Forecast update

Special Report

Koruna unlikely to weaken further, despite faster CNB cuts due to lower inflation

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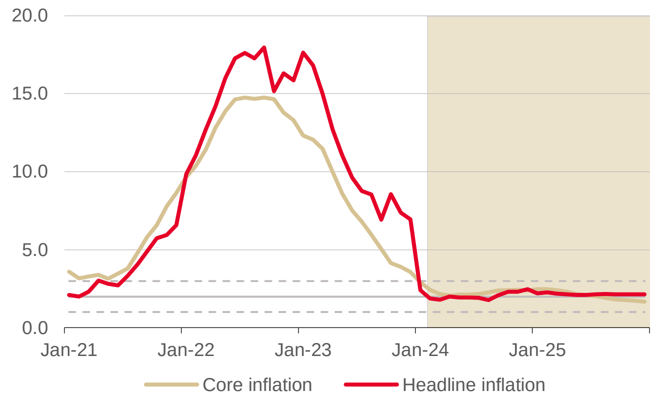
Given the lower January figure, we have revised our inflation estimate for this year from 2.7% to 2.1%. Both headline and core inflation are likely to remain within the CNB's tolerance band for the rest of the year. Given that fact, combined with the weak economy, we expect the CNB to cut rates at a faster pace. We forecast 75bp cuts in both March and May and a repo rate of 3.5% by the end of the year. Shorter-maturity market rates should continue to fall, while we do not see similar scope for longer maturities. The weakening of the koruna against the euro over the past six months has largely been due to the narrowing of the interest rate differential, but we do not expect this to continue. In contrast, the koruna could strengthen slightly by end-2024, supported by a recovery in domestic and external demand and a weakening of the US dollar.

Low January inflation favours faster CNB cuts

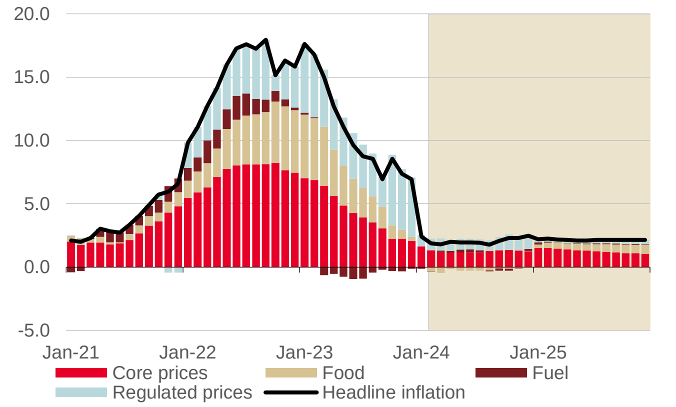
Recently published consumer price data showed a surprisingly rapid decline in inflation in January. Headline inflation fell to 2.3% yoy and core inflation to 2.9% yoy. The CNB had expected 3.0% yoy and 3.8% yoy respectively. We have analysed the January inflation data in more detail here: https://bit.ly/CPI_Jan24_EN. The January figure is traditionally the one that largely determines the inflation rate for the year as a whole, especially in a period of stable price developments without major economic shocks. After previous turbulent years, this could be the case in 2024. As a result of weaker inflation print in January, we thus lower our estimate for the year as a whole. While we originally estimated that inflation would average 2.7% in 2024, we now expect it to be 2.1%. For most of the year, we expect inflation to be around or even slightly below 2% yoy. Towards the end of the year, we then expect a temporary acceleration to 2.5% yoy due to the lower comparison base. Core inflation should remain slightly above 2% yoy throughout 2024. On average, we forecast it to reach 2.3%, although we expect demand pressures to gradually recover as household consumption picks up. January's data showed a marked slowdown in core price dynamics, which were broadly unchanged mom. At the end of last year, however, the momentum of core inflation had been rising.

Headline and core inflation likely to remain within the CNB's tolerance band until the end of the year (%, yoy)



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

Further regulated price increases should be offset by a slight decline in food prices this year (%, yoy)



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

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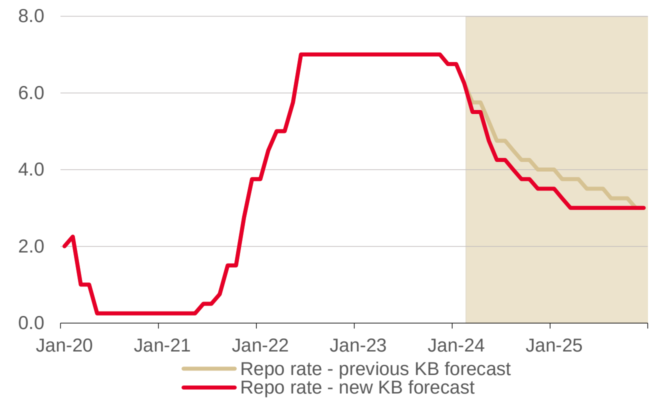
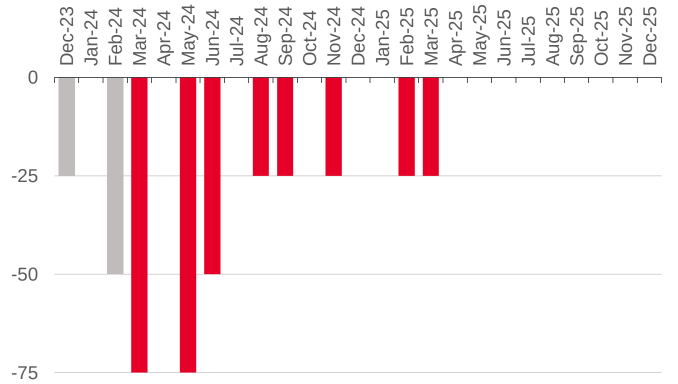
The Czech National Bank should start cutting interest rates more quickly. Uncertainty about January's inflation figure has so far been the bank's main justification for its cautious approach to rate cuts. While some uncertainty remains, it is certainly less than before the release of the January inflation figure. Nevertheless, both headline and core inflation are likely to remain within the CNB's tolerance band for the rest of the year. Combined with the weak economy, the current level of interest rates is therefore too restrictive. This is underlined by the traditional lag of monetary policy effects, which the central bank estimates at 12-18 months. We thus expect 75bp cuts at the March and May meetings, following the 50bp cut in February. We then expect -50bp in June, positioning the repo rate at just above 4% by mid-year. This would significantly reduce the current mismatch between economic data and monetary policy. We expect rate cuts of 25bp in August, September and November, and no change in December, bringing the repo rate to 3.5% by the end of the year. We expect further rate cuts of 25bp in February and March next year, when the repo rate should reach the policy-neutral level of 3%. Given that the CNB board has indicated that it considers the policy-neutral level to be slightly higher than the currently used 3%, it is possible that all rate cuts will eventually take place this year. However, we see the risks to our forecast as skewed towards a more gradual pace of rate cuts, given the board's desire to remain cautious despite favourable price developments. Moreover, the pace of rate cuts is likely to depend on the development of the Czech koruna.

As a result of lower inflation in January, we now expect the repo rate to fall faster, to 3.5% by the end of the year (%)



Source: CNB, Economic & Strategy Research, Komerční banka

We expect 75bp cuts in the repo rate at the March and May meetings (changes in bp)

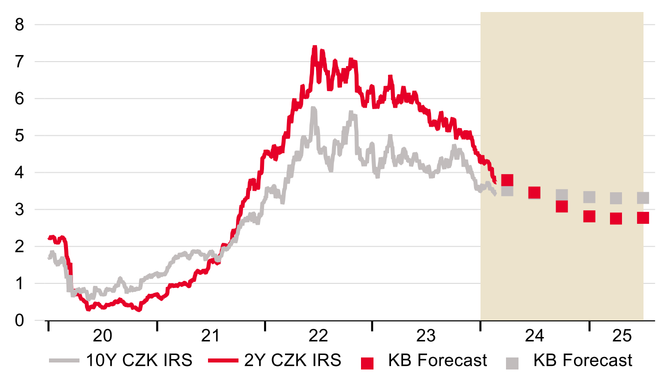


Source: Economic & Strategy Research, Komerční banka

Shorter term market rates could fall further

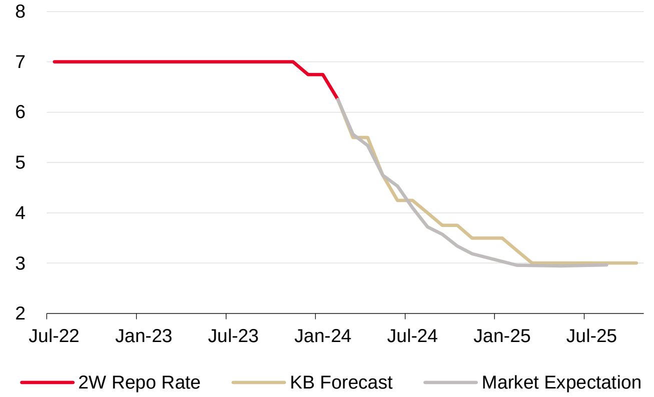
Both the Fed and the ECB will start to cut interest rates this year. Given the surprisingly positive US economic data in recent weeks, we no longer expect a US recession this year. As a result, we expect the Fed to cut its key rate by "only" 75bp this year, from the current 5.25%-5.50% to 4.50%-4.75% by the end of the year. For the ECB, our baseline scenario is for a 50bp cut in the deposit rate to 3.5% this year. However, given the ongoing weakness of the German economy, which is likely to have contracted for the second consecutive quarter in 1Q24, and market expectations (-100bp by the end of the year), the risk is skewed towards more significant monetary easing in the eurozone.

IRS forecast (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Expected CNB key interest rate path as of 21 February 2024 (%)



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

The shorter end of the CZK market interest rate curve has fallen sharply over the past month. This reflects an increase in the pace of the CNB's rate cut at the February meeting (to 50bp) and also the stronger-than-expected fall in inflation to 2.3% yoy in January. In our January forecast, we expected the repo rate to fall to 4% by the end of the year. However, we now believe that the decline will be more pronounced. Nevertheless, we do not expect the CNB repo rate to reach the 3% priced in by the financial markets this year, but rather to end the year at 3.5%. The scope for a further decline in longer swap rates from current levels is likely to be limited in our view.

CZK IRS outlook (end of period, %)

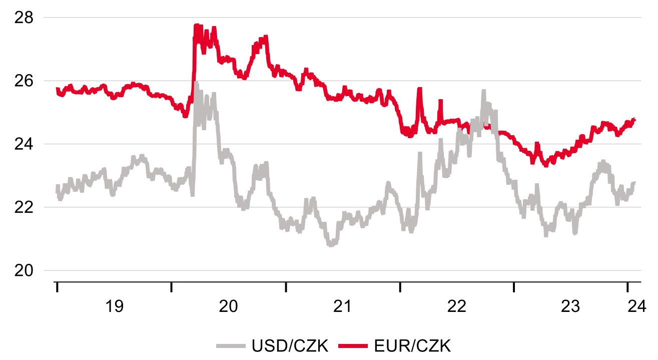
	1Q24f	2Q24f	3Q24f	4Q24f
2y	3.80	3.45	3.10	2.80
5y	3.35	3.15	3.05	2.95
10y	3.50	3.45	3.40	3.35

Source: Economic & Strategy Research, Komerční banka

Economic recovery and weakening USD could support CZK

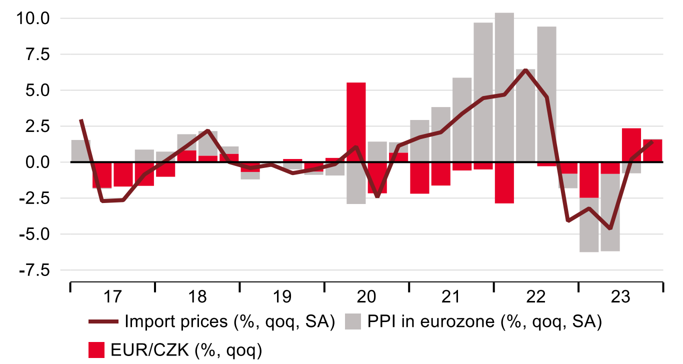
The inflationary impact of the weaker koruna is likely to make the CNB more cautious in cutting interest rates. Although the observed broad-based easing of inflationary pressures in January inflation would justify a rapid and significant easing of monetary policy, we believe that the CNB will again adopt a more cautious approach, partly because of the koruna exchange rate. The quarter-on-quarter decline in foreign producer prices came to a halt in 4Q23, which, together with the continued weakening of the spot exchange rate at the beginning of the year, created inflationary pressure from rising import prices. At the same time, CNB board members have frequently mentioned the upside risks of a weaker koruna in their recent statements.

The koruna continues to weaken, ...



Source: Bloomberg, Economic and Strategy Research, Komerční banka

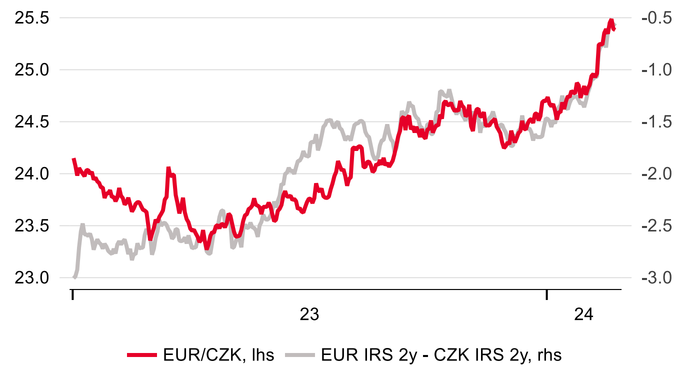
...which is pushing up import prices



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

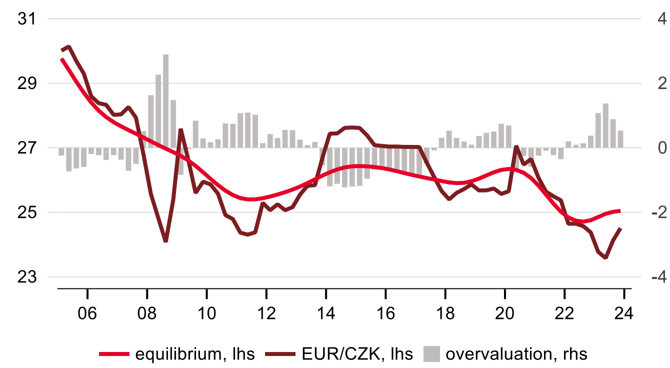
The koruna is weaker than expected in our January forecast and compared with the CNB's forecast. The narrowing interest rate differential has been an important factor in the recent depreciation. This is related to the observed easing of inflationary pressures and the return of annual inflation to close to the 2% target in January, which triggered an increase in financial market bets on a faster easing of domestic monetary policy. At the same time, we do not expect a further significant reduction of the differential, as the CNB's future actions, as priced in by the market, are broadly in line with our outlook. We had estimated the equilibrium exchange rate, given the economic fundamentals, at EURCZK 25.0 for 4Q24. In our view, this year's depreciation has thus more than compensated for the previous overvaluation of the koruna.

The weakening of the koruna in the last six months follows the narrowing of the interest rate differential



Source: Bloomberg, Economic & Strategy Research, Komerční banka

Fundamentally, we believe that the koruna is no longer overvalued



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.

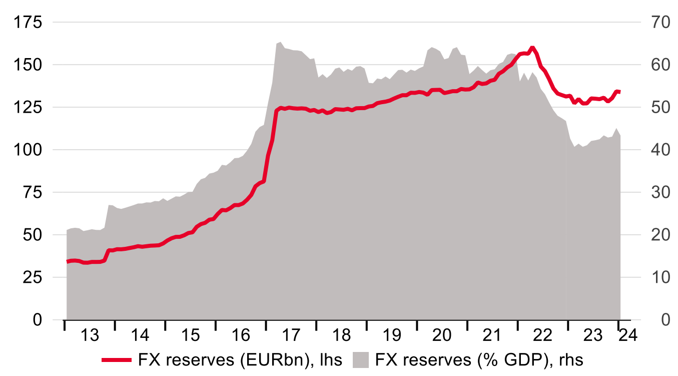
The scope for further weakening of the krona against the euro may soon be exhausted. As we write above, the interest rate differential is unlikely to narrow much further. In addition, we expect both the domestic economy and external demand to recover this year. In general, emerging market currencies should also benefit from global developments in foreign exchange markets associated with the weakening of the US dollar. A possible increase in the volume of CNB's FX reserve sales, which has been below €300m per month since August, could also play a stabilising role. The stock of CNB's foreign exchange reserves stood at €133.9bn at the end of January this year. Relative to the size of the economy, foreign exchange reserves amount to more than 40% of annual GDP and remain among the largest in the world. All in all, the koruna could strengthen slightly below EURCZK 25.0 by the end of the year.

Koruna exchange rate forecast (end of period)

	1Q24f	2Q24f	3Q24f	4Q24f
EUR/CZK	25.40	25.20	25.00	24.90
USD/CZK	23.10	22.30	21.55	21.45
EUR/USD	1.10	1.13	1.16	1.16

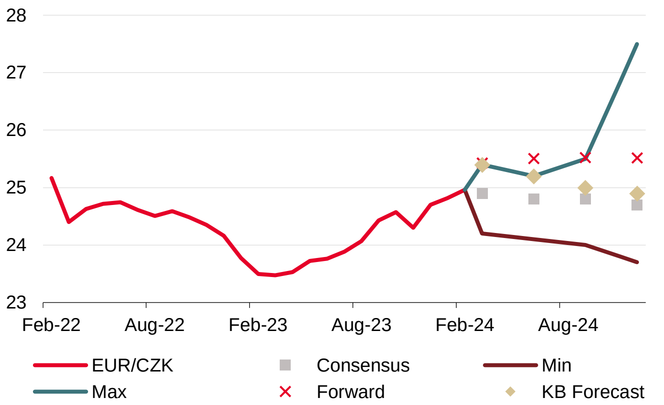
Source: Economic and Strategy Research, Komerční banka, SG Cross Asset Research

The CNB has significant foreign exchange reserves



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

Expected EUR/CZK path, Bloomberg consensus



Source: Bloomberg, Economic and Strategy Research, Komerční banka

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