Quarterly report

Czech Economic Outlook

Economy breathing but fitness is a long way off

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- **The Czech economy is expanding** The economy bottomed in 2Q but has now started to rebound. In the second quarter, the economic situation could be better than we had initially expected. However, for the coming quarters, we now expect a lower growth rate. All in all, the economy is likely return to pre-crisis levels by the end of 2021.

- **The inflation to decelerate** We expect that weaker demand will decelerate consumer price increases. Fuel prices will stay lower and the growth rate of food prices will decelerate. We still expect inflation to remain below 2% in 2021.

- **CNB unlikely to change rates at its August meeting** It will probably continue to consider current monetary policy easing as sufficient. One reason for this is that inflation is above the upper edge of the tolerance band. This is also likely to postpone the debate on the possible introduction of unconventional measures. However, the outlook for the economy is still uncertain and inflation is likely to slow significantly in the coming months. In our view, interest rates will remain low until the end of 2021.

- **Financial markets are paving the way for further koruna strengthening** Positive sentiment in global markets and rising rates are pushing the koruna to higher valuations. In our opinion, this trend will continue in the coming months and especially next year. The second wave of the pandemic and CNB intervention on the FX market remain a risk.

- **CZGB yields are rebounding from the bottom** Despite a record increase in the state budget deficit, the supply of CZGB will be minimal for the rest of the year. Next year, however, it will be similar to this year. Demand is gradually declining after historically record months, but will still remain higher than supply. In conjunction with rising IRS, yields will continue to grow.


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Legacy of COVID-19 will be with us for a while

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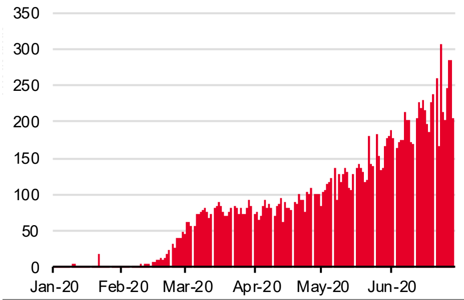
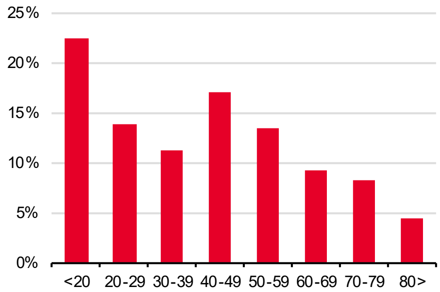
The epidemiological situation is deteriorating again. Following the rise in March, the global number of COVID-19-positive people stabilised in April and May, also thanks to the restrictive measures put in place by various governments, which in many cases resulted in the deepest recession ever. However, early summer has tempered optimistic expectations that higher air temperatures would paralyse the virus. Quite the contrary, the relaxation of measures to contain the pandemic's spread has had only one result: the number of infected people has started to rise again, particularly in large countries such as the US, Russia, and Brazil.

Daily increase in the COVID-19-positive population in the global economy (in thousands)



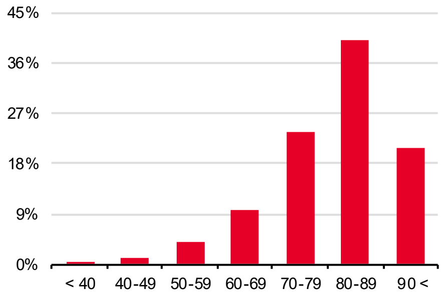
Source: Macrobond, Economic and Strategy Research, Komerční banka

Age structure of COVID-19-positive population of a selection of European countries



Source: INED, SG Cross Asset Research/Economics
Note: Data available for Austria, England & Wales, Denmark, Spain, Germany, France, Italy, Norway and the Netherlands

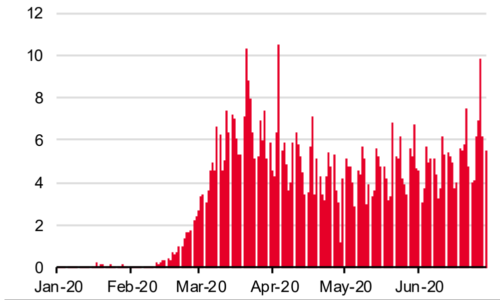
Age structure of COVID-19 deaths for a selection of European countries



Source: INED, SG Cross Asset Research/Economics
Note: Data available for Austria, England & Wales, Denmark, Spain, Germany, France, Italy, Norway and the Netherlands

While the number of infected people has accelerated, the daily death rate has remained fairly stable. Available data show that although the number of positive cases is somewhat larger among the younger age groups, the virus mainly poses a risk to seniors over the age of 70. The prevalence of the disease is now becoming more fragmented and concentrated into localised hotspots, which should make it easier to control and manage. We therefore do not expect the current situation to result in entire economies or sectors being locked down again. However, it is clear that the epidemiological situation will have a negative impact on future demand. Although the current global recession started on the supply side, i.e. interrupted manufacturing processes and closed national borders, the problem quickly shifted to the demand side. Households and companies are naturally displaying greater caution in both consumer and investment spending. Following the initial quick and strong easing of monetary policy, governments are now turning to fiscal policy to stimulate aggregate demand.

Daily growth in the number of covid-19 deaths in the global economy (in thousands)

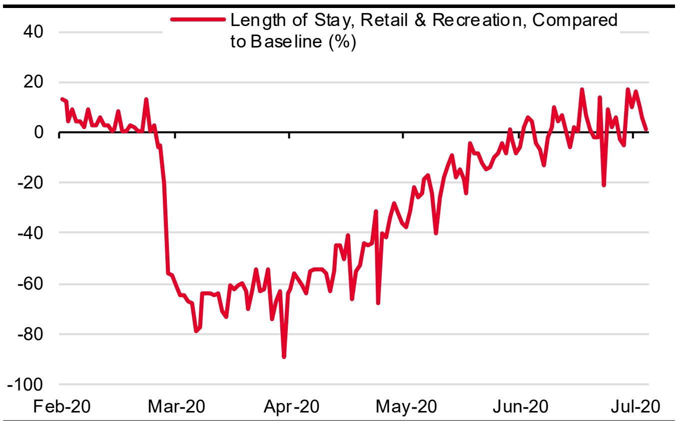


Source: Macrobond, Economic and Strategy Research, Komerční banka

Although the high frequency data indicates that in terms of activity we are back to pre-crisis levels, this is far from reality in terms of added value creation.

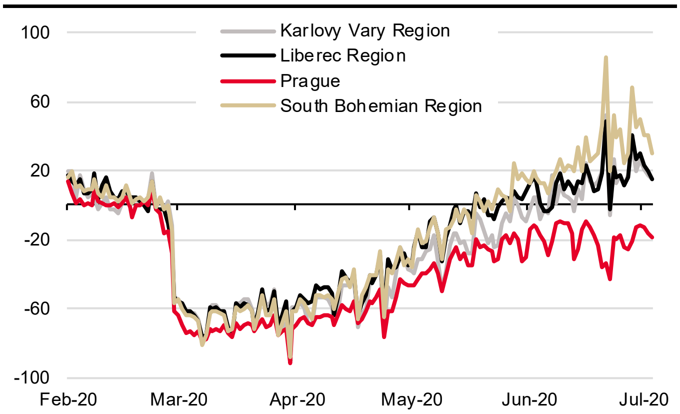
The relaxation of the restrictive measures that paralysed the economy during the state of emergency and the return to normal economic activity does not automatically mean a return to pre-coronavirus production in terms of both volume and structure. Automotive typically makes a significant contribution to added value creation in the Czech Republic. However, the sector has clearly not yet returned to pre-crisis levels. According to AutoSAP, motor vehicle production was still approximately one-fifth below its prior-year level in June. The change of trends is also apparent in tourism for example, both in terms of customer profiles (with a shift towards domestic tourism) and regions, as is borne out by some high frequency data. An example is the Google index of retail & recreational activity, which shows that we are back to normal. However, it is clear from regional data that the typical tourist destinations dependent on foreign clientele, such as Prague, are still well below normal levels, while Southern Bohemia, for example, has been boosted by high demand from Czech households for holidays in their own country.

Retail & Recreational activity is back to normal



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

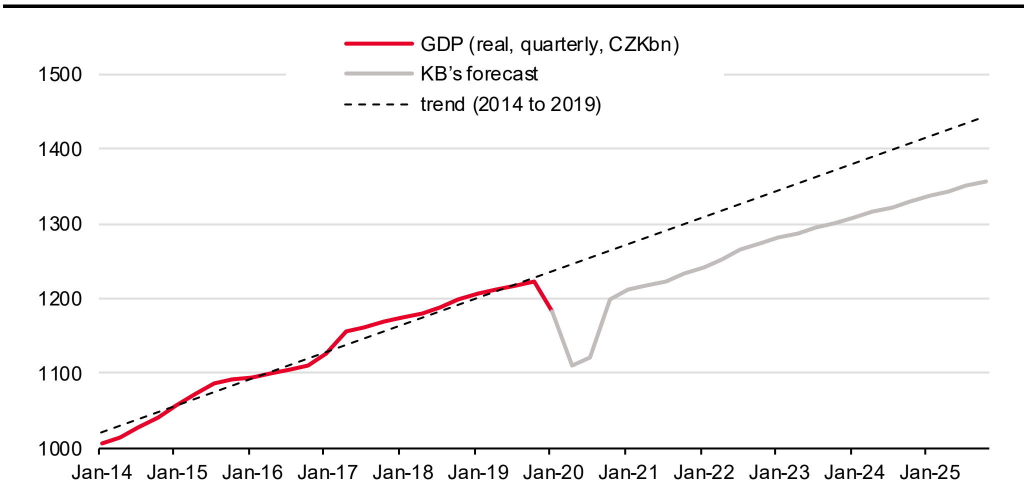
But Prague is still suffering from a lack of tourists



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

Economic activity will not return to pre-coronavirus levels quickly. As indicated in the previous *Czech Economic Outlook* two months ago, we don't expect a return to end-2019 levels again until late 2021. We have probably experienced one of the deepest slumps in the Czech economy's modern history. We expect the third quarter to be marked by stabilisation and the end of the year to bring the first signs of recovery.

We will not get back to pre-crisis levels until late 2021



Source: Economic and Strategy Research, Komerční banka, CZSO

Still enormous uncertainty associated with macroeconomic forecasts. We still don't know the extent to which the Czech economy declined in 2Q20 and thus the bottom from which it will rebound again. Our estimates show that in the end, the result won't be as bad as we had feared while calculating our previous forecast, which was actually one of the most optimistic estimates on the market. We will soon find out how the country performed in 2Q and therefore how relevant the current forecast is for this year as the CZSO is migrating to a new mode of GDP publication. Consequently, the first estimate for 2Q is to be published 14 days earlier than usual, on 31 July. When reading this edition of the *Czech Economic Outlook* you are therefore advised to focus on the economic story rather than on the specific numerical estimates.

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External Environment and Assumptions

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World economy getting back to normal

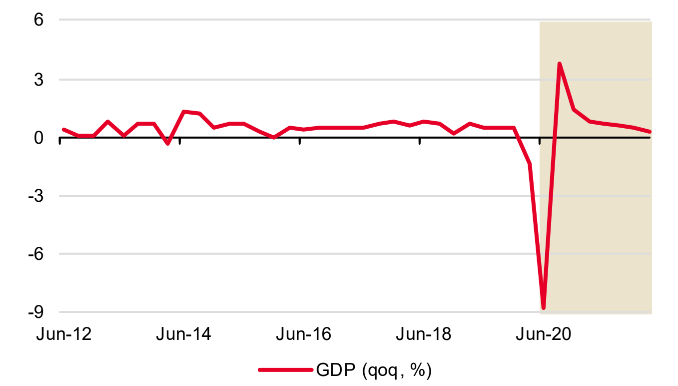
Economic activity in both the United States and the euro zone looks to be gradually returning to normal. GDP momentum likely will fall significantly in the second quarter, but we already expect solid growth in the third quarter. We do not expect inflation in either the euro area or the US to reach the central bank target this year or next. Thus, interest rates should remain at current historical lows for a long time. We also expect regional central banks to maintain a relaxed monetary policy. The Polish zloty and the Hungarian forint thus look set for further weakening.

US: substantial decline to be followed by significant growth

In 2Q, we expect the economy to drop by 30% qoq annualized.

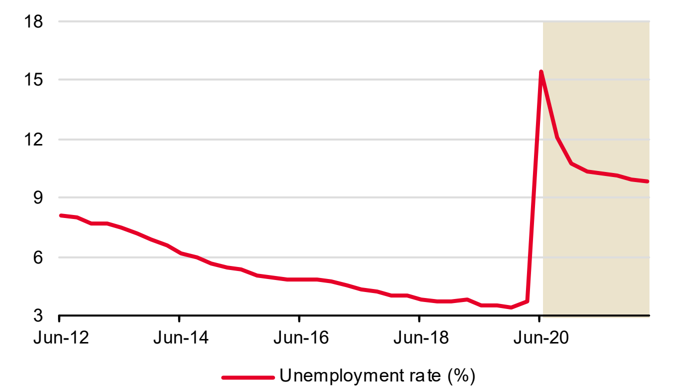
July data from the real economy appear to indicate that the worst is behind the United States. Retail sales grew soundly (7.5% mom), as did industrial production (5.4% mom). Leading indicators improved also (ISM index increased to 52.9 points, non-manufacturing ISM grew to 57.1 points). The number of jobless claims still remains high (16.2 million) but shows a declining trend. This all together suggests that the US economy has entered 3Q on the right foot. Further spread of the coronavirus, which in some states sparked renewed implementation of restrictive measures, represent a risk for our prognosis. What is clear, is that the GDP result for 2Q will be poor. Our forecast assumes an annualised drop of more than 30% qoq. In 3Q and 4Q, however, the economy should start to pick up at a solid rate. We expect GDP to grow by 16.5% qoq in 3Q and to rise 6% qoq in 4Q. Overall, we expect GDP growth to be down by 4.9% this year. What is important is how the economy will develop in 2021. Our forecast assumes GDP growth of 2.4%. Bloomberg consensus is 3.9%.

After a massive drop, the US economy should pick up pace



Source: Macrobond, SG Cross Asset Research/Economics

Unemployment rate in the double digits



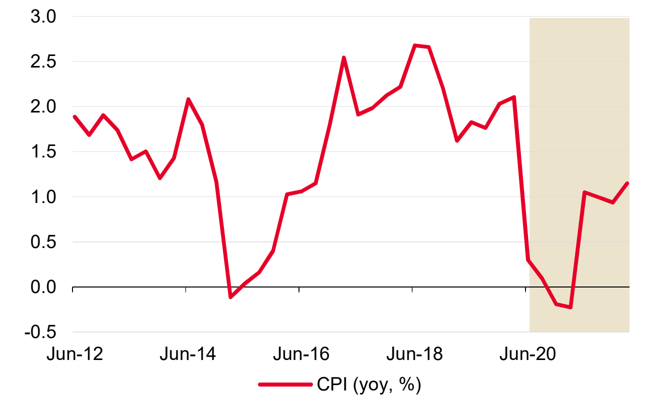
Source: Macrobond, SG Cross Asset Research/Economics

Still 14.5m jobs missing on the US labour market.

The US labour market could take a long time to recover from the coronavirus crisis. The unemployment rate reached 14.7% in April, its highest level since the 1930s. In June, it dropped to 11.1%, and room for any further decline is limited, in our view. Although the number of new jobs reached 4.8 million in June and 2.7 million in May, this still means that, compared to the pre-crisis period there are still 14.5 million jobs missing. By the end of this year, on our estimate, the unemployment rate will fall just below 10%. At the end of 2022, it should range between 6.5-7.0%. In addition, due to a still relatively high number of new cases of coronavirus infection, the improvement in the US labor market may be slower than we anticipate. As a result, the Fed will not be able to fulfill the mandate of full employment immediately. In addition, inflation will likely reach the 2% inflation target in 2022-2023 at the earliest. This means that interest rates will remain at current levels at least until the end of

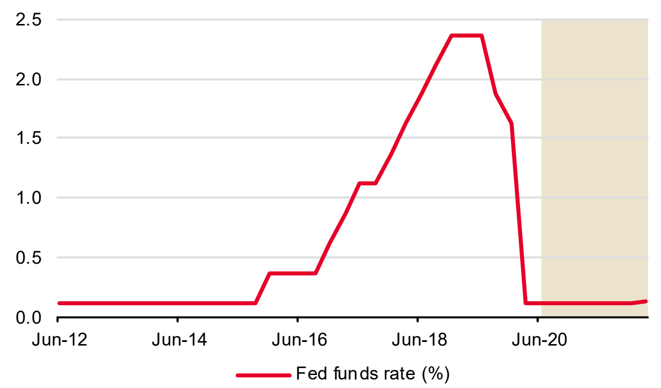
2022. Until then, the Fed will try to support the economy with available tools. In addition to the unlimited purchase of government bonds, it will also buy corporate bonds or bonds with a non-investment speculative rating (high-yield). The Fed has not yet bought high-yield bonds. Even so, the issuance of these bonds is now seeing an unprecedented boom.

Inflation unlikely to reach Fed target any time soon



Source: Macrobond, SG Cross Asset Research/Economics

Rates will remain at current level until 2022



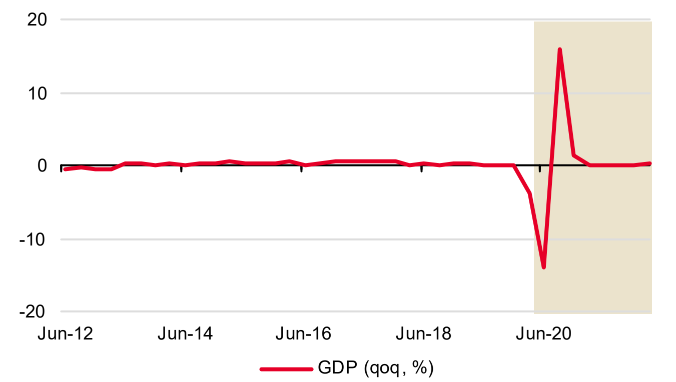
Source: Macrobond, SG Cross Asset Research/Economics

Euro area: massive drop to be followed by a solid rise

After a massive drop in 2Q, the economy will likely rise sharply.

Economic activity in the euro area is gradually returning to normal. This is evident in the leading indicators, which are already reaching pre-pandemic levels. However, according to estimates by SG economists, the level of activity still remained about 10% below the level before the coronavirus crisis. We therefore expect a more significant recovery in 3Q. On our assumptions, 2Q GDP will be down by 13.8% qoq. In 3Q20, however, we expect strong GDP growth at 16% qoq. On our forecast, euro area GDP for 2020 should fall by 6.3% (vs our previous estimate of a decline of 5.4%), and we expect growth of 5.2% for 2021 (vs 6.0% previously).

We expect a V-shaped recovery in the euro area



Source: Macrobond, SG Cross Asset Research/Economics

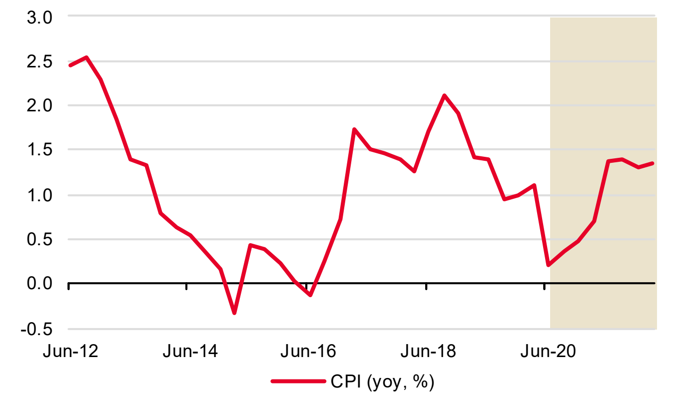
Unemployment to rise

Source: Macrobond, SG Cross Asset Research/Economics

Asset purchase programm (PEPP) to be extended by another EUR500bn.

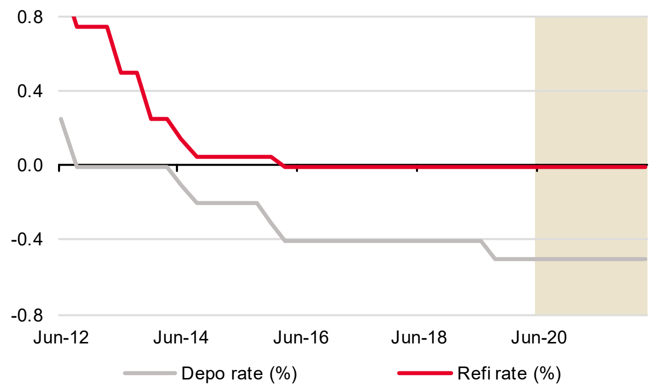
European Central Bank publishes new GDP forecast. Its outlook for this year remains rather pessimistic (-8.7%), although this is already an upward revision (from -9.5%). In our opinion, its 2020 estimate will be revised upwards at the September ECB meeting. According to the ECB forecast, inflation will remain well below the inflation target, which is our view as well. The ECB expects inflation at 0.3% for 2020, 0.8% for 2021, and 1.3% for 2022. In our view, inflation will not exceed 1.4% until 2024. For this reason, we expect the current pandemic asset purchase program (PEPP) in the amount of EUR1.35tn to be expanded by another EUR500bn. We expect to see this decision at the December meeting. Alternatively, the asset purchase program (APP), which so far is continuing at a monthly pace of EUR20bn, could be expanded. We expect the APP program to be ended at the beginning of 2023. Further steps by the ECB could include the inclusion of mortgage loans in the TLTRO program if household confidence and consumption falls sharply. Furthermore, the equity purchase program, or ETFs could be launched if there was too much volatility in the market, which would jeopardize economic growth. Further interest rate cuts would be ineffective, in our view.

Inflation at freezing point



Source: Macrobond, SG Cross Asset Research/Economics

Interest rates likely to remain at current levels for a long time



Source: Macrobond, SG Cross Asset Research/Economics

Recovery fund should help GDP growth in the euro area.

The recovery fund planned by the European Commission should also contribute to the recovery of the euro area economy. The programme is expected to reach EUR750bn, of which EUR390bn should be in the form of grants and EUR360bn in the form of loans. The According to the European Commission, fund should create two million jobs across the EU and increase the level of real euro area GDP by 1.75% in 2021 and 2022 and by 2.25% in 2024. According to the current allocation criteria, Italy, Spain, Greece and Bulgaria would benefit from the programme the most.

Hungarian forint and polish zloty to weaken

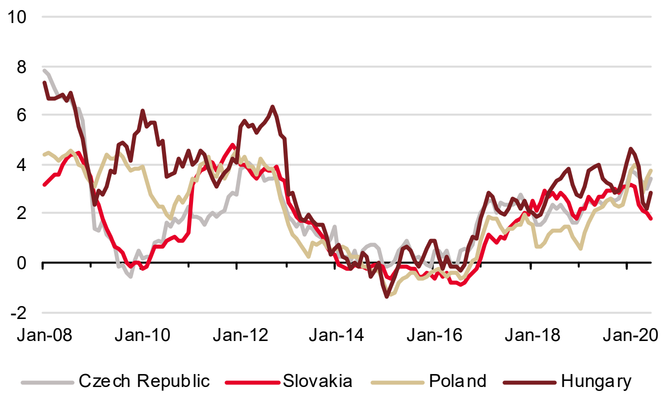
Polish central bank is rather pessimistic regarding the GDP growth.

National Bank of Poland left interest rates unchanged at 0.1% in July. It plans to continue with the ongoing asset purchase program. Core inflation shot up to 4.1% in June, the highest level since 2000. Even so, the central bank's rhetoric remains dovish. Indeed, the Bank fears a slower economic recovery and disinflationary pressures in the domestic economy, even though inflation is currently above its inflation target (3.3% in June vs inflation target at 2.5%). According to the central bank, inflation will decelerate due to the high comparison base and the shock caused by the coronavirus crisis. Inflation will even under-shoot the target in 2021 and 2022. It expects inflation to slow to 1.5% next year (after 3.3% this year) and to slightly accelerate to 2.1% in 2022. The central bank is relatively pessimistic about the further development of GDP growth. It expects the economy to contract by -5.4% this year. According to Bloomberg consensus, it should be -4.0%. Next year, it sees 4.9% growth in the economy (Bloomberg consensus is 4.3%). According to central bankers, Poland's zloty still does not reflect the external shock and measures already taken by the central bank to combat the effects of the coronavirus. On our forecast, the Polish zloty will continue to weaken in the coming months. At the end of this year, we see its rate at 4.68 EUR/PLN. We do not expect changes in monetary policy settings until at least mid-2021.

Prognosis of the Hungarian central bank too optimistic, in our view.

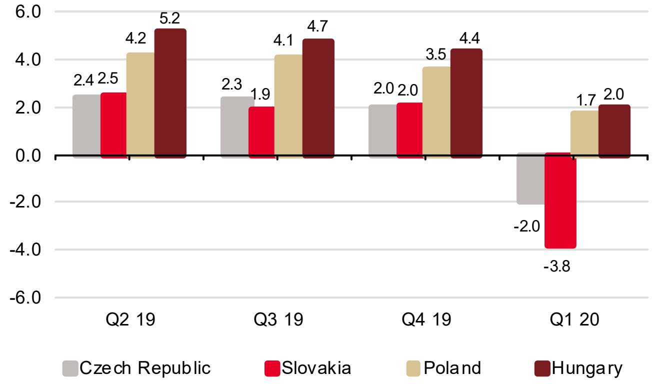
Hungary's central bank cut rates by another 15bp in July. The key three-month deposit rate thus reached 0.6%. We expect a further reduction in interest rates of 0.1bp to 0.5% at the end of 3Q. The Hungarian forint will thus remain under pressure. At the end of this year, we expect its rate at 375 EUR/HUF. We anticipate its further weakening not only because of the easing of monetary conditions, but also, unlike the central bank's optimistic forecast, the disappointment that economic developments are likely to bring. In its forecast, the central bank expects GDP dynamics to remain positive this year (0.3-2.0%). By contrast, the market consensus measured by Bloomberg sees a 4.9% drop in activity. The central bank projects 3.8-5.1% growth for the Hungarian economy in 2021. Bloomberg consensus is 4.1%.

Inflation in CEE region (%, yoy)



Source: Macrobond, Economic & Strategy Research, Komerční banka

GDP in CEE region (%, yoy)



Source: Macrobond, Economic & Strategy Research, Komerční banka

Macroeconomic outlook

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Economy returning to normal

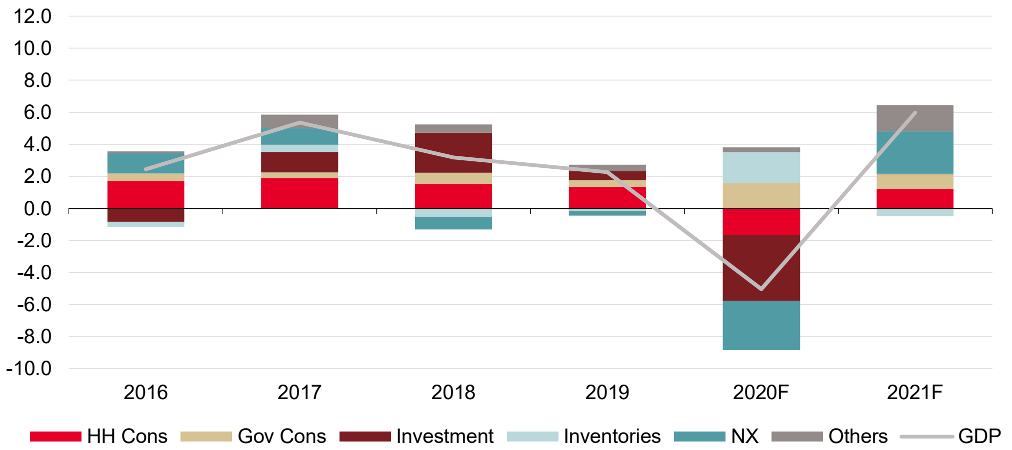
The economic outlook remains highly uncertain. However, the strong economic revival is visible in the data as well as in normal everyday life. We have increased our GDP forecast for this year to -5.0%. The damage in 2Q was probably smaller than expected, but the recovery in the coming quarters will be probably slightly slower than we had expected couple of weeks ago however. The pre-pandemic GDP levels are still expected to be reached at the turn of 2021/2022. The overall economy should still be anti-inflationary, although the inflation deceleration will be slower than we expected.

Main changes

GDP:
For 2020, we have revised up our forecast to -5.0% from -6.8%. For 2021, we expect economic growth to accelerate to 6.0%.

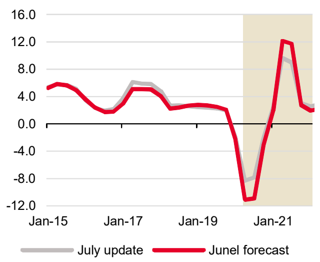
Inflation:
We have increased our forecast for 2020 to 3.0% from 2.4% due to higher import prices and faster core inflation.

Decline in investment and exports are the main drags on the economy in 2020 (% yoy)



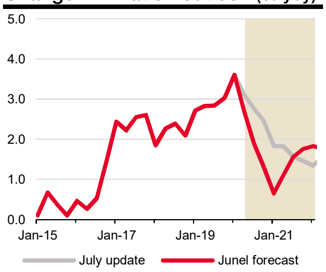
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Change to GDP outlook (% yoy)



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

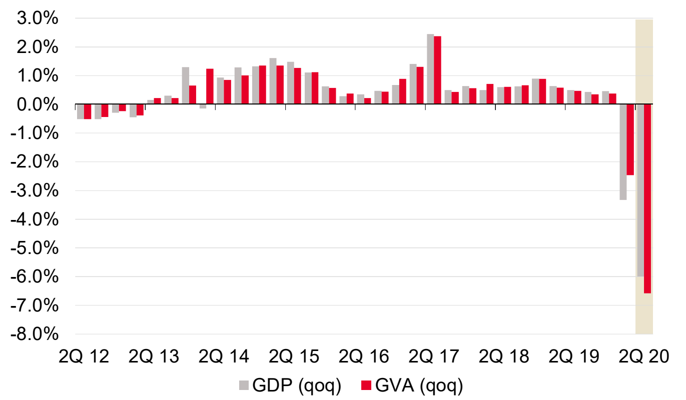
Change in inflation outlook (% yoy)



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

Monthly data points to a stronger rebound

GDP bottomed in 2Q



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

At the very beginning of our new forecast, the outlook is strongly influenced by the still very uncertain estimates in the near past. In the first quarter the economy declined by 3.4% qoq. In the second quarter the GDP decline was probably stronger as the economy started to unlock during May. Given the better-than-expected monthly data for May we have increased our GDP expectations in 2Q. From the demand side in 2Q, the decline was mainly driven by the fall in net exports followed by household consumption and fixed investments.

The drop in GDP in 2Q might not be that dramatic.

Although our call for a 6% qoq decline might look deep on first sight it is rather optimistic given the consensus, which might be slightly higher than 10% qoq. But some monthly data support our rather optimistic view. Especially strong were the retail sales for May, with a positive year-on-year result. And we expect that for June the retail sales printed another strong gain. Although the industrial output was still quite weak in May there are signs of a rebound already for June. The VAT budget filling also indicates that 2Q might not be as weak as the market consensus. Obviously, the uncertainty is high and we are especially aware of the external environment, where the GDP is expected to be weaker. However, the initial conditions of the Czech economy were favourable with an extremely tight labour market. The shock could have therefore been absorbed relatively well. However, compared with our previous forecast we expect a slower pace of recovery for the coming quarters. One of the reasons is the more cautious outlook on the manufacturing sector, where uncertainty about demand remains high despite the recent increase in confidence. **So we repeat our assertion that the pandemic shock is unique and could have many unforeseen consequences.**

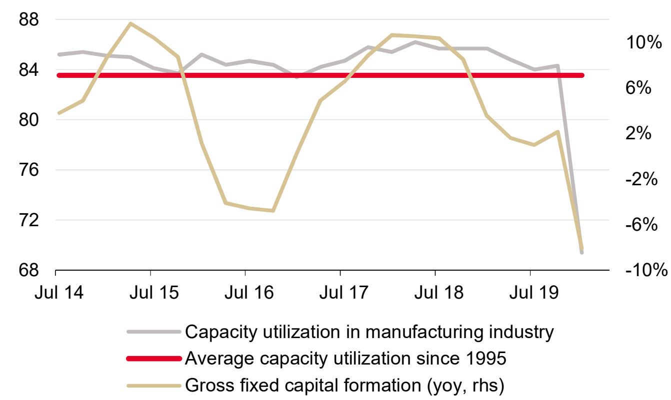
Economic policy was less expansionary than we expected.

The economic policy was expansionary but on the fiscal side the programmes were not effective as quickly as we hoped for. The social programmes and natural stabilisers, on the other hand, helped to support the labour market, which is now in much better shape than we had expected. Monetary policy acted quickly but we expected somewhat more eased monetary conditions however. Nevertheless, with the more optimistic outlook for 2Q, we have decreased the full-year expected GDP decline to "only" 5.0%. For the next year we have decreased our GDP growth estimate to 6.0%. **All in all, in our new forecast the pre-crisis GDP level should already be reached by the end of next year. The output gap is expected to stay negative until 2022.**

Industrial production on a rise

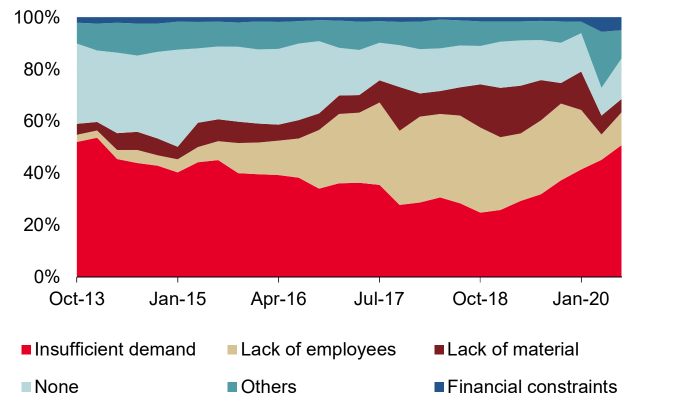
The manufacturing sector was bottoming in April with the year-on-year drop around one-third. Capacity utilisation dropped a long way below the long term average. Car production, an important part of the Czech industrial sector, almost stopped altogether. Insufficient demand has clearly become the key obstacle to growth. As the economy started to unlock we observe strong signs of a revival. In May the industrial output increased, bringing the year-on-year decline up to -25% (WDA). The continuing improvement of purchasing manager indicators and strong increases in car production indicate a significant improvement of the industrial output for June. However, the level of output remains well below the pre-crisis level.

Capacity utilisation fell far below the long-term average



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

Insufficient demand is the main barrier to industrial expansion



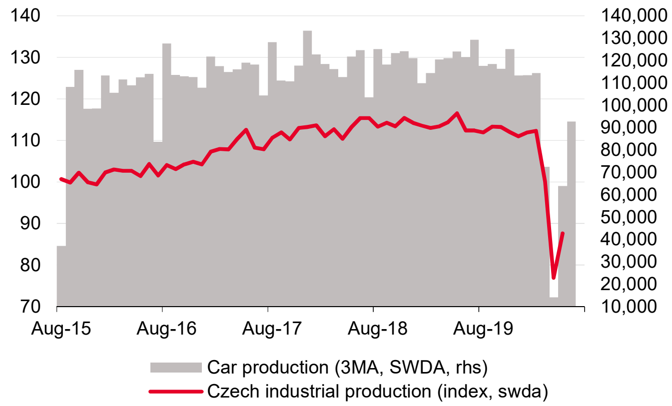
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Manufacturing confidence has increased to almost the same levels where it was before the pandemic. However, most of the increase in confidence has stemmed from improving future expectations. And that remains very uncertain and conditional on developments in relation to the epidemic. Our optimism increased especially due to the relatively more stable labour market and consumer spending. **But we remain cautious in respect to the manufacturing sector where the shock absorption will be longer.** The slower-than-expected fiscal response when it comes to the COVID-19 programmes also contributed to this view. The strong exposure of the Czech industrial sector to the car industry is risky in times when technological and regulatory changes make the sector a strong headwind. On the other hand, it seems that Czech car makers performed relatively well compared to other car producers.

Construction likely to decline due to limited capacity and lower demand

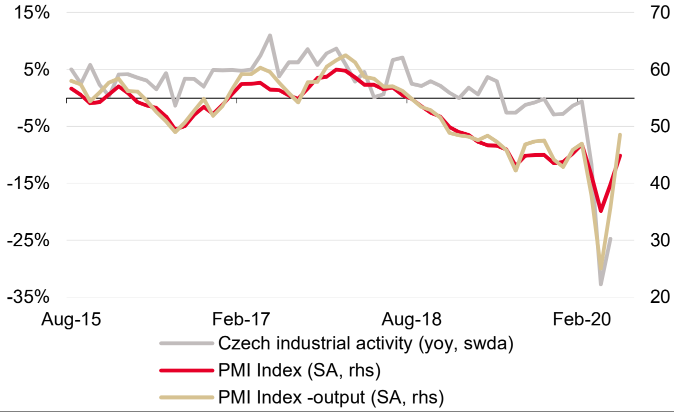
Construction also declined in the second quarter, albeit obviously not as strong compared to the manufacturing sector. Here the insufficient demand is still of a secondary importance as a barrier to growth while the shortage of labour force remained the main obstacle for expansion. We expect that this will gradually change as demand will gradually weaken. The sector should be supported by public infrastructure investments in general. However, even here some investments were interrupted or cancelled as a response to post COVID-19 developments and a shortage of financing at the municipal level. For this year we expect roughly flat construction output and for next year a decline of around 4 %.

Automotive industry hit hard but seeing a recovery now



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

Leading indicators are pointing to cautious improvement



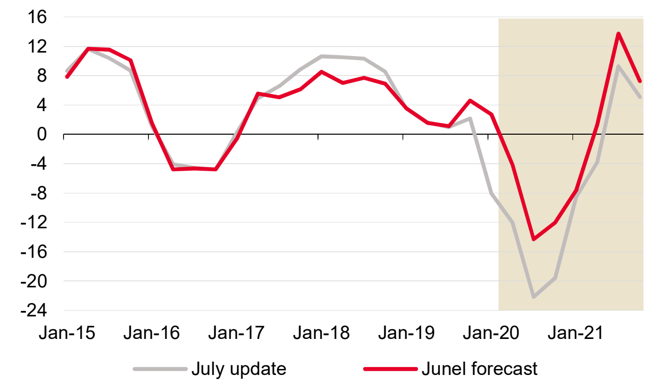
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Drop in investment activity and foreign trade

Investment and foreign trade should be the main drivers of GDP contraction.

Our view on the manufacturing sector corresponds with the deteriorating view on the expected fixed investments. While there are clear signs that the companies are keen to invest in modernisation digitalisation we expect a rather deeper negative impact on overall investment activity this year and a slower increase next year. In the short term this would be an argument for a better foreign trade balance. However, given the relatively positive view on household consumption, the foreign trade balance and the fixed investments will be the main drags on the economy this year. On the other hand, rising inventories and government spending will contribute positively to the GDP. We expect the foreign trade to be the main driver of GDP next year.

Drop in investments will be deeper (%, yoy)



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

Fiscal policy: the deepest public finance deficit in history

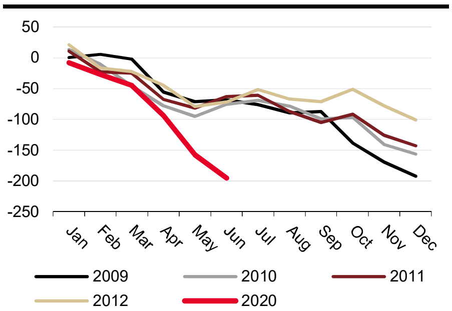
After a third increase in the state budget, the government expects a deficit of CZK500bn for 2020. However, expenditures are not growing much beyond the pre-pandemic trend, and the figures for the first half of the year show only a slight decline in revenues. We see a state budget deficit of CZK400bn this year, though the main reason for this lower figure is less investment than envisaged by the government given limited economic capacity, projects not being ready and lack of time for implementation. A second wave of the pandemic and further government economic support measures remain risks to our view. Municipalities and regions, as the only segment of public finance, remain in surplus, albeit the lowest one of recent years. For this year, we assume that their high reserves carried over from previous years will keep the budget balanced. However, we expect a slight deficit at health insurance companies. We expect overall public finances to see a record deficit of 7.6% of GDP this year, and we see only a slight improvement next year.

State budget to end year with smaller deficit than planned

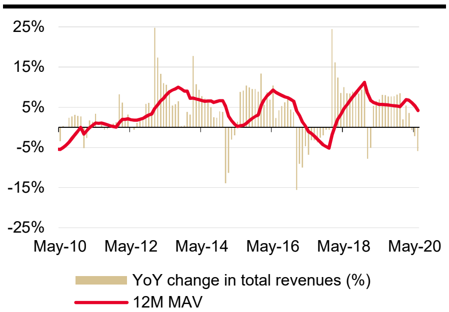
Figures for the first half of the year show a more modest shortfall than expected in tax revenues, while expenditures have not risen much above the trend of recent years. Along with less investment than planned, this will in our opinion lead to a deficit of CZK400bn.

In the first six months of this year, the state budget ran a deficit of CZK195.2bn, a CZK174.5bn increase compared to the same period last year. This is the largest deficit in the country's modern history, surpassing 2009's CZK192.4bn. In relative terms, however, the historically record deficit has not yet been exceeded (3.6% vs. 4.9% of GDP). June's state budget figures reveal the extent of the potential shortfall in tax revenues this year. Compared to same period last year, tax revenues are about 7% lower and are CZK40.9bn below the figure expected in the state budget. **The greatest impact of the COVID-19 crisis is in VAT collection, while in previous months the effect was most visible in personal income tax.** VAT collection was down 6.1% yoy in June, some CZK25.6bn below what was expected in the state budget. This represents more than half the total loss in state budget revenue. However, the ambitious VAT collection target is being hampered by the originally expected increase in revenues from this tax due to a change in the tax code (approximately CZK15bn). Nevertheless, this change was not approved and will not come into force until next year. Therefore, the state budget can no longer expect this one-off income, which is changed by the amendment to the state budget law. The budget is also being affected by increased state expenditure, up 17% yoy in the first six months. However, this figure is not much higher than in the months before the virus outbreak.

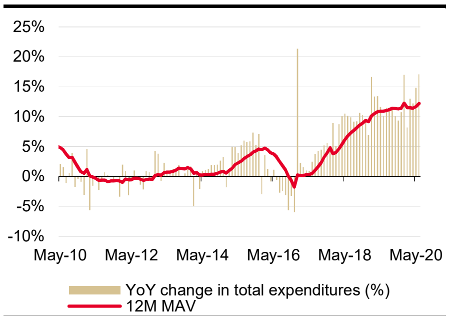
State budget in comparison with previous crises (CZKbn)



Tax collection shortfall being offset by non-tax revenues



Expenditure growth not significantly exceeding previous pace

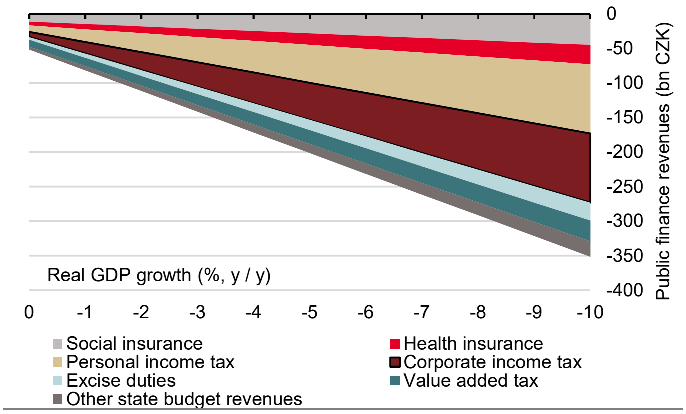


Source: Finance Ministry, Economic & Strategy Research, KB

The state budget is thus heading for its worst result ever. However, the June figures show that the impact of the crisis is not as strong as originally expected. This is one of the reasons we do not expect the state budget deficit to hit CZK500bn this year. State expenditures are not growing much beyond what is planned in the state budget, and there have been no dramatic changes on the revenue side either. In addition, in our opinion, the government will not be able to carry out all its planned expenditure this year. The state budget see a record amount of CZK140.2bn in investments. But the government has c.CZK33bn of unused expenditures from previous years. And in our opinion, the planned increase in investment this year will encounter a hurdle in the form of limited capacity in the domestic economy. In addition, more than two months of lockdown hampered planned projects, and the situation was not helped by a dispute between the municipalities and government over financing. Some projects will likely be postponed to next year. **In our view, the state budget deficit will be CZK400bn this year, implying an increase in public debt to 37.8% of GDP.** The risks are uncertainty regarding economic developments, a second wave of the pandemic, and further government support measures.

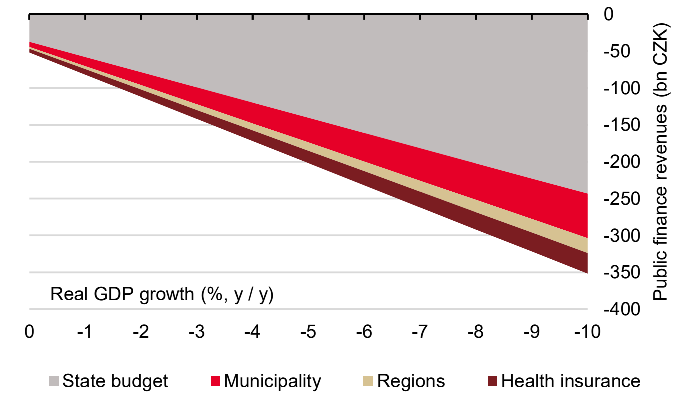
The potential shape of the state budget for next year is unknown given this year's events. **According to previous statements by the Ministry of Finance, however, the deficit should be based on this year's result.** The process of creating a new budget may take a month longer then usual, with the proposal not arriving in the Chamber of Deputies until the end of October. Due to more optimistic growth forecasts for the domestic economy next year, we expect a reduced deficit of CZK270bn in 2021.

Public finance revenue scenarios by category compared to MinFin's original budget (CZKbn)



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

Public finance revenue scenarios by recipient compared to the MinFin's original budget (CZKbn)



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

Overall public finances likely to see record deficit of 7.6% of GDP in 2020

Since our June forecasts, the situation of municipalities and health insurance companies has visibly deteriorated. In the first five months of this year, municipalities and regions had a surplus of CZK3.2bn, some 16.2% less than in the same period last year. However, the municipalities still have almost CZK200bn in their current accounts. In our view, their budget was supported in June by semi-annual corporate income tax payments. As state budget statistics show, the tax collection shortfall was not so big when some companies did not use the government tax reliefs. **We still expect municipalities to maintain a balanced budget this year and return to a slight surplus next year**. Health insurance companies however should be a little worse off, but our estimated shortfall of CZK20bn in health insurance should be offset somewhat by the recent price increase for state-insured persons. For this year, we assume a deficit of CZK10bn, which is comparable to 2009, but is only half in terms of GDP. **Health insurance companies should return to a balanced budget next year.**

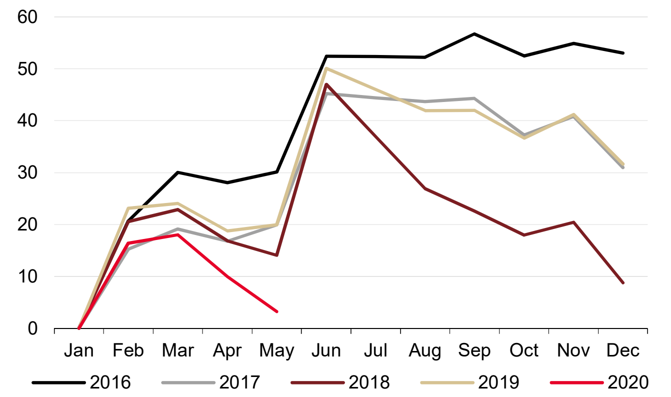
Public finances likely to see the worst deficit ever this year at 7.6% of GDP. Public debt should increase by 7.6pp this year to 39.6% of GDP.

Public finance forecasts

	2019	2020f	2021f	2022f	2023f	2024f
Balance (% GDP)	0.3	-7.6	-4.7	-3.1	-1.5	-0.6
Fiscal effort (pp GDP)	-0.4	-7.5	3.0	1.6	1.6	0.8
Public debt (CZKbn)	1738.7	2138.7	2408.7	2608.7	2708.7	2758.7
Debt ratio (% GDP)	30.2	37.8	39.6	40.9	40.5	39.6

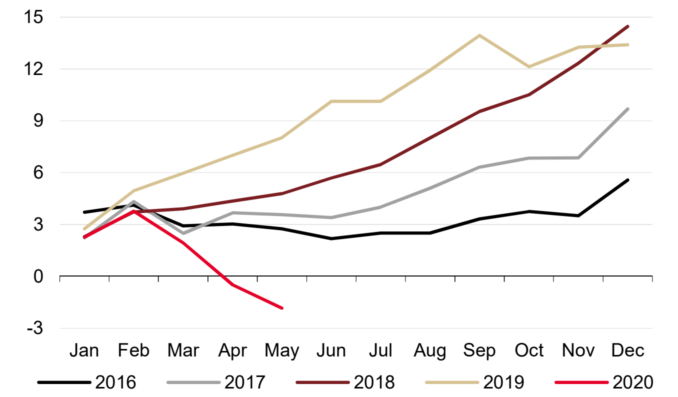
Source: CZSO, MinFin, Economic & Strategy Research, Komerční banka

Municipals remain in the red for the time being (CZKbn)



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

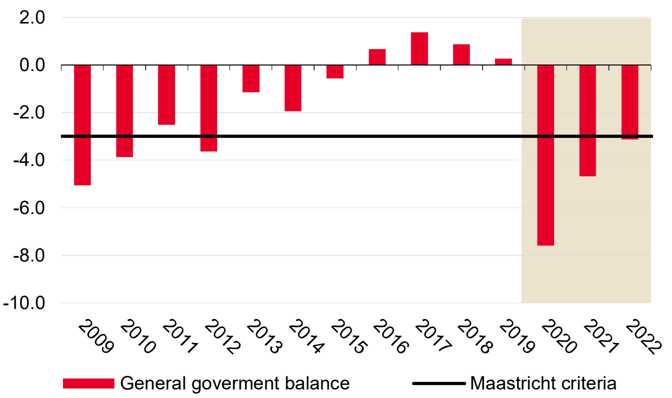
After several years health insurance companies went into deficit



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

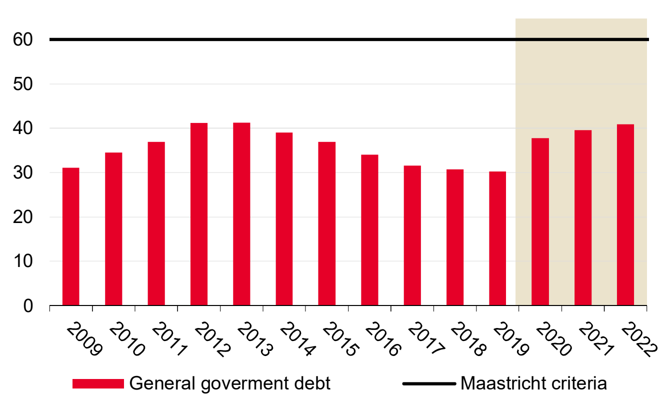
According to the ESA2010 methodology, public finances should see a deficit of 7.6% of GDP this year, some 2.5pp above 2009, currently the worst year of deficit on record. Next year, we see the deficit falling to 4.7% of GDP amid an economic recovery. **Public finance debt should increase significantly this year to 37.8% from 30.7% of GDP last year.** In the next two years, we see it peaking at 40.9% of GDP in 2022 and then starting to decline slightly.

Public finance balance (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

Public debt (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

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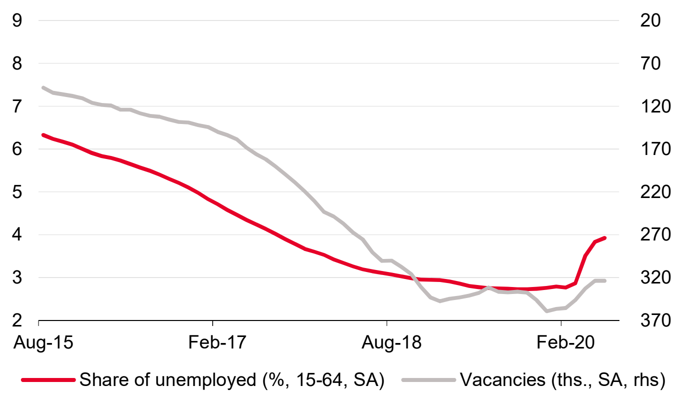
Unemployment rate rises slowly

Unemployment should rise, but government programmes and lots of vacancies have a strong cushioning effect.

From the inception of restrictions from end-March until June, the unemployment rate as measured by the Ministry of Labour and Social Affairs increased by only 0.7 percentage points to 3.7%. Given the magnitude of the economic shock we initially expected a faster increase. However, there was a mix of reasons that kept the unemployment rate from a biger rise. The number of vacancies was at 351,000 in February and by the end of 2Q it still remained very high at 335,000. The extremely tight labour market before the crisis created a natural buffer for people losing their jobs. Moreover, many companies are aware of the fact that firing people impetuously because of the pandemic could mean they will struggle to find employees when the outlook brightens. Economic policy also helped as many parents decided to stay at home at 80% of the wage level, financed by the government . The so called “Antivirus” government scheme (kurzarbeit) probably also significantly helped to keep companies from staff cuts as the state financed 30-80% of wages. The standard two months’ notice period makes a legal delay in labour market changes. Given the extent of the economic shock, the unemployment rate is about to rise further. However, most of the above mentioned factors that keep unemployment from rising will probably stay in place. The government stated that the Antivirus (kurzarbeit) programme will continue if there is a need. We assume it will continue until the end of this year. We expect that the unemployment rate will gradually continue to increase. But the unemployment rate will be peaking at a time of stronger economic expansion and therefore the peak will be relatively low at around 5-6 %.

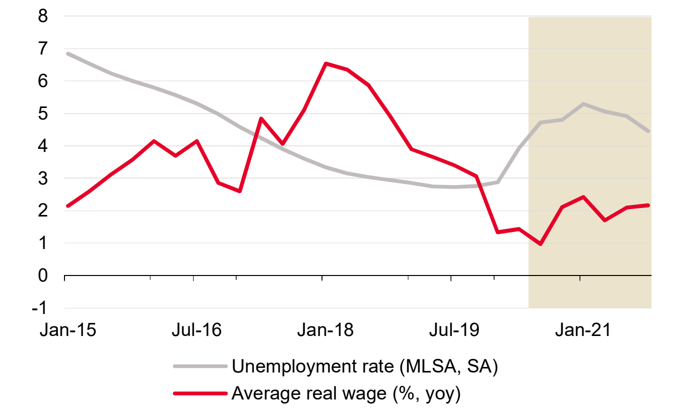
Our improved outlook for the economy and the labour market implies a somewhat better outlook for the wages. However, the situation of companies is far from favourable and cost cutting, including the wage bill, will be an important topic for many of them. We expect the average wage to rise by 4.5% this year and 3.8% next year. In real terms that would mean 1.5% in 2020 and 2.1% in 2021. Public sector wages will probably be the main driver of wages both this and next year.

High amount of vacancies provide a strong buffer



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

Unemployment rate will peak in 1Q 2021 (%)



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

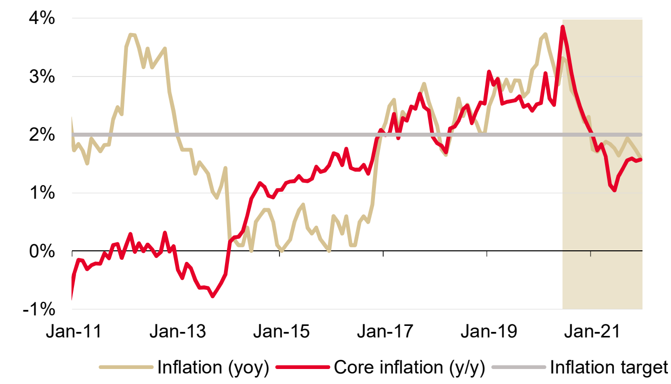
Albeit higher now, inflation should decelerate

We expect that the inflation will decelerate due to the negative shock to demand. But during the second quarter, prices rose higher than we expected and our overall view on the economy implies slower disinflation. However, we still expect that inflation will undershoot the 2% CNB inflation target in 2021.

We expect a gradual oil price rebound

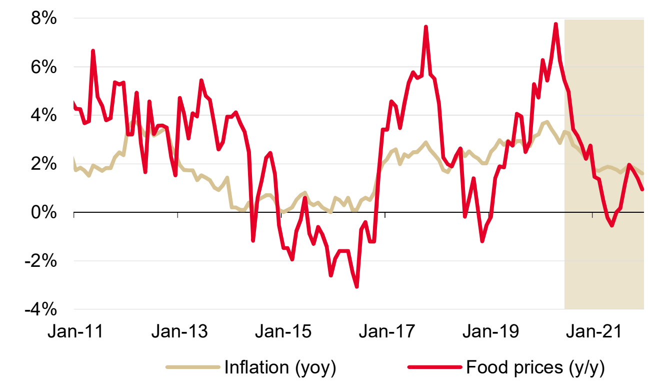
During the second quarter, consumer price growth accelerated. Meanwhile, fuel prices declined while food prices increases decelerated. However, the import prices increased significantly due to the trade disruptions and the weaker CZK. Importantly, core inflation accelerated. The lower VAT tax did not lead to lower prices. That can be interpreted as higher core inflation as well. But even without this tax issue, it seems the drop in demand was not as high as expected, which also corresponds to the more favourable development of the labour market. The negative demand side pressure on prices has so far been relatively muted. **We still expect that there will be significant negative pressure on consumer prices stemming from lower demand.** But disinflation will be slightly slower while core inflation will decelerate to a lesser extent.

Next year, inflation will probably undershoot the CNB target



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

Food price growth will decelerate



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

Oil prices remain lower and food price growth will probably decelerate.

Our expectations on oil prices has not changed much as we now expect Brent oil at USD40/bbl by the end of the year. Fuel prices are therefore expected to keep inflation at lower levels. Volatile food prices were pushing overall inflation up this year, but as they have increased already quite strongly we see rather limited room for further increase. **Therefore we assume that the rise in food prices will decelerate.** Renewed disruption to trade and harvesting due to another wave of the pandemic would be a risk that could lead to higher prices. However, we think the second wave will not be as disruptive as the first one. Excise tax changes on tobacco and alcohol contributed slightly to 2Q inflation and smaller additional increases are still in the pipeline. In 2020 the CZK is acting as a pro-inflationary influence. For the second half of 2020 we expect rather less appreciation and therefore the weak CZK will prevent inflation from faster deceleration. Obviously, should the CZK be as volatile as it was in the first half of this year, it would provide additional risk to our inflation forecast. While we expect only small energy price increases in 2021, we think that from 2022 energy prices will contribute more positively to inflation as the economy returns to normal and European green energy plans push energy prices higher.

All in all we expect that inflation will decelerate in the second half of 2020, mainly due to the weaker demand. As with the GDP estimate, the projections are more uncertain than usual.

Risks: epidemiology first and foremost

While there are many risks to the medium-term outlook, the main issues are connected to the uncertain evolution of the pandemic.

- **Second wave of the pandemic.** Although we think that in this event the lockdown would not have as destructive an impact as in March–May, GDP growth both this and next year would be significantly lower. Inflation would remain lower for longer, as would interest rates.
- **Vaccine discovered.** This is a strong upside risk for GDP, inflation or CZK exchange rate. However, we see this risk as smaller compared to the downside risk in the above-mentioned second wave of the pandemic, as the positive shock from the vaccine has tighter limits.
- **Fiscal policy reaction.** The Czech government has promised strong fiscal support, and our forecasts assume that fiscal policy will play a strong role. However, the implementation of the announced measures has been rather complicated, and their future remains unclear.
- **Brexit.** An unresolved issue that could have a major negative influence on European trade.

- **Trade wars.** With Donald Trump as the President of United States, the risk of renewed foreign trade tension remains and could jeopardise the recovery at any time.

Key economic indicators

	Q1 20	Q2 20	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	Q4 21	2019	2020	2021	2022	2023	2024
GDP and its breakdown														
GDP (real, yoy)	-2.0	-8.3	-7.9	-2.0	2.4	9.6	8.9	3.0	**2.3**	**-5.0**	**6.0**	**3.0**	**2.6**	**2.2**
Household consumption (real, yoy)	0.1	-5.1	-4.4	-4.5	-1.1	3.8	3.5	3.9	**2.9**	**-3.5**	**2.5**	**4.6**	**4.2**	**2.4**
Government consumption (real, yoy)	5.0	6.6	10.8	12.1	11.5	4.5	2.2	0.0	**2.3**	**8.6**	**4.5**	**0.2**	**0.7**	**1.6**
Fixed investments (real, yoy)	-8.1	-12.0	-22.2	-19.6	-8.6	-3.8	9.3	5.1	**2.1**	**-15.5**	**0.5**	**4.6**	**2.5**	**0.7**
Net exports (contribution to yoy)	-1.3	-6.0	-4.7	-0.3	-0.6	4.6	4.1	2.5	**-0.3**	**-3.1**	**2.6**	**0.9**	**0.4**	**1.0**
Inventories (contribution to yoy)	-0.5	1.2	5.5	1.4	1.8	1.0	-3.9	-0.8	**-0.2**	**1.9**	**-0.5**	**-0.3**	**-0.1**	**-0.3**
Monthly data from the real economy														
Foreign trade (CZK bn) (**)	41	21	35	26	43	43	32	35	**142**	**122**	**153**	**163**	**171**	**178**
Exports (nominal, yoy)	-5.9	-27.6	-29.3	-15.1	-7.7	24.7	19.7	11.7	**3.8**	**-20.6**	**12.1**	**7.6**	**4.0**	**4.7**
Imports (nominal, yoy)	-5.0	-22.2	-33.0	-16.1	-11.4	24.8	23.1	10.8	**1.5**	**-22.0**	**11.8**	**8.1**	**4.7**	**5.0**
Industrial production (real, yoy)	-4.1	-26.4	-19.0	-11.2	-6.0	24.4	17.7	12.3	**2.0**	**-15.2**	**12.1**	**10.3**	**6.7**	**6.8**
Construction output (real, yoy)	2.7	-7.4	0.1	2.4	-5.6	-11.4	0.3	0.1	**0.8**	**-0.6**	**-4.1**	**13.4**	**11.4**	**7.5**
Retail sales (real, yoy)	1.8	-2.3	-6.4	-5.8	-2.4	0.7	4.8	5.8	**4.9**	**-3.2**	**2.2**	**6.9**	**5.3**	**1.7**
Labour market														
Wages (nominal, yoy)	5.0	4.6	3.8	4.6	4.3	3.6	3.7	3.7	**6.4**	**4.5**	**3.8**	**6.6**	**6.4**	**3.6**
Wages (real, yoy)	1.3	1.4	1.0	2.1	2.4	1.7	2.1	2.2	**3.5**	**1.5**	**2.1**	**4.9**	**3.9**	**1.3**
Unemployment rate (MLSA)	3.0	3.7	4.7	4.9	5.4	4.9	4.9	4.6	**2.8**	**4.1**	**4.9**	**4.3**	**4.0**	**4.2**
Unemployment rate (ILO 15+)	2.0	1.8	4.2	3.7	3.1	2.3	2.5	1.8	**2.0**	**2.9**	**2.4**	**1.7**	**1.6**	**1.9**
Employment (ILO 15+, yoy)	-0.6	-0.4	-2.2	-1.6	-0.9	-0.1	1.7	2.0	**0.2**	**-1.2**	**0.7**	**0.8**	**0.1**	**-0.2**
Consumer and producer prices														
CPI Inflation (yoy)	3.6	3.1	2.8	2.4	1.8	1.8	1.6	1.5	**2.8**	**3.0**	**1.7**	**1.7**	**2.4**	**2.3**
Taxes (contribution to yoy inflation)	0.0	0.0	0.1	0.1	0.1	0.1	0.0	0.0	**0.0**	**0.3**	**0.2**	**0.0**	**0.0**	**0.0**
Core inflation (yoy) (*)	2.7	3.2	2.9	2.4	2.0	1.4	1.4	1.5	**2.6**	**2.8**	**1.6**	**1.7**	**2.1**	**2.0**
Food prices (yoy) (*)	6.0	6.5	3.7	2.9	1.1	-0.3	1.1	1.3	**2.8**	**4.8**	**0.8**	**1.8**	**2.7**	**2.8**
Fuel prices (yoy) (*)	1.0	-19.4	-3.8	0.5	5.4	26.6	5.9	-0.5	**-0.4**	**-5.4**	**9.3**	**-0.3**	**4.0**	**2.8**
Regulated prices (yoy) (*)	4.2	3.4	3.0	2.6	1.6	1.8	1.9	1.9	**4.5**	**3.3**	**1.8**	**1.9**	**2.8**	**2.5**
Producer prices (yoy)	1.4	-0.6	0.8	2.5	3.0	4.3	3.0	1.5	**2.6**	**1.0**	**2.9**	**1.6**	**2.8**	**2.2**
Financial variables														
2W Repo (%, average)	2.03	0.56	0.25	0.25	0.25	0.25	0.25	0.25	**1.92**	**0.77**	**0.25**	**0.54**	**1.20**	**1.70**
3M PRIBOR (%, average)	2.15	0.59	0.45	0.45	0.45	0.45	0.45	0.45	**2.12**	**0.91**	**0.45**	**0.72**	**1.40**	**1.80**
EUR/CZK (average)	25.6	27.1	26.6	26.5	26.3	26.2	25.5	25.2	**25.7**	**26.5**	**25.9**	**25.1**	**25.1**	**24.9**
USD/CZK (average)	23.3	24.6	24.0	23.5	23.1	22.6	22.2	21.4	**22.9**	**23.8**	**22.3**	**20.7**	**19.9**	**19.3**
External environment														
GDP in EMU (real, yoy)	-3.2	-16.7	-3.5	-2.1	1.9	18.3	1.9	0.6	**1.2**	**-6.4**	**5.7**	**1.3**	**1.7**	**1.7**
GDP in Germany (real, yoy)	-2.3	-12.0	-4.2	-3.2	-0.4	11.3	2.6	2.1	**0.6**	**-5.4**	**3.9**	**1.8**	**1.4**	**1.3**
CPI in EMU (real, yoy)	1.1	0.2	0.4	0.5	0.7	1.4	1.4	1.3	**1.2**	**0.6**	**1.2**	**1.2**	**1.3**	**1.5**
Brent oil price (USD/brl, average)	54.3	27.8	40.0	40.0	45.0	45.0	45.0	45.0	**64.9**	**40.5**	**45.0**	**50.0**	**58.7**	**61.6**
EURIBOR 1Y (%, average)	-0.27	-0.11	-0.16	-0.11	-0.07	0.00	0.07	0.14	**-0.22**	**-0.16**	**0.03**	**0.31**	**0.90**	**1.80**
EUR/USD (average)	1.10	1.11	1.11	1.13	1.14	1.16	1.16	1.18	**1.12**	**1.11**	**1.16**	**1.21**	**1.26**	**1.29**

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;
(**) the quarterly data are seasonally adjusted.

CNB Focus

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CNB unlikely to change rates at its August meeting

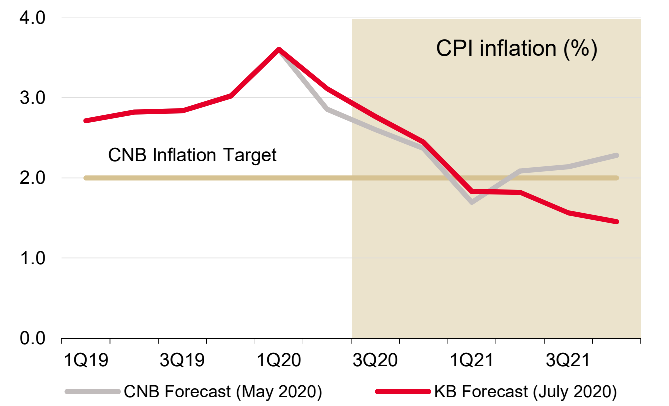
The Czech National Bank likely will continue to consider current monetary policy easing as sufficient and leave interest rates unchanged at its August meeting. One reason for this is that inflation is above the upper edge of the tolerance band. This is also likely to postpone the debate on the possible introduction of unconventional measures. However, the outlook for the economy is still uncertain and inflation is likely to slow significantly in the coming months. In our view, interest rates will remain low until the end of 2021. In addition, the risks are slightly biased towards the need for further significant monetary easing, but this would have to be implemented through unconventional instruments. We still believe that exchange rate intervention would be most probable in this case.

According to the CNB, the current easing of monetary policy is sufficient

During the first half of the year, the central bank reduced the repo rate by 200bp to 0.25% in order to dampen the effects of coronavirus.

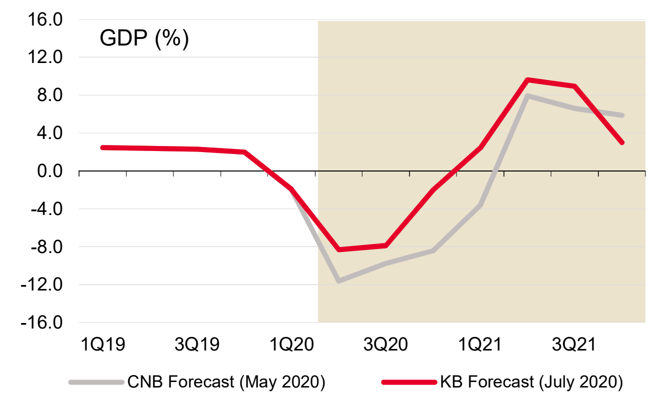
The Czech National Bank left interest rates unchanged in June. The two-week repo rate thus remained at 0.25%, and all the bank board members voted in favour of this. Unlike the CNB's previous steps, this did not come as a surprise to the market, as three central bankers, including Governor J. Rusnok, expressed their preference for interest rate stability before the meeting. The central bank stated that current easing of monetary policy was sufficient, following the 200bp reduction of interest rates in 1H20, as recent domestic economy developments roughly matched its forecast.

Inflation likely to slow over the forecast horizon…



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

… mainly due to weak demand



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

High inflation will not be a reason to raise rates

Current high inflation will likely slow in the second half of this year due to weak demand and a stronger Czech koruna. The CNB will thus have no reason to raise rates.

While the real economy was in line with the CNB forecast in 1Q, higher domestic inflation during the second quarter represents risk. The return of inflation above the upper limit of the CNB's tolerance band was not only related to normally volatile food and fuel prices. In May and June, higher core inflation surprised. It moved back above 3% and reached the highest value in the history of the time series, which has been available since 2007. Indeed, growth in consumer prices remains high, despite declining economic activity. However, we assume that inflation will slow in the second half of the year. The question is whether this will be to the central bank's 2% target, or below this.

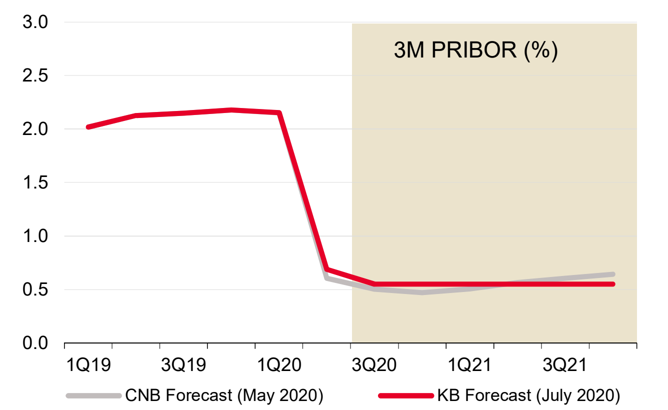
Higher inflation should not prompt the central bank to consider raising interest rates as the economic outlook is still uncertain. Disinflationary tendencies are already evident in the European economy as a whole. This should be reflected in lower prices of imported goods, which will be also affected by the stronger exchange rate of the Czech koruna compared to the CNB forecast. In addition, 1Q euro area GDP fell more than the central bank expected (-3.2% vs its -2.0% expectation). Current domestic inflation is fuelled by consumer demand, which is still relatively solid, as shown by May retail sales results. This is based on the still good situation of the Czech labour market, as the unemployment rate remains low. In the following months, however, the number of unemployed will probably increase. Demand is now lacking in manufacturing, which is an important source of employment in the Czech Republic. In this respect, however, there is unlikely to be a significant improvement by the end of the year.

Rates likely to remain at current levels until end-2021

If the CNB wants to deliver additional support to the economy, it will need to use unconventional measures, likely FX intervention.

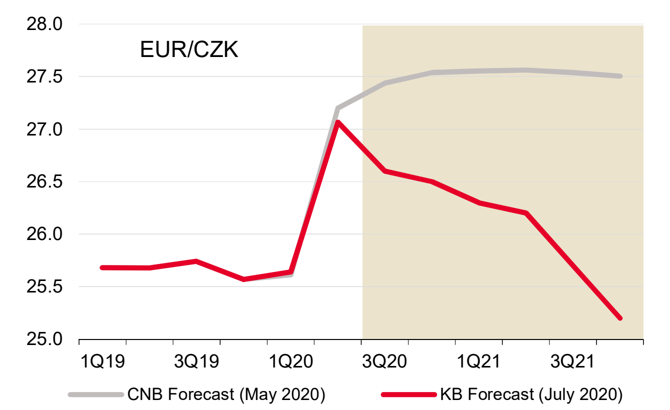
Our baseline forecast scenario is for stable interest rates until end-2021. Moreover, currently high inflation will probably defer the discussion on the introduction of unconventional tools. However, their use by the CNB is not excluded. The need for stronger easing of monetary policy may arise in the autumn, when it should be clear whether the economic recovery in the second half of the year is meeting expectations. If it is not, an additional economic policy response is likely. However, room for further reductions in interest rates is significantly limited, as their level is now close to the so-called technical zero. In addition, the impact of weak demand on price developments may have the strongest effect at the turn of this year and the next, as a large portion of sellers still reset their prices once a year, usually at the beginning. **The risks to the baseline forecast scenario are thus slightly biased toward the need for a more pronounced easing of the CNB's monetary policy, to which the renewed strengthening of the Czech koruna also contributes. Regarding unconventional instruments, we continue to believe that the most likely would be an exchange rate intervention.**

We expect low interest rates until end-2021 …



Source: CNB, Economic & Strategy Research, Komerční banka

… but the risk may be a stronger strengthening of the koruna



Source: CNB, Economic & Strategy Research, Komerční banka

Czech FX market

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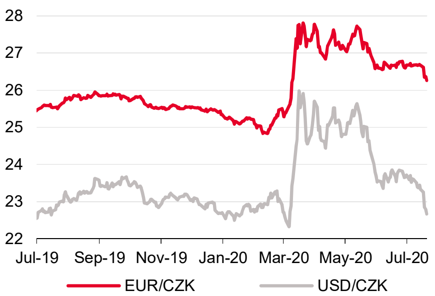
Koruna ready to strengthen further

The koruna has been supported in recent weeks by a rebound in market interest rates and positive sentiment towards EM FX. We expect this trend to continue and the koruna to gradually appreciate. We also expect volatility to ease in 2H20. A second wave of the coronavirus pandemic remains a risk. Meanwhile, the probability of CNB interventions on the FX market has decreased since our previous forecast. Despite the recent increase in the forward points, the conditions for FX hedging are slowly deteriorating, a trend we expect to continue through year-end. Therefore, we still recommend taking advantage of the current market conditions to hedge against CZK strengthening.

Financial markets are preparing the ground for the stronger koruna

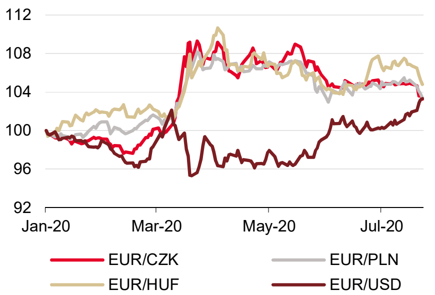
Better data from the real economy, led by higher inflation and the CNB's rhetoric, have supported our expectation of a rebound in market rates in recent weeks. Together with the risk-on mood in financial markets and investors' willingness to return to emerging markets, this has helped to push the koruna to its strongest level since the beginning of the COVID-19 crisis, earlier than we expected. Given that the CNB will no longer consider further interest rate cuts in our baseline scenario, market interest rates should gradually bounce from the bottom in the coming months, further increasing the koruna's attractiveness. We think it still has room to appreciate.

Koruna exchange rates over past twelve months



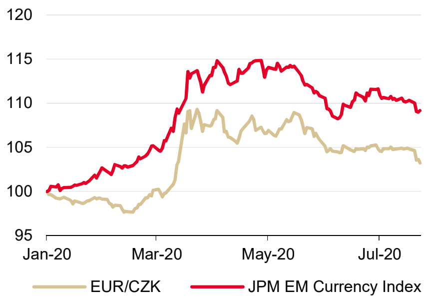
Source: Bloomberg, Economic and Strategic Research, Komerční banka

Performance of Central European currencies



Source: Bloomberg, Economic and Strategic Research, Komerční banka, 1.1.2020 = 100

Koruna still stronger than EM FX market



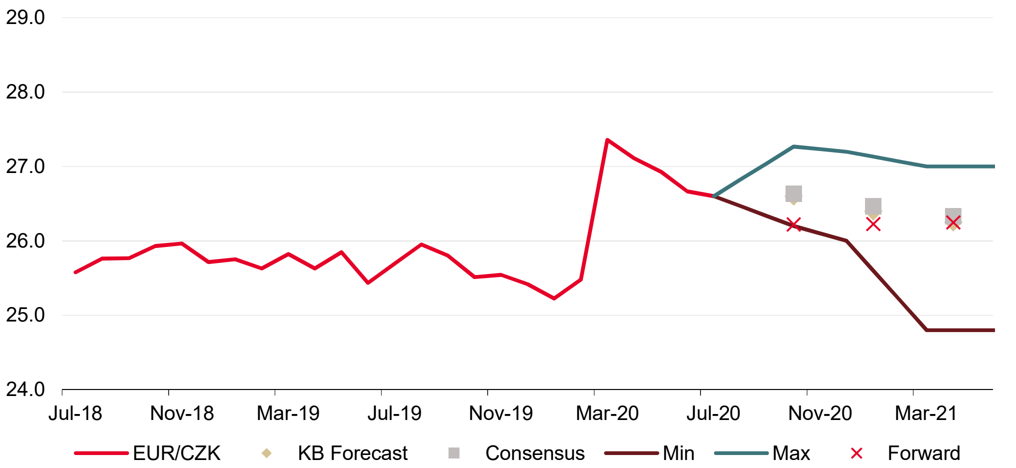
Source: Bloomberg, Economic and Strategic Research, Komerční banka, 1.1.2020 = 100

In the coming weeks, we expect the koruna to strengthen further as market interest rates continue to rise. The currency could appreciate more than we forecast if domestic market rates rise beyond our expectations (more in the next chapter). In our baseline scenario, we expect FX volatility to ease compared with 1H20, especially on the downside.

Second wave of pandemic and possible CNB intervention the main risks

Although macroeconomic data point to a gradual recovery, current epidemiological developments leave the possibility open for a second wave of the pandemic. Again, even a partial closure of the economy would have a negative impact on the koruna. This scenario would probably be common for all of Europe, and investors would again flee EM assets, including the koruna.

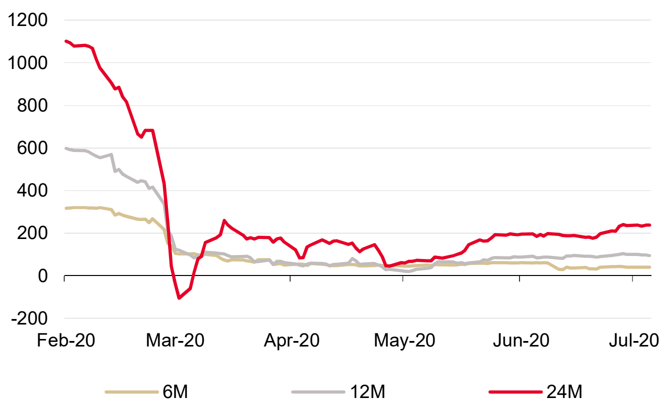
Expected EUR/CZK path, market consensus by Bloomberg (as of 28 July 2020)



Source: Bloomberg, Economic and Strategic Research, Komerční banka

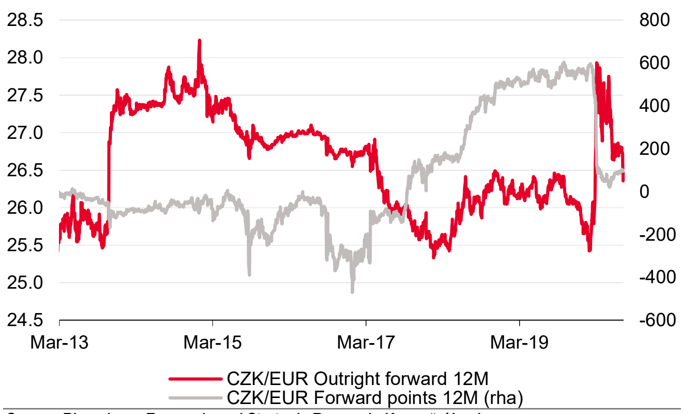
The risk of the CNB intervening on the FX market has declined since June forecast. Based on our new FX forecasts, we think the CNB is less likely to conduct interventions to weaken the koruna. In the longer term, however, this remains the most likely unconventional measure to further loosen monetary conditions if necessary, in our view. This could be triggered by a second wave of the pandemic or a slower economic recovery and the associated deflationary risks. On the other hand, although the CNB has recent experience instituting an FX floor, the board's current composition has taken a more restrained approach to this tool.

As interest rates rise, forward points begin to rebound



Source: Bloomberg, Economic and Strategic Research, Komerční banka

The conditions for hedging a weaker koruna are deteriorating



Source: Bloomberg, Economic and Strategic Research, Komerční banka

FX hedging conditions deteriorating

The koruna has strengthened since our June forecast, while market interest rates have bounced from their nadir and have been rising gradually, supporting growth in the forward points. However, higher rates have not full offset koruna appreciation, and **the conditions for FX hedging are thus deteriorating. We expect this trend to continue in the coming months**. Therefore, we still think exporters should use current FX levels to hedge.

Czech government bonds and the IRS market

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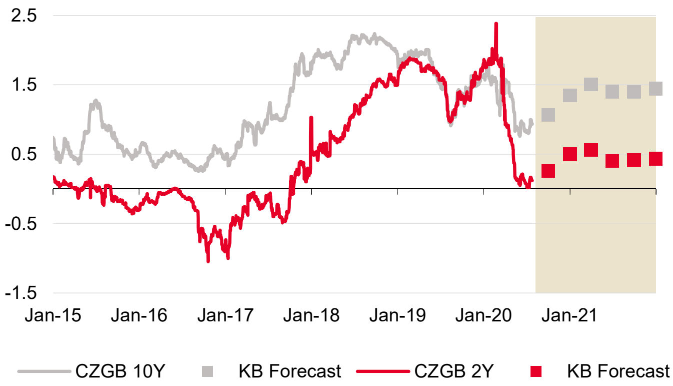
Interest rates and yields are bottoming out

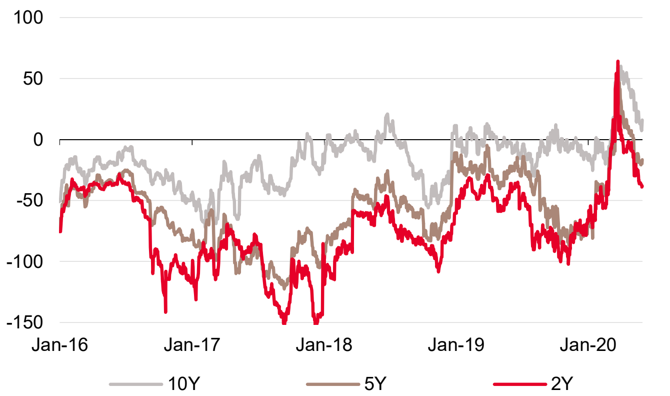
Despite a record increase in the planned state budget deficit, the supply of government bonds will be minimal in the second half of the year. In our opinion, this will be reflected in their richening in ASW terms in the coming months. Next year, however, the supply will be similar to this year due to the record maturity calendar. At the end of 2020, they should become cheaper again. Demand is gradually declining, but will continue to be higher than supply. Yields and IRS have detached from the bottom in recent weeks and, in our opinion, will continue to grow, especially in longer maturities. We still recommend pay the CZK 10y and 2s5s steepener. The conditions for interest rate hedging are gradually deteriorating.

CZGB yields (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

ASW spreads (bp)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

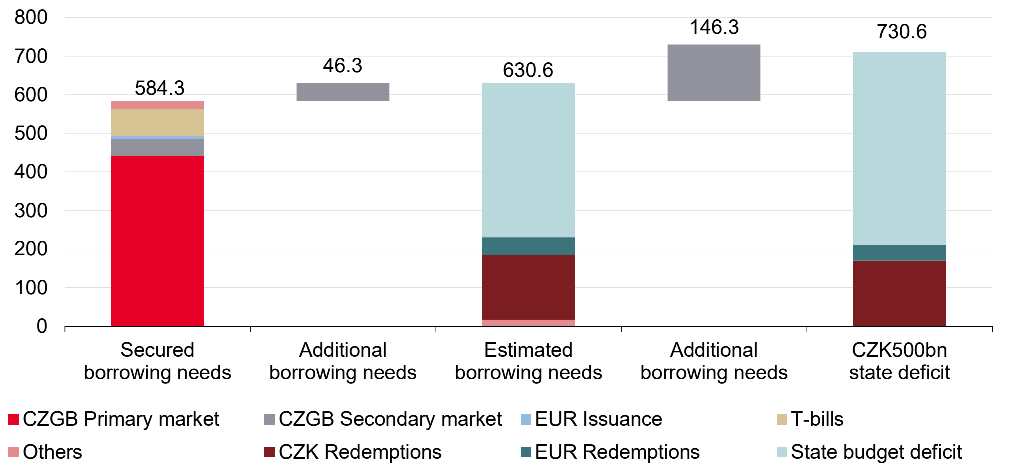
The supply of government bonds will dry up for the rest of the year

Due to our forecast for the state budget and the high issuance activity of the Ministry of Finance in previous months, we believe that the supply of government bonds will be very limited for the rest of the year.

Despite the repeated sharp increase in this year's state budget deficit, the Ministry of Finance was able to secure the vast majority of borrowing needs in the first half of the year. Compared to the official Debt Portfolio Management Quarterly Report, we assume CZK100bn lower borrowing needs of CZK630.6bn due to a more optimistic forecast of the state budget. **According to our calculations, the government has so far covered 89.7% of borrowing needs**, including the planned drawing of budget reserves.

For the rest of the year, the supply of new government bonds will be very limited. In addition, part of the remaining borrowing needs will probably be covered by euro issuance (approximately CZK11bn) and borrowing from supranational institutions (maximum CZK26.5bn). Alternatively, the government can draw these loans in CZK, which would increase this year's euro issuance and reduce the koruna issuance. In the basic scenario, however, we assume that the Ministry has to issue CZK27.7bn of CZGB, i.e. CZK5.5bn per month, which in our opinion gives the government the flexibility to react to the development of the state budget and conditions in the financial markets. In the event that the state budget falls to the deficit projected by the government, the CZGB issuance would be higher by CZK100bn. Even so, CZK25.5bn would remain to be issued by the end of the year, which is only slightly above the previous year's average. Another risk in the direction of higher issuance is the possible pre-financing of government bonds maturing in February next year to the amount of CZK26bn.

Borrowing needs this year



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

Next year, the maturity calendar includes CZK292bn of CZGB, which is roughly CZK80bn more than this year. For the time being, we expect a state deficit of CZK270bn for next year. However, the Ministry of Finance has suspended the publication of the outlook for the next year, and even the information available so far does not indicate the framework for 2021. In our opinion, however, it is very likely that borrowing needs will reach a similar level as this year.

Demand for CZGB is gradually declining, but will remain sufficient

Interest in domestic government bonds has broken historical records in previous months and has been steadily declining since then. However, the issuance activity of the Ministry of Finance also dropped significantly. Therefore, **demand continues to significantly exceed supply**. The initial high interest in shorter maturities gradually shifted to the cheaper longer end of the curve, but it has also richened significantly since then.

CZGB yield forecast

	3Q20f	4Q20f	1Q21f	2Q21f	3Q21f
2y CZGB yield (%)	0.25	0.50	0.55	0.40	0.40
5y CZGB yield (%)	0.75	1.05	1.15	1.05	1.05
10y CZGB yield (%)	1.05	1.35	1.50	1.40	1.40
10y CZGB ASW (bp)	10	30	30	10	10

Source: Economic & Strategy Research, Komerční banka

Government bond yields bottomed out for most of their maturities in early July and have been rising steadily since then. The main reasons are improving sentiment in global markets, surprisingly higher inflation and the CNB's neutral stance. In our opinion, this trend will continue for the rest of the year. Due to the limited supply on the primary market, government bonds should richen in the coming months in ASW terms. At the end of the year, however, we expect them to cheapen again due to discussions about the state budget for next year. These should show investors that the offer of government bonds next year will roughly correspond to this year's. The bund, which will detach from its current bottom, will also contribute to the growth of longer yields next year. The last movements of the curve compensated for the recent asymmetric richening of the short end. At the moment, we recommend, in ASW terms, go long in the short end and the belly of the curve (e.g. 1.25% Mar-25), and to minimise duration. From a technical point of view, we expect that by the end of August 3.85% of Sep-21 will be removed from the GBI-EM index, which is usually associated with a sell-off. However, part of this effect is already included in the current price.

Government bond overview

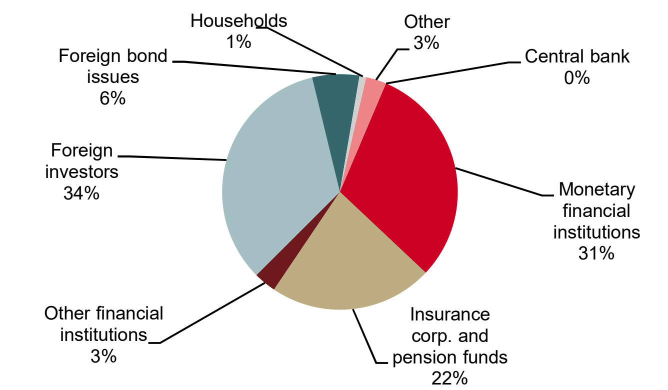
Government bond overview								Rich-cheap analysis											
Bond	Dur.	Issued last 90D	Issuance limit	Yield	Δ1W	Δ1M	FX hedged	ASW	Δ1W	Δ1M	Min	90D	Max	Z-Score	Rank	Spline spread	Rank	Carry Roll 90D	Rank
0.75 Feb-21	0.6	0.0	38%	-0.21	-1	0	-0.60	-52	-3	-4	-58.4		1.7	-1.1	14	-19.3	2	-4.8	18
3.85 Sep-21	1.1	1.3	100%	-0.06	0	0	-0.49	-63	1	6	-75.1		13.6	-0.5	2	-20.7	1	-1.2	17
0.00 Feb-22	1.6	0.0	6%	0.02	-2	9	-0.41	-46	-1	15	-75.6		31.5	0.1	1	-17.5	3	0.3	16
0.10 Apr-22	1.7	0.0	33%	0.04	-2	-8	-0.41	-43	-2	-9	-44.9		11.8	-0.9	7	-15.0	4	0.6	15
4.70 Sep-22	2.0	7.4	100%	0.02	-1	-2	-0.48	-54	-3	0	-59.7		21.9	-0.8	5	0.0	9	0.9	5
0.45 Oct-23	3.2	0.0	68%	0.35	-1	1	-0.23	-22	-3	-6	-25.5		45.3	-0.8	6	0.0	7	1.7	1
5.70 May-24	3.5	0.0	100%	0.30	-3	0	-0.32	-30	-5	-11	-30.7		55.7	-1.1	17	18.3	18	1.2	3
1.25 Feb-25	4.4	0.0	102%	0.62	1	10	-0.07	-3	-3	2	-15.6		51.6	-0.6	3	-2.4	5	1.3	2
2.40 Sep-25	4.8	4.5	69%	0.61	-2	6	-0.10	-11	-3	-4	-16.5		44.6	-1.1	13	4.7	15	1.0	4
1.00 Jun-26	5.7	7.0	82%	0.68	-2	5	-0.06	-3	-4	-9	-3.4		51.9	-1.3	18	3.7	13	0.8	6
0.25 Feb-27	6.4	11.1	88%	0.75	-1	9	0.00	0	-3	-2	-6.6		55.2	-1.0	11	0.0	6	0.7	11
2.50 Aug-28	7.4	4.6	72%	0.79	-2	8	0.09	-1	-3	-4	-7.7		80.1	-1.0	8	2.4	12	0.6	14
2.75 Jul-29	8.1	0.0	67%	0.82	-2	4	0.14	0	-5	-9	-2.4		69.3	-1.1	15	4.1	14	0.6	13
0.95 May-30	9.3	5.2	72%	0.90	-3	9	0.19	5	-5	-5	2.1		75.3	-1.0	12	0.0	11	0.7	12
1.20 Mar-31	9.9	11.6	41%	0.94	-2	8	0.25	5	-4	-3	-1.1		77.4	-1.0	10	0.0	8	0.7	8
2.00 Oct-33	11.6	5.2	73%	0.99	-1	5	0.34	5	-2	-8	1.5		81.7	-1.1	16	10.2	16	0.7	10
4.20 Dec-36	12.6	0.0	63%	1.14	-2	4	0.59	19	-4	-11	5.9		116.7	-1.0	9	13.8	17	0.7	9
1.50 Apr-40	16.9	5.7	21%	1.47	0	3	0.73	45	-1	-6	36.4		75.8	-0.8	4	0.0	10	0.8	7

Source: Economic & Strategy Research, Komerční banka
Note: More in CZGB Auction Alert

Structure of CZGB holders: the share of foreign holders decreased

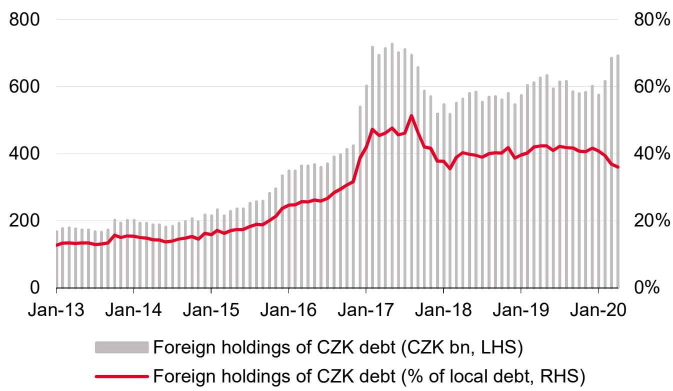
Holdings of CZGB by foreign investors in June fell again by six-tenths to 36%. At the beginning of the year, foreign entities still held 41.6% of all CZGB. In absolute terms, however, their volume has increased by CZK116.9bn over the past three months. Most new bonds were demanded mainly by domestic entities, led by banks. Over the same period, they increased their portfolios by CZK338.3bn. Thus, **in relative terms, the structure of holders of domestic government bonds has changed in favour of domestic players.** In the coming months, we expect that changes in the structure of holders will be minimal and the current situation can be considered as the new standard.

Holdings of CZK government debt (May 2020)



Source: MinFin, Economic & Strategy Research, Komerční banka

Share of non-resident bondholders decreased to 36.0%



Source: MinFin, Economic & Strategy Research, Komerční banka

Czech IRS market: rates are bottoming out

According to our expectations, koruna interest rate swaps rebounded during July and have been gradually rising. Better developments abroad, high domestic inflation and an end to the CNB monetary conditions easing opened up room for market interest rates to return to higher levels. In our opinion, this trend will continue for the rest of the year and especially in the coming year, despite the fact that we expect the first increase in CNB interest rates in 2022. The main part of the increase should take place mainly in longer maturities, which will lead to a steepening of the curve. Our rates forecast is also supported by the European

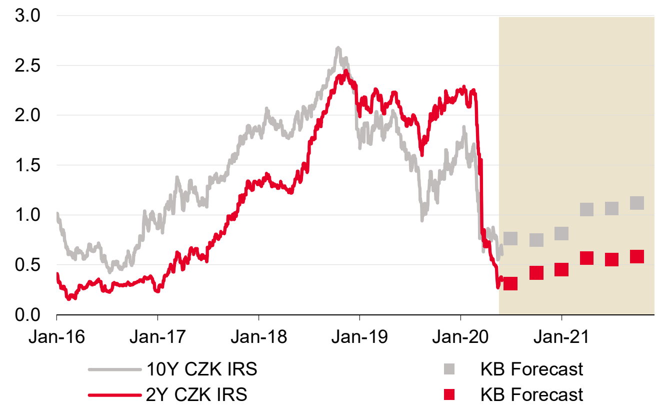
Union's approved recovery fund. It envisages a joint issue of government bonds, which in our opinion will be accompanied by a wave of pre-hedging, which should support the growth of euro rates and, consequently, koruna rates – especially in longer maturities. We still recommend paying the CZK 10y and the 2s5s steepener.

CZK IRS outlook

	3Q20f	4Q20f	1Q21f	2Q21f	3Q21f
2y	0.55	0.60	0.65	0.70	0.70
5y	0.75	0.85	0.95	1.05	1.05
10y	0.95	1.05	1.20	1.30	1.30

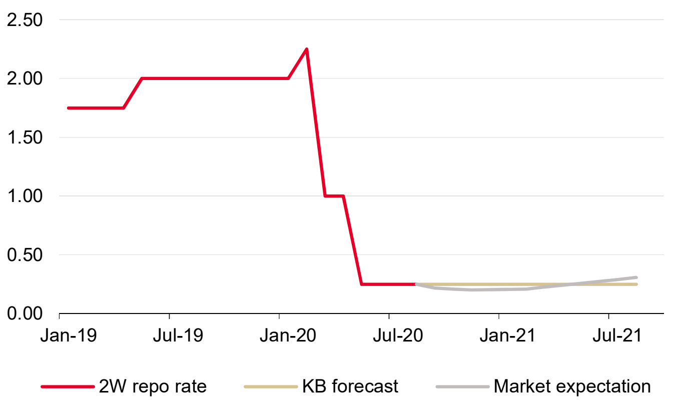
Source: Economic & Strategy Research, Komerční banka

CZGB yields (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

ASW spreads (bp)

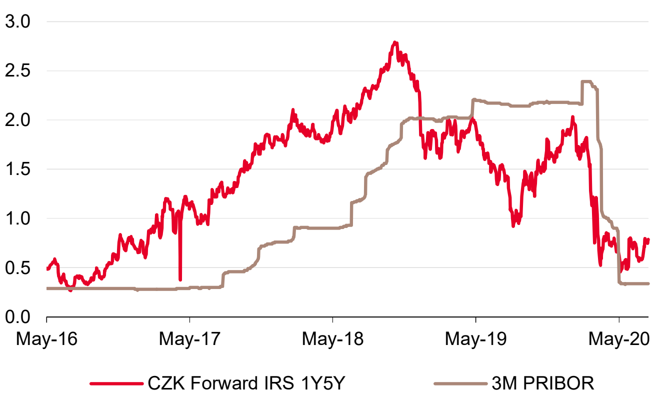


Source: Bloomberg, Economic and Strategy Research, Komerční banka

The conditions for IR hedging are deteriorating

Interest rates have bottomed out in recent weeks and are gradually rising along their entire curve. In our opinion, this trend will continue, which will worsen the conditions for hedging record low interest rates. Although we do not expect the CNB to raise interest rates for the first time until 2022, the financial markets are beginning to include this step in their prices in advance. The euro curve continues to be negative throughout its length, and dollar rates are still close to their all-time lows. In both cases, however, we expect their gradual increase in the second half of the year. Therefore, **we continue to recommend using the current conditions to hedge interest rate risk against future rate increases.**

The conditions for IR hedging are deteriorating



Source: Bloomberg, Economic & Strategy Research, Komerční banka

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

Forward \ Maturita	6M	1Y	18M	2Y	3Y	5Y	10Y
Spot	0.36	0.35	0.39	0.42	0.50	0.65	0.85
3M	0.32	0.36	0.41	0.45	0.53	0.68	0.87
6M	0.35	0.41	0.45	0.49	0.58	0.72	0.89
9M	0.41	0.45	0.49	0.53	0.62	0.75	0.91
1Y	0.47	0.50	0.54	0.57	0.67	0.78	0.93
18M	0.53	0.57	0.61	0.66	0.74	0.83	0.97
2Y	0.61	0.65	0.71	0.76	0.81	0.88	1.01
3Y	0.82	0.86	0.87	0.89	0.92	0.97	1.08

Source: Bloomberg, Economic & Strategy Research, Komerční banka, as of 27 July 2020

Banking Sector

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Credit growth gradually decelerates

The overall economic decline will have a dampening effect on credit growth. But the overall picture is far from catastrophic. **Real estate loans are expected to decelerate gradually, along with the gradual deterioration of the situation for households.** This should be more visible in 2021 where we expect real estate loans to rise by 4.1%. Lower interest rates could provide a small stimulus however. In nominal terms, our expectations for real estate price deceleration in 2020 and a slight decrease next year supports real estate loans deceleration as well.

The comparative base from 2019 is relatively low in terms of corporate loans as the companies were cautious, curtailing new investment. In 1Q, corporate loans accelerated but they started to weaken again from 2Q. **We expect that corporate lending will continue to decelerate until mid-2021 when the economy is expected to be on a significantly stronger footing.** Some sectors such as travel agencies and hotels are at higher risk. But the overall credit deceleration should not be dramatic given the government programmes aiming at credit growth support. **Consumer loans decelerated as a response to the pandemic shock and increased consumer uncertainty.** Although our outlook for the economy has improved, we still expect labour market deterioration and slower wage growth which in turn implies slower growth of consumer loans.

As uncertainty increased during the pandemic crisis, the pace of deposit increases accelerated. Companies were hoarding cash. Although such behaviour may prevail to some extent, we also expect that the deposit growth will decelerate as the situation normalises. For 2020 however, deposit growth will probably be above 10%.

Bank loans and deposits (%, yoy)

	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	2019	2020	2021	2022	2023	2024
Bank loans														
Total	6.9	5.5	4.4	5.1	2.3	3.4	4.0	3.9	**4.9**	**5.5**	**3.4**	**5.5**	**6.5**	**5.7**
Households - real estate loans	7.1	6.5	6.4	5.6	4.6	4.0	3.7	4.3	**7.3**	**6.4**	**4.1**	**4.8**	**6.3**	**5.6**
Households - consumer loans	7.0	4.2	4.7	1.3	2.3	4.6	5.4	5.3	**6.7**	**4.3**	**4.4**	**5.2**	**6.4**	**6.3**
Corporate loans	6.4	5.7	2.2	5.2	0.6	3.2	5.0	3.1	**4.2**	**4.9**	**3.0**	**5.7**	**5.2**	**5.0**
Deposits														
Total	10.9	14.7	11.9	9.5	5.0	0.0	1.3	4.8	**9.6**	**11.8**	**2.8**	**5.6**	**5.8**	**5.3**
Households	8.0	9.3	9.0	7.7	5.6	3.4	2.0	2.6	**7.2**	**8.5**	**3.4**	**4.1**	**5.8**	**5.1**
Non-financial corporations	11.7	10.9	9.3	10.8	7.3	5.6	7.7	6.2	**5.1**	**10.7**	**6.7**	**4.9**	**4.5**	**5.5**
Others	15.5	26.5	18.4	12.4	2.2	-8.1	-3.9	8.2	**17.9**	**18.2**	**-0.4**	**8.5**	**6.8**	**5.6**
Ratios														
Loans/GDP	62.1	62.8	64.2	64.1	64.2	63.1	62.5	61.9	**60.4**	**63.3**	**62.9**	**62.8**	**63.6**	**64.5**
Deposits/GDP	91.7	99.6	99.8	91.8	97.3	96.8	94.5	89.4	**86.2**	**95.7**	**94.5**	**94.4**	**95.0**	**96.0**
Loans/deposits	67.7	63.0	64.4	69.9	66.0	65.2	66.1	69.3	**70.2**	**66.2**	**66.6**	**66.6**	**67.0**	**67.2**
Interest rates														
Real estate loans	2.6	2.5	2.5	2.6	2.9	2.9	2.9	2.9	**2.7**	**2.5**	**2.9**	**3.4**	**4.1**	**4.4**
Consumer loans	8.2	7.3	6.7	7.7	8.0	7.9	7.7	7.5	**8.4**	**7.5**	**7.7**	**7.2**	**7.3**	**7.4**
Corporate loans	3.2	2.5	2.6	3.1	3.3	2.9	2.9	2.8	**3.3**	**2.9**	**3.0**	**3.1**	**3.6**	**4.0**
Share of NPL														
Real estate loans	1.1	1.2	1.6	1.7	1.4	1.3	1.7	1.7	**1.3**	**1.4**	**1.5**	**1.6**	**1.3**	**1.1**
Consumer loans	4.1	4.3	5.9	6.5	5.6	5.5	5.7	8.6	**4.2**	**5.2**	**6.4**	**7.8**	**7.0**	**6.6**
Corporate loans	3.1	3.3	4.5	6.3	6.8	6.3	5.9	5.6	**3.4**	**4.3**	**6.2**	**5.2**	**4.2**	**2.1**

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

Key Economic Indicators

Macroeconomic indicators – long-term outlook

		2017	2018	2019	2020	2021	2022	2023	2024
GDP	real, %	5.4	3.2	2.3	-5.0	6.0	3.0	2.6	2.2
Inflation	average, %	2.5	2.1	2.8	3.0	1.7	1.7	2.4	2.3
Current account	% of GDP	1.4	0.4	-0.3	-1.5	2.2	1.8	1.3	1.5
3M PRIBOR	average, %	0.4	1.3	2.1	0.9	0.5	0.7	1.4	1.8
EUR/CZK	average	26.3	25.6	25.7	26.5	25.9	25.1	25.1	24.9
USD/CZK	average	23.4	21.7	22.9	24.1	22.5	20.8	19.9	19.4

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

FX & interest-rate outlook

		27.07.2020	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21
EUR/CZK	end of period	26.2	26.6	26.5	26.3	26.2	25.5
USD/EUR	end of period	1.17	1.11	1.13	1.14	1.16	1.16
CZK/USD	end of period	22.3	24.0	23.5	23.1	22.6	22.0
3M PRIBOR	end of period	0.34	0.35	0.35	0.35	0.45	0.45
10Y IRS	end of period	0.84	0.95	1.05	1.20	1.30	1.30

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

Monthly macroeconomic data

		X-19	XI-19	XII-19	I-20	II-20	III-20	IV-20	V-20	VI-20
Inflation (CPI)	%, mom	2.7	3.1	3.2	3.6	3.7	3.4	3.2	2.9	3.3
Inflation (CPI)	%, yoy	0.5	0.3	0.2	1.5	0.3	-0.1	-0.2	0.4	0.6
Producer prices (PPI)	%, mom	0.9	0.9	2.1	2.4	1.4	0.4	-0.8	-0.9	-0.3
Producer prices (PPI)	%, yoy	-0.3	-0.1	0.1	1.3	-0.7	-0.5	-0.5	0.4	-0.1
Unemployment rate	% (MLSA)	2.6	2.6	2.9	3.1	3.0	3.0	3.4	3.6	3.7
Industrial sales	%, yoy, c.p.	-3.0	-5.5	-0.5	-1.3	-0.3	-10.2	-33.7	-29.4	n.a.
Industrial production	%, yoy, c.p.	-3.0	-6.5	-0.2	0.5	0.6	-9.5	-35.5	-28.8	n.a.
Construction output	%, yoy, c.p.	-0.3	4.5	4.5	6.0	5.3	-0.3	-4.6	-7.6	n.a.
Retail sales	%, yoy, c.p.	2.6	3.0	4.4	1.6	3.5	-12.0	-21.5	-12.2	n.a.
External trade	CZK bn (national met.)	8.0	12.9	-9.5	17.1	21.4	2.4	-25.3	1.3	n.a.
Current account	CZK bn	-9.5	-1.6	-10.6	12.1	40.0	22.5	-9.2	4.2	n.a.
Financial account	CZK bn	8.3	-13.2	17.1	15.4	49.3	46.5	-8.7	17.0	n.a.
M2 growth	%, yoy	8.1	7.6	7.1	8.0	7.9	9.9	9.3	9.0	n.a.
State budget	CZK bn (YTD cum.)	-19.6	-38.6	-28.5	-8.0	-27.4	-44.7	-93.8	-157.4	-195.2
PRIBOR 3M	%, average	2.17	2.18	2.18	2.17	2.34	1.95	0.96	0.46	0.34
EUR/CZK	average	25.7	25.5	25.5	25.2	25.1	26.6	27.3	27.3	26.7
USD/CZK	average	23.2	23.1	22.9	22.7	23.0	24.1	25.1	25.0	23.7

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

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