Quarterly report

Czech Economic Outlook

Hawks returning

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■ **Economy on threshold of rapid expansion** The Czech economy is likely to rebound to growth in the second quarter of this year, and this growth will likely accelerate in subsequent quarters.

■ **Inflation remains elevated** Inflation is being supported by rising oil prices. Core inflation is falling only very slowly. Next year, we expect inflation to slow to 2%, with import prices having a disinflationary effect.

■ **CNB interest rates are likely to remain low until November, when we expect a first hike** This would likely trigger a gradual normalisation of monetary policy. At end-2022, we forecast the key repo rate to be 1.25%.

■ **Peak interest rates and government bond yields still not on the horizon** Interest rates and government bond yields rose sharply in the first quarter. They should continue to rise, albeit at a slower pace. Financial markets appear to count on the CNB raising interest rates. In the CZGB space, the market may be surprised by low supply in the second half of the year.

■ **Coming rate hike is moving the koruna to stronger levels** The koruna got rid of its COVID premium in March and has returned to its original strengthening trajectory. The resumption of growth in market rates, combined with global optimism and a stronger euro against the US dollar, should push the koruna to stronger level.

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Households poised for spending spree

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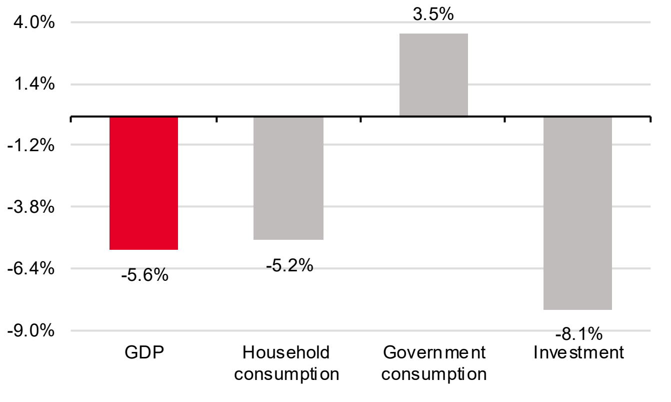
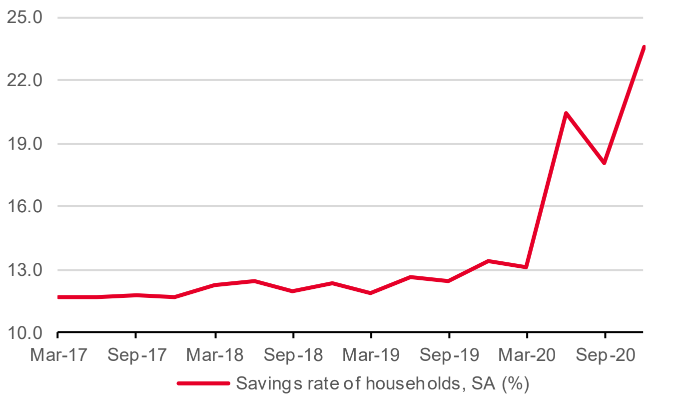
From an economic standpoint, the worst year in the Czech Republic's recent history is over. We expect to see rapid growth as early as the second half of this year. Last year's economic downturn of 5.6% was the most severe in the Czech Republic's recent history, but it certainly was not a typical recession. Traditionally the most stable part of GDP, household consumption, recorded an unprecedented slump of 5.2%. However, thanks to monetary and fiscal easing and targeted efforts to mitigate COVID, the main reason for the slump was not fear of a markedly deteriorating standard of living. Rather, the severe contraction in private consumption was due to consumers' inability to spend, with most of the brick-and-mortar shops and personal service operations closed down. Unsurprisingly, the household savings rate surged to unprecedented levels.

2020: A uniquely different recession – household consumption plummeted while investments felt by single digits only (yoy)



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

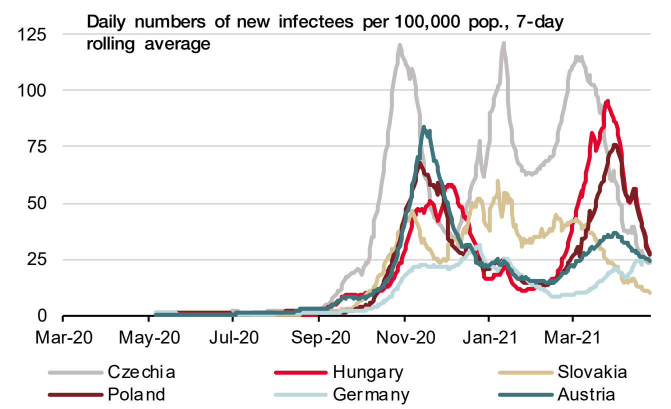
The household saving rate surged to its highest ever level …but there was nowhere to spend it



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

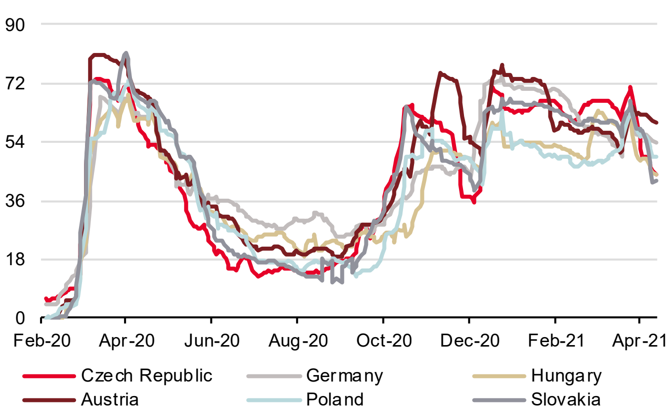
These savings are a promise of strong consumer spending once the pandemic measures are fully lifted. And it is the phase-out of restrictive measures that should, together with progress on the vaccination front, trigger debate about a potential new spiral of rate hikes. We continue to expect that the November CNB Board meeting will bring the first rate hike. However, the hawks on the Board may look for this move in the summer.

During the last three waves, the CR has had some of the world's highest figures in terms of the daily number of infected



Source: Macrobond, Economic and Strategy Research, Komerční banka

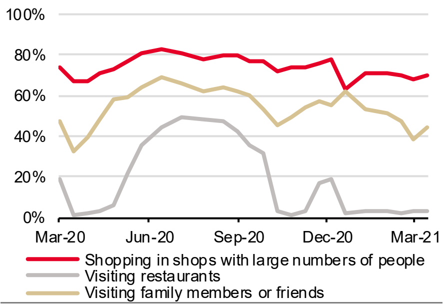
Last summer's easing of restrictions was premature The COVID-19 Stringency Index



Source: Macrobond, Oxford University, Economic and Strategy Research, Komerční banka

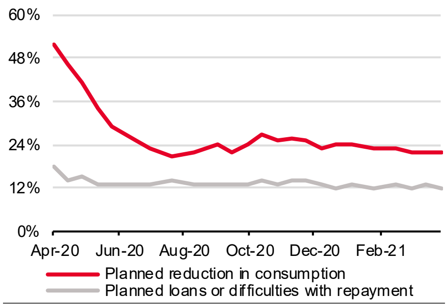
Unfortunately, we did not see an appreciable improvement in the pandemic situation in the first quarter of this year. This was a vindication of the subheading of our previous *Czech Economic Outlook*, which read *The Way out of the Vale of Tears*. For the Czech Republic, the first quarter proved to be worst quarter to date, recording the world's highest figures for both per capita number of newly infected people and number of deaths. The extent of restrictions on economic life was almost unchanged from the spring of 2020, but they were kept in place for much longer than during the first wave.

Social activities during the pandemic (percentage of respondents)



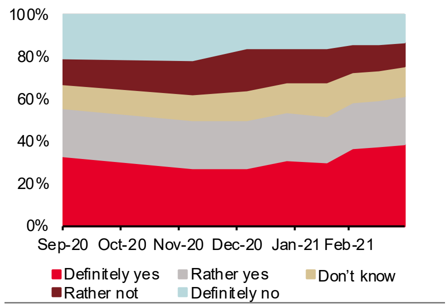
Source: Economic and Strategy Research, Komerční banka, zivotbehempandemie.cz

Households' response to the deteriorated economic situation



Source: Economic and Strategy Research, Komerční banka, zivotbehempandemie.cz

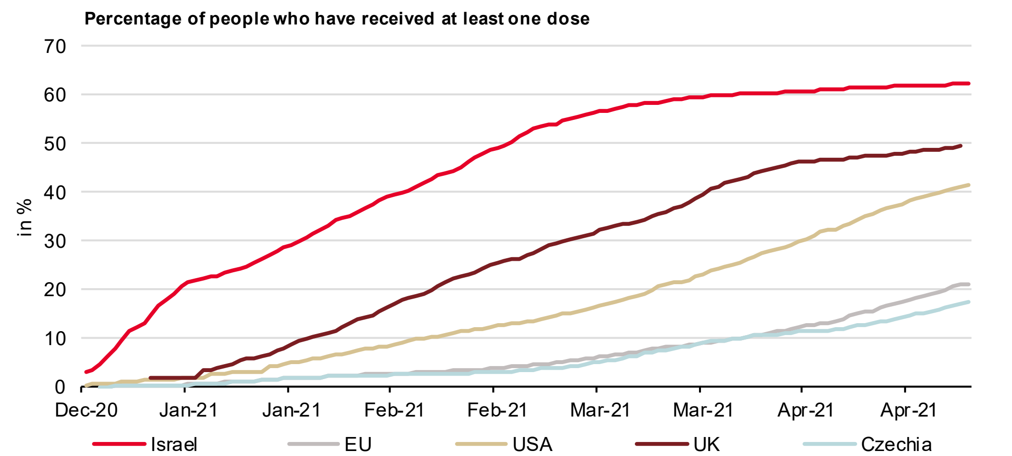
Vaccination willingness (percentage of respondents)



Source: Economic and Strategy Research, Komerční banka, zivotbehempandemie.cz

From an economic and social perspective, the major shock was the first pandemic wave a year ago. However, in terms of the number of infected people in the Czech Republic, it was the weakest. We have gradually learned how to live with the pandemic, but because the situation is perceived to be seemingly endless, there has been a certain change in households' behaviour in this latest wave. The positive developments include a significant increase in testing during 1Q21, in part due to government pressure, and a greater willingness among people to be vaccinated (younger people without secondary education and from poorer households are the most hesitant group). In social groups affected by the restrictive measures – in particular sole traders, people with a lower level of education, and low-income households – concerns about losing employment are growing. Nevertheless, the level of concern about losing employment is relatively unchanged, i.e. consistently low in the population at large. The situation is now also affecting people's mental health. Some 12 13% of the adult population have faced some form of depression early this year; for example, among housewives with children, the figure is as high as 20%. Surveys of households' behaviour during the recession mirror what we have seen in the hard data. In the first spring and second autumn waves, households responded to the situation by reducing their consumption and increasing their level of savings. This was not repeated in the subsequent waves; households would have been willing to spend if they had had anywhere to do so.

The EU should catch up with the US and the UK on vaccinations in 2Q21



Source: Macrobond, Economic and Strategy Research, Komerční banka

A significant acceleration in the overall level of vaccination is what will help to reopen the economy and kick-start the confidence recovery process in all sectors of the economy, primarily in services. We see encouraging examples in countries where vaccination has progressed rapidly (Israel, the US, and the UK). Jobs are recovering quickly, sales are rising, and economic activity is increasing in general. The EU countries, including the Czech Republic, have been lagging behind on the vaccination rate so far. We expect the vaccination drive to accelerate in May. Combined with the current improvements in the pandemic situation, this will make it possible to phase out the restrictive measures. As early as the second half of this year, therefore, we forecast the economy to be running without any major restrictions in place. One of the reasons is also the upcoming general election (see Box 1). Strong economic growth and an appreciating koruna over the last few years should then cause the Czech Republic's reclassification in the GBI index from an emerging to a developed market. This will likely have a negative impact on the Czech government bond market, as we discuss in detail in Box 2.

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External environment and assumptions

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Exiting the pandemic

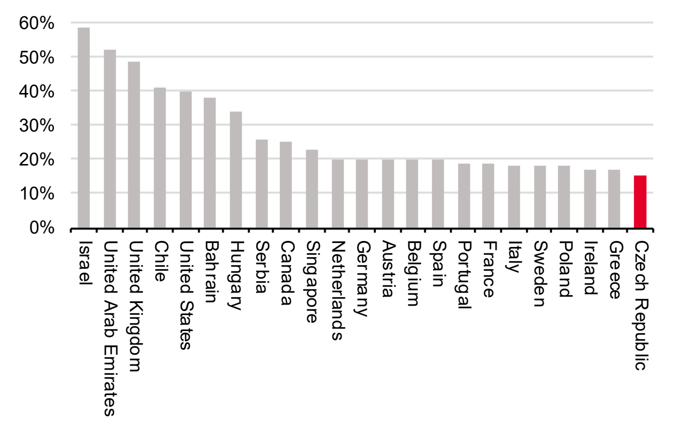
The global economy is gradually recovering from the pandemic-induced crisis. The combination of extremely loose monetary policy, strong fiscal stimulus and a low comparison base should see the US economic grow this year at the fastest rate in decades. The euro area should return to normal in the second half of the year. Inflation in the US will likely reach a multi-year high this year, and even European inflation should exceed 2%. However, the factors pushing inflation higher should prove temporary, and inflation will likely again fall below the Fed and ECB targets next year. Interest rates are likely to rise in the US in the second half of 2023 at the earliest and in the euro area in 2024. However, the Fed will likely start reducing asset purchases early next year.

US: fastest growth in decades

Economy benefiting from extremely loose monetary policy, fiscal stimulus and vaccination.

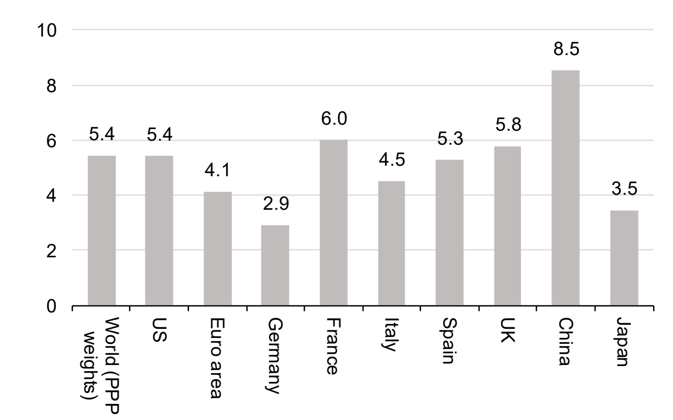
US economy recovering from pandemic. Vaccination is advancing rapidly, the economy is gradually opening up, and financial institutions are competing to raise estimates for this year's GDP growth. The economy is benefiting from extremely loose monetary policy and strong fiscal stimulus (Americans earning $75,000 a year or less received a check for $600 in January and a further $1,400 in March). The stimulus is visible in current consumption, the real estate market, and the auto market, with sales in the latter at their highest level since 2018.

Percentage of population given at least one vaccine dose



Source: Reuters, SG Cross Asset Research/Economics

Expected GDP growth in 2021 (%)

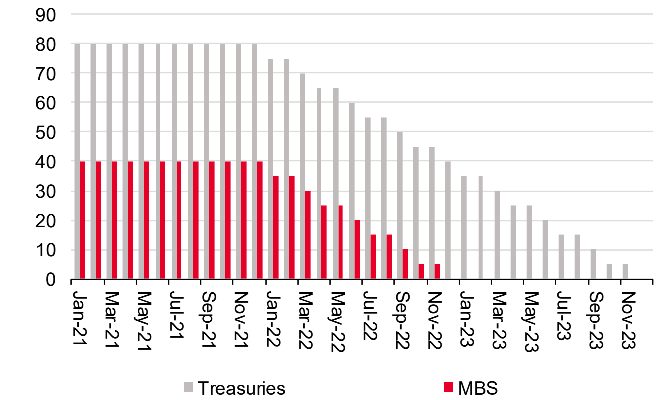


Source: SG Cross Asset Research/Economics

GDP growth likely to be best in decades.

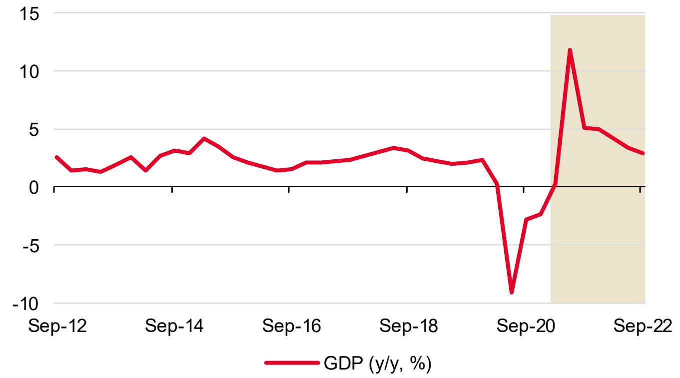
GDP growth this year set to be strongest in decades. We expect a growth rate of 5.4%, which would be the highest since 1984. The Fed is even more optimistic at 6.5%. Thus, the era of extremely loose monetary policy is slowly expiring, though this is not evident in the dot. The dot plot still sees interest rates unchanged until the end of 2023. Of the 18 governors of the Federal Reserve, only seven see an increase in rates in this period. However, this number is gradually increasing, and we believe that it will converge on our forecast, i.e. a rate hike in the second half of 2023.

Fed likely to start tapering next year (USDbn/month)



Source: SG Cross Asset Research/Economics

GDP growth set for a record year



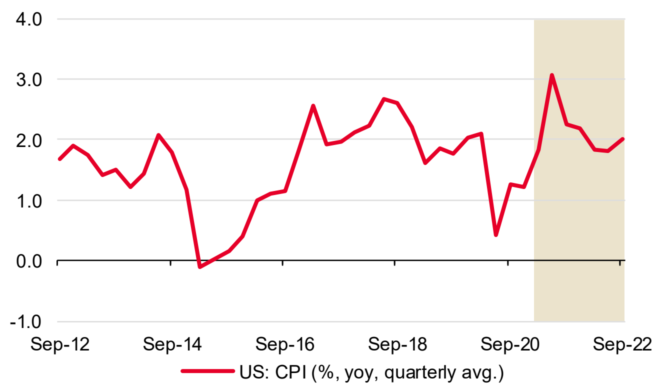
Source: SG Cross Asset Research/Economics

Fed to continue buying assets at USD120bn per month for time being. We think it will start reducing purchases at the beginning of next year, with the forward guidance likely to reflect this in the second half of this year. This is also in line with the statements of Fed representatives. According to James Bullard, the Fed should start considering reducing asset purchases when the vaccination rate reaches 75-80%, which should be in the autumn.

Inflation likely to jump above 3% but then return quickly to 2%.

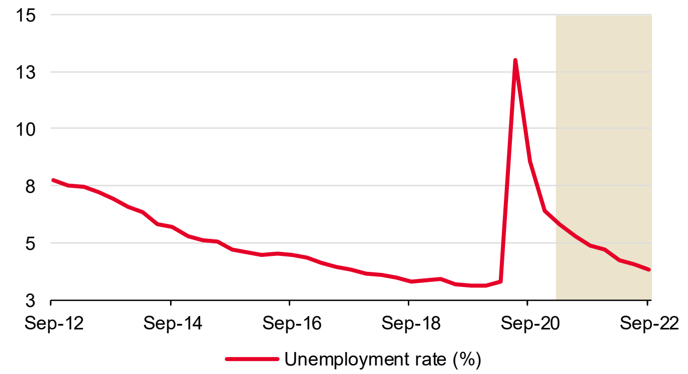
Rising inflation expectations to contribute to pressure to tighten monetary policy. US inflation will likely be pushed up in the spring by high fuel prices, a low comparison base and rising prices in the service sector. It should rise above 3%, but these effects will likely fade, and inflation should then fall again to 2% in the second half of this year. In the first half of next year, it will likely decelerate even further. In addition, the Fed will likely not fulfil its labour market mandate any time soon. Although the situation is rapidly improving (916,000 more jobs added in April), more than eight million jobs are still absent compared to pre-pandemic levels. With the opening of restaurants and services, the supply of vacancies should expand rapidly. However, unemployment is unlikely to fall below 4% until the beginning of 2023.

Temporary rise in inflation likely in coming months



Source: SG Cross Asset Research/Economics

Unemployment rate will likely continue to decline gradually



Source: SG Cross Asset Research/Economics

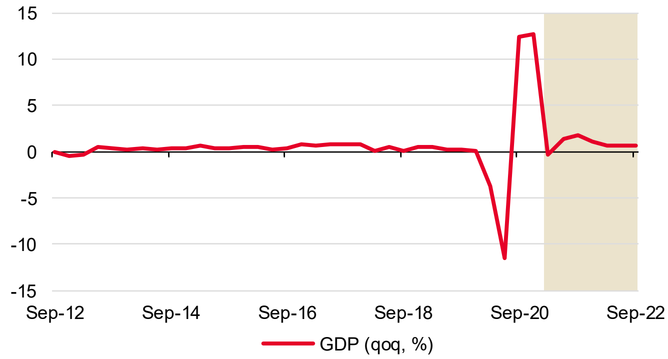
Eurozone: vaccination to allow return to normal in 2H

Vaccination should allow economy to return to normal before summer.

Data show euro area coping relatively well with current wave of pandemic. The manufacturing PMI remains high, offering hope for further positive developments in this area. Risks include problems with supply chains and the lack of some components, pushing up input prices. For the time being, however, both domestic and foreign demand remain solid. On the other hand, pandemic-related restrictions are still affecting the service sector.

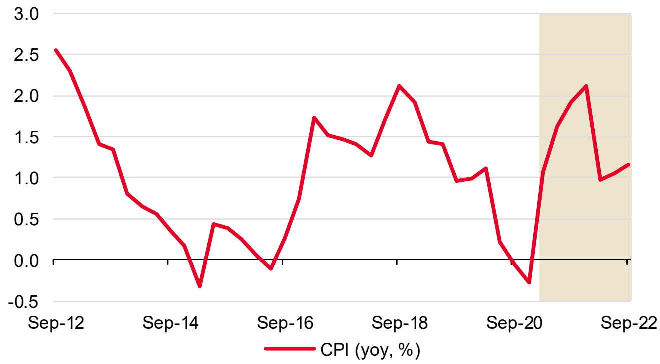
Restrictions could start to ease more in May, economy could return to normal by summer. This would happen thanks to vaccination (people aged 65+ and healthcare professionals should be vaccinated by the end of May and people over the age of 50 in early June). In 2Q-4Q, we expect the euro area economy to grow by an average of 1.3% qoq. For the whole of this year, we expect GDP growth of 4.1%, after last year's decline of 6.8%. The economy is likely to reach pre-crisis levels in the middle of next year.

Economy likely to have stagnated in first quarter



Source: SG Cross Asset Research/Economics

Inflation likely to exceed 2%



Source: SG Cross Asset Research/Economics

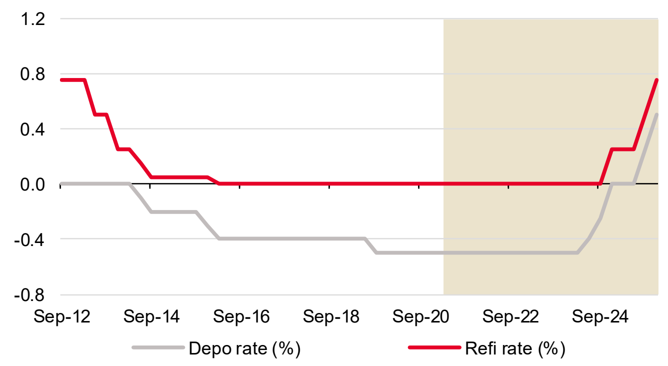
Inflation likely to exceed 2% this year.

Inflation should rise to 1.6% yoy in 2Q21 due to higher fuel prices and low base effect. In the second half of this year, it will likely even exceed 2%, mainly due to last year's VAT reduction in Germany. Overall, inflation should average 1.6% this year (2020: 0.3%) and core inflation 1.2% (2020: 0.7%). However, there are significant risks to these forecasts. After the economy reopens, prices in services may rise more sharply. In addition, the prices of many consumer basket items are currently imputed, so their subsequent real prices may show higher price growth. Another risk is supply chain problems and upward pressure on input prices. Nevertheless, the upward effects on inflation will likely subside next year (we see oil at $55/bbl, so base effects will no longer help), and we see both headline and core inflation returning to an average of 1.1%.

Discussions about end of pandemic program will intensify.

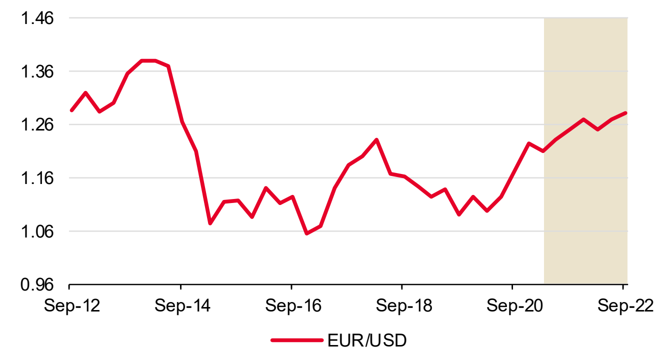
For a central bank seeking to maintain favourable financing conditions, rising inflation will be a communication challenge. The ECB is likely to continue to try to drag down yield growth by asset purchases. The pandemic program will likely thus run at approximately the current level in the coming months, i.e. around EUR20bn per week. However, purchases are likely to still exceed EUR15bn for the rest of the year. In our view, the ECB will not want to start ending its program before the Fed, which means at the beginning of next year. Even then, we assume that the end of the pandemic program will be smoothed by an increase in asset purchases under the APP program and extension of TLTRO4 until the middle of next year. However, with the economic recovery likely accelerating in the second half of this year, the discussion around the end of the pandemic program should intensify, which would create space for further growth in European yields and thus in Czech yields. We still expect an increase in ECB key interest rates in 2024.

ECB: We expect rate hikes in 2024



Source: Macrobond, SG Cross Asset Research/Economics

Euro should strengthen again after faltering in 1Q

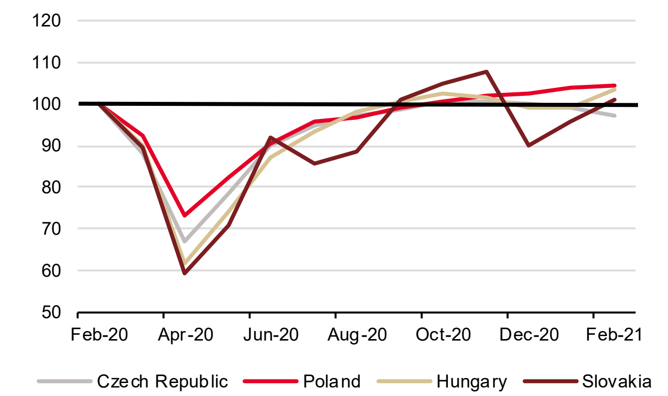


Source: Macrobond, SG Cross Asset Research/Economics

CEE: supply problems hamper industry

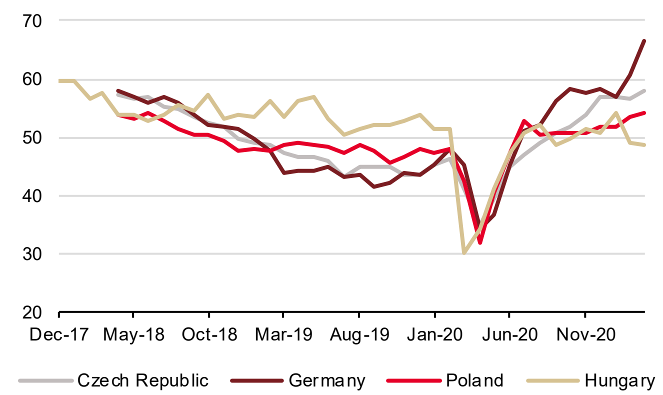
Central Europe coping relatively well with current wave of pandemic. Output in the industrial sector is still close to pre-crisis levels, with leading indicators (at least in Poland and the Czech Republic) promising further growth. The activity is mainly being supported by growing foreign demand, which is then reflected in higher revenue from new orders and a larger volume of production. On the other hand, countries in the region are struggling with delivery delays, which is pushing up input prices. The barriers to an even stronger recovery in industry now thus lie on the supply side, not the demand side.

Industry stays around pre-crisis level (February 2020 = 100)



Source: Macrobond, Economic & Strategy Research, Komerční banka

PMI indices promise further growth of the industry (points)

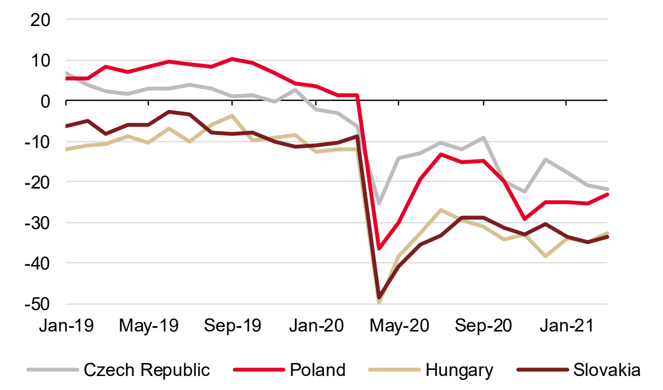


Source: Macrobond, Economic & Strategy Research, Komerční banka

Household savings at record levels.

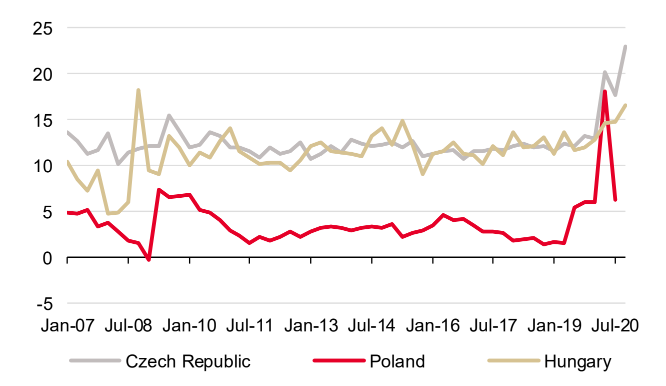
Services and retail sectors still suffering from restrictive measures. Consumer confidence in the region remains low. As a result of closed shops, households have nowhere to spend, so their savings have grown. They are at record levels in the Czech Republic and Hungary. The question is how consumers will deal with them after the lifting of restrictions. So far, retail sales remain below pre-crisis levels. The spending of savings could kick-start the regional retail trade. GDP growth in the region should range between 3.5-4.5% this year. The outlook is also favourable for 2022, when more EU money will start to flow into CEE countries, which should support investment activity.

Consumer confidence remains low (points)



Source: Macrobond, Economic & Strategy Research, Komerční banka

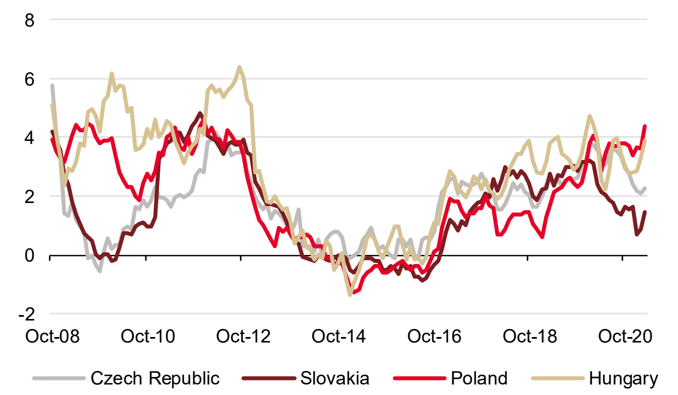
Household saving rate (%)



Source: Macrobond, Economic & Strategy Research, Komerční banka

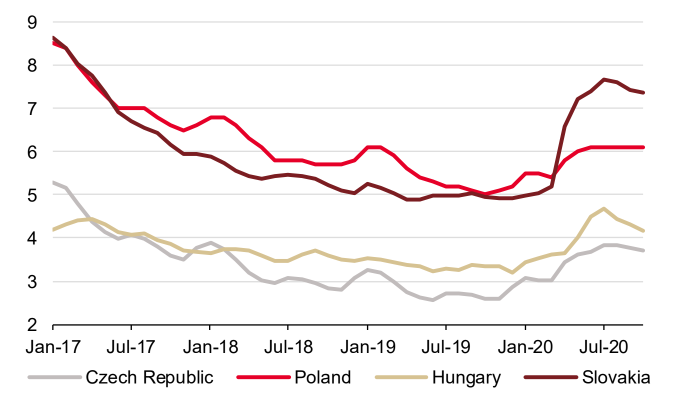
Inflation in the region is rising. In Hungary, it could get as high as 5% in spring, according to the central bank, significantly exceeding the inflation target. However, the growth would likely be driven by extraordinary factors that will disappear, and inflation should gradually return to the 3% target. Polish inflation will likely develop similarly, reaching 3.4% on average in 2Q21, according to the local central bank.

Inflation will likely grow further (%, yoy)



Source: Macrobond, Economic & Strategy Research, Komerční banka

Unemployment staying at higher levels (%)



Source: Macrobond, Economic & Strategy Research, Komerční banka

CNB set to be first CEE country to raise interest rates.

Policies of regional central banks will likely differ. Despite rising inflation, the Polish central bank's rhetoric remains dovish. The bank considers the rise in consumer prices to be temporary and beyond the control of monetary policy. Governor Glapinsky has repeatedly stated that interest rates will not change for the duration of his term (until the middle of next year). We think a rate increase will come under consideration first in 3Q22. The Czech and Hungarian central banks are likely to be the first in the region to raise interest rates. While we expect the first increase in the Czech Republic in November, the Hungarian central bank has declared its readiness to raise rates in the second half of this year (the 3M deposit rate). But we expect this step only in 1Q22. However, should the forint weaken above EUR/HUF 370, the central bank may raise the one-week rate (now at 0.75%). But given the relatively good condition of the Hungarian economy, we expect the forint to strengthen. At the end of this year, we see it at EUR/HUF 340. The Polish zloty is also likely to strengthen this year. In the short term, it may be affected by the uncertainty associated with the Constitutional Court's decision regarding foreign-currency mortgages, but it should then head to EUR/PLN 4.3 at the end of this year.

Macroeconomic outlook

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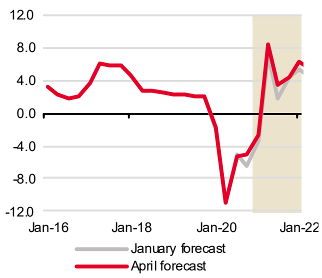
Main changes

GDP:
For 2021, we have increased the GDP forecast to 3.4% from the previous estimate of 2.6%. In 2022, we expect the economy to grow by 4.7%.

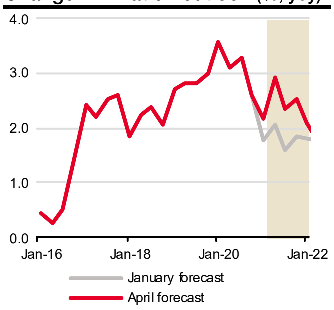
Inflation:
For 2021, we increased our inflation estimate to 2.5% from the previous 1.8%, mainly due to higher food prices. In 2022, we expect inflation to average 1.9%.

Change to GDP outlook (%, yoy)



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

Change in inflation outlook (%, yoy)

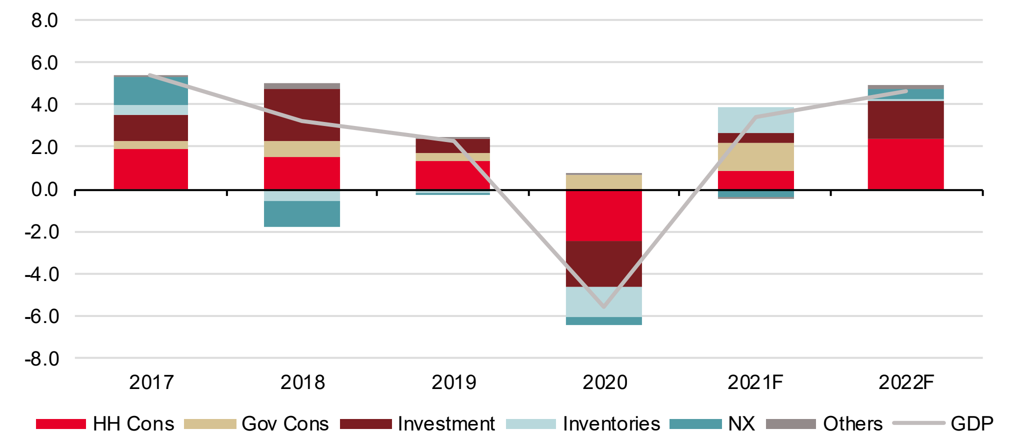


Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Czechia at the beginning of a strong economic expansion

The economy will start to expand again from the second quarter of this year. Its dynamics will accelerate significantly in the second half of the year and above-average growth will continue next year. Inflationary pressures will gradually build up, to which monetary policy will respond under the condition that the risk of further waves of the coronavirus pandemic declines. Inflation will remain above 2% this year, but it should slow down to the inflation target next year. Short-term real and nominal developments will still be highly volatile in the coming quarters. The main risk to the forecast remains the pandemic.

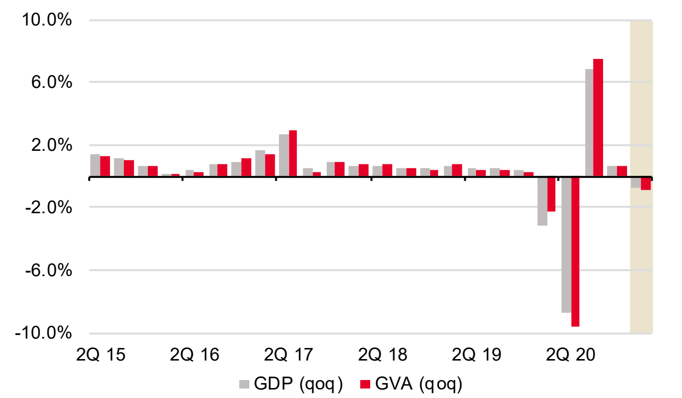
From 2H 2021 GDP growth will be driven by household consumption and investment (%, yoy)



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

The economy will start to grow from the second quarter of this year

GDP probably fell at the beginning of 2021



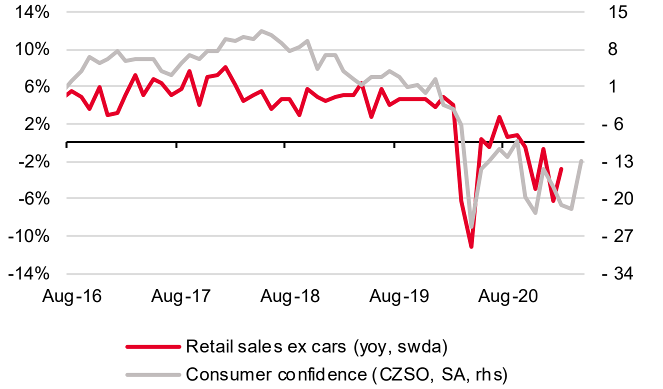
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Despite the autumn wave of the pandemic, the Czech economy grew by 0.6% qoq in the last quarter of 2020 in a situation where a decline was expected. It is true that the development of industrial production and consequently foreign trade helped the economy to keep pace. **However, without the very strong contribution from government consumption, the Czech economy would have declined by 0.8% qoq.** In addition, during the fourth quarter, government measures were significantly relaxed for about three weeks. This was followed by a sharp worsening of the epidemic, and then a renewed tightening of measures after Christmas – and even more so since March 2021. Importantly however, industry did not largely shut down as it did in the spring of 2020. External demand remained strong. However, the situation in foreign trade in the first quarter was complicated by border queues due to the high degree of contagion in the Czech Republic. Export activity weakened, which to some extent was also related to pre-supply in connection with the end of the transitional post-Brexit period – and the introduction of new environmental standards in the automotive industry in force since the beginning of this year. However, the main complication for Czech industry and thus foreign trade was the limited supply of components for production. Purchasing managers' surveys indicated that deliveries saw delays that were at record levels.

The economy probably contracted in 1Q 2021.

On the other hand, there were also sharp increases in orders. For the first quarter of this year we expect a decline in the total value-added in industry by about 1% qoq. The question remains how fast the turnaround in the manufacturing sector can take place in a situation where the pandemic is receding. Leading indicators have shown strong growth since March. At the same time, some carmakers have announced production restrictions due to missing components. As a result of anti-pandemic measures, a quarter-on-quarter weakening can be expected on the value-added side in most sectors of the economy – and especially in the important area of private services and trade. In our opinion, only the ICT sector recorded a more significant increase in value-added in the first quarter, and probably also the areas of health, social care and education-related services. On the expenditure side, in addition to the already mentioned weakening of foreign trade, we expect a further quarter-on-quarter decline in household consumption and investment in fixed capital. Given their previous weakness, this should now be a relatively weak decline. The operation of stores and shops was dramatically reduced throughout the first quarter. Consumer confidence fell again after a brief loosening in December and a subsequent slight increase. A larger decline in household consumption will be partially hampered by a reduction in personal income taxes in the first quarter, but a more significant effect should be noticeable later when stores and services are opened again (for more on the impact of tax cuts on consumption, see the previous *Economic Outlook* at https://bit.ly/KB21Q1EN). The high level of government spending should support the economy in the near future. In summary, we expect a decline in GDP of 0.8% in the first quarter, which would mean a moderation of the year-on-year decline to -2.6% from the previous -4.8%.

Consumer confidence fell back in 1Q21



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

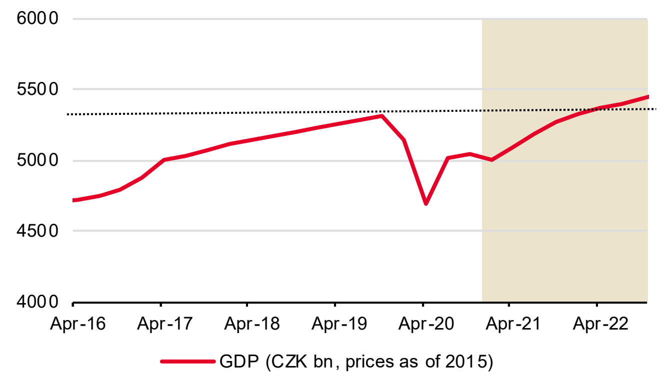
Return of GDP to its pre-crisis level in 2022

The ending of anti-epidemic measures is the main precondition for the strong expansion of the economy.

We anticipate that anti-epidemic measures will loosen during the second quarter. This should continue in the second half of the year as the proportion of the population that is vaccinated will increase significantly. In the third and fourth quarters, anti-epidemic measures that limit economic activity should be phased out completely. In addition to the immediate effects, especially in household consumption, investment activity should increase and inventories, which fell last year, should also recover. It is likely that the above mentioned problems in the supply of components to production will increase the inventories of work in progress this year. In foreign trade, exports will not continue in the growthdynamics started in the second half of 2020, but on the contrary, the dynamics of imports of goods, especially investment and also the above-mentioned stocks, will intensify. The key is the assumption of developments abroad, where we expect growth of 4.1% this year and 3.6% next year for the euro area economy.

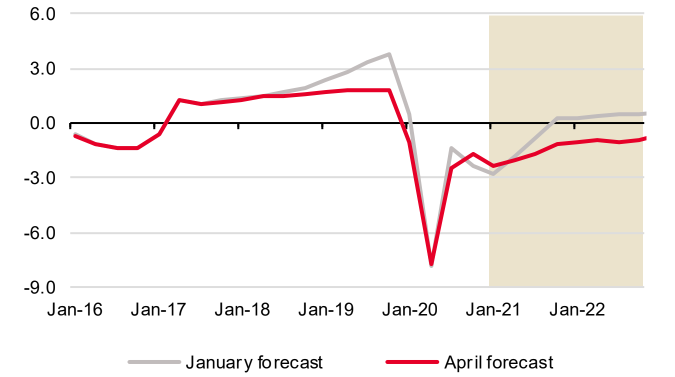
The development of the economy at the end of last year, together with the improved outlook for the external environment and for the second half of the year in general (thanks to vaccinations) has led to an increase in our economic forecast for this year to 3.4% from the previous estimate of 2.6%. The higher economic pace from the second half of this year will also lead to faster full-year economic growth next year, which we expect to be 4.7%. With a recession of 5.6% last year, the pre-crisis level of real GDP should be reached by the beginning of 2022. This is half a year earlier than in the previous forecast. In our model view, however, the output gap will be closed later, due to the assumption of faster growth of potential output. This would generally indicate lower inflationary pressures. However, in the case of household consumption, which will be the driving force of the economy from the second half of this year and the whole of next year, we expect faster growth above its equilibrium level and which will thus generate inflationary pressures.

Return of GDP to its pre-crisis level already in 2022 (CZKbn)



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

But slower closing of the GDP gap (%)



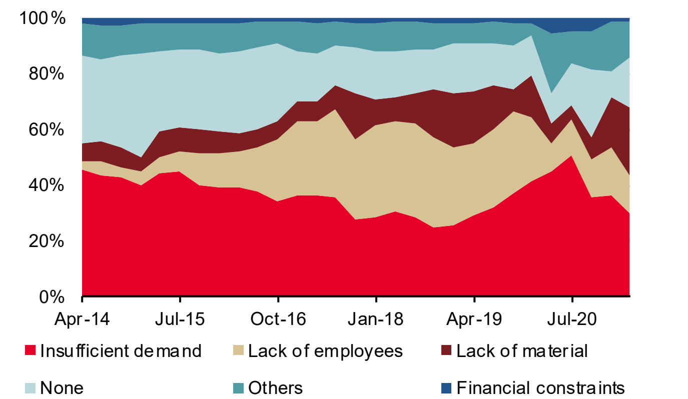
Source: Economic & Strategy Research, Komerční banka

Industry will see a return to growth, but the problems with the supply of components will not disappear

Industry is particularly bothered by delayed deliveries of components.

Industrial production grew by a strong 3.6% qoq in the fourth quarter. In a year-on-year comparison, slightly positive growth dynamics resumed at the end of last year, when production increased by 1.7%. In January, however, industrial production fell by 0.8% month-on-month and then again in February by 2.0%. The decline was particularly noticeable in the automotive industry, where production grew by 16% yoy at the end of the year, while it fell by 8% yoy two months later. Higher production may have played a role before the tightening of emission standards. However, the key role was probably played by the issue of missing components, especially semiconductors necessary for the production of cars, but also other products such as consumer electronics and IT. A number of car manufacturers, including the Czech Škoda and Toyota companies, have announced production restrictions. The exception is Hyundai, which has a higher stock of necessary components thanks to a different strategy during the crisis. **The prevailing view is that**

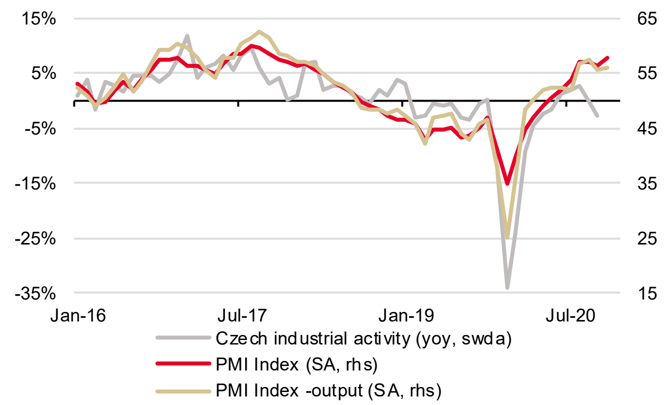
Barriers to industrial output growth



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

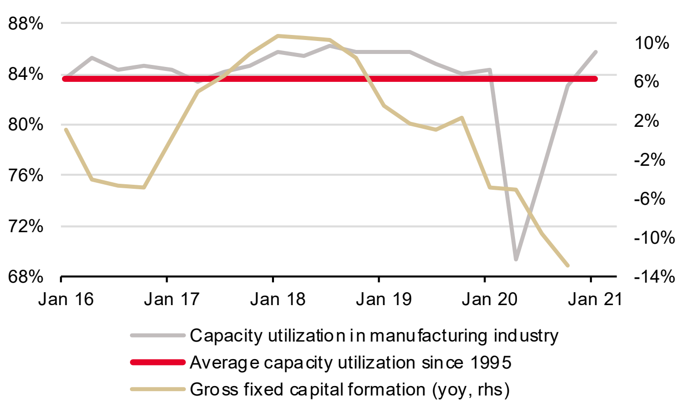
component problems could persist for the rest of the year. On the other hand, there are a number of reports indicating growing demand, with the assumption of growth in foreign economies being a strong reason for expecting the expansion of Czech industry, which is strongly linked through exports. At the same time, we have soft data showing that even with limited supplies, industrial production should grow, even if the growing demand is not being fully met by the supply of components. Last year, the dominant barrier to growth was in the form of insufficient demand – but that is likely to recede this year. On the contrary, the problem of subcontracting is increasing and staff shortage problems are likely to persist, although they could subside slightly with the reopening of schools. Even during the first quarter, there was a real threat of forced closures of industry due to the worsening of the pandemic. Although this risk still exists theoretically, the prospect of the early immunisation of the population has greatly decreased the chances of such closures. Moreover, political reluctance to take such a step was relatively clear at a time when the pandemic situation was deteriorating badly in 1Q21. We do not expect industries to temporarily close, although the risk of another pandemics wave is certainly still possible. At the beginning of this year, we expected a decline in industrial production by about 2.5%. **Since the second quarter, however, we expect growth in industrial production to average between 1.5% and 2% qoq.** The low base will mean that the full-year result could be close to 9%. In addition, the outlook for the growth of foreign economies gives good hope for the expansion of industry in the coming years to around 5-6% per annum.

Leading indicators show the expansion of manufacturing



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

Capacity utilisation back to its pre-crisis level

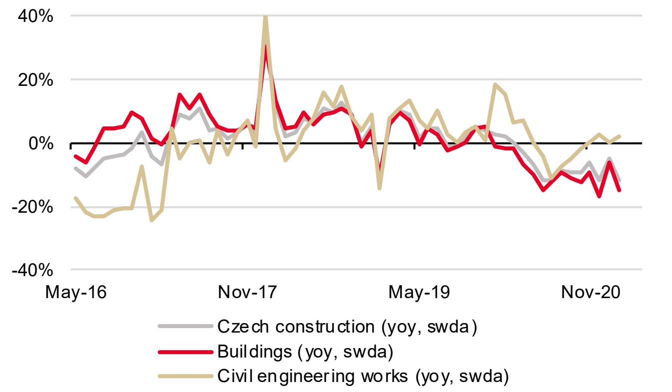


Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

The construction industry will stagnate this year and there will be a recovery next year.

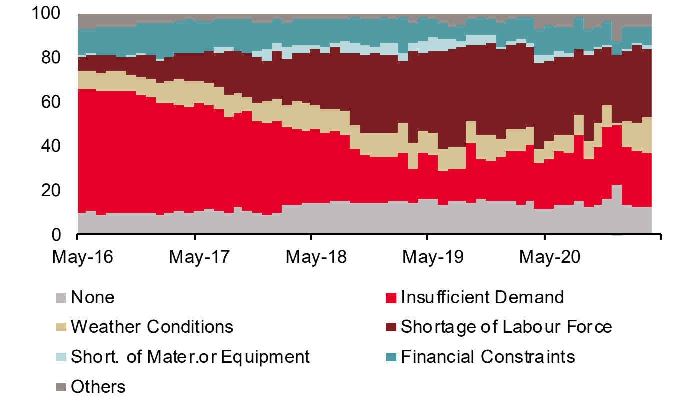
In the case of construction, it is still true that the main decline took place in the first half of last year. Since then, its performance has remained at about the same level and fell slightly at the end of 2020. For the whole of last year, the decline in construction reached 5.1% in real terms (in the methodology of national accounts the decline in the value-added figure was 3.4%). The beginning of this year started with slight growth, which hardly indicates a change in the trend. For the rest of the year, we expect some stagnation in construction output at its current levels, so the full-year result could be slightly negative. We do not expect production to pick up until next year. Our outlook for the economy remains optimistic, but that will only be reflected in the construction sector with a significant delay. The industry is still plagued by a shortage of workers and, in the long run, a very long permit procedure for investment projects. The retreat of the pandemic has a chance to attract back foreign workers who left the Czech Republic in the period since it started. On the other hand, construction should be supported by infrastructure investments, where the EU Recovery Plan will play a positive role (we also paid more attention to this in the previous *Czech Economic Outlook* at https://bit.ly/KB21Q1EN). After all, infrastructure investments maintained the output of construction production last year as well. Next year, we expect construction to grow by around 4%.

The construction industry remains weak



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

A shortage of employees is seen as the main barrier for growth in construction



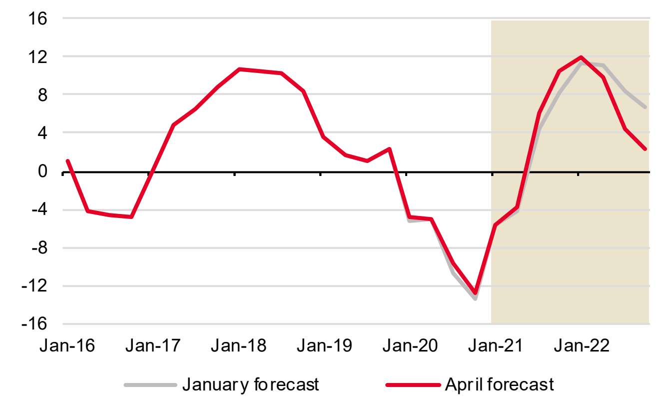
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Investment activity of companies and household consumption at the beginning of expansion

This year, inventories will be restored and investment in fixed capital will grow. Household consumption will accelerate significantly.

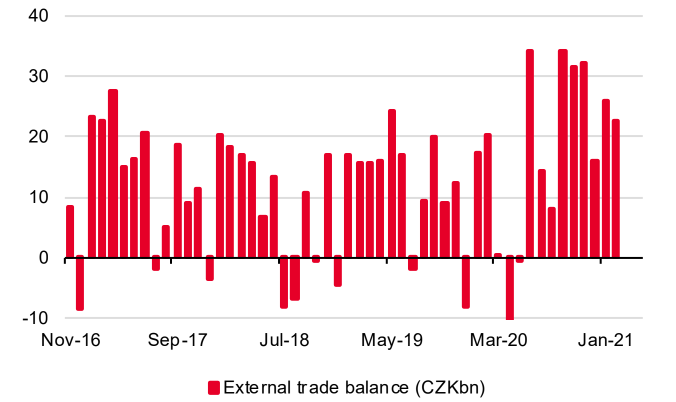
Investment in fixed capital, together with the fall in household consumption, was the main item reducing GDP last year on the expenditure side. However, we have been expecting a turnaround in both items since the second quarter of this year. Household consumption usually has a certain time lag behind positive developments such as rising income and confidence in the economy. This time around, however, it is possible to already count on some areas being caught up more quickly due to deferred consumption, which could not be realised at the time of all the restrictions. Households also accumulated significant savings. These have been growing strongly since the beginning of the pandemic. **The household savings rate rose to a record 23.3% in the fourth quarter of 2020.** For comparison, in 2019, the average savings rate of the population in the Czech Republic was the standard 12.5%. In 2020, real household income grew by 2.8%, while their consumption expenditure fell by 2.9%. On the other hand, the investment rate fell by just one percentage point, with many households investing in real estate during the pandemic. An additional accumulation of savings is likely to occur this year as well, with the contribution of reduced income taxes. It is unlikely that the accumulated savings rate will return quickly to the previous level, but instead much more likely to decrease – so it may be a relatively quick additional impetus to the economy in the order of 2-3% of GDP. **For the whole of this year, we expect growth in household consumption of 1.8% before accelerating to 5.3% next year.**

Investments will increase significantly from the second half of 2021 (%, yoy)



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

Net exports rose at a record high in 2H 2020 (CZKbn)



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

In the case of enterprises, the decline of expenditure in fixed capital investment was a strong 8% last year. In 4Q20, the decline moderated to a quarter-on-quarter rate of 1.6%. For the first quarter of this year, we expect a rather weak decline in investment activity. Although the economy still suffered from closure, on the other hand, optimism about economic development has been growing sharply with the impending immunisation of the world's population. Investment in inventories had already started to increase at the end of last year, and we expect this trend to intensify during the first half of this year. Gradually, investments in fixed capital should increase as well. **For the whole of this year, we expect them to grow by 1.8% and accelerate to 7.1% next year.**

The expected growth in household consumption and investment corresponds to the weak contribution of foreign trade. Due to the significant growth of exports in the second half of last year, albeit with low import activity on the other hand, foreign trade reached a record surplus of CZK184bn last year. However, according to our forecast for 2021, it will decrease to roughly the same level as was seen in 2019.

Fiscal policy: Better results than expected

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Last year, Czech public finances saw a record deficit of 6.2% of GDP. The state budget's result was much worse than this, but the deficit was lower than expected. We assume a similar scenario for this year. The second half should bring a recovery in household consumption and thus a higher collection of indirect taxes. Moreover, COVID spending should be lower than the government expects this year too. We thus leave our forecast for the state budget deficit at CZK400bn (6.7% of GDP). Next year, we see the deficit falling to CZK300bn (5.0% of GDP). Municipalities and social security funds should continue to run surpluses thanks to record levels of government support. We see the public finance deficit deepening to 6.5% of GDP this year, with no consolidation likely until next year. Public finance debt rose to 38.1% of GDP last year and should continue to rise, likely hitting 45.3% of GDP in 2023.

State budget to benefit from better tax collection and lower COVID costs

The government deficit progressed in accordance with the approved plan in the first quarter of this year. Collection of direct taxes was higher, but collection of indirect taxes was lower than foreseen by the Ministry of Finance.

The government ended the first three months of this year with a deficit of CZK125.2bn. Unsurprisingly, this is by far the worst March state budget result in the history of the Czech Republic. However, it roughly corresponds to the planned trajectory, which envisages a deficit of CZK500bn for 2021 (8.3% of GDP). Like last year, the first quarter saw higher collection of direct taxes but weaker indirect tax income than expected by the Ministry of Finance. In combination with slightly higher non-tax revenues, the revenue side of the state budget is lagging expectations, but only by a negligible CZK6.7bn. The year-on-year decline in tax revenues in February and March accelerated to a new high of almost 10%, which is comparable to the crisis in 2009.

On the other hand, the expenditure side is contributing to a lower deficit than planned due to the traditional slow start to investments, on which the state saved CZK23bn. However, we assume that this will be made up for in the second half of the year. In terms of current expenditure, there was some pre-financing of transfer expenditures, especially to municipalities and the business sector. These expenditures will contribute to a slower widening of the deficit in the second half of the year. In total, expenditures are CZK6.5bn lower than would correspond to an even drawdown according to the approved state budget plan.

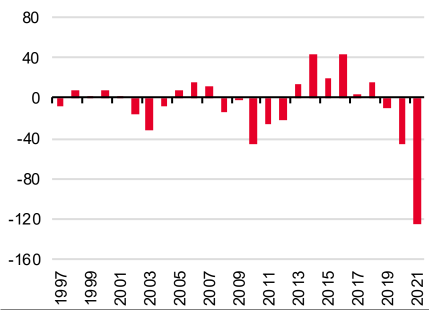
We leave our forecast for this year's state budget deficit at CZK400bn, which puts us below the market consensus. We assume that tax revenues will increase beyond the budget during the year and that COVID expenditures will be lower as a result.

Our forecast still foresees a final state budget deficit of CZK400bn for 2021 (6.7% of GDP), while market consensus assumes a deeper deficit. We have several reasons for our outlook: (1) we think collection of direct taxes will be higher than planned by the Ministry of Finance, 2) indirect taxes, especially VAT, should increase in the second half of the year due to the re-opening of the economy and higher household consumption than envisaged by the Ministry of Finance, and (3) interim data show significantly reduced interest in COVID compensation, which according to our estimates will save CZK10-15bn compared to the plan. In our view, the state budget this year will continue the trend of undervaluing revenues and, like last year, savings on COVID programs. Thus, we expect a lower state budget deficit than foreseen in the government's approved plan.

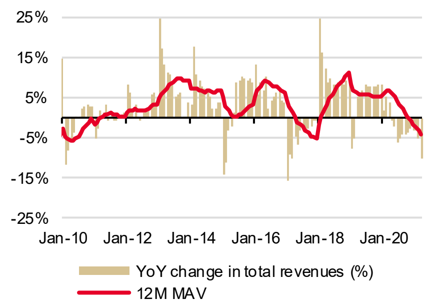
Beyond pandemic developments, the main risk to our forecast is the path of investment and the campaign before the October general elections. The state budget envisages a record volume of state investment of CZK185.4bn (3.1% of GDP), which is relatively ambitious. Last year, we were positively surprised by capital expenditure coming in only slightly lower than planned. Since then, however, the construction sector has declined significantly, and the reduced capacity of the economy, combined with political changes, may lead to lower investment and, thus, savings in the state budget. On the contrary, the upcoming elections may bring new expenditures to the state budget, like we saw last year in the form of a one-off contribution to pensioners (worth CZK15bn).

The outlook for next year is very uncertain. According to the Ministry of Finance, the draft state budget will allow for a deficit of at least CZK300bn in 2022 (5.0% of GDP). For now, however, all attention is focused on this year, and we should get more details about 2022 in the summer. In addition, the upcoming elections complicate the situation (more in Box 1). The draft budget will be submitted by the current government but must be approved by the new Chamber of Deputies. However, there will be little room for adjustments after the elections, and we see no reason next year's state budget deficit should exceed the mentioned level. As for this year, we expect a better result than outlined in the MinFin plan.

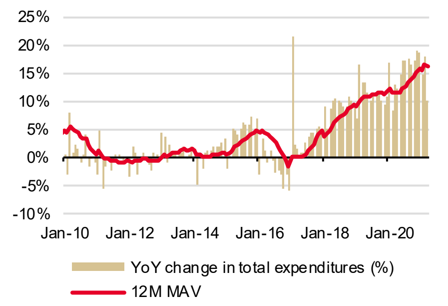
Comparison of March state budget results (CZKbn)



Revenues should be higher this year compared to the approved plan



Expenditure growth is slowing and should help reduce the deficit



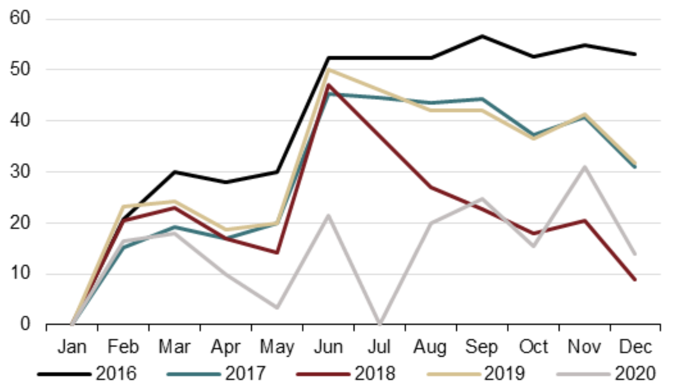
Source: Finance Ministry, Economic & Strategy Research, KB

Other sectors to continue to help reduce the general government deficit

Last year, municipalities saw a surplus of CZK14.5bn (ESA2010), about half the amount of the previous year. On the other hand, the 2018 surplus was CZK6bn lower than in 2020. In the context of the pandemic, we see this as a great result, strongly supported by the government through extraordinary transfers from the state budget (up CZK49bn year-on-year). Despite the crisis, municipal investments increased by 9.5% and current expenditures by 8.6% yoy. There was also an increase in cash in municipalities' current accounts, to almost CZK230bn (+13% yoy). This creates a cushion for potential management problems and investment for the coming years. **As with the state budget, we expect a better result for municipalities this year than does the Ministry of Finance**. We see a surplus of CZK10bn (MinFin: CZK0.3bn). It cannot be assumed that municipalities will receive the same extraordinary support from the state budget as last year. As with the state budget, however, we expect faster growth in tax revenues. This should help to achieve an even higher surplus of CZK30bn in 2022.

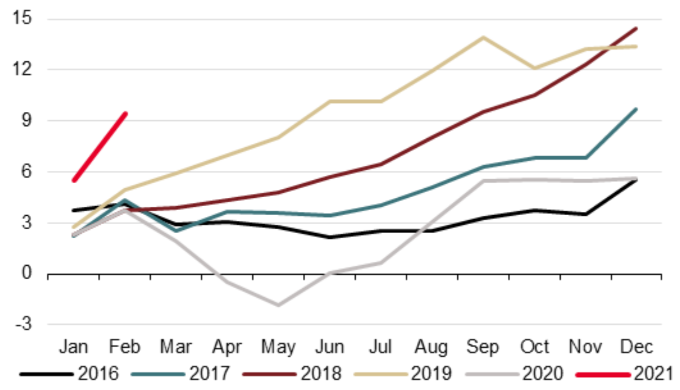
Social security funds saw a loss of CZK1.6bn last year (ESA2010), the worst result since 2014. However, health insurance companies ended up with a slight surplus in cash terms. Overall, we see the outcome positively in view of the cost-intensive year brought on by the pandemic. There was a two increases in payments for state-insured persons, which significantly increased the income of health insurance companies and prevented a decline in the deficit. After a further increase in payments with effect from the beginning of this year, we assume that the social security sector will end this year with a surplus of CZK8bn. The first two months have shown the best result so far, which is a positive sign. On the other hand, the question is how the March peak of the pandemic and delayed payments for medical care will be reflected in the budget. This is clearly the biggest risk for this sector.

Municipalities surprise positively (CZKbn)



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

Higher payments for state-insured persons kept insurance companies in surplus (CZKbn)



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

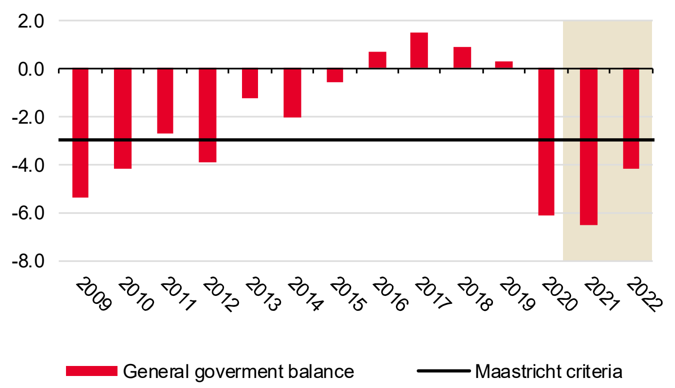
Public finances saw a record deficit last year. We expect a further increase this year. Public debt has reached its highest level since 2015 and should continue to grow.

Public finance forecasts

	2019	2020f	2021f	2022f	2023f	2024f
Balance (% GDP)	0.3	-6.2	-6.5	-4.2	-2.9	-1.7
Fiscal effort (pp GDP)	-0.8	-3.8	-1.0	1.8	1.3	1.1
Public debt (CZKbn)	1739.9	2153.0	2553.0	2853.0	3078.0	3228.0
Debt ratio (% GDP)	30.3	38.1	42.5	44.4	45.3	45.1

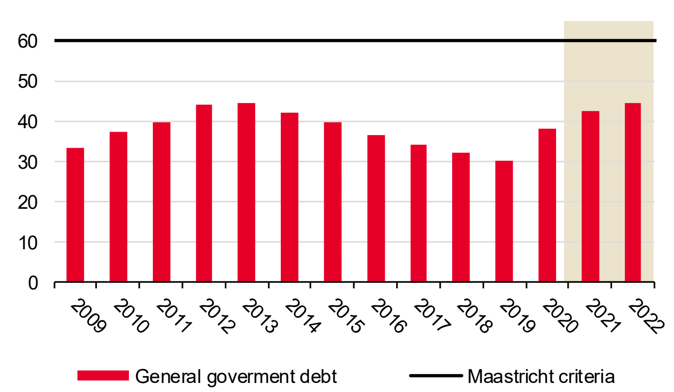
Source: CZSO, MinFin, Economic & Strategy Research, Komerční banka

Public finance balance (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

Public debt (% of GDP)



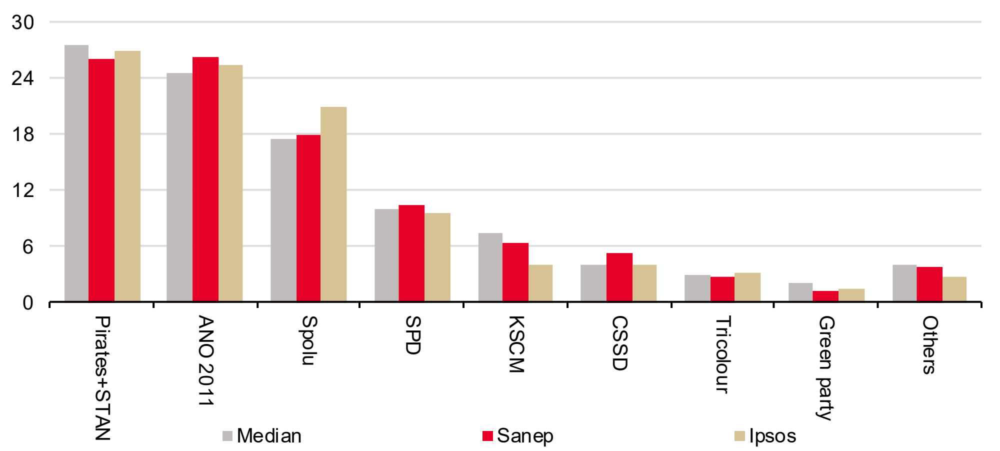
Source: CZSO, Economic & Strategy Research, Komerční banka

Last year, public finances saw a record deficit of 6.2%, using the ESA2010 methodology. This was 6.5pp more than in 2019 and 0.8pp more than the previous worst year, 2009. This year, we expect the general government deficit to grow further to 6.5% of GDP, mainly due to a higher state budget deficit. On the contrary, municipalities and social security funds should again help public finances, reducing the deficit by 0.3pp. The Ministry of Finance's April forecast assumes a deficit of 8.8% of GDP. Although we expect a similar pace of economic recovery as the MinFin, we see higher tax revenues. On the other hand, in our view, spending plans will not be fulfilled again. For next year, our forecast sees the general government deficit worsen from 3.6% of GDP to 4.2%. Consolidation of the state budget is likely to be slower than previously anticipated. However, the upcoming elections are a symmetrical risk that may change the setting of fiscal policy. Public debt increased to 38.3% of GDP at the end of last year. In year-on-year terms, debt increased by 8.0pp to the highest level since 2015. We expect debt to continue to grow in the next three years, reaching a record 45.3% of GDP in 2023. Subsequently, the public sector debt should gradually begin to decline.

Box 1: General elections will not be reflected in public finances until 2023

General elections are due to take place in the Czech Republic on 8 and 9 October. In 2017, they were won by ANO 2011, which took 29.6% of the vote (78 seats), while ODS (Civic Democratic Party) came second with 11.3% (25 seats), Pirates came third with 10.8% (22 seats), SPD (Freedom and Direct Democracy) took 10.6% (22 seats), KSCM (Communist Party) 7.8% (15 seats), CSSD 7.3% (15 seats), KDU-CSL (Christian and Democratic Union) 5.8% (10 seats), TOP 09 5.3% (7 seats) and STAN (Mayors and Independents) 18% (6 seats). Since then, however, the balance of power has shifted. As a result of the COVID crisis, ANO has according to the most recent polls lost its position as the most likely candidate for an unequivocal win and, in some polls, it has even moved into second place behind Pirates+STAN (according to the Median and Ipsos research agencies for public opinion). The last time ANO was not in the leadership position was in March 2014. While in 2018 the party of the current prime minister received support of around 35% in the polls, at present its support is roughly 10pp lower.

Voting preferences (%, March 2021)



Source: Economic & Strategy Research, Komerční banka, Median, Sanep, Ipsos

Polls suggest that the battle for electoral victory will be probably fought between ANO and Pirates+STAN. However, neither group is likely to get enough votes to form a majority government. ANO would find it very difficult to obtain support from other parties if it won. Therefore, if it wins, there is a risk that the party would rule without a vote of confidence for a time, which would destabilise the domestic political scene. This was the case in 2017, when ANO did not gain the confidence of the Chamber of Deputies, but President Zeman left the minority government to rule for six months. In the case of a Pirates+STAN victory, a coalition with Spolu (ODS, KDU-ČSL, TOP09) looks like the most probable scenario. However, given the wide dispersion of views, the question is how stable such a coalition would be. Another scenario that cannot be completely ruled out is a technocratic government. Moreover, the situation will not be alleviated by the new electoral law, which will continue to favour the most successful parties, but less so than before.

In the area of public finances, the election results are unlikely to change anything in the short term. The budget for next year should have been more or less completed by the current government, and the next government will have neither the time nor space to intervene to alter the proposal fundamentally. While there may be transfers of money between chapters, we do not expect any significant adjustments. This means that public finances are unlikely to change until 2023. Regardless of which party wins the election, it will sooner or later have to look for new revenues in the state coffers and/or reduce expenditures. The Pirate party has already stated that it would seek additional income through higher taxes on mining, the introduction of a digital tax or higher taxation of commercial real estate. However, pressure to raise taxes would be dampened by a strong economic recovery, which would lead to a natural increase in state revenues. At the same time, a record amount of EU funds is set to flow into the Czech Republic during this period (we focused on the topic here: https://bit.ly/KB21Q1EN). In our view, the elections are also unlikely to bring significant changes in employment policy. Regarding the use of kurzarbeit and similar tools, the main parties are united.

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Labour market remains stable

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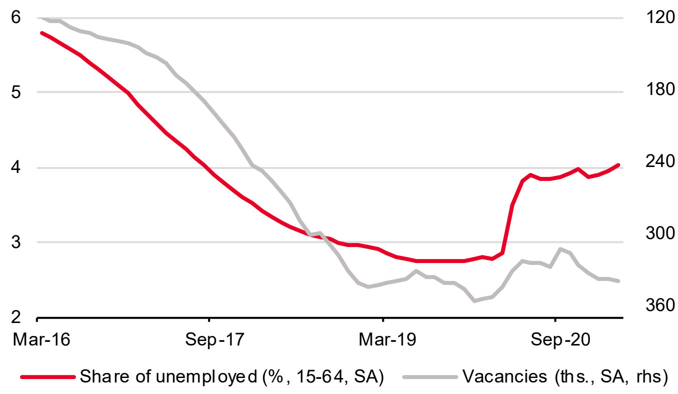
Ongoing government support programs, tightness of the labour market before pandemic and the impending strong economic recovery have resulted in a stable labour market, and this should persist throughout this year. Next year, we see the unemployment rate falling, but only slightly, as unemployment has increased only minimally despite the pandemic-induced recession. Wage growth will likely be driven by the public sector this year, and with the economic recovery, faster wage growth should resume in the private sector as well.

We expect only a minimal increase in the unemployment rate.

Unemployment rate at 4.2% at end-1Q21 under MLSA methodology. This was an increase of 1.2pp yoy, with most of it coming in 2Q20. The introduction of government programs to support the labour market and the improvement of the pandemic in the third quarter resulted in the unemployment rate stabilising. The third wave of the pandemic this year again paralysed the economy amid anecdotal reports of redundancies, but on the other hand a number of companies spoke of a persistent shortage of employees with the required qualifications. Job vacancies decreased slightly in 2020 but remained above 300,000, rising to 340,000 in recent months. **There was no increase in unemployment at the beginning of this year**

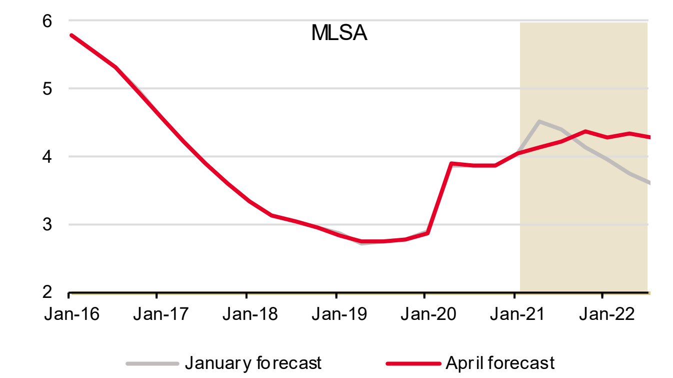
Our outlook for unemployment unchanged for near future. The pandemic and economic downturn would have led to much higher unemployment in the absence of the 'Antivirus' program, under which the state reimburses part of the wage costs of companies whose activities are limited due to the pandemic. Given the parlaimentary election in 2021 and the government's actions to date, we anticipate that this program will be in effect until 4Q21 before a transition to Kurzarbeit (short-time working). However, we expect the economy to expand in the second half of this year, with less need therefore for a government program to support the labour market. **We expect unemployment to peak at around 4.5% in 4Q21 before a gradual decline. Due to an expected increase in frictional unemployment, we slightly increase the equilibrium unemployment rate (NAIRU) to 3% from the previous 2.6% (ILO) in our model.**

Number of vacancies rising again



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

We expect only a minimal rise in unemployment (%, SA)



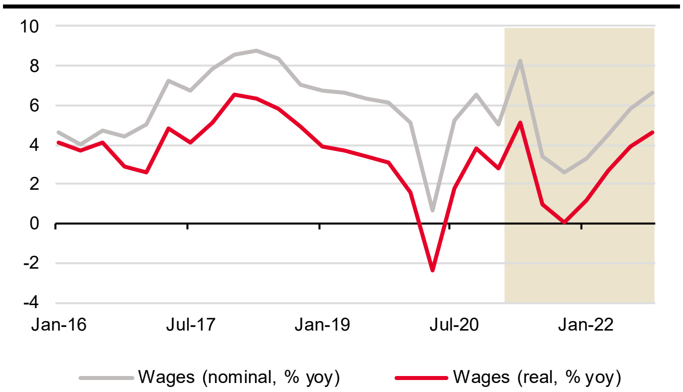
Source: MLSA, Macrobond, Economic & Strategy Research, Komerční banka

Average wages in 4Q20 again surprised positively. Despite the second pandemic wave, wage growth increased by 1.9% qoq (seasonally adjusted) and 6.5% yoy. In real terms, this meant growth of 3.8% yoy. **In the same period, however, employment fell by 0.5% qoq and 1.9% yoy, especially with regard to working hours** (after full-time equivalents, employment fell by almost 3%). According to the national accounts, the volume of wages and salaries paid increased by 2.3% yoy in the fourth quarter, a decrease of 1.0% yoy in real terms. Average wage growth was also supported by the fact that less qualified and worse paid employees lost their jobs. Extraordinary remuneration in healthcare had a significant positive effect, as wages here increased by 31% yoy.

Average wage growth to be supported mainly by public sector this year.

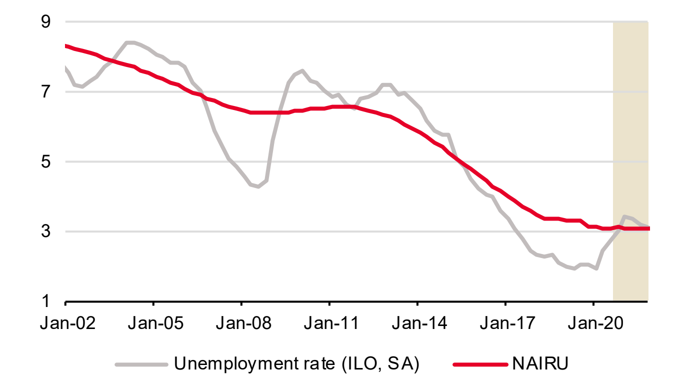
For 1Q21, we expect average wage growth to have slowed to 0.5% qoq and 5.0% yoy. However, the driving force was again likely the public sector, where salaries are rising in health, social services and education. On the contrary, in the private sector, we expect an increase of only 2.1% yoy, which in real terms means a slight decrease. Data from industry and construction for the first few months of this year indicate a significant slowdown in wage growth. We expect a similar picture for the rest of the year, although with renewed economic growth, wage developments will differ significantly by sector. **In summary, we expect a 4.8% increase in the average nominal wage this year and a slight acceleration to 5.0% next year, when wage growth in the private sector could accelerate.**

We expect a slowdown in average wage growth (%, yoy)…



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

… but upward pressure on wages could rise by end-2021 (%)



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

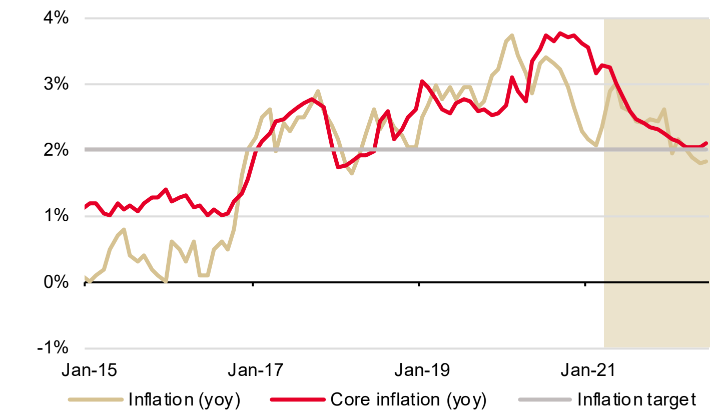
Inflation decelerating slowly

This year, consumer prices will likely rise by an average of 2.5% before slowing to 1.9% in 2022. Core inflation remains subdued, but costs at petrol stations are rising due to higher oil prices. The easing of anti-pandemic measures could lead to significant price fluctuations. We expect a gradual resumption of domestic inflationary pressures, but after the rise in oil prices has subsided, import prices should have a disinflationary effect.

Core inflation expected to subside only slowly.

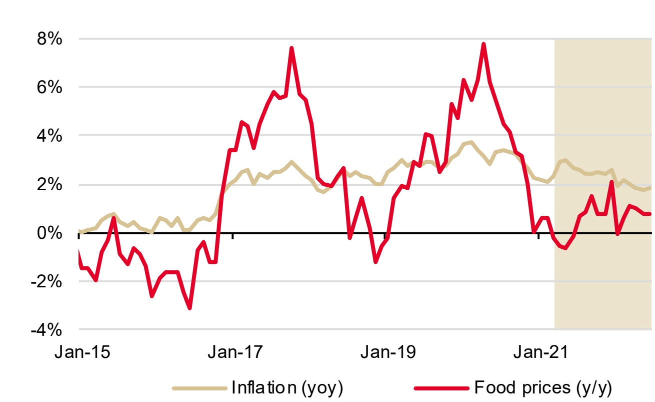
Inflation slowed in 2H20, mainly due to lower food prices. Growth in the core component of the consumer basket – which does not include food, fuel, regulated prices and changes in indirect taxes – has slowed by less than we expected. And at the beginning of this year, there was a significant increase in month-on-month core inflation, which thus reached 3.3% yoy in March. Stores and services are likely to reopen in the second quarter, and how retailers and service providers respond in terms of prices remains to be seen. Recent estimates of declining consumer prices due to weak demand, which have not yet been materialized, may for example be reflected in additional adjustments to prices, discounts or other events with a significant impact on prices. **However, there are also indications that some traders will hike prices due to higher costs and insufficient capacity**, which decreased during the pandemic. We therefore anticipate that although the economy is operating below its potential, core inflation will subside only very slowly. We expect it to average 2.8% this year after last year's 3.4%. Next year, we expect it to average 2.1%, reflecting the expected strengthening of the Czech koruna, rising interest rates and a further slowdown in inflation abroad. This year, we expect inflation of 1.7% in the euro area, but next year we expect it to slow to 1.1% again. **Import prices should therefore have a disinflationary effect from the end of this year.**

Year-on-year inflation may briefly move close to 3%



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

Food prices to have disinflationary effect in 2021



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

We expect oil to be stable at close to USD65/bbl.

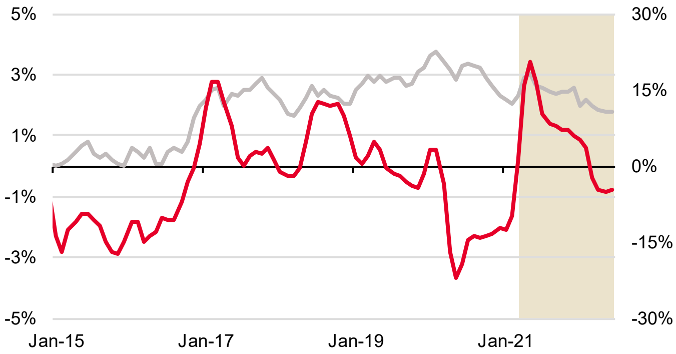
This year has seen an increase in petrol station prices due to higher oil prices. Although the higher oil prices may be reflected in other prices, we do not expect oil prices to continue to rise. On the contrary, we assume stability near USD65/bbl (Brent). From this point of view, we will see large year-on-year increases in petrol station prices, as last year the price of oil fell to an extremely low USD20/bbl. However, we do not expect any further significant rise in petrol station prices in the coming months. On the contrary, given our forecast for oil price stability and a stronger koruna against the dollar, the effect prices at petrol station should act disinflationary next year.

Given our outlook for agricultural commodity prices, we expect only a gradual increase in food prices after faster growth in the past two years.

Increase in excise tax will boost inflation slightly; lower energy prices are holding it back.

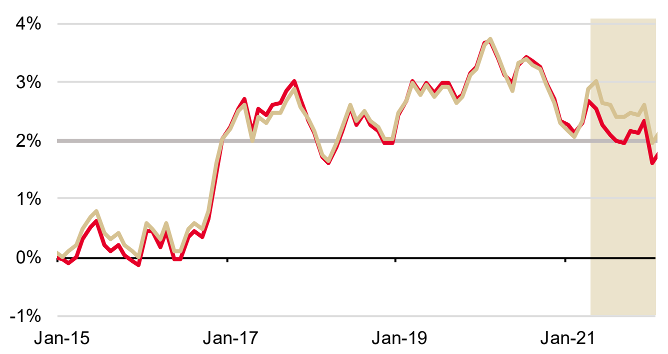
The increase in excise duty on tobacco and alcohol will again support inflation this year, while diesel taxes are lower. The overall effect here should be to add 0.3pp to inflation this year. **Due to the fall in energy prices at the end of last year, regulated prices have begun to have a disinflationary effect.** In year-on-year terms, regulated prices fell slightly in March, and we expect growth to be weak this year (0.7%). We expect a small increase in energy prices this year in the second half as the economy recovers, and we expect an increase in regulated prices from next year

Petrol station prices up significantly



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

Monetary policy inflation is close to 2%



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

From the above, it is clear that there is much uncertainty around price developments. What should come as no surprise, however, is that a base effect will increase annual inflation in the second quarter, possibly to the psychological level of 3%. We expect the rate to decline to 2.4% yoy on average in the third quarter. The risk to our forecast, which the CNB has also mentioned, is short-term price adjustments after the reopening of shops and services, when supply does not have to meet demand. Indications of such a development can be seen among producers, where a Markit report for March states that a shortage of raw materials led to the sharpest rise in input prices in the survey's history, to which many companies responded by raising prices to pass on some of the higher costs to customers.

In summary, we expect inflation to decelerate only slowly and average 2.5% this year. Next year, we see it slowing to 1.9%, with core inflation returning to close to 2% after an estimated 2.8% this year.

Risks: COVID-19 still the main risk

We still consider potential pandemic developments to be the main risks to our short- and medium-term forecasts. These include:

- **Vaccination campaign has insufficient effect.** In our baseline scenario, we expect the positive impact of the vaccination campaign to allow the economy to operate with minimal restrictions on social contact in the second half of this year. Failure to achieve this would fundamentally affect our forecast for the economy.
- **Another pandemic wave.** We expect the gradual opening up of the economy from 2Q. We are not assuming another pandemic wave and the associated tighter restrictions. Should this assumption be wrong, our forecast would likely see a significant downward revision.
- **Impact of lower taxes on consumption.** When calculating the effect of the reduction in personal income tax, we assume a marginal propensity to consume of 0.6 and, in the case of the one-off contribution to all pensions, of 0.8. However, the overall impulse may be weaker or stronger

or otherwise distributed in time. In addition, the fact that 2021 is an election year increases the chances of fiscal ‘gifts’ to voters.

- **Price development during a pandemic.** This is a question of how companies approach pricing. Price developments in services that are currently closed may differ from estimates.

- **External environment.** We expect a recovery in the external economy. This expectation is strongly dependent on defeating the pandemic and increased vaccination. A further recession in the euro area would mean the risk of another decline for the Czech economy as well.

Key economic indicators

	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	Q4 21	Q1 22	Q2 22	2020	2021	2022	2023	2024	2025
GDP and its breakdown														
GDP (real, yoy)	-5.1	-4.8	-2.6	8.4	3.5	4.5	6.3	5.4	-5.6	3.4	4.7	3.4	3.2	2.8
Household consumption (real, yoy)	-3.6	-8.3	-6.6	3.7	2.0	8.2	9.2	6.9	-5.2	1.8	5.3	3.2	3.7	3.0
Government consumption (real, yoy)	0.3	7.0	7.2	9.0	9.8	1.6	-0.9	-1.0	3.5	6.9	-0.6	1.6	1.4	1.8
Fixed investments (real, yoy)	-9.6	-12.8	-5.6	-3.7	6.2	10.4	11.9	9.9	-8.0	1.8	7.1	1.9	3.6	3.8
Net exports (contribution to yoy)	1.4	3.7	1.8	4.8	-3.5	-4.4	-1.1	-0.1	-0.3	-0.3	0.4	1.1	0.3	0.3
Inventories (contribution to yoy)	-2.1	-2.4	-1.0	1.4	2.5	2.3	0.3	0.1	-1.5	1.3	0.1	-0.2	-0.1	-0.1
Monthly data from the real economy														
Foreign trade (CZK bn)	38	9	57	80	61	42	26	15	184	145	136	125	131	138
Exports (nominal, yoy)	-0.9	10.6	9.2	30.0	10.9	4.3	7.5	8.1	-4.2	13.6	7.0	5.0	6.8	5.1
Imports (nominal, yoy)	-4.3	3.4	6.9	25.9	15.3	11.6	9.0	9.6	-5.7	14.9	7.5	4.9	7.5	5.5
Industrial production (real, yoy)	-3.7	1.7	0.4	27.7	3.8	3.4	7.7	7.1	-7.1	8.8	6.5	4.6	6.3	4.8
Construction output (real, yoy)	-9.4	-8.4	-9.7	-2.8	2.4	5.6	1.2	5.4	-5.1	-1.1	4.1	6.1	6.5	4.7
Retail sales (real, yoy)	1.3	-2.0	-1.9	3.2	-1.5	3.9	6.8	5.2	-0.6	0.9	5.3	6.1	5.7	4.0
Labour market														
Wages (nominal, yoy)	5.2	6.5	5.0	8.2	3.4	2.6	3.3	4.5	4.4	4.8	5.0	6.8	6.8	5.6
Wages (real, yoy)	1.8	3.8	2.8	5.2	1.0	0.0	1.2	2.7	1.2	2.2	3.1	4.9	4.7	3.6
Unemployment rate (MLSA)	3.8	4.0	4.2	3.9	4.1	4.5	4.5	4.1	3.6	4.2	4.3	4.2	3.9	3.9
Unemployment rate (ILO 15+)	2.9	3.0	3.4	3.3	3.3	3.1	3.1	2.9	2.6	3.3	3.0	2.7	2.5	2.5
Employment (ILO 15+, yoy)	-1.5	-1.6	-1.7	-0.4	0.2	0.7	1.2	0.4	-1.3	-0.3	0.5	0.3	0.3	0.0
Consumer and producer prices														
CPI Inflation (yoy)	3.3	2.6	2.2	2.9	2.4	2.6	2.1	1.8	3.2	2.5	1.9	1.8	2.0	2.0
Taxes (contribution to yoy inflation)	0.0	0.0	0.0	0.3	0.4	0.4	0.4	0.1	0.0	0.3	0.2	0.2	0.1	0.0
Core inflation (yoy) (*)	3.7	3.7	3.3	3.0	2.5	2.3	2.1	2.0	3.4	2.8	2.1	1.9	2.0	2.1
Food prices (yoy) (*)	4.0	1.7	0.3	-0.2	0.4	1.2	1.0	1.0	4.5	0.4	1.2	1.0	1.2	1.5
Fuel prices (yoy) (*)	-14.2	-13.1	-7.2	14.4	7.1	3.7	-0.8	-3.5	-11.4	4.5	-2.0	-0.8	1.4	0.3
Regulated prices (yoy) (*)	3.4	1.8	0.2	0.1	0.3	2.1	2.2	2.5	3.2	0.7	2.2	2.3	2.9	2.7
Producer prices (yoy)	-0.3	0.1	1.5	3.9	3.9	3.7	2.1	0.6	0.1	3.3	1.0	1.1	1.8	1.7
Financial variables														
2W Repo (%, average)	0.3	0.3	0.3	0.3	0.3	0.4	0.6	0.9	0.8	0.3	1.0	1.7	2.2	2.3
3M PRIBOR (%, average)	0.3	0.4	0.4	0.4	0.4	0.5	0.7	1.0	0.9	0.4	1.1	1.9	2.3	2.4
EUR/CZK (average)	26.5	26.7	26.1	25.7	25.4	25.2	25.0	25.0	26.5	25.6	24.9	24.2	23.7	23.1
External environment														
GDP in EMU (real, yoy)	-4.2	-4.9	-1.5	12.9	2.2	3.9	5.0	4.2	-6.8	4.1	3.6	2.1	1.9	1.7
GDP in Germany (real, yoy)	-4.0	-3.7	-3.4	9.4	2.7	3.5	6.1	4.5	-5.3	3.1	4.0	1.9	1.6	1.4
CPI in EMU (real, yoy)	0.0	-0.3	1.1	1.6	1.9	2.1	1.0	1.1	0.3	1.7	1.1	1.1	1.5	1.5
Brent oil price (USD/brl, average)	43.2	44.3	60.9	67.5	65.0	65.0	65.0	65.0	42.4	64.6	65.0	65.3	66.1	67.1
EURIBOR 1Y (%, average)	-0.4	-0.5	-0.5	-0.4	-0.3	-0.2	-0.2	-0.1	-0.3	-0.4	-0.1	0.2	1.2	2.7
EUR/USD (quarter eop, year average)	1.17	1.19	1.20	1.23	1.25	1.27	1.25	1.25	1.14	1.24	1.27	1.31	1.33	1.35

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

CNB Focus

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Higher rates in the second half of the year

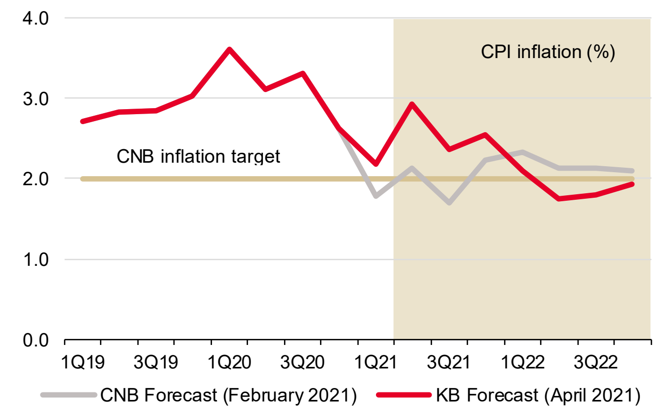
The CNB interest rates are likely to remain low until November, when we expect a first hike. The main reason for continued interest rate stability is uncertainty surrounding the pandemic and economic developments. The low vaccination rate means that we cannot rule out another wave of infection. Meanwhile, central bankers say they would rather delay raising rates than rush an increase. Following the significant rate of infection at the beginning of the year, the CNB's May forecast is likely to call for lower GDP growth in 2021 and a later increase in interest rates. On the other hand, this year's inflation forecast could shift slightly upwards. We expect a stronger economic rebound only in 2H21, when enough people are vaccinated. A November rate hike of 25bp would likely to trigger a gradual normalisation of monetary policy. At end-2022, we expect the key repo rate to be 1.25%. However, the risk to our rates forecast is that the central bank hikes earlier – as soon as 3Q. This could take the form of a speedy response by the CNB to significantly improving leading indicators or to rapid increases in consumer prices due to pent-up demand after the opening of shops and services.

Interest rates remain low due to the pandemic

After being cut by a total of 200bp in 1H20, the two-week repo rate has remained unchanged.

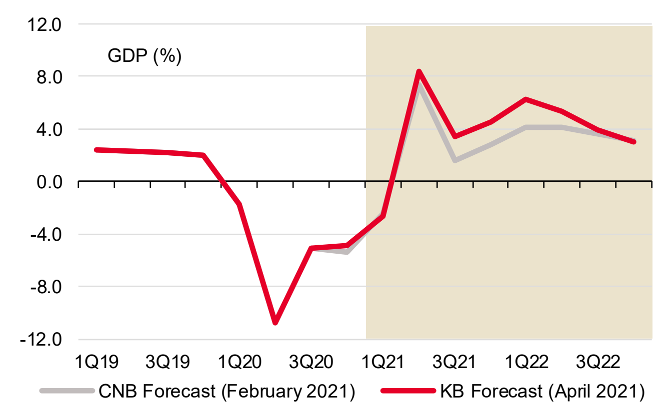
The first quarter of this year was marked by continued interest rate stability. The two-week repo rate thus remains 0.25%, and the discount and Lombard rates were not changed either (0.05% and 1.00%, respectively). According to the CNB, the main reason for interest rate stability is uncertainty surrounding the pandemic and economic developments. The number of new infections soared again in the few first months of the year, which led to a further tightening of virus-related measures. Despite its greater resilience during the autumn wave of the pandemic, the economy is likely to shrink slightly in 1Q vs the previous quarter.

Inflation likely above the CNB forecast this year



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

Stronger economic rebound likely only in 2H21



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

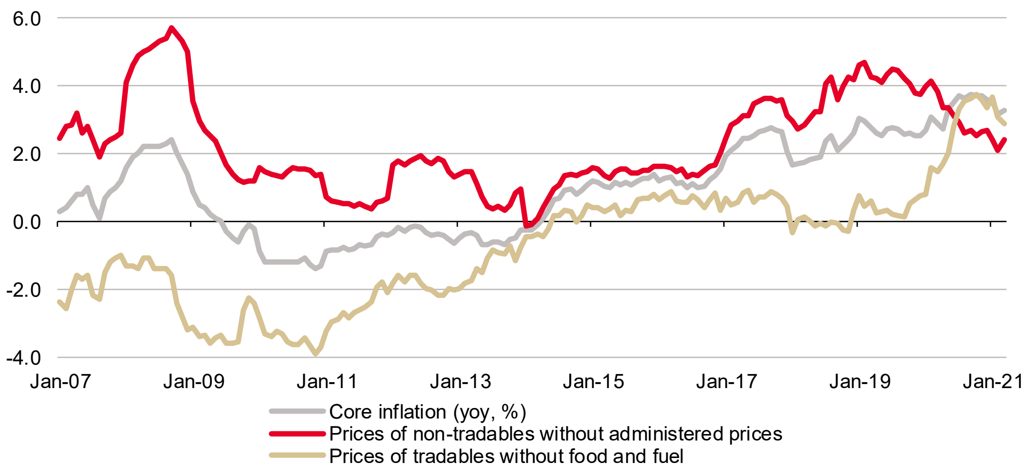
Weaker economy with slightly higher inflation

The economy should remain weak in 1H due to the rapid spread of the virus at the beginning of 2021 and an only gradual easing of the pandemic measures.

The economy's stronger resilience was reflected in the 4Q results, with growth of 0.6% qoq. This was slightly better than the CNB forecast of stagnant GDP. Government consumption was especially higher, growing at about twice the rate of the CNB forecast, while net exports printed slightly above the estimate. On the other hand, household consumption and investment declined more year-on-year than the central bank had expected. For 1Q21, the CNB's February forecast assumed a 0.2% qoq decline in GDP, with its subsequent increase by 0.7% in 2Q. However, this trajectory did not include the above-mentioned significant deterioration of the pandemic situation at the beginning of the year. **It is thus very likely that the CNB's May forecast will bring a worsened outlook for the economy.** We expect GDP to decline by 0.8% qoq in 1Q and recover by 1.6% in 2Q. Taking into account the last few central bank forecasts, which were among the most pessimistic, it can be assumed that the CNB's 2Q forecast in particular will be lower. As a result, the CNB may reduce its full-year estimate, for which it currently expects growth of 2.2%. Our forecast includes full-year GDP growth of 3.4% for 2021, partly due to the assumption of a strong economic rebound in 2H.

Inflation was higher in 1Q than the central bank had expected. Year-on-year growth in consumer prices averaged 2.2%, but the CNB had forecast 1.8%. Food prices grew faster than the CNB forecast and core inflation was also higher. Within core inflation, growth in the price of tradables hovered around 3%, while the price of non-tradables grew at just over 2%. The year-on-year decline in fuel prices was more moderate than the CNB forecast as well. On the other hand, a slower increase in regulated prices pushed inflation slightly lower. There was even more of a difference for the CNB's producer prices forecast. Producer prices increased by an average of 1.6% in 1Q, while the CNB expected a 1% year-on-year decline. **Stronger wage growth has also been putting upward pressure on domestic consumer prices.** In nominal terms, average wages rose by 6.5% yoy vs the CNB forecast of only 2.2%.

Core inflation remains above 3%, mostly due to the price of tradables; growth in the price of non-tradables slowed to 2%



Source: CNB, Economic & Strategy Research, Komerční banka

Higher inflation in 1Q and faster price dynamics abroad are likely to shift the inflation outlook slightly above in the CNB's May forecast.

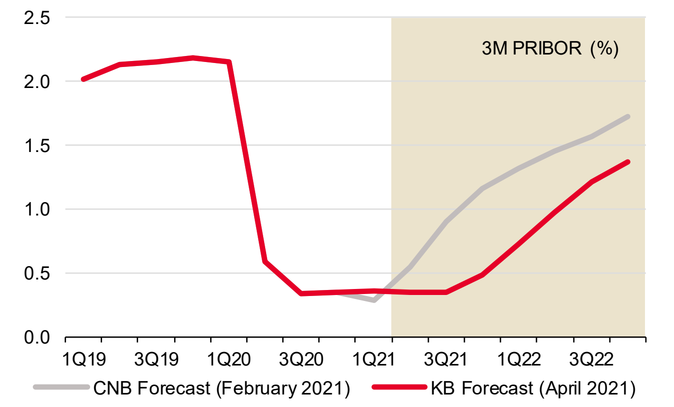
In the CNB's May forecast, foreign price developments are also likely to raise the domestic inflation outlook. This is evidenced by the latest update to the CNB's external assumptions in late March. While the CNB's February forecast included 1.4% year-on-year consumer price inflation in the effective euro area this year, updated assumptions on the external environment already speak of 1.8%. Growth in producer prices in the effective euro area is even twice as high in the updated assumptions (3.3% vs 1.6%). However, imported inflation may be partly moderated by exchange rate trends. In 1Q, the koruna was one percent stronger against the euro than the CNB had expected. According to the central bank, it should continue to strengthen to slightly above EUR/CZK 25 at end-2021. We have a similar FX forecast. The worsened economic outlook mentioned above should also weigh on inflation. **However, in our opinion, inflationary effects prevail in the CNB's May forecast, which could lead to a slight revision towards higher inflation this year.** We expect consumer price inflation to average 2.5% this year vs the 2.0% CNB forecast from February. In terms of structure, this year's inflation will mainly reflect a significant year-on-year rise in the price of oil; core inflation should fall from 3.4% to 2.8%, according to our forecast.

Policy normalisation to start in November

Central bankers do not want to rush raising interest rates.

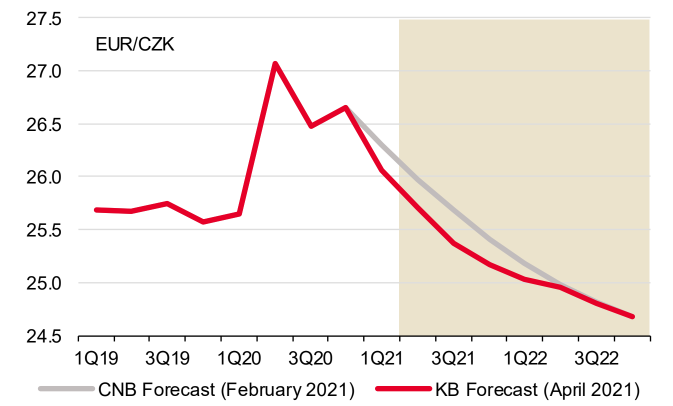
We forecast a first increase of 25bp in the key repo rate in November. Most CNB board members have said that interest rates will remain at current levels for at least 1H21. Although the pandemic situation has already improved significantly, virus-related measures are likely to be lifted only gradually. **The rate of vaccination in the Czech Republic is still relatively low, so the risk of another wave remains considerable.** Services and retail have been closed for almost a year, and at the beginning of this year, there were also problems in manufacturing, which has lacked key production inputs due to disruptions in supply chains. Not surprisingly, the financial position of some companies has deteriorated significantly during the pandemic. Recently, there has been a slight increase in the number of non-performing loans. This trend may increase with the expected reduction in support through government programmes. It will thus be important for the CNB to maintain conditions for easy access to cheap liquidity in the early stages of economic recovery. This is also confirmed by the words of central bankers, who state that **they would rather be late in raising interest rates than raise them prematurely and jeopardise nascent growth in the economy.**

Interest rates likely to rise at end-2021



Source: CNB, Economic & Strategy Research, Komerční banka

Stronger koruna to help tighten monetary conditions



Source: CNB, Economic & Strategy Research, Komerční banka

The financial market expects two interest rate hikes by the CNB by end-2021, the first in 3Q and the second in 4Q.

2H21 should bring a strong economic recovery, and together with a higher vaccination rate, the CNB should be able to start normalising monetary policy. According to our forecast, the November rate hike should thus start the process of gradual policy tightening, leading to higher interest rates next year as well. At end-2022, we expect a two-week repo rate of 1.25%. The CNB's February forecast is for the first increase in interest rates in 2Q and for two more hikes by the end of the year. Its hawkish tone is also reflected in the trajectory of rates for next year, in the last quarter of which the CNB expects a repo rate of 1.6%. However, regarding statements by CNB board members, rates will remain stable for a longer period. The financial market does not anticipate an increase in policy rates in 2Q either. It expects two rate hikes by the end of the year, the first in 3Q and the second in 4Q. **Given the poor rates of infection at the start of 2021, we expect the CNB's May forecast to point to a withdrawal from the 2Q increase in interest rates.** However, the rate of increase in interest rates is likely to be similar, and so their entire forecast trajectory will probably only shift one quarter ahead. The sharp rate increase in the CNB forecast is related to the strong forward-looking component of the central bank's prediction model, in which this year's level of rates responds mainly to economic growth next year (the CNB forecasts GDP growth of 3.8% for 2022). The CNB board, which has so far been reserved regarding the rapid rise in interest rates in the CNB's forecast, will thus likely be more comfortable with the new May forecast.

Along with the repo rate, the Lombard rate will probably also rise in November. On the other hand, in our opinion, the discount rate will remain at the current 0.05% until 2H22.

We expect the central bank to want to restore the standard symmetric band around the key repo rate of 100bp. Interest rates trended in a similar manner during the last cycle of tightening monetary policy, i.e. in the period from April 2017 to February 2020.

Higher rates already in 3Q are a risk

A significant rise in inflation, which may be a response to strong demand for goods and services after the opening of shops, could contribute to an earlier hike in interest rates.

In our opinion, an earlier increase in interest rates in 3Q is a risk to our forecast. Some central bankers mentioned that sufficient signs of an improvement in the economy would take the form of good trends in leading indicators, which would make the board not feel a need to wait for the official GDP data to implement a rate increase. Given the expected economic downturn in 1Q and the gradual easing of virus-related measures, GDP for 2Q is unlikely to be dazzling. As a result, we will probably not see a more significant recovery in economic activity until 3Q. **Although the summer months could already offer optimistic-looking leading indicators, in our opinion, the vaccination rate will not yet be high enough to rule out another pandemic wave. Further development of inflation is also a big unknown**, as it is still not fully clear in which direction consumer prices will trend after the stores open. **At present, we see more risks on the side of higher inflation.** This is due to the favourable development of household incomes, which have been supported by expansionary fiscal policy. As shops have been closed, however, households did not have much room to spend their money, and so savings rates reached a record high. After the shops open, this pent-up demand may be rapidly unleashed and cause a significant rise in prices. Inflationary risks are now also accumulating in manufacturing, due to rising input prices. **Overall, risks to our monetary policy interest rate forecasts are biased toward an earlier-than-expected increase, but the predicted rate of increase is not in jeopardy, in our opinion.**

Czech IRS market and government bonds

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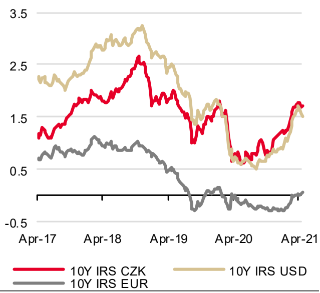
The peak is not on the horizon, but growth will likely slow

Interest rates and government bond yields rose sharply in the first quarter. They should continue to rise, albeit at a slower pace. Financial markets appear to be counting on the CNB raising interest rates over a two-year horizon. On the other hand, in the longer term they still appear to underestimate the pace of monetary policy normalisation. From a hedging point of view, longer maturities are still attractive. Government bonds have already grown substantially, so the second half of the year could surprise the financial markets with short supply. The lack of government bonds could thus dampen growth in yields driven by the IRS curve, and in ASW terms we expect a reversal of the trend and their gradual richening. The story of expansionary fiscal policy is finished, and, in our opinion, the second half of the year will probably be driven by the probable reclassification of the Czech Republic from a developing country to a developed country, which paradoxically would negatively affect Czech government bonds.

Czech IRS market: The CNB and global development support rapid growth

The first quarter of this year saw a massive rise in interest rates in global markets, triggered by the prospect of vaccination and economic recovery in the second half of this year. This is also associated with higher inflation expectations and faster central bank responses. As a result, the first quarter exceeded all expectations and led to significant forecast revisions, including ours. SG strategists have shifted the outlook for the end of this year for the ten-year dollar rate from 1.60% to 2.05% and the euro rate from 0.20% to 0.40%, with current macroeconomic developments leaving risks on the upside. **And although recent weeks have shown a partial correction of previous rate hikes, we do not expect the trend to change. Short periods of stagnation or decline cannot be ruled out for the following months either. However, interest rates look set to continue to rise.**

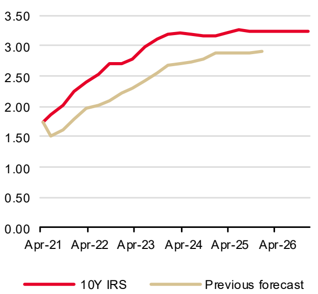
Core and CZK rates



Source: Bloomberg, Economic & Strategy Research, Komerční banka

Although our January forecast was one of the boldest on the market, since then the development of the markets has surpassed us by three quarters in terms of the ten-year CZK rate. In shorter maturities, the surprise was significantly lower, however, our new forecast moved higher. The main reason is global growth, especially in the US, and the change in our assumptions for the external environment. Nevertheless, the domestic financial market also played an important role, reacting significantly more aggressively to the CNB's rhetoric. Although in the new forecast we expect only slightly faster growth of central bank interest rates next year, we assume that investors should integrate normalising monetary policy much faster, which should be reflected in the short end of the curve.

IRS forecast change



Source: Economic & Strategy Research, Komerční banka

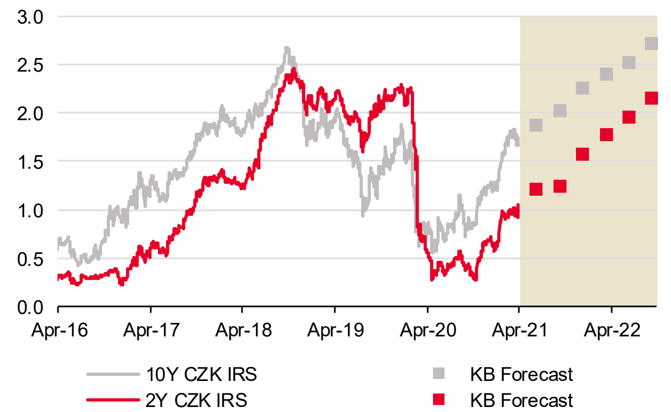
CZK IRS outlook (end of period, %)

	2Q21f	3Q21f	4Q21f	1Q22f	2Q22f
2Y	1.20	1.25	1.60	1.80	1.95
5Y	1.70	1.80	2.05	2.20	2.35
10Y	1.90	2.05	2.25	2.40	2.55

Source: Economic & Strategy Research, Komerční banka

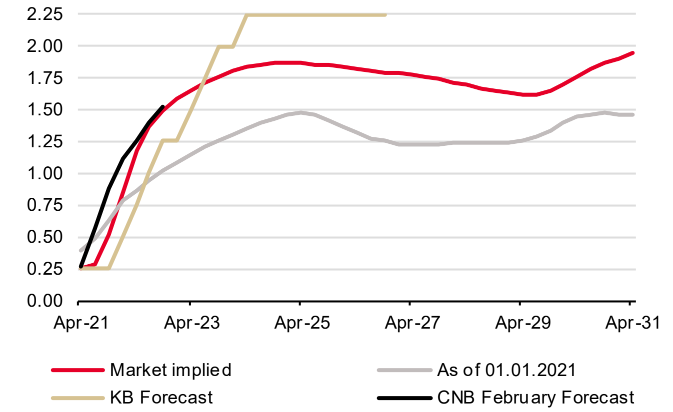
The CNB's May meeting and the announcement of its new forecast should be crucial for the coming months. Recent weeks have shown a decline in koruna rates back to the levels of early March. Although the central bank's new forecast is likely to show a downward revision of the economic outlook, higher inflation should maintain the hawkish tone of the Board that we have seen in previous meetings. We expect that May will support market rates again. We see more space especially at the longer end of the curve. In short maturities of up to two years, the financial markets in our opinion overestimate the potential increase in the CNB's interest rates, while in the longer term, despite rapid growth, they still underestimate the normalisation of monetary policy. **Compared to our January forecast, we have thus increased the expected value of the two-year IRS at the end of this year from 1.25% to 1.60% and the ten-year from 1.80% to 2.25%.** The whole curve should be steeper over the course of the year, however, before the end of this year, this trend should reverse due to the CNB rate hike. In this context, we recommend *Pay CZK 5y IRS.*

IRS forecast (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Expected CNB key interest rate trend

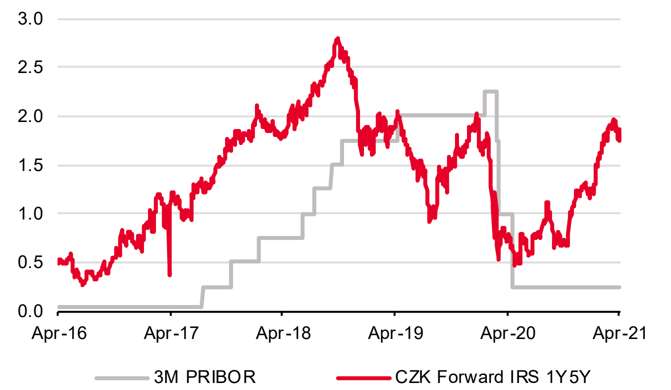


Source: Bloomberg, CNB, Economic and Strategy Research, Komerční banka

Hedging conditions remain advantageous especially in the longer term

Due to the CNB's aggressive forecast, which we do not think will change much in May, the financial markets are still raising their stakes for a rapid rise in central bank interest rates over a two-year horizon. Currently, the market expects the two-week repo rate to rise to less than 1.50% at the end of 2022, which is only a few basis points below the CNB's February forecast. Although we see one increase in central bank interest rates (by the standard 25bp) less at this horizon, we do not expect the financial markets to lower their expectations. **On the other hand, in our view, the markets continue to underestimate hikes in CNB interest rates in the longer term, which can be used to hedge interest rate risk.** The central bank continues to reiterate that it sees the value of the equilibrium rate at 2.5-3.0%, which is where long-term expectations of markets should go. At present, they do not even reach 2% in a 5-10 year horizon, which is also why we expect the fastest growth for the following months in this segment of the curve. On the other hand, even these options are gradually closing since the last forecast, and we do not expect anything to change in this trend.

Interest rate hedging conditions are deteriorating



Source: Bloomberg, Economic & Strategy Research, Komerční banka

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

Forward \ Maturity	6M	1Y	18M	2Y	3Y	5Y	10Y
Spot	0.43	0.59	0.93	1.09	1.38	1.67	1.83
3M	0.53	0.89	1.11	1.28	1.51	1.75	1.88
6M	0.82	1.19	1.31	1.48	1.66	1.83	1.93
9M	1.26	1.42	1.53	1.64	1.78	1.90	1.98
1Y	1.56	1.57	1.70	1.76	1.88	1.96	2.01
18M	1.56	1.77	1.83	1.90	1.97	2.01	2.05
2Y	1.96	1.97	2.01	2.04	2.07	2.05	2.09
3Y	2.11	2.12	2.12	2.12	2.10	2.04	2.15

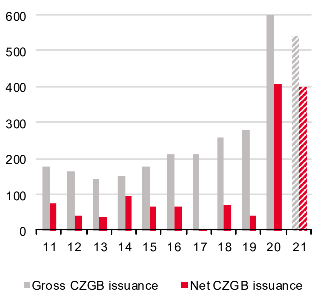
Source: Bloomberg, Economic & Strategy Research, Komerční banka, as of 28/4/2021

The markets likely to face surprisingly low CZGB supply

Financial markets have fully taken into account the high supply of government bonds.

In our view, the financial markets have fully priced in massive CZGB supply, similar to last year's record amount. At the same time, there is no indication that the government should have problems financing the record state budget deficit. After rather average March auctions, demand almost doubled in April. On the other hand, the Ministry of Finance's April macroeconomic forecast shows the expected public finance deficit significantly worsening, and *Debt Portfolio Management Quarterly Report* (see https://bit.ly/3dx0ASJ) took into account in its projection of this year's issuance an increase in the planned state budget deficit from the beginning of the year. In our view, the government is thus giving the impression of a significantly higher CZGB issuance compared to our forecast (more on the state budget in the *Fiscal Policy* chapter). Since the beginning of the year, according to our calculations, the Ministry of Finance has already secured about 60% of this year's borrowing needs. **We therefore expect that in the second half of the year the financial markets will likely be surprised by low CZGB supply, similar to what we witnessed last year.**

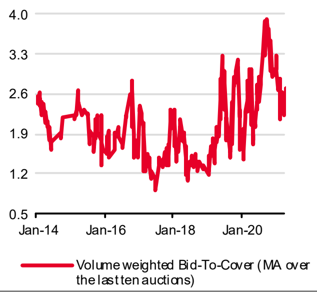
CZGB issuance (CZKbn)



Source: MinFin, Economic & Strategy Research, Komerční banka

Due to optimistic expectations of the development of fiscal policy compared to the market, our forecast for this year's government bond issuance remains almost unchanged. Minor adjustments were made only in the structure of financing borrowing needs thanks to the €2bn that the government received from the European Commission under the SURE program. These funds will be used to cover all of this year's foreign currency borrowing needs, which results in: 1) the elimination of the need to issue bonds denominated in euros; and 2) an unexpected source of euro funding would not affect the EUR/CZK xccy basis.

Demand for government bonds is starting to grow again



Source: CNB, Economic & Strategy Research, Komerční banka

Funding programme and issuance activity for 2021 (CZKbn)

	MinFin	KB
State budget deficit	500.0	400.0
Transfers and other operations of state financial assets	0.0	0.0
T-Bonds denominated in local currency redemptions	141.4	141.2
T-Bonds denominated in foreign currency redemptions	56.0	51.6
Redemptions and early redemptions on savings bonds	0.0	0.0
Money market instruments redemptions	25.4	25.4
Redemption of T-bills		25.4
Redemption of other money market instruments		0.0
Repayments on credits and loans	3.5	3.5
Total financing needs	**728.4**	**647.1**
Money market instruments		20.0
T-bills		20.0
Other money market instruments		0.0
Gross issuance of CZK-denominated T-bonds on domestic market	min. 580	544.0
Gross issuance of EUR-denominated T-bonds on domestic market		0.0
Gross issuance of T-bonds on foreign market		0.0
Gross issuance of savings government bonds		12.0
Received credits and loans		52.3
Financial asset and liquidity management		18.8
Total financing sources		**647.1**
Gross borrowing requirement		**628.3**
Net CZGB issuance		**402.8**

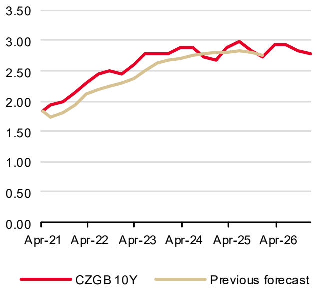
Source: MinFin, Economic and Strategy Research, Komerční banka

Main part of CZGB yield growth is finished

Government bond yields should continue to grow. However, the speed will be dampened by lower supply, which should lead to ASW richening.

Over the past two quarters, the ten-year yield on government bonds has risen from 0.85% to almost 2% and has also cheapened sharply in ASW terms. This was due to a combination of high government bond yields on global markets, the CNB's aggressive monetary policy outlook, and the Czech government's expansionary fiscal policy, which resulted in a massive increase in government bond supply. In our view, the first two reasons should have slightly less of an effect on the growth of Czech government bond yields in the coming months, while fiscal policy has played its part. Demand has been growing in recent weeks, while supply, in our view, will be lower than the market currently expects. ASW spreads are thus likely to have limited room for further growth, and in the coming months, according to our forecast, they will begin to tighten again, dampening further yield growth driven by the IRS curve. By the end of this year, we expect significantly lower yield growth than we have seen in previous quarters. The two-year yield should move to 1.15% and the ten-year yield to 2.15%. Compared to our January forecast, we now expect higher levels of government bond yields, but the change is significantly smaller than in the case of the IRS. In the case of bonds, we also expect a steeper shape of the curve, which should peak before the end of this year. From the ASW's point of view, the belly of the curve is currently the cheapest, while the short-end offers carry-roll sweet spot.

CZGB forecast change



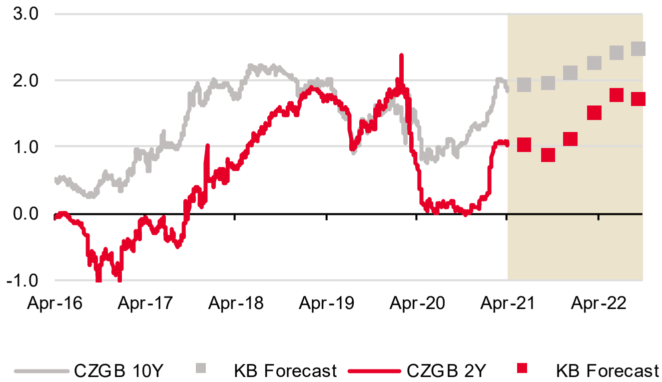
Source: Economic & Strategy Research, Komerční banka

CZGB yield forecast (end of period)

	2Q21f	3Q21f	4Q21f	1Q22f	2Q22f
2y CZGB yield (%)	1.05	0.90	1.15	1.55	1.80
5y CZGB yield (%)	1.65	1.60	1.80	2.05	2.25
10y CZGB yield (%)	1.95	2.00	2.15	2.30	2.45
10y CZGB ASW (bp)	5	-3	-11	-10	-10

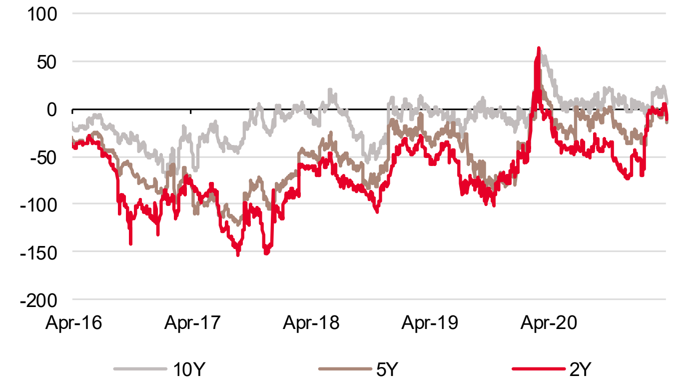
Source: Economic & Strategy Research, Komerční banka

CZGB yields (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

ASW spreads (bp)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

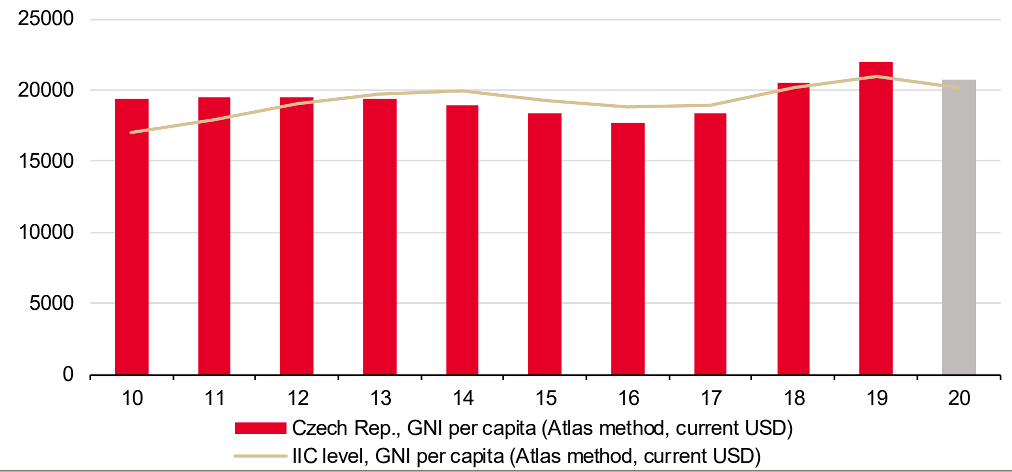
Box 2: CZGBs likely to say goodbye to the GBI-EM family

The Czech Republic's GNI per capita in USD terms fell below JPM's index income ceiling (IIC) for three consecutive years due to koruna depreciation against the dollar and weaker GDP growth. It was subsequently moved from the JPM Government Bond Index (GBI) to the GBI-EM in 2017. Based on the volume of assets under management (AUM) benchmarked against an index, the GBI-EM is significantly smaller than the GBI, but the reclassification led to significant inflow into CZGBs. This was due to the fact that the weight of the Czech Republic is substantially higher in emerging markets than in developed markets. However, the net effect is difficult to quantify due to the timing of the Czech National Bank (CNB)'s exit from the FX floor in April 2017, which also spurred large inflows of foreign capital into CZGBs in expectation of CZK gains.

Since the beginning of 2017, the koruna has strengthened 16.5% against the dollar and the Czech Republic has seen several years of solid economic growth. This moved the country above IIC in 2018 and 2019, and we believe this threshold was exceeded in 2020 as well. Thus, the Czech Republic's GNI likely exceeded the IIC for three consecutive years, which is the criterion for inclusion in developed market indices. Once the final 2020 data are published, we expect the relevant authorities to announce the country's reclassification as a developed market. Nevertheless, this is unlikely to happen until January 2022, in our view, and then take effect in March 2022 or later.

Overall, we expect that this event will cause a significant outflow from the CZGB market and lead to a short-term weakening of the koruna, causing it to underperform CEE peers. More details on the market impact, timing and affected CZGBs can be found in *CZGB Focus: CZGBs likely to say goodbye to the GBI-EM family* (see https://bit.ly/2RQOZ93).

Since 2018, the Czech Republic has exceeded the threshold for inclusion in DM indices



Source: Macrobond, World Bank, JPM, Economic and Strategy Research, Komerční banka
Note: 2020 GNI is an KB estimate

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
3.85	Sep-21	0.4	0.0	100%	-0.35	-6	-11	-1.14	-76	-18	-16	-106		-47	-0.8	20	38.1	20	-91.9	20
0.00	Feb-22	0.8	0.0	6%	0.21	-11	4	-0.64	-31	-4	3	-59		17	0.7	3	0.3	10	4.4	17
0.10	Apr-22	1.0	0.0	100%	0.50	-2	2	-0.42	-9	-1	4	-49		-3	1.2	1	-23.0	1	15.4	1
4.70	Sep-22	1.3	0.0	100%	0.57	8	0	-0.52	-23	-1	-3	-69		-18	1.1	2	-13.4	2	14.6	3
0.45	Oct-23	2.5	0.0	80%	0.95	-2	1	-0.53	-25	-17	-4	-50		-10	0.4	5	-12.1	4	14.9	2
5.70	May-24	2.9	0.0	100%	0.95	-2	-2	-0.68	-43	-21	-9	-72		-24	0.4	6	5.9	15	12.6	5
0.00	Dec-24 *	3.6	25.3	27%	1.21	1	4	-0.46	-24	-13	-1	-39		-12	0.5	4	-6.8	6	12.5	6
1.25	Feb-25	3.7	0.0	100%	1.23	-1	-2	-0.46	-26	-15	-4	-38		-12	0.0	11	-3.7	7	13.5	4
2.40	Sep-25	4.1	11.0	76%	1.34	-3	-11	-0.39	-22	-15	-11	-37		-5	0.0	10	-1.8	8	11.1	7
1.00	Jun-26	4.9	4.7	100%	1.46	-2	-12	-0.29	-18	-16	-14	-28		-2	-0.3	14	-0.3	9	10.1	8
0.25	Feb-27	5.7	0.0	83%	1.52	-3	-9	-0.23	-16	-14	-8	-25		0	-0.3	13	3.2	13	9.3	9
2.50	Aug-28	6.6	3.4	84%	1.65	-2	-5	-0.05	-8	-15	-6	-24		7	0.2	8	6.4	16	7.0	11
2.75	Jul-29	7.3	12.2	83%	1.70	-4	-8	0.05	-4	-13	-7	-19		12	0.1	9	6.9	18	6.0	12
0.05	Nov-29	8.4	16.8	50%	1.71	-5	-9	0.05	-4	-12	-7	-11		11	-0.7	18	7.0	19	5.1	13
0.95	May-30	8.6	18.9	100%	1.76	-4	-12	0.12	0	-13	-11	-9		16	-0.5	17	3.8	14	4.9	14
1.20	Mar-31	9.2	43.4	100%	1.81	-4	-14	0.20	1	-12	-12	-10		19	-0.4	16	1.2	11	4.4	16
1.75	Jun-32 *	10.0	11.2	27%	1.82	NA	NA	0.26	-2	-14	-14	-1		12	-0.8	19	1.6	12	3.8	18
2.00	Oct-33	10.8	5.5	84%	1.91	-6	-12	0.37	2	-15	-12	-10		21	-0.3	15	-7.4	5	3.7	19
4.20	Dec-36	11.9	15.8	95%	2.04	-6	-8	0.55	6	-16	-10	-19		25	0.3	7	-12.3	3	4.8	15
1.50	Apr-40	16.1	4.2	24%	2.23	-8	-9	0.61	17	-16	-10	4		33	0.0	12	6.5	17	7.3	10

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

Czech FX market

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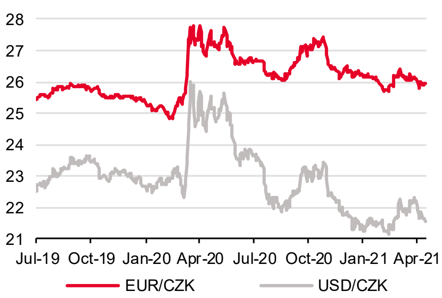
Approaching rate hike pushing koruna to stronger levels

During March, the koruna lost its COVID premium and returned to its original strengthening trajectory. Within the region, the Polish zloty has greater potential to appreciate, but we think the Czech currency offers the best risk-reward. The key event for the coming weeks will be the CNB's May meeting. In our view, this will again cause market interest rates to rise and, in conjunction with the continued strengthening of the euro against the US dollar and positive global sentiment, push the koruna to stronger levels. Our forecast for EUR/CZK is 25.50 at end-1H and 25.10 at year-end. We expect it to reach pre-COVID levels by end-1H22. Further waves of the pandemic and central bank reactions remain a risk. We have made only cosmetic adjustments to our forecasts since January, and we still expect the koruna to outperform the market expectations. Forwards imply a EUR/CZK level that is 1.20 weaker than we expect on a 1y horizon. The currently subdued market rates make hedging conditions more favourable.

Koruna again the top performing currency in Central Europe

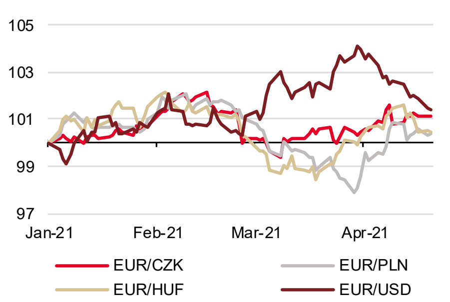
The first quarter was marked by the peak of the pandemic in the region, which impacted financial markets and exchange rates. But investors are now looking to the future. **The prospects of economic recovery in 2H21 and discussions on raising policy rates have been boosting CE currencies** since the beginning of February, and we expect this trend to continue in the coming months. In Central Europe, we think the Polish zloty has the greatest potential to appreciate, but the koruna offers the best risk-reward ratio due to the impending increase in CNB rates.

CZK exchange rates



Source: Bloomberg, Economic and Strategic Research, KB

Performance of CE currencies



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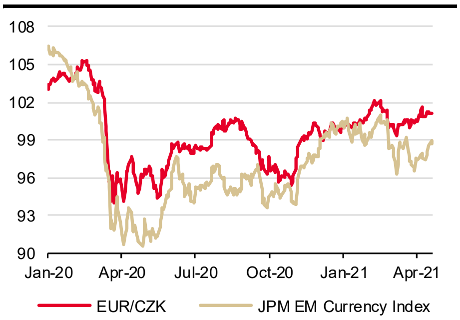
Koruna failing to detach from market



The koruna wiped out its COVID premium in the second half of March and has returned to its appreciation trajectory, driven by rising koruna market rates and global optimism based on vaccinations and the re-opening of the economy. However, April saw a break in the growth of dollar interest rates, which led to a correction in rates in regional markets, including the koruna. Its interest rate differential against the euro returned to the levels we saw in the first half of March, and what had been the driving force behind the koruna's strength in previous weeks became an obstacle.

Koruna exchange rate forecast (end of period)

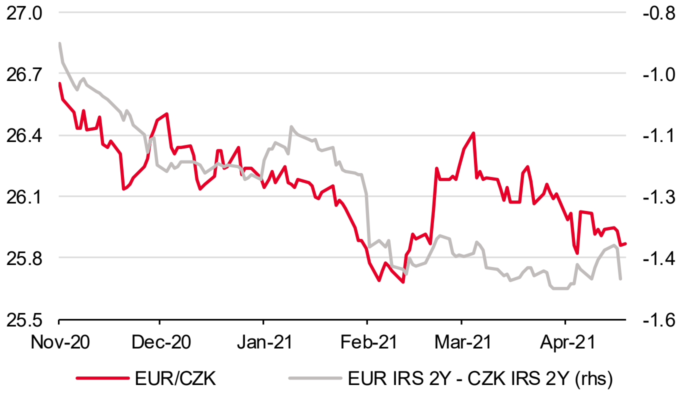
	2Q21f	3Q21f	4Q21f	1Q22f	2Q22f
EUR/CZK	25.50	25.30	25.10	25.00	24.90
USD/CZK	20.75	20.25	19.75	20.00	19.90
EUR/USD	1.23	1.25	1.27	1.25	1.25

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

On the contrary, global developments, namely the stronger euro against the dollar, general optimism from the impending end of the pandemic and investors' increasing risk appetite are pushing the koruna to stronger levels. The Czech currency thus finds itself in the grips of deteriorating domestic and positive global conditions.

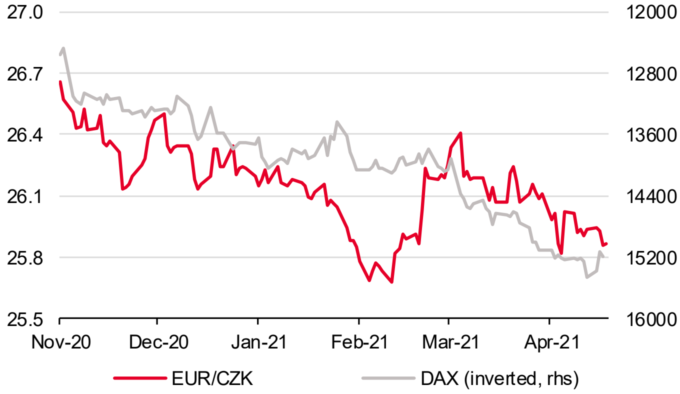
For the coming weeks, we expect the CNB's May meeting to be crucial. In our view, this should cause market interest rates to rise, acting as a catalyst for koruna appreciation. According to our SG colleagues, the euro should continue to strengthen against the US dollar, despite increased volatility, while global markets should maintain their optimistic mood in the coming months. Overall, **we expect 2Q21 to see the strongest appreciation this year**, bringing the EUR/CZK to 25.50. The CNB is currently discussing the timing of its first hike, and we think this will remain the biggest driver of koruna appreciation for the remainder of the year. In 2H21, the pace of strengthening should slow slightly, and we expect **EUR/CZK to end this year at 25.10**. Going forward, we expect this trend to continue, with the Czech currency returning to pre-COVID levels in 1H22.

Koruna balances between…



Source: Bloomberg, Economic and Strategic Research, Komerční banka

… deteriorating domestic environment and global optimism



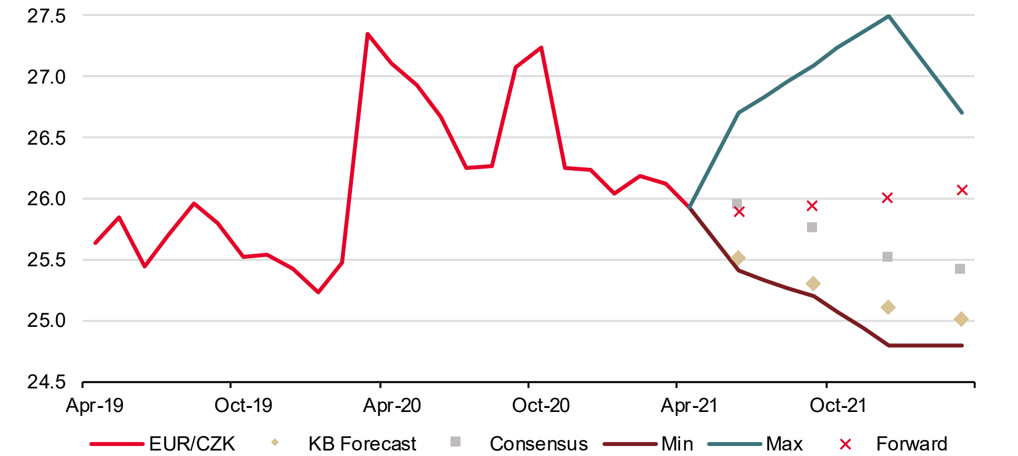
Source: Bloomberg, Economic and Strategic Research, Komerční banka

Despite increased exchange rate volatility, the koruna is close to the level we expected for this time of year, so we make only cosmetic adjustments. We raise our expected koruna appreciation at the one-year horizon by CZK0.10-0.15. **The main reasons for the change are faster than previously expected economic recovery and a more aggressive reaction of market interest rates to the CNB's hawkish rhetoric.** At the moment, financial markets expect a roughly CZK0.40 weaker trajectory than we forecast, implying roughly the same gap over the market as in January.

The risks remain the same, but their intensity is declining

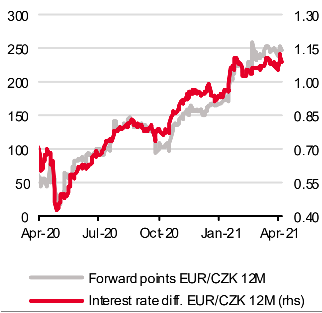
The main risk for the koruna remains the local COVID rates. Further deterioration in the coming months would likely lead to a weaker koruna. On the other hand, the sensitivity of financial markets has been gradually declining since the beginning of the pandemic, and any negative shock would probably be less severe than we saw in autumn 2020, which, according to our estimates, cost the koruna CZK0.40. On the other hand, **the CNB's monetary policy remains a symmetrical risk.** Faster economic recovery and persistent inflationary pressures would lead to an earlier rise in interest rates and, in turn, a stronger koruna. On the contrary, the delayed effect of the second and third waves of the pandemic and government measures could reveal a moribund economy, including a more pronounced undershooting of the inflation target, which would delay the tightening of monetary policy until next year and cause the koruna to miss our forecast.

Expected EUR/CZK path, market consensus by Bloomberg (as of 26 April 2021)



Source: Bloomberg, Economic and Strategic Research, Komerční banka

EUR/CZK forward points and interest rate differential development

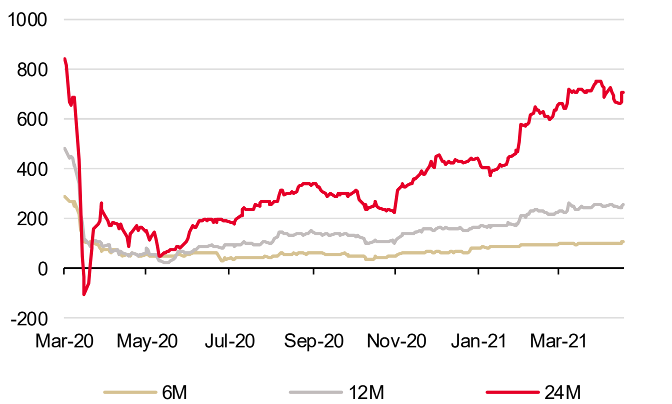


Source: Bloomberg, Economic and Strategic Research, Komerční banka

Interest rates retreat from highs – Good time to hedge

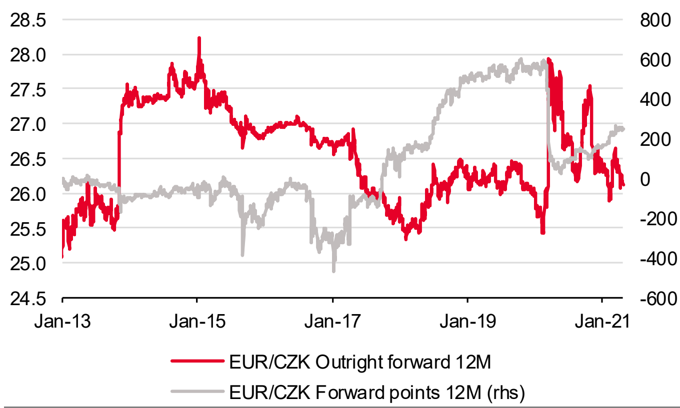
We expect EUR/CZK to reach 25.00 in one year, i.e. about 3.8% koruna appreciation. As interest rates continue to rise, so do forward points. However, this does not fully mitigate the pace of koruna strengthening. Overall, we expect the conditions for hedging FX risk to deteriorate again. That said, **the difference between the 1y forward and the expected level on the spot market has slightly widened to CZK1.20 since our January forecast**, which we believe provides an attractive hedging opportunity. The timing is also supported by the current decline in market interest rates from recent highs. In our view, it is only a matter of time before interest rates rise again, particularly for longer maturities, while rates up to one year have significantly less growth potential. The koruna spot exchange rate should thus benefit the most from this situation, while forward points will again be unable to offset CZK strengthening**, resulting in a further worsening of hedging conditions.**

Rising interest rates support forward points



Source: Bloomberg, Economic and Strategic Research, Komerční banka

The hedging conditions back at pre-COVID levels



Source: Bloomberg, Economic and Strategic Research, Komerční banka

Banking Sector

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Credit and savings expansion accelerates

Despite the winter wave of the pandemic, we have raised our economic growth forecast for this year. We should see positive developments in the banking sector, with housing loan growth and real estate prices continuing to rise. Loans to corporations should start increasing in the first half of this year as companies gain more confidence in the future. As the pandemic subsides, consumer credit should return to growth and the strong savings rate should gradually slow. Non-performing loans should increase only slowly.

Real estate market still growing rapidly

Investment in housing is leading to faster growth in property prices.

House prices rose by 7.2% in 2020, and the first few months of this year suggest no change in this trend. While housing supply remains more or less stable, demand is being fuelled by investment appetite, low interest rates and generally relaxed conditions for mortgage loans. **And the rate of housing loan growth continues to accelerate rapidly – at the end of last year, year-on-year growth was 8.0%, and it probably accelerated to close to 10% in the first quarter.** We anticipate that expectations of future growth in interest rates and rising house prices in the coming quarters will result in a similar rate of mortgage growth during 2021. In this light, we think that the CNB will start communicating the possibility of a tightening of mortgage rules as early as this year. This could support demand for mortgages further in the short term. The tightening of these rules could take place this year, but in terms of financial stability, the current real estate trend is not a threat, so the CNB will likely act based on economic developments only after the pandemic. **After last year's housing loan growth of 7.4%, we expect a further strong increase of 9.0% this year and a slowdown to 6.5% next year.**

Bank loans and deposits (% yoy)

	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	Q4 21	Q1 22	Q2 22	2020	2021	2022	2023	2024	2025
Bank loans														
Total	4.5	4.2	4.5	4.3	5.4	6.7	6.6	6.6	5.2	5.2	6.3	5.5	5.8	5.6
Households - real estate loans	7.5	8.0	9.8	8.6	8.8	8.7	7.5	6.9	7.4	9.0	6.5	5.2	5.1	5.1
Households - consumer loans	2.7	0.8	0.2	1.9	3.6	6.0	7.0	7.6	3.8	2.9	7.3	6.9	6.9	6.4
Corporate loans	2.3	0.3	0.8	0.3	2.5	5.8	7.4	8.0	3.5	2.3	7.4	5.2	5.5	5.3
Deposits														
Total	10.4	8.9	13.4	13.3	9.2	10.9	4.2	3.8	9.9	11.7	3.9	5.2	5.7	5.7
Households	10.5	12.1	13.3	12.2	10.3	7.3	4.4	3.2	10.2	10.8	3.7	5.1	5.9	5.7
Non-financial corporations	14.6	11.2	12.9	11.6	8.0	9.2	4.9	3.5	11.7	10.4	4.0	4.8	4.8	5.2
Others	7.5	-0.5	13.9	16.3	8.1	21.8	3.3	4.9	7.7	15.0	4.1	5.7	6.0	5.8
Ratios														
Loans/GDP	63.9	63.6	66.2	64.2	64.6	63.8	65.1	63.6	63.2	64.7	63.9	63.8	63.9	64.1
Deposits/GDP	98.1	91.3	106.1	105.4	102.6	95.2	102.0	101.8	94.1	102.3	98.8	98.4	98.5	98.8
Loans/deposits	65.2	69.7	62.4	60.9	62.9	67.0	63.9	62.5	67.2	63.3	64.8	65.0	65.0	65.0
Interest rates														
Real estate loans	2.2	2.1	2.1	2.0	2.1	2.2	2.3	2.3	2.3	2.1	2.4	2.6	2.8	3.0
Consumer loans	8.0	7.7	7.4	7.4	7.7	7.8	7.9	7.9	8.0	7.6	8.0	8.5	8.6	8.5
Corporate loans	1.4	1.9	2.5	2.5	2.6	2.7	3.0	3.2	2.2	2.6	3.3	4.1	4.5	4.4
Share of NPL														
Real estate loans	1.0	1.1	1.2	1.4	1.6	1.6	1.7	1.7	1.1	1.5	1.7	1.8	1.8	1.8
Consumer loans	4.1	5.1	5.5	5.9	6.6	7.0	7.5	8.0	4.4	6.3	7.9	8.4	8.3	7.8
Corporate loans	3.3	4.2	4.3	4.5	4.8	5.1	5.6	6.0	3.4	4.7	6.0	6.1	5.5	5.1

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

Consumer credit to return to growth

Improved consumption should lead to increase in consumer credit.

After the outbreak of the pandemic last year, consumer credit stagnated. At the beginning of this year, we saw a small increase. If the economy strengthens as we expect, consumer credit growth should accelerate from the second quarter. We expect growth of 2.9% for 2021 and 7.3% for 2022.

Loans to non-financial corporations on threshold of expansion

Investment loans likely to accelerate.

At the end of last year, corporate loans fell by 1.1% (SA) compared to the third quarter due to the second wave of the pandemic and increased uncertainty, and year-on-year growth fell to almost zero. There is likely to have been a small increase in the first quarter of this year, but growing optimism due to vaccination should accelerate demand for investment and thus for loans. **We see growth of 2.3% this year and 7.4% next year.**

Hoarding of deposits should slowly weaken

Deposits continue to increase.

Deposits continue to grow given cautiousness among households and companies, the rapid growth of housing loans and, this year, a reduction in personal income tax. As the economy returns to growth and optimism intensifies, the savings rate should decline, albeit we see no rapid turnaround. In 2020, deposits were up 10.2% for individuals and 11.7% for enterprises. At the beginning of this year, we saw a quarter-on-quarter slowdown, which should continue in the coming quarters. In terms of the full year, we expects deposits growth rates to be similar to last year, with the slowdown becoming more apparent in 2022.

Bad loans not up significantly yet

Non-performing loans likely to increase only slowly.

We anticipate that the economic downturn in 2020 will lead to an increase in non-performing loans (NPLs). For the time being, however, this is happening only very slowly. With regard to further developments, the economy will of course play a key role. We anticipate a gradual increase in NPLs but nothing dramatic. In the case of NPLs for consumer loans, we expect an increase from the current 5.5% to 7.9% in 2022. For NPLs for non-financial corporations, we expect an increase from the current 4.3% to 6.0% in 2022. For mortgages, we forecast an increase in NPLs to 1.6% by end-2021 from the current 1.2% and a slight increase in this level to 1.8% in the coming years.

Key Economic Indicators

Macroeconomic indicators – long-term outlook

		2018	2019	2020	2021	2022	2023	2024	2025
GDP	real, %	3.2	2.2	-5.6	3.4	4.7	3.4	3.2	2.8
Inflation	average, %	2.1	2.8	3.2	2.5	1.9	1.8	2.0	2.0
Current account	% of GDP	0.4	0.3	3.6	0.5	0.2	1.1	0.9	0.8
3M PRIBOR	average, %	1.3	2.1	0.9	0.4	1.1	1.9	2.3	2.4
EUR/CZK	average	25.60	25.70	26.50	25.60	24.90	24.20	23.70	23.10
USD/CZK	average	21.70	22.90	23.20	20.70	19.50	18.50	17.80	17.10

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

FX & interest-rate outlook

		27.04.2021	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22
EUR/CZK	end of period	25.9	25.50	25.30	25.10	25.00	24.90
USD/EUR	end of period	1.21	1.23	1.25	1.27	1.25	1.25
CZK/USD	end of period	21.5	20.75	20.25	19.75	20.00	19.90
3M PRIBOR	end of period, %	0.36	0.35	0.35	0.60	0.90	1.10
10Y IRS	end of period, %	1.80	1.90	2.05	2.25	2.40	2.55

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

Monthly macroeconomic data

		VII-20	VIII-20	IX-20	X-20	XI-20	XII-20	I-21	II-21	III-21
Inflation (CPI)	%, mom	3.4	3.3	3.2	2.9	2.7	2.3	2.2	2.1	2.3
Inflation (CPI)	%, yoy	0.4	0.0	-0.6	0.2	0.0	-0.2	1.3	0.2	0.2
Producer prices (PPI)	%, mom	-0.1	-0.5	-0.4	0.3	-0.1	0.0	0.0	1.4	3.3
Producer prices (PPI)	%, yoy	0.1	-0.3	0.2	0.4	-0.5	0.2	1.3	0.7	1.4
Unemployment rate	% (MLSA)	3.8	3.8	3.8	3.7	3.8	4.0	4.3	4.3	4.2
Industrial sales	%, yoy, c.p.	-3.6	-6.5	-1.1	-1.5	-0.3	8.0	-5.0	-2.6	n.a.
Industrial production	%, yoy, c.p.	-2.7	-6.4	0.8	3.0	1.8	8.5	-5.1	-0.5	n.a.
Construction output	%, yoy, c.p.	-10.4	-9.7	-7.9	-10.5	-8.4	-11.4	-5.2	-11.0	n.a.
Retail sales	%, yoy, c.p.	-0.5	-3.0	-2.0	-3.7	-8.3	0.4	-7.6	-4.9	n.a.
External trade	CZKbn (national met.)	14.4	8.0	34.1	31.6	32.3	15.9	25.7	22.5	n.a.
Current account	CZKbn	20.3	17.3	32.8	7.8	18.3	-3.9	28.7	24.3	n.a.
Financial account	CZKbn	23.1	30.7	75.4	-17.9	-9.8	17.3	19.1	8.7	n.a.
M2 growth	%, yoy	10.1	9.8	11.2	10.8	10.7	10.5	11.0	11.9	n.a.
State budget	CZKbn (YTD cum.)	-205.1	-230.3	-252.7	-274.0	-341.5	-367.4	-31.5	-86.1	-125.2
PRIBOR 3M	%, average	0.34	0.34	0.34	0.35	0.35	0.35	0.36	0.36	0.36
EUR/CZK	average	26.5	26.2	26.7	27.2	26.5	26.3	26.1	25.9	26.2
USD/CZK	average	23.1	22.1	22.7	23.1	22.3	21.6	21.5	21.4	22.0

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

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