Quarterly report

Czech Economic Outlook

No rate cuts this year but more in 2024

- **Economic recovery in sight** After a technical recession, the economy stagnated in 1H23. We expect economic growth to resume in 2H23 and 2024. Its main source should be growth in household consumption, supported by an increase in real wages and a reduction in excess savings. GDP is set to grow by 0.1% this year and by 1.8% next year.

- **Inflation to fall below 2%** We expect inflation to remain around 8% yoy until year-end. Its steep fall at the start of next year will likely be driven by a sharp drop in energy prices and the government's proposed VAT changes. We forecast inflation to reach 11% in 2023, slow to 1.3% in 2024 and rise slightly again to 2.2% in 2025. Core inflation should remain above 2%.

- **The CNB unlikely to adjust rates before year-end** We expect the first rate cut in February next year vs September this year as in our previous forecast. But we think that the cuts will have to be faster next year, with the repo rate at 4% by end-2024.

- **Temporary pause in the rate decline trend** The postponement of the start of the CNB's monetary easing cycle should also shift the decline in market interest rates. The inverse shape of the curve is likely to be maintained throughout next year.

- **A weakening but still strong koruna** The CNB's policy, combined with a rapidly weakening US dollar, should keep depreciation pressures at bay. We expect the EURCZK 24.10 level to be reached in the next 12 months.

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Protracted restrictions could be an issue

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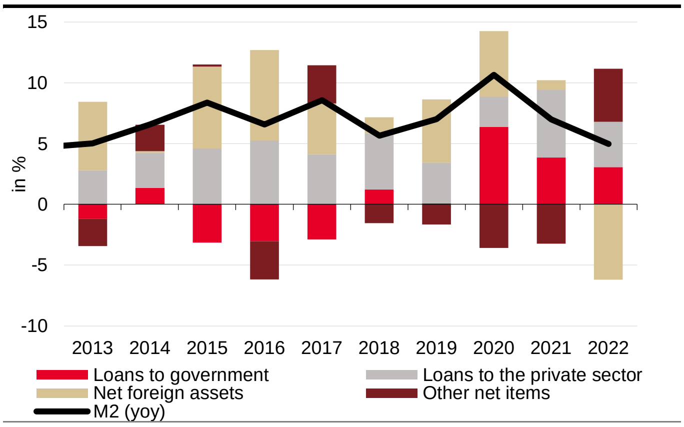
It may seem like the Czech economy has been marking time and nothing significant has happened in the last three months, but, **from a macroeconomic forecast perspective, the level of uncertainty has in fact increased.** As is often the case, the main source of this uncertainty is economic policy.

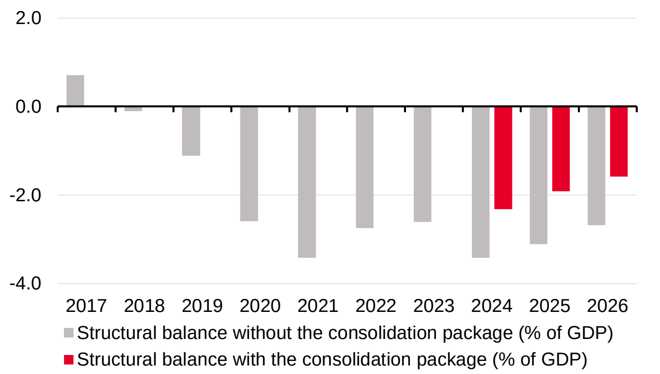
From a fiscal policy standpoint, the key issue is the impact of the austerity (or consolidation) package presented by the Czech cabinet in early May and, which is currently going through the legislative process in the Parliament. Its parameters could therefore change. But the basic framework is clear, and was passed by the House of Deputies in the first reading. The cabinet's proposal envisages a reduction in the public deficit to GDP ratio, of 1.1pp in 2024 and 1.2pp in 2025. In Box 2, Jaromír Gec analyses in detail a simulation of this restriction in economic growth and inflation, concluding that the negative impact on real GDP growth would be no more than 0.7pp in 2024e, and much lower in 2025e (around 0.2pp). However, the primary objective of the package is *not* to impair economic growth but to put public finance back on a sustainable track and reinforce the economy's growth potential for the future.

In the last 3 years, the government sector has been a major source of money issuance



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

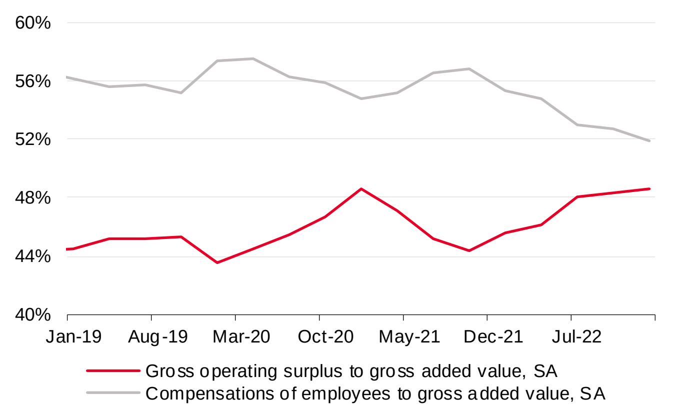
Without any intervention, the structural deficit will not shrink appreciably



Source: Czech Ministry of Finance, Economic and Strategy Research, Komerční banka
Note: Structural balance of public finances estimated by KB, impact of the package as assumed by the Czech Ministry of Finance

Its very logic makes the fiscal package restrictive, and so it will also combat inflation. Martin Gürtler has calculated (see our special report on *The Impact of the Proposed VAT Changes Should Be Slightly Anti-Inflationary;* available here: https://bit.ly/VAT_changes_CZ) that even the initial impact of changes in VAT alone should be anti-inflationary. It would be slightly inflationary only in an extreme scenario of demand so strong that the prices of items transferred to the lower VAT rate do not decrease. But the package is not only about VAT but also, in particular, about deficit reduction. Another effect will therefore be lower money issuance by the government as another anti-

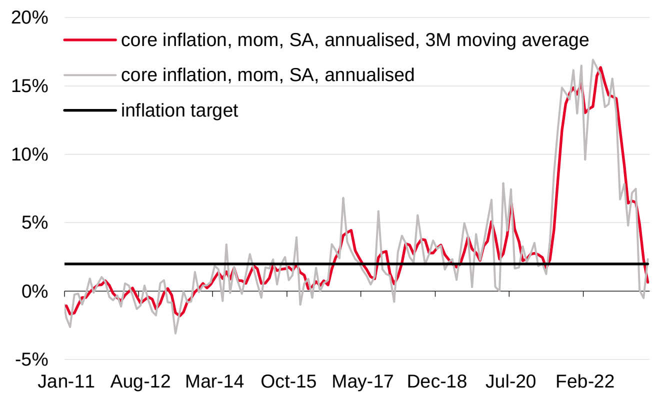
Non-financial companies' profit margins are rising at the expense of employees' wages



Source: CZSO, Macrobond, Economic and Strategy Research, Komerční banka inflationary factor. Our overall estimate is (see Box 2) that the package will reduce inflation by 0.4pp in 2024 and by 0.3pp in 2025.

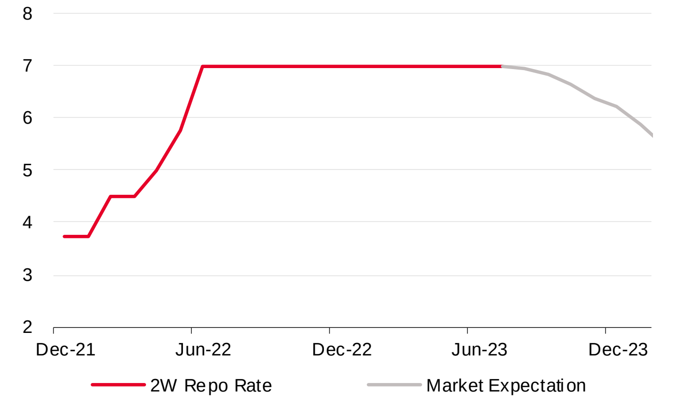
The central bank is also fighting inflation through a restrictive policy. In addition to the above-mentioned anti-inflationary effect of fiscal policy, the decline in energy commodity prices and weak consumer demand will be gradually reflected in inflation. The year-and-a-half long drop in real consumption, clearly documents Czech households' reluctance to pay high prices for goods and services. Jaromír Gec and Kevin Tran Nguyen show in their box (Box 1) that the post-pandemic inflation shock has mainly hit employees. Last year's dramatic fall in real wages had led to a return to the trend in real labour productivity; and we believe there is a low risk of a wage-inflation spiral. Nor do we expect any significant inflation impact from the release of accumulated savings. In the inflationary environment, their structure is shifting towards financial instruments with lower liquidity, from current accounts to term deposits and, in particular, mutual funds and other investment vehicles.

The current (core) inflation dynamics are even below the 2% target



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

The forward-looking market expects quite significant cuts to the CNB's key rate this year



Source: Bloomberg, Macrobond, Economic and Strategy Research, Komerční banka
Note: Updated as of 24 July 2023

Market participants are aware of the low month-on-month core inflation dynamics registered during the second quarter. Seasonally adjusted and annualised, core inflation has fallen below the inflation target. Given the length of the monetary policy transmission process, this constellation would help the central bank to cut rates quite visibly until the end of this year. And the market follows this historical experience when in the prices of financial instruments it envisages that the CNB's rates will be over one percentage point lower by the end of this year. However, the central bankers' rhetoric on rates is profoundly different. Their '*higher-for-longer*' mantra is not only unflagging; it even gained strength at the CNB Board meeting in June.

We fear a certain 'protraction' of the monetary restriction during which rates would not be cut this year. Naturally, their reduction next year would be all the faster. And the implications, in our mind? Next year, inflation would be below the target and economic growth lower than if the CNB started to cut rates this year. We therefore expect average inflation of 1.3% and real GDP growth of 1.8%. We are more than curious about the CNB Board meeting in August and its new inflation forecast. In our view, the forecast will already show the need to cut rates soon, which, after all, the central bank's May forecast already indicated.

The worst half of the year is over, we believe. In particular the economy's performance in 2Q23 was a disappointment for us in that it resulted in what basically was economic stagnation for the whole first six months. **But the second half of the year should already look better from the perspective of both producers and consumers. The input costs are**

decreasing for producers and we also believe that consumer demand will recover before the end of this year. The reason is that we expect growth in real wages from the second quarter of this year. Combined with the gradual release of accumulated savings, this should be felt positively in real consumption. However, the return pre-pandemic levels of household consumption will be long. But we are perhaps at the beginning of this journey. We hope you enjoy reading this summer's edition of Komerční banka's *Czech Economic Outlook*!

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External environment and assumptions

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Inflation unlikely to return to central bank targets this year

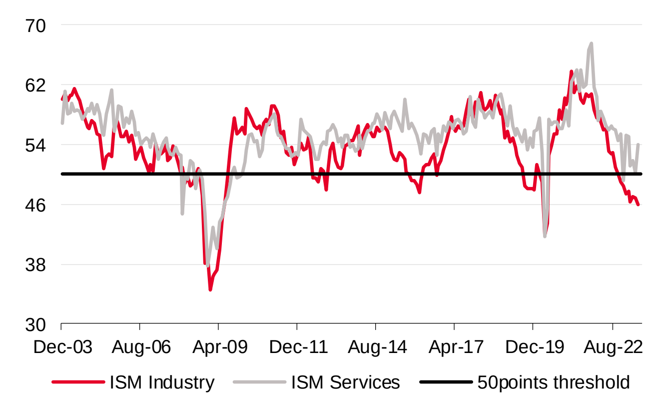
Although inflation has slowed significantly in the US and euro area, it is still well above central banks' targets. The core component in particular remains high. The ECB will likely thus have to continue tightening monetary conditions. The deposit rate should reach 4% in September, but the risks are biased towards an even higher level. In the US, rate hikes appear to be approaching an end shortly. Tighter US monetary policy should lead to a gradual cooling of the economy, which we expect to enter recession in the first half of next year. By contrast, the euro area will benefit for the time being from the auto industry recovery, falling energy prices, high profit margins allowing companies to continue to invest and hire new staff, as well as continued high household savings and solid wage growth.

US: economy likely to start to slow in 2H23

Monetary and fiscal policy to be restrictive.

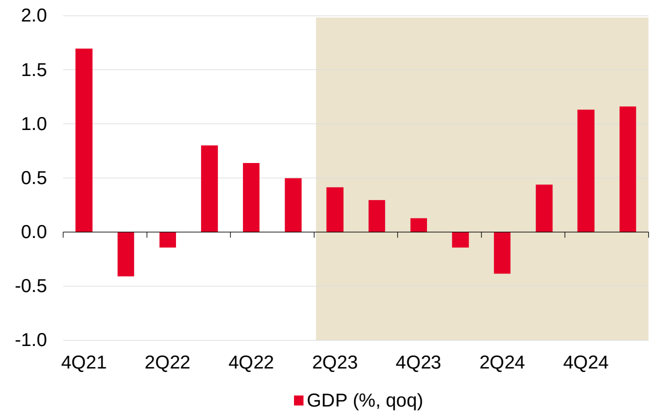
The US economy grew at an annualised rate of 2.0% qoq in 1Q23. The outlook is also solid for 2Q23 (our estimate is 1.7% qoq annualised). However, we expect activity to cool in the second half of the year, with the US entering recession in the first half of next year, albeit a short and shallow one. We see several factors at play here. Concerns about US bank failures have dissipated but have turned into greater caution in lending. This, coupled with companies' efforts to maintain high profit margins in an environment of rising wage costs (employee compensation is currently rising at a rate of 5-5.5% yoy), will likely put downward pressure on investment. Fiscal policy should also be restrictive (the Supreme Court blocked President Biden's plan to forgive $430bn of student loan debt). Meanwhile, the labour market remains tight, with monthly job additions well above the 150,000 mark, which we view as expansionary. Workers in the hospitality, accommodation, tourism and healthcare sectors are still in demand. There, employment numbers have not yet reached pre-pandemic levels. Once they do so, which should be within a few months, job creation will likely drop significantly.

Economic activity is slowing



Source: Macrobond, SG Cross Asset Research/Economics

US economy likely to face recession in early 2024

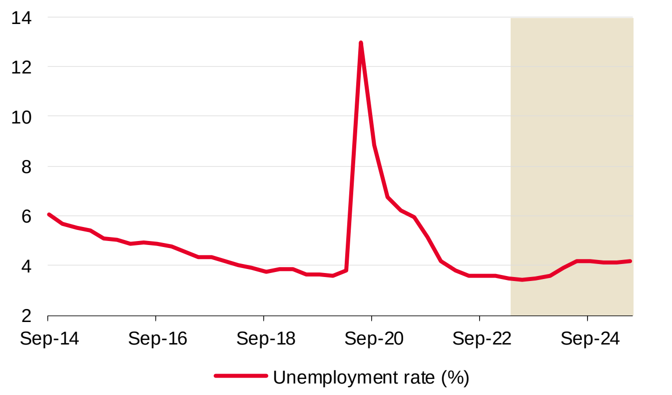


Source: Macrobond, SG Cross Asset Research/Economics

Rent prices preventing inflation from returning to target.

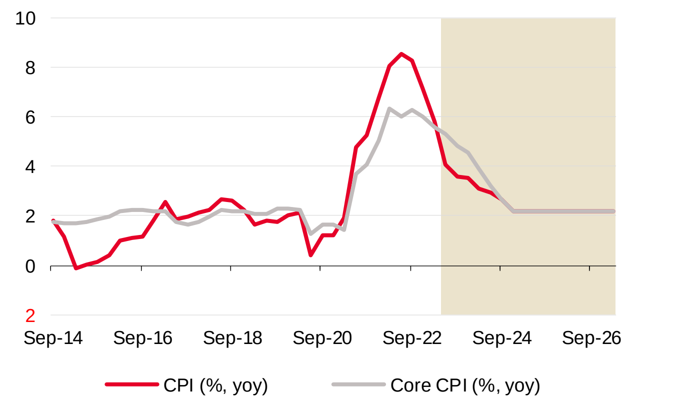
A cooling labour market should help inflation return to the Fed's 2% target, although we don't expect this until late next year. Headline inflation has already eased considerably from last year's peak of 9.1% yoy to June's 3%, but the core component is still high (4.8% yoy in June). The problem is rent prices, which are the largest item in the US consumer basket (25%) and are still rising, reaching a 7.8% yoy pace in June. For inflation to start approaching the 2% target, this rate would need to be at most 4%, and we expect it to converge on that in the coming months. The Fed will thus raise interest rates only once more, in our view, at the coming July meeting. We then expect the first rate cut in the first quarter of next year.

Labour market remains tight



Source: SG Cross Asset Research/Economics

Core inflation does not want to fall



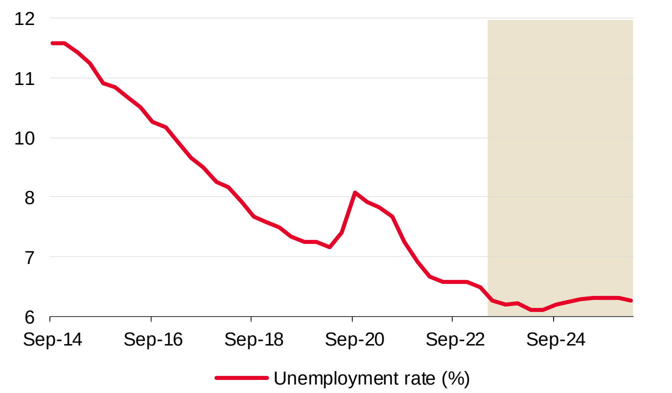
Source: SG Cross Asset Research/Economics

Euro area: high inflation, low growth

With employment still rising, it is difficult to envisage recession.

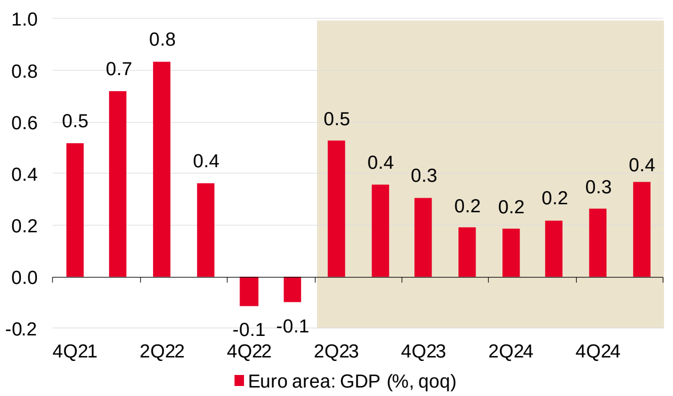
The euro area has proven very resilient to external shocks (GDP growth of 3.5% in 2022), even if the fact that GDP growth fell by 0.1% qoq for a second consecutive quarter in 1Q23 means that the economy could be said to be in technical recession. Moreover, it is difficult to contemplate recession when employment is growing (0.3% qoq in 4Q22 and 0.6% qoq in 1Q23) and unemployment is at historical lows. Firms still have a strong ability to pass on high prices to end customers and therefore enjoy high margins. At the same time, they have substantial liquidity cushions from the COVID crisis, so they continue to invest despite tighter monetary conditions. Even so, investment activity should weaken in the coming quarters, which is why we expect only moderate growth.

Labour market is tight



Source: SG Cross Asset Research/Economics

GDP likely to grow moderately

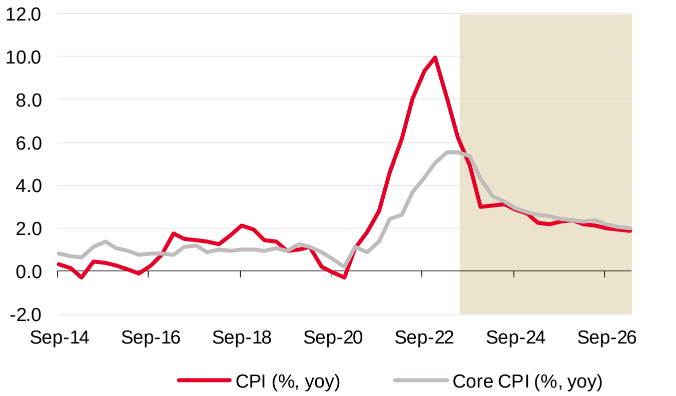


Source: SG Cross Asset Research/Economics

Demand in euro area exceeds supply in many sectors.

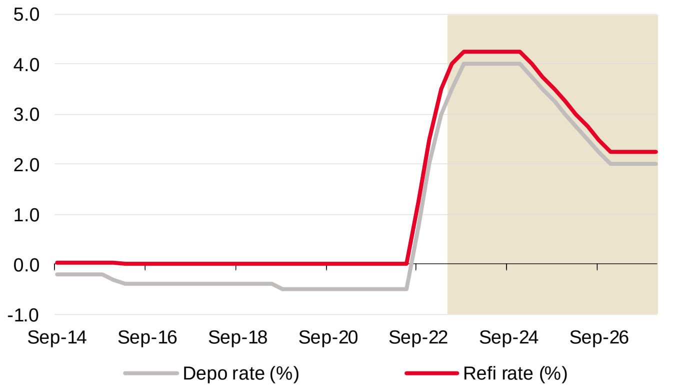
Although the PMI indicators in industry fell well below the 50 level (43.4 points in June), partly due to lower order volumes and partly to improved supply-chain conditions, the outlook for European industry is not too bad. Industrial production has been affected in recent months by a few factors, mainly efforts to save energy. Adjusted for these factors, however, it grew. Moreover, demand is outstripping supply in many sectors. This is the case in the auto industry, where production is still only at 92% of its pre-covid level. The excess of demand over supply is evident across the economy. Despite high inflation, real disposable incomes fell by only 0.1% in 2022 thanks to solid wage growth and government measures. Moreover, households still have high savings (8.2% of nominal GDP in 4Q22), so household consumption, unlike investment activity, should revive in the second half of this year.

Core inflation still high



Source: SG Cross Asset Research/Economics

ECB rates likely to rise further



Source: SG Cross Asset Research/Economics

ECB likely to continue to tighten monetary conditions.

Rising wages and resurgent household consumption will likely keep core inflation high (5.5% by August this year, 5% on average for the whole of this year, 4% at the end of 2024) and prevent the ECB from cutting interest rates before 2025. Instead, it will probably have to raise them, with the deposit rate peaking, in our view, at 4% in September. The risks, however, are biased toward even higher rates. At the same time, the ECB will have to accelerate the reduction of its balance sheet. Reinvestment of maturing bonds and of the pandemic PEPP programme will also need to end. For regulatory reasons, and due to the ECB's losses from holding excess liquidity, the central bank will sooner or later have to start selling bonds even before they mature. It is likely to continue reducing its balance sheet even when it has already started to cut interest rates, otherwise it will not get to any reasonable level of balance sheet (roughly half the current EUR4tn). Continued monetary tightening, the end of the energy crisis and economic growth should support the euro. We see EURUSD at 1.16 at the end of this year and 1.21 at the end of next year.

CEE: inflation slows, monetary policy to be looser

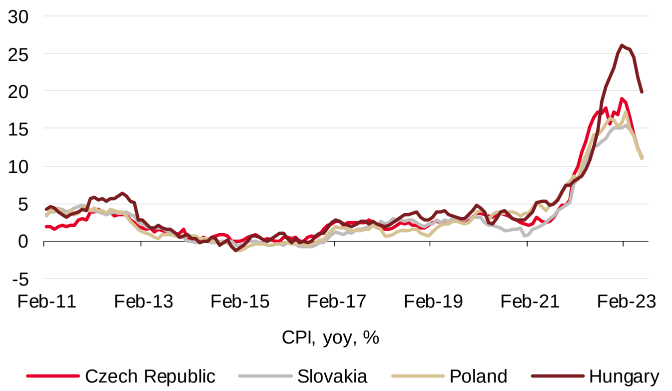
Hungarian central bank likely to continue cutting overnight deposit rate.

Inflation in the region is slowing (to 11.5% yoy in June in Poland, 20.1% yoy in Hungary). The Hungarian central bank has already started to cut the overnight deposit rate (from 18% to the current 16%) and will likely continue to do so, by 100bp per month until September, bringing the overnight rate to the same level as the key three-month deposit rate at 13%. Our SG colleagues forecast that the 3M deposit rate should start to be cut in 1Q24, falling to 10% in that quarter and then to 8% in 2Q24. For now, the central bank prefers a more cautious approach to prevent a sell-off in the domestic currency. Thus, we see EURHUF moving mostly in the range of 375-380 in the coming months.

National Bank of Poland set for initial rate cut in September.

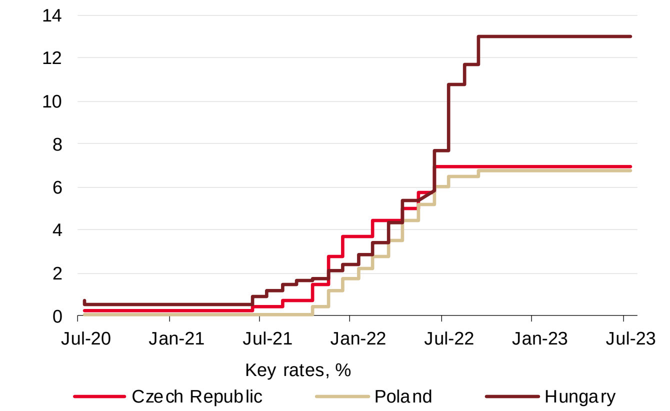
The Polish central bank is also likely to start cutting interest rates this year. Inflation will likely fall below 10% in September and continue to decelerate rapidly. We therefore expect the National Bank of Poland to cut the key rate by 25bp from the current 6.75% this September, with a 50bp cut to follow in October. We expect four 25bp cuts in 2024. Thus, in the second half of this year, we see the zloty weakening, with EURPLN at 4.60-4.65.

Inflation in the region is falling



Source: Macrobond, Economic & Strategy Research, Komerční banka

Rates stopped rising



Source: Macrobond, Economic & Strategy Research, Komerční banka

Macroeconomic forecast

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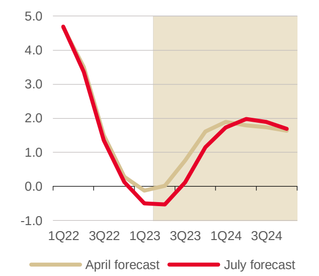
Major changes

GDP:
In our view, the economy will grow by just 0.1% this year, which is less than expected in our previous forecast (0.6%). However, the second half of 2023 should be marked by an economic recovery, as we expect household consumption growth to resume. For 2024, we are forecasting the same GDP growth rate as in the previous forecast (1.8%), but only due to the lower comparative base this year.

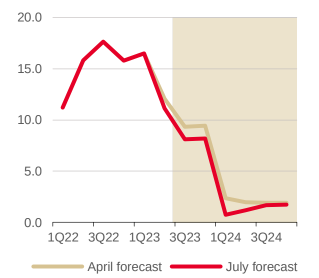
Inflation:
We have lowered our inflation estimate for this year from 11.8% to 11.0% and for next year from 2.0% to 1.3%. This was mainly due to the faster retreat of inflation over the past quarter. The decline in inflation below the central bank's target in 2024 is due to the expected fall in consumer energy prices, as well as the government's proposed fiscal consolidation and VAT changes. However, core inflation is set to remain above 2% this year and next.

Change in GDP forecast (%, yoy)



Source: CZSO, Economic & Strategy Research, Komerční banka

Change in CPI forecast (%, yoy)

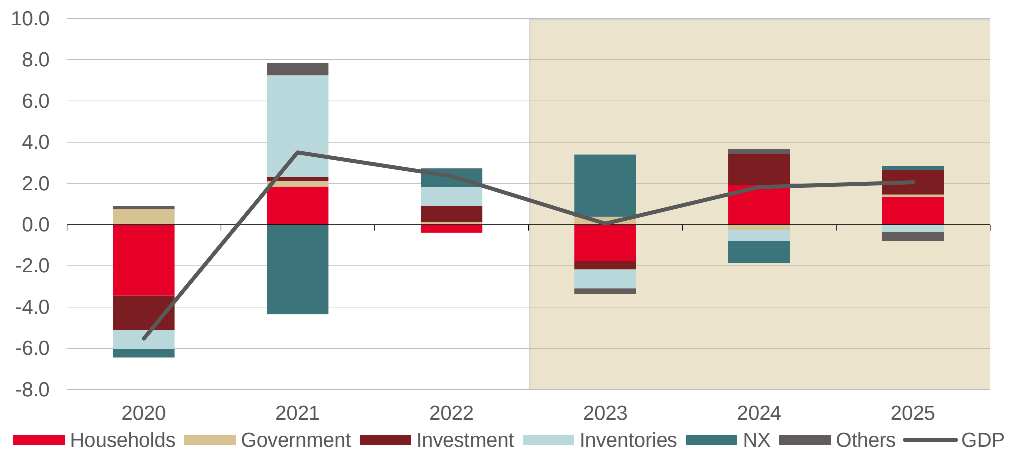


Source: CZSO, Economic & Strategy Research, Komerční banka

Rapid decline in inflation to help economic recovery

After the Czech economy went through a mild recession in the second half of last year, the start to this year has not been very encouraging. We estimate that GDP stagnated in the first half of the year. However, we expect economic growth to resume in the second half of 2023. This should be driven mainly by a recovery in household consumption, which has fallen sharply. With inflation declining rapidly and the labour market still tight, real wages should start to rise. The slowdown in price increases should also provide the impetus for a gradual reduction in the high level of excess savings. However, planned fiscal consolidation or excessively tight monetary policy are likely to dampen economic growth next year.

We expect GDP to grow by only 0.1% this year and accelerate to 1.8% next year (%, yoy)

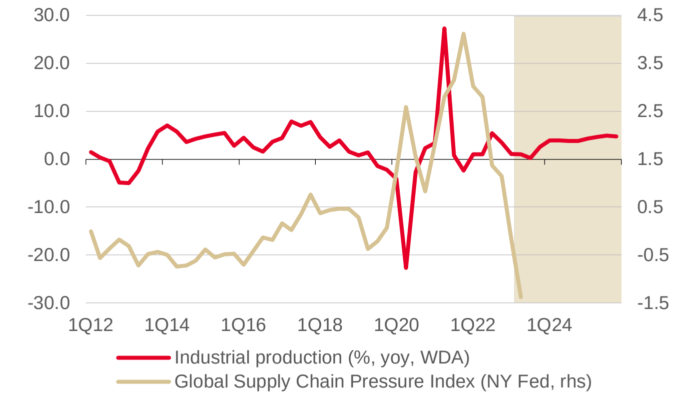


Source: CZSO, Economic & Strategy Research, Komerční banka

Economy to be flat this year

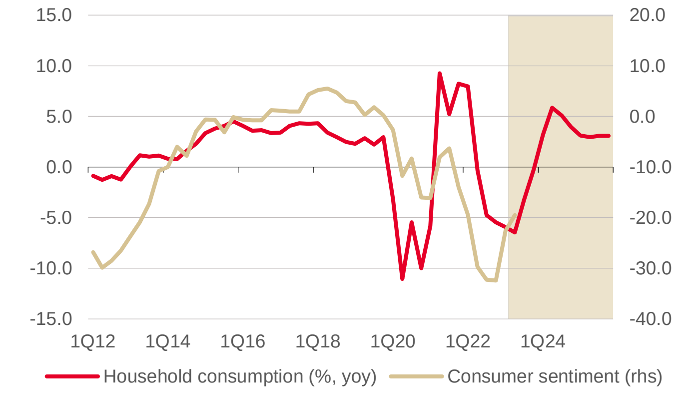
The Czech economy performed below our expectations in 1Q23. GDP was flat, whereas we had forecast growth of 0.2% qoq. The economy did not contract further as it did during the technical recession in 2H22, but there was no recovery either. Household consumption was a negative surprise as it continued to decline qoq, contrary to our expectation of moderate growth. In 1Q23, it fell for the sixth consecutive quarter and was 9.6% lower in real terms than in pre-pandemic 4Q19. Its level was thus roughly the same as in the second half of 2016. Presumably, the sharp decline in household spending was mainly due to a similarly pronounced dip in real wages. Fixed investment was also lower in 1Q23. In this case, it was the third consecutive quarter of decline and the pace accelerated significantly to -1.1% qoq. Overall, 1Q23 was marked by weak domestic demand. On the other hand, this was offset by significantly higher net exports, both compared to the previous quarter and to our expectations. We believe that this was due to the completion and subsequent export of previously unfinished production. Indeed, parts that were initially missing became available as supply chains started to function again, which had a positive impact on car production. This scenario is supported by the fact that the positive contribution to GDP growth from net exports was largely offset by the negative contribution from the change in inventories. Actual output in the manufacturing sector was broadly unchanged qoq in 1Q23. The economy was 1% below its pre-pandemic level in 1Q23.

Supply chains have returned to normal



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

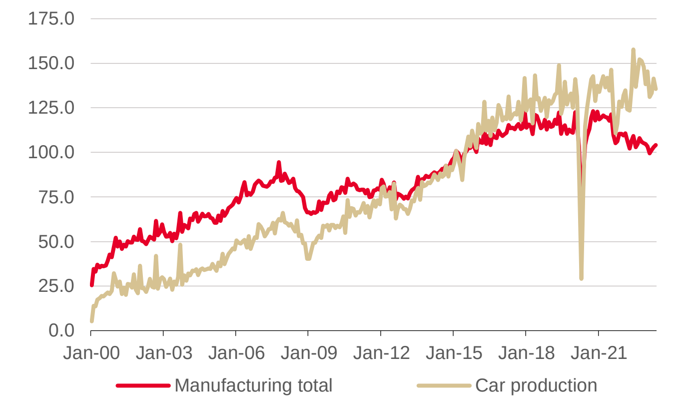
Household consumption should gradually recover



Source: CZSO, Economic & Strategy Research, Komerční banka

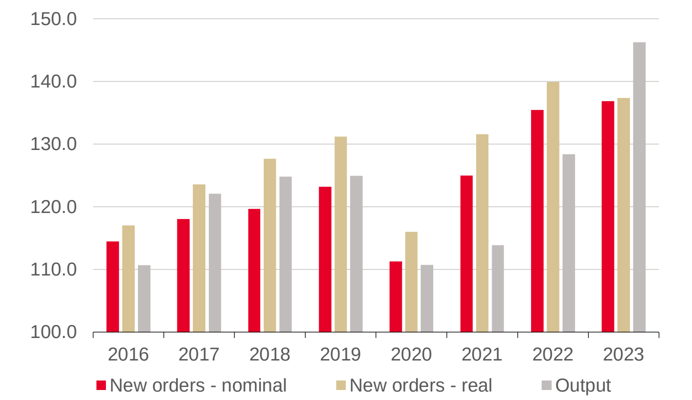
In our view, the weakness of the economy continued in 2Q23. We estimate that GDP grew by only 0.1% qoq (in our previous forecast we had expected +0.4% qoq). Its development structure should be similar to that of 1Q23. Consumer demand has not improved. On the contrary, the development of sales in retail and services points to a further significant deterioration. In 2Q23, we expect household consumption to fall by 1.4% qoq after -1.8% qoq in 1Q. Very subdued demand and uncertainty about its future development do not bode well for fixed investment, which we forecast to decline by 0.8% qoq. Lower domestic demand should continue to be offset by higher net exports. In 2Q23, the impact from the exports of previously unfinished production is likely to have intensified, as indicated by the monthly foreign trade statistics. This would also imply that the negative contribution from the change in inventories has continued. In addition, higher net exports are also likely to have been supported by the pick-up in industrial production in 2Q, according to available monthly data. The automotive industry, which is important for the Czech economy, is still likely to have a backlog of orders from the previous two years. In 2021 and 2022, the volume of new car orders far exceeded production in both nominal and real terms due to a shortage of parts. So far this year, however, car production has exceeded new orders. We believe that this is due to a combination of falling demand for industrial goods and the completion of previous orders. However, our assessment is that the order backlog for 2021–2022 is not yet fully exhausted. By contrast, the rest of the manufacturing sector is likely to be worse off in terms of orders.

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



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

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

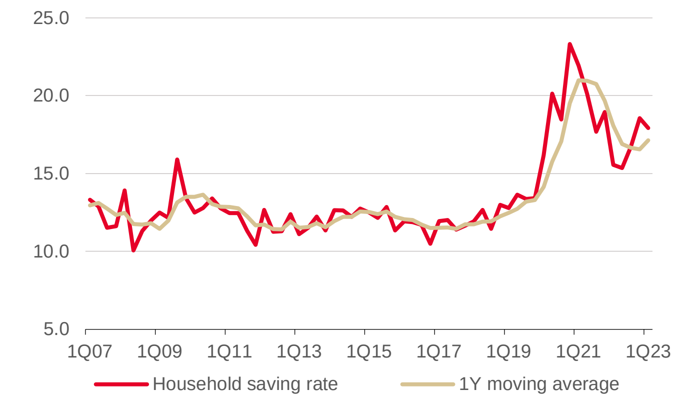


Source: CZSO, Economic & Strategy Research, Komerční banka
Note: All three indicators refer to car production. The average for this year is calculated from available data from January to May.

We expect the economy to return to its pre-pandemic level of 4Q19 in 1Q24. However, household consumption is unlikely to return to pre-pandemic levels until 4Q26.

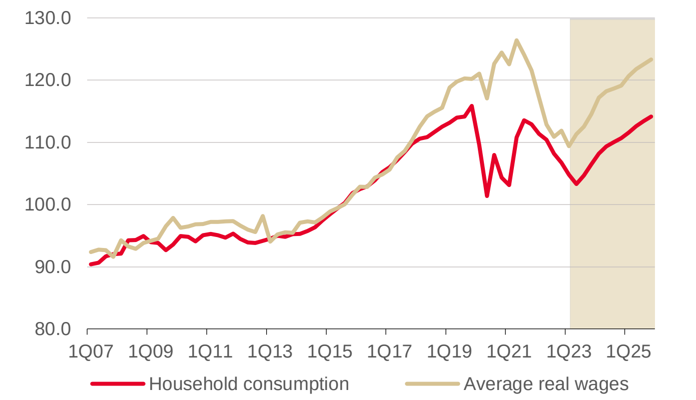
We expect the economy to grow by only 0.1% this year and to accelerate to 1.8% next year. In our April forecast, we estimated GDP growth at 0.6% this year and 1.8% next year. While GDP is likely to have been broadly flat in 1H23, our new forecast includes a resumption of growth in 2H. We expect GDP growth of 0.4% qoq in 3Q23 and a slight acceleration to 0.6% qoq in 4Q23. The main driver of this recovery should be higher household consumption. In our view, this should reflect a resumption of real wage growth as well as a gradual unwinding of the high level of excess savings. The household saving rate has been high since the start of the pandemic, despite the significant decline in real wages mentioned below. Between 1999 and 2019, households set aside an average of 12% of their disposable income. Between 1Q20 and 1Q23, however, this share rose to 18.5%. As a result, we believe that households currently have a large amount of excess savings. We estimate their level at just under 10% of nominal GDP in 2022 (see Box 1). This is not unusual from a global perspective, as other developed countries have similar levels of excess savings.

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



Source: CZSO, Economic & Strategy Research, Komerční banka

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



Source: CZSO, Economic & Strategy Research, Komerční banka

As inflation and uncertainty recede, we expect households' excess savings to be gradually reduced over the forecast horizon. The liquidity structure of the excess savings argues against a sharp decline that could generate a strong inflationary impulse. At least part of the excess savings is held in less liquid investment instruments such as shares or bonds. Thus, while we expect real household consumption to rise steadily over the forecast horizon, we do not expect it to return to its pre-pandemic level of 4Q19 until the end of 2026. Moreover, our assumptions about the external environment imply that excess savings will also be spent abroad. A recovery in external demand may boost domestic industry, which is currently suffering from a decline in new orders. In terms of the structure of GDP, the economy is likely to be supported mainly by higher net exports this year, partly as a result of the export of previously unfinished production. The contribution from domestic demand is likely to be clearly negative this year. However, we expect a turnaround next year. The recovery we expect in household consumption and fixed investment should lead to higher imports, resulting in a negative contribution from net exports to GDP growth. According to our forecast, the economy should return to pre-pandemic levels in 1Q24, two quarters later than in the previous forecast.

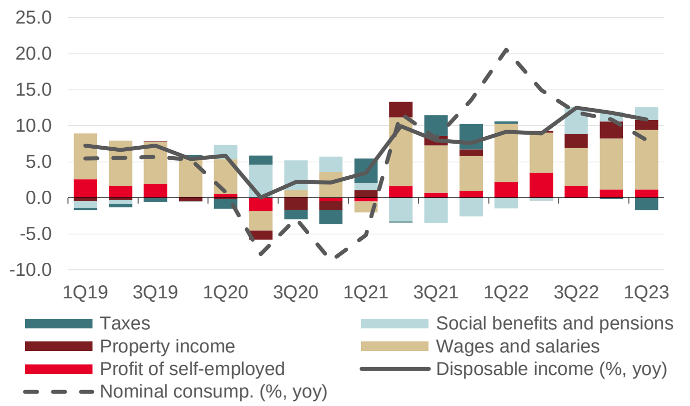
The main risks to our GDP forecast are a possible continuation of weak household consumption and the nature of economic policy. A recovery in household consumption growth in 2H23 is a key assumption of our forecast. If this does not happen, the economy is likely to contract this year. Our forecast for next year includes the negative impact on GDP growth from the fiscal consolidation announced by the Czech government (see Box 2). Within the structure of GDP, this is visible in a decline in government consumption, but it is also set to dampen private consumption growth. If fiscal consolidation were to be either less pronounced next year or not take place at all, economic growth could be slightly higher. An earlier interest rate cut by the central bank would have the same effect. As we describe below, we believe that the CNB will keep rates on hold until the end of this year, i.e. slightly longer than would be optimal. In our scenario, this will lead to lower economic growth at the turn of 2024 and 2025. The general uncertainty in our forecast is the development of foreign economies, which will be an important factor for the performance of manufacturing.

Renewed real wage growth in a tight labour market

In our view, the ongoing labour shortage and the reversal of the previous sharp decline will contribute to a resumption of qoq real wage growth from 2Q23 onwards.

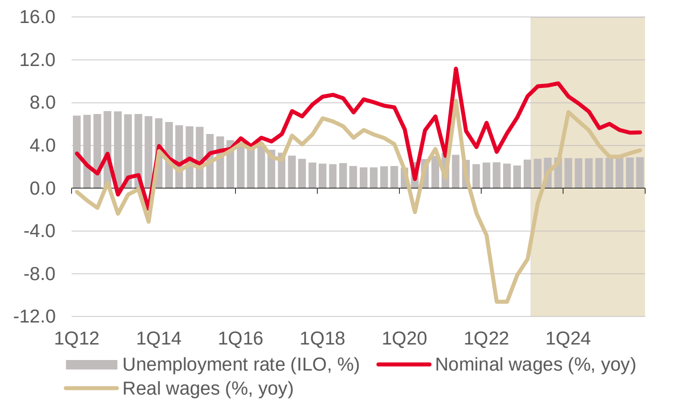
The labour market continues to face significant labour shortages and unemployment remains minimal. According to our estimate, the ILO unemployment rate rose only slightly from 2.7% in 1Q23 to 2.8% in 2Q23 on a seasonally adjusted basis, while the share of unemployed persons (MLSA methodology) stagnated at 3.6%. The seasonally adjusted ratio of the number of registered unemployed to the number of vacancies offered through the job offices decreased slightly from 0.95 in 1Q23 to 0.92 in 2Q23. In contrast, this ratio continued to rise over the past year, but only by a total of 0.2. This means that there was still roughly one unemployed person for every job vacancy. We expect unemployment to remain very low over the forecast horizon. We expect the ILO rate to remain below 3% and the share of unemployed persons below 4%. In line with the economic recovery, we expect employment growth to resume both this year and next, after declining during the previous three years.

Pensions and social benefits boosted disposable income growth



Source: CZSO, Economic & Strategy Research, Komerční banka

Real wage growth to resume this year



Source: CZSO, Economic & Strategy Research, Komerční banka

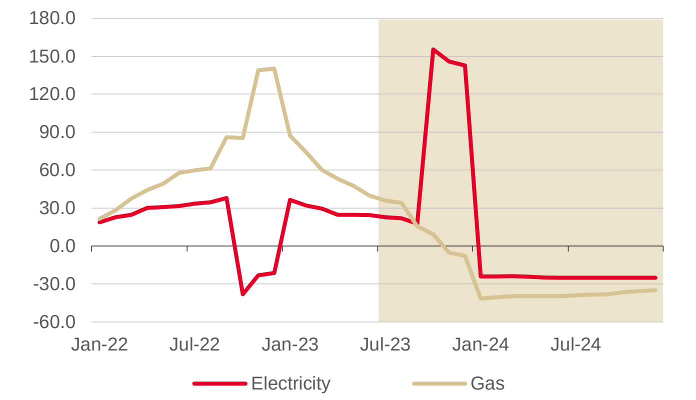
We expect average nominal wages to grow by 9.4% this year and 7.3% next year. This year's growth should be slightly lower than our April forecast (10.4%), while next year's should be slightly higher (we had originally expected 6.6% for 2024). The forecast revision is driven by slower-than-expected nominal wage growth in 1Q23 (8.6% yoy vs 9.5% in the April forecast). However, we continue to believe that the ongoing tightness in the labour market and the steep decline in real earnings will be the reason for continued rapid nominal wage growth in the coming quarters. The yoy decline in real wages has continued for six consecutive quarters, reaching -6.6% yoy in 1Q23. Compared to the pre-pandemic level in 4Q19, average real wages fell by 8.9% to a level last seen in the second half of 2017 (thus, the decline was similarly steep as that of real consumption). The decline in household purchasing power was slowed only by the increase in old-age pensions and social benefits, which are indexed to the inflation rate. However, with inflation receding and nominal growth continuing, we estimate that real wages have started to rise qoq in 2Q23. Moreover, this growth is set to continue over the rest of the forecast horizon. Rising nominal wages should not be a problem for companies. Over the period just past, firms have been able to pass on higher costs to final consumers and even increase their profit margins (see Box 1). By contrast, wage growth has lagged well behind inflation, leaving workers to bear the brunt of inflation. In our view, this will be at the forefront of wage negotiations for at least the next year. In the course of 2025, real wages should therefore return to their pre-pandemic level of 2019.

Inflation to fall below 2% next year thanks to cheaper energy

Core inflation is set to remain high above 2% this year and next due to the expected recovery in demand. We do not expect core inflation to return to the CNB's target until 2025.

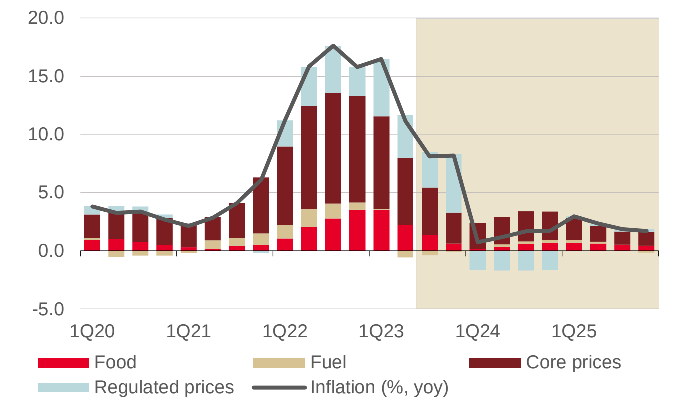
The second quarter of this year saw an unexpectedly rapid decline in inflationary pressures. Headline inflation slowed from an average of 16.5% yoy in 1Q23 to 11.1% yoy in 2Q23, while our forecast was for a decline to 12% yoy. Except regulated prices, all components of inflation showed less momentum than in our April forecast. However, the most surprising development was in the core component, which traditionally tends to be the most persistent. Core inflation fell from 11.9% yoy in 1Q23 to 8.7% yoy in 2Q23. But even more striking, according to our estimates, was the slowdown in its seasonally adjusted mom dynamics, from an average of 0.58% in 1Q23 to 0.17% in 2Q23. This means that annualised core inflation fell from around 7% to 2% and was in line with the CNB's target. We think that such a sharp easing in core inflationary pressures was due to a significant downturn in domestic demand. In all components, headline inflation was also pushed down by the effect of last year's higher base. In June, annual inflation fell to single digits (9.7% yoy) for the first time since January 2022 and was the lowest since December 2021.

Electricity and gas prices set to fall by about a third (%, yoy)



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

Regulated prices to be the main driver of headline inflation



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

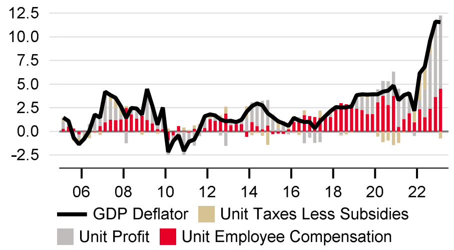
After 11% this year, we expect inflation to fall sharply to 1.3% next year before accelerating slightly to 2.2% in 2025. Our previous forecast was 11.8% this year and 2% in 2024. We expect inflation to remain close to 8% yoy in 2H23. The effect of last year's comparison base will work in the opposite direction in 4Q23. This is due to the introduction of a special energy tariff in 4Q22, which brought electricity prices down markedly. However, this will be a purely statistical effect that will temporarily accelerate the yoy dynamics of regulated prices. Consumer energy prices are likely to have peaked and, in our view, should fall significantly at the beginning of next year. Energy suppliers' new price lists should start to reflect the fall in wholesale prices. As in our previous forecast, we expect electricity, gas and heating prices to be around a third lower yoy in January next year. The VAT changes proposed by the government should also be reflected in consumer prices from January 2024, and we expect them to reduce annual inflation by 0.4pp. We write more about this estimate in our special report here: https://bit.ly/VAT_changes_EN. These two effects are set to temporarily push annual inflation below 1% early next year. However, monetary policy relevant inflation, which excludes the impact of indirect tax changes, is likely to remain slightly above 1%, averaging 1.7% over the whole of next year. On the other hand, we expect core inflation to remain high next year. We expect it to fall from 7.6% this year to 3.9%. This is because we believe that the recovery in demand and the unwinding of excess savings amid ongoing labour market tensions and higher wage growth will lead to a partial recovery in core price pressures. Core inflation should return to the 2% target in 2025 (as should headline inflation once the fall in energy prices and the impact of the VAT changes have faded). However, despite the impact of the resumption of demand pressures, we have revised down our forecast for core inflation. In our April forecast, we expected core inflation to reach 8.9% this year, before slowing to 4.6% in 2024 and 2.7% in 2025.

We see the risks to the inflation forecast as tilted to the downside. These relate mainly to the possibility that growth in household consumption will not recover and that demand pressures on price increases will remain very subdued. There is also a risk that the pass-through of the recent decline in commodity prices to consumer prices for energy and food will be stronger than we assume in the forecast.

Box 1: Subdued domestic demand pressures

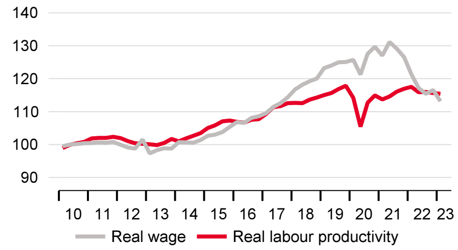
The post-pandemic inflation shock had an asymmetric impact on the economy. For example, this can be illustrated by breaking down the GDP deflator into the contributions from unit labour costs and gross operating surplus. This suggests that firms were able to respond to cost increases with higher prices relatively nimbly and thus maintain or even increase their profitability. Efforts to compensate for the previous decline in margins or increased uncertainty and the creation of a cushion in the event of the adverse scenarios could have also played a role. Wages, on the other hand, lagged significantly behind price dynamics due to their slow adjustment and the easing of labour market tensions, resulting in employees absorbing most of the inflation burden.

GDP deflator (%, yoy)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Net taxes are defined as taxes on production and imports minus subsidies on production; net taxes, profits and labour costs are expressed per unit of real output.

Real wage and labour productivity (2010 = 100)



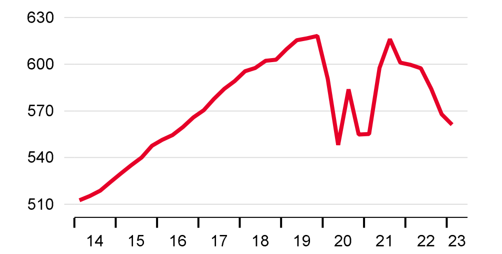
Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Labour productivity is measured as the ratio of real GDP to total employment according to the national accounts.

From a long-term perspective, last year's fall in real wages brought their level closer to that of labour productivity. While real wage growth significantly outpaced labour productivity in 2017-2020 in particular, the situation reversed last year. The almost four-year episode of noticeable inflationary pressures from the labour market has thus subsided.

In our view, the labour market, which is still short of labour, is likely to see pressure from employees to at least partially offset the previous sharp fall in real wages. However, we think whether firms accept wage increases at the expense of a decline in their profit margins or, on the contrary, try to pass it on to consumers, which would threaten to unleash the dreaded wage-inflation spiral, will likely be crucial for future price developments.

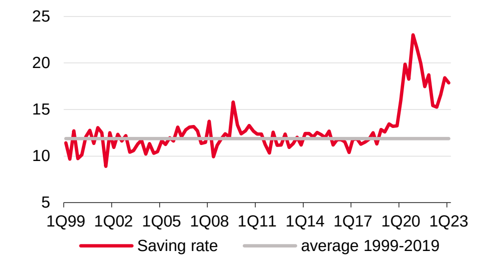
We do not expect the wage-inflation spiral scenario to materialise. Not only does the latest data on wage dynamics not suggest this, but we do not expect passing on costs to consumers and maintaining increased margins to materialise, mainly because firms are facing significantly subdued domestic demand. According to National Accounts statistics, household consumption in real terms fell qoq for the sixth consecutive quarter in 1Q23, a trend which we believe is likely to have continued in the second quarter of this year. On a level basis, real consumption in 1Q23 was no longer far from pandemic levels during lockdowns. With this in mind, even its eventual gradual recovery may not lead to significant demand inflationary pressures, in our view.

Household consumption (CZKbn, 2015 prices)



Source: CZSO, Economic & Strategy Research, Komerční banka

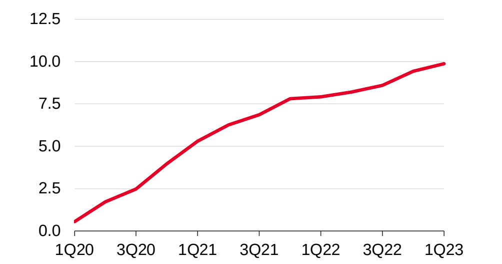
Gross savings (% of disposable income)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: The household savings rate is defined as the ratio of gross savings to gross disposable income, including an adjustment for the net share of households in pension fund reserves.

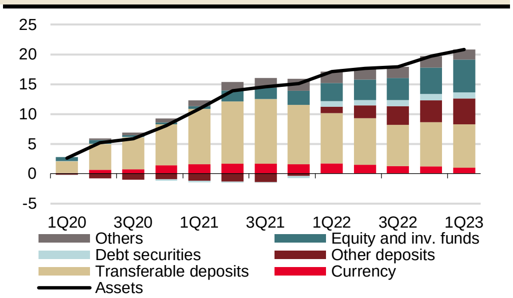
However, a possible faster dissolution of accumulated savings remains an inflationary risk on the demand side. The creation of 'excess savings', which was initially forced by economic closures during the pandemic, continued even after the economy reopened. This is illustrated by the persistently high savings rate, which is still significantly elevated compared to the pre-pandemic long-term average (11.9% over the 1999-2019 period), reaching 17.9% in 1Q23. Cumulatively in 1Q23, excess savings have already amounted to nearly 10% of annual GDP, according to our estimates.

Cumulative excess savings since 4Q19 (% of annual nom. GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Excess savings are estimated based on the deviation of the savings rate from the long-term average (1999-2019) over the period 1Q20 - 1Q23.

Cumulative inflows of households and NPISHs' financial assets since 4Q19 (% of annual nom. GDP)



Source: CNB, CZSO, Economic & Strategy Research, Komerční banka
Note: Other deposits = time or otherwise restricted deposits, including savings deposits and non-transferable debt securities, certificates of deposit
NPISH = Non-profit institutions serving households

However, in our baseline scenario, we assume that the dissolution of excess savings will proceed at a gradual pace. This would mainly be driven by the structure of the cumulative increase in households' financial asset flows, which started to shift significantly into less liquid forms such as equities, mutual funds or time deposits last year. We therefore regard any excessive inflationary pressures from this source as merely a risk.

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Monetary policy

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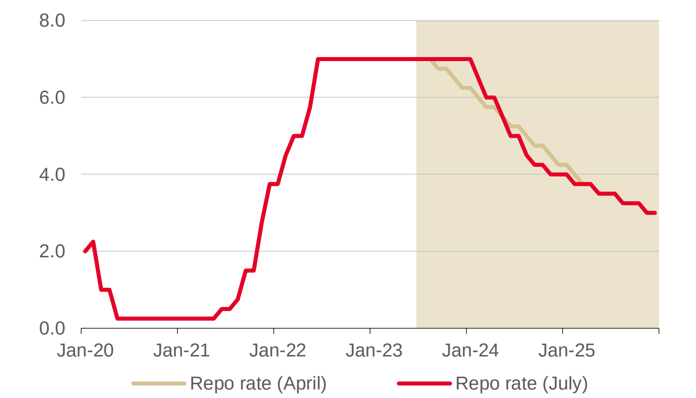
CNB rates on hold until year-end and more cuts in 2024

The Czech National Bank is likely to keep interest rates on hold for the rest of the year. Whereas in our previous forecast we envisaged the first interest rate cut in September this year, we now expect it in February of next year. However, we believe that the CNB will have to cut rates more quickly in 2024. We expect the repo rate to reach 5% by mid-2024 and to fall to 4% by year-end. The policy-neutral level of 3% should not be reached until the end of 2025.

We expect the CNB to keep the repo rate at the current 7% until the end of the year. However, in our view, this will be followed by a rapid reduction, with the repo rate falling to 4% by end-2024.

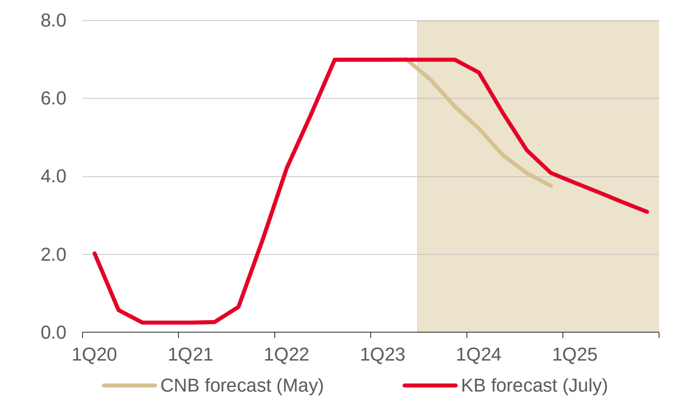
The Czech National Bank is likely to keep its key repo rate at 7% for the whole of this year, longer than we originally thought. In our April forecast, we expected the first rate cut in September and the repo rate to fall to 6.25% by the end of this year. However, communications from the bank board have been hawkish over the past quarter. Governor Michl said at a press conference after the most recent CNB meeting that a rate cut had not been discussed at all. And as he has done several times in the past, he also reiterated that interest rates would either remain unchanged or rise at the next meeting, which is scheduled for early August. According to Michl, interest rates will remain at current or higher levels for an extended period, despite the recent decline in inflation – which is slightly faster than the CNB forecast (the central bank had expected inflation to be 10.1% yoy in June). The governor believes that financial market expectations, which prior to the CNB's June meeting had priced in 100bp of rate cuts by the end of this year, are exaggerated. Moreover, central bankers are commenting mainly on yoy inflation. They are making the start of rate cuts conditional on a sufficient decline and a clear path towards the 2% target. As mentioned above, we expect yoy inflation to end the year at around 8% due to the lower base of 4Q22, which is still well above the CNB's target and above the expected level of the repo rate. The significant decline in mom inflation from the previous months has not been reflected in the board's statements.

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



Source: CNB, Economic & Strategy Research, Komerční banka

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



Source: CNB, Economic & Strategy Research, Komerční banka

The stability of interest rates at current levels for an extended period will lead to faster rate cuts next year. According to our new forecast, the repo rate will be 6% at the end of 1Q24 and 5% at the end of 2Q24, before falling to 4% at the end of 2024. The policy-neutral level of 3% should not be reached until 4Q25. Although we expect the CNB to cut rates more quickly next year, the average level of the repo rate in 2024 and 2025 remains broadly unchanged from our April forecast. Compared with our previous forecast, monetary policy is likely to be tighter at the turn of the year than economic and inflation developments would warrant. This is underlined by the downward revision of our inflation forecast, especially for the core component. The overvalued koruna will also play a role. We expect the pressure for lower interest rates to increase in 2H23 due to the still subdued economy and weakening inflation. This should also be reflected in the CNB's forecast. The CNB's May forecast already recommended starting to cut rates in the current quarter, and the repo rate was expected to fall below 6% by the end of this year. Moreover, the risks to this forecast are tilted to the less inflationary side. The later policy response has been acknowledged by the central bankers themselves when they mention that they would dampen the economy rather than risk the persistence of higher inflation for a longer period. From a communication point of view, a sharp drop in headline inflation should facilitate rate cuts next year, although this will be mainly driven by lower energy prices. We expect the CNB to start cutting rates by 50bp at the February meeting. The central bank is likely to be behind the curve by then. Although January inflation will not be known at the CNB's February meeting, estimates of its level should already point to a significant decline.

Uncertainty about the CNB's rate path remains high, but we see the risks to our forecast as skewed towards earlier and faster rate cuts. This is related to the risks to our macroeconomic scenario mentioned above. The development of domestic demand will be crucial. If household consumption does not pick up in the coming months, as we expect, and mom core inflation remains very subdued as a result, the pressure for monetary easing will increase significantly. If the central bank leaves interest rates unchanged anyway, an excessively tight monetary policy would result in a weaker economic performance next year than we currently forecast. The board's continued reluctance to heed its own forecast makes it much more difficult to predict the CNB's next steps.

Fiscal policy

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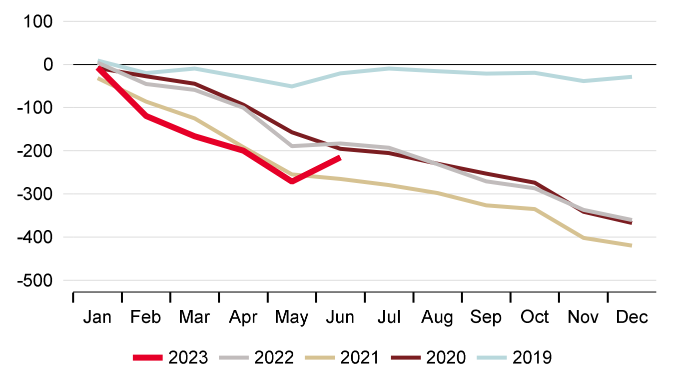
The first step towards fiscal consolidation

The state budget deficit narrowed considerably in June. However, in our view, this year's deficit is still likely to exceed the approved CZK295bn without additional savings. The proposed consolidation package will not only reduce the state budget gap in the coming years, but will also slow GDP growth and inflation. We expect the public deficit to return to below 3% of GDP from next year onwards. The overall public debt will continue to rise, but will roughly stabilise relative to nominal GDP in 2025-2026.

June rescued the state budget result for the first half of the year

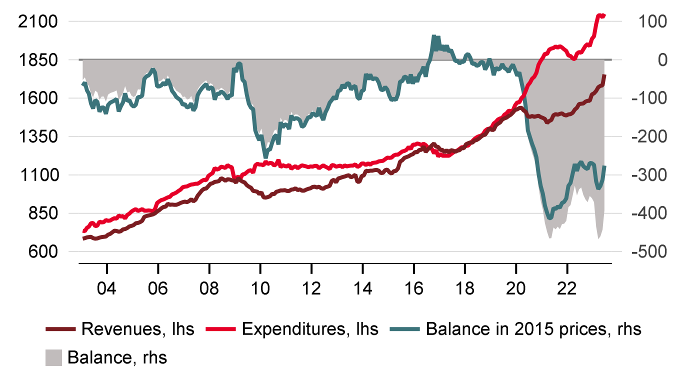
By the end of June, the state ran a budget deficit of CZK215.4bn. Month-on-month, the state budget deficit eased by CZK56bn in June (from CZK271.4bn in May). June has traditionally been a month when the state's interim performance improved, even during the pre-pandemic period, which was mainly due to seasonal corporate income tax (CIT) collections. Meanwhile, CIT receipts this year were also supported by solid profitability in the corporate sector. The June result was also supported this time by EU revenues, specifically for projects under the National Recovery Plan, which have already been pre-financed on the expenditure side.

State budget balance (CZKbn, ytd cumulative)



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

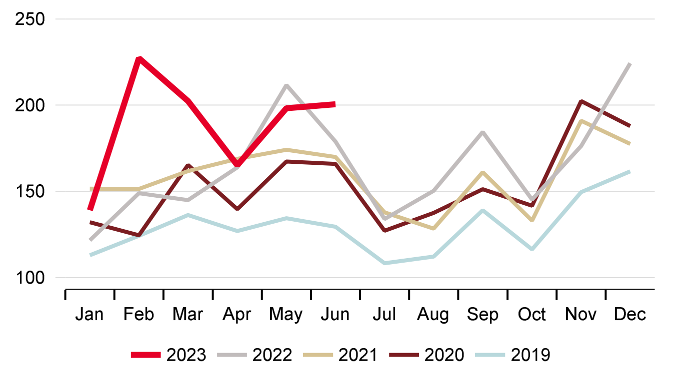
Budget revenues and expenditures (CZKbn, 12m cumulative)



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

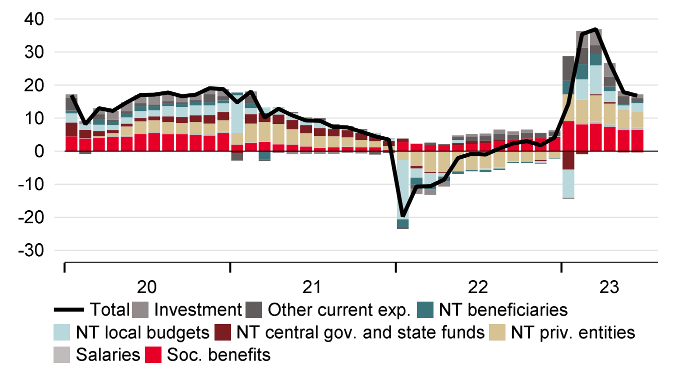
The year-on-year deterioration of the state budget balance by CZK32.4bn in June was mainly due to higher expenditure. This increased by CZK162.6bn overall (16.8%) compared to last year, mainly due to an increase in social spending, assistance to households and firms in the context of high energy prices, more expensive servicing of the national debt and higher investment. Expenditure on social benefits, mainly due to pension indexation, rose by 16.8% yoy (CZK62.5bn) in the first six months of this year. The pension insurance system itself reached a record deficit of CZK40.3bn by the end of June (up by CZK30.0bn yoy). Meanwhile, since June, the pension expenditure has been affected by another extraordinary indexation.

State budget expenditure (CZKbn, non-cumulative)



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

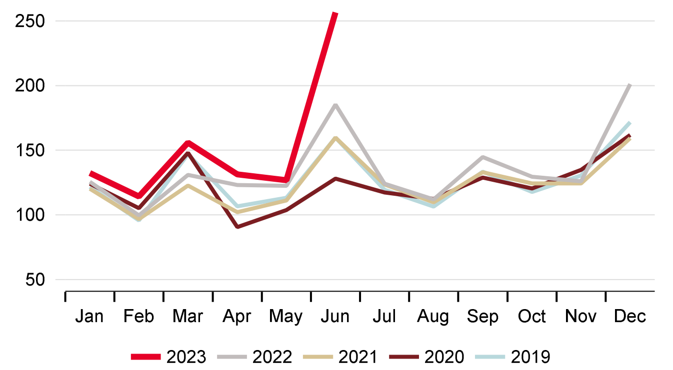
State budget expenditure (%, pp, yoy, ytd cumulative)



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

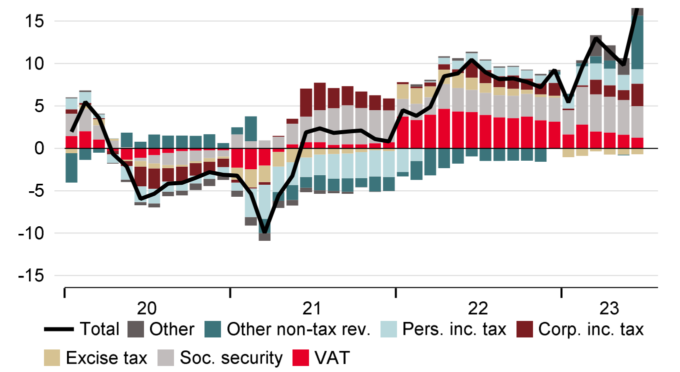
Revenue growth in June saw a significant boost from the inflow of EU funds under the National Recovery Plan. Total revenues since the beginning of the year were CZK130.2bn higher year-on-year and 16.5% higher in relative terms. The main contributors to the increase in revenues were EU revenues (CZK44.6bn), insurance premiums (CZK29.1bn), corporate income tax (CZK20.9bn), personal income tax (CZK13.3bn), and VAT (CZK13.3bn). In our view, VAT collection (up by 6.1% yoy) indicates that real household consumption remained relatively subdued. This is related to the fall in real wages, especially last year. According to our forecast, they have not, on average, been able to keep up with the rise in price level this year either. On the other hand, the 23.8% year-on-year increase in corporate income tax collections confirms that firms have experienced solid profitability.

State budget revenue (CZKbn, non-cumulative)



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

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



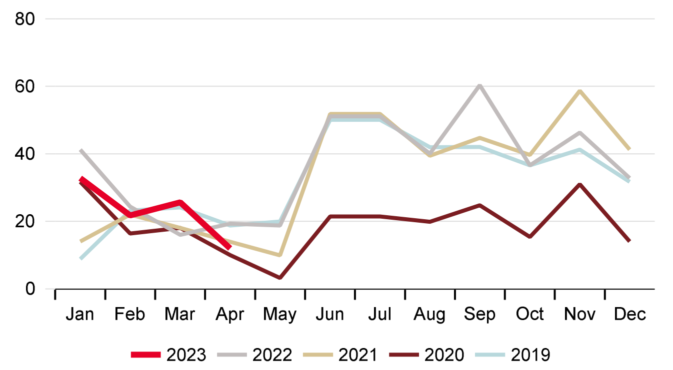
Source: Finance Ministry, Macrobond, Economic & Strategy Research, Komerční banka

The June data show that the chances of meeting the approved deficit of CZK295bn have not yet altogether disappeared, but risks remain. The state budget deficit widened by CZK67.3bn on average between July and December (CZK168.1bn between 2002 and 2022). Nevertheless, from our perspective, the balance of risks of the approved budget with a deficit of CZK295bn is skewed towards a deeper deficit. Compared to the original proposal, the deficit should be increased by almost CZK20bn due to lower collections from windfall taxes (after including reduced spending on energy aid). On the revenue side meanwhile, another CZK50bn from emission allowances – which cannot be counted as state budget revenue, has fallen away. Moreover, as regards expenditure, there has been another extraordinary indexation of old-age pensions since June, which should increase expenditure by around CZK15bn compared to the plan. The higher approved dividend from CEZ, together with higher corporate income tax collections and likely also individual income tax and social contributions, can cover only part of these risks. **As a result, in the baseline scenario (without additional austerity measures this year), we still assume a state budget deficit of CZK315bn.**

The municipal surplus has narrowed

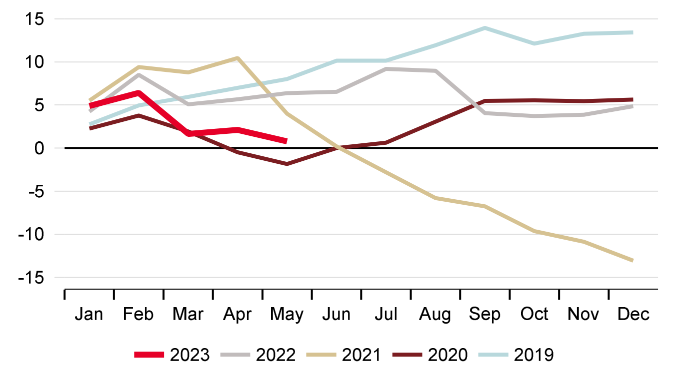
By the end of June, the budgets of municipalities were in surplus by CZK12.0bn. Although revenues increased by CZK38.5bn (18.3%) year-on-year, higher expenditures (by CZK45.8bn, 24%), driven mainly by an increase in current expenditures, resulted in a CZK7.4bn year-on-year decline in the positive balance of the budget to CZK12bn. Health insurance companies also remain in a slight surplus.

Municipal finances (CZKbn, ytd cumulative)



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

Health insurers' finances (CZKbn, ytd cumulative)



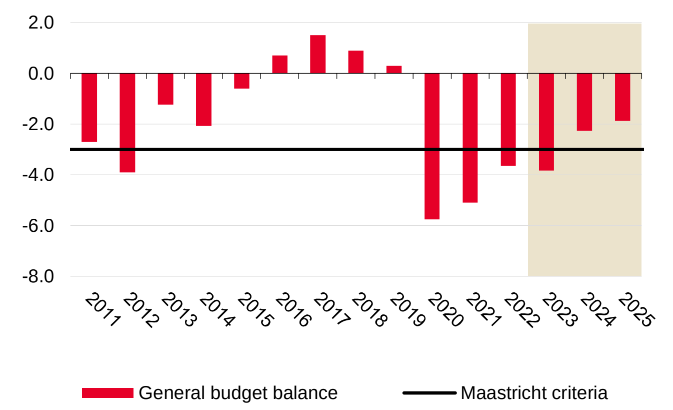
Source: Finance Ministry, Macrobond, Economic & Strategy Research, Komerční banka

Public finance forecasts

	2021	2022	2023f	2024f	2025f	2026f
Balance (% GDP)	-5.1	-3.6	-3.8	-2.3	-1.9	-1.6
Fiscal effort (pp GDP)	-0.8	0.7	0.1	0.3	0.4	0.3
Public debt (CZKbn)	2,566.7	2,997.1	3,312.1	3,552.1	3,762.1	3,942.1
Debt ratio (% GDP)	42.0	44.2	45.1	45.6	46.4	46.4

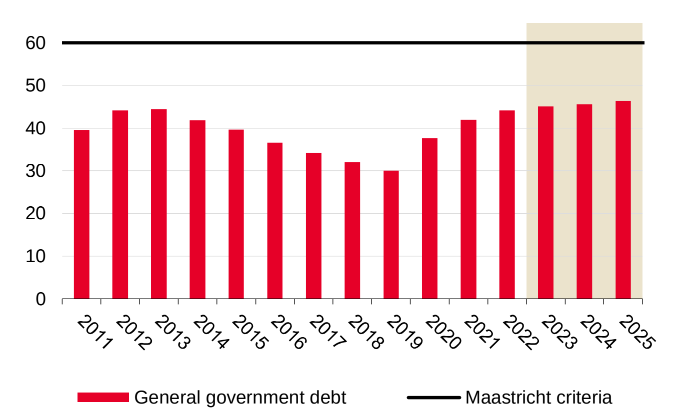
Source: CZSO, Macrobond, MinFin for published data, Economic & Strategy Research, Komerční banka
Note: Fiscal effort is measured as the year-on-year change in the general government balance, adjusted for the economic cycle and one-off operations on GDP in pp.

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

Public finance deficit will fall below Maastricht's 3% of GDP in 2024

We expect the overall general government deficit to reach 3.8% of GDP this year. The proposed consolidation package will subsequently bring the general government deficit down

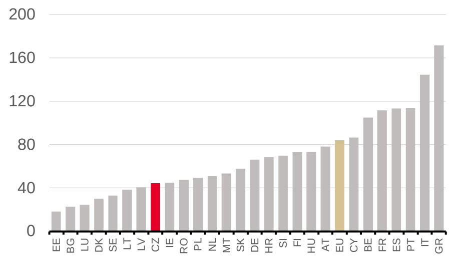
In our view, this year's public finances will end with a slightly higher deficit relative to GDP than last year. The consolidation package will contribute to a visible deficit reduction in 2024 and 2025.

to close to CZK240bn next year, which should correspond to 2.3% of GDP (see Box 2 below for more on the consolidation package). Nominal public sector debt-to-GDP will grow at an average annual rate of 0.6pp over the period 2023-2026, according to our estimate, and reach 46.4% of GDP in 2026. While the consolidation package is a welcome contribution to alleviating the structural mismatch between government revenues and expenditures, it is only the first necessary step towards a solution from our perspective. Indeed, on unchanged parameters, public finances would have otherwise started to deteriorate rapidly from the 2030s onwards due to unfavourable demographic developments.

Box 2: Government consolidation package has potential to reduce inflation and GDP growth

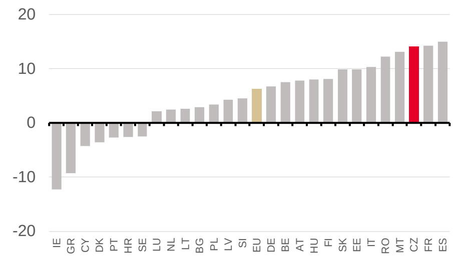
In the Czech Republic, the growth of public debt was one of the highest in the EU in 2020-2022. In addition to the immediate effects of the pandemic, the war in Ukraine and high energy prices, domestic public finances are burdened by a high structural deficit that is unrelated to the economy's position in the cycle. Non-cyclical effects are estimated by the Ministry of Finance (MinFin) to account for the majority of the public deficit in both 2021 and 2022. Nevertheless, the level of public debt to GDP in the Czech Republic remains relatively low compared to that of other countries. At 44.1% of GDP, it is the eighth least indebted country in the EU and only slightly above half the EU average.

Public debt in 2022 (% of GDP)



Source: Eurostat, Economic & Strategy Research, Komerční banka

Change in public debt-to-GDP ratio in 2020-2022 (pp)



Source: Eurostat, Economic & Strategy Research, Komerční banka

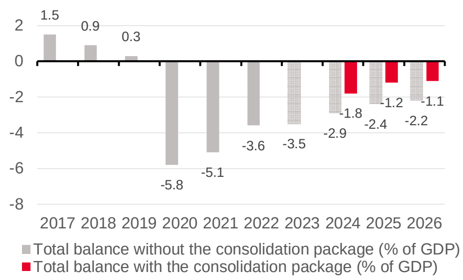
MinFin expects the proposed consolidation package to contribute to a decline in the general government deficit to 1.8% of GDP next year compared to 2.9% of GDP without consolidation. Consequently, the general government deficit should reach 1.2% of GDP in 2025, compared to the 2.4% of GDP projected in the Ministry's April forecast. The difference between the deficit-to-GDP ratios in the two scenarios is thus 1.1pp in 2024 and 1.2pp in 2025. Hence, most of the estimated effect of the package on macroeconomic variables is already visible next year.

Impact of the proposed measures on the state budget (CZKbn)

	2024	2025
Reduction in expenditure	**62.4**	**15.9**
Subsidies	45.6	8.8
State operating expenditure	6.1	5.1
Salaries	9.7	0.0
Other expenditure	1.0	2.0
Increase in revenue	**31.7**	**37.5**
Corporate income tax	0.0	22.0
Sick leave	11.9	1.1
Property tax	9.0	0.3
Tax exemptions	2.3	5.3
Self-employed constributions	3.0	4.5
Tobacco tax	3.1	2.8
Gambling tax	3.9	0.0
Personal income tax	1.8	0.9
Deductions from work agreement	1.8	0.2
Alcohol tax	0.5	0.6
Other revenue	-1.6	-0.1
VAT revision	-4.1	0.0
Total	**94.1**	**53.4**

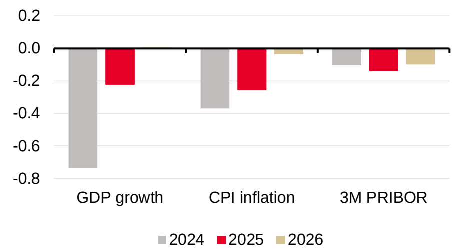
Source: Finance Ministry, Economic & Strategy Research, Komerční banka

Impact of the package on the gen. gov. deficit - MinFin assumptions



Source: Finance Ministry, Economic & Strategy Research, Komerční banka
https://odok.cz/portal/services/download/attachment/KORNCS3KM4TB/ (in Czech)

Economic impact of the consolidation package - KB estimate (pp)



Source: Economic & Strategy Research, Komerční banka
Note: estimation of the impact of the austerity package based on the BVAR model on GDP growth and the price level, as well as on the short-term interest rate. Structural shocks to the ratio of general government revenue and expenditure to GDP were identified based on sign restrictions.

Our estimate of the effects of the austerity package on the economy is based on a BVAR simulation of structural shocks of a magnitude consistent with the proposed measures. For this purpose, we combine separate impulse responses of two types of aggregate structural shocks: 1) a structural shock changing the share of government spending in GDP and 2) a structural shock changing the share of revenue in GDP. Our modelling approach thus abstracts from the possible impacts of different types of measures. We have also adopted the assumption that the changes for 2024 and 2025 will always take effect from the first of January. Given the construction of the model, where shocks are modelled as unexpected, it should also be borne in mind that the estimates of the impacts on macroeconomic variables presented here are more likely to be upper bounds. This is because rational economic agents start to adjust their behaviour in light of expected future shocks before the measures are in place and, as a result, their impact is more continuous over time and has a smaller amplitude than in the case of an unexpected shock.

In our view, the consolidation package will help to dampen overall inflationary pressures, but through slower economic growth. Next year, compared with a scenario in which the consolidation package is not adopted, consumer inflation should be as much as 0.4pp lower and GDP growth as much as 0.7pp weaker, according to our model estimates. As a result of the phasing-in effect, the savings in the government budget should be reflected in inflation to a broadly similar extent in 2025. Due to the high empirically estimated persistence of interest rates, their response to these shocks is only moderate and has a gradual onset, but persists for a longer period. We also described the effects of the government's proposed consolidation package for 2024-2025 in the Special Report: https://bit.ly/3BUnVcG.

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Summary forecast table

	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23	Q1 24	Q2 24	Q3 24	2022	2023	2024	2025	2026	2027
GDP and its breakdown														
GDP (real, yoy, %)	0.1	-0.5	-0.5	0.1	1.2	1.7	2.0	1.9	2.4	0.1	1.8	2.1	2.4	2.3
Household consumption (real, yoy, %)	-5.4	-5.9	-6.5	-3.2	-0.2	3.2	5.8	5.1	-0.8	-4.0	4.5	3.1	2.1	1.6
Government consumption (real, yoy, %)	0.6	3.1	3.0	1.9	0.0	-1.0	-1.7	-1.4	0.6	2.0	-1.2	0.6	1.7	2.0
Fixed investments (real, yoy, %)	0.8	-1.6	-2.5	-1.8	0.0	3.4	6.0	6.9	3.0	-1.5	5.8	4.3	3.4	3.3
Net exports (contribution to yoy)	2.2	3.1	4.2	2.6	2.2	-0.1	-1.7	-1.5	0.9	3.0	-1.1	0.2	0.6	0.6
Inventories (contribution to yoy)	0.2	-0.8	-1.4	-0.7	-0.9	-0.7	-0.4	-0.5	0.9	-0.9	-0.5	-0.4	-0.2	-0.2
Monthly data from the real economy														
Foreign trade (CZK bn)	-53.6	42.0	41.6	28.1	15.1	51.2	25.6	19.4	-202.6	126.8	110.5	184.9	242.1	283.5
Exports (nominal, yoy, %)	13.5	10.1	-0.6	2.4	6.5	4.8	8.9	8.8	13.8	4.5	6.9	8.9	6.8	7.0
Imports (nominal, yoy, %)	15.5	4.9	-10.0	-5.8	0.5	4.2	10.7	9.8	18.8	-2.8	7.4	7.5	6.0	6.6
Industrial production (WDA, yoy, %)	3.4	1.1	1.0	0.2	2.6	3.9	3.9	3.8	2.7	1.2	3.8	4.6	4.2	4.0
Construction output (real, yoy, %)	-0.7	-0.6	-1.1	2.9	0.3	-2.2	6.0	7.6	3.6	0.4	5.5	5.5	3.7	3.7
Retail sales (WDA, yoy, %)	-8.6	-7.7	-6.4	-2.6	0.9	4.0	6.5	5.3	-3.0	-3.9	4.8	1.5	1.7	1.6
Labour market														
Wages (nominal, yoy, %)	6.6	8.6	9.5	9.6	9.8	8.6	7.9	7.2	5.3	9.4	7.3	5.5	4.4	4.2
Wages (real, yoy, %)	-8.1	-6.6	-1.4	1.5	2.4	7.1	6.2	5.4	-8.4	-1.0	5.7	3.2	2.4	2.0
Unemployment rate (MLSA, %)	3.6	3.8	3.5	3.6	3.6	3.9	3.5	3.6	3.4	3.6	3.6	3.7	3.8	3.9
Unemployment rate (ILO 15+, %)	2.2	2.6	2.7	2.8	3.0	2.8	2.7	2.7	2.3	2.8	2.8	2.9	2.9	3.0
Employment (ILO 15+, yoy, %)	-0.6	0.8	0.7	1.1	0.6	0.9	1.0	0.9	-0.5	0.8	0.9	0.3	0.1	0.1
Consumer and producer prices														
CPI Inflation (yoy, %)	15.8	16.5	11.1	8.1	8.2	0.7	1.2	1.7	15.1	11.0	1.3	2.2	1.9	2.2
Taxes (contribution to yoy inflation)	1.6	0.0	0.2	0.2	0.1	-0.4	-0.4	-0.4	0.6	0.1	-0.4	0.0	0.0	0.0
Core inflation (yoy, %) (*)	13.8	11.9	8.7	5.9	4.0	3.7	3.8	4.2	13.1	7.6	3.9	2.1	2.1	2.3
Food prices (yoy, %) (*)	18.7	18.3	11.9	6.7	2.8	1.5	2.5	4.0	12.8	9.9	3.2	3.1	2.2	2.1
Fuel prices (yoy, %) (*)	15.1	-5.0	-21.8	-17.7	-6.7	5.2	11.0	11.5	34.2	-12.8	9.7	1.9	-3.6	0.7
Regulated prices (yoy, %)	16.3	32.7	25.2	20.2	34.8	-10.6	-11.1	-11.1	20.9	28.2	-10.8	1.5	2.0	2.0
Producer prices (yoy, %)	21.8	15.0	3.6	0.8	0.3	-0.6	3.7	4.4	24.3	4.9	2.9	1.6	1.0	1.9
Financial variables														
2W Repo (%, average)	7.0	7.0	7.0	7.0	7.0	6.7	5.6	4.7	6.0	7.0	5.3	3.5	3.0	3.0
3M PRIBOR (%, average)	7.3	7.2	7.2	7.3	7.3	6.9	5.9	4.9	6.3	7.2	5.5	3.7	3.3	3.3
EUR/CZK (average)	24.4	23.8	23.6	23.8	23.9	24.0	24.1	24.2	24.6	23.8	24.1	24.0	23.8	23.6
External environment														
GDP in EMU (real, yoy, %)	1.8	1.0	0.7	0.7	1.1	1.4	1.1	0.9	3.5	0.9	1.1	1.3	1.5	1.4
GDP in Germany (real, yoy, %)	0.8	-0.5	-0.1	-0.3	0.5	1.0	0.9	0.8	1.9	-0.1	0.9	1.3	1.3	1.3
CPI in EMU (yoy, %)	9.9	8.0	6.2	4.9	3.0	3.1	3.1	2.9	8.4	5.5	2.9	2.2	2.1	1.9
Brent oil price (USD/bbl, average)	87.6	84.2	77.3	85.0	90.0	95.0	95.0	100.0	101.0	84.1	97.5	89.4	80.5	80.0
EUR/USD (quarter eop, year average)	1.02	1.07	1.09	1.14	1.16	1.18	1.20	1.20	1.05	1.12	1.20	1.24	1.26	1.26

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

Czech IRS market and government bonds

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Temporary pause in the rate decline trend

Domestic market interest rates have declined visibly since the beginning of the second quarter against the backdrop of fading inflation. The entire market interest rate curve remains significantly inverted. We estimate that the decline in the short end of the curve will pause temporarily due to the later-than-market-expected start of domestic monetary easing. The CNB will start lowering monetary policy rates early next year, in our view. For longer rates, we see more limited scope for a significant decline, although we expect some reduction there as well. CZGBs are likely to become more expensive relative to market rates next year, supported by a significant year-on-year decline in financing needs. Therefore, the decline in their yields could be faster next year than in the case of CZK IRS.

Czech IRS market: disinflation depresses market interest rates

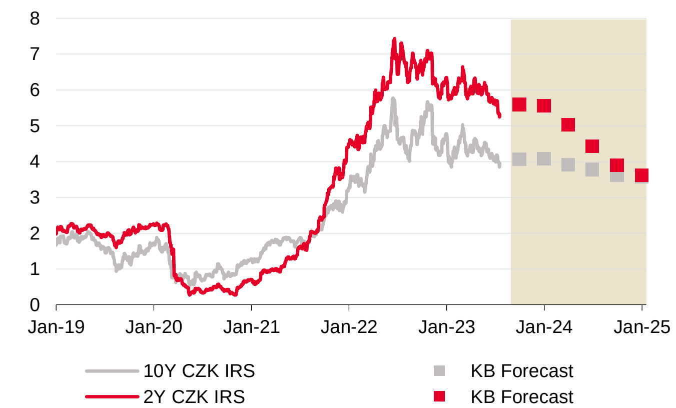
The postponement of the start of the CNB's monetary easing cycle until next year will also shift the decline in market interest rates. The inverse shape of the koruna curve will thus probably be maintained throughout next year.

Domestic market rates have fallen significantly since the start of the second quarter. They have written off around 80bp on shorter maturities. This was probably mainly related to rapidly subsiding domestic inflation, but also to the lacklustre performance of the domestic economy. In contrast, euro and dollar market interest rates rose slightly over the same period, as core price pressures in particular continued to show resilience in the US and euro area.

In our view, the decline in domestic monetary policy rates will be slower than markets expect. According to market contracts, the repo rate will fall by 100bp in aggregate by the end of the year. This is too aggressive, in our view. Instead, we are counting on a more cautious approach by the CNB, which should be consistent with the stability of monetary policy rates by the end of this year. Their subsequent decline from the beginning of next year should be faster compared to our April forecast, but compared to the market we still expect higher monetary policy rates throughout next year than currently priced in.

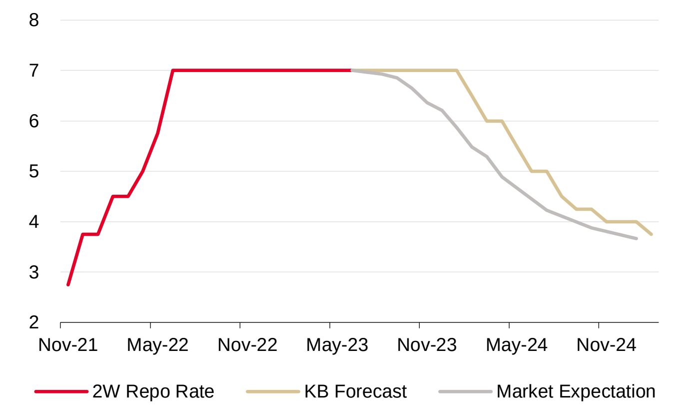
The short end of the market interest rate curve should roughly stabilise by the end of the year after the CNB's rate cut scope is corrected. Compared to the market, we believe that the decline in yields will be more gradual and will start rather at the turn of the year. For longer-term CZK IRS, we see more limited scope for a significant decline, as the effects of fading high inflation on the one hand and the recovery in economic activity in combination with high euro market rates on the other should roughly offset each other.

IRS forecast (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

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



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

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

CZK IRS outlook (end of period, %)

	3Q23f	4Q23f	1Q24f	2Q24f
2y	5.60	5.55	5.05	4.40
5y	4.45	4.50	4.20	3.90
10y	4.05	4.05	3.90	3.80

Source: Economic & Strategy Research, Komerční banka

Forwards and the euro market still offer hedging opportunity

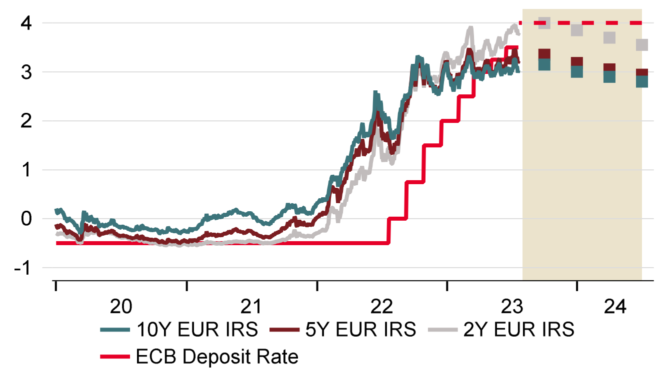
As market interest rates fall, conditions for rate fixing are starting to improve. However, the persistent inversion of the entire curve still provides more favourable conditions in the forward market. Noticeably lower interest rates compared to domestic rates also continue to prevail in the euro market. While the ECB deposit rate is expected to peak at 4.0% and remain at this level for an extended period of time, euro market interest rates are likely already near their peak, according to our estimate.

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

Forward	Maturity 1Y	2Y	3Y	5Y	10Y
Spot	6.35	5.30	4.69	4.14	3.90
3M	5.86	4.84	4.36	3.95	3.80
6M	5.11	4.37	4.02	3.75	3.68
9M	4.64	4.07	3.81	3.62	3.61
1Y	4.09	3.76	3.59	3.50	3.54
2Y	3.42	3.33	3.31	3.37	3.45
3Y	3.23	3.25	3.31	3.41	3.49

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

Euro area rates (%)



Source: Bloomberg SG Cross Asset Research/Economics

The supply of CZGBs will decrease significantly next year

The high government budget deficit, combined with other financing needs, will keep the supply of Czech government bonds elevated for the rest of this year. We assume that the state budget deficit will arrive at CZK315bn this year, but in the case of additional savings, we still cannot rule out reaching the planned deficit of CZK295bn, as we discuss in the *Fiscal Policy* chapter. In 1H23, the Ministry of Finance (MinFin) covered its financing needs not only through primary auctions of domestic government bonds, but also through secondary market activity. By 24 July, CZK228.8bn worth of CZGBs had been sold in auctions this year, while the MinFin carried out secondary market operations (in the form of switch auctions and tap sales) amounting to CZK68.3bn. Maintaining this momentum should make it possible to fulfil the set plan, which envisages the issuance of CZK400-500bn of CZGBs this year, with a margin. For 3Q23, the MinFin has set an indicative volume of CZK125.0bn of offered CZGBs again. According to the published update of the *Funding Strategy*[1], the issue of a Eurobond is still in play. **Overall, we expect the financing needs this year to reach CZK665.7bn (9.1% of GDP) compared to last year's CZK635.6bn (9.4% of GDP).**

[1] https://www.mfcr.cz/assets/en/media/2023-06-30_The-Czech-Republic-Funding-and-Debt-Management-Strategy-for-2023-Second-Half-Update.pdf

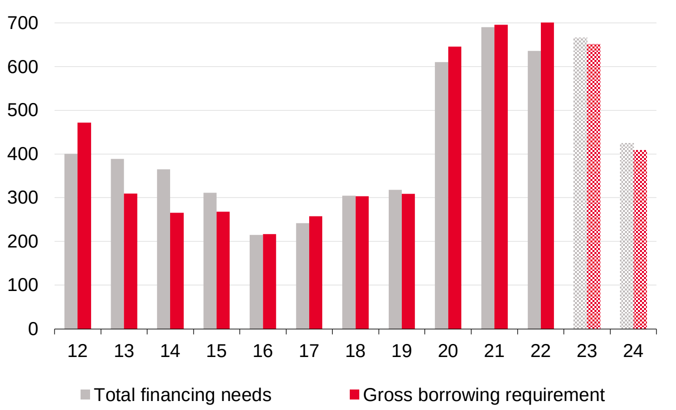
Issuance activity will decrease significantly next year. This will reflect lower maturing debt redemptions, but also a noticeable decline in the government budget deficit. We estimate total financing needs for 2024 at CZK424.2bn (5.4% of GDP).

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	1.0	1.0
Money market instrument redemptions	145.2	145.2
Redemption of T-bills		0.0
Redemption of other money market instruments		145.2
Repayments on credits and loans	3.0	3.0
Total financing needs	**645.7**	**665.7**
Money market instruments		80.0
T-bills		20.0
Other money market instruments		60.0
Gross issuance of CZK T-bonds on domestic market	Min. 400-500	475.5
Gross issuance of EUR T-bonds on domestic market/eurobond		51.9
Gross issuance of government savings bonds		10.0
Received credits and loans		33.3
Financial asset and liquidity management		15.0
Total financing sources		**665.7**
Gross borrowing requirement		**650.7**
Net CZGB issuance		**275.3**

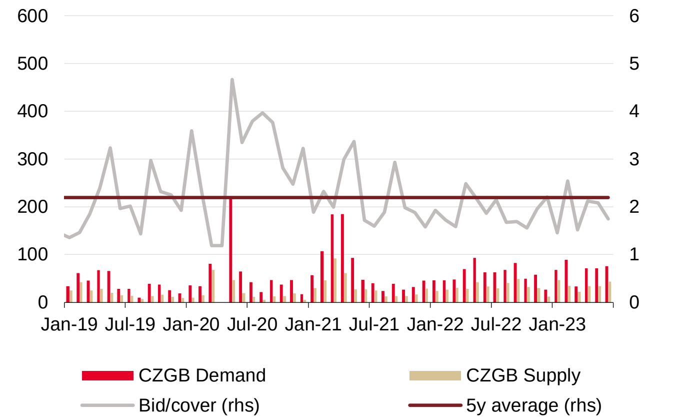
Source: Economic and Strategy Research, Komerční banka, MinFin

Financing needs (CZKbn)



Source: Economic and Strategy Research, Komerční banka, MinFin

CZGB primary market (CZKbn)



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

CZGB yield forecast (end of period)

	3Q23f	4Q23f	1Q24f	2Q24f
2y CZGB yield (%)	5.40	5.35	4.70	4.10
4y CZGB yield (%)	4.65	4.65	4.15	3.75
10y CZGB yield (%)	4.20	4.20	3.95	3.85
10y CZGB ASW (bp)	15	10	5	5

Source: Economic & Strategy Research, Komerční banka

Reduced supply will accelerate the decline in CZGB yields next year

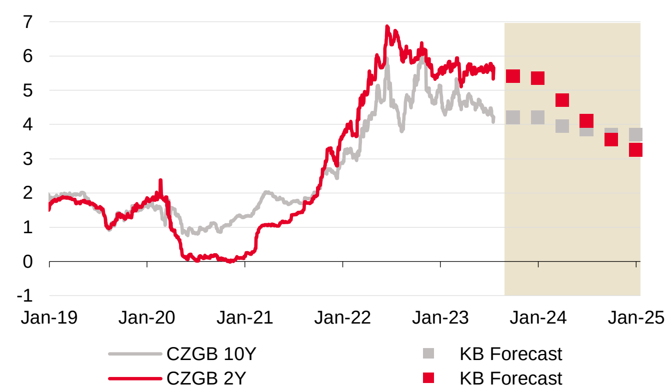
Similar to the IRS, government bond yields are lower compared to the beginning of 2Q. However, the reduction in yields was slightly less pronounced for CZGBs than for the IRS curve. Thus, in ASW terms, bonds have become slightly cheaper. The lower supply should contribute to a more pronounced decline in CZGB yields next year than for CZK IRS (i.e. relative richening of bonds). These factors will be temporarily dampened by the persistent increased issuance until the end of this year. Overall, however, as with market interest rates, bonds with shorter maturities should have more room to fall next year. The decline in yields for longer maturities should only become more noticeable in 2024.

Sovereign rating overview

	Local currency	Outlook	Foreign currency	Outlook	Next rating review
S&P	AA	STABLE	AA-	STABLE	13 October 2023
Moody's	Aa3	NEGATIVE	Aa3	NEGATIVE	24 November 2023
Fitch	AA-	NEGATIVE	AA-	NEGATIVE	25 August 2023

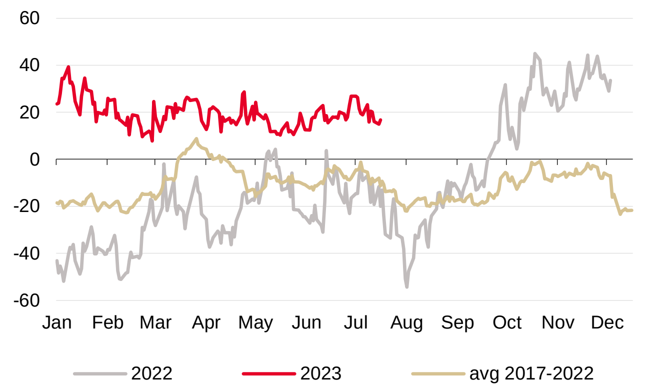
Source: Economic and Strategy Research, Komerční banka, Bloomberg

CZGB yield forecast (%)



Source: Economic and Strategy Research, Komerční banka, Bloomberg

10y CZGB ASW (bp)



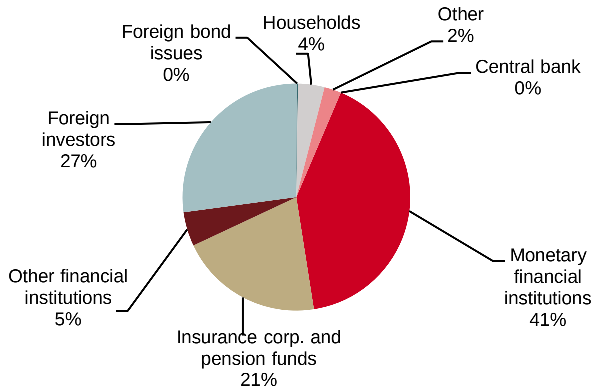
Source: Economic and Strategy Research, Komerční banka, Bloomberg

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**
5.70 May-24	0.8	0.0	100%	5.79	3	8	3.41	-85	6	22	-162		-85	4.1	1	20.8	19	-92.0	20
0.00 Dec-24	1.3	0.0	34%	5.75	0	12	4.15	-30	-1	29	-106		-30	2.3	2	-18.5	3	-54.3	18
1.25 Feb-25	1.5	0.0	100%	5.30	-3	-11	3.87	-50	4	21	-99		-47	2.0	3	14.4	18	-57.2	19
2.40 Sep-25	2.0	0.0	85%	5.00	-5	-27	3.81	-26	-3	3	-59		-16	1.1	4	7.5	14	-46.4	17
6.00 Feb-26	2.3	0.0	67%	4.56	1	-30	3.49	-42	-4	0	-65		-35	1.0	5	28.8	20	-44.4	16
1.00 Jun-26	2.8	0.0	100%	4.64	0	-28	3.67	-17	-4	-2	-44		-3	0.5	6	5.1	13	-36.9	15
0.25 Feb-27	3.4	0.0	90%	4.47	3	-29	3.60	-7	4	1	-26		6	0.4	7	-1.4	11	-30.4	14
2.50 Aug-28	4.6	0.0	94%	4.22	-3	-28	3.43	1	-1	-3	-9		10	0.1	9	-11.4	6	-20.8	11
5.50 Dec-28	4.4	14.1	68%	4.06	-5	-25	3.28	-12	-1	-1	-24		2	-0.1	11	0.8	12	-21.5	12
2.75 Jul-29	5.4	0.0	100%	4.13	-6	-29	3.36	4	-2	-4	-3		17	-0.6	13	-11.5	5	-16.4	10
0.05 Nov-29	6.1	0.0	57%	4.10	-6	-30	3.33	1	-1	-8	0		19	-2.7	20	-9.5	7	-14.1	9
0.95 May-30	6.3	0.0	100%	4.09	-6	-28	3.31	3	-2	-5	1		18	-2.1	17	-8.6	8	-12.8	6
5.00 Sep-30	5.7	17.9	101%	4.07	-4	-27	3.31	5	1	-4	-10		14	0.2	8	-6.6	9	-13.5	7
1.20 Mar-31	7.0	0.0	100%	4.05	-7	-30	3.28	2	-1	-7	4		19	-2.4	19	-3.1	10	-10.7	4
1.75 Jun-32	7.9	0.0	100%	4.01	-6	-23	3.24	1	1	-4	1		18	-2.0	15	9.1	15	-8.6	2
2.00 Oct-33	8.7	0.0	100%	4.04	-6	-23	3.28	5	0	-4	7		23	-2.1	16	13.1	17	-8.0	1
3.50 May-35	9.4	4.7	41%	4.09	-3	-15	3.38	11	1	1	3		26	-0.4	12	9.4	16	-9.5	3
4.20 Dec-36	9.8	0.0	100%	4.14	-6	-17	3.45	17	0	2	7		27	-0.1	10	-14.1	4	-12.8	5
1.95 Jul-37	11.6	2.8	34%	4.10	-3	-18	3.35	6	0	0	3		25	-1.4	14	-25.7	2	-13.5	8
1.50 Apr-40	13.8	0.0	44%	4.23	1	-18	3.38	11	1	-1	10		30	-2.3	18	-179.1	1	-24.1	13

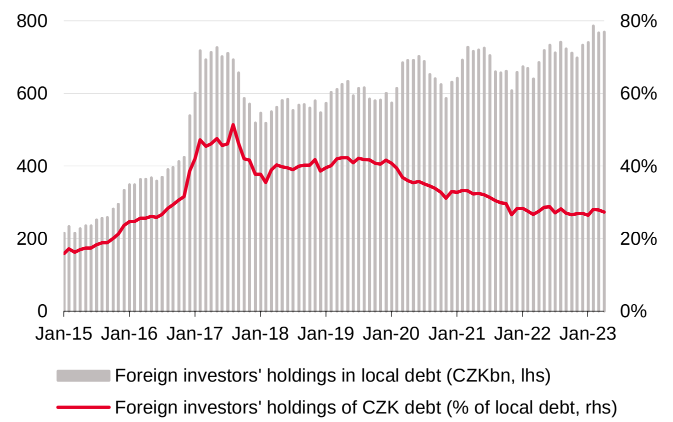
Source: Economic & Strategy Research, Komerční banka; Note: more details in CZGB Auction Alerts

Holdings of CZK government debt (May 2023)



Source: MinFin, Economic & Strategy Research, Komerční banka

The share of non-resident bondholders has stabilised



Source: MinFin, Economic & Strategy Research, Komerční banka

Czech FX market

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A weakening but still strong koruna

The narrowing interest rate differential helped put an end to the koruna's appreciation against the euro in the second quarter of this year. Verbally, the CNB continues to support the domestic currency. However, the central bank has not intervened since last October and still has significant foreign exchange reserves. Given high interest rates in the eurozone, an only gradual domestic economic recovery and the tangible real appreciation in the koruna so far, we forecast EURCZK to reach 24.10 in the next 12 months.

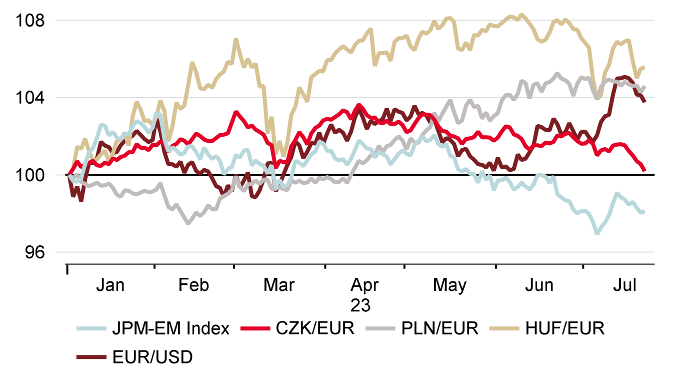
CZK strengthening takes a break

The koruna stopped appreciating against the euro in 2Q23. In an environment of narrowing interest rate differentials, emerging market currencies generally did not perform well in the second quarter of this year. Against a backdrop of reduced exchange rate volatility, helped by continued verbal intervention by the CNB, the koruna partially retraced previous gains in 2Q23, weakening by 1.2% against the euro.

CZK exchange rates

Source: Bloomberg, Economic and Strategy Research, Komerční banka

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

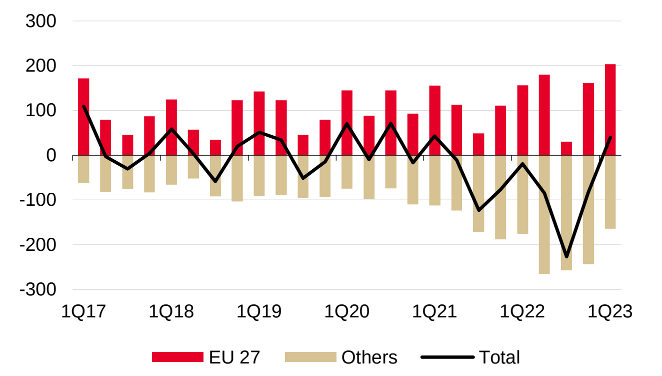


Source: Bloomberg, Economic and Strategy Research, Komerční banka
Note: A value above 100 indicates an appreciation of the CZK, PLN or HUF against the EUR, or an appreciation of the EUR against the USD from 1 January 2023.

The koruna continued to be supported by foreign trade. This is evident in the significant nominal surplus on merchandise trade with the euro area, which continued to grow in 2Q23. The current account of the balance of payments itself turned positive in the first quarter of this year, for the first time in two years, and remained positive in April and May. The recovery in trade with the EU is thus already more than offsetting imports (mainly of commodities) from other countries.

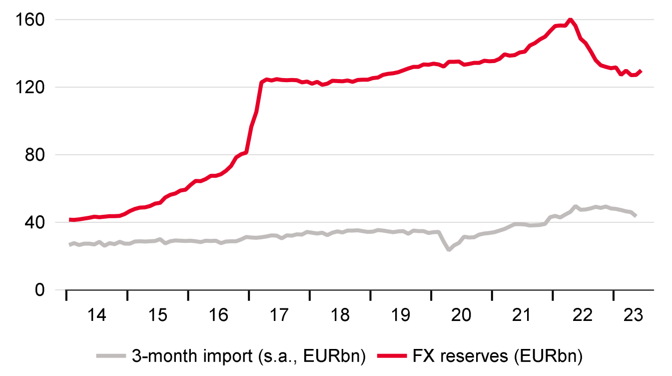
The CNB continues to keep a protective hand on the koruna. However, the last time it intervened to support the koruna was last October. At the end of June this year, its foreign exchange reserves stood at EUR130.0bn, roughly 44% of annual GDP. This gives the central bank room to continue its current policy. In general, the CNB's stated commitment to preventing '*excessive fluctuations of the koruna*' increases the attractiveness of the domestic currency for foreign investors, who are consequently less exposed to potential exchange-rate losses.

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

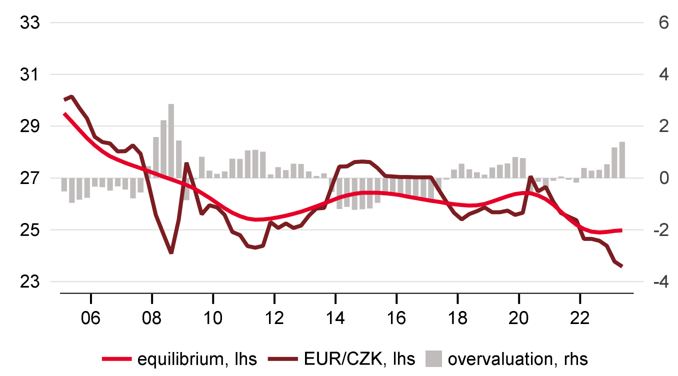
We have revised our forecast for the koruna exchange rate to weaker levels. Over the next 12 months, we expect the koruna to reach EURCZK 24.10.

The narrowing interest rate differential is not conducive to a resumption of the koruna appreciation trend. The differential between 2y CZK IRS and 2y EUR IRS has already fallen by about 75% from its peak last July amid tightening monetary policy abroad and the end of the CNB rate hiking cycle (the 2y swap spread has narrowed from 6pp to 1.5pp). Nevertheless, its further significant narrowing could resume only in 2024 given the currently too aggressive market pricing of the pace of domestic rate cuts (a drop in the CNB repo rate of 100bp by year-end) despite two more ECB rate hikes this 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
Note: The estimated equilibrium exchange rate is based on a model of the economy's internal (output gap) and external (net export-to-GDP gap) equilibrium.

The koruna has appreciated considerably in real terms over the past year. Indeed, the price level, as measured by the GDP deflator and CPI, has risen significantly faster in the Czech Republic than in the euro area. This may also exhaust the potential for further nominal appreciation. Our equilibrium model[2] has persistently indicated that the koruna remains fundamentally overvalued against the euro.

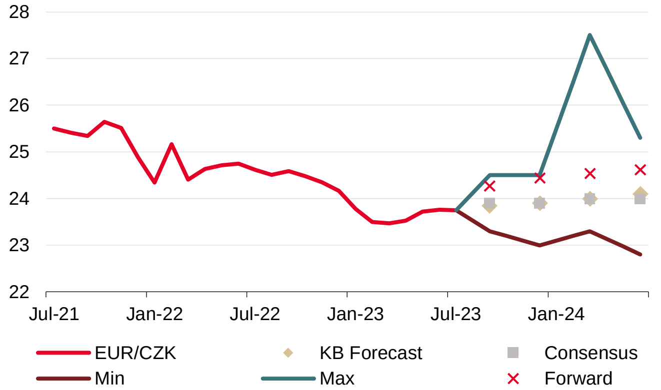
Koruna exchange rate forecast (end of period)

	3Q23f	4Q23f	1Q24f	2Q24f
EUR/CZK	23.85	23.90	24.00	24.10
USD/CZK	20.90	20.60	20.35	20.05
EUR/USD	1.14	1.16	1.18	1.20

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

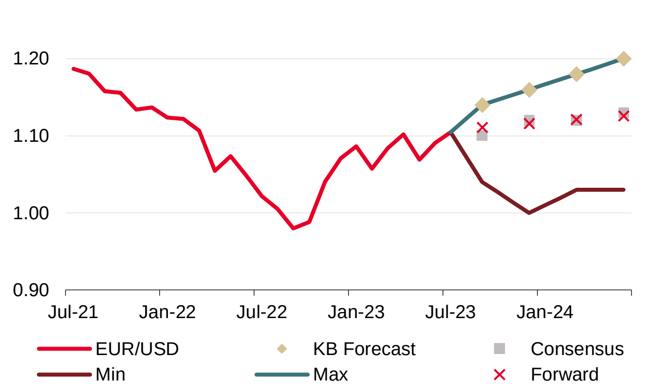
[2] The hypothetical equilibrium value is based on the average of model filtrations of real bilateral exchange rates against the euro that are consistent with the internal and external equilibrium of the economy. Real exchange rates are deflated using the CPI, PPI and GDP deflator due to the increased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

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



Source: Bloomberg, Economic and Strategy Research, Komerční banka

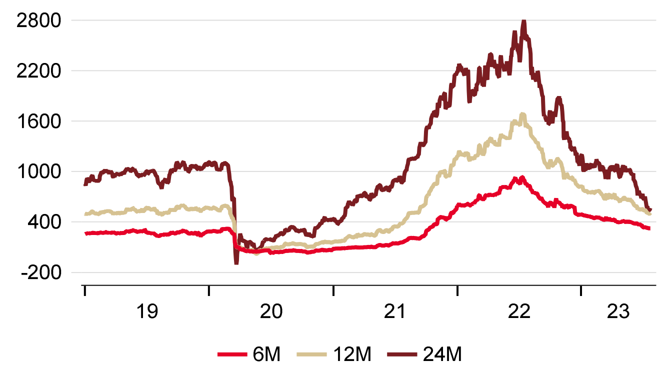
Expected EUR/USD path, Bloomberg market consensus (as of 24 July 2023)



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

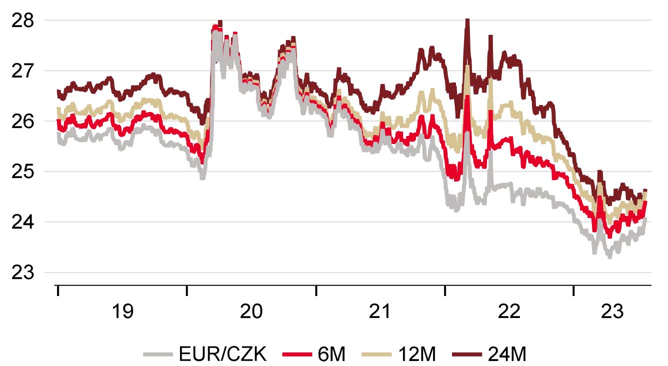
Over the next 12 months, downward pressures on the koruna are partly offset by a weakening US dollar, in addition to the projected improvement in the external trade balance. We expect the former to move to EURUSD 1.20 by the middle of next year. Moreover, slowing domestic inflation could help close the inflation gap between the domestic economy and the euro area. We expect the CNB's still substantial foreign exchange reserves to act in the same direction. **Overall, we expect the koruna to reach EURCZK 24.10 over a 12-month horizon.**

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

CZK weakening has improved hedging conditions for exporters

EURCZK forwards depreciated in the context of a weakening koruna spot exchange rate. We expect market interest rates in both the euro area and the Czech Republic to rise by the end of the third quarter. Only a slightly declining interest rate differential should therefore push forward rates to modestly stronger levels. Conversely, the weakening of the spot rate should skew them towards weaker levels. Overall, we believe forward exchange rates against the euro may tend to weaken slightly over the coming months.

Banking sector

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Credit impulse set to remain weak, recovery to come next year

The sluggish upturn in the economy and tight domestic and foreign monetary policy should underpin low credit activity this year. The sizeable amount of own funds held by both firms and households, due respectively to strong profitability and accumulated savings, should also contribute to reducing credit activity. We expect the correction in real estate prices to continue throughout 2023, although the overall decline is likely to be only mild. The mortgage market is set to continue down the path of a slow recovery, but we foresee a more tangible recovery in 2024. The same goes for consumer finance. The appeal of higher interest rates is set to support the expansion of deposits, which should outpace credit growth. Tighter monetary policy and the gradual rebound in economic growth are likely to lead to a marginal increase in the share of non-performing loans. We envisage a more significant credit impulse from the easing of monetary policy only at the beginning of next year.

Further mild decline in house prices and slow thawing of the mortgage market

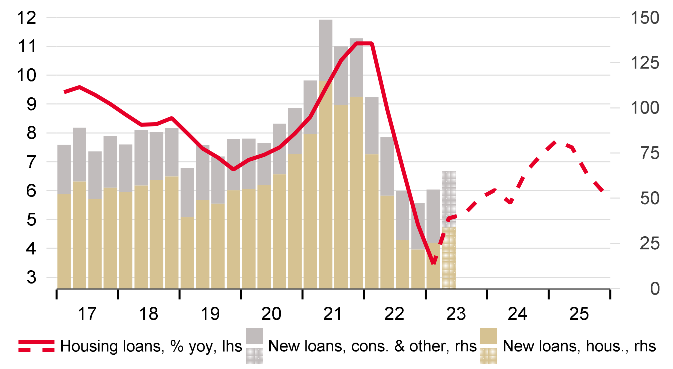
Activity in the mortgage market is set to continue to increase only slowly. We expect the decline in residential real estate prices to continue this year.

The downturn in residential real estate prices continued in 2Q. Offer prices for flats fell by 1.6% qoq in 1Q23, the same as in the preceding quarter. Given the higher comparative base, they were 0.7% yoy lower after rising 9.8% yoy in 1Q23. The house price index indicated a 1.2% qoq decrease in 1Q23, after it had already shown a 1.7% qoq decline in 4Q22, unlike offer prices. We expect residential real estate prices to continue to fall qoq over the remainder of the year, albeit at a gradually slower pace. We estimate the yoy decrease in flats' prices will reach 4.5% by the end of this year. However, we expect growth to resume next year, amid recovering demand, as mortgage availability improves and households use up their accumulated savings. Moreover, constrained supply due to weaker construction activity in 2022 and 2023 ought to put upward pressure on prices. Nonetheless, a modest cooling of the property market, together with the solid wage growth we estimate for this year, should continue to improve housing affordability in Czechia, which however remains one of the least affordable housing markets among EU and OECD countries.

A moderate decline in house prices is set to be followed by renewed growth next year, partly owing to the limited supply

Source: CZSO, Economic & Strategy Research, Komerční banka
Note: The data on dwelling completions and starts (last available data from May) are extrapolated for June and purely indicative for 2Q23.

We expect a gradual unfreezing of the mortgage market this year and a more tangible rebound next year (%, CZKbn)



Source: CNB, Economic & Strategy Research, Komerční banka

The mortgage market has shown signs of a slight recovery since the beginning of the year. New loans picked up again qoq in 2Q23. However, according to data compiled by CBA volumes are still 56% lower than in 1H22, which was supported by frontloading of mortgages. We expect the gradual recovery to continue for the rest of the year, aided by the CNB's deactivation of the DSTI upper limit on mortgages. However, the slowdown compared to 1H22 is still likely to be significant. Following last year's average growth of 7.9%, we estimate the mortgage market will grow 4.9% this year on average.[3] We anticipate a more tangible rebound next year (6.4%), aided by falling interest rates, strong wage growth both this year and next and the drawdown of excess household savings.

Bank loans and deposits (%, yoy)

	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23	Q1 24	Q2 24	Q3 24	2022	2023	2024	2025	2026	2027
Bank loans														
Total	5.8	4.9	6.1	5.4	5.6	6.7	6.3	6.9	6.2	5.5	6.7	6.7	5.9	5.6
Households - real estate loans	4.8	3.4	5.0	5.2	5.7	6.0	5.6	6.6	7.9	4.9	6.4	6.9	5.3	4.9
Households - consumer loans	7.3	7.0	9.9	9.8	7.9	6.5	5.3	6.0	7.3	8.6	6.1	6.8	6.2	6.0
Corporate loans	4.1	2.8	5.0	3.7	5.7	7.2	6.6	7.3	6.8	4.3	7.0	6.2	6.2	6.1
Deposits														
Total	6.5	7.3	5.3	5.3	6.7	5.4	5.4	5.2	6.8	6.2	5.4	5.1	5.0	4.7
Households	5.1	5.8	5.6	5.8	5.7	6.2	6.3	5.9	4.2	5.7	6.0	5.4	5.3	4.6
Non-financial corporations	4.4	9.9	11.6	6.2	8.1	2.6	2.3	2.7	7.3	8.9	3.2	3.3	3.8	3.9
Others	12.2	8.0	0.5	4.0	7.8	6.1	6.2	5.7	11.7	5.1	6.1	5.9	5.5	5.3
Ratios														
Loans/GDP	60.0	59.1	59.0	59.3	58.5	59.0	59.1	59.6	61.4	59.0	59.2	60.2	61.1	61.6
Deposits/GDP	86.4	95.1	93.8	93.6	85.1	93.8	93.1	92.6	95.2	91.9	91.1	91.2	91.7	91.6
Loans/deposits	69.5	62.1	62.9	63.4	68.7	62.9	63.5	64.4	64.7	64.3	65.1	66.1	66.7	67.3
Interest rates														
Real estate loans	4.9	5.2	5.3	5.3	5.3	5.3	5.0	4.8	4.5	5.3	4.9	4.5	4.4	4.5
Consumer loans	9.7	9.5	9.5	9.6	10.0	10.2	10.1	9.6	9.1	9.6	9.7	8.5	8.3	8.6
Corporate loans	9.0	8.9	8.6	8.7	8.7	8.3	7.2	6.2	7.9	8.7	6.8	5.0	4.6	4.6
Share of NPL														
Real estate loans	0.7	0.7	0.7	0.9	0.9	1.0	1.1	1.2	0.7	0.8	1.1	1.4	1.5	1.8
Consumer loans	3.9	3.9	3.9	4.8	5.1	5.2	6.1	6.6	4.1	4.4	6.3	7.6	7.8	8.5
Corporate loans	3.4	3.2	3.1	3.0	3.0	3.0	3.1	3.2	3.5	3.1	3.2	3.8	3.9	4.3

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

Consumer finance set to grow only slightly given accumulated savings

The recovery in household demand this year will likely provide only a mild boost to consumer finance.

The improvement in consumer sentiment and the rebound in consumer spending in 2H23 is likely to be accompanied by only modest growth in consumer finance. Households should benefit from strong disposable income growth and accumulated savings, in our view. Provided interest rates fall and activity in the mortgage market rebounds more markedly, we see consumer lending picking up more strongly in 2024. That should translate to a modest increase in the indebtedness of households, i.e. the ratio of loans to households to nominal GDP. We estimate the consumer credit market will grow 8.6% this year (7.3% in 2022), also due to elevated price levels in the economy. In 2024, we expect growth to average 6.1%.

Credit impulse of non-financial firms to remain fairly subdued this year

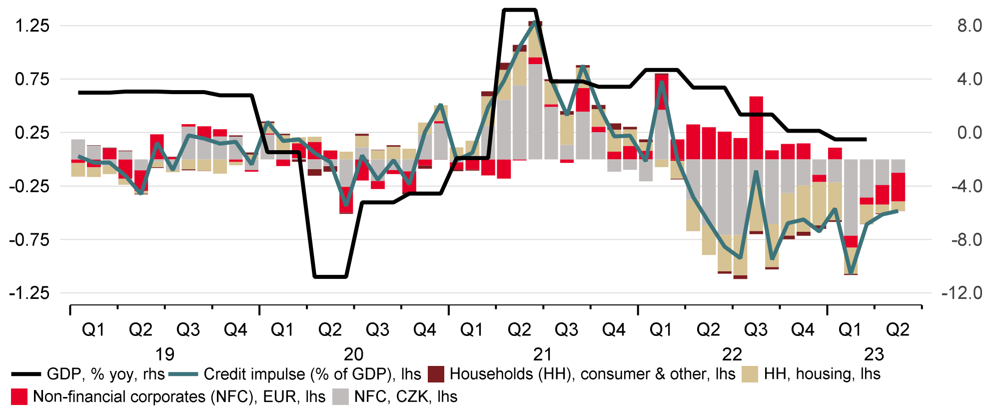
A tighter monetary policy and a lower need for operational financing are set to limit NFCs credit activity this year.

Credit activity by non-financial corporates (NFC) remained weak in 2Q. While the volume of new koruna loans rebounded slightly qoq from the very weak 1Q23 levels, the volume of euro financing continued to decline. Tighter monetary conditions both domestically and abroad are likely to continue to dampen NFCs' credit demand. Less need for working capital financing – due to fading supply chain issues and strong disinflation in producer prices – should also support this trend, as should the sizeable amount of own funds available to finance future growth. Given the interest rate differential, albeit gradually narrowing, foreign currency lending – accounting for 47% of all NFC loans – should remain appealing and thus continue to slightly support lending activity in 2023. We expect a strong credit impulse from NFCs in 2024 with stronger investment growth and easing domestic monetary policy. We

[3] In April 2023, Sberbank's portfolio was re-included in the CNB statistics, which has significantly increased the volume stock of loans. Sberbank's portfolio had been removed from the banking sector statistics in April 2022.

estimate the credit to NFCs will grow 4.3% on average this year (up 0.7pp compared to our April forecast), following 6.8% growth in 2022. Growth should accelerate to 7% on average in 2024, on our estimates.

The credit impulse remains weak, with both households and firms contributing – the latter more strongly this year



Source: CNB, CZSO, Economic & Strategy Research, Komerční banka
Note: Credit impulse is defined as the change in the volume of new borrowing, often given as % of annual GDP. The presented credit impulse represents the yoy change in new borrowing of the non-financial private sector to trailing 12M nominal GDP. It is further decomposed according to the use of the loan for households and currency denomination for firms. As opposed to monthly credit indicators (last data point from May 2023), GDP (as of 1Q23) is in quarterly frequency.

Deposit growth to outpace credit growth again this year

The deposit expansion should be supported by disposable income growth. Higher appreciation of savings and liquidity are also likely to contribute.

Strong disposable income growth should support the expansion of household deposits in 2023. Acting in the opposite direction, we expect a recovery in consumer spending in an environment of elevated price levels and believe the outflow of funds to non-banking solutions in search of a better yield will continue. The sound financial health of NFCs and continued high interest rates should also be reflected in the growth in total deposits, which we expect to again outpace credit growth this year. We estimate deposit growth will average 6.2% in 2023, following strong growth of 6.8% in 2022, which was supported by the appeal of the domestic currency, or its yield generation.

Loan portfolios of domestic banks to remain very robust

The share of non-performing loans is likely to rise slightly – but remain near historically low levels.

Default rates remain very low across sectors – close to historical lows – reflecting both solid corporate profitability and the sound financial situation of households, which continue to carry a substantial savings cushion. However, tighter credit conditions are set to gradually translate to increases, albeit only marginal, in the shares non-performing loans. According to CNB's Bank Lending Survey, banks are no longer tightening credit standards in the face of weaker credit demand. Higher volumes of foreign currency borrowing, or mortgage interest rate resets at higher levels are risks skewed toward a higher rise in NPLs. Nonetheless, even this would be unlikely to cause significant problems for the well-capitalised domestic banking sector.

Key economic indicators

Macroeconomic indicators – long-term outlook

		2020	2021	2022	2023	2024	2025	2026	2027
GDP	real, %	-5.5	3.5	2.4	0.1	1.8	2.1	2.4	2.3
Inflation	average, %	3.3	3.8	15.1	11.0	1.3	2.2	1.9	2.2
Current account	% of GDP	2.0	-2.7	-6.1	-0.2	-0.7	-0.2	0.2	0.4
3M PRIBOR	average, %	0.9	1.1	6.3	7.2	5.5	3.7	3.3	3.3
EUR/CZK	average	26.5	25.6	24.6	23.8	24.1	24.0	23.8	23.6
USD/CZK	average	23.2	21.7	23.4	21.3	20.2	19.5	18.9	18.7

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

FX & interest-rate outlook

		24-07-2023	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24
EUR/CZK	end of period	24.12	23.85	23.90	24.00	24.10	24.25
USD/EUR	end of period	1.11	1.14	1.16	1.18	1.20	1.20
CZK/USD	end of period	21.81	20.90	20.60	20.35	20.05	20.20
3M PRIBOR	end of period, %	7.10	7.15	7.15	6.30	5.25	4.45
10Y IRS	end of period, %	3.86	4.05	4.05	3.90	3.80	3.65

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

Monthly macroeconomic data

		X-22	XI-22	XII-22	I-23	II-23	III-23	IV-23	V-23	VI-23
Inflation (CPI)	%, yoy	15.1	16.2	15.8	17.5	16.7	15.0	12.7	11.1	9.7
Inflation (CPI)	%, mom	-1.4	1.2	0.0	6.0	0.6	0.1	-0.2	0.3	0.3
Producer prices (PPI)	%, yoy	24.1	21.3	20.1	19.0	16.0	10.2	6.4	3.6	1.9
Producer prices (PPI)	%, mom	0.6	-1.0	-1.1	5.8	-0.3	-1.0	-1.2	-0.8	-0.3
Unemployment rate	% (MLSA)	3.5	3.5	3.7	3.9	3.9	3.7	3.6	3.5	3.4
Industrial production	%, yoy, c.p.	3.4	1.3	2.3	0.8	2.4	3.1	-1.8	-1.6	n.a.
Industrial sales	%, yoy, c.p.	19.9	18.3	9.1	9.1	12.9	13.5	7.2	2.1	n.a.
Construction output	%, yoy, c.p.	2.1	-0.2	-4.4	7.3	-4.6	-2.6	-8.2	-4.5	n.a.
External trade	CZKbn (national met.)	-25.2	-26.5	-1.8	8.8	15.1	18.1	10.3	11.8	n.a.
Current account	CZKbn	-36.8	-42.5	-4.3	14.3	19.5	5.8	16.7	0.9	n.a.
Financial account	CZKbn	-7.4	-13.3	-38.4	26.8	17.3	33.8	29.1	-27.4	n.a.
M2 growth	%, yoy	5.9	5.9	5.6	6.3	7.0	6.7	7.5	7.3	n.a.
State budget	CZKbn (YTD cum.)	-286.7	-337.1	-360.4	-6.8	-119.7	-166.2	-200.0	-271.4	-215.4
PRIBOR 3M	%, average	7.28	7.27	7.26	7.22	7.20	7.19	7.18	7.18	7.15
EUR/CZK	average	24.5	24.4	24.3	23.9	23.7	23.7	23.4	23.6	23.7
USD/CZK	average	24.9	23.9	22.9	22.2	22.2	22.1	21.4	21.7	21.9

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

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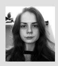

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