consumer price inflation entered double-digit territory in February, reaching 12.7% in March. In terms of month-on-month dynamics, the largest price jump took place in January. This was mainly due to the rise in regulated energy prices, which was further exacerbated by the return of VAT payments. However, the dynamics of price growth remained very high over the next two months across the whole spectrum of the consumer basket. Core inflation, which is adjusted for food prices, regulated prices, changes in indirect taxes and fuel, i.e. items that are only little or not all affected by monetary policy, have also accelerated. Its three-month moving average rose to a high of 14.8% in annualized terms (SA) in March. Our projections of economic development and the impact of the tightened monetary policy indicate a significant slowdown in this rate since the second quarter of this year. The considerable slowdown in the growth of real estate prices and hence imputed rents that we expect should also make a slight contribution to disinflation this year. On the other hand, the slowdown in subcontracting, the second-round effects of rising energy prices and higher inflation expectations counteract the slowdown in inflation. In other words, the longer the inflation rate stays high, the greater persistence it will have. This is also a strong argument in favour of tightening monetary policy. We expect that the CNB will react more cautiously with regard to the risks arising from the war in Ukraine. Developments so far have led to an upward shift in our inflation forecast for the near future as well as over the medium term. **We expect an average core inflation rate of 10.8% this year and 4.2% next year. We envisage it slowing down to a 2% month-on-month annualized rate in Q4 2023.**

Year-on-year inflation heading to 14%



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

Rise of food prices will also accelerate



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

After a turbulent start to the year, we expect a gradual drop in oil prices below USD100/barrel and thus a reduction in the price at petrol stations.

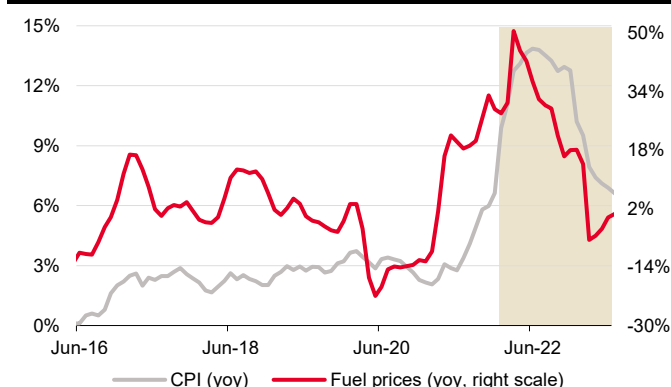
The price of Brent crude oil rose to USD100/barrel in February, which was about USD20 above our expectations. Russia's military attack on Ukraine followed, and the price of oil fluctuated sharply in the range of USD100-130/barrel. In mid-April, it was close to USD108/barrel. This development, together with the short-term weakening of the Czech koruna against the US dollar and the significant contribution of fears of further price increases at petrol stations, led in March to an unprecedented 21.7% month-on-month price jump. For the second quarter, we assume an oil price of USD120/barrel with a gradual decline to USD95 in the fourth quarter. So far, oil market developments in April look better than our forecast for the entire quarter. In the case of the koruna, we expect it to strengthen slightly against the dollar over the remainder of the year. Government efforts to monitor margins at gas stations are likely to put some downward pressure on them. The planned reduction of the excise tax by CZK1.50 per litre in the period from June to September will also contribute to the reduction. **In summary, we expect prices to decline at petrol stations from April.**

Food prices were moderate last year, but their growth accelerated at the beginning of 2022. The main reason was rising energy prices. Added to this is the expected rise in agricultural commodity prices in connection with the war between Russia and Ukraine, and thus reduced supplies, especially of wheat. For this reason, we have increased our food price growth estimate for this year to 8.5%, and to 3.8% for next year. With regard to current assessments of uncertainties, we perceive risks to actually be in the direction of even faster growth.

Energy prices for consumers are likely to rise sharply.

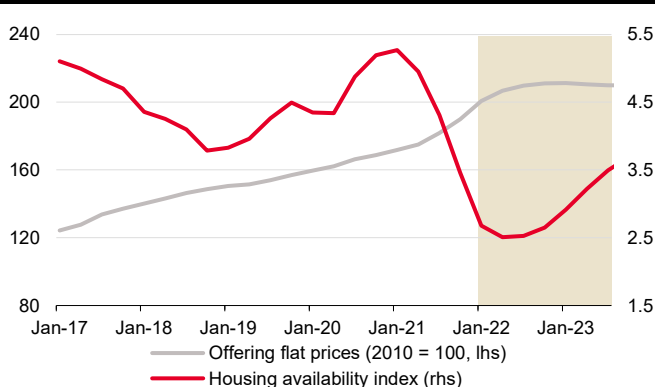
Although already in our forecast in October 2021, the expected developments in regulated energy prices began to increase significantly. However, we did not anticipate that a serious conflict in Ukraine would occur and ultimately lead to energy price increases, especially of natural gas. While expectations about a future decline in market energy prices prevailed earlier this year, those expectations disappeared with the war in Ukraine. The average price for consumers is significantly behind market developments. For comparison, the year-on-year growth in the annual gas forward price was about 360% in March. The price of gas for households increased by about "only" 38% over the same period. The market part of the price here thus has considerable room for growth at current market prices. **We expect market natural gas prices to be generally stable by the end of the year and decline gradually next year. In this scenario, we expect regulated prices to rise by an average of 25% next year (excluding the effect of tax changes), i.e. even slightly faster than this year.** The risks to even higher growth are considerable. The unclear outlook for energy prices after 2023 has led us to simplify the assumption of their stability in the longer term.

We expect decrease of prices at gas stations



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

The slowdown in property prices will contribute to lower inflation



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

Inflation is traditionally increased by excise duties on alcohol and tobacco on the order of tenths; this year, however, it will be slightly reduced by the above-mentioned lowering of excise duty on fuels. However, given the context of the current level of inflation, these factors look inferior.

In summary, we expect the annual inflation rate to peak at around 14% in the middle of this year. Its seasonally adjusted 3M moving average of month-on-month, annualized changes reached an extreme 30% in March, mainly due to the price jump in January. We expect this rate to slow significantly to 6% at the end of this year and to 2% at the end of 2023. For the year-on-year inflation rate, however, this would mean returning to single-digit territory in Q1 next year and reaching the 2% year-on-year inflation target only in 2024.

Overall, we estimate that inflation will average 12.6% this year and slow to 7.2% in 2023.

Risks: The war & impacts of pandemic

While the global pandemic still has very strong effects, the dominant risk for the Czech Republic has been the rise in energy prices in connection with the war in Ukraine:

■ **Price development and its effect on economy.** Inflation surprised to the upside, with energy being the main driver. The war in Ukraine has exacerbated this development and is a significant risk, especially in the case of natural gas in connection with a possible reduction in its supplies from Russia. This would have a strong negative impact on GDP and a positive impact on inflation.

■ **Problems in supply chains.** We anticipate that problems with the supply of components and materials for production will persist until the end of this year and weaken in 2023. This assumption means a significant impact on economic performance and price developments. This risk is now affected both by the Covid-19 pandemic, which still has a strong impact on economic activity in a number of countries in particular, and by the war in Ukraine. In the case of the Czech Republic and advanced economies, we do not anticipate any additional lockdowns due to Covid-19.

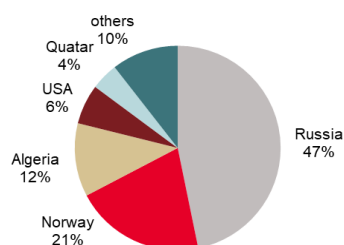
■ **Capital outflows from emerging markets.** The period of monetary policy tightening by the American Fed and the ECB may bring significant changes in global capital flows and contribute to higher volatility of foreign exchange markets, which could also affect the exchange rate of the koruna with an impact on interest rates and inflation. Increased risk aversion in connection with the war in Ukraine could contribute to this as well.

■ **Fiscal policy.** The new government promises fiscal consolidation. If it actually pushed through more restrictive budgets for 2023 and beyond than we anticipate, this would imply lower interest rates than we anticipate.

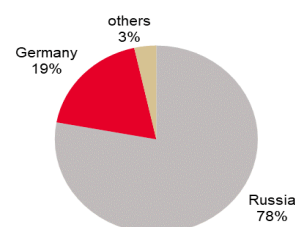
Box: Risks of gas supply shutdown

With the outbreak of war in Ukraine, the risk of cutting off supplies of energy from Russia to Europe increased. Already in March, we published a report containing an estimate of the potential impacts of such a scenario (see <https://bit.ly/3psdUO8>). While in the case of oil, it is relatively easy to import this commodity from countries outside Russia, albeit at a higher cost, in the case of gas, the dependence on Russia is high and depending strongly on the pipelines. Russia's share of the total imports of natural gas into the EU last year was about 47%. The Czech Republic is completely dependent on Russian gas. Although part of its gas is imported from Germany, it is also of Russian origin (see chart). Colleagues in SG estimate that in the case of the eurozone, a complete cut-off of gas supplies from Russia would lead to a negative impact on GDP of 4-5pp. If, for example, there were a shutdown of supplies for the whole of next year, it would mean a full-year decline in the eurozone economy of around 2%. SG considers such a scenario unlikely. **Similar simulations for the Czech Republic would show a decline in the economy of about 4-5% (instead of the estimated growth of 2.8% for 2023).** It should be added that the estimates of these impacts are very uncertain and the estimates we present are among the more pessimistic. The question is the speed and ability to switch to other energy sources, as well as the level of European storage before the winter of 2022. Shutdowns next year could have less of an impact due to business responses than simulations in the 2021 data suggest.

Import of natural gas into eurozone in 2021



Import of natural gas into Czech Rep. in 2021



Source: Economic and Strategy Research, Komerční banka, Bloomberg

In addition to the negative impact on GDP, the shutdown of gas supplies from Russia would also lead to greater upward pressure on consumer prices. In the above-mentioned report published in March, we estimated an additional impact on inflation of 2pp for this year – up to 11%. Even without the implementation of this scenario, however, we have increased our inflation forecast for this year to 12.6%. The shutdown of gas supplies would thus lead to an additional increase in inflation of the afore-mentioned two percentage points. Compared to the baseline, this crisis scenario not only works with a larger negative supply shock, but also with a significant drop in domestic demand. The development of interest rates would then depend on whether it would be less bad for the central bank to tolerate higher inflation – and the threat of a stronger de-anchoring of inflation expectations – than lower growth or even a decline in the economy associated with the deteriorating labour market and even lower demand due to higher energy prices and negative consumer sentiment. However, it can be assumed that in this scenario, the effects of higher rates on the real economy would eventually be felt and the central bank would have to loosen monetary policy. In such a situation, regional currencies could come under significant downward pressure, which could reach the order of 5-10%, and the CNB would probably use foreign exchange reserves to stabilise the exchange rate.

Summary forecast table

	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23	2021	2022	2023	2024	2025	2026
GDP and its breakdown														
GDP (real, yoy, %)	3.6	3.6	4.4	2.1	0.3	0.3	0.6	2.6	3.3	1.8	2.8	2.9	2.2	2.1
Household consumption (real, yoy, %)	6.5	9.3	10.2	2.2	-2.6	-0.9	-0.9	0.3	4.3	2.0	0.9	2.3	2.6	2.9
Government consumption (real, yoy, %)	7.0	1.0	2.8	4.1	-1.5	2.4	2.1	2.1	3.0	1.9	1.5	0.5	1.6	1.6
Fixed investments (real, yoy, %)	2.0	3.0	3.8	-0.2	3.0	3.9	4.1	4.4	0.6	2.6	4.4	3.4	3.4	2.6
Net exports (contribution to yoy)	-8.5	-8.2	-3.8	-1.4	1.4	-0.6	-0.1	1.5	-4.5	-1.1	1.2	1.1	0.7	0.7
Inventories (contribution to yoy)	6.0	5.8	1.8	1.8	0.1	-1.1	-1.1	-1.5	4.4	0.6	-0.8	-0.2	-0.3	-0.4
Monthly data from the real economy														
Foreign trade (CZK bn)	-54	-28	3	-5	-19	-12	18	18	-4	-32	46	91	127	162
Exports (nominal, yoy, %)	3.8	2.8	5.8	2.4	9.6	5.7	4.4	3.1	13.0	5.8	3.5	5.2	5.1	3.9
Imports (nominal, yoy, %)	17.4	14.6	12.7	4.3	5.4	4.1	2.9	0.9	19.3	6.5	1.6	4.2	4.4	3.3
Industrial production (real, yoy, %)	-1.1	-1.0	-1.4	-2.3	0.0	-0.4	1.6	0.5	8.0	-1.0	1.8	4.2	4.7	3.1
Construction output (real, yoy, %)	2.3	5.7	15.3	6.6	10.3	12.1	15.0	9.0	2.0	11.1	9.4	7.2	4.5	3.8
Retail sales (real, yoy, %)	3.5	6.7	6.5	-1.0	-1.9	-1.9	0.8	1.0	4.2	0.4	1.9	3.2	3.1	3.7
Labour market														
Wages (nominal, yoy, %)	5.7	4.0	5.8	5.8	6.4	8.8	10.3	10.4	6.1	6.7	10.1	5.4	5.8	6.5
Wages (real, yoy, %)	1.5	-2.0	-4.9	-6.7	-6.1	-3.3	1.0	2.8	2.2	-5.3	2.8	3.1	3.8	4.4
Unemployment rate (MLSA, %)	3.5	3.5	3.4	3.1	3.1	3.5	3.6	3.2	3.7	3.3	3.5	3.5	3.6	3.7
Unemployment rate (ILO 15+, %)	2.7	2.2	2.0	2.0	2.1	2.2	2.2	2.1	2.8	2.1	2.2	2.3	2.4	2.5
Employment (ILO 15+, yoy, %)	0.4	0.8	0.9	2.0	1.1	0.8	1.0	-0.1	-0.3	1.2	0.1	-0.1	0.0	-0.2
Consumer and producer prices														
CPI Inflation (yoy, %)	4.1	6.1	11.2	13.4	13.3	12.6	9.3	7.3	3.8	12.6	7.2	2.3	1.9	2.0
Taxes (contribution to yoy inflation)	0.2	-0.7	0.4	0.4	0.3	1.1	0.2	0.3	-0.1	0.5	0.3	0.2	0.2	0.2
Core inflation (yoy, %) (*)	4.8	7.7	10.5	12.1	11.5	9.1	6.5	4.5	4.8	10.8	4.2	2.1	2.0	2.0
Food prices (yoy, %) (*)	1.4	2.3	6.7	8.4	8.8	10.1	6.0	4.4	0.8	8.5	3.8	1.4	2.0	2.4
Fuel prices (yoy, %) (*)	19.4	29.6	36.8	41.0	35.1	20.7	9.4	-3.2	15.3	33.4	0.1	-2.3	1.1	2.5
Regulated prices (yoy, %)	0.3	-0.9	15.7	20.3	22.9	29.4	25.1	25.4	-0.1	22.1	25.2	4.4	0.0	0.0
Producer prices (yoy, %)	9.0	12.8	21.8	21.3	19.1	15.6	5.5	1.8	7.1	19.5	2.1	1.6	1.9	2.0
Financial variables														
2W Repo (% , average)	0.7	2.3	4.2	5.3	5.5	5.5	5.3	4.6	0.9	5.1	4.3	3.0	3.0	3.0
3M PRIBOR (% , average)	0.9	2.8	4.6	5.6	5.8	5.6	5.2	4.5	1.1	5.4	4.3	3.2	3.2	3.2
EUR/CZK (average)	25.5	25.4	24.4	24.4	24.4	24.3	24.1	24.0	25.6	24.4	24.0	23.6	23.5	23.3
External environment														
GDP in EMU (real, yoy, %)	4.0	4.6	5.4	3.4	1.7	2.0	1.9	2.2	5.6	3.1	2.1	1.9	1.6	1.5
GDP in Germany (real, yoy, %)	2.9	1.8	4.1	2.3	1.5	2.5	2.4	2.4	3.1	2.6	2.1	1.6	1.4	1.4
CPI in EMU (real, yoy, %)	2.9	4.7	6.1	7.2	6.7	5.4	3.1	2.0	2.6	6.4	2.1	2.4	1.9	1.9
Brent oil price (USD/bbl, average)	74.8	78.2	96.1	120.0	105.0	95.0	93.0	92.5	70.2	104.0	92.2	90.0	89.2	90.0
EURIBOR 1Y (% , average)	-0.5	-0.5	-0.4	-0.1	0.2	0.5	0.7	0.9	-0.5	0.0	1.0	1.9	2.5	3.1
EUR/USD (quarter eop, year average)	1.18	1.14	1.11	1.08	1.10	1.13	1.16	1.18	1.18	1.11	1.18	1.22	1.25	1.28

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

CNB Focus



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We expect rates to peak at 5.5% and not to fall before 2023

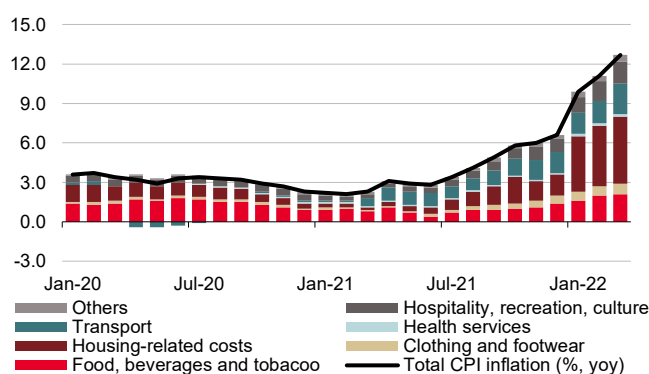
Inflation continued to rise at the beginning of the year, significantly exceeding the CNB's forecast. The central bank thus raised interest rates further to the current 5%. Given the possible impact on economic growth of the war in Ukraine and high inflation, risks on further interest rate developments are now more balanced. At the May meeting, we expect the CNB to hike the repo rate by 50bp to 5.5%, which should represent the peak. In our opinion, the CNB could now exclude some of the external price pressures from its policy. However, we do not see interest rates starting to fall back to the 3% policy-neutral level before the beginning of 2023.

Inflation continued to accelerate in 1Q22, by significantly more than the CNB had expected. Inflation expectations are well above the central bank's 2% target.

The ongoing increase in inflation compelled the Czech National Bank to continue raising interest rates at the beginning of this year. It hiked the key repo rate by 75bp in February and by 50bp in March to the current 5%. While the average repo rate in 1Q22 was broadly in line with the CNB's February forecast, the central bank had projected a gradual decline in the rate from 2Q. However, the rise in consumer prices at the beginning of the year significantly exceeded the CNB estimates. In March, inflation reached 12.7% yoy vs the 9.8% yoy expected by the CNB. While fuel, energy, and food prices grew faster in 1Q than the bank expected, core inflation developed roughly in line with its forecast.

Strong upward pressure on prices was reflected in a further sharp rise in inflation expectations. According to the March CNB survey, non-financial corporations expect inflation to be 7.1% yoy at the one-year horizon and 5.9% yoy at the three-year horizon. In December, they expected 4.4% and 4.2%, respectively, already well above the central bank's 2% target. Based on the CZSO indicator, households' concerns about rising prices are at an all-time high. This is probably the main reason why households consider the current situation unsuitable for making large purchases. The negative effects of high inflation on household consumption were already apparent in 4Q21, when it fell by 1.8% qoq.

Inflation remains broad-based, with increased energy, fuel and food prices having a significant effect



Source: CZSO, Economic & Strategy Research, Komerční banka

Non-financial corporations expect inflation of 7.1% at the one-year horizon and 5.9% yoy at the three-year horizon



Source: CNB, Economic & Strategy Research, Komerční banka

The CNB's new forecast is likely to assume lower GDP growth and higher inflation this year. This would make it more difficult for the bank board to decide on further interest rate movements.

The CNB's new forecast is likely to be based on a significantly lower estimate for economic growth this year and a higher inflation projection. Czech GDP as a whole developed roughly in line with the CNB forecast in 4Q21. However, this was only due to much higher inventories than the central bank had expected, as other expenditure components lagged the CNB forecasts. At a press conference after the last meeting of the bank board

in March, Governor Rusnok warned that the CNB's new forecast would imply just half the economic growth reflected in the previous forecast. In February, the bank expected GDP to grow by 3.0% this year. As is in our forecast, the impact of high inflation on household purchasing power and persistent supply chain issues are likely to be the reasons for a lower estimate of GDP growth. In the case of inflation, on the other hand, we can expect an upward revision of the February forecast, which projected an increase in consumer prices of 8.5% on average this year. In addition to the already mentioned higher-than-expected inflation at the beginning of the year, the sharp increase in commodity prices caused by the war in Ukraine will also have a significant impact. Moreover, this effect will be strengthened by a slightly weaker koruna, which traded at an average of 24.64 per euro in 1Q22, while the CNB expected an average of EUR/CZK 24.50 (i.e. a 0.6% stronger level).

With regard to further interest rate developments, the risks are now more balanced, so central bankers are likely to be more cautious as they hike rates further. Although the risk of prolonged high inflation is still present, it is now offset by the real threat of slow growth or even a downturn in the economy if the worst-case scenario of gas supply disruptions from Russia materialises. This partly reduces the need for a further marked increase in interest rates. The CNB's Graph of Risks to the Inflation Projection (GRIP), published in March, which already takes into account the expected effects of the Russia-Ukraine war on economic developments in the Czech Republic, also speaks in this sense. Accordingly, Governor Rusnok said that he would only expect a "cosmetic" increase in interest rates.

According to our forecast, CNB repo rate will peak at 5.5% in May, and will not start to fall before the beginning of next year.

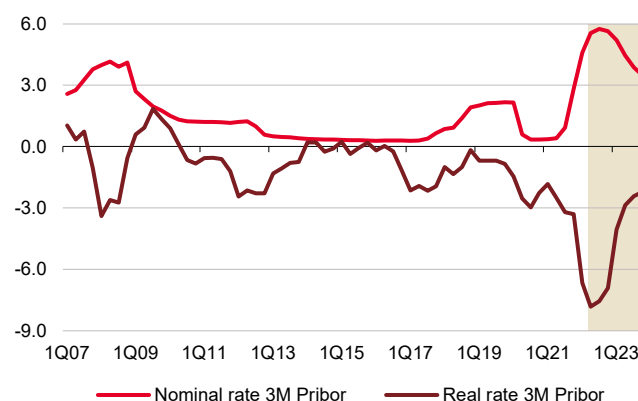
We expect the CNB to raise the two-week repo rate by 50bp to 5.5% at the May meeting, and to hold it at that level until the end of this year. The CNB was among the first to raise interest rates in the middle of last year, and the impact in terms of cooling domestic demand should be evident in a slowdown in core inflation from the second half of this year. The sharp fall in real wages that we anticipate this year, should also contribute to this. We assume that the share of rising energy and food prices in yoy inflation will increase in the coming months. We expect inflation to reach a peak of around 14% in the middle of the year, and to remain in double digits until its end. Due to the persistence of strong inflationary pressures, the risks to our interest rate forecasts are still skewed towards a possibly higher peak or a delayed decline.

Households' fears of inflation are at an all-time high, which is reflected in restraint on larger purchases



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: average for 2003-2021 = 100

We expect interest rates to peak at 5.5% in May, and not to fall before the beginning of next year



Source: CNB, Economic & Strategy Research, Komerční banka

Given our forecast of inflation structure and the already high level of interest rates, we think the CNB could now exclude some of the external price pressures from its policy. Governor Rusnok mentioned this possibility at a press conference after the March meeting. Regarding FX intervention, we expect the central bank to re-enter the foreign exchange

market only in the event of strong financial market pressure weakening the koruna, as was the case at the beginning of March. We do not expect the CNB to intervene in order to artificially strengthen the currency, as such a move would have a strongly negative impact on the export-oriented part of the economy, which is already plagued by persistent supply chain bottlenecks and rapid growth in input prices. In our view, the negative effects on the economy from a sharp strengthening of the koruna would be much stronger than those resulting from higher interest rates, which are still markedly negative in real terms. We do not expect the CNB to start to cut rates back to a policy-neutral 3% before the beginning of next year.

There will be a change in CNB governor from 1 July, but we do not expect this to result in any major shift in the monetary policy stance. The current Governor Rusnok is likely to play a strong advisory role in President Zeman's decision on the new head of the central bank. We think the current Deputy Governors Nidetzky and Mora are the most likely candidates.

Czech IRS market and government bonds



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Yields are close to the peak

Market rates have experienced a further increase across maturities in recent months, following surprisingly strong inflationary pressures in the Czech Republic and abroad. The entire market interest rate curve has thus remained significantly inverted. However, as domestic monetary policy rates approach the peak and rising inflation expectations gradually begin to decline, the potential for rising market rates should soon run out. In our opinion, they are close to their peak and the shorter end of the curve in particular may soon begin to gradually decline, with the prospect of CNB rates starting to return to neutral levels over the next year amid a slowdown in economic growth. The conditions for interest rate hedging have deteriorated significantly as interest rates have risen. At least the inversion of the entire curve or the use of lower interest rates in the euro market offer a hedging opportunity. In an environment of heightened uncertainty caused by the war in Ukraine, government bonds have slightly cheapened vis-a-vis the IRS. Stronger-than-expected issue activity in primary auctions could dampen the 'traditional' richening on government bonds against the IRS curve observed in 2H of previous years. However, demand for bonds remains solid, which in turn will keep their yields below the IRS.

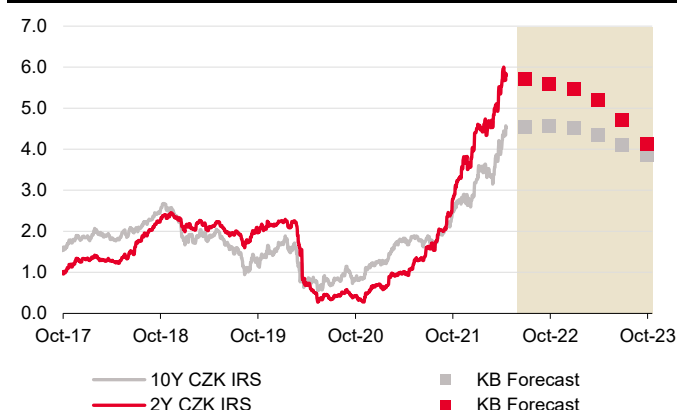
High inflationary pressures in the Czech Republic and abroad have pushed the IRS curve well above pre-target highs. We expect rates to be close to their peak. The curve will maintain its inverse shape at least throughout this year and will not be adjusted until the first half of 2023, mainly in connection with the decline in CNB rates.

Czech IRS market rates still on the rise, despite the war in Ukraine

Market interest rates saw a further sharp rise in the first quarter of this year. This was mainly due to surprisingly strong inflationary pressures, which increased the stakes for rising rates in the Czech Republic and abroad. In total, the yield curve has shifted since the beginning of the year by approximately 120-130bp. The general tendency to tighten monetary policy has not been significantly disrupted by the war in Ukraine. Although its effects are clearly anti-growth, at the same time, the further rise in energy prices caused by the war will lead to faster inflation. This puts the central bank in an awkward position and generally makes the desired 'soft landing' more difficult. The CNB indicated that it could ignore the primary pro-inflationary pressures arising from the war when deciding on monetary policy due to their supply-side nature. Even so, we believe that due to increased inflationary expectations, the solid situation in the domestic labour market and the secondary effects of higher energy prices, it will be forced to raise interest rates even further and then keep them at this elevated level for a longer period of time.

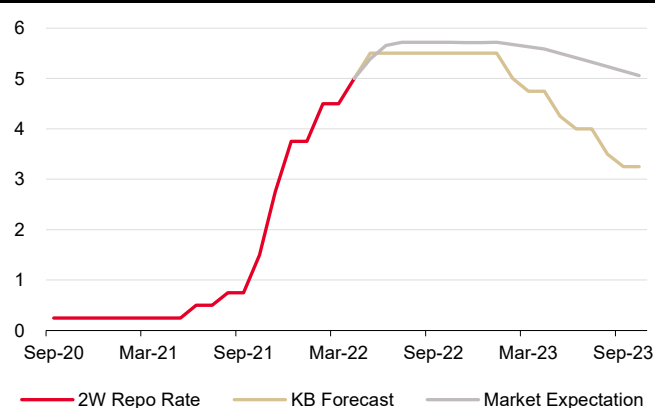
Financial markets expect the CNB's two-week repo rate to peak at 5.5-5.75%. This is roughly in line with our expectation, which is for the base rate to rise by another 50 basis points to 5.5% at the May meeting. In our opinion, the key rate should remain at this level until about the end of the first quarter of next year, when we could see its first reduction. In our opinion, this will subsequently continue due to the easing of inflationary pressures, with the base rate expected to reach a neutral 3% in the first quarter of 2024. We expect a similar development for IRS rates. In our opinion, they are already approaching their peak. Their subsequent decline should be more pronounced for rates with shorter maturities, which are more sensitive to changes in domestic monetary policy settings.

IRS forecast (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Expected CNB key interest rate path as of 22.4.2022 (%)



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

The start of the CNB's rate cuts next year will help normalise the shape of the yield curve. We assume that the significantly inverted shape will remain at least throughout this year and that it will not settle until the first half of 2023 in connection with the turnaround in monetary policy rates, which will reduce its short end.

CZK IRS outlook (end of period, %)

	2Q22f	3Q22f	4Q22f	1Q23f
2Y	5.70	5.60	5.45	5.20
5Y	5.15	5.15	5.05	4.85
10Y	4.55	4.55	4.50	4.35

Source: Economic & Strategy Research, Komerční banka

Forwards and the euro market still offer better interest rate hedging

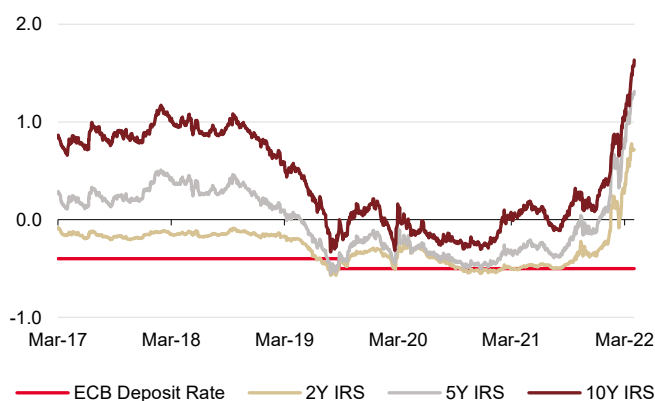
Due to the significant increase in the IRS curve in recent months, the conditions for hedging interest rate risk have deteriorated sharply. Also, the proximity of the peak in market rates does not indicate appropriate timing for domestic interest rate fixation. Thus, an opportunity can currently be seen only in the persistently high inversion of the entire IRS curve, which improves conditions in the forward market, i.e. when using interest rate hedging with a delayed start. With this tool, dizzyingly high levels of the nearest maturities can be cut off and, to some extent, one can benefit from the lower long end of the curve. Despite the recent increase in market interest rates, we still see an opportunity in the euro market, which, in contrast to the Czech market, still offers significantly lower rates.

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

	Maturity						
	6M	1Y	18M	2Y	3Y	5Y	10Y
Spot	5.80	6.07	5.91	5.92	5.54	5.05	4.52
3M	6.16	6.15	6.02	5.86	5.47	4.99	4.49
6M	6.16	6.04	5.94	5.67	5.30	4.87	4.42
9M	5.95	5.93	5.70	5.48	5.13	4.75	4.35
1Y	5.75	5.83	5.45	5.29	4.97	4.64	4.29
18M	5.75	5.28	5.08	4.90	4.68	4.43	4.18
2Y	4.68	4.73	4.57	4.51	4.39	4.23	4.07
3Y	4.22	4.27	4.21	4.21	4.14	4.10	4.01

Source: Bloomberg, Economic & Strategy Research, Komerční banka, as of 22 April 2022

Euro rates continue rising (%)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

Higher issuance activity in the primary market may take longer this year

Compared to the original assumptions, CZGB supply will be increased this year mainly by additional expenses associated with the consequences of the war in Ukraine. We currently assume that the state budget will end in a deficit of CZK310bn this year, which in combination with other financing needs (especially redemptions of previously issued bonds) would mean a need for a total issue of koruna bonds worth around CZK422.6bn this year. In addition, the Ministry of Finance expects to refinance 2012 euro bonds maturing in May for a total of EUR2.75bn this year. It is probable that the MinFin will finance this instalment at least in part by issuing new Eurobonds. In addition to significantly lower yields, they could benefit from the recent involvement of the Central Securities Depository of Czech Republic in the European clearing system operated by the central banks of the euro area countries. This subsequently allowed Czech euro bonds to be classified as eligible assets in Eurosystem credit operations.

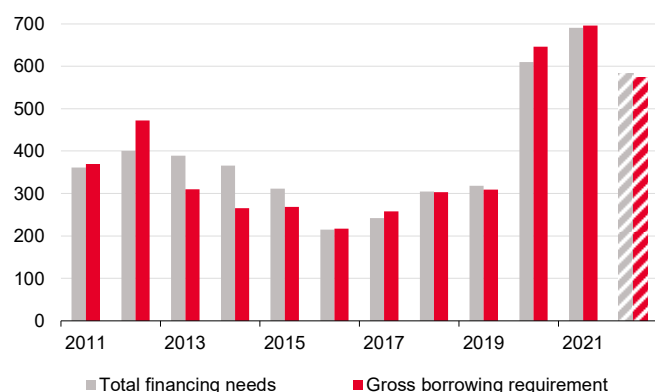
We expect the financing need for this year to reach CZK582.1bn (9% of GDP), which would mean a visible decrease compared to last year's CZK690.4bn (11.3% of GDP). However, increased spending, mainly related to the war in Ukraine, has not yet been pre-financed. Therefore, we assume that increased issuance activity in primary auctions could dampen the richening of government bonds against the IRS curve for the rest of the year (visible in previous years). However, the total issuance activity this year is strongly conditioned by the further development of the war in Ukraine and the way that additional state budget expenditures are financed (part of the expenditures should be covered by EU resources).

Funding programme and issuance activity (CZKbn)

	2022	
	MinFin	KB
State budget deficit	280.0	310.0
Transfers and other operations of state financial assets	0.0	0.0
T-Bonds denominated in local currency redemptions	145.4	145.4
T-Bonds denominated in foreign currency redemptions	74.3	74.3
Redemptions and early redemptions on savings bonds	0.2	0.2
Money market instruments redemptions	49.0	49.0
Redemption of T-bills		33.3
Redemption of other money market instruments		15.7
Repayments on credits and loans	3.2	3.2
Total financing needs	552.1	582.1
Money market instruments		20.0
T-bills		20.0
Other money market instruments		0.0
Gross issuance of CZK T-bonds on domestic market	Min. 350-400	422.6
Gross issuance of EUR T-bonds on domestic market		90.0
Gross issuance of T-bonds on foreign market		0.0
Gross issuance of savings government bonds		41.1
Received credits and loans		0.0
Financial asset and liquidity management		8.4
Total financing sources		582.1
Gross borrowing requirement		573.7
Net CZGB issuance		277.2

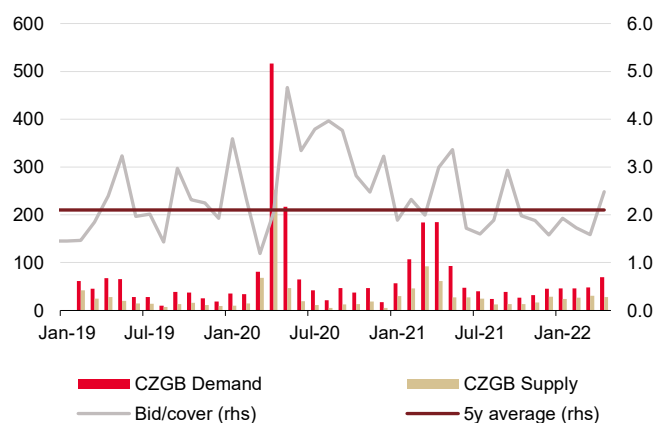
Source: Economic and Strategy Research, Komerční banka, MinFin

Financing needs (CZKbn)



Source: Economic and Strategy Research, Komerční banka, MFCR

CZGB primary market (CZKbn)



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

CZGB yield forecast (end of period)

	2Q22f	3Q22f	4Q22f	1Q23f
2y CZGB yield (%)	5.35	5.25	5.10	4.85
5y CZGB yield (%)	4.95	4.90	4.80	4.60
10y CZGB yield (%)	4.40	4.40	4.30	4.15
10y CZGB ASW (bp)	-18	-18	-21	-18

Source: Economic & Strategy Research, Komerční banka

CZGB yields will soon peak

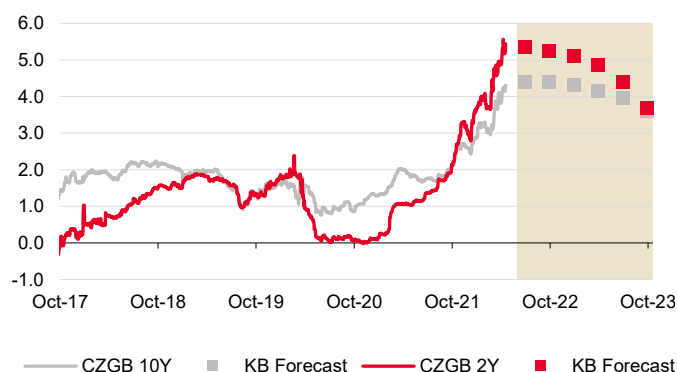
Government bond yields, like the IRS, have continued to rise sharply since the beginning of this year. A total rise of 130-170bp with a more significant increase at the shorter end of the yield curve has been observed. Despite the still relatively solid demand for CZGBs, which was temporarily weakened mainly by the outbreak of war in Ukraine, the increase in CZGB yields was slightly more pronounced than in the case of the IRS curve, and CZGBs thus cheapened in ASW terms. Although we see room for further cheapening in the event of the need to cover increased state budget expenditures with domestic sources, in our opinion CZGB yields will remain lower compared to the IRS curve. In our opinion, Czech government bond yields should fluctuate close to their peak in the coming months and subsequently, like the IRS, begin to decline close to long-term equilibrium values.

Sovereign rating overview

	Local currency	Outlook	Foreign currency	Outlook	Next rating review
S&P	AA	STABLE	AA-	STABLE	29-Apr
Moody's	Aa3	STABLE	Aa3	STABLE	5-Aug
Fitch	AA-	STABLE	AA-	STABLE	6-May

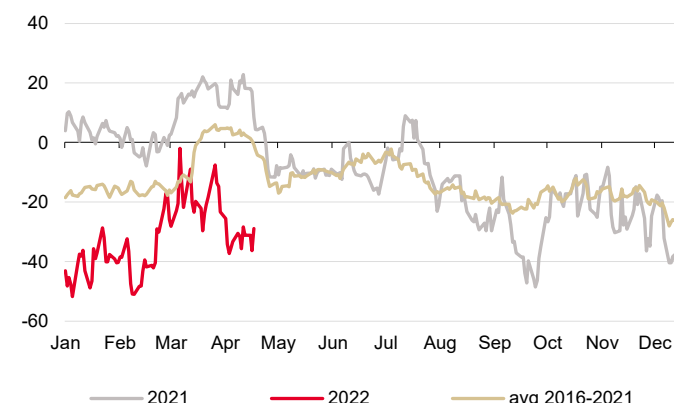
Source: Economic and Strategy Research, Komerční banka, Bloomberg

CZGB yield forecast (%)



Source: Economic and Strategy Research, Komerční banka, Bloomberg

10y CZGB ASW (bp)



Source: Economic and Strategy Research, Komerční banka, Bloomberg

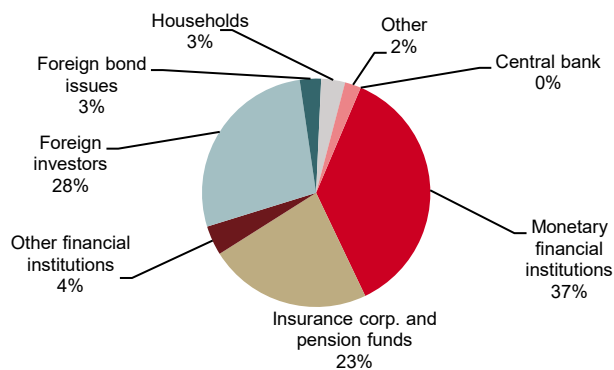
Government bond overview

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
4.70 Sep-22	0.4	0.0	100%	5.26	16	62	-0.38	-45	-4	25	-120		-2	0.8	8	16.4	18	-50.7	19
0.45 Oct-23	1.4	0.0	80%	5.38	9	76	0.45	-69	-9	4	-84		-31	-0.7	19	-12.3	1	-8.4	15
5.70 May-24	1.9	0.0	100%	5.22	19	74	0.68	-69	-6	-1	-98		-32	0.0	16	-5.7	5	-7.8	11
0.00 Dec-24	2.5	0.0	34%	5.11	17	84	1.04	-48	-2	15	-87		-25	0.5	11	-3.3	6	-8.6	18
1.25 Feb-25	2.6	0.0	100%	5.12	21	96	1.14	-44	0	27	-93		-31	1.2	5	-6.2	4	-8.4	16
2.40 Sep-25	3.1	5.1	85%	5.00	13	78	1.31	-38	-5	16	-82		-27	1.2	4	-2.9	7	-8.2	14
1.00 Jun-26	3.9	0.0	100%	4.86	21	88	1.45	-31	-2	20	-73		-23	1.4	2	-0.4	9	-8.4	17
0.25 Feb-27	4.6	0.0	83%	4.74	22	90	1.52	-29	0	27	-76		-27	1.7	1	2.2	13	-7.8	12
2.50 Aug-28	5.6	0.0	94%	4.47	17	74	1.56	-35	-7	18	-67		-25	1.2	3	9.2	17	-8.0	13
2.75 Jul-29	6.2	8.2	100%	4.40	23	69	1.62	-32	-3	10	-62		-15	1.1	7	5.9	15	-7.7	10
0.05 Nov-29	7.3	4.5	57%	4.41	23	71	1.66	-22	-5	12	-46		-11	1.2	6	1.2	11	-6.8	9
0.95 May-30	7.4	0.0	100%	4.33	19	61	1.65	-29	-7	3	-47		-10	0.4	13	5.3	14	-6.6	8
1.20 Mar-31	8.0	0.0	100%	4.28	20	59	1.70	-25	-3	3	-44		-4	0.5	10	2.1	12	-6.0	7
1.75 Jun-32	8.7	20.0	100%	4.24	21	53	1.77	-22	-3	-3	-45		-3	0.5	9	-1.8	8	-5.0	6
2.00 Oct-33	9.7	0.0	100%	4.26	21	54	1.91	-18	-5	-4	-38		5	0.4	14	-8.9	2	-4.0	5
3.50 May-35 * 10.1	20.2	20.2	33%	4.25	21	55	2.00	-21	-6	-4	-29		2	-0.4	18	-8.1	3	-2.7	4
4.20 Dec-36	10.6	0.0	100%	4.25	19	52	2.04	-21	-8	-5	-49		9	0.2	15	0.1	10	-1.3	3
1.95 Jul-37	12.2	2.4	10%	4.24	24	54	1.98	-15	-2	-4	-45		9	0.4	12	6.8	16	-0.3	2
1.50 Apr-40	14.7	3.3	40%	4.26	26	45	1.95	-12	-3	-16	-38		24	-0.4	17	45.6	19	3.2	1

Source: Economic & Strategy Research, Komerční banka

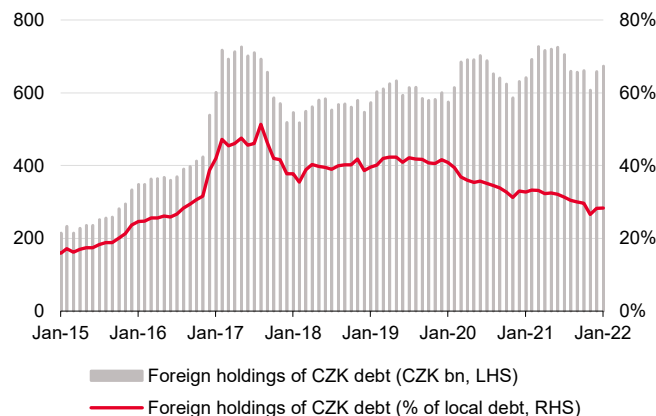
Note: More details in CZGB Auction Alerts

Holdings of CZK government debt (February 2022)



Source: MinFin, Economic & Strategy Research, Komerční banka

The share of non-resident bondholders declines



Source: MinFin, Economic & Strategy Research, Komerční banka

Czech FX market



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Weak economic growth will not support the koruna

There is limited scope for further strengthening of the domestic currency in the coming months. In the short term, the koruna will continue to be supported by a significant interest rate differential. However, both the strong dollar and the significant recent real strengthening of the koruna, supported by rising domestic prices, will counter this, leaving less room for nominal appreciation. We expect the koruna to strengthen to EURCZK24.1 within one year. At the same time, record interest rate differential values are pushing forward points to new highs. Even though the spot exchange rate strengthened after the negative sentiment partially subsided, the conditions for hedging against its appreciation have slightly improved compared to the beginning of this year. In our opinion, the advantage of hedging may be partially increased by one-off fluctuations in the spot rate associated with a possible increase in aversion to EM currencies. The main risk for the koruna, especially this year, is the development of the conflict in Ukraine and its economic consequences.

The koruna has withstood the war shock very well so far

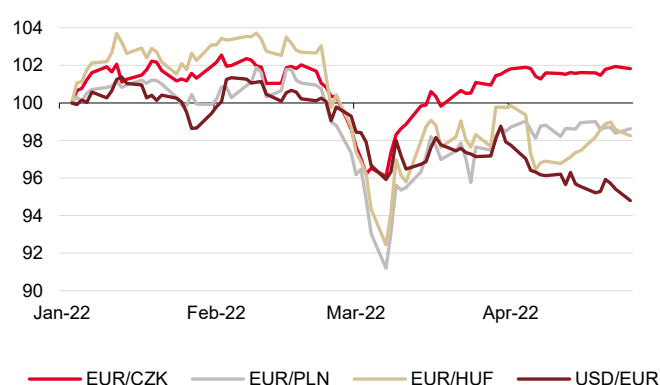
The CE currencies have been under significant pressure since the outbreak of war in Ukraine. The koruna has been the best performing of these currencies. After the first wave of negative sentiment subsided, it was the only one to make a profit compared to the beginning of the year. It benefits from being at the greatest geographical distance from the conflict, but also from solid economic fundamentals supported by a record-breaking interest rate differential. Last but not least, the CNB's intervention also contributed to the relatively rapid return of the domestic currency to stronger levels. Although it may not have intervened in the market much, its determination to prevent excessive exchange rate fluctuations is highly credible for markets and stabilizing per se, given that it has one of the largest foreign exchange reserves in the world (approximately 60% of GDP).

CZK exchange rates



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Performance of CE currencies (1. 1. 2022 = 100)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

We have revised our koruna exchange rate forecast to stronger levels. At the end of the year, we expect the koruna to reach EURCZK24.20 and to strengthen to EURCZK24.10 at the one-year horizon. The koruna will continue to be supported mainly by the wide interest rate differential.

Space for further strengthening is limited in the coming months. On the one hand, the koruna will continue to be supported by a significant interest rate differential in the near term. On the other hand, a strong dollar will have the opposite effect, as dollar appreciation is usually associated with the weakening of emerging market currencies. At the same time, at least in the shorter term, the recent appreciation of the real exchange rate, supported by higher price growth in the Czech Republic, will drain the space for the nominal appreciation of the koruna. Based on real exchange rate filtering, the koruna may even appear overvalued at the moment, creating a risk of slower appreciation. At the same time, net

exports are unlikely to help the koruna this year either. On the one hand, the real strengthening of the exchange rate makes domestic exports less competitive (similarly to the unfavourable development of terms of trade), and at the same time domestic exports will probably suffer from weaker production owing to a component shortage for most of this year.

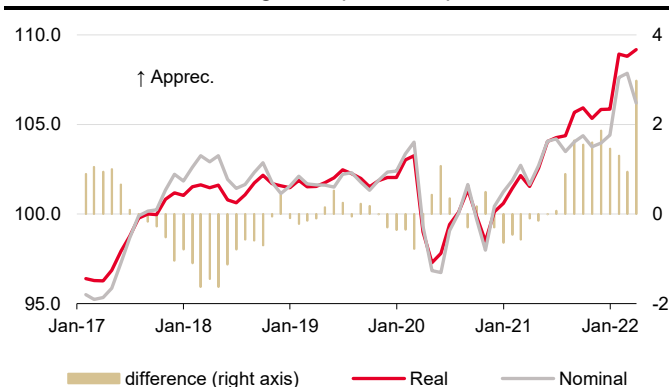
In our opinion, the gradual strengthening of the koruna could resume in the second half of this year. This will again be the result of several opposing factors. On the one hand, the koruna's support from the interest rate differential will begin to weaken. The differential will slowly begin to close, first of all as interest rates abroad begin to rise, and then as domestic rates will be returning back to neutral levels next year. On the other hand, according to our assumptions, the US dollar should weaken, which will boost the koruna. In our opinion, the channel of real appreciation should gradually start pushing in the same direction once increased domestic inflationary pressures start to ease. Overall, we expect the koruna to roughly stagnate at first, followed by a gradual strengthening to EURCZK24.2 at the end of 2022 and EURCZK24.1 at the end 1Q23.

EUR/CZK and interest rate differential



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Effective koruna exchange rate (2020=100)



Source: CNB, Economic and Strategy Research, Komerční banka, trade-weighted effective koruna exchange rate in 2020, real effective exchange rate deflated by PPI

The main risk for the koruna is a worsening of the war in Ukraine and its economic consequences

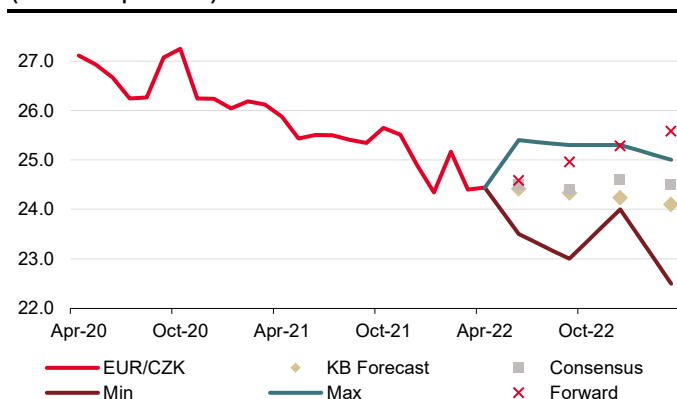
Our forecast assumes a slightly stronger koruna than what the market forecasts, in the range EURCZK0.10-0.40 within one year. The main risk, especially this year, is a worsening of the conflict in Ukraine and its economic consequences. If a significant escalation were to cause a complete interruption of Russian gas supplies to the Czech Republic (on which the Czech Republic is almost 100% dependent), it would probably put significant downward pressure on the koruna. Although the CNB has publicly communicated its determination to take action against "excessive" exchange rate fluctuations in the foreign exchange market, that doesn't necessarily mean that it would be willing to use the exchange rate as a monetary policy tool for a longer period, as in the past. In the event of fluctuations caused by deteriorating fundamentals (which includes the risk of a halt in domestic industry due to gas shortages), the exchange rate may act as a buffer, and depreciation would prevent the full shock from spilling over into the real economy. US dollar movements, specifically the pace of monetary tightening in the US, remain a risk for the koruna exchange rate as well.

Koruna exchange rate forecast (end of period)

	2Q22f	3Q22f	4Q22f	1Q23f
EUR/CZK	24.40	24.35	24.20	24.10
USD/CZK	22.60	22.10	21.45	20.75
EUR/USD	1.08	1.10	1.13	1.16

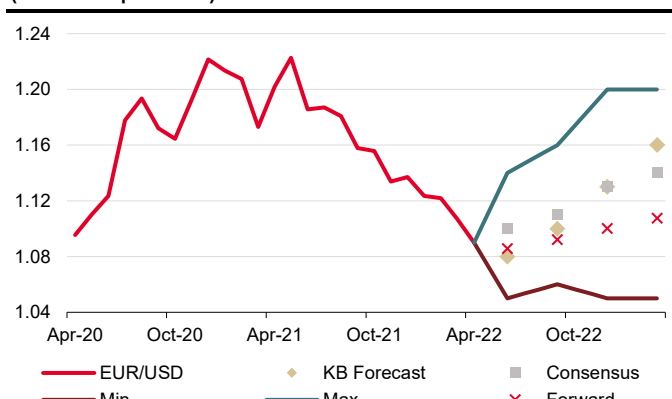
Source: Economic and Strategy Research, Komerční banka, SG Cross Asset Research

Expected EUR/CZK path, market consensus by Bloomberg (as of 22 April 2022)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Expected EUR/USD path, market consensus by Bloomberg (as of 22 April 2022)

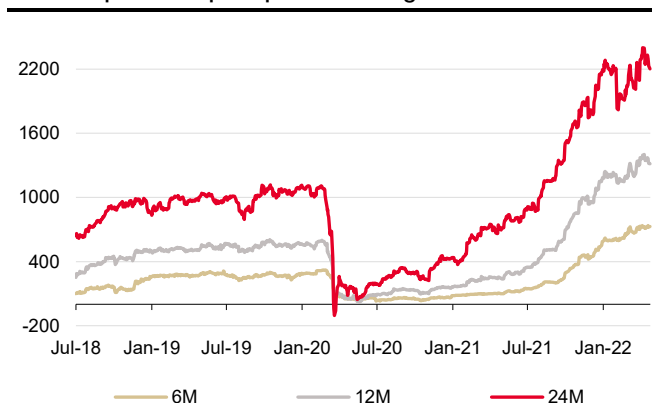


Source: Bloomberg, Economic and Strategy Research, Komerční banka, SG Cross Asset Research

Record interest rate differential pushes forward points to new highs

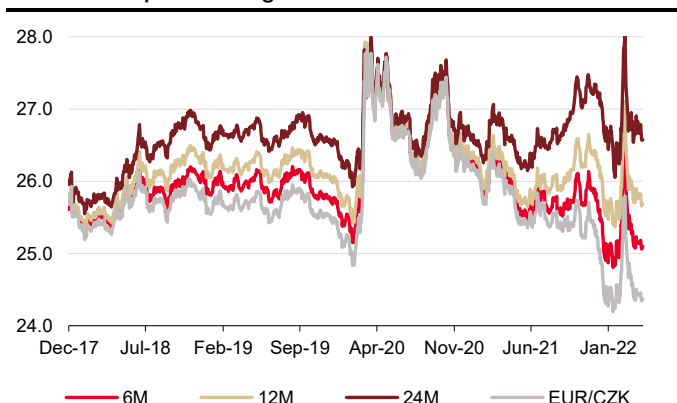
The interest rate differential vis-à-vis euro rates continues to exceed its previous highs. This is reflected in forward points, especially in longer maturities. Despite the strengthening of the spot exchange rate after the negative sentiment partially subsided, the conditions for hedging against its appreciation have slightly improved compared to the beginning of this year. Over the one-year horizon, it is currently possible to reach close to EURCZK25.65, and over two years, EURCZK26.55. The potential for further improvement is, in our view, at least temporarily exhausted. Given the expected early peak of the interest rate differential and its subsequent gradual closing in combination with a slightly strengthening spot rate, hedges may be made more attractive by eventual one-off spot rate fluctuations associated with a possible increase in aversion to regional or emerging market currencies.

Forward points surpass pre-COVID highs



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Forward vs spot exchange rate EUR/CZK



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Banking sector



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Credit growth is likely to slow

At the beginning of the year, the improved economic outlook had a positive effect on lending activity. The expansion of mortgages was helped by the prospect of a close tightening of the conditions for their provision, as well as the expectation of a further increase in interest rates. However, the outlook for the economy has deteriorated, interest rates continue to rise and stricter rules for mortgages came into force in April. Therefore, we expect a cooling of lending activity. This should also lead to a slowdown in the hitherto very fast pace of rising real estate prices. The dynamics of deposits should also slow down. The deteriorating economic outlook implies a gradual increase in the share of non-performing loans.

Higher interest rates, stricter mortgage rules and worse economic confidence will lead to a cooling of the real estate and mortgage markets.

We still expect a slowdown in mortgage and real estate price growth

The rise in the prices of residential real estate in the Czech Republic has accelerated again. In the first quarter, house and apartment prices rose by an average of almost 17% yoy. Their quarter-on-quarter dynamics also accelerated. We believe that there are growing reasons to expect a slowdown here. This is a reduction in housing affordability due to the worsening economic outlook and higher uncertainty, and the fact that prices are higher again. In our opinion, interest rates hikes and stricter rules will lead to a reduction in the hitherto rapidly growing volume of mortgages. Its pace probably reached over 11% yoy in the first quarter, and the effort to take draw mortgages under the previous conditions played a role here. Pumping will still have inertia in the coming months. However, we have been expecting a significant slowdown in quarter-on-quarter growth since the second quarter. After last year's growth in housing loans by less than 10%, we expect this year to increase by an average of 8%, which is due to the strong first half of the year. An increased effort can be expected to finance the purchase of real estate with cash.

Bank loans and deposits (% yoy)

	Q1 21	Q2 21	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22	Q4 22	2021	2022	2023	2024	2025	2026
Bank loans														
Total	4.4	7.0	6.9	9.6	8.9	6.7	3.9	4.4	4.9	8.0	4.9	5.9	5.7	5.7
Households - real estate loans	10.5	11.1	11.4	9.3	6.8	4.5	2.5	2.8	9.9	8.0	3.4	5.6	5.5	5.1
Households - consumer loans	4.1	6.5	7.4	7.0	6.5	5.8	5.4	5.4	3.3	6.7	5.7	6.3	6.5	5.8
Corporate loans	1.9	5.8	7.9	10.3	8.8	7.5	6.9	6.8	0.9	8.6	6.9	5.8	5.3	6.0
Deposits														
Total	7.2	6.6	6.3	5.9	5.1	5.8	2.0	3.4	8.3	5.8	3.7	4.8	5.5	5.1
Households	10.2	7.0	6.5	6.4	4.8	5.2	4.1	3.7	10.2	5.7	4.5	5.4	5.5	5.5
Non-financial corporations	6.6	7.5	8.1	5.3	5.9	6.8	5.7	7.1	8.3	6.5	6.5	5.3	5.7	3.9
Others	2.7	4.6	4.7	5.3	5.2	6.4	-4.5	-0.2	4.9	5.4	0.2	3.3	5.2	5.1
Ratios														
Loans/GDP	62.7	62.9	64.6	64.2	64.4	63.2	63.2	63.0	63.5	64.1	63.0	63.0	63.8	64.6
Deposits/GDP	98.8	89.9	100.7	98.1	97.9	89.6	96.6	95.3	97.7	96.6	93.8	92.8	93.7	94.3
Loans/deposits	63.5	69.9	64.2	65.4	65.8	70.5	65.4	66.1	65.1	66.5	67.3	67.9	68.1	68.6
Interest rates														
Real estate loans	2.5	2.8	3.7	3.9	3.9	3.7	3.5	3.3	2.4	3.8	3.2	2.8	2.7	2.7
Consumer loans	7.6	7.7	8.0	9.1	9.7	10.2	10.5	10.3	7.4	9.2	10.1	9.1	9.1	9.3
Corporate loans	1.9	4.3	5.8	6.8	7.0	7.0	6.7	5.9	2.4	6.7	5.7	4.4	4.2	4.2
Share of NPL														
Real estate loans	1.1	1.1	1.0	1.1	1.1	1.1	1.2	1.3	1.0	1.1	1.3	1.5	1.6	1.7
Consumer loans	5.4	5.4	4.6	5.4	6.0	6.1	6.1	6.5	5.3	5.5	6.7	7.9	8.4	8.7
Corporate loans	4.3	4.3	3.8	3.8	4.1	4.6	5.1	5.3	4.3	4.1	5.2	4.9	4.8	4.6

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

Real estate prices usually react with a significant delay to impulses from the real economy, and therefore here we estimate more significant negative effects of developments on prices rather in the years 2023–2024, when we expect virtually stagnant residential housing prices.

Consumer credit growth will also slowdown

The labor market is still an argument for the growth of consumer credit.

Due to higher interest rates and the deteriorating economic outlook, we expect the quarter-on-quarter growth rate of consumer credit to slow down from the second quarter until the end of this year. On the other hand, the favorable dynamics on the labor market and the outlook for nominal growth in personal consumption, which, however, is due to high inflation this year in particular, support the higher dynamics. In summary, we expect the average growth rate of consumer credit by 6.7% this year and a slowdown to 5.7% next year.

Lending to businesses remain volatile

The growth rate of loans to companies accelerated at the turn of the year, but now we expect a slowdown again.

We have increased the estimate of the growth rate of loans to non-financial corporations to 8.6% this year from the previous 5.1%. However, the reason is not a more optimistic outlook, but better-than-expected developments at the turn of last year and this year. On the contrary, the worsening outlook for the economy and investment, persistent problems in the subcontracting of components to production and rising interest rates, according to our forecast, imply a slowdown in quarter-on-quarter growth since the second quarter. Next year, we expect an improvement in the situation in subcontracting and also a decline in interest rates, which should be reflected in the acceleration of the growth dynamics of loans to companies and for the whole of 2023 to achieve an average growth of 6.9%.

Also, the rise of deposits will probably slow down

The growth in the volume of deposits will slow below the expansion in the volume of loans.

Higher interest rates, a more cautious outlook and nominal wage growth indicate a continued expansion of deposits. This may be offset by the worse financial situation of some households. In summary, we expect a slowdown in quarter-on-quarter growth in both household and corporate deposits after a solid increase at the beginning of the year. For the whole year, we would thus estimate the growth of deposits by an average of 5.8%, i.e. slower than loans by about 2 percentage points, while last year it was the opposite case.

Higher interest rates will increase the share of NPLs

The share of non-performing loans will grow gradually.

We estimate that the share of non-performing loans (NPLs) in consumer and corporate loans fell to even more favorable levels at the beginning of the year. In the case of mortgages, the share of NPLs is only 1%. The war in Ukraine and the deteriorating economic outlook for the near future have pushed these expected trajectories upwards, increasing the share of non-performing loans of all types mentioned. However, these should still be levels that should not cause major problems for the financial sector.

Key economic indicators

Macroeconomic indicators – long-term outlook

		2019	2020	2021	2022	2023	2024	2025	2026
GDP	real, %	3.0	-5.8	3.3	1.8	2.8	2.9	2.2	2.1
Inflation	average, %	2.8	3.2	3.8	12.6	7.2	2.3	1.9	2.0
Current account	% of GDP	0.3	2.0	-0.8	-3.6	-1.6	-1.2	-1.9	-2.3
3M PRIBOR	average, %	2.1	0.9	1.1	5.4	4.3	3.2	3.2	3.2
EUR/CZK	average	25.7	26.5	25.6	24.4	24.0	23.6	23.5	23.3
USD/CZK	average	22.9	23.2	21.7	22.0	20.3	19.4	18.8	18.2

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

Note: KB forecasts are in red

FX & interest-rate outlook

		26-04-2022	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23
EUR/CZK	end of period	24.3	24.40	24.35	24.20	24.10	23.95
USD/EUR	end of period	1.08	1.08	1.10	1.13	1.16	1.18
CZK/USD	end of period	22.5	22.60	22.10	21.45	20.75	20.30
3M PRIBOR	end of period, %	5.40	5.75	5.65	5.65	5.45	4.75
10Y IRS	end of period, %	4.56	4.55	4.55	4.50	4.35	4.10

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

Note: KB forecasts are in red

Monthly macroeconomic data

		VII-21	VIII-21	IX-21	X-21	XI-21	XII-21	I-22	II-22	III-22
Inflation (CPI)	%, mom	3.4	4.1	4.9	5.8	6.0	6.6	9.9	11.1	12.7
Inflation (CPI)	%, yoy	1.0	0.7	0.2	1.0	0.2	0.4	4.4	1.3	1.7
Producer prices (PPI)	%, mom	7.8	9.3	9.9	11.6	13.5	13.2	19.4	21.3	24.7
Producer prices (PPI)	%, yoy	1.6	1.2	0.7	1.9	1.2	-0.1	6.9	2.2	4.2
Unemployment rate	% (MLSA)	3.7	3.6	3.5	3.4	3.3	3.5	3.6	3.5	3.4
Industrial sales	%, yoy, c.p.	-0.2	1.5	-3.9	-7.8	4.2	0.9	4.0	-0.3	n.a.
Industrial production	%, yoy, c.p.	4.9	8.0	-1.6	-6.1	11.0	8.3	15.6	9.2	n.a.
Construction output	%, yoy, c.p.	-1.4	4.8	3.5	1.1	5.5	11.3	7.9	18.9	n.a.
Retail sales ex autos	%, yoy	3.7	4.6	3.5	7.7	11.8	0.1	8.5	4.6	n.a.
External trade	CZKbn (national met.)	-9.8	-28.0	-15.9	-16.6	4.8	-15.8	8.2	-4.4	n.a.
Current account	CZKbn	-24.2	-44.3	-15.4	-14.5	-12.0	-27.3	7.7	-5.8	n.a.
Financial account	CZKbn	-40.2	-30.0	1.3	-11.3	-39.3	20.1	-8.4	-22.2	n.a.
M2 growth	%, yoy	10.2	9.9	8.8	8.2	8.0	7.3	6.9	6.1	n.a.
State budget	CZKbn (YTD cum.)	-279.4	-298.1	-326.3	-335.0	-401.5	-419.7	3.9	-45.3	-59.1
PRIBOR 3M	%, average	0.69	0.94	1.11	2.02	2.97	3.50	4.21	4.69	4.86
EUR/CZK	average	25.6	25.5	25.4	25.5	25.4	25.2	24.5	24.5	25.0
USD/CZK	average	21.7	21.6	21.6	22.0	22.3	22.3	21.6	21.6	22.7

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

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