Quarterly report

Czech Economic Outlook

Energy prices: From villain to hero

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■ **Recession behind us, economic growth ahead.** The economy experienced a technical recession in 2H22. This year, we expect a recovery in household consumption and industrial production. GDP is set to grow 0.6% this year and 1.8% next year.

■ **Cheaper energy to push inflation towards target.** The higher comparative base should contribute to a further decline in annual inflation, which should average 11.8% this year. Next year, we expect a significant reduction in consumer energy prices, bringing inflation down to an average of 2%. However, we expect core inflation to remain above 2%.

■ **CNB rates to remain higher for longer.** This is indicated by the board's statements as well as the economic recovery and higher wage growth we expect. We forecast a first rate cut in September this year and policy-neutral 3% only in 2025.

■ **Later and slower rate decline.** The short end of the yield curve should gradually decrease in line with the start of domestic monetary easing in 3Q23, reducing the inversion of the curve.

■ **Koruna strengthening trend running out of steam.** Amid a further narrowing of the interest rate differential vs the eurozone and tangible real appreciation so far, we expect the koruna to weaken slightly against the euro over the next 12 months.

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The Czech economy's wheels are turning again


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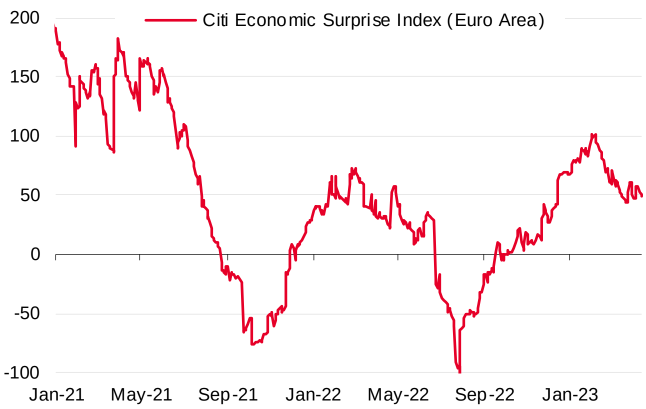
In the January issue of the *Czech Economic Outlook,* we concluded our editorial saying: "*So let's look forward to springtime. As it approaches, consumer sentiment should start to pick up as the economic situation steadily improves and the days get brighter and longer*." A few months on, and we can note that the economic acceleration is becoming increasingly visible, although March and April feeling temperatures have hardly been springlike.

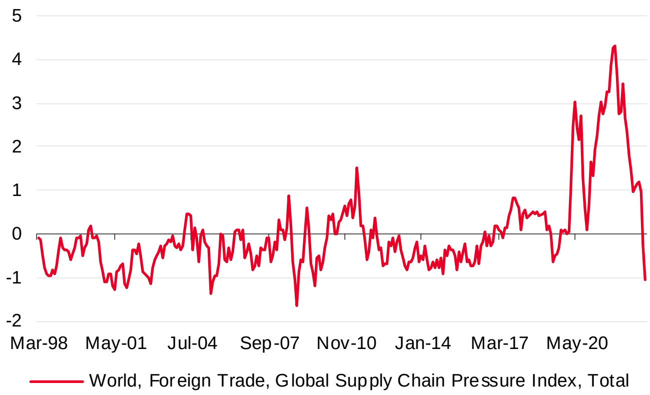
For the Czech economy, 2023 started well, last year having indeed marked the end of recession. We really went out on a limb with the title of our previous *Czech Economic Outlook*: "*There was a recession? When?".* We were among the very few to expect the Czech economy to grow during the first quarter of this year – by an infinitesimal 0.1%, but grow nonetheless –following the slight qoq declines in the second half of last year. We are now even more convinced of this. We think the first three months of 2023 will show the Czech economy having grown by 0.2% qoq. And the picture is even brighter when we zoom in on the country's key trading partner, as our colleagues at Société Générale expect the German economy to have grown by 0.4% qoq during 1Q23. The hitches in the global supply chain seem to be over and the recently released European indicators, including those from German industry, have continued to surprise on the upside.

Euro area's economic indicators have continued to surprise on the upside



Source: Macrobond, Economic and Strategy Research, Komerční banka
Note: Above-zero values for CESI indicate a positive surprise in the published data versus the market consensus, while below-zero values indicate the opposite – a negative surprise.

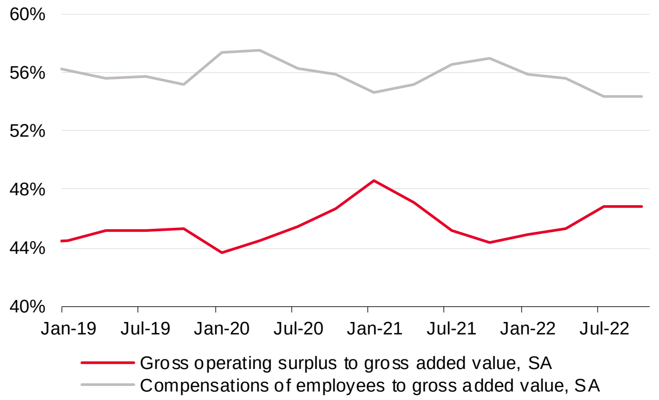
The hitches in the global supply chain appear to be over



Source: Macrobond, Economic and Strategy Research, Komerční banka

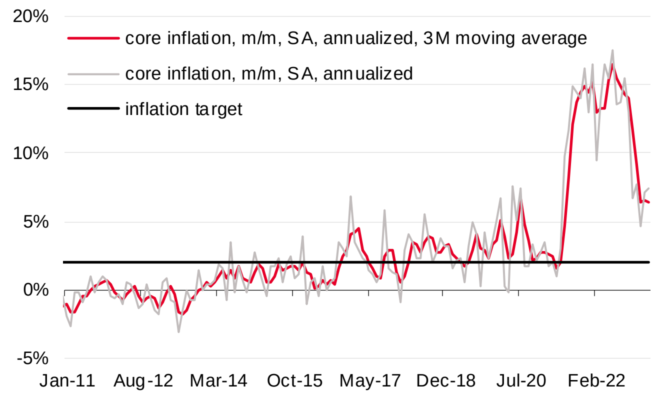
The shallow recession in the second half of last year basically had no impact on the tight labour market, which was also tackling the inflow of Ukrainian refugees. The share of unemployed did not rise above 4% during the first three months of this year; it stopped rising just under that percentage; and now, strengthened by seasonal factors, it is declining again. The reason is the general shortage of workers and the difficulties faced by companies in the last crises, when they found it difficult to rehire previously laid-off workers. The labour market is a major inflationary risk. Judging by the incomplete statistics for the early months of this year, in this year's wage bargaining employees seem to be putting the emphasis on the effect of last year's inflation shock and the related fall in real wages. We are seeing double-digit year-on-year growth in nominal wages in both industry and construction at the beginning of 2023. The wage bargaining process to date shows that employers are willing to compensate employees for the high inflation, to a considerable extent. After all, last year, companies were able to pass on input-cost inflation to end-consumers, a fact evidenced by the levels of profitability in the non-financial corporate sector. The ratio of gross operating surplus to the created added value rose last year, and precisely at the expense of employee compensation. This year, the declining prices of other inputs, such as energy and international transport, are creating room for companies to increase wages. The growth of wages and the conduct of the government, which has become a major money issuer due to excessive budget deficits over the last three years, are therefore factors that must necessarily trigger concerns among central bankers.

Non-financial corporations' profit margins rose at the expense of employees in 2022



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

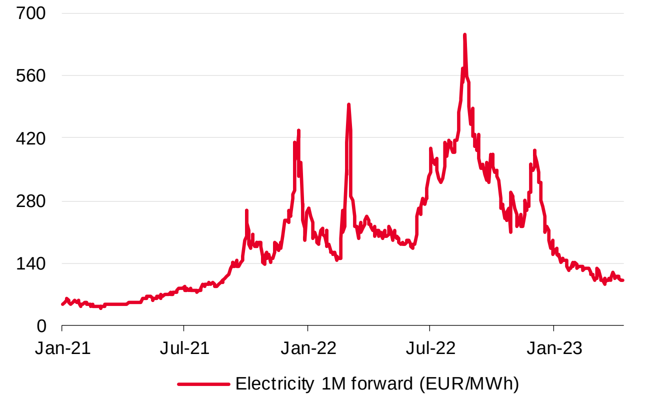
Core inflation is not declining fast enough



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

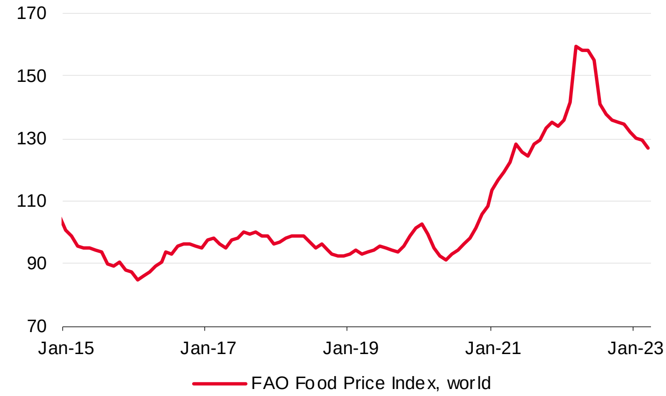
Inflation rates are set to fall, as are interest rates. But the question is when. We consider that food prices are now peaking, while energy-commodity market prices have now dropped to levels seen prior to the Russia-Ukraine war. Energy prices significantly contributed to inflation last year and, similarly, they should now work in the opposite direction; in short, *energy prices are turning from villain to hero*. Because of last year's high statistical base, yoy inflation should therefore continue to decline rapidly and may fall to single-digit values as early as mid-2023. The biggest unknown is core inflation – there is a risk that it will move towards the inflation target only very slowly. This risk is likely to discourage central bankers from cutting rates. The coming weeks should shed light on how serious the Czech cabinet is about public finance consolidation; central bankers' willingness to make (wage development permitting) the first rate cut in the autumn will be determined by this.

The electricity market price is at pre Russia-Ukraine war levels



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Global food prices are past their peak (2014-2016=100)



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

In a few days, we will get the first flash estimate of the Czech economy's performance during the first quarter. Even the 0.2% qoq growth that we expect, and which is one of the most optimistic forecasts in the market, would still mean a yoy decline (by 0.1%). For 2Q23, we forecast only zero growth yoy. **The media and some politicians may try to make us all believe that we are in a recession. We do not think that we are.** The Czech Republic is almost the only EU member state (together with Spain) whose economy has yet to return to **the pre-pandemic level, and we expect it to do so in the third quarter of this year**.

Our updated macroeconomic forecasts suggest a further fall in inflation, continuous low level of unemployment and acceleration in the pace of economic activity over the coming months. Combined with steadily improving external demand, all of this should be reflected in rising confidence indicators, recent turbulence in the US and European banking sector notwithstanding. As Kevin Tran Nguyen shows in the box *Czech banking sector provides an anchor to wider financial sector*, Czech banks are very resilient. It is my hope therefore that this edition of Komerční banka's *Czech Economic Outlook* will lift your spirits this spring.

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External environment and assumptions


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Lowering interest rates does not appear to be on the agenda

Monetary policy tightening in the US appears to be coming to an end. However, we do not expect interest rate cuts this year. Given high core inflation and a tight labour market, monetary easing and the onset of a recession is not likely until 2024 in our view. In contrast, the euro area seems to be moving away from a potential recession. Even the German economy looks set to avoid it. The priority for the ECB should therefore be inflation, the core component of which is only likely to return to target gradually. We estimate that the deposit rate will rise to 4% in September this year. We consider the European banking sector to be sufficiently stable to allow the ECB to fully commit to its target. It has other tools than interest rates to ensure banking stability.

US: rate cuts likely to come later than the market expects

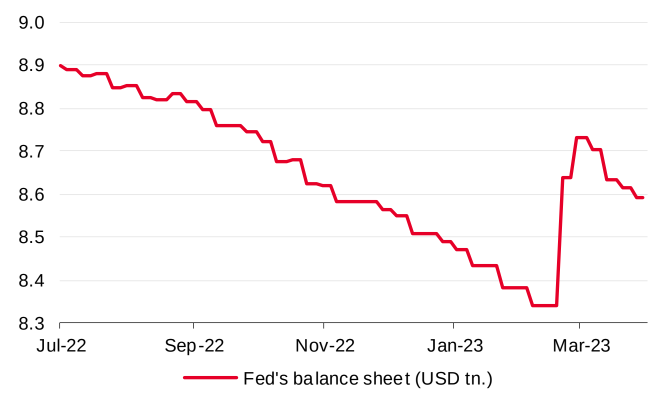
The Fed's key rate should peak at 5.00%-5.25%.

In March, the US Federal Reserve raised its key interest rate by 25bp to 4.75-5.00%. The central bank made this move despite difficulties in the local banking sector, with Fed Chair J. Powell saying that further monetary tightening may yet be delivered; and indeed the Fed's current forecast also envisages this. The fact that concerns persist about further problems in the US banking sector is evidenced by high interest on the part of banks for additional liquidity. The Fed's balance sheet, which had fallen by $0.6 trillion (as of March 10) thanks to the tapering of asset purchases initiated in the middle of last year, has risen again to $8.7 trillion (as of March 24) mainly due to the banking crisis. While it is likely to fall again once concerns ease, it nevertheless illustrates the whole situation well. Still, we expect the central bank to raise interest rates one more time in May, by 25bp to a terminal 5.00-5.25%. We would then expect rates to stay at that level for some time, which is also in line with the Fed's forecast.

The market expects interest rates to fall as early as this year.

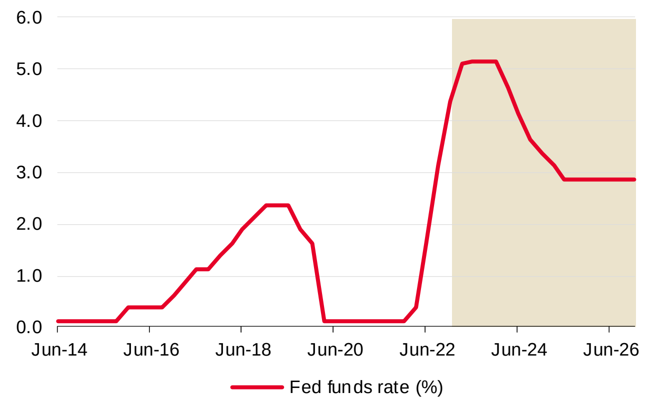
Market expectations are significantly more aggressive on further policy easing, assuming cuts of more than 50bp over the second half of the year. Nevertheless, given high core inflation and the economy's solid performance so far, our forecast assumes that the first rate cut will not take place until early next year.

The banking crisis has again inflated the Fed's balance sheet



Source: Macrobond, SG Cross Asset Research/Economics

Monetary policy tightening appears to be nearing its peak



Source: Macrobond, SG Cross Asset Research/Economics

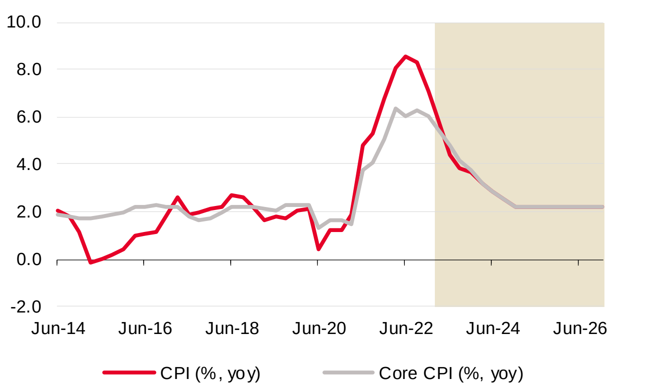
High rental prices are preventing a slowdown in core inflation.

Core inflation reached 5.6% in March. A slowdown in core inflation will require a lower rate of rental price growth (we expect such a slowdown in the coming months) than the current 8-9% yoy, as well as a cooling of the labour market. Job creation has surprised to the upside in recent months. The number of workers in some sectors, such as healthcare, recreation, and education, has still to return to pre-pandemic levels, although this should be achieved in the coming months, and job creation should begin to slow. Core inflation should then start to decelerate, falling to 2% by the end of 2024 on our forecasts.

Economy probably grew at a solid pace in 1Q23.

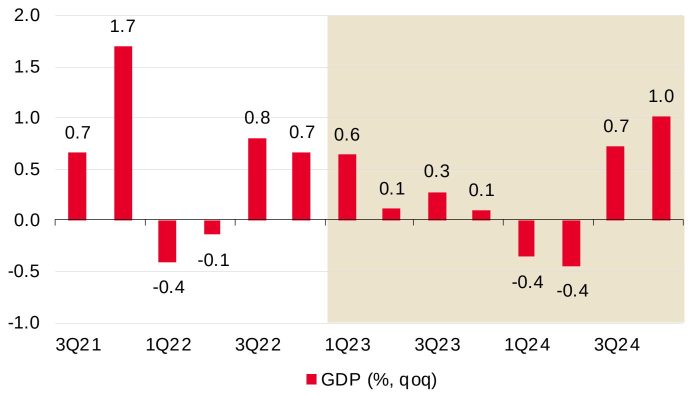
Thanks to a strong labour market and solid wage growth, personal spending remains high in real terms (forecast +4.4% qoq annualised in 1Q23). We estimate this should have helped the economy to grow by 2.2% qoq annualised in 1Q23. We forecast much lower GDP growth in the following quarters and expect the US economy to go through a shallow recession in the first half of 2024. At that same time, the Fed should start to cut rates to a level of 2.75%-3.00% in 1H25, on our forecasts.

Inflation only returning to target at end-2024 at the earliest



Source: Macrobond, SG Cross Asset Research/Economics

US economy likely to face a recession in early 2024



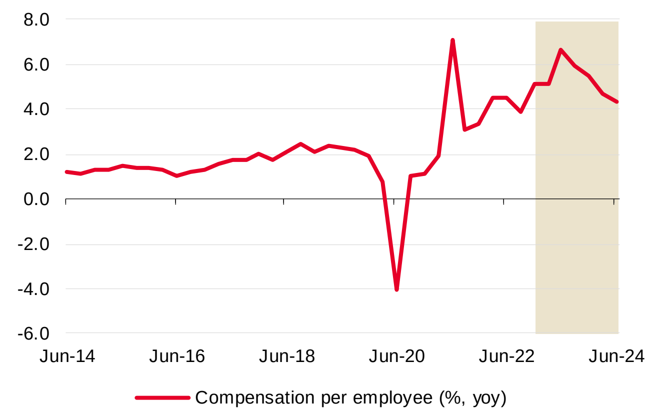
Source: Macrobond, SG Cross Asset Research/Economics

The euro area: moving away from a recession

German economy is likely to avoid a recession.

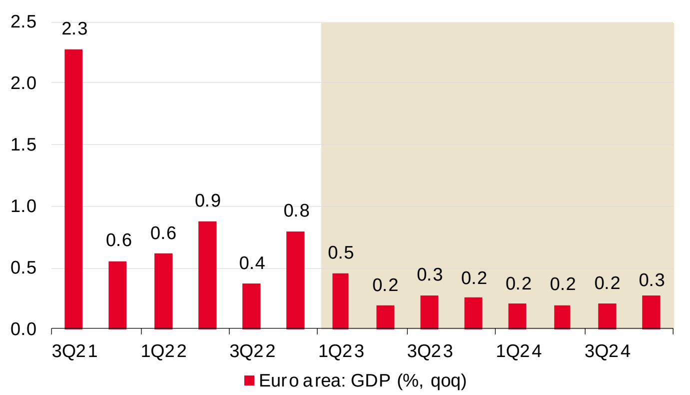
The euro area is likely to avoid recession this year, in our view. Even Germany should be spared. The German economy's strong industrial orientation held back growth in the final quarter of last year. However, with subcontracting problems fading and energy prices falling, the automotive industry and sectors heavily dependent on energy supplies are reviving rapidly. Thus, German industry is surprising on the upside, which should have helped contribute to 0.4% qoq GDP growth in 1Q23.

Wages in the euro area have been growing strongly



Source: Macrobond, SG Cross Asset Research/Economics

Eurozone seems to be moving away from a recession



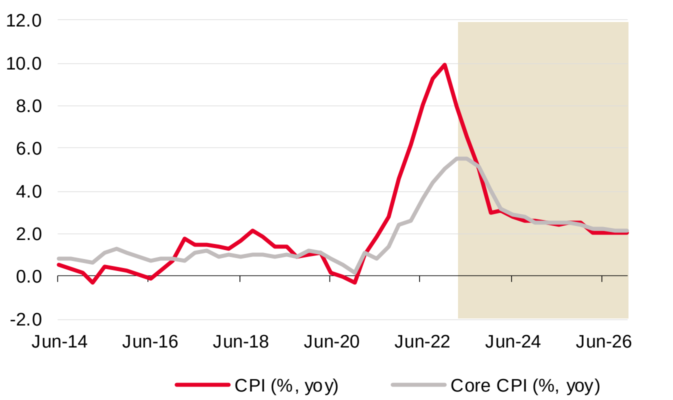
Source: Macrobond, SG Cross Asset Research/Economics

For the euro area as a whole, we forecast +0.5% growth qoq in 1Q and positive GDP growth for the following quarters, on the back of excess household savings, government support programmes, historically low unemployment (SGe forecast 6.6% in 2023) and solid wage growth (SGe forecast 5.7% in 2023). Companies are also enjoying relatively high margins, and are willing to invest and to hire new employees.

ECB is likely to have to continue hiking rates.

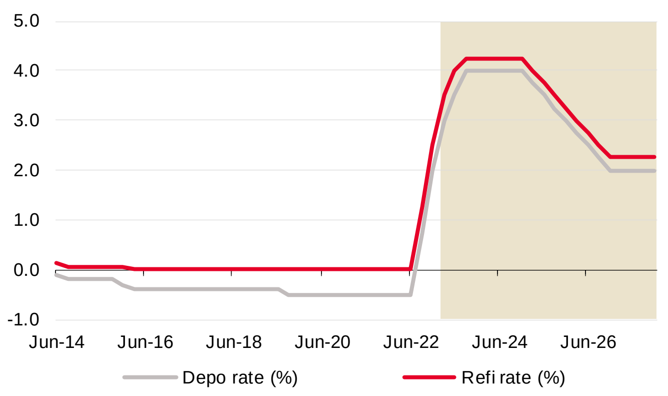
The European Central Bank raised interest deposit rate by the announced 50bp to 3% in March, despite the problems of Switzerland's second-largest bank, Credit Suisse. The interest rate hikes will continue, in our view, up to 4%, the level we expect the deposit rate to reach in September this year. The risks are, however, tilted towards less monetary tightening given the uncertainty surrounding the future development of the banking sector. Financial markets are pricing in expectations of less than three rate hikes, while at the same time seeing the first rate cut as early as the beginning of the next year. We do not expect the first easing of monetary conditions until 1Q25, forecasting core inflation to return to close to 2% at the end of 2026. At the same time, we expect the ECB to accelerate the pace of balance sheet reduction to €20bn per month in June, €25bn per month in September, while in February 2024 it is also likely to start reducing the volume of assets purchased under the pandemic programme (by €15-20bn per month).

Euro area inflation remains high (% yoy, quarterly averages)



Source: SG Cross Asset Research/Economics

ECB to continue raising rates (%)



Source: SG Cross Asset Research/Economics

CEE: rates to head down, the question is when

We expect the Polish central bank to cut interest rates in September.

Polish inflation slowed to 16.1% yoy in March, from 18.4% in February. We expect this trend to continue in the coming months. The Polish central bank will start to consider cutting interest rates when inflation decreases below 10%, according to some of its members. We therefore expect a first interest rate cut in September this year, of 25bp. The next such move, of 50bp, is likely to follow in October, bringing the key interest rate from the current 6.75% to 6.00%. The Polish zloty should be stable over the course of this year, according to our forecasts, at around EURPLN 4.65-4.75.

The Hungarian central bank is likely to start cutting O/N rate.

Inflation has also peaked in Hungary, although it remains at high levels (25.2% yoy in March). However, core inflation still rose slightly in March (from 25.2% to 25.7%). We thus expect the key three-month interest rate to be cut only in 1Q24, when it should fall from the current 13% to 10%. The central bank should start lowering the overnight deposit rate (currently 18%) in May this year. We expect the rate to decrease to 13% in the third quarter. In any case, the central bank is only likely to resort to such steps when it is sure that they will not lead to a sell-off in the Hungarian forint and a resumption of inflation. We expect the Hungarian forint exchange rate to remain stable at around EURHUF 380 over the year.

Macroeconomic forecast and monetary policy

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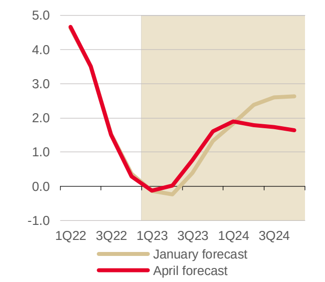
Major changes

GDP:
We expect the economy to grow by 0.6% this year, which is higher than our previous forecast of 0.3%. Household consumption and industrial production should recover. We expect GDP growth to accelerate to 1.8% in 2024 (vs 2.4% in the previous forecast).

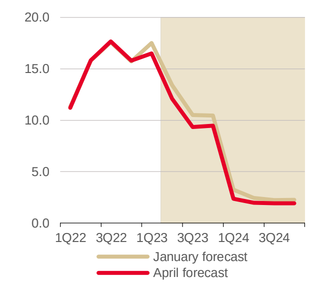
Inflation:
We have lowered our inflation forecast for this year from 12.9% to 11.8% and for next year from 2.5% to 2.0%. This is mainly due to the inclusion of the assumption of a gradual decline in consumer energy prices. Core inflation, however, is likely to remain above the CNB's 2% target in both years.

Change in GDP forecast (%, yoy)



Source: CZSO, Economic & Strategy Research, Komerční banka

Change in CPI forecast (%, yoy)

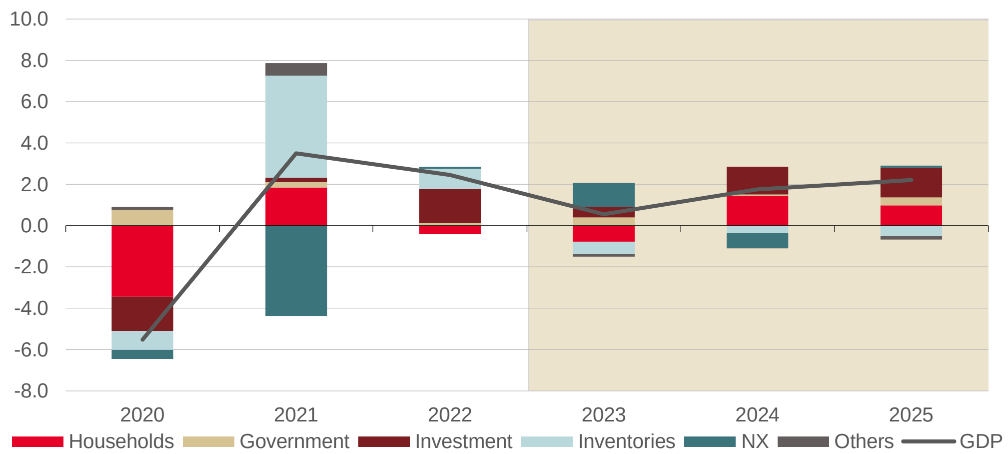


Source: CZSO, Economic & Strategy Research, Komerční banka

Renewed economic growth and receding inflation

The Czech economy went through a mild recession in the second half of last year, which we believe has now ended. This year we expect a gradual recovery in household consumption and the economy as a whole. Lower uncertainty and higher wage growth, combined with a tight labour market, will help to boost household spending. The technical recession has not yet led to an increase in unemployment and is unlikely to do so. Industrial production should also contribute to economic growth, helped by the positive growth prospects of foreign economies. Meanwhile, the recovery in domestic demand is likely to hinder a decline in core inflation. Nevertheless, headline inflation should reach the CNB's 2% target next year, mainly due to cheaper energy. Significantly lower wholesale energy prices are already starting to feed through to consumer prices. We do not expect the CNB to raise interest rates further, but it is likely to keep them high for a longer period of time.

We expect the economy to grow by 0.6% this year and accelerate to 1.8% next year (%, yoy)



Source: CZSO, Economic & Strategy Research, Komerční banka

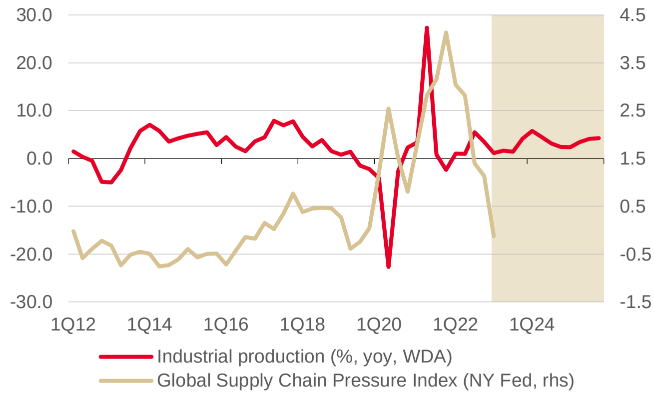
Recession is over, economy set to grow this year

The Czech economy experienced a mild recession in the second half of last year. After a contraction of 0.3% qoq in 3Q22, GDP fell by 0.4% qoq in 4Q. This was only slightly worse than we had expected (our January forecast was for a 0.3% qoq GDP decline in 4Q22). Thus, our expectation that the recession would be shallow has come true. Qualitatively, the structure of GDP also developed in line with our forecast. Lower household consumption continued to be the main contributor to the economic downturn. It declined in real terms for a fifth consecutive quarter in 4Q22 (by 2.8% qoq) – and was around 8% lower than in pre-pandemic 4Q19. Households spent less due to high prices. Inflation significantly exceeded nominal wage growth, which led to a decline in consumer purchasing power. Moreover, this occurred amid heightened uncertainty related to the impact of high energy prices and a possible rise in unemployment. Fixed investment also fell in 4Q22 compared with the previous quarter. This was due to lower government investment, while private investment continued to grow slowly. However, the negative trend in domestic demand was offset by a further increase in net exports. This reflected a recovery in industrial production and the completion of work in progress due to better functioning input supplies. Growth in inventories was lower in 4Q compared with the previous quarter, but remained at elevated levels. The economy as a whole was 1% below its pre-pandemic level in 4Q22.

The economy will reach its pre-pandemic level of 4Q19 in the third quarter of this year. This is one quarter earlier than in the previous forecast.

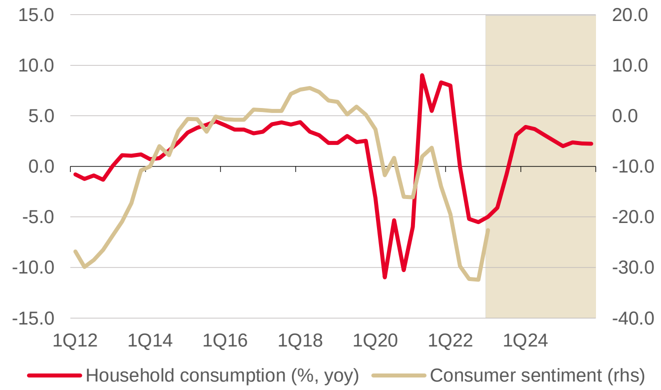
We continue to believe that the recession is over and a gradual recovery will start this year. Our estimate is that the economy grew by 0.2% qoq in 1Q23, 0.1pp higher than in our previous forecast. We expect a slight increase in household consumption, as indicated by the monthly sales figures in retail and services. Pessimistic scenarios about the strong negative impact of high energy prices have not materialised, and consumer sentiment therefore started to improve at the beginning of the year. According to the CZSO indicator, this has reached its highest level since March of last year, when it fell sharply as a result of Russia's invasion of Ukraine. The component assessing households' concerns about price increases was at its lowest level since 2016 in March this year. In addition to lower concerns about the impact of high energy prices helped by the government taking protective measures, the reversal of the trend in inflation – which has been declining on a year-on-year basis since February – may also have had an impact. Moreover, we estimate that nominal wage growth accelerated further at the beginning of 2023. We expect these factors to remain in place for the rest of the year, leading to a further increase in household spending in the coming quarters. In contrast, industrial production weakened at the beginning of the year, mainly due to renewed supply chain problems in the automotive sector. However, according to data from the Automotive Industry Association (AutoSAP), car production rose by a strong 35.5% mom in March (10.5% mom on a seasonally adjusted basis). This March was the best month for car production since the end of 2019, and despite a weaker start to the year, the performance of carmakers in 1Q23 was close to pre-pandemic levels. The situation in global supply chains has also returned to normal, according to the Global Supply Chain Pressure Index (GSCPI). Its March reading was close to the lowest level in the time series available since 1997. For the export-oriented manufacturing sector, the very strong German industrial data seen in recent months and expectations of faster Chinese economic growth are also good news. The fall in wholesale energy prices should be a positive impulse for energy-intensive sectors. As a result, we expect industrial production to rise during the rest of the year and to make a significant contribution to GDP growth via net exports.

Functioning of global supply chains is fully restored



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

Household consumption set to grow gradually



Source: CZSO, Economic & Strategy Research, Komerční banka

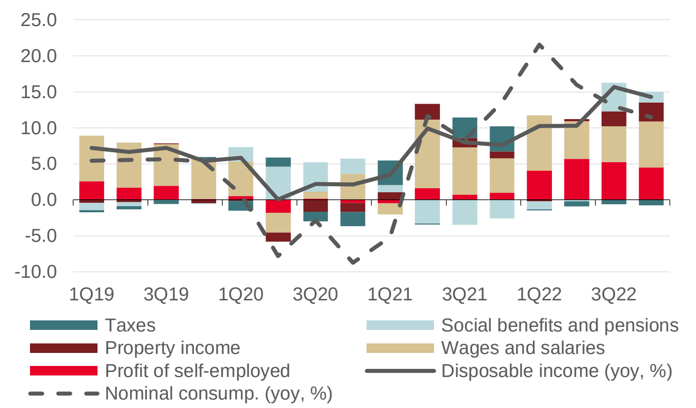
We expect the Czech economy to grow by 0.6% this year and accelerate to 1.8% next year. Compared to the previous forecast, this year's estimate is slightly higher (0.6% vs 0.3%) albeit lower for next year (1.8% vs 2.4%). We expect GDP to grow at a rate of 0.4-0.5% qoq in all three remaining quarters of this year, so a slightly negative output gap should close in 2H23. Pre-pandemic levels of economic activity should be reached in 3Q23, one quarter earlier than previously forecast. The economy in 2023 will be supported mainly by higher net exports, reflecting stronger industrial production and weaker imports, which are signs of the still relatively subdued domestic demand. We expect household consumption to increase qoq in each quarter of this year. However, the recovery is likely to be gradual and, on a full-year basis, developments will continue to mirror the deep declines from 2H22. We forecast a decline in household consumption of 1.7% in 2023, followed by an increase of 3.3% next year. Fixed investment should grow slightly this year (+1.8%) and accelerate in 2024 (+4.9%). This is likely to be supported by investments in automation, motivated by the ongoing labour shortage in the labour market, or by the transformation of the economy towards more sustainable modes of production and consumption, with strong financial help from the EU.

Increasing wage growth amid low unemployment

The technical recession has not led to an increase in unemployment and, according to our forecast, will not do so. The ongoing tightness in the labour market will contribute to an acceleration in nominal wage growth to above 10% this year.

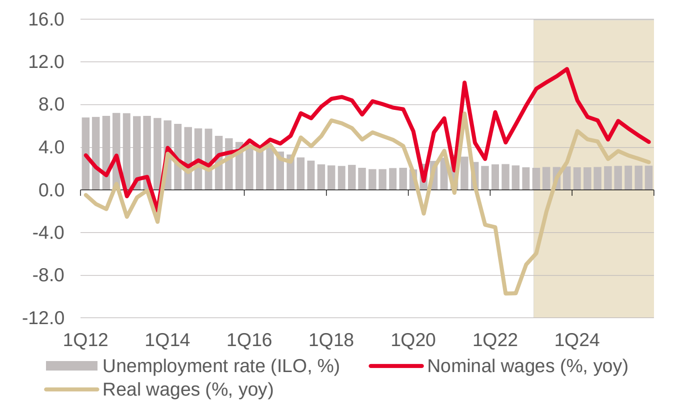
The increase in unemployment due to the technical recession has not yet occurred and we no longer expect this to happen. On the contrary, according to our estimates, the ILO unemployment rate (CZSO) and the share of unemployed persons (MLSA) fell slightly in 1Q23 (to 2.1% and 3.6% respectively) after seasonal adjustment. Data from the job offices show that there was roughly one unemployed person for every job vacancy in 1Q23. In our January forecast, we had expected a slight increase in unemployment due to the fall in demand and high energy prices. However, the drop in wholesale energy prices to pre-war in Ukraine levels and our expectations of a recovery in the domestic and global economies should help to prevent even a small rise in unemployment. Thus, the tightness in the Czech labour market, characterised by labour shortages in all occupations, will persist. Accordingly, we expect the unemployment rate to stagnate around current levels. With the return of economic growth, a modest rise in employment figures should gradually resume.

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

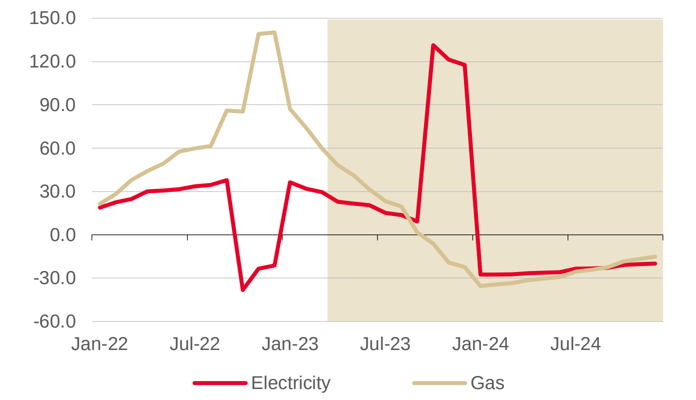
According to our forecast, nominal wage growth will average 10.4% this year and slow to 6.6% next year. This is higher than the previous forecast in both years (last time we forecast growth of 9.9% and 5.4% respectively). The fact that wage growth will accelerate from an average of 6.5% last year to around 10% this year is indicated by published information on the results of collective bargaining in companies. Some of them even point to a rise of more than 10%. Our above-consensus expectation that wage growth this year will be a reflection of high inflation combined with ongoing labour market tensions is starting to materialise. Despite higher nominal growth, however, real wages are likely to fall again this year. While real wages fell by 7.5% on average last year, we expect them to decrease by only 1.0% this year. As was the case last year, real wages are likely to lag behind labour productivity, which we expect to remain broadly unchanged this year. Therefore, double-digit nominal wage growth is unlikely to worsen the favourable financial situation of Czech companies. On a qoq basis, we expect real wages to rise over the remaining three quarters of the year, reflecting a gradual decline in inflation and continued nominal wage growth. Together with the other previously mentioned factors, this is likely to contribute to a recovery in household consumption. In addition, household savings remain at a high level, supported by a still high savings rate. The savings rate was 21.8% in 4Q22, while it was usually only slightly above 10% before the pandemic. Nominal wages grew by an average of 7.9% yoy in 4Q22, but the increase in total disposable household income was almost twice as high (14.3% yoy). This was due to rapid increases in pensions and social benefits. Household income developments should thus provide sufficient support for a recovery in expenditures.

Inflation to fall to 2% next year, but only thanks to cheaper energy

According to our forecast, inflation will average 11.8% this year, down from 15.1% last year. Next year, we expect inflation to fall sharply to an average of 2%, mainly on the back of cheaper energy.

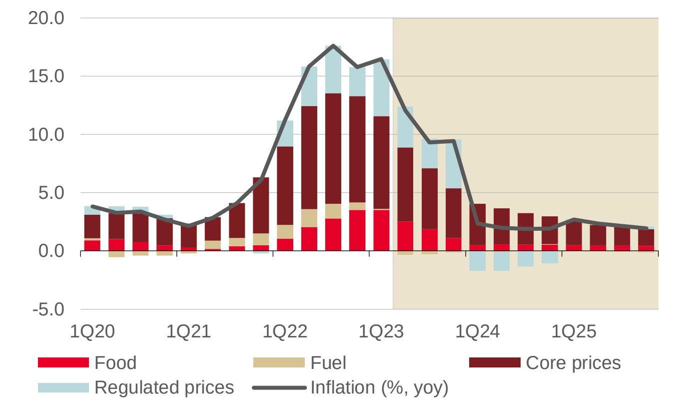
Consumer price growth in 1Q23 was lower than we had expected in the previous forecast. Inflation averaged 16.5% yoy, compared with our estimate of 17.5% yoy. This deviation was mainly related to the traditional January price adjustment, around which there was a lot of uncertainty and which in the end was not as high as we had expected. Nevertheless, there was a sharp rise in prices in January. This was due to energy prices, where the fading impact of the special energy tariff and further price increases to the level of government's price caps were evident. Although annual inflation accelerated in January, it did not break the record of 18% yoy in September of last year. In February and March, inflation has fallen rapidly to 15% yoy. The rising statistical base had a significant effect. This is evident in all inflation components, but especially in fuels. These were 17.6% cheaper yoy in March.

We expect electricity and gas to be one-third cheaper (%, yoy)



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

Regulated prices will be the main driver of headline inflation



Source: CZSO, Economic & Strategy Research, Komerční banka

While energy prices were pushing inflation up last year and this year, the opposite should be true next year. Since our previous forecast, there has been a significant turnaround in energy markets. Wholesale electricity and gas prices have fallen to pre-war levels and, more importantly, have remained there for the past three months. Energy suppliers are already starting to respond, with average household electricity and gas prices falling slightly in February and March. However, most households are still likely to be paying prices at the level of the government caps. In our view, the decline in household energy prices should continue for the rest of the year, but only at a gradual pace. We do not expect a more significant reduction until early next year, when suppliers are most likely to adjust their price lists. Electricity for delivery in about a year's time now costs around EUR/MWh 150 on the wholesale market, while gas costs EUR/MWh 50. The government caps for the market price of electricity and gas are set at CZK/MWh 6,050 and CZK/MWh 3,025, which at the current exchange rate of the koruna is about EUR/MWh 250 and EUR/MWh 125, respectively. Therefore, the wholesale price of electricity is now around 40% lower than the price cap, and gas price 60% lower. Our energy price assumptions, on which the new forecast is based, assume that the average electricity price for final consumer will be around 30% lower yoy in January next year and the average gas price 35% lower. Our assumptions are therefore rather conservative, but at the same time they take into account the fact that the market price of electricity and gas only accounts for part of the final consumer price. Consequently, we have significantly revised our forecast for regulated prices. Whereas in the January forecast we expected an average increase of 37.3% this year and stagnation next year, in the current forecast we foresee an increase of 25.2% for 2023 and a decrease of 9.9% in 2024. Changes in expected energy prices are thus the main factor behind the change in the headline inflation forecast.

Core inflation is likely to only decline slowly as a result of the recovery in demand and faster wage growth, while remaining above 2% this year and next.

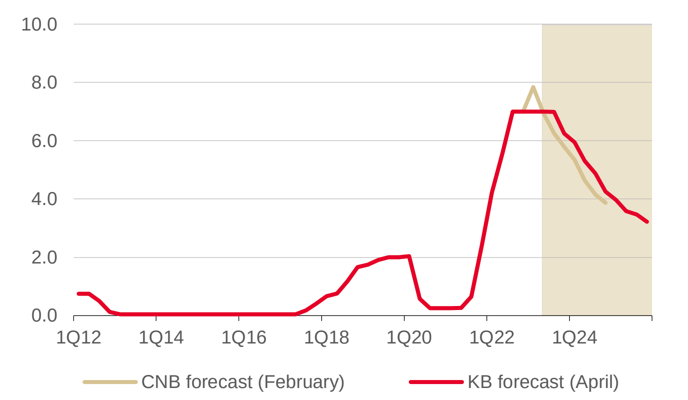
We expect inflation to average 11.8% this year and to slow significantly to 2.0% next year. The estimates for both years are lower than our previous forecast (last time we expected 12.9% for 2023 and 2.5% for 2024). Annual inflation is likely to fall further in the coming months. We expect it to decline slightly below 10% yoy around mid-year, but to remain there in 2H23. While a higher comparative base will push annual inflation down in the first three quarters of this year, the situation will reverse itself in 4Q23. In 4Q22, the consumer price statistics included the introduction of a special energy tariff, which led to a significant drop in electricity prices. This effect will temporarily accelerate the year-on-year increase in regulated prices in 4Q23. At the beginning of next year, however, we expect the aforementioned sharp decline in household energy prices. Headline inflation should therefore fall below 3% yoy in 1Q24 and return to the CNB's 2% target from 2Q24.

Core inflation will subside only very slowly and will remain above 2% this year and next, in our view. In terms of mom dynamics, the decline in core inflation was essentially halted in 1Q23, when seasonally adjusted core inflation hovered around an annualised 7% level. This may have been influenced by the recovery in consumer demand and the acceleration in nominal wage growth that we estimate, as well as by the absence of additional CNB rate hikes in 2H22. At the end of this year, we expect core inflation to fall to 6% yoy (as in the previous forecast), from 11.5% yoy in March. For the full-year outlook, we expect core inflation to reach 8.9% and to fall to an average of 4.6% next year. In our view, the 2% target in terms of mom annualised core inflation will not be reached until 2025. Food price inflation is also likely to be above the CNB's 2% target this year and next.

Inflation expectations remain elevated, despite a slight fall (%)

Source: CNB, Economic & Strategy Research, Komerční banka

CNB repo rate may start to fall in 2H23 (%)



Source: CNB, Economic & Strategy Research, Komerční banka

CNB interest rates to remain higher for longer

In our view, the CNB will keep the repo rate at the current 7% until September this year, when it could start to fall gradually to a policy-neutral level of 3% at the end of 2025. Compared to the previous forecast, we thus expect higher rates for a longer period.

The central bank continued to keep interest rates unchanged in 1Q23. Although we take it as very real that the upside risks to inflation cited by CNB board members will materialise, we nevertheless do not expect further rate hikes. The risks are mainly in regards to the double-digit nominal wage growth associated with the tight labour market and the recovery in household consumption, which, as mentioned above, we believe will hinder the decline in core inflation. However, as these risks materialise, interest rates are likely to remain at current levels for a longer period. 'Higher for longer' interest rates is the key theme to be found in almost all of the statements made by the CNB board recently.

We expect the first cut in CNB rates this September, with a subsequent decline in the key repo rate to 6.25% at end-2023 and to the policy-neutral level of 3% at end-2025. Compared with the January forecast, we have thus slightly postponed the start of the expected reduction in interest rates (we had originally expected the first cut in August). We have also significantly reduced the pace of rate cuts in our forecast. As a result, the policy-neutral level of interest rates has been postponed by one year in our forecast (previously we had estimated 3% at the end of 2024). The main reasons for this are the persistence of core inflation, the acceleration in wage growth, the recovery in demand and the economy as a whole, as well as the continued strong interest rate smoothing tendencies of the current CNB board. Persistently high inflation expectations have also been working in the direction of higher for longer interest rates. According to the latest CNB survey in March, non-financial corporations expect inflation to be 8.9% yoy on a one-year horizon and 6.2% yoy on a three-year horizon. It remains the case that both the timing and the pace of rate cuts are subject to a high degree of uncertainty. This is compounded by the board's reluctance to follow the CNB's staff forecast, which in the past has provided a guide to the future monetary policy stance. Moreover, the CNB board has been relying more on the exchange rate to fight inflation recently, and we expect this to continue for at least the rest of the year. However, the effect of the exchange rate on the economy and prices is much more difficult to predict in the longer term than in the case of interest rates. At the same time, higher interest rates over a longer period of time and the central bank's policy of a strong koruna, which we believe is currently overvalued relative to economic fundamentals, will have a negative impact on the real economy. These are the main reasons we are revising down our forecast for Czech GDP growth in 2024 (from 2.4% to 1.8%).

Fiscal policy

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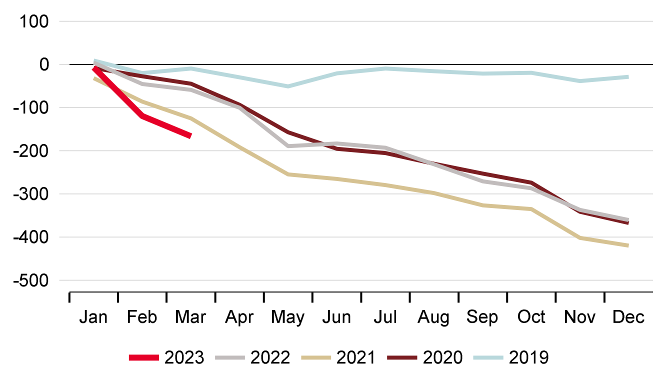
Still in emergency mode

The discrepancy between revenues and expenditures at the level of the state budget has widened again since the beginning of this year, after having eased last year. In our view, this year's deficit is likely to exceed the approved CZK295bn by at least CZK20bn. We expect a gradual reduction in the state budget deficit in the coming years. Starting next year, we expect the general government deficit to return to below 3% of GDP. While overall public debt should continue to rise, elevated inflation is likely to act as a pronounced brake on its increasing relative to nominal gross domestic product, especially this year.

State budget deficit has started to widen again this year

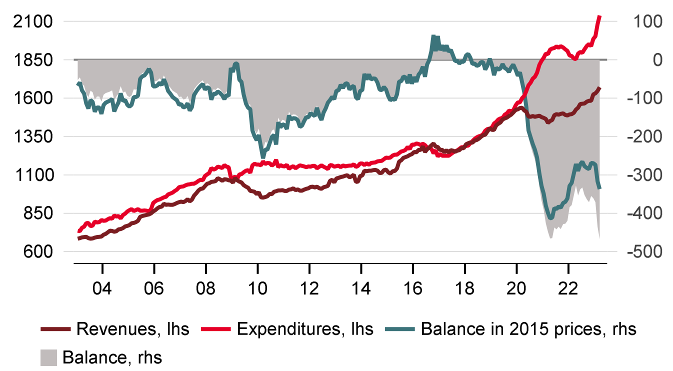
The deficit of CZK166.2bn is the worst ever result at the end of March. While incomes rose by 13% year-on-year in the first quarter, their growth is still lagging inflation. At the same time, the dynamics of spending has gained momentum this year and is significantly outpacing CPI inflation. Also, the cumulative deficit over the last twelve months the deepest ever in March, reaching CZK467.4bn. The trend mismatch between revenues and expenditures is thus comparable to 2021. However, relative to nominal GDP, the state budget deficit is somewhat milder than in the pandemic period, given high inflation.

State budget balance (CZKbn, YTD cumulative)



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

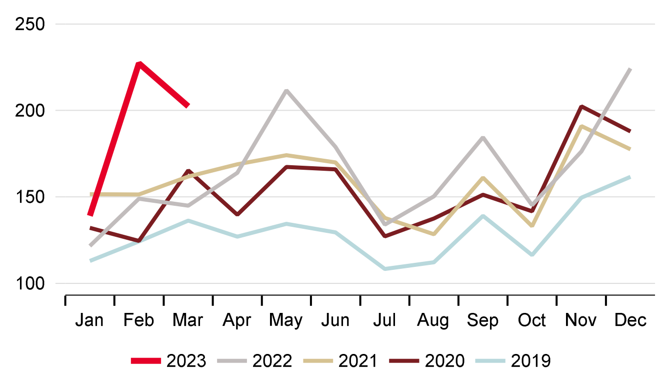
Budget revenues and expenditures (CZKbn, 12m cumulative)



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

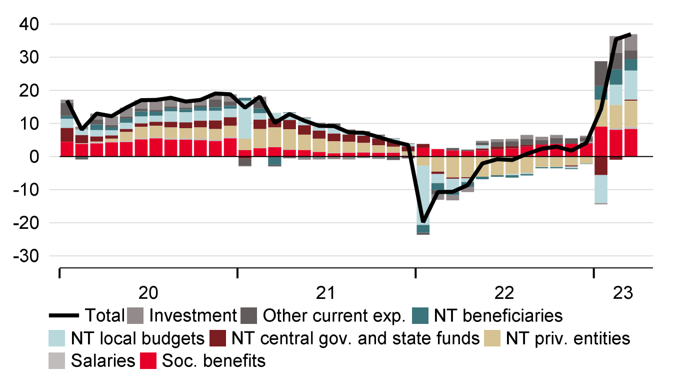
The year-on-year deterioration in the state budget balance of CZK107bn in 1Q23 was mainly due to higher expenditure. It increased by CZK153.3bn (36.9%) compared to last year, mainly due to an increase in social spending, assistance to households and firms in the context of high energy prices, more expensive servicing of the national debt, as well as last year's budget provisioning accompanied by lower pre-financing. Expenditure on social benefits, mainly as a result of pension indexation, increased by 18.7% yoy in the first three months of this year (CZK34.5bn). The additional expenditure has not yet been covered by extraordinary revenues, but this is also related to their time mismatch. So far, CZK8.2bn has been collected in levies on the excess revenues of electricity producers. For the whole year, the Ministry expects that these levies (CZK12.3bn), together with the windfall profits tax (WFT, CZK28bn), should bring a total of CZK40.3bn. Although this is markedly less than the CZK100bn included in the original budget, the lower market prices of energy will not, on the other hand, require such a significant expenditure to compensate households and firms for the price shock. Thus, especially in the second half of the year, the widening of the state budget deficit should be significantly slower than to date.

State budget expenditure (CZKbn, non-cumulative)



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

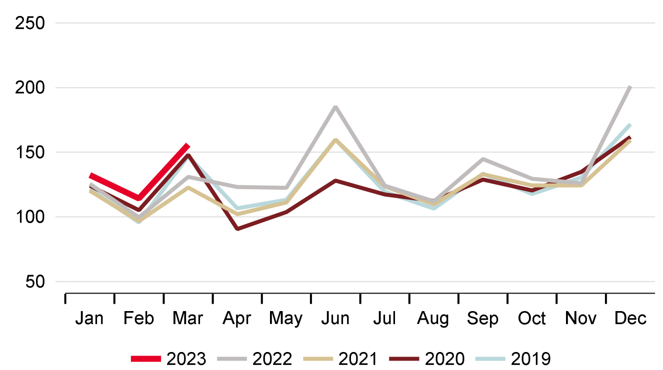
State budget expenditure (%, pp, yoy, YTD cumulative)



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

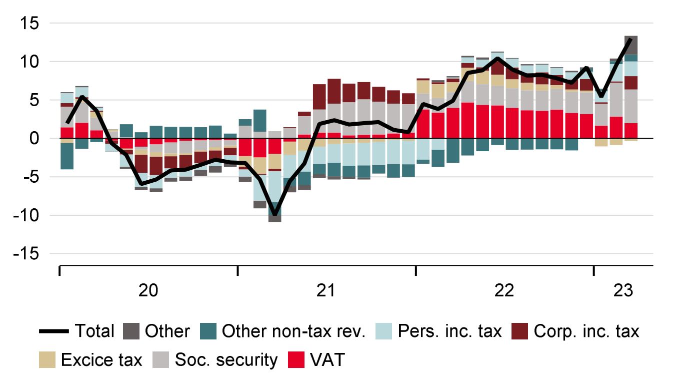
Income growth continues to lag behind inflation. Although total income was CZK46.2bn higher yoy (13.0%) in 1Q, price level growth averaged around 16.5% yoy in 1Q. In our view, the VAT collection (up by 9.7% yoy) shows therefore that real household consumption has remained subdued although we expect it to have risen slightly quarter-on-quarter. On the one hand, this is related to the fall in real wages, which, especially last year and, according to our forecast, on average this year as well, have not been able to keep up with the growth in price levels. Their nominal dynamics did accelerate markedly, however, at the beginning of the year, according to the data from the state budget and monthly indicators. On the other hand, households have seemingly continued to amass significant savings at the beginning of this year. According to the national accounts data, the rate of savings in 4Q22 was roughly double the long-term average.

State budget revenue (CZKbn, non-cumulative)



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

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



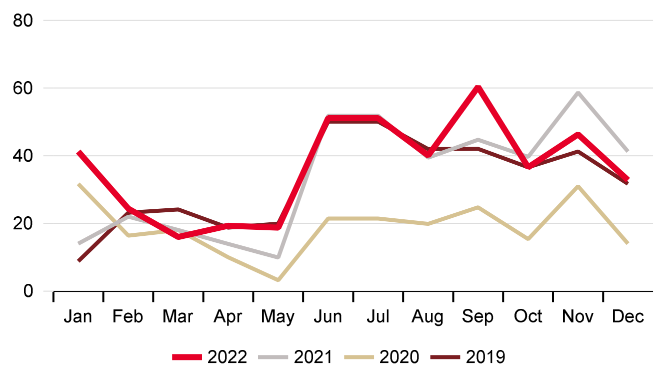
Source: Finance Ministry, Economic & Strategy Research, Komerční banka

This year's state budget deficit is likely to exceed CZK300bn again. Although the approved budget plans for a deficit of CZK295bn, the additional extraordinary indexation of old-age pensions will bring additional expenditure of around CZK15bn, which was not included in the original proposal. Moreover, the dynamics of tax revenues will be weakened this year by the subdued growth in the domestic economy. Overall, we expect a state budget deficit of CZK315bn in the baseline scenario. However, in the context of the aforementioned significant downward revision of expected WFT collections this year, we see a risk of an even deeper deficit.

Municipal surplus narrowed slightly last year

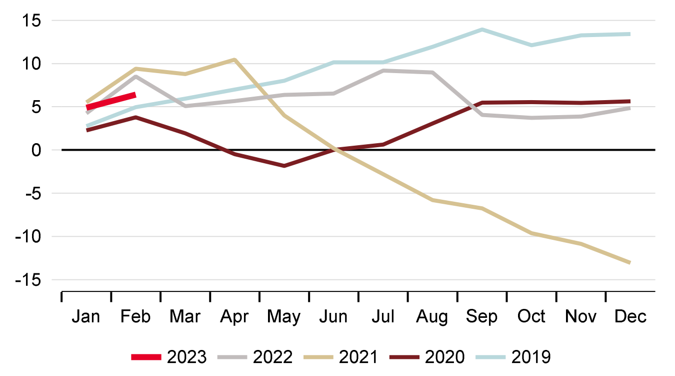
Last year, the budgets of local municipalities operated with a surplus of CZK32.8bn. Although expenditures increased by CZK74.3bn yoy, the balance was only CZK8.6bn lower compared to 2021, as their tax revenues continued to grow, inter alia, as a result of nationally higher VAT collections on the back of high inflation. According to interim data, health insurers are on track for a slightly positive balance this year.

Municipal finances (CZKbn, YTD cumulative)



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

Health insurers' finances (CZKbn, YTD cumulative)



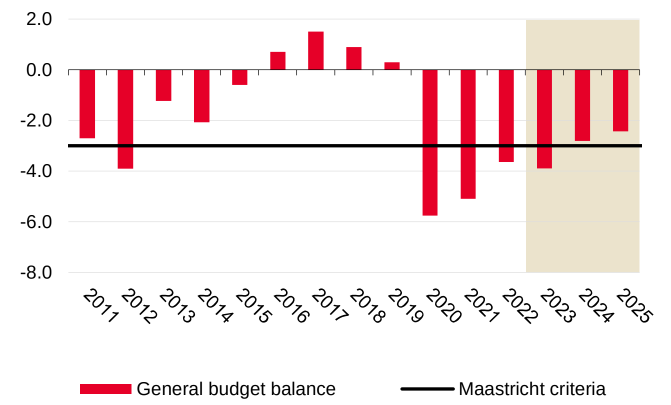
Source: Finance Ministry, Macrobond, Economic & Strategy Research, Komerční banka

Public finance forecasts

	2021	2022	2023f	2024f	2025f	2026f
Balance (% GDP)	-5.1	-3.6	-3.9	-2.8	-2.4	-2.1
Fiscal effort (pp GDP)	-0.8	0.7	0.2	-0.2	0.4	0.3
Public debt (CZKbn)	2566.7	2997.1	3312.1	3572.1	3812.1	4032.1
Debt ratio (% GDP)	42.0	44.1	45.7	46.3	47.1	47.6

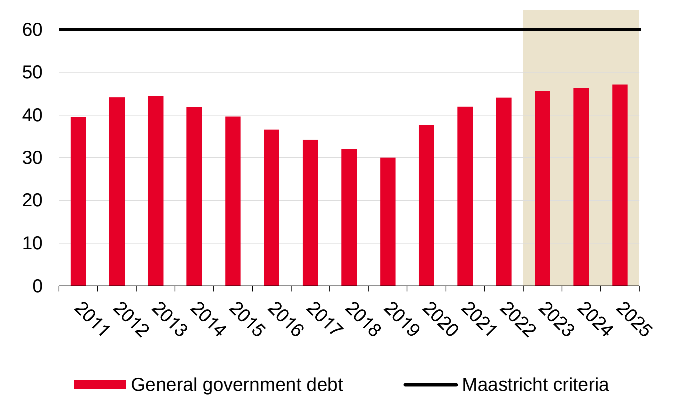
Source: CZSO, Macrobond, MinFin for published data, Economic & Strategy Research, Komerční banka
Note: Fiscal effort is measured as the year-on-year change in the general government balance, adjusted for the economic cycle and one-off operations on GDP in pp.

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 could fall below Maastricht's 3% of GDP in 2024

In our view, this year's public finances will end with a slightly higher deficit relative to GDP than last year. The consolidation of the public finance is likely to be only moderate in the coming years.

We expect the overall general government deficit to reach 3.9% of GDP this year. A more significant increase in the deficit should be prevented by continued buoyant price growth as well as fiscal efforts, reflecting, among other things, attempts to cover additional expenditure with extra revenue. We also expect the traditionally surplus performance of municipalities to continue to support a lower general government deficit this year. We expect that consolidation of public finances should continue in the future amid the threat of a rating downgrade and rising government debt-servicing costs. The government is still determined to reduce the structural deficit, but specific proposals have not yet been discussed, and we thus still expect a state budget deficit of CZK260bn next year. Overall, we believe that this will reduce the public deficit to 2.8% of GDP in 2024. Nominal public sector debt to GDP is set to grow by an average of 0.9pp per year over the period 2023-2026 to reach 47.6% of GDP in 2026. Going forward, however, significant public finance reforms will be needed given that, all else equal, the public finances would start to deteriorate rapidly from the 2030s onwards due to adverse demographic developments.

Summary forecast table

	Q3 22	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23	Q1 24	Q2 24	2022	2023	2024	2025	2026	2027
GDP and its breakdown														
GDP (real, yoy, %)	1.5	0.3	-0.1	0.0	0.8	1.6	1.9	1.8	2.5	0.6	1.8	2.2	2.5	2.4
Household consumption (real, yoy, %)	-5.2	-5.5	-5.0	-4.1	-0.7	3.1	3.9	3.7	-0.9	-1.7	3.3	2.2	2.1	2.4
Government consumption (real, yoy, %)	-1.8	0.9	2.3	2.7	4.2	-0.8	-0.4	-0.4	0.6	2.1	0.3	2.0	1.9	1.8
Fixed investments (real, yoy, %)	7.2	4.6	1.9	2.4	0.4	2.7	4.2	4.8	6.2	1.8	4.9	5.0	4.1	3.4
Net exports (contribution to yoy)	2.7	1.8	2.0	2.3	0.4	-0.1	-0.9	-1.1	0.1	1.2	-0.7	0.1	0.5	0.4
Inventories (contribution to yoy)	-0.1	-0.4	-0.8	-1.3	-0.1	-0.2	0.0	-0.2	1.0	-0.6	-0.4	-0.5	-0.4	-0.2
Monthly data from the real economy														
Foreign trade (CZK bn)	-66.2	-50.7	38.9	1.9	-35.0	-32.0	45.0	27.0	-200.1	-26.3	74.1	126.9	178.2	218.4
Exports (nominal, yoy, %)	22.4	13.6	11.4	7.3	4.6	8.7	10.0	9.1	13.8	8.0	8.5	7.4	6.8	5.9
Imports (nominal, yoy, %)	22.3	15.2	6.5	0.8	1.7	6.8	9.8	7.1	18.6	3.9	6.3	6.5	6.0	5.4
Industrial production (real, yoy, %)	6.1	2.3	1.1	0.7	1.0	4.1	4.9	4.9	2.6	1.7	4.2	3.4	3.9	3.8
Construction output (real, yoy, %)	-0.8	-0.7	-2.1	-1.5	5.2	2.4	2.8	8.1	3.6	1.0	7.8	5.2	2.6	3.3
Retail sales (real, yoy, %)	-7.5	-9.2	-6.6	-3.5	0.2	3.8	4.7	4.6	-3.3	-1.5	3.7	1.3	1.5	2.3
Labour market														
Wages (nominal, yoy, %)	6.2	7.9	9.5	10.1	10.7	11.3	8.4	6.8	6.5	10.4	6.6	5.5	4.3	4.7
Wages (real, yoy, %)	-9.7	-7.0	-5.9	-2.0	1.2	2.6	5.5	4.7	-7.5	-1.0	4.4	3.1	2.3	2.7
Unemployment rate (MLSA, %)	3.4	3.6	3.8	3.7	3.7	3.6	3.9	3.7	3.4	3.7	3.7	3.8	3.9	3.9
Unemployment rate (ILO 15+, %)	2.2	2.2	2.1	2.1	2.1	2.3	2.2	2.1	2.3	2.1	2.2	2.3	2.3	2.3
Employment (ILO 15+, yoy, %)	-1.2	-0.6	1.0	0.7	0.8	0.1	0.1	0.2	-0.5	0.7	0.2	0.1	0.2	0.2
Consumer and producer prices														
CPI Inflation (yoy, %)	17.6	15.8	16.5	12.0	9.3	9.4	2.3	2.0	15.1	11.8	2.0	2.3	1.9	2.0
Taxes (contribution to yoy inflation)	0.1	1.6	0.0	0.2	0.2	0.1	0.1	0.0	0.6	0.1	0.1	0.0	0.0	0.0
Core inflation (yoy, %) (*)	14.5	13.8	11.9	9.5	7.7	6.3	5.5	4.8	13.1	8.9	4.6	2.7	2.2	2.1
Food prices (yoy, %) (*)	15.2	18.7	18.3	13.2	9.2	5.2	2.8	3.2	12.8	11.5	3.0	2.5	1.9	1.6
Fuel prices (yoy, %) (*)	37.3	15.1	-5.0	-16.1	-16.6	-9.6	0.5	-2.2	34.2	-11.8	0.1	-2.0	-2.5	0.2
Regulated prices (yoy, %)	28.1	16.3	32.7	23.4	16.2	28.5	-11.8	-11.1	20.9	25.2	-9.9	1.2	1.8	2.0
Producer prices (yoy, %)	25.9	21.8	15.6	9.7	7.7	6.6	4.1	3.1	24.3	9.9	3.1	1.7	1.2	1.5
Financial variables														
2W Repo (%, average)	7.0	7.0	7.0	7.0	7.0	6.3	5.9	5.3	6.0	6.8	5.1	3.6	3.0	3.0
3M PRIBOR (%, average)	7.3	7.3	7.2	7.3	7.2	6.6	6.2	5.7	6.3	7.1	5.4	3.9	3.3	3.3
EUR/CZK (average)	24.6	24.4	23.8	23.5	23.7	23.8	23.8	23.8	24.6	23.7	23.8	23.7	23.5	23.3
External environment														
GDP in EMU (real, yoy, %)	2.4	1.8	1.6	1.0	0.9	1.2	1.0	0.9	3.6	1.2	0.9	1.3	1.5	1.4
GDP in Germany (real, yoy, %)	1.4	0.9	0.3	0.4	0.2	0.9	1.0	1.0	1.9	0.5	1.0	1.2	1.3	1.3
CPI in EMU (yoy, %)	9.3	9.9	7.9	6.6	5.0	3.0	3.1	2.8	8.4	5.6	2.8	2.6	2.1	1.9
Brent oil price (USD/bbl, average)	107.1	87.6	84.2	105.0	95.0	95.0	90.0	92.5	101.0	94.8	90.9	85.0	80.8	80.9
EUR/USD (quarter eop, year average)	1.01	1.02	1.07	1.10	1.14	1.18	1.15	1.16	1.05	1.12	1.16	1.20	1.24	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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Later and slower rate decline

Domestic market interest rates remained volatile in the first quarter of this year. However, the fall in global yields following the collapse of US banks is almost forgotten in the case of European rates. The entire market interest rate curve remains significantly inverted. The short end of the yield curve should continue to decline gradually in line with the expected start of domestic monetary easing in 2H23, but at a visibly slower pace than in the previous forecast. For longer rates, we see even more limited scope for a significant decline, although we expect some reduction there as well. Conditions for interest rate fixing have improved slightly since the beginning of the year. CZK forwards and lower rates on the euro market still offer an opportunity. CZGBs are unlikely to become significantly more expensive relative to market rates due to the persistently elevated supply. The development of their yields in the coming quarters should therefore be similar to that of market rates.

Czech rates market IRS: shocks in the banking sector almost forgotten

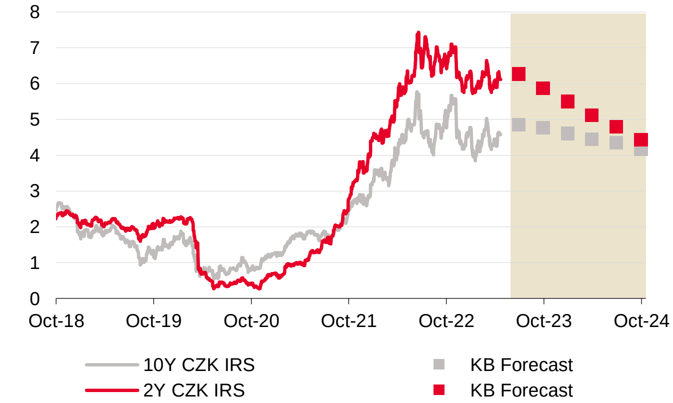
The expected start of the monetary easing cycle by the CNB against a backdrop of increased volatility is gradually lowering interest rates, especially those with shorter maturities. In our view, this should continue. However, the inverted shape of the CZK curve is likely to be maintained not only this year but also for most of 2024.

Market interest rates have remained volatile since the beginning of the year. The initial rise, which reflected the surprising inertia of inflationary pressures and the resilience of the global economy, was more than offset by a reverse movement at the beginning of March, both in our country and especially in the case of US interest rate swaps. This was related to turbulence in the overseas banking sector as well as renewed market fears of a recession. However, as the whole situation calmed down, interest rates in Europe, including the CEE region, went up again, which was further supported by the CNB's hawkish rhetoric on the domestic front. Overall, Czech rates are around 30bp lower than at the beginning of the year, depending on maturity.

The financial markets expect the CNB's repo rate cutting cycle to start in 3Q23. This is also in line with our forecast. We think the CNB could make the first 25bp cut in September. Compared to the previous forecast, we expect a later and more gradual pace of domestic monetary easing. This is mainly due to persistent core inflation and accelerating wage growth, combined with repeated assurances from the CNB that a rate cut is not yet on the table.

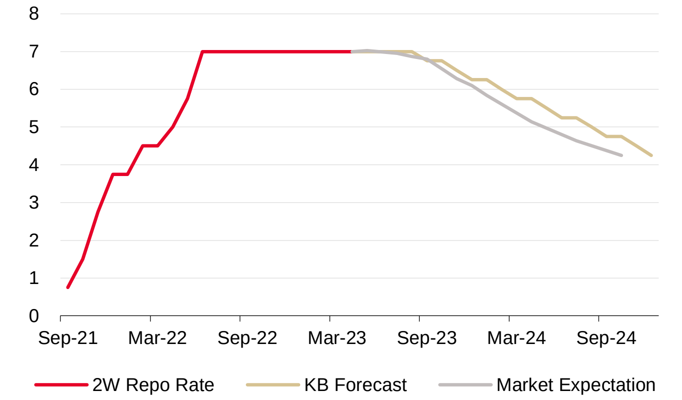
The short end of the market interest rate curve should continue to decline gradually over the medium term, in line with the start of domestic monetary easing in 3Q23. In the short term, however, there may be a slight increase, similar to what we expect for market rates in the euro area and the US. Compared to the market, we believe that the decline in yields will be more gradual, mainly due to our expectation of a later start of monetary policy rate cuts in the US and, in the case of the euro area, a higher ECB terminal rate (more in the *External Environment* chapter). We see more limited scope for a significant decline in domestic longer-term interest rates. Indeed, our forecast assumes that the US economy will not contract this year, while the markets are still pricing in this scenario.

IRS forecast (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Expected CNB key interest rate path as of 25 April 2023 (%)



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

The start of the CNB's rate cutting cycle will help to gradually normalise the shape of the domestic yield curve. However, given the only gradual return of monetary policy rates back to the equilibrium level of 3%, we expect the inverse shape of the curve to be maintained not only throughout this year but also for most of next year. It will only straighten out towards the end of next year, mainly due to the decline in the short end.

CZK IRS outlook (end of period, %)

	2Q23f	3Q23f	4Q23f	1Q24f
2Y	6.25	5.85	5.50	5.10
5Y	5.30	5.10	4.90	4.65
10Y	4.85	4.75	4.60	4.45

Source: Economic & Strategy Research, Komerční banka

Forwards and the euro market still offer hedging opportunity

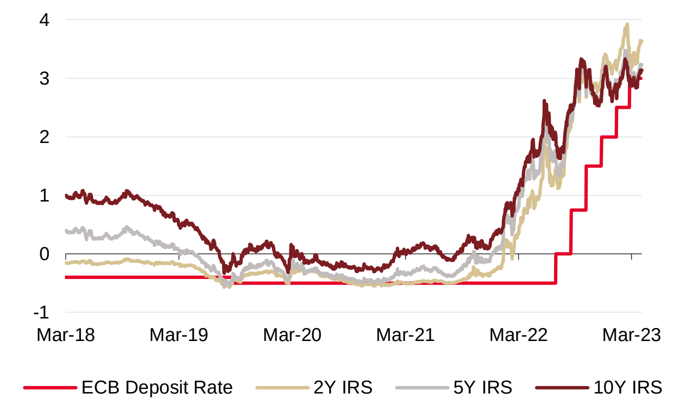
As market interest rates have fallen, rate fixing conditions are starting to improve. However, the persistent inversion of the entire curve is still bringing more favourable conditions to the forward market. Noticeably lower interest rates compared to domestic rates also continue to prevail in the euro market. We expect a further increase in euro swaps in the coming months with the ECB deposit rate to peaking at 4.0% and remaining at this level for an extended period of time. The market, on the other hand, expects the rate to peak at 3.75% and to start declining at the beginning of next year.

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

Forward \ Maturity	1Y	2Y	3Y	5Y	10Y
Spot	6.93	5.94	5.34	4.80	4.38
3M	6.60	5.54	5.05	4.61	4.32
6M	5.98	5.12	4.76	4.43	4.22
9M	5.41	4.76	4.51	4.27	4.14
1Y	4.76	4.41	4.26	4.12	4.06
2Y	4.06	4.00	3.95	3.93	3.97
3Y	3.95	3.89	3.90	3.89	3.99

Source: Bloomberg, Economic & Strategy Research, Komerční banka, as of 25 April 2023

Euro area rates (%)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

MinFin meets objectives, CZGB supply to remain elevated

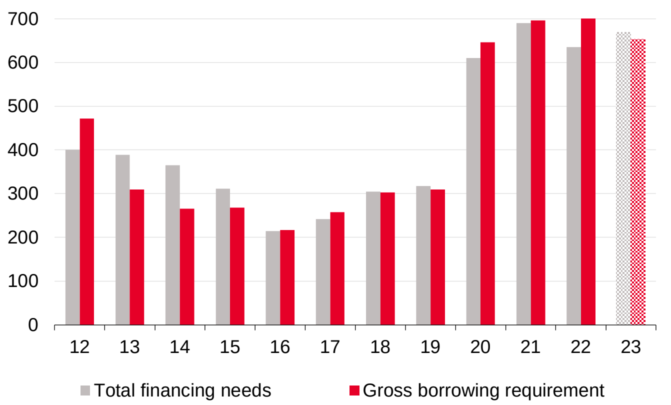
The significant state budget deficit combined with other financing needs will keep the supply of Czech government bonds high for the rest of this year. We expect the state budget deficit to head towards CZK315bn this year, but the risks are skewed towards an even deeper deficit, as we describe in the *Fiscal Policy* chapter. In 1Q23, the Ministry of Finance (MinFin) covered its financing needs not only with primary auctions of domestic government bonds, but also with significant activity in the secondary market. By 19 April, a total of CZK115.7bn worth of bonds had been sold in auctions this year, while the MinFin also carried out (mostly switch) operations on the secondary market in the amount of CZK45.5bn. From this perspective, it is so far succeeding in fulfilling the set plan, which envisages the issuance of CZK400-500bn of CZGBs this year. For 2Q23, the MinFin has set the indicative volume of CZK125.0bn for the offered koruna bonds again. **Overall, we expect the financing needs this year to reach CZK669.0bn (9.2% of GDP) compared to last year's CZK635.6bn (9.4% 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	0.4	0.4
Money market instrument redemptions	149.5	149.5
Redemption of T-bills		0.0
Redemption of other money market instruments		149.5
Repayments on credits and loans	2.6	2.6
Total financing needs	**649.0**	**669.0**
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	474.5
Gross issuance of EUR T-bonds on domestic market/eurobond		56.2
Gross issuance of government savings bonds		10.0
Received credits and loans		33.3
Financial asset and liquidity management		15.0
Total financing sources		**669.0**
Gross borrowing requirement		**654.0**
Net CZGB issuance		**274.3**

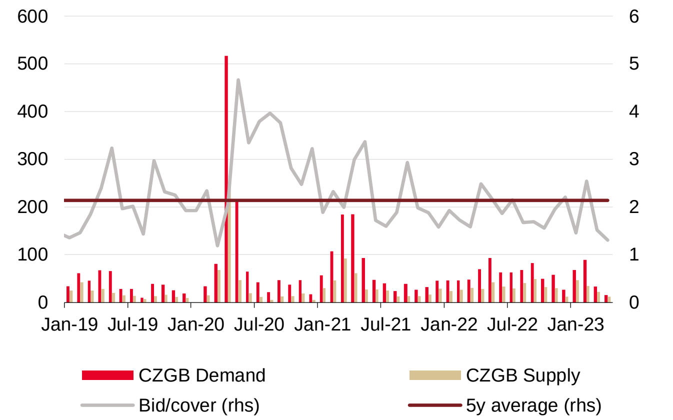
Source: Economic and Strategy Research, Komerční banka, MinFin

Financing needs (CZKbn)



Source: Economic and Strategy Research, Komerční banka, MFCR

CZGB primary market (CZKbn)



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

CZGB yield forecast (end of period)

	2Q23f	3Q23f	4Q23f	1Q24f
2y CZGB yield (%)	5.65	5.30	5.00	4.80
4y CZGB yield (%)	5.45	5.20	4.95	4.70
10y CZGB yield (%)	5.05	4.95	4.80	4.65
10y CZGB ASW (bp)	20	20	20	20

Source: Economic & Strategy Research, Komerční banka

Yields on longer CZGBs will probably fall more visibly only in 2024

Similar to the IRS, government bond yields are lower than at the beginning of the year. However, the reduction in yields was slightly less pronounced for CZGBs than for the IRS curve. Thus, in ASW terms, CZGBs at shorter maturities have become relatively cheaper by about 10bp. Given the increased supply, we expect that for longer maturities (5-10 years), the richening of bonds in ASW terms will progress only gradually from the currently elevated levels towards a long-term equilibrium. Thus, the evolution of their yields should largely follow market interest rates, which (as described above) will slowly decline. Conversely, shorter bonds (2y) are currently slightly more expensive relative to the IRS compared to long-term levels in ASW terms, and so may in turn become relatively cheaper. However, the main trend in shorter maturity bond yields will also be similar to that of market rates, i.e. a continuation of the gradual downward trend.

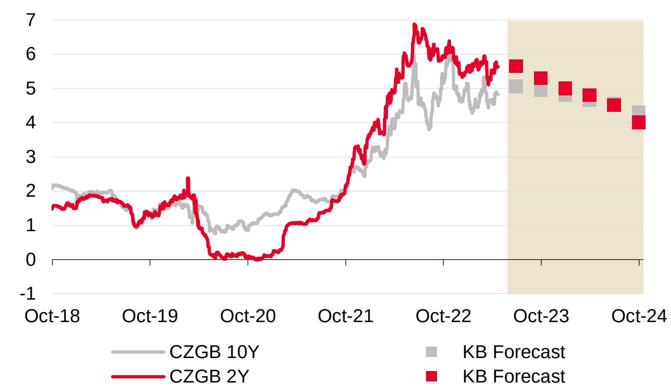
We do not expect a rating downgrade and a related increase in the risk premium in the baseline scenario. In early March, Fitch affirmed the Czech Republic's current rating and its negative outlook. According to the agency, a downgrade could be triggered by a possible lack of fiscal consolidation (a continued increase in public debt to GDP) and/or a persistence of inflation at high levels. In April, the Czech Republic's rating, including its stable outlook, was confirmed by S&P. After last year's threat of an energy crisis, which did not materialise, the health of domestic public finances is now the focus of attention of the rating agencies. However, given its good starting position in the form of a relatively low absolute debt-to-GDP ratio, even with a moderate pace of consolidation, the Czech Republic's rating may not be downgraded, in our view, for the time being.

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	26 May 2023
Fitch	AA-	NEGATIVE	AA-	NEGATIVE	25 August 2023

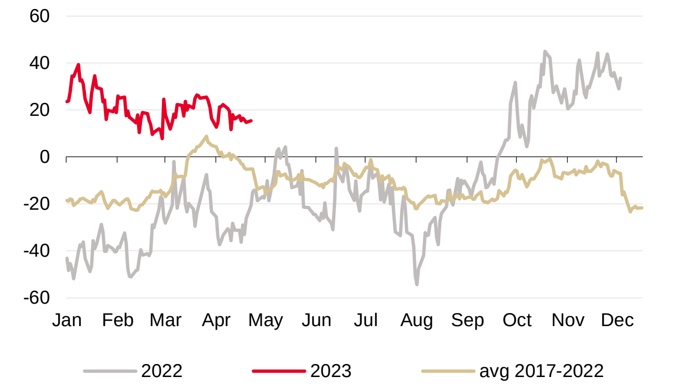
Source: Economic and Strategy Research, Komerční banka, Bloomberg

CZGB yield forecast (%)



Source: Economic and Strategy Research, Komerční banka, Bloomberg

10y CZGB ASW (bp)



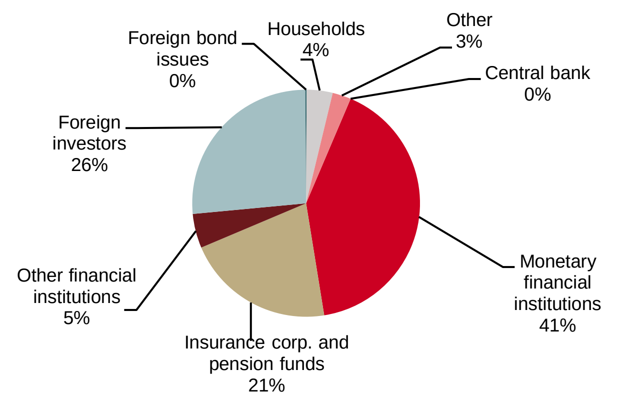
Source: Economic and Strategy Research, Komerční banka, Bloomberg

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
0.45 Oct-23	0.5	0.0	80%	6.09	2	60	2.80	-117	13	71	-245		-10	-0.5	12	-12.3	1	-118.5	21
5.70 May-24	1.0	0.0	100%	5.63	-5	34	2.87	-136	-1	15	-160		-103	-0.3	9	8.5	19	-64.9	20
0.00 Dec-24	1.5	0.0	34%	5.59	-4	43	3.47	-77	9	22	-106		-52	0.2	3	-8.1	2	-33.3	19
1.25 Feb-25	1.7	0.0	100%	5.32	-17	27	3.27	-86	4	8	-99		-47	-0.8	15	13.0	21	-32.4	18
2.40 Sep-25	2.2	0.0	88%	5.31	-14	28	3.45	-42	6	7	-75		6	0.2	4	-3.8	6	-23.3	17
6.00 Feb-26	2.5	0.0	67%	5.05	-24	25	3.33	-45	2	12	-70		-21	0.2	2	9.4	20	-18.5	16
1.00 Jun-26	3.0	0.0	100%	5.04	-15	24	3.40	-28	4	9	-47		-6	0.0	6	3.1	16	-16.2	14
0.25 Feb-27	3.6	3.0	91%	4.94	-22	20	3.41	-17	1	5	-33		10	-0.4	11	0.4	13	-14.2	13
2.50 Aug-28	4.7	0.0	94%	4.77	-28	12	3.35	-6	0	2	-18		20	-0.7	14	-1.7	10	-6.3	11
5.50 Dec-28	4.6	16.2	77%	4.76	-26	20	3.39	-3	-2	6	-24		19	0.4	1	-3.6	7	-16.4	15
2.75 Jul-29	5.4	0.0	101%	4.72	-27	11	3.36	0	-1	1	-10		28	-0.8	16	-3.2	8	-3.1	4
0.05 Nov-29	6.3	0.0	58%	4.72	-27	10	3.36	3	-1	0	-3		30	-1.5	20	-4.4	3	0.4	1
0.95 May-30	6.5	0.0	100%	4.71	-26	11	3.36	5	-1	-1	-2		31	-1.2	17	-4.0	5	-1.4	3
5.00 Sep-30	5.9	33.8	87%	4.66	-23	13	3.36	4	0	-1	-9		29	-0.1	7	0.5	14	-4.4	7
1.20 Mar-31	7.2	0.0	100%	4.68	-24	12	3.36	6	-2	-2	2		33	-1.4	19	-2.0	9	-4.1	5
1.75 Jun-32	7.9	4.1	102%	4.64	-14	13	3.36	9	1	-6	1		30	-0.6	13	3.1	17	-6.1	10
2.00 Oct-33	8.9	0.0	100%	4.68	-12	15	3.44	15	2	-5	6		55	-0.3	10	1.9	15	-7.2	12
3.50 May-35	9.1	5.1	42%	4.62	-14	9	3.50	16	2	-8	3		38	-0.2	8	7.2	18	-5.1	9
4.20 Dec-36	9.9	0.0	100%	4.66	-13	12	3.61	22	4	-5	3		43	0.1	5	-4.0	4	-5.0	8
1.95 Jul-37	11.5	10.4	37%	4.57	-14	5	3.49	8	2	-10	0		44	-1.3	18	-1.6	11	-4.1	6
1.50 Apr-40	13.9	2.9	45%	4.67	-15	8	3.54	13	1	-6	8		47	-1.7	21	0.0	12	0.0	2

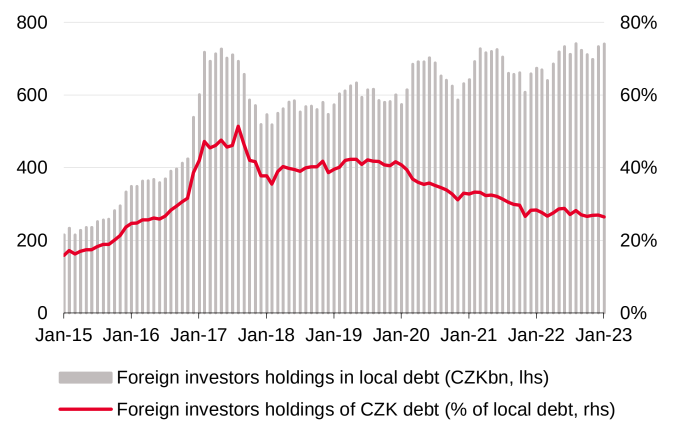
Source: Economic & Strategy Research, Komerční banka; Note: More details in CZGB Auction Alerts

Holdings of CZK government debt (February 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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The strengthening trend in the koruna is running out of steam

The continued return of investors to the Central European region and the recovery in foreign trade in the first quarter of this year have helped lift the koruna to stronger levels. The CNB continues to keep a protective hand over the domestic currency. However, it has not had to intervene since last November and still has substantial foreign exchange reserves. Nevertheless, we do not expect the strengthening trend in the koruna to continue, especially in the context of further narrowing of the interest rate differential and the tangible real appreciation so far. We expect it to weaken slightly to EURCZK 23.80 over the next 12 months.

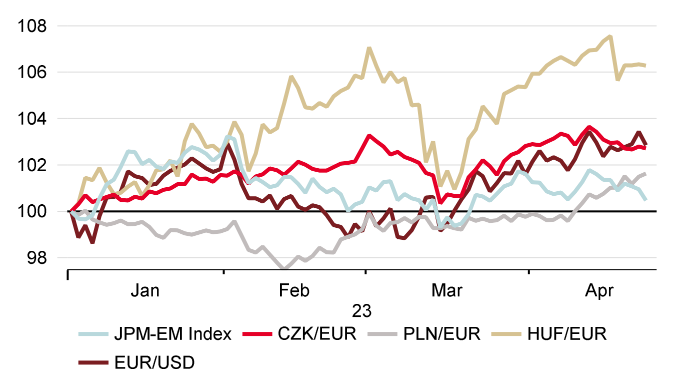
CE currencies have further strengthened their positions this year

Both the HUF and the CZK strengthened even more against the EUR than the EUR did against the USD in 1Q23. The positive sentiment stemmed in part from lower energy-commodity prices on the markets, in the context of a relatively warm winter, new alternative sources and energy savings. In addition, the recession in Europe is starting to look less imminent, according to the latest data. Investors, who for most of last year mainly preferred the US dollar as a 'safe haven', have started to return to emerging market currencies, including those of central Europe.

CZK exchange rates

Source: Bloomberg, Economic and Strategy Research, Komerční banka

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

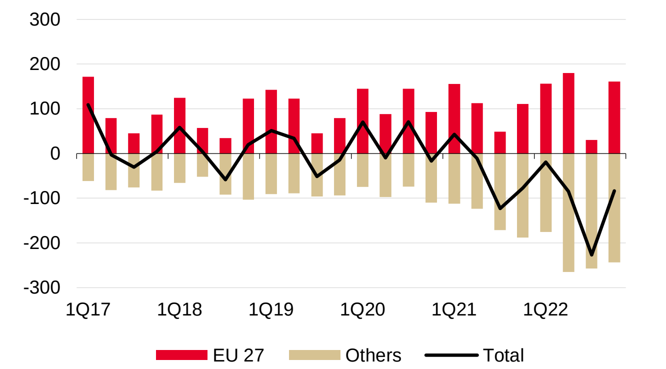


Source: Bloomberg, Economic and Strategy Research, Komerční banka
A value above 100 indicates an appreciation of the CZK, PLN or HUF against the EUR, or an appreciation of the EUR against the USD from 1 January 2023.

The koruna is also supported by foreign trade, which is gradually recovering as supply chain constraints ease. This can be seen in the significant surplus on trade in goods with the euro area, which continued to grow in January and February in nominal terms. The current account of the balance of payments in 1Q itself turned into a surplus for the first time in two years, according to data for the first two months of the year (but remained in deficit in 1Q23 after seasonal adjustment). The recovery in trade with the euro area is thus starting to more than offset imports of commodities from other countries, the prices of which have already fallen significantly.

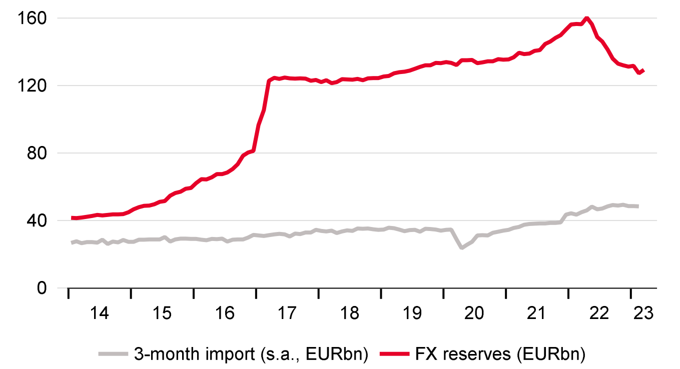
The CNB also still has a protective hand over the koruna. However, it has not had to intervene to support the koruna since last November. At the end of March this year, the CNB's foreign exchange reserves stood at EUR129.3bn, or just under 50% of GDP. This level, combined with the easing of depreciation pressures, gives the central bank room to continue its current policy. In general, the CNB's stated commitment to preventing "excessive fluctuations in 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

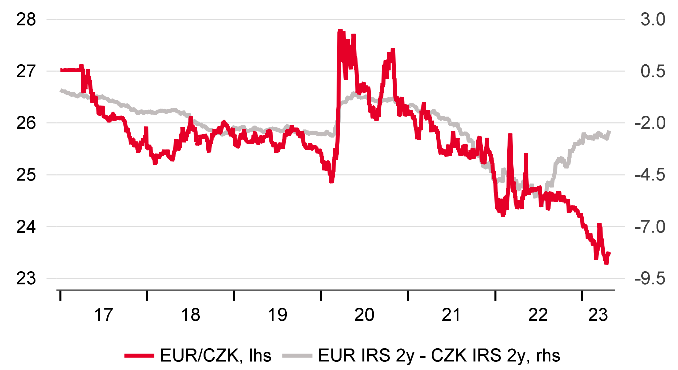


Source: CNB, Macrobond, Economic and Strategy Research, Komerční banka

We have revised up our forecast for the koruna exchange rate to stronger levels, mainly due to more positive developments in foreign trade. With the decline in the interest rate differential, we expect the koruna to weaken to EURCZK 23.80 over the next 12 months.

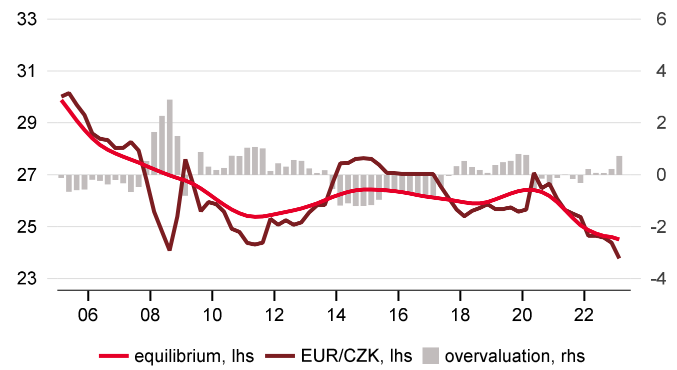
The interest rate differential is not very supportive of further koruna appreciation. The differential between two-year market interest rates in the Czech Republic and the euro area has already fallen by more than half from its peak in July last year amid monetary policy tightening abroad and a dove-like turnaround in the CNB Board, although the currency did not fall further during 1Q. We expect, however, that the differential may narrow a little more. Indeed, we expect the ECB deposit rate to rise from the current 3% to 4% out to September and then stay there for an extended period. The market, on the other hand, expects the terminal rate to peak at around 3.7% and to start falling as early as the turn of this year and next year. Over the past year, the koruna has also appreciated considerably in real terms, with the price level measured by the GDP deflator and the CPI index rising noticeably faster in the Czech Republic than in the euro area. This may also exhaust the potential for nominal appreciation in the future. Our equilibrium model also continues to indicate persistent fundamental overvaluation of the koruna against the euro.[1]

EUR/CZK and interest rate differential



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Equilibrium EUR/CZK exchange rate



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

The depreciations pressures on the koruna will be partly offset by US dollar weakening and an improving external trade balance. The dollar could move to EURUSD 1.18 by the end of this year, according to our forecasts. The recovery in foreign trade should also continue this year, supported by the reopening of the Chinese economy. Moreover,

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[1] 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.

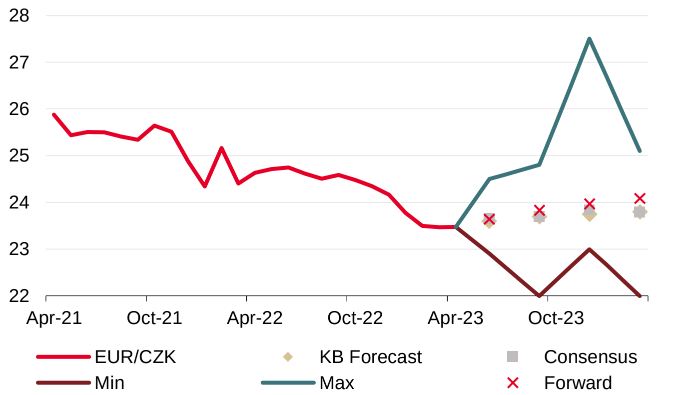
slowing domestic inflation could contribute to closing the domestic economy's inflation gap vs the euro area. We expect the CNB's still-substantial foreign exchange reserves to act in the same direction. **Overall, we think the depreciation tendency will prevail slightly in any case, resulting in the koruna weakening towards EURCZK 23.80 over the next 12 months.**

Koruna exchange rate forecast (end of period)

	2Q23f	3Q23f	4Q23f	1Q24f
EUR/CZK	23.60	23.70	23.75	23.80
USD/CZK	21.45	20.80	20.15	20.70
EUR/USD	1.10	1.14	1.18	1.15

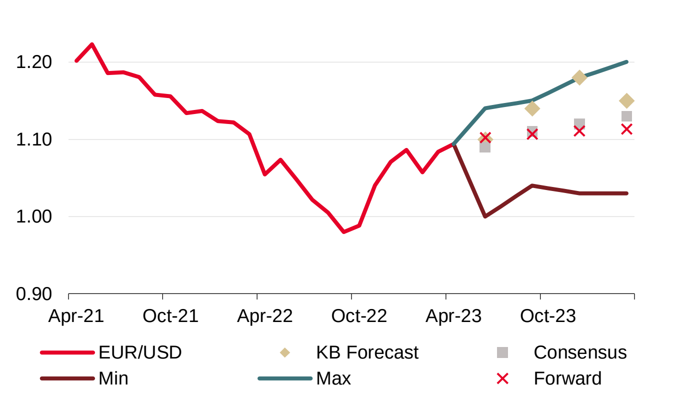
Source: Economic and Strategy Research, Komerční banka, SG Cross Asset Research

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



Source: Bloomberg, Economic and Strategy Research, Komerční banka

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

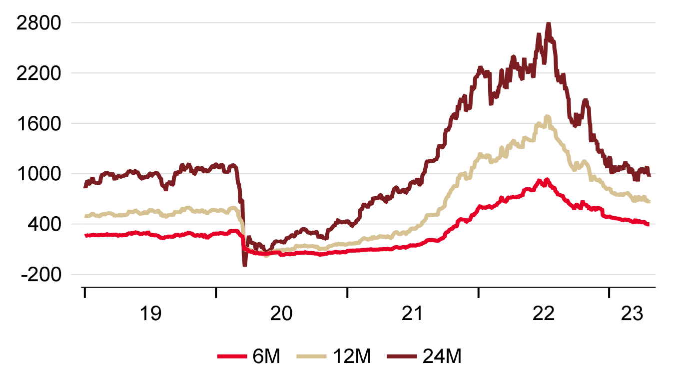


Source: Bloomberg, Economic and Strategy Research, Komerční banka, SG Cross Asset Research

Risks to the outlook for the koruna remain considerable

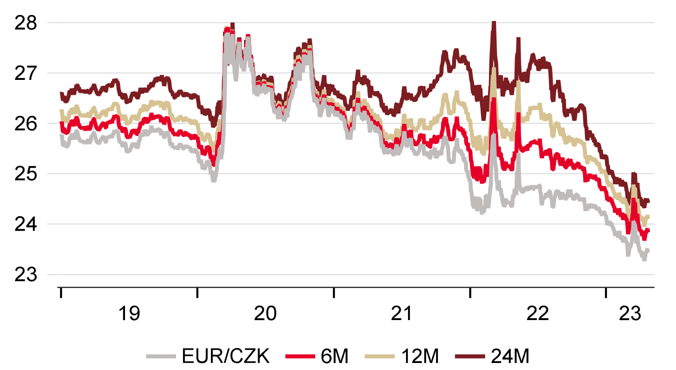
The general risk, particularly for the second half of this year, remains a possible return of energy-shortage problems. This could again put pressure on Central European currencies. In the opposite direction, faster disinflation and a stronger recovery in foreign trade represent upside risks. External developments also remain highly uncertain, with regard to the depth of a possible recession in the US and the US dollar trend, the speed of monetary tightening and the level of the Fed and ECB terminal interest rates. There could also be increased volatility on the back of a possible public exit from the current intervention regime by the CNB.

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

The strengthening of the CZK has worsened hedging conditions for exporters

Forward EURCZK also firmed in the context of the strengthening spot rate. We expect market interest rates in the euro area to rise further in the coming months. The interest rate differential may thus narrow slightly more. This would largely offset the slight weakening of the spot exchange rate. In our view, there is not therefore much room for forward rates to further appreciate significantly in the medium term. In the short term, however, the risk of continued strengthening cannot be ruled out.

Banking sector

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Credit contraction to be followed by only sluggish recovery

Lending activity of non-financial corporations should continue to slow markedly. The gradual take-off of the domestic economy and the continued effect of both domestic and external monetary tightening should contribute to the slowdown in credit activity. A modest correction in residential property prices is likely to continue for the rest of the year, although the mortgage market is likely to remain fairly muted this year given high interest rates. Consumer finance should be similarly affected, although a gradual recovery in consumer demand is set to offer a modest boost. Higher appreciation of savings and deferred investment should in turn support a strong deposit expansion, outpacing credit growth. The reverberations of tighter monetary policy and a gradual recovery of economic growth are likely to result in only a modest increase in the share of non-performing loans.

Slow unfreezing of the mortgage market and a mild correction in real estate

Mortgage lending likely to remain sluggish this year. This year's price correction of residential real estate is set to be only mild.

The cooling of the residential real estate market continued. In 1Q23, flats' offer prices fell by 1.5% qoq (SA), while realised prices of (second-hand) flats – published with a delay – had already recorded a decline (-0.6% qoq) in the preceding quarter. On a yoy basis, however, offer prices are still 9.8% higher. We expect the cooling of the property market to continue for the rest of the year. However, it should be only a modest price correction of up to about 6%, which is likely to be concentrated in the lower segment of housing, together with energy-intensive and recreational properties. The slight decline in property prices, together with the solid wage dynamics we estimate for this year, should significantly improve housing affordability in Czechia, which still has one of the lowest levels of housing affordability among EU and OECD countries, largely on the back of sharp price increases over the last two years.

Bank loans and deposits (% yoy)

	Q3 22	Q4 22	Q1 23	Q2 23	Q3 23	Q4 23	Q1 24	Q2 24	2022	2023	2024	2025	2026	2027
Bank loans														
Total	7.6	5.8	5.7	6.0	5.1	5.1	5.4	5.5	**6.2**	**5.5**	**6.2**	**7.2**	**6.1**	**5.5**
Households - real estate loans	6.8	4.8	3.7	5.1	4.9	5.1	5.1	4.6	**7.9**	**4.7**	**5.6**	**7.0**	**5.9**	**5.0**
Households - consumer loans	6.0	7.3	6.1	7.9	7.5	5.7	5.3	4.8	**7.3**	**6.8**	**5.5**	**6.9**	**6.9**	**6.1**
Corporate loans	7.9	4.0	3.2	4.1	2.6	4.7	4.8	5.5	**6.8**	**3.6**	**6.3**	**7.8**	**6.5**	**6.0**
Deposits														
Total	7.9	6.5	9.2	6.6	6.7	7.7	4.3	5.0	**6.8**	**7.5**	**5.1**	**5.2**	**4.6**	**4.5**
Households	3.6	5.1	5.9	6.4	6.4	6.5	6.5	6.3	**4.2**	**6.3**	**6.4**	**5.9**	**4.9**	**4.6**
Non-financial corporations	11.1	4.4	9.2	9.3	5.5	8.0	2.4	5.2	**7.3**	**8.0**	**4.5**	**3.5**	**3.5**	**3.9**
Others	13.1	12.2	14.6	5.0	8.1	10.2	2.1	2.7	**11.7**	**9.5**	**3.2**	**5.3**	**4.9**	**5.0**
Ratios														
Loans/GDP	61.5	59.9	60.0	59.6	60.0	59.0	59.2	59.0	**61.4**	**59.7**	**59.4**	**60.5**	**61.2**	**61.7**
Deposits/GDP	97.1	86.2	97.4	96.0	96.2	87.0	95.2	94.5	**95.1**	**94.2**	**92.7**	**92.7**	**92.5**	**92.4**
Loans/deposits	63.3	69.5	61.6	62.1	62.4	67.8	62.2	62.4	**64.7**	**63.5**	**64.1**	**65.3**	**66.3**	**66.9**
Interest rates														
Real estate loans	4.9	4.9	5.1	5.1	5.1	4.9	4.8	4.7	**4.5**	**5.0**	**4.7**	**4.3**	**4.2**	**4.2**
Consumer loans	9.7	9.7	9.8	10.0	10.1	10.2	10.0	9.9	**9.1**	**10.0**	**9.7**	**8.9**	**8.6**	**8.8**
Corporate loans	8.4	9.0	8.7	8.8	8.8	8.2	7.7	7.2	**7.9**	**8.6**	**6.9**	**5.3**	**4.7**	**4.7**
Share of NPL														
Real estate loans	0.7	0.7	0.7	0.9	1.0	1.0	1.1	1.2	**0.7**	**0.9**	**1.2**	**1.4**	**1.6**	**1.8**
Consumer loans	4.0	3.9	4.0	4.8	5.5	5.8	6.0	6.4	**4.1**	**5.0**	**6.6**	**7.6**	**8.0**	**8.5**
Corporate loans	3.3	3.4	3.3	3.4	3.4	3.5	3.5	3.6	**3.5**	**3.4**	**3.8**	**4.4**	**4.4**	**4.6**

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

New mortgage volumes rose at the start of the year. However, the stock of loans continues to be affected by the drawdown of previously contracted mortgages with more favourable terms. Overall, mortgage lending activity is likely to remain subdued this year. Following last year's average growth of 7.9%, we estimate the mortgage market to expand by 4.7% this year, including a significant contribution from the re-inclusion of Sberbank's portfolio.[2] With a gradual decline in interest rates and the support of this year's solid wage growth, a more significant rebound in mortgages is likely to occur only next year (5.6%), we estimate.

Gradual recovery in household consumption to slightly boost consumer credit

Consumer credit is set to remain muted in 1H23, while 2H23 is likely to be boosted by the pick-up in consumer demand.

We expect the subdued growth in consumer credit to continue in 1H23 owing to only a modest recovery in consumer demand and a high savings build-up. With a gradually strengthening recovery in the latter half of the year, driven by strong wage growth, albeit with a substantial savings cushion built up, consumer loans are likely to pick up modestly. However, indebtedness – ratio of consumer loans to GDP – is unlikely to rise, given the substantial amount of own funds in the form of savings and the high interest rate environment.

Significant cooling of credit activity of non-financial corporations

The lower need for working capital and tighter monetary conditions are likely to limit the lending activity of non-financial firms this year.

Last year's credit activity of non-financial corporates (NFC) was significantly boosted by the need for operational financing due to supply chain issues and the substitution of koruna and euro loans. However, against the backdrop of ebbing supply chain problems, a significant easing of inflationary pressures in the production sectors and tighter monetary policy – both domestic and abroad – these factors are fading. That should largely drive the slowdown in NFC credit growth this year. NFC indebtedness is thus expected to continue declining, similar to last year – when NFC profit margins grew – despite strong lending activity. Given the interest rate differential, albeit gradually narrowing, foreign currency financing – currently accounting for 46% of all NFC loans – should remain fairly appealing and thus slightly support lending activity this year, albeit substantially less so compared to last year. Following last year's growth of 6.8%, we estimate a marked slowdown to 3.6% this year.

High savings and deferred investment to support deposit expansion this year

Deposit growth will outpace credit growth this year as well.

The continued high savings rate, supported by solid disposable income growth, paired with a slight recovery in consumer demand, should support the expansion of household deposits, which we estimate to grow by 6.3% this year. However, increased personal expenditures and an outflow of funds to non-banking solutions in search of better yield on substantial savings is set to act in the opposite direction. The solid financial health of NFC, deferred investment and higher appreciation of funds due to high interest rates should also have a positive impact on overall deposit growth. We estimate deposits to grow 7.5% this year, following last year's 6.8% growth, well above the rate of credit growth.

Loan portfolio of domestic banks to see only a mild increase in risk

Only a modest increase in the share of non-performing loans.

We are yet to observe a rise in the share of non-performing loans (NPL) across sectors. NPL shares continue to hover near historical lows. Tighter credit conditions should, however, cause a delayed increase in the risk level of loan portfolios, although it is likely to be only a modest increase given the still-sizable cushion of household savings and sound NFC balance sheets. The higher volume of foreign currency loans taken out last year and the higher volume of mortgage refixations expected to occur this year are risks to the upside. Nevertheless, these should not pose a significant problem for the domestic banking sector, as we also show in the Box below.

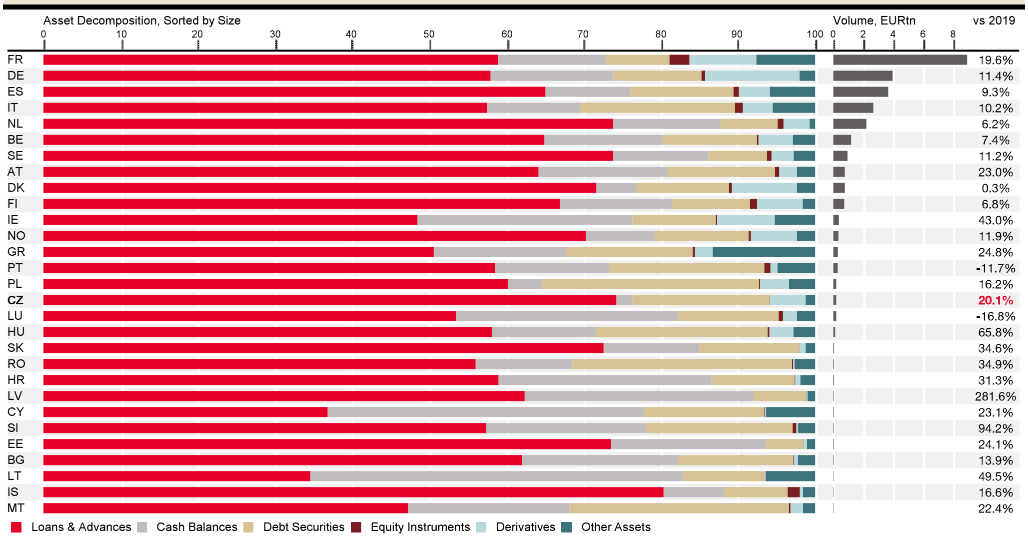
[2] We estimate that the re-inclusion of Sberbank's portfolio, expected in 2Q23, should lift both the stock of housing and consumer loans by 1.5% qoq and 0.8% qoq in the case of total business loans.

Box: Czech banking sector provides an anchor to wider financial sector

In the following box, we examine the state of the domestic banking sector in light of recent turbulence abroad. The recent turbulence in the financial markets was first ignited by the collapse of several US banks, notably Silicon Valley Bank (SVB), which was primarily caused by deposit outflows. The European banking sector was not spared either. The prompt intervention of regulators prevented the imminent collapse of the systemically important Swiss bank Credit Suisse. These events spread significant unease in the banking sector and raised concerns regarding financial stability. However, as shown below, these concerns are diluted within the context of the Czech banking sector, which is in a good position to withstand any further turbulence.

One of the key characteristics of Czech banks is a relatively conservative business model. The client loan portfolio accounts for more than 46% of assets on the consolidated balance sheet of domestic banks.[3] Nearly 39% are mortgage loans alone, while the share of secured loans likely to be even higher, partly also owing to the significant exposure to the property development sector. Moreover, the relatively stable asset side is backed by a relatively low funding risk. The conservative portfolio is largely supported by a diversified base of client deposits. The loan-to-deposit ratio stands at just under 62%, up about 7pp from two years ago, mainly due to the declining leverage of non-financial corporates.

Czech banks have a conservative asset base, with the loan book comprising one of the largest shares among European banks



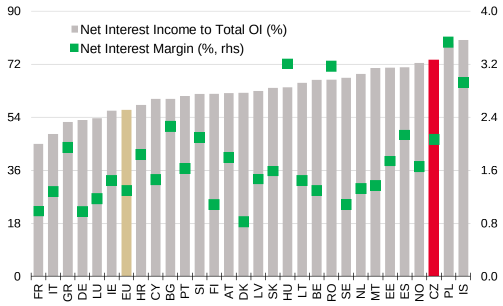
Source: EBA, CNB, Economic & Strategy Research, Komerční banka
Note: Loans & Advances includes loans and claims where the counterparty is a central bank. In the case of Czech Republic, it is largely influenced by the large liquidity deposited with the central bank.

Not only do Czech banks enjoy a fairly stable source of income, but on a comparatively low-risk portfolio, they are able to generate above-average returns compared to European peers. Their more conservative approach is exhibited by one of the highest shares of net interest income in total operating income, at 74% vs the EU median of 64%. Relative to the average asset base, the profitability of domestic banks is one of the highest in Europe.[4]

[3] Including loans and claims with the counterparty of another credit institution, e.g., including interbank loans.

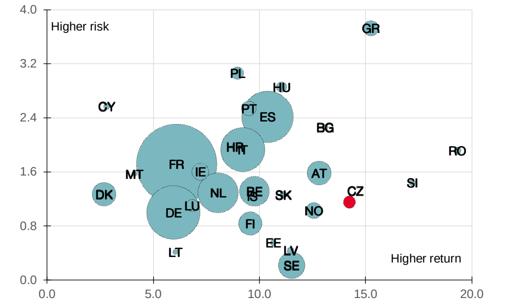
[4] Comparisons are made with respect to countries in the European Economic Area (EEA), which fall under the regulatory supervision of the European Banking Authority (EBA).

One of largest shares of NII* (4Q22)



Source: EBA, CNB, Economic & Strategy Research, Komerční banka
*NII = net interest income

Highly profitable banking sector (ROE x NPE)

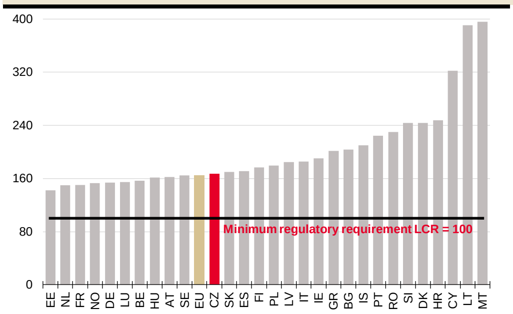


Source: EBA, Economic & Strategy Research, Komerční banka
Note: the size of the markers refers to the size of the banking sector. NPE (non-performing exposures, %) on x-axis and ROE (return on equity, %) on y-axis.

Despite a shallow recession at the end of last year and interest rates remaining at relatively high levels, there has been no significant deterioration in the health of the loan portfolio so far. The non-performing loans (NPL) ratio still hovers near historical lows across segments. However, the above-mentioned factors ought to have a traditionally lagged impact on the rise, albeit only modest, in the NPL ratios.

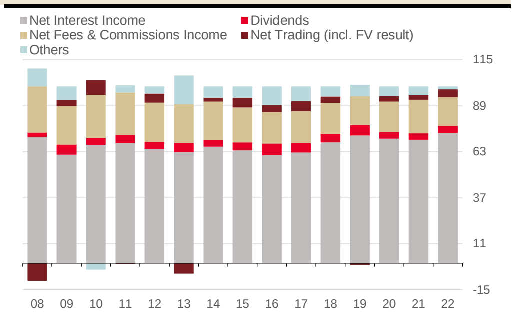
The risk of potential deposit outflows is also mitigated by the strong liquidity of domestic banks, which are comfortably compliant with regulatory requirements. The liquidity coverage ratio (LCR) – the ratio of high-quality liquid assets (HQLA) to simulated outflows over a 30-day stress period – is roughly at the average of other European banks and well above the regulatory minimum. In addition, domestic banks have significant funds deposited with central banks – as of February 2023, the volume of exposure to central banks amounted to 27% (CZK2.6tn) of total assets. The bond portfolio (held to maturity) also does not pose a significant risk with respect to its revaluation. Although their share of assets has increased by almost 7pp over the last two years, the effect of their revaluation on regulatory capital is only small.

Liquidity coverage ratio (LCR, %, 4Q22)



Source: EBA, Economic & Strategy Research, Komerční banka

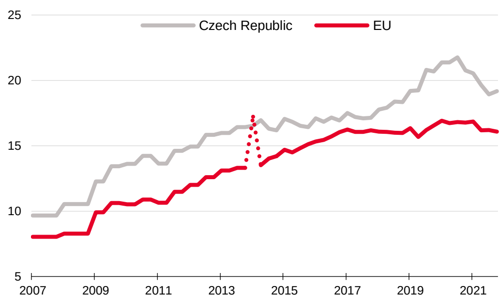
Decomposition of net operating income (%)



Source: CNB, Economic & Strategy Research, Komerční banka
Note: FV = fair value

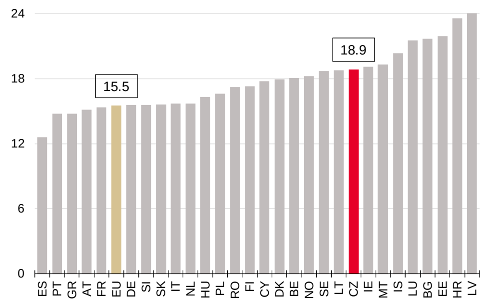
Since the 2008 financial crisis, the regulatory framework regarding capital requirements has significantly tightened. The Czech banking sector, however, has long held substantial capital buffers; and compared to other European banks, Czech banks are among the best capitalised institutions. Since 2008, the Tier 1 capital ratio has increased by almost 9pp to 19.2% as of 3Q22. Furthermore, in terms of return on equity, domestic banks perform above average compared to European peers (see above).

The evolution of T1 capital ratios (%)



Source: ECB, Economic & Strategy Research, Komerční banka
Note: end-2014 was likely affected by the change in the regulatory framework under the EBA supervision.

CET1 capital ratio (%, 4Q22)



Source: EBA, Economic & Strategy Research, Komerční banka

Overall, their solid position partially inoculates Czech banks against the potential effects of a deeper crisis of confidence, which has, however, already partially dissipated. Domestic banks have a relatively conservative and healthy portfolio with low funding risk – in part thanks to a high excess of deposits over loans – ample liquidity and a substantial capital buffer to absorb potential losses. Nonetheless, the area where the effects of the crisis of confidence in the banking sector are still strongly reverberating, and which also at least partially affects our banks, is the primary bank debt issuance market, which is recovering only slowly.

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Key economic indicators

Macroeconomic indicators – long-term outlook

		2020	2021	2022	2023	2024	2025	2026	2027
GDP	real, %	-5.5	3.5	2.5	0.6	1.8	2.2	2.5	2.4
Inflation	average, %	3.3	3.8	15.1	11.8	2.0	2.3	1.9	2.0
Current account	% of GDP	2.0	-2.8	-6.1	-1.8	-0.9	-0.5	-0.2	0.0
3M PRIBOR	average, %	0.9	1.1	6.3	7.1	5.4	3.9	3.3	3.3
EUR/CZK	average	26.5	25.6	24.6	23.7	23.8	23.7	23.5	23.3
USD/CZK	average	23.2	21.7	23.4	21.1	20.5	19.9	19.0	18.5

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

FX & interest-rate outlook

		25-04-2023	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24
EUR/CZK	end of period	23.5	23.60	23.70	23.75	23.80	23.85
USD/EUR	end of period	1.10	1.10	1.14	1.18	1.15	1.16
CZK/USD	end of period	21.4	21.45	20.80	20.15	20.70	20.55
3M PRIBOR	end of period, %	7.18	7.20	7.05	6.55	6.05	5.55
10Y IRS	end of period, %	4.41	4.85	4.75	4.60	4.45	4.35

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

Monthly macroeconomic data

		VII-22	VIII-22	IX-22	X-22	XI-22	XII-22	I-23	II-23	III-23
Inflation (CPI)	%, yoy	17.5	17.2	18.0	15.1	16.2	15.8	17.5	16.7	15.0
Inflation (CPI)	%, mom	1.3	0.4	0.8	-1.4	1.2	0.0	6.0	0.6	0.1
Producer prices (PPI)	%, yoy	26.8	25.2	25.8	24.1	21.3	20.1	19.0	16.0	10.2
Producer prices (PPI)	%, mom	0.3	-0.1	1.2	0.6	-1.0	-1.1	5.8	-0.3	-1.0
Unemployment rate	% (MLSA)	3.3	3.4	3.5	3.5	3.5	3.7	3.9	3.9	3.7
Industrial sales	%, yoy, c.p.	13.9	31.1	27.7	19.9	18.3	9.1	9.4	13.1	n.a.
Industrial production	%, yoy, c.p.	-1.6	10.7	9.2	3.4	1.3	2.3	0.9	2.0	n.a.
Construction output	%, yoy, c.p.	-2.5	2.8	-2.6	2.1	-0.2	-4.4	7.3	-4.3	n.a.
External trade	CZKbn (national met.)	-23.0	-29.8	-13.4	-25.2	-25.0	-0.5	9.2	14.3	n.a.
Current account	CZKbn	-45.7	-110.9	-70.7	-36.8	-42.5	-4.3	12.7	13.3	n.a.
Financial account	CZKbn	-57.7	-143.7	-24.0	-7.4	-13.3	-38.4	8.3	-5.8	n.a.
M2 growth	%, yoy	5.3	5.3	5.5	5.9	5.9	5.6	6.3	7.0	n.a.
State budget	CZKbn (YTD cum.)	-192.7	-231.1	-270.9	-286.7	-337.1	-360.4	-6.8	-119.7	-166.2
PRIBOR 3M	%, average	7.30	7.27	7.25	7.28	7.27	7.26	7.22	7.20	7.19
EUR/CZK	average	24.6	24.6	24.6	24.5	24.4	24.3	23.9	23.7	23.7
USD/CZK	average	24.2	24.3	24.8	24.9	23.9	22.9	22.2	22.2	22.1

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

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