

Quarterly report

# Czech Economic Outlook

## There was a recession? When?



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■ **Gradual resumption of economic growth.** In 2H22, the economy experienced a shallow and short-lived recession. This year, we expect a gradual recovery. Industrial production is likely to benefit from a high order backlog and renewed supply of inputs, while domestic demand should be supported by higher wage growth and falling energy prices.

■ **Inflation to remain in double digits this year.** We expect annual inflation to accelerate in January due to the end of the special energy tariff and the rise in energy prices, but after that it should start to moderate. Due to elevated energy prices, inflation is unlikely to fall below 10% yoy by year-end. Next year, we foresee a sharp reduction towards the CNB's 2% target.

■ **CNB missed the right moment for further rate hikes.** In our view, interest rates will remain at current levels until August this year, when they could start to fall gradually to a policy-neutral 3% by the end of 2024.

■ **Market rates on a downward trend.** We expect the short end of the curve to continue to decline gradually in line with the start of domestic monetary easing in 2H23 and weakening inflationary pressures.

■ **The koruna not out of the woods yet.** Despite the CNB's presence on the FX market and the recovery in foreign trade, we expect the koruna to weaken slightly against the euro by the end of the year, mainly due to the decline in the interest rate differential.



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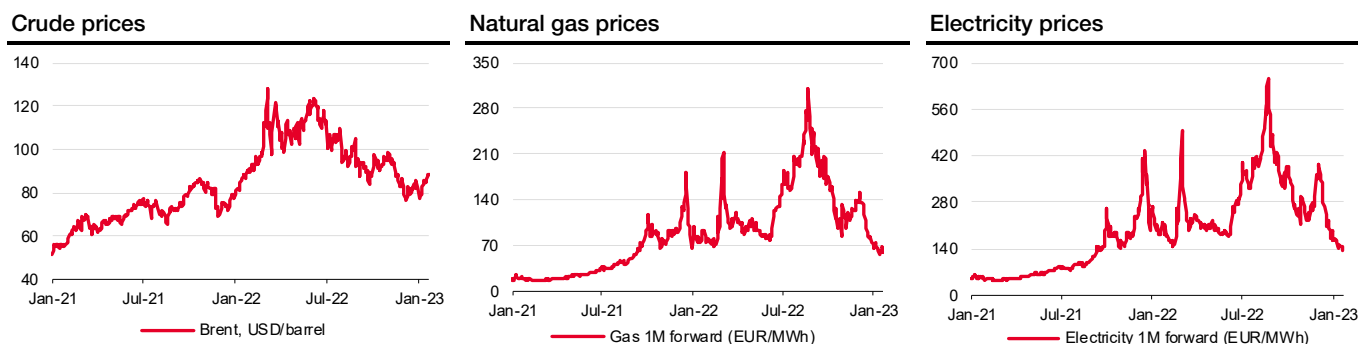
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## The Czech economy's wheels have not frozen up



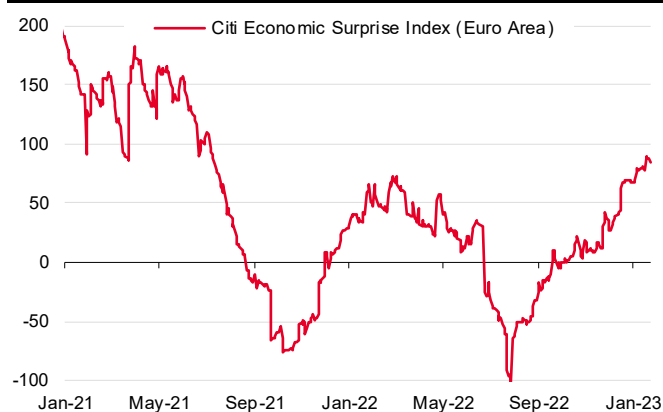
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**2022 is over; it will go down in the history books as the year Europe was confronted with a war at its borders because of Russia's invasion of Ukraine.** Naturally, this has had significant economic consequences. The war and Western countries' subsequent economic sanctions have had a major impact on the price of commodities, and primarily on energy prices. The dramatic rise in these prices has only added fuel to the fire of mounting inflationary pressures. As winter approached, there were significant concerns about the physical availability and financial affordability of the key energy resources, mainly gas.

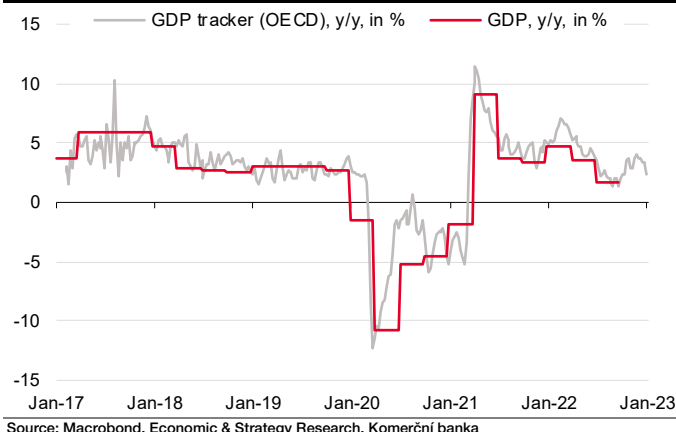


In the editorial of the last *Czech Economic Outlook* edition, “*The Czech economy is losing power*”, we forecast that the Czech economy's wheels would not freeze up. One quarter later, it would seem that this has proven to be the case. **The last three months of 2022 had above-average temperatures**, as confirmed by the Czech Hydrometeorological Institute's data for the Czech Republic. January is on track to continue this unusually warm weather trend, and not only in Central Europe. The mild weather experienced to date this winter is one of the factors that has caused a turnaround in the trend of the developments in energy markets, in combination with austerity measures adopted by European households and businesses and supply from alternative sources. In January, key commodity prices have even declined to their pre-war levels.

### Euro area's economic indicators are surprisingly positive



### OECD's GDP tracker indicates no recession in Czech Republic

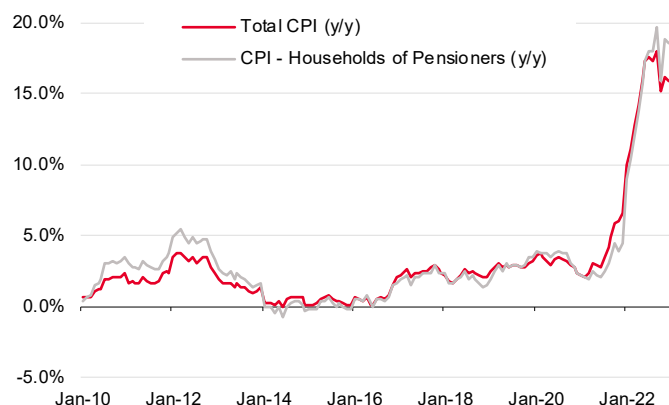


**The Czech Republic's economy was losing energy in the second half of last year.** For the third quarter, a real qoq decline of 0.2% was reported and according to our estimates, it reached 0.3% in the fourth quarter. Nevertheless, all indicators now point to the Czech economy's recession being shallow. **In addition, 2023 is shaping up to be a year of gradual recovery in economic activity, in our view**, given the outlook for the Czech Republic's major

trading partners. The euro area's economy has apparently not fallen into recession at all and, in addition, Germany – a key trading partner for Czechia – has evaded it by a hair's breadth. And on top of that, the reported leading indicators from the euro area are surprisingly positive.

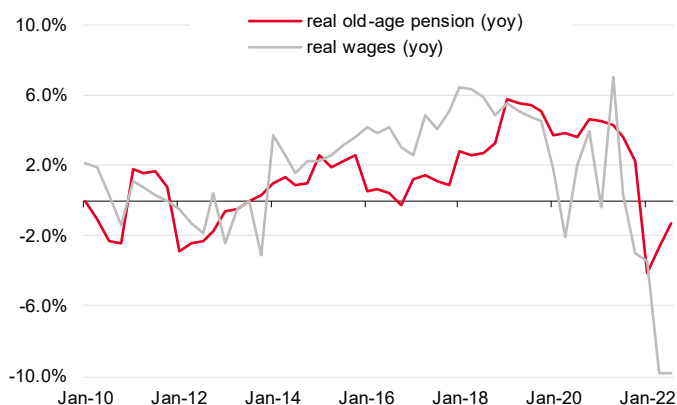
**Last year was clearly marked by inflation in the Czech Republic.** Inflation averaged at 15.1% and thus was the highest since 1993. The situation triggered discussions on the nature of the inflation in terms of its source, and whether it had been caused primarily by demand or by supply; this had relatively fundamental monetary policy implications, particularly given the change in CNB Governor in July 2022. Furthermore, the rate hikes ended when the central bank's board was partly replaced. Debates on the impact of high inflation on the various economic entities are also relevant. Kevin Tran Nguyen discusses this issue in this *Czech Economic Outlook* edition in a special box. And the result is evident: to date, companies have been able to pass on their higher costs to their customers. Therefore, the eroded purchasing power is impacting mainly on households, but not with the same intensity on all. For example, although pensioners were experiencing a higher rate of inflation because of their greater relative share of expensive foodstuffs and energy, thanks to indexation schemes, the decline of old-age pensions in real terms was insignificant last year, in particular when compared with the drop in real wages. It is no wonder then that the consumer recession has actually been with us for a long time. Household consumption has been declining continuously since 4Q21.

**Inflation for pensioners is higher, ...**



Source: Economic & Strategy Research, Komerční banka, CZSO

**... but the drop in real income is more dramatic for employees**

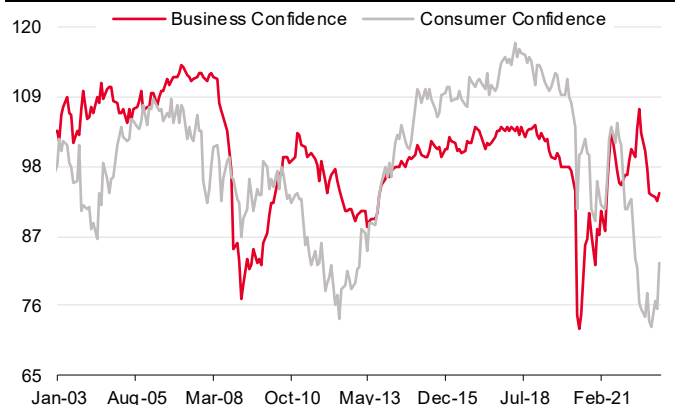


Source: Economic & Strategy Research, Komerční banka, CZSO, Czech Social Security Administration

**Czech consumers tend to be very sensitive to the economic situation.** In periods of economic expansion, consumer confidence usually surpasses business sentiment, while in periods of economic downturn it is exactly the other way around. This development had substantive causes last year. As mentioned above, and we discuss it in the box in detail, companies were

mostly able to pass through the rising costs into their end prices. However, no proportionate increase in wages took place and the purchasing power of employees' earnings as well as

**Consumer sentiment at the freezing point**



Source: Economic & Strategy Research, Komerční banka, Czech Statistical Office  
Note: Long-term average (2003-2021) = 100, seasonally adjusted

savings dropped to record low levels. At the end of 2022, consumer confidence reached its lowest level since 1998.

**This year will be difficult but there is no reason for extreme pessimism.** The country's recession was apparently only a short episode in the second half of last year. This is the reason why we have opted for "*There was a recession? When?*" as a title for this edition of the *Czech Economic Outlook*. We believe that the labour market situation will not deteriorate dramatically in the coming months and employment will continue to be high thanks to the short-lived, shallow recession. As for inflation, it has already peaked in early 2023, and it is only a matter of time when not only the market rates but also the monetary policy rates decline; we expect this to happen in the second half of this year.

**So, let's look forward to springtime. As it approaches, consumer sentiment should start to pick up** as the economic situation steadily improves and the days get brighter and longer. I am confident that reading Komerční banka's *Czech Economic Outlook* will make the remaining winter weeks more pleasant for you!

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## External environment and assumptions



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### Major economies will likely avoid recession this year

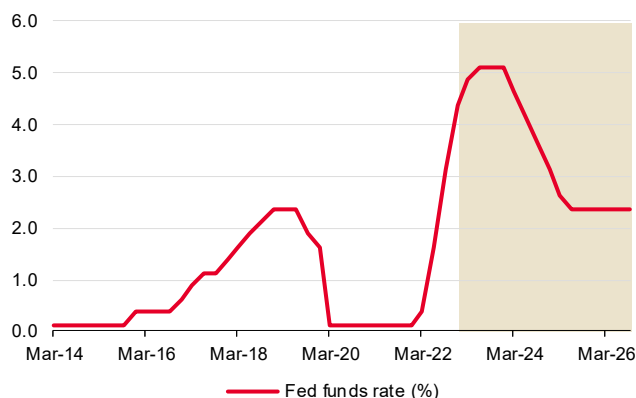
Inflation will likely not return to the US and European central banks' targets this year, in our view, implying that they will both have to continue with their tightening monetary conditions. SG economists expect the key rate to rise to 5.0%-5.25% in the US (this level is likely to be reached in May), and to 3.75% in the euro area (by July). In both cases, the financial markets are, in our view, underestimating the central banks' actions. In addition, rates could go even higher than we expect. We forecast that both economies will avoid a recession this year. In the US, we expect a shallow recession only in early 2024.

### US: markets underestimate the Fed's actions

We see the Fed key terminal rate at 5.0-5.25%, risks concentrated to the upside.

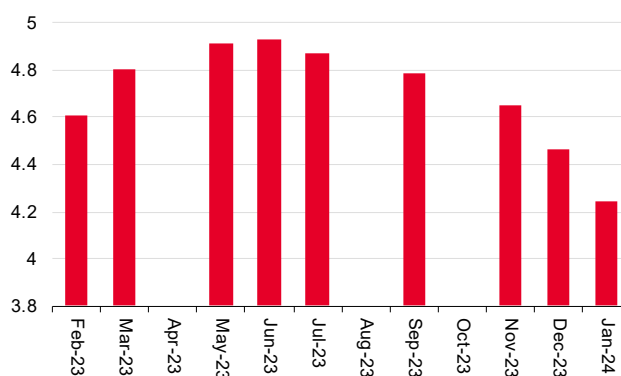
The US Federal Reserve raised its key interest rate by 50bp to 4.25%-4.50% in December. At the same time, the central bankers' new projection implied a further 75bp increase, bringing the key rate to a terminal level of 5-5.25%. This is also in line with our forecast, which foresees the key rate reaching this level in May this year. Market expectations have stalled at 5%. Moreover, forward rates already include in their prices the assumption that the central bank will start cutting interest rates in the second half of this year. By the end of the year, the rate should already be back to 4.5%, according to the market expectations. However, we consider this assumption to be unfounded as even the central bank does not foresee interest rate cuts in its forecast. On the contrary, it emphasises that rates will have to remain at a higher level for a longer period. Moreover, for the central bank to be able to cut interest rates, inflation would have to start approaching 2-3% yoy or a deeper recession would have to be imminent. However, we have not yet observed such signals. We see the first rate cut only in 1Q24. The rate should reach the level of 2.25-2.50% in mid-2025, in our view.

Fed to raise rates to 5.0-5.25%, risks are to the upside



Source: SG Cross Asset Research/Economics

Market expects interest rate cuts already this year

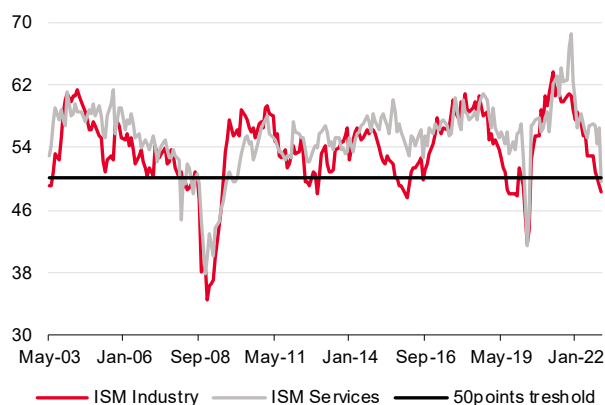


Source: Bloomberg

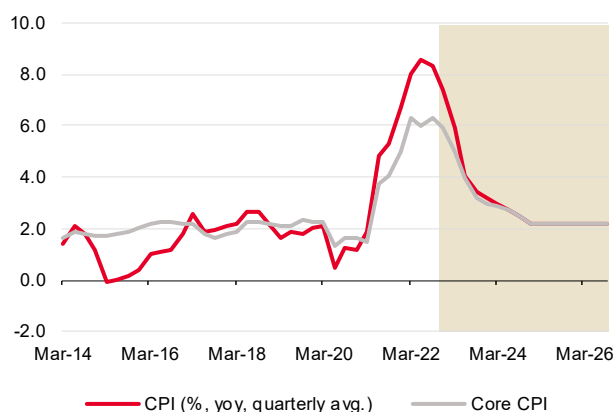
**Our estimate assumes a mild recession in the United States only in early 2024.** GDP for 4Q22 could reach up to 2.5% qoq annualised growth, which would mean that its full-year dynamics would be higher than our original estimate (1.2%). While leading indicators have deteriorated significantly, falling below the 50-point threshold, they are still not in recessionary territory. The labour market remains very strong. Job creation is still outpacing growth in the labour force. Sectors such as healthcare, hospitality and entertainment are still lagging 2020 levels in terms of headcount and are looking for new hires to return to their normal performance. This, in turn, is contributing to wage growth (we expect personal incomes to grow 6% this year), adding fuel to the inflationary fire. While inflation had already slowed down

at the end of last year (from June highs of 9.1% yoy to 6.5% yoy in December), this was mainly due to a decline in used car and energy prices. However, these categories do not have enough weight to offset rising rent prices (currently up 9% yoy, while a max 3-5% rise would be needed to slow inflation).

ISM index below 50, but not in recession territory



Inflation to return to target at end-2024 at the earliest



## Euro area will likely avoid recession

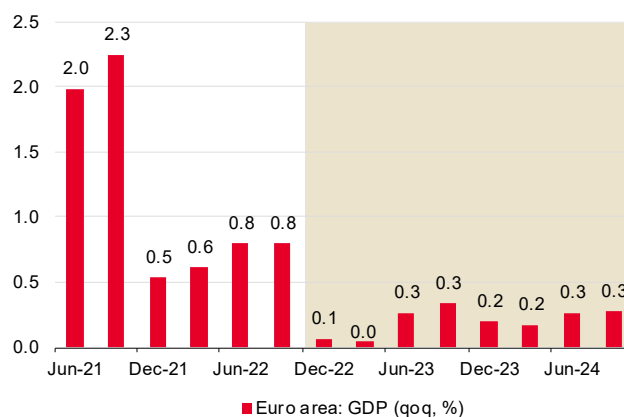
Households benefit from savings and tight labour market.

**The euro area economy showed solid resilience to energy and cost shocks last year, growing sequentially by 0.6%, 0.8% and 0.3% qoq in the first three quarters.** Households continued to benefit from accumulated pandemic savings, government support and historically low unemployment (6.5% in November). These factors, albeit to a lesser extent, should remain in play this year, with solid wage growth continuing (our estimate for this year is 4.5%).

Unemployment rate remains near historical lows



Eurozone will avoid recession (GDP, q/q, %)



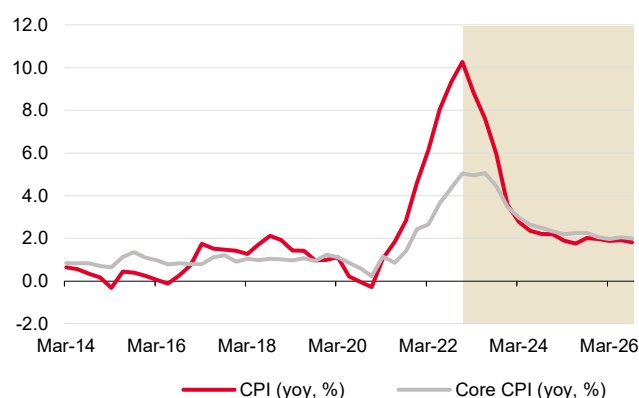
**While the unemployment rate will likely rise slightly this year (to 7.1%), it will still be well below its equilibrium level (our NAIUR estimate is 8.5%).** Meanwhile, businesses are benefiting from their strong ability to pass on high input prices to end customers, which is then reflected in their high profit margins. The willingness of companies to invest and recruit new employees thus persists. Subcontracting problems are also disappearing, which is helping the recovery in the automotive industry. The German economy, which posted zero qoq growth in 4Q22, is also likely to avoid a recession. For the whole of this year, we have revised our estimate for Germany from zero growth to 0.5%.

Core inflation is forecast to be above 5% also in the coming months.

**In December, the European Central Bank raised rates by 50bp as expected (deposit rate to 2.0%, repo rate to 2.5%).** At the same time, it announced that it would start quantitative tightening at EUR15bn per month from March. This is a very moderate pace, in our view, which means the ECB will have to push inflation to lower levels through higher interest rates. We therefore expect the deposit rate to climb to 3.75% by July this year. We expect 50-point hikes in all three interest rates in January and March, and 25-point hikes in May, June and July, with the last hike expected to be on the deposit rate only.

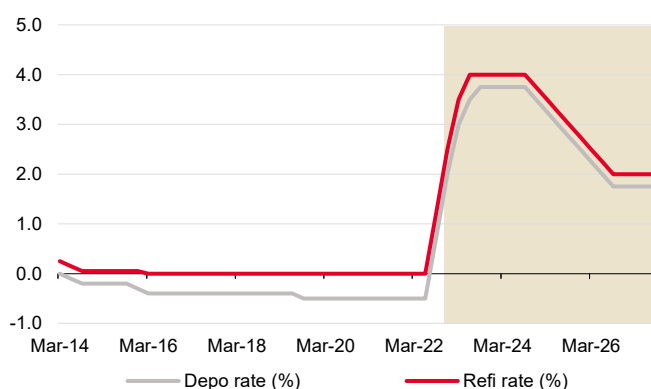
**However, the risks are concentrated in the direction of an even sharper tightening of monetary conditions through the interest rate channel.** It will all depend on the further development of inflation, which, although it seems to have peaked at 10.7% yoy in October last year, will slow down only gradually. Core inflation is forecast to be around 5% for the whole of the first half of this year, and to stay well above 2% until the end of 2024. The ECB will therefore not be able to start cutting interest rates before it is confident that inflation will be close to the inflation target within a year or so. We therefore do not expect the first rate cut until the end of 2024.

**Euro area inflation past its peak (% , yoy, quarterly averages)**



Source: SG Cross Asset Research/Economics

**ECB to continue raising rates (%)**



Source: SG Cross Asset Research/Economics

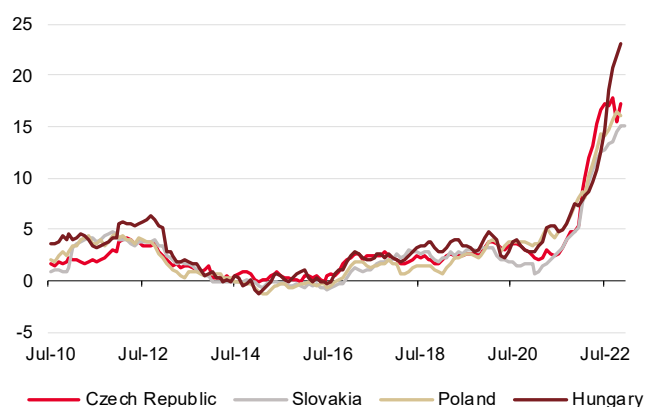
Neither the Hungarian or Polish central banks will hike interest rates.

## CEE: the end of the rate hikes cycle

**Inflation in the region is already close to its peak.** Polish inflation surprised by slowing down to 16.6% yoy in December, when the market expected it to remain around November's level (17.5% yoy). Inflation is likely to pick up further in January and February but is unlikely to rise above the 20% level. The central bank, led by Governor Glapinsky, remains dovish, so in our view will already leave rates unchanged at 6.75%. We then expect the first rate cut (by 50bp) in October. The Hungarian central bank is also unlikely to move rates in the near term. Inflation accelerated to 24.5% yoy in December from 22.5% in November due to the removal of the fuel price cap. Inflation is likely to accelerate slightly further in the first few months of the year, so we expect the central bank to keep the overnight deposit facility at the current high level of 18%. The 3m base deposit rate will remain at the current 13%, the level at which we forecast the overnight rate to return to in 2H this year.

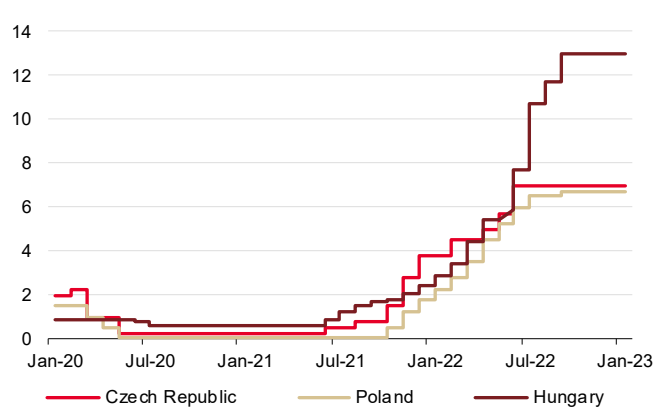


**Inflation in the region at historical highs (HICP, %, yoy)**



Source: Bloomberg, Economic & Strategy Research, Komerční banka

**Monetary tightening at an end (key rates, %)**



Source: Bloomberg, Economic & Strategy Research, Komerční banka

## Macroeconomic forecast and monetary policy



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### Major changes

#### GDP:

We expect the economy to grow by just 0.3% this year, which is slightly less than in the previous forecast (0.5%). The good news, however, is that the recession, which was shallow and short-lived, is likely to have passed. There should be a gradual recovery over the course of this year, which should translate into higher GDP growth next year. We estimate it at 2.4%, which is lower than the previous forecast (3.1%).

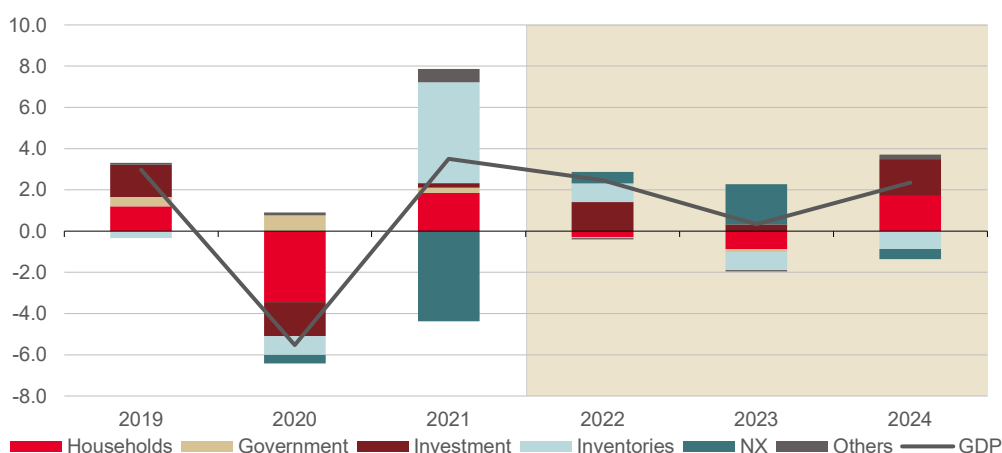
#### Inflation:

We have raised our inflation estimate for this year from 12.0% to 12.9%, influenced by the expected stronger rise in energy prices. Next year, energy price growth should subside, as well as growth in other inflation components. Inflation should therefore fall significantly to an average of 2.5%, slightly lower than we had forecast a quarter earlier (2.8%).

### Shallow and short-lived recession has passed

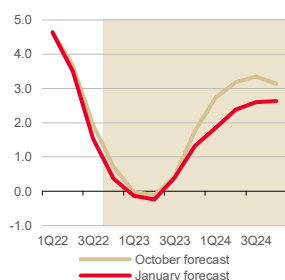
We estimate that the Czech economy contracted by 0.5% in the second half of last year and expect a gradual recovery in economic growth this year. As a result, the recession should only be technical, caused mainly by declining domestic demand. The labour market is therefore likely to remain tight, with only a slight increase in unemployment. This should contribute to higher nominal wage growth. Inflation is unlikely to fall below 10% yoy this year and it is set to continue to weigh heavily on households' purchasing power. Next year, inflation should converge to the CNB's 2% target. We do not expect the CNB to raise rates further, while the start of rate cuts is approaching.

We expect GDP to grow by only 0.3% this year and accelerate to 2.4% next year (% , yoy)



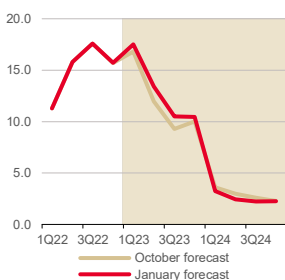
Source: CZSO, Economic & Strategy Research, Komerční banka

### Change in GDP forecast (% , yoy)



Source: CZSO, Economic & Strategy Research, Komerční banka

### Change in CPI forecast (% , yoy)



Source: CZSO, Economic & Strategy Research, Komerční banka

### Technical recession is over, gradual recovery about to begin

**Declining household consumption contributed to the quarter-on-quarter decline in the Czech economy in 3Q22.** GDP fell by 0.2% qoq, which was slightly lower than our forecast of a stagnant economy. Due to high inflation and the associated drop in real wages, as well as increased economic uncertainty linked first to the pandemic and then to the war in Ukraine, household spending declined for the fourth consecutive quarter. While in nominal terms household consumption was 12.4% higher year-on-year in 3Q22, it declined 5.7% net of the effect of rising prices. Real household consumption was therefore at the same level seen at the beginning of 2021 and 6% lower compared to the pre-pandemic 4Q19 level. However, the sharp drop in consumer spending in 3Q22 was offset by the positive contribution of net exports to qoq GDP growth, which was related to a rebound in industrial production, helped by a partial resumption of input supplies. The increase in production was particularly strong in the automotive industry.

**The economy was in a shallow and short-lived recession in 2H22, according to our estimates.** We expect GDP to decrease by 0.3% qoq in 4Q22. Two consecutive quarter-on-quarter declines would therefore meet the definition of a technical recession. In our view, the continued economic contraction was mainly due to falling household consumption, and after a 3.2% qoq decline in 3Q22, we expect a 1.4% qoq contraction in 4Q. Rapid price growth and increased uncertainty, the same factors as in the case of consumption, are also likely to have had a negative impact on fixed investment. As a result, fixed investment likely declined throughout 2H22. In contrast, industrial production is likely to have continued to grow. Although demand for industrial goods is falling, businesses still have a large backlog of

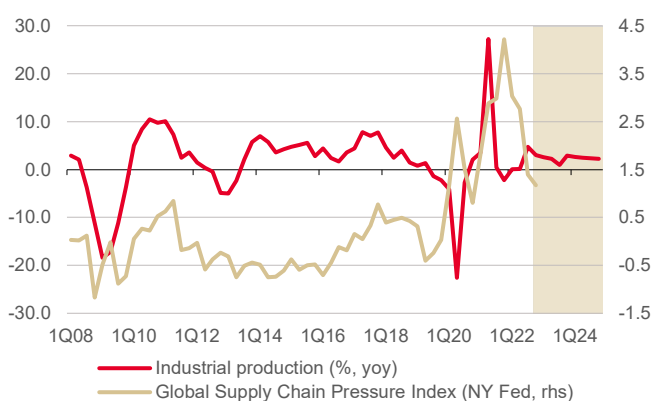
orders from previous months. These orders were not delivered due to missing components. However, the situation in supply chains has improved to such an extent that the constraint of material shortages is becoming less limiting for companies. Based on an indicator from the NY Fed, tensions in supply chains are at their lowest in about two years. Consequently, the structure of economic growth in 4Q22 was likely similar to that of a quarter earlier. Higher net exports largely offset the decline in domestic demand.

In our view, the technical recession, forced mainly by a decline in consumer demand, is already over. We expect a gradual recovery in economic growth over the course of this year.

### The recession will be replaced this year by a gradual recovery in economic growth.

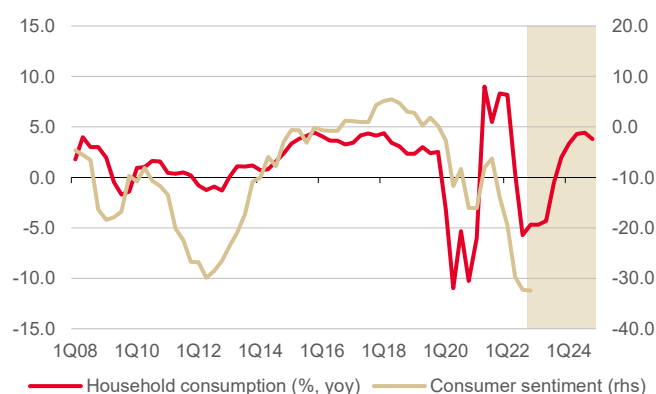
The economy still has some catching up to do, as it has not yet even reached pre-pandemic levels. It lagged by around 0.6% in 3Q22. We expect industrial production growth to continue throughout this year. The positive effect of the completion of previous orders should remain – at least for the next few months – stronger than the negative effect resulting from the lower number of new orders. The persistently high level of inventories in the national accounts continues to indicate a high level of work-in-progress. Moreover, the optimistic outlook for external demand is good news for the export-oriented industry. According to external assumptions of our forecast, not only the eurozone economy, but also the economy of Germany, the most important trading partner for the Czech Republic, should avoid recession. Meanwhile, a significant correction in prices on wholesale energy markets should provide a boost to energy-intensive industries. Both electricity and natural gas were trading at pre-war prices at the beginning of this year. Electricity on wholesale markets was around EUR/MWh120 and gas around EUR/MWh60. This is the lowest since autumn 2021 in both cases. With consumer price growth slowing and wage dynamics accelerating, as well as the situation around the physical availability and price affordability of energy calming down, we expect domestic demand to first stabilise and then gradually resume its growth path this year. This is likely to be the case for both household consumption and fixed investment. Consumer sentiment is no longer worsening but remains at very low levels. We expect GDP growth of 0.1% qoq in 1Q23 and a slight acceleration to 0.2% qoq in 2Q. The first half of the year will therefore still be marked by a relatively weak performance of the economy.

Tensions in supply chains have eased significantly



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

Household consumption to recover gradually



Source: CZSO, Economic & Strategy Research, Komerční banka

The economy is unlikely to return to pre-pandemic levels (end-2019) until the last quarter of 2023.

**According to our forecast, the economy will grow by just 0.3% this year, before accelerating to 2.4% next year.** Compared to our previous forecast, this year's growth is slightly lower (0.3% vs 0.5%), while that for next year significantly lower (2.4% vs 3.1%). The depth and length of the recession remained unchanged in our forecast (lasting two quarters and implying GDP contraction of a total 0.5%), but the economic downturn came a quarter earlier than we had anticipated. The pace of expected recovery this year is slower than in our previous forecast. The changes to our GDP forecast are mainly related to the weaker outlook for household consumption. However, this is already significantly affected by the decline in 3Q22, which was much stronger than we had foreseen. For the whole of this year, we

expect household consumption to decline by 1.9%, while next year it should rise by 4.0%. We expect the contribution of net exports to GDP growth to be significantly positive this year and slightly negative next year. This reversal will be influenced by the gradual fading of the catch-up effect of industrial production combined with a recovery in domestic demand, which will gradually spill over into higher imports. In our view, fixed investment will increase only slightly this year (+1.2%) and will grow faster next year (+6.4%). This should be helped by the absorption of EU funds, in which the Czech Republic is still behind schedule. In our forecast, the achievement of the pre-pandemic GDP level of 4Q19 is again postponed by one quarter to the last quarter of this year.

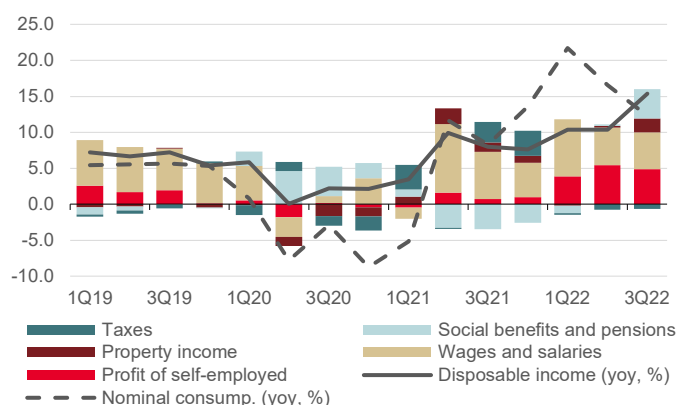
**The main risks to our GDP forecast are the possibility of worse economic developments abroad or a continued rapid decline in consumption.** The possible disruption of gas supplies remains a risk, but its significance has decreased. The high filling of gas storage facilities and supplies from alternative sources, as well as the mild winter so far, are contributing factors.

### Low unemployment to persist and wage growth set to accelerate

The labour market is likely to remain tight despite the technical recession. This should contribute to higher nominal wage growth, but it is unlikely to be enough to cover inflation this year.

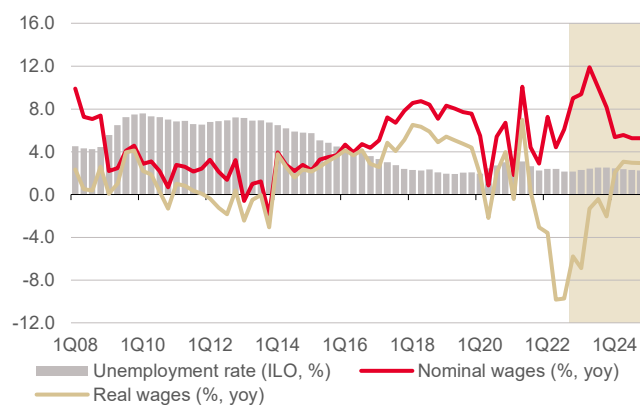
**Unemployment rate remains at very low levels and labour market tensions persist.** Both the ILO unemployment rate and the share of unemployed persons have returned to near pre-pandemic record-low levels. Although the number of job vacancies had fallen in the previous months, it still exceeded the number of unemployed registered at the labour offices. Labour markets in neighbouring countries are also tight, with the unemployment rate in the euro area falling to historically low levels. This may further increase the demand for domestic workers, especially in the case of more skilled occupations. We expect the shallow and short-lived recession to result in only a small, delayed increase in unemployment, in the case of the ILO unemployment rate from the current near 2% to 2.5%. This is lower than we had expected in our previous forecast. Contributing to this is the lower-than-expected unemployment rate in recent months. As the economy picks up again, employment growth should also gradually resume at a moderate pace.

**Pensions and social benefits boosted disposable income growth**



Source: CZSO, Economic & Strategy Research, Komerční banka

**Real wages to continue to fall this year due to inflation**



Source: CZSO, Economic & Strategy Research, Komerční banka

### We expect average nominal wages to rise by 9.9% this year and by 5.4% next year.

According to leading indicators, the end of last year was already marked by stronger wage dynamics. Some companies decided to compensate employees for at least part of the decline in real wages due to high inflation, either in the form of extra bonuses or higher tariffs. Wage increases were also implemented in the autumn for some public sector employees. According to our estimates, the growth in average nominal wages accelerated from 6.1% to 9.0% yoy in 4Q22 and was 6.7% for the whole of last year. However, this fell far short of last year's inflation of 15.1% and so real wages are likely to have fallen by a significant 7.2% in 2022. We

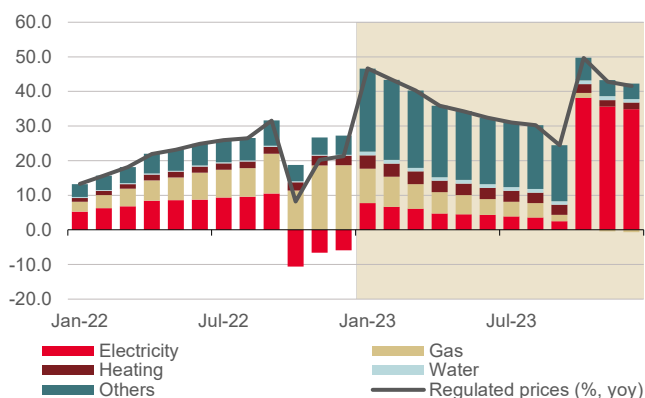
expect that the tight labour market and the deep fall in real wages last year should support a further acceleration in nominal wages this year, with a full-year growth of 9.9%. This is a slightly lower compared to the previous forecast (+12.2%). However, we have raised our forecast for next year from +4.2% to +5.4%. The faster growth in average nominal wages should thus be spread more over time. The good financial situation of companies and the fact that employees have so far been the most strongly affected by the inflation (we discuss this topic more in the box below) should also contribute to the accelerating wage dynamics. In real terms, wages are likely to see a further decline this year, at our estimate of 2.7%, before resuming moderate growth next year. However, with moderating inflation and higher wage momentum, real wages could rise in quarter-on-quarter terms from 2H23. This factor is also likely to contribute to a stabilisation first and then to a moderate increase in household consumption. The relatively strong dynamics of disposable income, which grew by 15.4% yoy in 3Q22, significantly more than wages, will be beneficial as well. Higher growth in disposable income is due to a rapid increase in pensions and social benefits. Meanwhile, the savings rate has remained elevated above 15%, despite declining household purchasing power, whereas the usual level before the pandemic was around 10%.

### Inflation to remain double-digit this year

We expect inflation to accelerate to 19% yoy in January due to the unwinding of the effect of the special energy tariff and further energy price increases, and it is unlikely to decrease below 10% yoy until the end of this year.

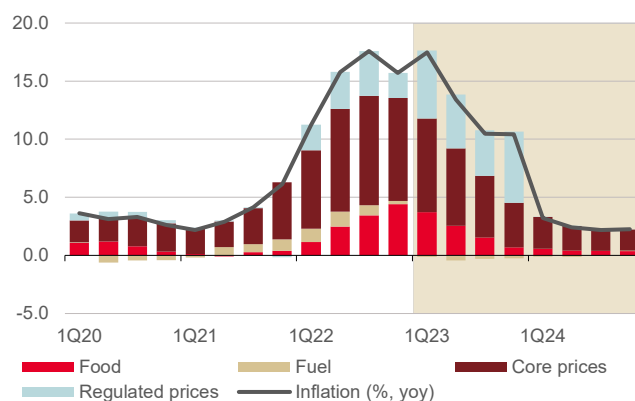
**Inflation in 4Q22 developed in line with our forecast.** It decreased to an average of 15.7% yoy, which was fully in line with our expectations. The decline in yoy inflation from its September peak of 18% was driven by the effect of the government's special energy tariff, which significantly reduced households' electricity bills (we wrote more on this topic here: <https://bit.ly/3rJTT66>). Year-on-year inflation was also pushed down by a slowdown in fuel price growth, reflecting both a higher comparative base as well as the actual drop in crude oil prices due to the strong correction in commodity markets. Core inflation, on the other hand, remained strong, despite a small decline to slightly above 13% yoy. Food price inflation accelerated even further to above 20% yoy.

#### Growth in regulated prices to accelerate further this year



Source: CZSO, Economic & Strategy Research, Komerční banka

#### Inflation to remain elevated due to an increase in regulated prices



Source: CZSO, Economic & Strategy Research, Komerční banka

**In January, we expect inflation to accelerate to 19% yoy, as the effect of the special energy tariff fades and energy prices increase further.** Compared to our initial estimate, inflation is therefore likely to be higher at the start of this year. An important contributor to this revision is the announced increase in the price of heating and water, which we estimate to be around 20% mom in both cases. The increase in the average electricity price, which is likely to hit the government's cap at the start of the year, could then be around 125% mom (a combination of the fading effect of the special energy tariff and a further increase in the electricity price). In contrast, we estimate that the price of gas, which had been rising briskly in the preceding months, was already above the cap at the end of last year. With the introduction of price caps, gas could then become slightly cheaper in January. The sharp

rise in energy prices as a whole is likely to be reflected in a significant increase in the regulated prices, which, according to our forecast, will rise by 37.3% on average this year. We expect the share of regulated prices in inflation will gradually increase over the course of the year. In December, housing-related costs, including energy, accounted for around one-third of annual inflation.

After 15.1% last year, inflation will average 12.9% this year. Next year, we forecast it to decrease significantly to an average of 2.5%.

#### **We expect inflation to average 12.9% this year and to slow markedly to 2.5% next year.**

This year's estimate is slightly higher than our previous forecast (12.0%), while the one for next year is slightly lower (we expected 2.8% last time). January this year should be the peak of the current inflation wave, after which year-on-year consumer price growth should moderate. The higher comparison base for fuel and core prices will have a significant impact. We expect core inflation to gradually ease as a result of weak demand. However, its further development is the most uncertain of all inflation components, especially with regard to the rate of the traditional January price reassessment, which will essentially set the level of annual core inflation for the rest of the year. At the end of 2023, we forecast core inflation to be around 6% yoy. Food price inflation should also moderate. After the January pick-up, we expect headline annual inflation to slow down for the rest of the first half of this year. However, we forecast that its decline will stop in the second half of the year and that headline inflation is likely to remain around 10% yoy throughout this period. This will be due to a lower 4Q22 base related to the impact of the special energy tariff on electricity prices. Once this impact has passed, headline inflation should fall substantially in early 2024 and average around 3% yoy in 1Q24, in our view. As in the previous forecast, we do not expect a return to the 2% target until the second half of next year. We view the risks to our inflation forecast as balanced. As mentioned above, the biggest uncertainty is around the January price reassessment. On the one hand, this could reflect a significant rise in energy prices, but on the other hand, price increases could be held back by the observed decline in demand. The further development of energy prices is also very uncertain. As a result, we have adopted a simplified assumption in our forecast that, following the January increase, regulated prices will remain unchanged over the rest of the forecast horizon.

#### **We no longer see a risk of further CNB rate hikes**

In our view, the CNB will keep the repo rate at the current 7% until August this year, when it could start to cut it gradually to a policy-neutral level of 3% at the end of 2024.

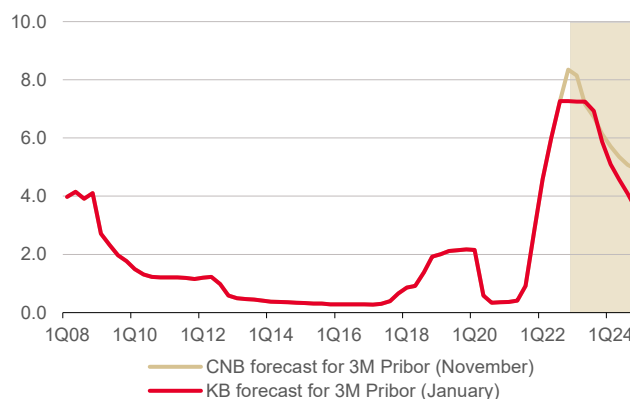
**We expect the central bank's base repo rate to remain at the current 7% until August this year, after which it could decline gradually.** In our forecast, we expect the repo rate at 5% by end-2023 and at a policy-neutral 3% by end-2024. This is the same rate outlook that we had in our previous forecast. However, the beginning of rate cuts is associated with a large degree of uncertainty, as it will likely depend on the economy and inflation developments, and possibly also on foreign central banks' policies.

**NFCs' inflation expectations remain elevated (%)**



Source: CNB, Economic & Strategy Research, Komerční banka

**CNB's interest rates have already peaked (%)**



Source: CNB, Economic & Strategy Research, Komerční banka



**We assess the risks to our CNB interest rate forecast as roughly balanced, whereas our previous forecast highlighted the risk of further hikes.** This is mainly due to the current CNB wait-and-see policy, which in our view, is the reason why the board has already missed the ideal moment for a further rate hike and therefore also for an earlier return of inflation to its 2% target. A further interest rate increase could miss the mark due to the delay in monetary policy (1-1.5 years), as it would only be reflected in consumer price developments around the middle of next year. However, by then, barring any further unforeseen shocks, inflation should already be within the central bank's tolerance band, according to our forecast, even without further rate hikes. A new central bank forecast to be published in early February, or the likely start of the globally observed disinflationary trend, could support the dovish board in cutting interest rates. While the CNB board has been resistant to further rate hikes so far, it could cut them more easily, in our view. The unanchored inflation expectations and accelerating wage growth remain the risks in the direction of higher interest rates, or rather their stability over the longer term, than we expect in our forecast. According to the CNB's December survey, non-financial corporations expect inflation of 10.1% yoy at the one-year horizon and 7.0% yoy at the three-year horizon. Compared to the September survey (10.3% for 1 year and 7.5% for 3 years), this is slightly lower, but still well above the 2% inflation target. Overall, however, with each additional month of stable interest rates, the likelihood of another hike declines significantly. We also continue to expect that the CNB will intervene against the excessive weakening of the koruna, even though developments on the FX market at the turn of the year did not require its physical presence.

**Box: The great inflation tax and its impact on the respective economic sectors**

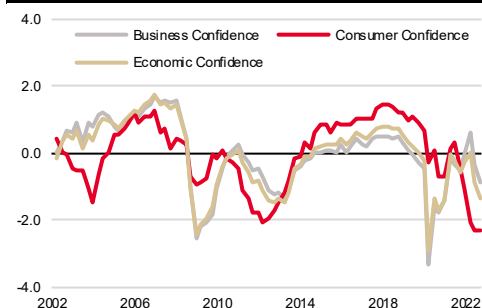
**The Czech economy has been dealing with an unprecedented inflationary shock,** in response to which in a typical forward-looking fashion the CNB began tightening monetary policy as early as in June 2021, only for the hiking cycle to grind to a halt last August. This box examines the nature of the inflation burden and the effects of the restrictive monetary policy on different sectors of the economy.

**The high inflationary environment, exacerbated by soaring energy prices, led consumer confidence to plummet to historical lows last year,** while business sentiment remained relatively firm vs historical averages, albeit declining steadily in 2H22. On a similar note, consumer spending has been a drag on economic growth since 4Q21 which heavily impacts the trade sector. On the other hand, the industry and services sectors have notably remained resilient and made significant contributions to the economic growth, boosted by subsiding supply chain issues and the revival of economic activity in 1H22 following lockdowns, respectively.

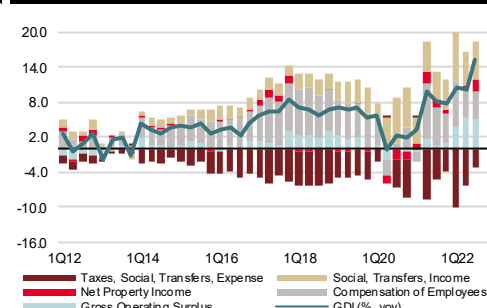
**High inflation averaging 15.1% in 2022 has taken a large toll on the financial situation of households.** Rising living costs have forced households to dip into their excess savings which were boosted by withheld spending during the lockdowns. That, together with the expansive fiscal policy, is likely to have significantly cushioned the impact of high inflation so far. Meanwhile, real wages plunged 9.8% yoy in 3Q22 as nominal wage growth of 6.1% yoy was far from sufficient to compensate for inflation. Likewise, in real terms, the purchasing power of household deposits has dropped all the way back to pre-COVID levels. At 2015 prices, more than CZK380bn has been wiped off household bank deposits since 2Q21 when their buying power was at its strongest. In nominal terms, the ratio of household deposits to GDP has fallen by nearly 5bp from the 1Q21 peak, which illustrated the pandemic-related excess savings. Moreover, the liquidity of the excess savings has deteriorated slightly as households have begun shifting funds to term deposits and other investment solutions, as they seek to benefit from higher interest rates and search for yield. Data for 3Q22 indicate that the gross savings ratio remains high compared to historical levels. This also reflects a more than 15% yoy rise in households' nominal disposable income (HDI), with the growing contribution

of mainly social contributions and pensions as well as self-employment income, due to previous year's lower comparative base. By comparison, employee compensation has risen by only 6% yoy, similarly to the quarter earlier.

#### The rift between consumer and business sentiment remains substantial (z-scores)

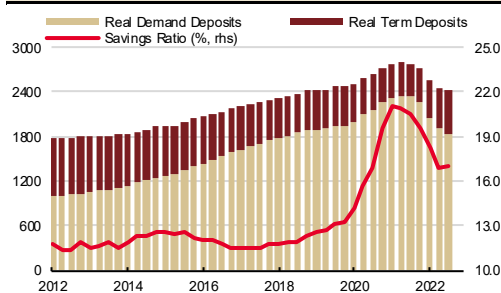


#### Social contributions supported the growth in disposable income (pp, % yoy)

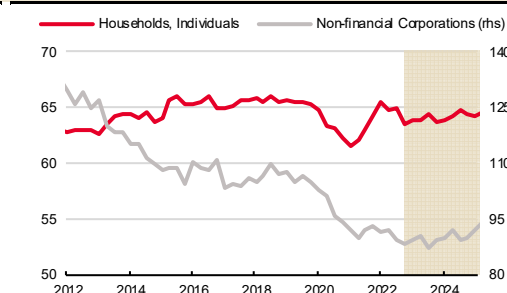


**The brunt of inflation has fallen on households particularly severely given the overhang of deposits to loans,** which has become more pronounced as credit activity in this sector has slowed markedly, especially in 2H22. We expect it to remain suppressed for most of this year as well. By comparison, within the banking sector, non-financial corporations' (NFC) deposits began to exceed loans only in 2020. Additionally, demand for loans by NFCs has not worsened dramatically, as it remained solid last year. Notably, while the stock of loans denominated in Czech crowns has been steadily falling since 1Q22, firms largely sought EUR financing due to an attractive interest rate differential which continues to narrow. Foreign currency-denominated loans currently account for more than 45% of all bank loans to NFCs, up from nearly 28% five years ago. However, this effect starts to wane.

#### Households continue to save while the buying power of their deposits erodes (CZKbn, %)



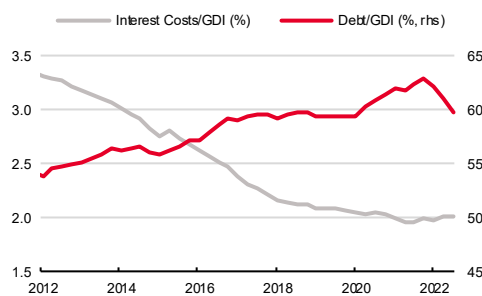
#### Loans-to-deposits ratio in the banking sector (%)



**Nevertheless, this solid credit activity – largely driven by operational financing as firms cope with higher input prices – has not led to NFCs to become excessively leveraged.** The ratio of total debt (incl. securitised debt) to gross operational surplus (GOS) remains near historical lows. Meanwhile, household indebtedness has fallen as disposable income has risen.

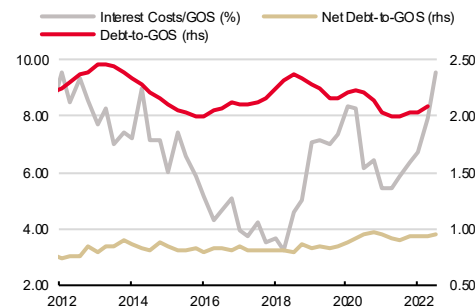


### Household indebtedness is falling while the interest cost burden hovers near historical lows



Source: CNB, CZSO, Economic & Strategy Research, Komerční banka  
Note: Interest costs from the stock of loans to households, GDI denotes gross disposable income

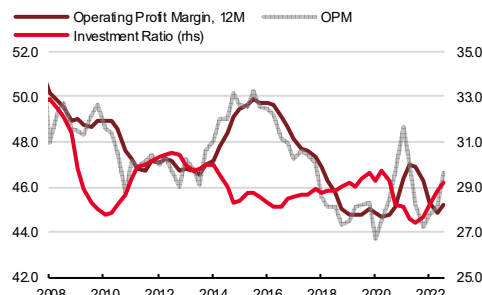
### NFCs' debt remains at lower levels while their service costs keep rising



Source: CNB, CZSO, Economic & Strategy Research, Komerční banka  
Note: Interest costs from sectoral accounts of NFCs. Net debt is adjusted for currency and deposits

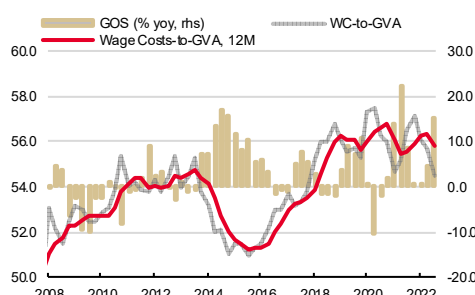
**Despite significant headwinds, the gross operating margin in the NFC sector has continued to improve since 3Q21.** The share of labour costs in gross value added (GVA) in the NFP sector decreased further in 3Q22 and has stabilised at around 56% over the past three years. Nevertheless, it had been steadily rising since 2015. Within the whole economy, approximately 51% of total output is attributed to labour. However, the share has been slowly slipping in recent quarters.<sup>1</sup> NFCs' margins (GOS/GVA) have not come under excessive pressure. Moreover, they continue to invest more. Against soaring input prices – producers' price growth averaged 24.3% over 2022 – companies have seemingly been able to transfer increased costs to end-consumers, while their bottom lines have come away more or less unscathed.

### NFCs' operating profit margin (OPM) and investment ratio (%)



Source: CZSO, Economic & Strategy Research, Komerční banka  
Note: 12M denotes a trailing twelve-month sum

### Share of labour costs in GVA has stabilised for NFCs



Source: CZSO, Economic & Strategy Research, Komerční banka  
Note: GVA, NZ denote gross value added and compensation of employees in the NFC sector, respectively

**The current monetary policy setting has triggered a financial cycle slowdown, especially in the household sector as the mortgage market has come to a standstill.** On the other hand, despite while monetary policy transmission being faster in terms of interest rates charged on NFC loans compared to households,<sup>2</sup> NFC credit activity has remained strong, mainly thanks to foreign currency-denominated loans. The interest cost burden for households, expressed as a ratio of interest costs on the stock of loans to GDI, has declined steadily over the past ten years and is currently still hovering near historical lows. The impact of tighter monetary conditions is more evident in the rising interest cost burden for NFCs in proportion to GOS. However, considering the low level of leverage and overhang of bank

<sup>1</sup> The labour share of the output is adjusted for the share of self-employed persons.

<sup>2</sup> The faster transmission of the monetary policy for NFCs compared to households on loans is given by the interest rate fixations of the latter. The lower rates on households' deposits are given by maturity transformation and liquidity reasons.

deposits over loans – which moreover earn higher interest compared to household deposits – the net financial burden for NFCs is not disproportionately threatening.

**Inflation has taken a heavy toll, particularly on households whose buying power, both in terms of wages and excess savings, has massively eroded.** Simultaneously, NFCs have managed, at least in part, to successfully transfer the burden of increased costs onto end-consumers without compressing their margins. They have also managed to keep the share of labour costs restrained despite improved margins. The firm footing enjoyed by businesses should leave room for solid wage growth to bolster household income. Moreover, it should be reflected in only a limited increase in layoffs. In view of our expectations for the monetary policy setting and its continuing transmission, interest costs should continue to rise. However, given the above-mentioned factors, they should remain tolerable for both households and firms.

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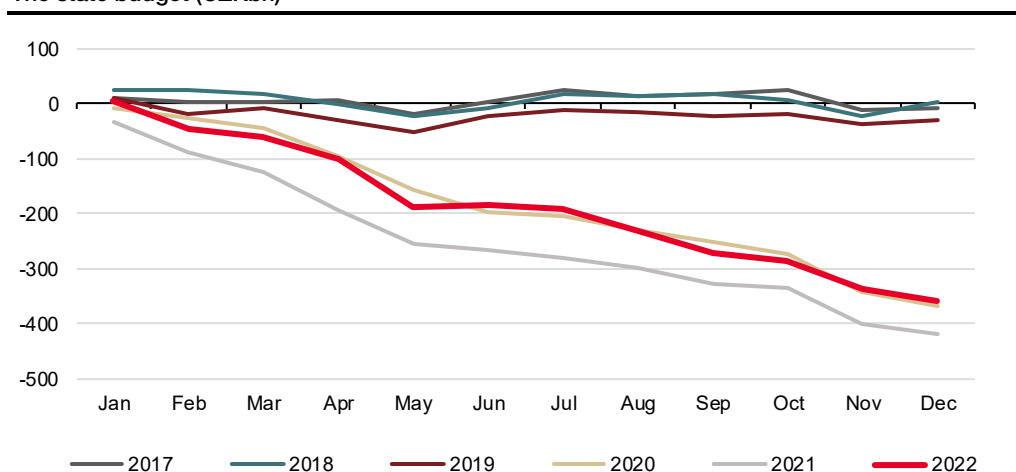
## Fiscal policy: inflation is slowing debt growth

The state budget closed last year with a deficit of CZK360.4bn, similar to pandemic year 2020. In our view, this year's deficit could exceed the approved CZK295bn by at least CZK20bn, mainly due to another extraordinary indexation of old-age pensions. Against the negative backdrop of the effects of subdued economic growth and a deep structural deficit, we expect the reduction of the state budget deficit to continue at a gradual pace in the coming years. Thus, while overall public debt is set to continue to rise, its increase relative to nominal gross domestic product is likely to be curbed by inflation (especially this year).

### State budget recorded third-worst result in history last year

The state ran a deficit of CZK360.4bn for the whole of last year. Compared to the record year 2021, the deficit was lower by CZK59.3bn, due to higher tax revenues. Expenditure also increased year-on-year, mainly reflecting last year's (triple) indexation of old-age pensions.

The state budget (CZKbn)



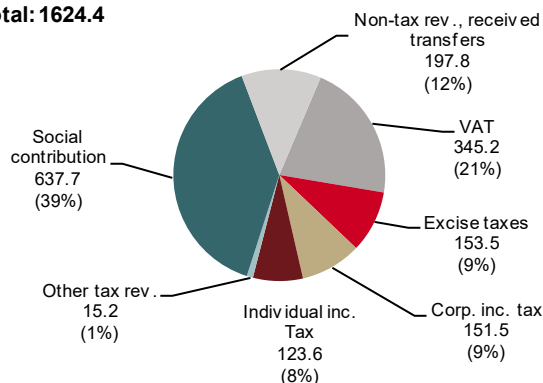
Source: Finance Ministry, Macrobond, Economic & Strategy Research, Komerční banka

**Wage and employment growth, as well as higher inflation, have helped the budget to raise more revenue.** The overall year-on-year increase of CZK137.2bn was mainly due to higher VAT collection, but also to social security contributions, corporate income tax,

individual income tax and excise duties. Against that, revenues from EU budgets decreased year-on-year (by CZK8.3bn to CZK118bn), as only 58.5% of the full-year plan was fulfilled.

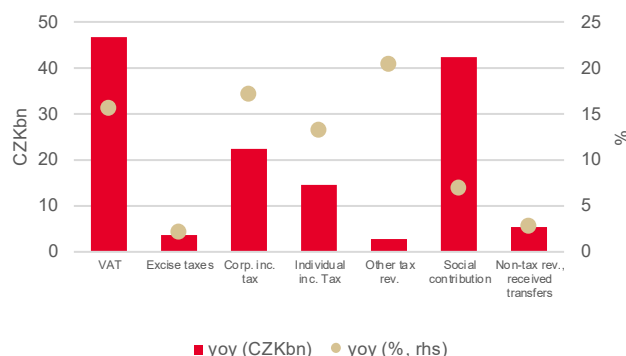
State budget revenues in 2022 (CZKbn, % of total)

Total: 1624.4



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

Annual change in state budget revenues in 2022

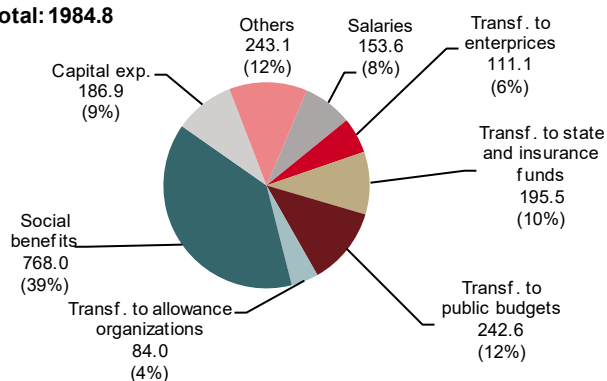


Source: Finance Ministry, Economic &amp; Strategy Research, Komerční banka

**Rising expenditure (by CZK77.9bn year-on-year) was mainly due to an increase in social benefits, capital expenditure, but also in the servicing cost of the national debt.** CZK75.7bn more was spent on social benefits year-on-year. The largest item here was pensions, which were indexed three times last year, and thus expenditure on them increased by CZK57.6bn year-on-year to CZK588.1bn. In the social area, increases in housing and material need benefits, one-off child allowances and humanitarian aid also worked in the same direction. The introduction of the so-called *savings tariff*, including the waiver of the fee for renewable energy sources also played a role. Expenditure on servicing the national debt amounted to CZK49.7bn last year, up by CZK7.5bn year-on-year. A slight year-on-year increase was recorded in capital expenditure (CZK9.7bn), where higher transfers to the State Fund for Transport Infrastructure played a major role. The additional expenditure was partly offset by the absence of pandemic aid, which was reflected in CZK36.1bn lower year-on-year transfers to businesses.

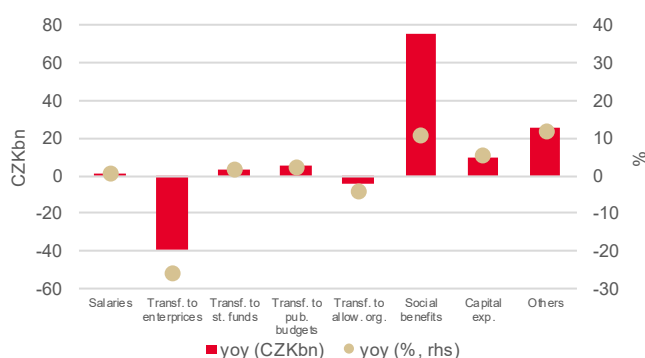
State budget expenditure in 2022 (CZKbn, % of total)

Total: 1984.8



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

Annual change in state budget expenditure in 2022



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

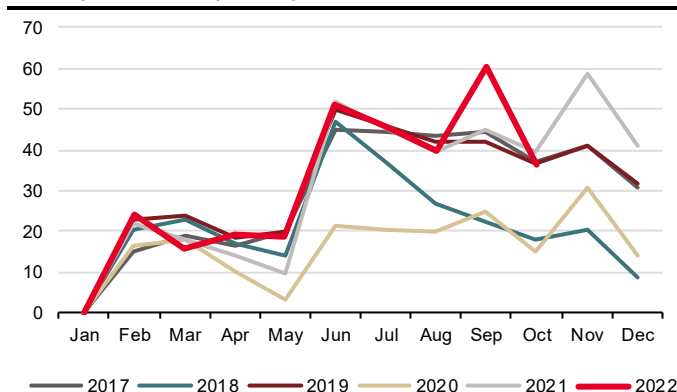
**This year's state budget deficit is likely to exceed CZK300bn again.** Although the government approved the budget with a deficit of CZK295bn, we believe that the condition for further extraordinary indexation of old-age pensions (not included in the approved budget) was probably already met in January 2023, and will thus be effective with the traditional five-month delay from June 2023. We estimate that, as a result, spending should be higher by around CZK20-25bn compared to the original proposal. In addition, the dynamics of tax

revenues are set to be weakened by the significantly subdued growth of the domestic economy. Overall, we expect a state budget deficit of CZK315bn.

### Municipalities remain in surplus

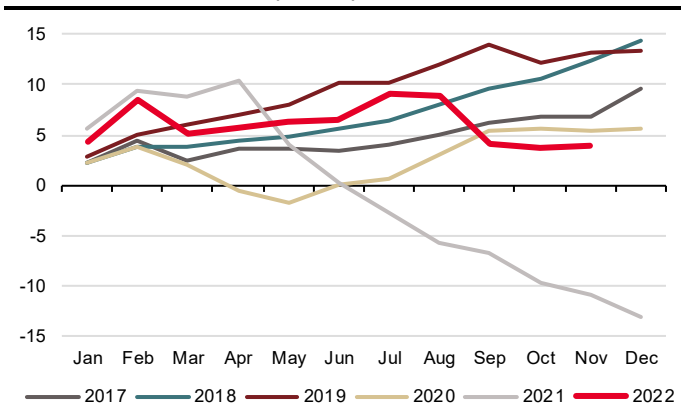
**The budgets of local governments ended in a surplus of CZK36.6bn at the end of October 2022 YTD.** This continued to be driven mainly by rising tax revenues, among others, following higher VAT collections due to high inflation. This was partly offset by an increase in expenditure, but this increased less year-on-year than revenue. For the whole of last year, we still expect a surplus of CZK30bn for territorial budgets. We estimate that health insurers may also end last year in a slight surplus.

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	-5.0	-3.8	-3.3	-2.9	-2.4
Fiscal effort (pp GDP)	-0.9	0.6	1.4	0.4	0.4	0.5
Public debt (CZKbn)	2566.6	2927.0	3242.0	3522.0	3782.0	4012.0
Debt ratio (% GDP)	42.0	43.1	44.1	45.3	46.2	46.6

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

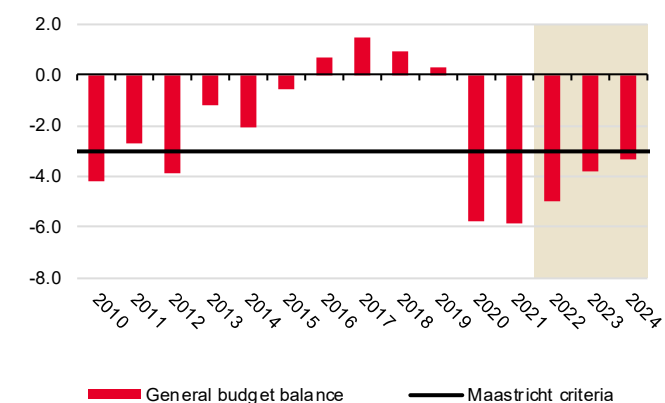
Note: Fiscal effort is measured as the year-on-year change in the cyclically adjusted general government balance on GDP in pp.

### Price growth improves the balance of public finances vis-à-vis GDP

**The general government deficit is expected to reach 3.8% of GDP this year,** 1.2 pp lower than last year. In our view, the moderation of the deficit will be driven by continued buoyant price growth as well as slightly higher fiscal effort, reflecting, among other things, the aim of covering additional expenditure through extra revenue. The traditionally surplus performance of municipalities should continue to work in the direction of a lower general government deficit this year. We anticipate that consolidation of public finances should continue in the future amid the threat of a rating downgrade and rising government debt-servicing costs. However, the government does not foresee any significant savings or revenue increases in its approved medium-term outlook (the state budget deficit is CZK260bn in 2025), so we expect only a gradual consolidation of public budgets. Overall, we expect the general government deficit to decline to 3.3% of GDP next year. Nominal public sector debt to GDP is projected to grow by 0.9bp per year on average over the period 2023-2026 to reach 46.6% of GDP in 2026. However, significant reforms will be needed on both the revenue and expenditure sides going forward. Indeed, on unchanged parameters, the budget performance would start to deteriorate very rapidly in the 2030s due to adverse demographic developments.

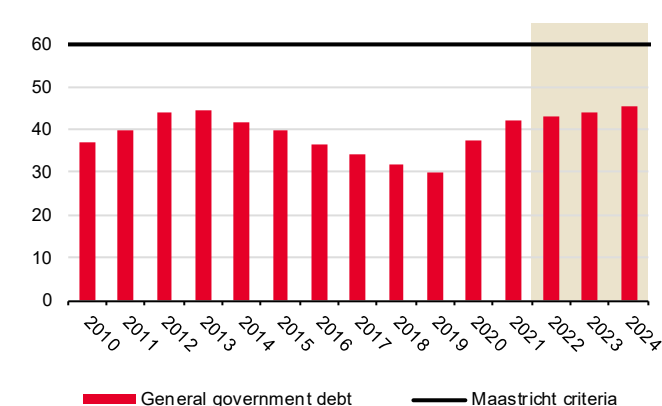
In our view, this year's public finances will end with a slightly smaller deficit than last year. However, the consolidation of the government's economy will be only moderate in the coming years.

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

## Summary forecast table

	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23	Q1 24	2021	2022	2023	2024	2025	2026
<b>GDP and its breakdown</b>														
GDP (real, yoy, %)	3.5	1.5	0.4	-0.1	-0.2	0.4	1.3	1.8	3.5	2.5	0.3	2.4	2.5	2.6
Household consumption (real, yoy, %)	0.4	-5.7	-4.7	-4.7	-4.3	-0.5	2.0	3.4	4.1	-0.6	-1.9	4.0	2.6	2.6
Government consumption (real, yoy, %)	1.8	-1.6	-3.0	-2.2	-1.4	0.4	0.0	0.2	1.4	-0.2	-0.8	-0.2	1.4	1.9
Fixed investments (real, yoy, %)	6.8	4.7	3.0	0.1	-0.3	1.4	3.8	6.2	0.8	5.4	1.2	6.4	5.5	4.4
Net exports (contribution to yoy)	-0.1	3.5	2.5	2.9	3.1	1.1	0.6	-0.5	-4.4	0.6	1.9	-0.5	0.1	0.4
Inventories (contribution to yoy)	1.3	0.2	0.0	-0.3	-0.8	-1.0	-1.3	-1.0	4.9	0.9	-0.9	-0.8	-0.2	-0.2
<b>Monthly data from the real economy</b>														
Foreign trade (CZK bn)	-70.7	-65.6	-76.2	20.4	-25.6	-45.3	-59.2	55.5	-9.0	-223.6	-109.7	65.6	137.3	239.7
Exports (nominal, yoy, %)	11.3	21.9	16.3	16.3	11.9	6.0	9.9	5.0	13.4	14.2	11.0	6.5	7.2	7.4
Imports (nominal, yoy, %)	19.8	21.7	20.2	13.2	7.5	3.9	8.0	2.2	19.8	19.6	8.0	3.0	5.9	5.7
Industrial production (real, yoy, %)	0.0	5.3	2.6	3.2	0.7	0.2	2.6	1.3	8.0	2.1	1.7	2.8	2.5	2.9
Construction output (real, yoy, %)	3.0	-1.7	-0.8	-2.9	-3.7	2.8	1.3	1.1	2.0	2.7	-0.6	7.8	5.4	2.0
Retail sales (real, yoy, %)	-2.8	-7.1	-8.0	-6.4	-3.3	0.4	4.2	5.8	4.2	-2.8	-1.3	5.9	3.5	2.7
<b>Labour market</b>														
Wages (nominal, yoy, %)	4.4	6.1	9.0	9.4	11.9	10.0	8.2	5.4	4.8	6.7	9.9	5.4	4.6	4.6
Wages (real, yoy, %)	-9.8	-9.7	-5.8	-6.9	-1.3	-0.4	-2.0	2.1	1.0	-7.2	-2.7	2.8	2.4	2.7
Unemployment rate (MLSA, %)	3.1	3.5	3.7	3.9	3.7	3.8	4.1	4.0	3.7	3.4	3.9	3.8	3.7	3.7
Unemployment rate (ILO 15+, %)	2.4	2.2	2.1	2.4	2.4	2.6	2.5	2.5	2.8	2.3	2.5	2.4	2.2	2.3
Employment (ILO 15+, yoy, %)	-0.1	-1.3	-1.6	0.3	-0.7	0.1	0.4	0.5	-0.4	-0.9	0.0	0.5	0.3	0.2
<b>Consumer and producer prices</b>														
CPI Inflation (yoy, %)	15.8	17.6	15.7	17.5	13.4	10.5	10.4	3.2	3.8	15.1	12.9	2.5	2.1	1.9
Taxes (contribution to yoy inflation)	0.2	0.1	1.2	0.1	0.2	0.3	0.2	0.1	-0.1	0.5	0.2	0.1	0.0	0.0
Core inflation (yoy, %) (*)	13.8	14.7	13.9	12.8	10.5	8.3	6.1	4.2	4.8	13.2	9.4	3.3	2.7	2.5
Food prices (yoy, %) (*)	14.6	20.0	25.6	22.3	15.2	9.1	4.6	3.1	0.8	16.7	12.8	2.4	1.9	1.8
Fuel prices (yoy, %) (*)	44.4	31.5	13.5	3.4	-8.7	-6.7	-3.4	-3.7	15.3	31.6	-3.8	-2.3	1.1	-1.2
Regulated prices (yoy, %)	23.3	28.0	16.4	43.0	33.8	28.2	44.3	0.0	-0.1	20.9	37.3	0.0	0.0	0.0
Producer prices (yoy, %)	27.7	25.9	21.8	12.3	6.2	4.7	4.6	3.5	7.1	24.3	7.0	2.8	2.8	2.3
<b>Financial variables</b>														
2W Repo (% , average)	5.6	7.0	7.0	7.0	7.0	6.7	5.6	4.8	0.9	5.9	6.6	4.1	3.0	3.0
3M PRIBOR (% , average)	6.0	7.3	7.3	7.3	7.3	6.9	5.9	5.1	1.1	6.3	6.8	4.3	3.3	3.3
EUR/CZK (average)	24.6	24.6	24.4	24.1	24.2	24.2	24.2	24.3	25.6	24.6	24.2	24.4	24.6	24.7
<b>External environment</b>														
GDP in EMU (real, yoy, %)	4.3	2.3	1.8	1.2	0.7	0.7	0.8	1.0	5.5	3.5	0.9	1.0	1.4	1.6
GDP in Germany (real, yoy, %)	1.7	1.3	1.3	0.6	0.8	0.6	0.9	1.0	2.8	1.9	0.7	1.1	1.3	1.3
CPI in EMU (real, yoy, %)	8.0	9.3	10.3	8.9	7.6	6.0	3.6	2.8	2.6	8.4	6.5	2.4	1.9	1.9
Brent oil price (USD/bbl, average)	113.2	107.1	87.6	98.0	108.0	100.0	94.0	95.5	70.2	101.0	100.0	97.8	100.0	100.0
EUR/USD (quarter eop, year average)	1.06	1.01	1.02	1.06	1.10	1.12	1.12	1.13	1.18	1.05	1.10	1.14	1.16	1.20

Source: CZSO, MLSA, Bloomberg, Macrobond, Economic &amp; Strategy Research, Komerční banka

Note: (\*) these parts of inflation are adjusted for the primary effect of indirect tax changes

## Czech IRS market and government bonds



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Retreating inflationary pressures at home and abroad have pushed the domestic IRS curve down across maturities. We expect shorter rates in particular to continue to gradually decline. The curve is likely to maintain its markedly inverted shape throughout this year.

### On a downward trend

**Domestic market interest rates have visibly declined across maturities since the beginning of 4Q22, following domestic and global disinflation and the prospect of a slowdown in monetary policy tightening by key central banks. The entire market interest rate curve remains significantly inverted. The short end of the market interest rate curve should continue to decline gradually in line with the expected start of domestic monetary easing in 2H23. We see more limited scope for a significant decline in longer rates, although we expect some reduction there as well. Conditions for interest rate fixing have improved as rates have fallen. Forwards still offer an opportunity, as does taking advantage of lower rates in the euro market. Government bonds are unlikely to become significantly more expensive relative to market rates due to the persistently elevated supply. The development of their yields should therefore follow that of market rates in the coming quarters.**

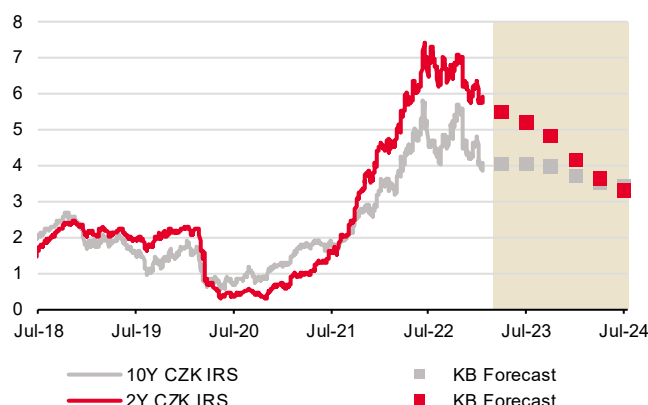
### Czech IRS market: rates caught between global disinflation and dovish CNB

**Market interest rates have seen a visible decline since the beginning of 4Q22.** This has been helped by growing indications that global inflation is past its peak, the threat of an energy crisis is diminishing and the pace of monetary tightening by key central banks will slow. There has been a significant decline since the beginning of the final quarter of last year in both euro (down by around 40bp) and dollar market interest rates (down by up to 50bp), which, in addition to falling inflation, has been linked to investor fears of a recession. In the case of the Central European region, markets have started to bet that the monetary tightening cycle is over and that the next change in interest rates will be a rate cut. The domestic market interest rate curve has fallen by more than 100bp over the same period (excluding the shortest maturities).

**Financial markets expect the CNB to cut the repo rate for the first time in 3-6 months.** In our view, the gradual decline in monetary policy interest rates could start in 3Q23. We still perceive risks (of higher wage growth, looser fiscal policy, unanchoring of inflation expectations and continued monetary tightening abroad) that could delay the turn of the domestic monetary policy rudder. At the same time, however, given the speed of the global disinflationary process and the sitting out the hikes by CNB, we already assess the risks overall as balanced rather than tilted in an inflationary direction.

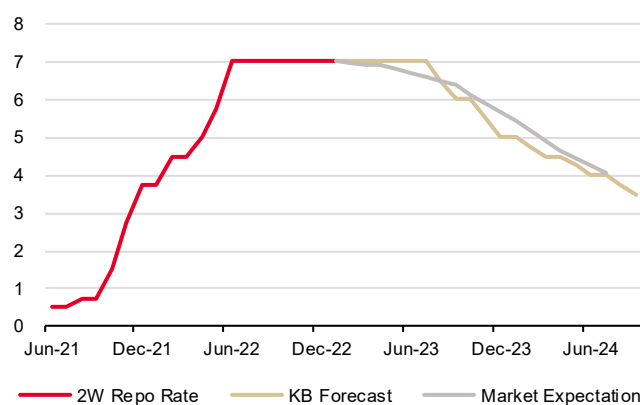
**The short end of the market interest rate curve should continue to decline gradually in line with the start of domestic monetary easing in 2H23.** Compared to the market, however, we expect it to descend somewhat more modestly due to our assumption of a later start to domestic monetary policy rate cuts and a higher ECB terminal rate. For longer rates, we see more limited scope for a more significant decline. First, our forecast assumes that there will be no recession in the US or the euro area this year (but at least in America, it is still the market consensus). The downward trend may also be held back by the January acceleration in domestic inflation, which we estimate to have reached around 19% yoy. As a result, this could keep inflation expectations elevated for an extended period.

IRS forecast (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Expected CNB key interest rate path as of 24 January 2023 (%)



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

**The start of the CNB's rate cutting cycle this year will help to normalise the shape of the yield curve.** We expect that the inverse shape of the curve will be maintained throughout this year. Its straightening will occur only during 1H24 mainly due to the decline in the short end.

CZK IRS outlook (end of period, %)

	1Q23f	2Q23f	3Q23f	4Q23f
2Y	5.55	5.25	4.85	4.20
5Y	4.45	4.40	4.15	3.75
10Y	4.05	4.10	4.00	3.75

Source: Economic & Strategy Research, Komerční banka

**Forwards and the euro market still offer an opportunity to hedge interest rate risk**

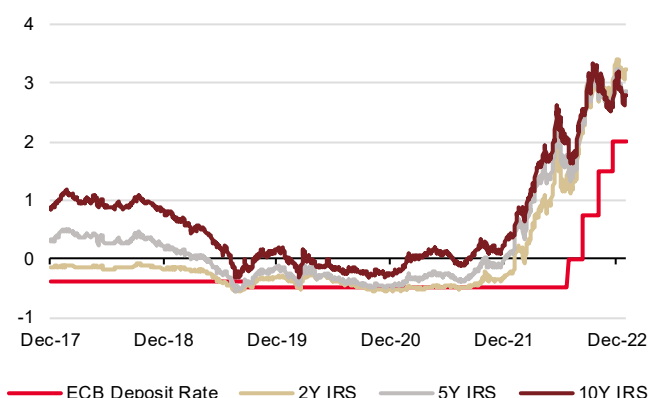
**As the IRS has declined in recent months, rate-fixing conditions have improved.** The persistent inversion of the entire curve is bringing more favourable conditions to the forward market. Noticeably lower interest rates compared to domestic rates also continue to prevail in the euro market. Meanwhile, we expect euro swaps to rise further in the coming months as we assume the deposit rate to peak at 3.75%, while the market currently sees it at around 3.3%.

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

		Maturity				
		1Y	2Y	3Y	5Y	10Y
Forward	Spot	7.05	5.93	5.18	4.54	4.09
	3M	6.75	5.47	4.84	4.33	3.96
	6M	6.16	5.03	4.51	4.12	3.86
	9M	5.44	4.57	4.21	3.94	3.76
	1Y	4.73	4.17	3.94	3.78	3.67
	2Y	3.57	3.52	3.51	3.51	3.53
	3Y	3.47	3.47	3.49	3.50	3.72

Source: Bloomberg, Economic & Strategy Research, Komerční banka, as of 24 January 2023

Euro rates continue to rise (%)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

**2023 will be marked by continued elevated CZGB supply**

**The significant state budget deficit combined with other financing needs will keep the supply of Czech government bonds high this year.** We forecast that the state budget deficit will head towards CZK315bn this year. This, combined with other financing needs (mainly maturing bond repayments), would imply a total koruna bond issue of around CZK464.5bn.



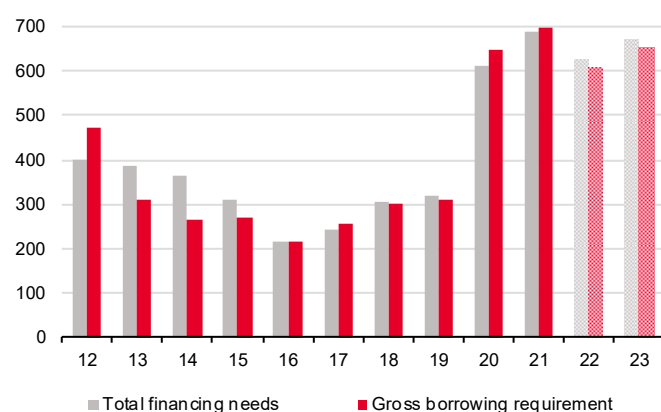
The CZGB supply could thus increase by around CZK40bn year on year in 2023, according to our estimate. The MinFin has set the indicative supply volume at CZK125.0bn for 1Q23 and CZK400-500bn for 2023 as a whole. According to the MinFin Strategy, the final amount will depend on financial market developments, the extent of involvement of state financial assets in covering financing requirements, and the possible use of EIB and CEB loans. As regards new (at least 3) benchmark CZGBs, the MinFin plans to emphasise longer maturities, given the shape of the yield curve and the medium-term target of an average maturity of 6.5 years for government debt (at the end of 2022, the average maturity was 6.2 years). The issuance of a Eurobond will also be in play. A test issue of EUR1.0bn (a combination of primary and secondary markets) took place last year. **Overall, we expect the financing requirement this year to reach CZK669.0bn (9.1% of GDP) compared to CZK626.0bn (9.2% of GDP) last year.**

#### Funding programme and issuance activity (CZKbn)

	2023	
	MinFin	KB
State budget deficit	295.0	315.0
Transfers and other operations of state financial assets	1.4	1.4
T-bonds denominated in local currency redemptions	200.2	200.2
T-bonds denominated in foreign currency redemptions	0.0	0.0
Redemptions and early redemptions on savings bonds	0.4	0.4
Money market instrument redemptions	149.5	149.5
Redemption of T-bills		0.0
Redemption of other money market instruments		149.5
Repayments on credits and loans	2.6	2.6
<b>Total financing needs</b>	<b>649.0</b>	<b>669.0</b>
Money market instruments		40.0
T-bills		20.0
Other money market instruments		20.0
Gross issuance of CZK T-bonds on domestic market	Min. 400-500	464.5
Gross issuance of EUR T-bonds on domestic market/eurobond		55.5
Gross issuance of government savings bonds		0.0
Received credits and loans		94.0
Financial asset and liquidity management		15.0
<b>Total financing sources</b>		<b>669.0</b>
<b>Gross borrowing requirement</b>		<b>654.0</b>
<b>Net CZGB issuance</b>		<b>284.3</b>

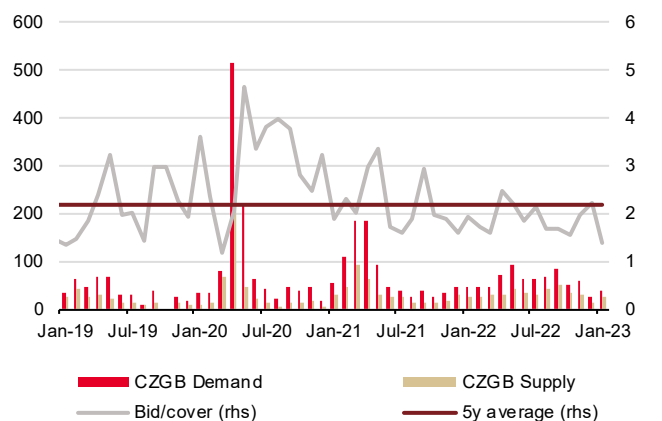
Source: Economic and Strategy Research, Komerční banka, MinFin

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)

	1Q23f	2Q23f	3Q23f	4Q23f
2y CZGB yield (%)	5.15	4.85	4.40	3.75
5y CZGB yield (%)	4.65	4.55	4.30	3.85
10y CZGB yield (%)	4.35	4.35	4.20	3.95
10y CZGB ASW (bp)	30	25	20	20

Source: Economic & Strategy Research, Komerční banka

### Yields on longer CZGBs will probably fall more visibly only in 4Q23

**CZGB yields, like the IRS, have visibly declined in recent months.** Over the last quarter, however, the decline in CZGB yields has been somewhat less noticeable than in the case of the IRS curve, so in ASW terms, bonds have become about 8-25bp cheaper, with this more pronounced at shorter maturities. Given the increased supply, we expect that for longer maturities (5-10 years), the richening of bonds in ASW terms will progress only gradually from the currently elevated levels towards a long-term equilibrium. Thus, the evolution of their yields should largely follow market interest rates, which (as described above) will fall gradually. Conversely, shorter bonds (2y) are currently slightly more expensive relative to the IRS than long-term levels in ASW terms, and so may instead experience a slight relative cheapening. However, the main trend in shorter maturity bond yields will also be similar to that of market rates, i.e., a continuation of the downward trend, in our view.

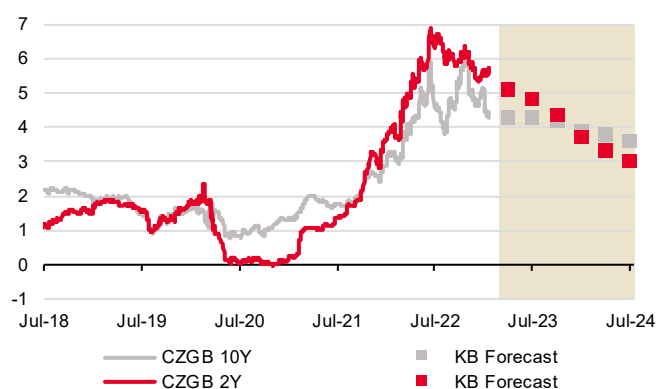
**Compared to our previous forecast, the risk of an increase in the risk premium has decreased.** Apart from the long-term unsustainability of the current set-up of the domestic public finances, one of the main reasons why both Fitch and Moody's rating agencies downgraded the outlook for the domestic rating to "negative" last year was the risk of a deepening energy crisis. This has not materialised; on the contrary, market prices of energy commodities are in many cases below the levels before the start of the war in Ukraine.

### Sovereign rating overview

	Local currency	Outlook	Foreign currency	Outlook	Next rating review
S&P	AA	STABLE	AA-	STABLE	14 April 2023
Moody's	Aa3	NEGATIVE	Aa3	NEGATIVE	26 May 2023
Fitch	AA-	NEGATIVE	AA-	NEGATIVE	3 March 2023

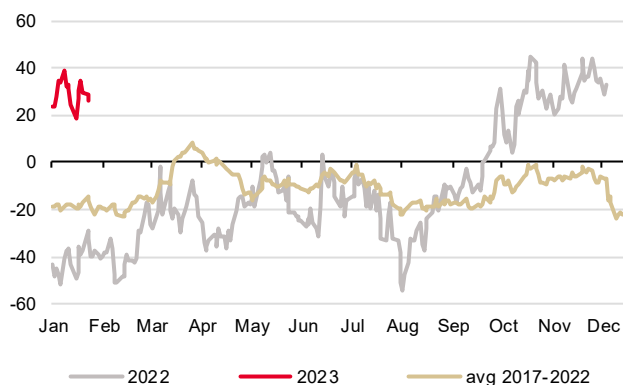
Source: Economic and Strategy Research, Komerční banka, Bloomberg

CZGB yield forecast (%)



Source: Economic and Strategy Research, Komerční banka, Bloomberg

10y CZGB ASW (bp)



Source: Economic and Strategy Research, Komerční banka, Bloomberg

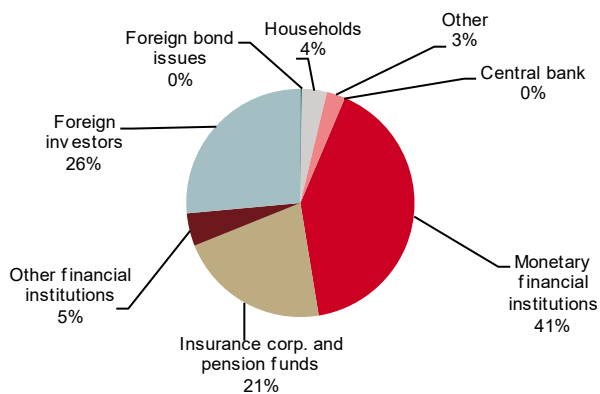
## Government bond overview

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
0.45 Oct-23	0.7	0.0	80%	6.51	-14	6	2.87	-73	-6	4	-93		-10	-0.5	19	-46.2	1	-63.7	21
5.70 May-24	1.2	0.0	100%	5.58	2	13	2.82	-115	-14	23	-148		-83	0.0	12	18.1	21	-56.7	20
0.00 Dec-24	1.8	0.0	34%	5.40	12	19	3.09	-69	-12	36	-105		-52	0.5	3	12.8	18	-42.1	19
1.25 Feb-25	1.9	0.0	100%	5.35	19	-2	3.12	-57	-3	22	-81		-31	-0.1	13	10.2	16	-39.4	18
2.40 Sep-25	2.4	3.7	85%	5.23	16	3	3.32	-22	-3	34	-63		6	1.0	1	1.4	11	-32.9	17
6.00 Feb-26	2.7	0.0	67%	4.93	15	-20	3.21	-29	-4	20	-61		-17	0.5	2	16.8	20	-31.9	16
1.00 Jun-26	3.2	0.0	100%	4.84	18	-33	3.22	-19	1	6	-49		9	-0.1	15	16.0	19	-28.3	15
0.25 Feb-27	3.8	6.0	90%	4.79	16	-25	3.29	-3	3	22	-36		13	0.3	7	4.8	13	-23.7	14
2.50 Aug-28	5.0	0.0	94%	4.57	15	-41	3.27	5	1	11	-27		25	0.1	10	-2.1	9	-17.9	12
5.50 Dec-28	4.9	17.7	41%	4.52	13	-38	3.28	4	-2	13	-24		21	0.3	5	-1.2	10	-18.3	13
2.75 Jul-29	5.7	0.0	100%	4.55	13	-40	3.32	15	1	13	-23		30	0.3	6	-11.6	2	-15.2	11
0.05 Nov-29	6.5	0.0	57%	4.50	19	-44	3.26	12	0	8	-12		33	-0.4	17	-9.3	6	-13.3	9
0.95 May-30	6.7	0.0	100%	4.48	12	-45	3.27	14	1	8	-6		34	-0.5	18	-10.2	5	-12.6	8
5.00 Sep-30	6.2	11.7	45%	4.42	13	-38	3.31	14	1	15	-17		29	0.3	8	-6.9	7	-13.3	10
1.20 Mar-31	7.3	0.0	100%	4.44	13	-48	3.29	16	1	6	-11		34	-0.2	16	-10.3	4	-10.9	7
1.75 Jun-32	8.2	15.9	102%	4.35	8	-53	3.29	14	0	2	-7		35	-0.6	20	-2.3	8	-9.1	6
2.00 Oct-33	9.1	0.0	100%	4.33	8	-57	3.34	16	-3	0	-2		55	-0.7	21	2.7	12	-7.6	5
3.50 May-35	9.4	1.7	34%	4.33	7	-48	3.45	22	-4	7	2		38	-0.1	14	8.3	14	-7.1	4
4.20 Dec-36	10.2	0.0	100%	4.36	8	-48	3.55	29	-8	6	1		43	0.3	4	10.4	17	-6.5	2
1.95 Jul-37	11.8	12.0	19%	4.38	8	-42	3.47	24	-4	12	1		44	0.1	11	9.8	15	-5.9	1
1.50 Apr-40	13.8	0.0	41%	4.52	10	-30	3.50	31	-5	19	11		47	0.2	9	-11.1	3	-6.9	3

Source: Economic &amp; Strategy Research, Komerční banka

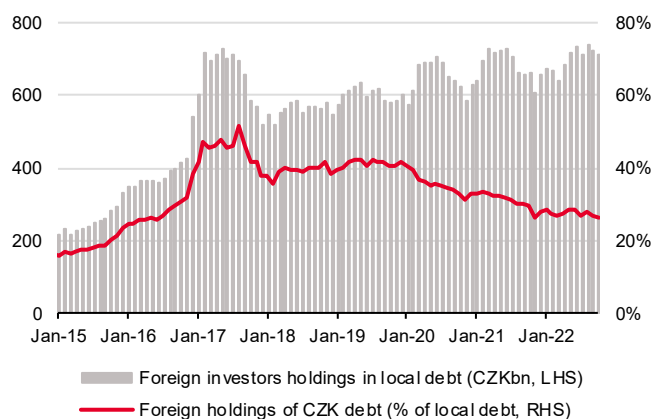
Note: More details in CZGB Auction Alerts

**Holdings of CZK government debt (November 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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### The koruna not out of the woods yet

The retreat in risk aversion and the recovery in foreign trade in the final quarter of last year have helped the koruna climb to stronger levels. The CNB continues to keep a protective watch over the domestic currency. However, it has probably not had to intervene since November and still has substantial foreign exchange reserves. In our view, the significant gains the koruna has enjoyed at the beginning of this year are unlikely to be maintained and will correct at some point, especially amid further narrowing of the interest rate differential. The conditions for hedging against koruna appreciation have deteriorated markedly due to the decline in the interest rate differential, but we expect the scope for this trend to continue is limited.

### Market sentiment reversed in 4Q22

**Regional currencies benefited from a retreat in risk aversion at the end of the year.**

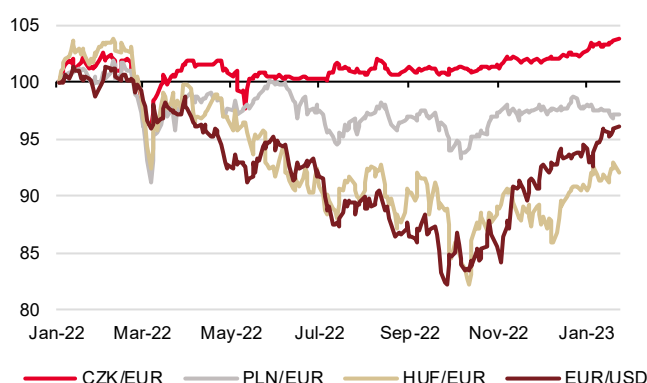
Bleak scenarios revolving around acute gas shortages did not materialise in the end. At the turn of the year, the turnaround in sentiment towards the Central European region was also helped by a drop in energy commodity prices on the markets amid a relatively warm winter and a slowdown in demand for natural gas. As a result, investors, who for most of the past year had mainly preferred the US dollar as a safe haven, have started to return.

CZK exchange rates



Source: Bloomberg, Economic and Strategy Research, Komerční banka

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

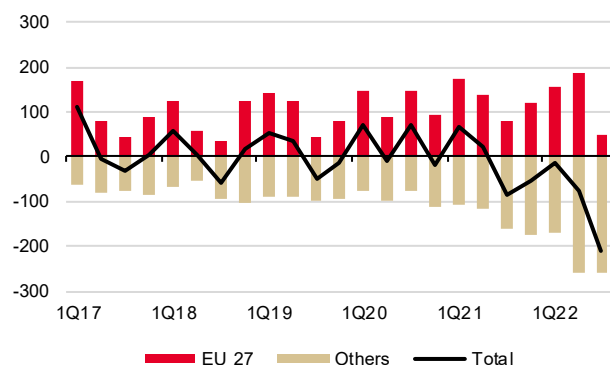


Source: Bloomberg, Economic and Strategy Research, Komerční banka  
A value above 100 indicates an appreciation of the CZK, PLN or HUF against the EUR, or an appreciation of the EUR against the USD from 1 January 2022.

**At the end of last year, a recovery in foreign trade began to take hold as a result of the easing of supply chain issues.** This was evident from the significant increase in the merchandise trade surplus in the euro area in October and November. Although the current account of the balance of payments itself (as well as the overall trade balance) remains in deficit, this is mainly due to imports of high-priced commodities (in particular oil and natural gas) and should therefore have a more immediate impact on the koruna-dollar exchange rate. More importantly for the EURCZK pair, the current account balance with the euro area, or the EU, remained positive in 3Q22, although there was an above-normal outflow of FDI dividends, which was reflected in the primary income deficit. However, this did not continue in 4Q22, according to the monthly data for October and November. We can assume, therefore, (current account balance of payments data on a territorial basis are only available on a quarterly frequency) that there was a noticeable widening of the current account surplus with the EU in the final quarter of last year. In addition to the turnaround in sentiment, this may have been another factor why fundamental depreciation pressures (also aided by low liquidity) on the koruna against the euro have eased noticeably recently.

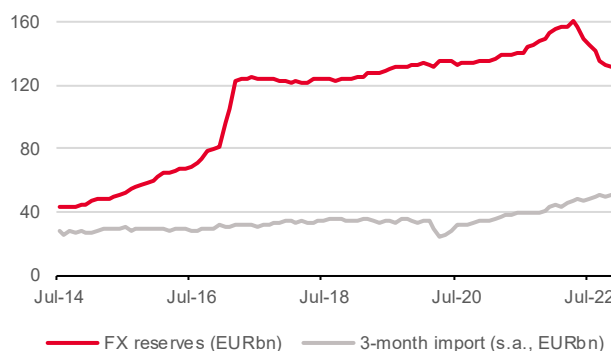
**The CNB also still has a protective hand over the koruna.** However, according to our estimates, it has not had to intervene to support the koruna since last November. In the period from May to November, the CNB spent a total of EUR25.6bn to defend the koruna against depreciation, which corresponds to 15.9% of the total foreign exchange reserves since their peak in April 2022, when they amounted to EUR160.4bn. At the end of last year, foreign exchange reserves stood at EUR132.2bn, or around 50% of GDP. This level, combined with the easing of depreciation pressures, provides the CNB with a safe space to continue its current policy.

Current account of BoP of the Czech Republic (CZKbn)



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

CNB FX reserves



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

We revised up our forecast for EURCZK due to slightly lower depreciation pressures. We expect the koruna to depreciate towards EURCZK 24.25 to the euro by the end of the year, mostly due to the decline in the interest rate differential.

**Depreciation pressures may not yet have had the last word.** The interest rate differential has already more than halved since its peak in July last year, amid tightening monetary policy abroad and a dovish shift in the CNB's Board. When the interest rate differential, as measured by the difference in two-year interest rate swaps, was at a similar level to now (2.7bp) over a year ago, the koruna was trading at EURCZK 25.50. Moreover, we expect the ECB deposit rate to rise from the current 2% to 3.75% this July, but the market expects the terminal rate to be around 3.3%. Relative to the eurozone, the domestic economy (and the exchange rate) is at a disadvantage even with respect to economic growth. While demand in the domestic economy has fallen significantly, and contributed to the (technical) recession in the second half of last year, we are working with the assumption that the euro area will avoid recession altogether. The koruna has also appreciated significantly in real terms over the past year, with the price level, as measured by both the GDP deflator and the CPI index, rising noticeably faster in the Czech Republic than in the euro area. This may also curtail the potential for it to appreciate nominally in the future.

**At the end of 2022, the koruna was overvalued against its equilibrium value by around CZK0.3 to the euro (EURCZK 24.30 vs. 24.60).<sup>3</sup>**

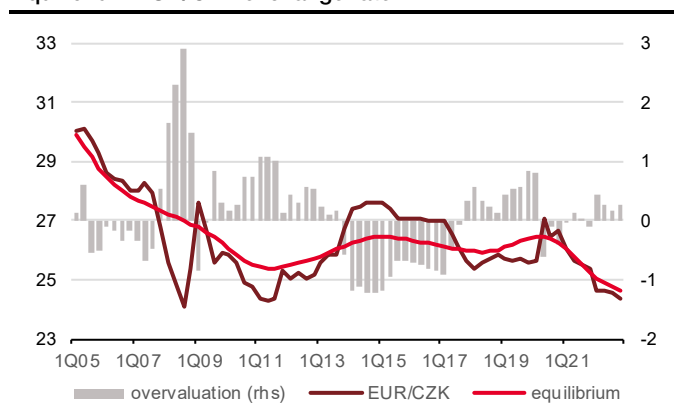
<sup>3</sup> The hypothetical equilibrium value is based on the average of model filtrations of real bilateral exchange rates against the euro that are consistent with the internal and external equilibrium of the economy. Real exchange rates are deflated using the CPI, PPI and GDP deflator due to the increased uncertainty about the reliability of the various price level indicators, which have deviated significantly from each other over the past year.

EUR/CZK and interest rate differential



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Equilibrium EUR/CZK exchange rate

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

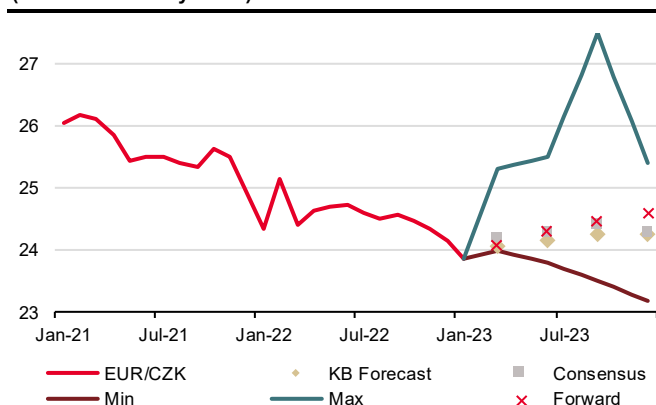
The pressures on the koruna should be partly offset by the weakening of the US dollar and an improving external trade balance. The US dollar could move to EURUSD 1.12 by the end of this year, according to our forecasts. The recovery in foreign trade should also continue this year, supported by the reopening of the Chinese economy. In addition, the slowdown in domestic inflation could contribute to closing the inflation gap of the domestic economy vis-à-vis the euro area. We expect the CNB's still substantial foreign exchange reserves to act in the same direction. **Overall, we expect depreciation tendencies to prevail slightly anyway, resulting in a slight weakening of the koruna towards EURCZK 24.25 by the end of the year.**

Koruna exchange rate forecast (end of period)

	1Q23f	2Q23f	3Q23f	4Q23f
EUR/CZK	24.05	24.15	24.25	24.25
USD/CZK	22.70	21.95	21.65	21.65
EUR/USD	1.06	1.10	1.12	1.12

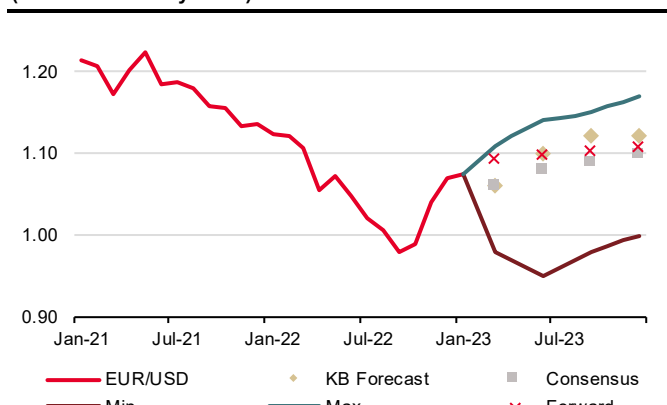
Source: Economic and Strategy Research, Komerční banka, SG Cross Asset Research

Expected EUR/CZK path, market consensus by Bloomberg (as of 24 January 2023)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Expected EUR/USD path, market consensus by Bloomberg (as of 24 January 2023)



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

### Risks to the outlook for the koruna remain considerable

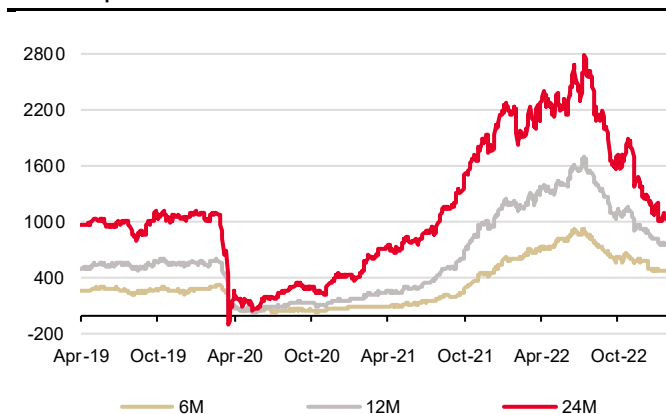
The risk, particularly for the second half of the year, stems from a possible return of the energy shortage problems. This could again put pressure on Central European currencies. In the opposite direction, faster disinflation and a recovery in foreign trade could surprise. External developments also remain a significant source of uncertainty: the depth of

a possible recession in the US and/or the EU, the development of the US dollar, and the speed of tightening and terminal interest rates in the US and the euro area, respectively. Increased volatility could also be brought about by a possible public exit by the CNB from the current intervention regime.

### The decline in the interest rate differential further depresses forward points

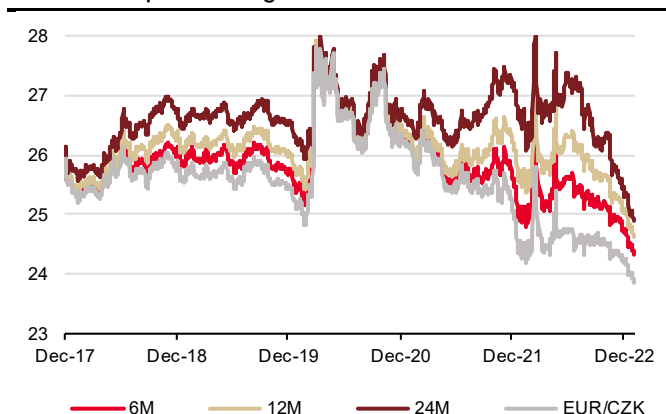
**The conditions for hedging the exchange rate against appreciation have deteriorated further as the interest rate differential has fallen.** We expect market interest rates in the euro area to rise further in the coming months. The interest rate differential may thus narrow slightly further. This should be largely offset by a slight weakening of the spot exchange rate. In our view, forward rates therefore have limited scope for further appreciation in the coming months.

Forward points



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Forward vs spot exchange rate EUR/CZK



Source: Bloomberg, Economic and Strategy Research, Komerční banka



## Banking sector



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### Modest slowdown in bank credit likely this year

Loans to non-financial corporations significantly contributed to solid loan growth last year, especially in 2H22. This year, however, is likely to see muted credit activity across the board due to weaker economic growth and the reverberating effects of stricter monetary policy. Residential real estate prices have continued to moderate and the coming quarters should see only modest declines, we estimate. Nonetheless, mortgage loan activity will likely remain subdued due to lower demand and more expensive financing. A similar fate likely awaits consumer finance. We anticipate deposit expansion to remain robust, boosted by household savings and the solid financial footing on the corporate side. We expect the drawn-out recovery from the mild and short-lived recession to be accompanied by a very limited realisation of risk on the loan portfolios.

Mortgage market will likely remain muted this year. Residential real estate should only see a mild price correction.

**Mortgage lending to remain muted, as house prices head for small correction**  
The residential real estate market continued to slow in 4Q last year, although offer prices still rose by 0.5% qoq on a seasonally adjusted basis (vs 2.4% qoq in 3Q). Meanwhile, actual realised prices, published with a longer delay, grew by 1.2% qoq (SA) in 3Q. Nonetheless, in yoy terms, offer prices are still more than 18% higher and Czechia still ranks high amongst countries with the worst housing affordability in the EU, or even the OECD. The residential real estate market is likely to continue to cool and we foresee prices declining over the coming quarters, albeit only modestly. The decline should be concentrated primarily on the lower-priced segment of residential real estate, including energy-intensive and recreational properties, as they flood the market, while the mortgage market should come to a near standstill. A moderate decline coupled with our anticipation for solid wage growth implies an improvement in housing affordability which, however, will only marginally compensate for the substantial worsening since 2020 due to the exorbitant growth in real estate prices.

#### Bank loans and deposits (% yoy)

	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23	1Q24	2021	2022	2023	2024	2025	2026
<b>Bank loans</b>														
<b>Total</b>	6.9	7.6	6.4	4.9	5.2	4.3	4.3	4.6	4.9	6.3	4.7	5.8	6.5	6.4
Households - real estate loans	8.8	6.8	4.9	2.9	3.5	3.0	3.0	3.5	9.9	7.9	3.1	5.1	6.8	6.5
Households - consumer loans	7.0	6.0	7.5	6.3	6.8	6.6	4.5	4.7	3.3	7.4	6.1	5.8	6.4	7.0
Corporate loans	7.7	7.9	6.2	4.2	5.3	4.0	5.0	5.8	0.9	7.3	4.6	6.8	6.8	6.3
<b>Deposits</b>														
<b>Total</b>	8.3	7.9	7.9	9.4	7.9	5.6	5.4	4.3	8.3	7.2	7.1	5.0	5.3	5.5
Households	4.1	3.6	4.3	6.5	5.6	5.2	4.6	3.4	10.2	4.0	5.5	4.9	6.1	6.2
Non-financial corporations	5.6	11.1	9.9	8.5	8.8	4.4	5.8	4.7	8.3	8.7	6.9	5.4	4.7	4.7
Others	18.0	13.1	14.9	15.0	11.1	7.2	6.9	5.5	4.9	12.3	10.1	4.9	4.3	5.1
<b>Ratios</b>														
<b>Loans/GDP</b>	61.6	61.5	60.2	59.1	58.5	58.7	58.0	57.7	63.5	61.5	58.6	58.3	58.9	59.5
<b>Deposits/GDP</b>	98.6	97.1	87.3	96.9	96.1	93.9	85.0	94.5	97.7	95.4	93.0	91.9	91.8	92.0
<b>Loans/deposits</b>	62.4	63.3	68.9	61.0	60.8	62.6	68.2	61.1	65.1	64.6	63.1	63.6	64.3	64.9
<b>Interest rates</b>														
<b>Real estate loans</b>	4.4	4.9	4.8	4.8	4.8	4.7	4.5	4.3	2.4	4.5	4.7	4.1	3.9	3.9
<b>Consumer loans</b>	8.8	9.7	9.7	10.1	10.2	10.5	10.5	10.0	7.4	9.1	10.3	9.5	8.5	8.6
<b>Corporate loans</b>	7.9	8.4	8.0	8.1	8.2	7.9	6.9	6.1	2.4	7.6	7.8	5.3	4.1	4.1
<b>Share of NPL</b>														
<b>Real estate loans</b>	0.8	0.7	0.7	0.9	1.1	1.2	1.3	1.3	1.0	0.7	1.1	1.4	1.6	1.7
<b>Consumer loans</b>	4.0	4.0	3.9	4.3	5.2	5.9	6.0	6.5	5.2	4.1	5.4	7.1	7.8	7.9
<b>Corporate loans</b>	3.5	3.3	3.5	3.8	4.1	4.4	4.6	4.7	4.1	3.5	4.2	4.8	5.0	4.7

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

**The latter half of 2022 was marked by a significant cooling of the mortgage market**, but the figures were still largely influenced by the drawdown of front-loaded mortgages with more favourable terms. Following an estimated 7.9% growth in 2022, we expect the mortgage market to remain nearly frozen for most of this year, expanding by only 3.1% on average. In addition, the return of Sberbank's mortgage portfolio to the statistics, which we expect to occur by 2Q23, will significantly boost figures for this year. With the longer-term rates returning to more favourable levels and the resumption of stronger economic growth, we expect mortgage lending not to recover until next year, when it should grow by 5.1%.

### Slowdown in consumer finance on the back of weaker consumption

Growth in consumer finance is set to moderate further due to weaker consumption and higher propensity to save.

**The marked slowdown in consumption and persistent negative consumer sentiment** contributed to weaker growth in consumer finance last year, especially in the latter half of the year.<sup>4</sup> Weaker household demand and higher rates on consumer loans will likely limit consumer lending significantly this year. On the other hand, continued tightness in the labour market and the associated solid wage growth should counter that. We estimate consumer credit growth to slow to 6.1% yoy this year after an estimated 7.4% last year. Persistently high inflation will remain a significant contributor, as living costs surge and indebtedness rises.

### Non-financial corporate credit activity to cool off this year

Demand for operational and foreign-denominated financing should gradually decline – we expect overall lending activity to decline significantly in 2023.

**The credit appetite of non-financial corporations (NFC) remained broadly resilient** last year, with loans to NFCs growing by 7.3% on average, according to our estimates. The borrowing was primarily directed towards operational financing and the substitution of koruna and euro loans. While the stock of the former has steadily declined since 2Q22, demand for the latter has increased significantly. Currently, their share in the stock of all loans is slightly above 45%, whereas five years ago it was 28%. The trend in operational financing should gradually weaken as the supply chain issues continue to abide and producer prices come back down as commodity prices fall. Moreover, the increasing cost of euro-denominated financing, in line with our view of the ECB policy path, should also discourage NFP credit activity. We expect weaker economic growth this year, albeit with a solid contribution from net exports and a partial recovery in investments towards the end of the year, to lead credit growth to NFCs to drop to 4.6% on average, or 5.1% in the case of total business loans.

### Deposit growth set to exceed loan growth this year

Household savings, good financial health and deferred investments on the corporate side will likely boost deposit expansion.

**Households' propensity to save, supported by solid growth in disposable income**, in large part thanks to both pension indexation and solid wage growth, will likely help household deposits to expand. However, increased personal costs and an outflow of funds to non-bank solutions in the search for yield amid persistently high inflation will likely work in the opposite direction. We estimate household deposits to grow by 5.5% on average this year. Good financial health and deferred investment activity on the corporate side will likely contribute positively to overall deposit growth, which we expect to average at 7.1% this year.

### Mild recession and lower growth likely to result in small increase in credit risk

A mild recession followed by a drawn-out economic recovery should result in only a minor increase in NPLs.

**We have yet to see a material realisation of risk on the bank portfolios**, with non-performing loan (NPL) ratios still close to historical lows. In our view, a weaker economic performance and tighter credit conditions should lead to a slight increase in NPLs this year. However, given the delayed response of the credit cycle to macroeconomic developments, it will be very gradual. Moreover, the interest cost burden for both corporates and households remains at favourable levels (see Box). Increasing exposure to foreign currency-denominated loans poses a slightly increased risk, but the upcoming provisioning should be quite sufficient, especially given the resilience of the domestic banking sector

<sup>4</sup> 4Q22 figures were significantly affected by the reclassification of loans in the volume of CZK6bn, which were added to the stock of consumer loans

## Key economic indicators

### Macroeconomic indicators – long-term outlook

		2019	2020	2021	2022	2023	2024	2025	2026
GDP	real, %	3.0	-5.5	3.5	2.5	0.3	2.4	2.5	2.6
Inflation	average, %	2.8	3.2	3.8	15.1	12.9	2.5	2.1	1.9
Current account	% of GDP	0.3	2.0	-0.8	-6.2	-3.8	-1.8	-1.4	-0.3
3M PRIBOR	average, %	2.1	0.9	1.1	6.3	6.8	4.3	3.3	3.3
EUR/CZK	average	25.7	26.5	25.6	24.6	24.2	24.4	24.6	24.7
USD/CZK	average	22.9	23.2	21.7	23.4	22.0	21.4	21.2	20.6

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

Note: KB forecasts are in red

### FX & interest-rate outlook

		24-01-2023	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
EUR/CZK	end of period	23.9	24.05	24.15	24.25	24.25	24.30
USD/EUR	end of period	1.08	1.06	1.10	1.12	1.12	1.13
CZK/USD	end of period	22.1	22.70	21.95	21.65	21.65	21.45
3M PRIBOR	end of period, %	7.21	7.25	7.30	6.40	5.40	4.85
10Y IRS	end of period, %	3.94	4.05	4.10	4.00	3.75	3.60

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

Note: KB forecasts are in red

### Monthly macroeconomic data

		IV-22	V-22	VI-22	VII-22	VIII-22	IX-22	X-22	XI-22	XII-22
Inflation (CPI)	%, yoy	14.2	16.0	17.2	17.5	17.2	18.0	15.1	16.2	15.8
Inflation (CPI)	%, mom	1.8	1.8	1.6	1.3	0.4	0.8	-1.4	1.2	0.0
Producer prices (PPI)	%, yoy	26.6	27.9	28.5	26.8	25.2	25.8	24.1	21.3	20.1
Producer prices (PPI)	%, mom	2.3	1.9	1.4	0.3	-0.1	1.2	0.6	-1.0	-1.1
Unemployment rate	% (MLSA)	3.3	3.2	3.1	3.3	3.4	3.5	3.5	3.5	3.7
Industrial sales	%, yoy, c.p.	-7.3	4.5	2.7	-2.5	9.9	8.4	2.9	0.5	n.a.
Industrial production	%, yoy, c.p.	0.7	18.8	18.2	12.8	29.6	26.9	19.5	17.8	n.a.
Construction output	%, yoy, c.p.	3.4	4.3	1.5	-4.1	1.8	-2.9	1.0	-0.8	n.a.
External trade	CZKbn (national met.)	-28.4	-27.7	-14.6	-22.6	-29.6	-13.3	-25.1	-25.5	n.a.
Current account	CZKbn	-2.3	-21.2	-50.6	-40.7	-101.1	-68.9	-34.8	-39.3	n.a.
Financial account	CZKbn	-12.5	-47.9	-58.4	-57.9	-123.0	-41.0	-26.8	-17.2	n.a.
M2 growth	%, yoy	5.6	6.3	5.3	5.3	5.3	5.5	5.9	5.9	n.a.
State budget	CZKbn (YTD cum.)	-100.1	-189.3	-183.0	-192.7	-231.1	-270.9	-286.7	-337.1	-360.4
PRIBOR 3M	%, average	5.36	5.97	6.64	7.30	7.27	7.25	7.28	7.27	7.26
EUR/CZK	average	24.4	24.8	24.7	24.6	24.6	24.6	24.5	24.4	24.3
USD/CZK	average	22.6	23.4	23.4	24.2	24.3	24.8	24.9	23.9	22.9

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

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