Quarterly report

Czech Economic Outlook

A sleepy start for the economy

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- **Economy likely to grow again this year, albeit slowly** We expect growth of 0.8% after a contraction of 0.4% in 2023. The gradual recovery should be underpinned by higher household consumption amid renewed real wage growth and a reduction in high savings.

- **Decline in inflation but not enough to reach 2% target** We expect inflation to decline from 10.7% in 2023 to 2.7% in 2024. While regulated and core price growth is likely to exceed the central bank's target, food is likely to be cheaper, helped by a lower VAT rate.

- **CNB likely to continue cutting rates but keep policy restrictive** We expect the repo rate to fall from 6.75% currently to 4% by the end of this year and not reach the policy-neutral level of 3% before the end of 2025. The bank's board is likely to remain cautious, as core inflation looks set to moderate only slowly.

- **Market interest rates stabilising after the previous downturn** The yield curve should continue steepening this year in tandem with the easing of CNB's monetary policy. However, a decline in longer-term rates should be hampered by external developments.

- **Reversal of CZK's weakening trend is in sight** We expect the koruna to weaken slightly further vs the euro in the short term. It should start to appreciate again from 2H24 amid improving domestic fundamentals and a weakening US dollar, in our view.

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The worst is over

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Our October edition of the *Czech Economic Outlook* was entitled *Looking for growth impetus*, as the Czech economy had declined a significant 0.6% qoq in the third quarter of 2023 following its stagnation in the first half of 2023. Nevertheless, it did not fall into technical recession. Our estimate indicates that the economy grew by 0.2% in the fourth quarter of 2023 compared with the preceding quarter.

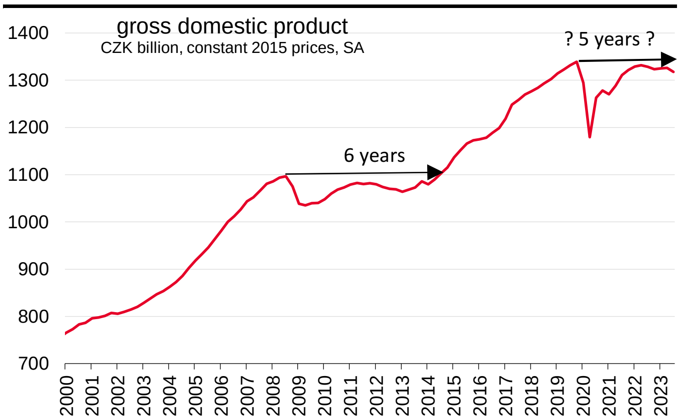
The Czech economy slumped last year but avoided technical recession. The economy hit its local trough in 3Q23.

We have not found any distinct growth impetus, but we believe that the worst is now over from the perspective of the real economy's dynamics. However, recovery will be very slow this year; compared with the preceding forecast, we have halved the country's growth prospects for 2024. Our forecast for 0.8% growth means that we will only achieve the pre-pandemic end-2019 level at the end of 2024. That is, two whole quarters later than we believed in October. Thus, the period of the pandemic and the war in Ukraine, together with the associated energy crisis, has deprived the Czech economy of the equivalent of five years. For comparison: after the recession following the global financial crisis in 2008 and the subsequent European debt crisis, it took six years for the output of the Czech economy to return to the pre-crisis level. In addition, the structure was fundamentally different.

Investments were a pleasant surprise last year.

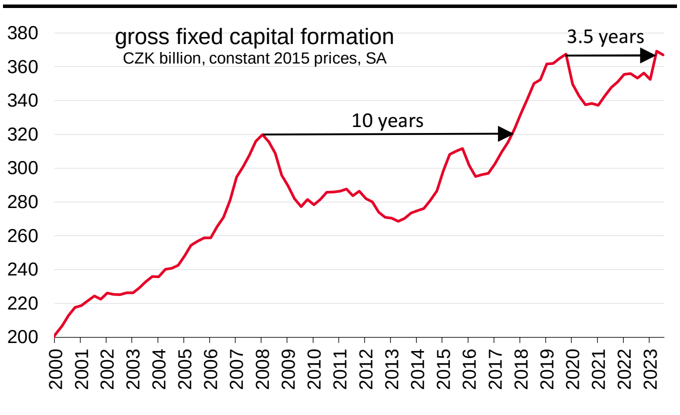
Being a small export-oriented economy, the Czech Republic is sensitive to shocks in external demand. On the other hand, it is also quite adaptable and Czech exporters are able to respond very quickly and flexibly. Ultimately, it was domestic demand that posed a much more serious problem in both of these periods of recession in the end. And the fundamental factor is the completely different structure of domestic demand in each of these crises. In terms of investment activity, one whole decade had to pass before the volume of investments returned to the pre-crisis, mid-2008 level. On the contrary, in the case of the current cycle, investments had climbed back to their end-2019 level by the middle of last year. For the first three quarters of 2023, the Czech investment rate was one of the highest in the European Union. A combination of the decline in expected financing costs thanks to lower interest rates and the availability of finances from EU funds should continue to drive solid investment activity this and next year, although we have revised investments downward from our October forecast, in particular for this year.

In terms of overall output, we are not yet above the pre-pandemic level…



Source: CZSO, Economic and Strategy Research, Komerční banka

… but we are already there in terms of investments.

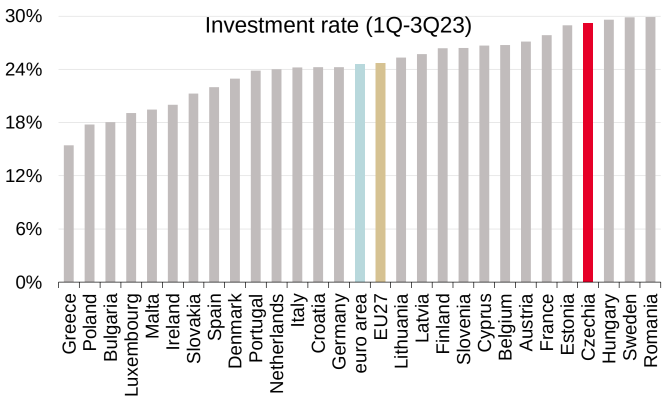


Source: CZSO, Economic and Strategy Research, Komerční banka

On the other hand, household consumption was a real disappointment last year.

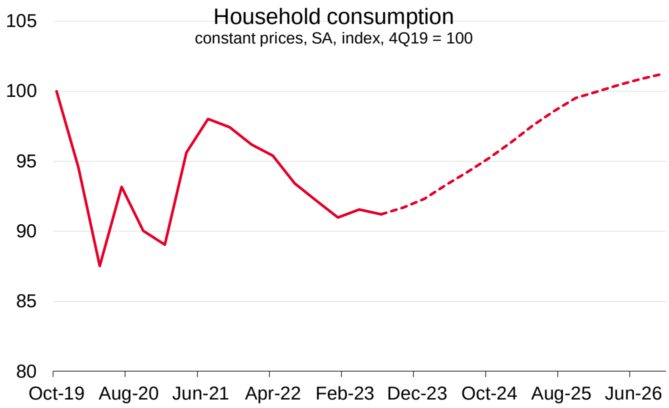
The key problem in the current cycle is the absence of domestic consumer demand, primarily due to the drop in real wages, as we analysed in detail in the October issue of the *Czech Economic Outlook*. However, better days lie ahead in this respect as well. Real wages have been growing qoq since the second quarter of last year; one of the reasons is the persistently tight labour market, since the economic slowdown has not caused any visible increase in unemployment and this trend will continue this year. We expect real wages and household consumption to reach their pre-pandemic levels in the first half of 2026.

Investment activity last year was one of the highest in the EU



Source: Eurostat, Economic and Strategy Research, Komerční banka
Note: Rate of investment is defined as gross fixed capital formation divided by gross value added.

Household consumption will reach its pre-pandemic level in the first half of 2026



Source: CZSO, Economic and Strategy Research, Komerční banka

Lower inflation and lower interest rates will help the economy to recover this year.

Declining inflation will play an important role in helping trigger household consumption. Despite significant general uncertainty at the beginning of the year and more specifically due to the January figure due to the implementation of the new fiscal package, we believe that yoy consumer prices growth will stay below the upper limit of the CNB's tolerance zone, i.e. below 3% for most of this year, although we expect average inflation at 3% in the last quarter of this year. This will allow the central bank to cut rates at each of its board meetings until November, which will also be reflected in the market rates and, as mentioned above, in lower financing costs of investment activity. Kevin Tran discusses the impacts on the mortgage market and, in general, on the real estate market in detail in his box. Not surprisingly, we expect activity in the real estate market to recover, including a resumption of house price growth.

Growth will become visible in the second half of the year.

And so, the local economic bottom is over for us. But recovery will be very gradual. After all, the beginning of this year is marked by the implementation of the Czech cabinet's restrictive fiscal package and the monetary policy will soften its restrictive nature only slowly. The recovery in economic activity will therefore start to be visible mainly in the second half of this year.

The combination of lower inflation and economic growth for 2024 means just one thing: this year will be better than last year. Enjoy reading the winter edition of Komerční banka's *Czech Economic Outlook*!

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External environment and assumptions

Fed and ECB to ease, the question is when and how much

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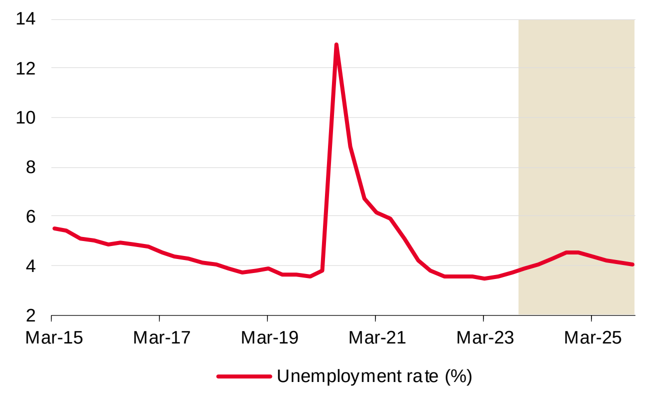
The cycle of interest rate hikes in the United States and the euro area ended last year. The main topic of discussion now will be when the Fed and the ECB will start to cut and to what extent. Market expectations are quite vigorous, pricing in a roughly 140bp of rate cuts in the US this year, as well as in the euro area. We expect a first rate cut in the US this May. Indeed, the economy is expected to go through a recession in 2Q and 3Q that should, however, be shallow and short-lived. The key rate should be at 3.75-4.00% at the end of the year, according to our forecast. Even so, the first step will require easing in the labour market and stronger signs of slowing economic activity. The risks are thus tilted towards a later rate cut rather than an earlier one. In the euro area, we expect the first rate cut to come in September, with another to follow in December. The reason for the caution is core inflation, which will not reach the ECB's target until 2026, and the fact that the euro area is expected to avoid recession.

USA: economy slows down, enters recession in 2Q

The labour market will have to cool before the rate cut cycle can start.

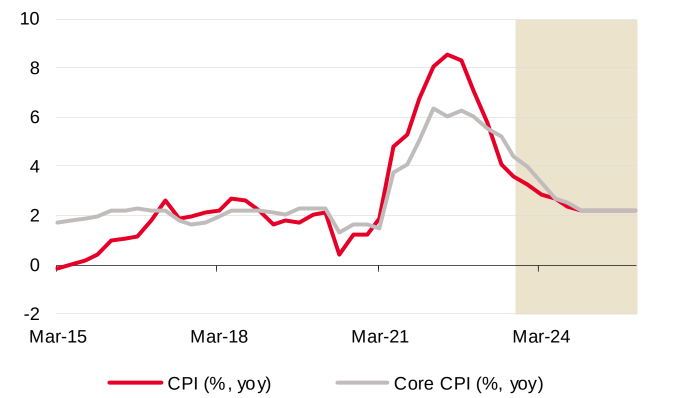
The US labour market is still able to create a relatively high number of new jobs, 216k in December. This is mainly due to the fact that some sectors are still catching up to pre-pandemic levels of employment. However, they are already approaching that level and once it is reached, job creation will start to slow down rapidly. This will be one of the main conditions for the US Federal Reserve to cut interest rates. Inflation developments should allow such a move. Rent prices remain a risk: their growth rate will need to slow to 3.5% yoy to reach the inflation target (in December, the annual growth rate of rents reached 6.2%). However, inflation excluding rent prices is already at 2%, which allows the Fed to talk about cutting interest rates. Our estimate is that headline inflation should be just above 2% by the end of this year. Its core component should also fall, due to the aforementioned deterioration in the labour market.

US labour market remains tight



Source: Macrobond, SG Cross Asset Research/Economics

Inflation will get back to the 2% target

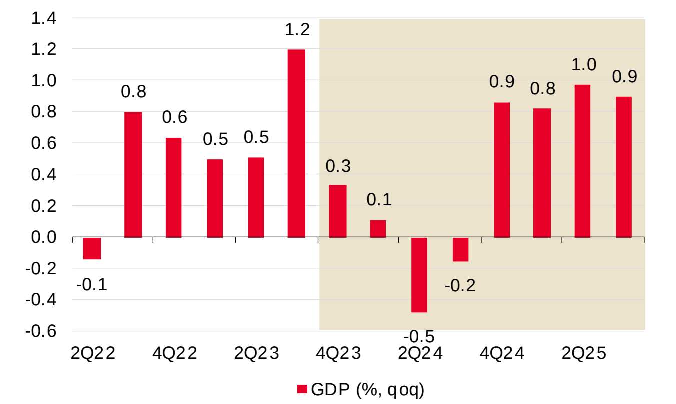


Source: Macrobond, SG Cross Asset Research/Economics

We expect the first rate cut in May.

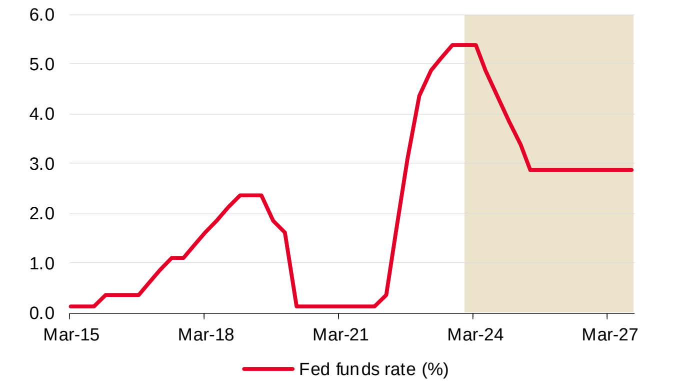
In any case, the impact of the tighter monetary policy is already evident in the economy. The housing market is strongly subdued, and corporate investment is also weakening. Although popular 30-year fixed mortgage rates have already fallen to levels around 6.5%, having been close to 8% as recently as October, they are still a significant drag on new lending. Smaller banks in particular, which are more sensitive to interest rates, are suffering. Car sales are also losing momentum and consumer demand is weaker. In our view, the US economy will thus go through a shallow recession in 2Q and 3Q of this year. As a result of the slowdown in economic activity, the Fed will, according to our forecast, start a cycle of interest rate cuts in May. At the end of the year, the key rate should be at 3.75-4.00%. Its decline should stop at 3% by the middle of next year. By that time, the economy should be growing briskly again. After this year's expected 0.9% (SGe), it should add 2.7% next year.

US economy will go through a shallow recession



Source: Macrobond, SG Cross Asset Research/Economics

We expect the Fed to cut rates in May for the first time



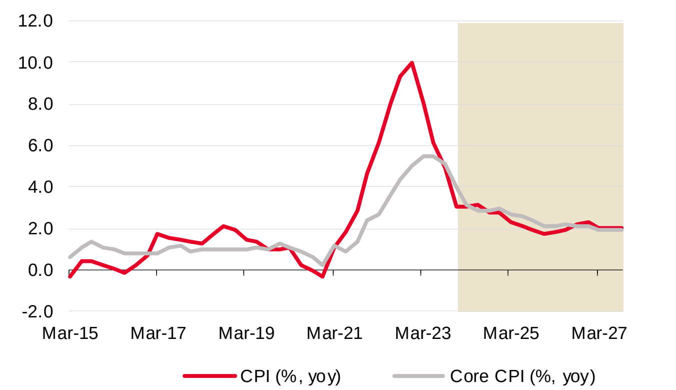
Source: Macrobond, SG Cross Asset Research/Economics

Euro area: first rate cut in September

ECB rates stable till September.

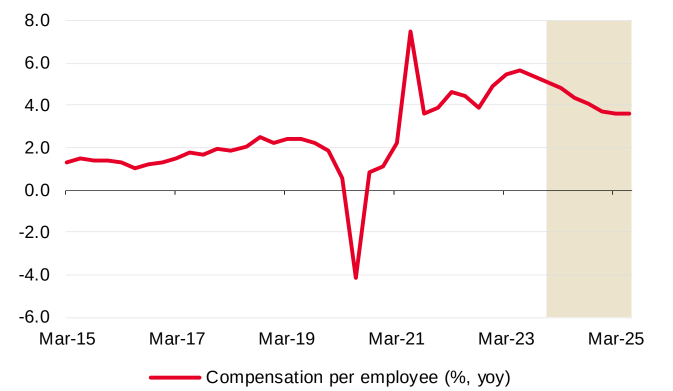
In our view, the ECB will leave interest rates unchanged until September, when we expect the first cut. Such a move may come sooner, but likely not in 1H24 as the financial markets expect. They include a roughly 140bp in rate cuts in their prices for this year. In our view, the central bank will now need sufficient evidence that inflation is indeed returning to target. It was 2.9% yoy in December, while its core component was 3.4%. Although both indicators will decline over the course of the year, the ECB's 2% target will not be reached by the end of the year. We expect headline inflation to be at 2.6% in December and core inflation at 2.4%. With unemployment at historically low levels (6.4% in December) and rising wage costs at the same time as falling labour productivity, we believe the ECB will wait until September this year to cut interest rates. January and February inflation, and especially wage developments, will be important for the ECB, as it could set the price spiral in motion again.

Euro area inflation to miss target this year



Source: Macrobond, SG Cross Asset Research/Economics

Wage growth is fast by European standards



Source: Macrobond, SG Cross Asset Research/Economics

Pace of ECB's balance sheet reduction is slow.

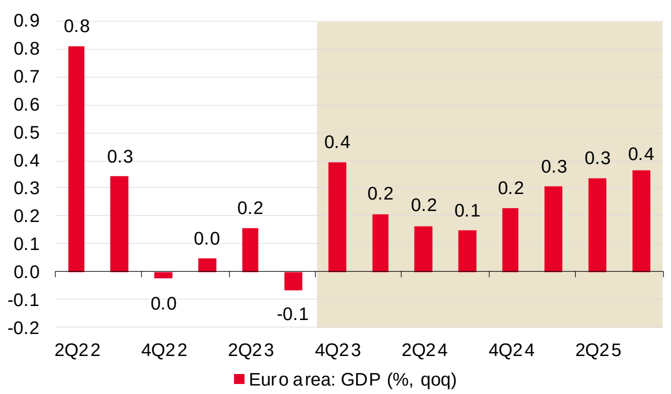
The reduction of the ECB's balance sheet continues slowly. Reinvestments from the pandemic PEPP programme should be roughly halved by the middle of this year (EUR7.5bn per month), ending in early 2025. This would mean an increase in quantitative tightening (QT) of only EUR45bn this year, a highly unambitious plan (capping under the APP runs at

EUR30bn per month). The financial markets are thus unlikely to be affected by this procedure, but at the same time it will not contribute much to the normalisation of the balance sheet. The central bank is expected to comment more on these issues in the review of its operational tools this spring. If the pace of QT does not accelerate, the ECB risks being criticized for its high holdings of government bonds as well as for the mounting losses resulting from its huge balance sheet.

Consumption should be the driver of the European economy.

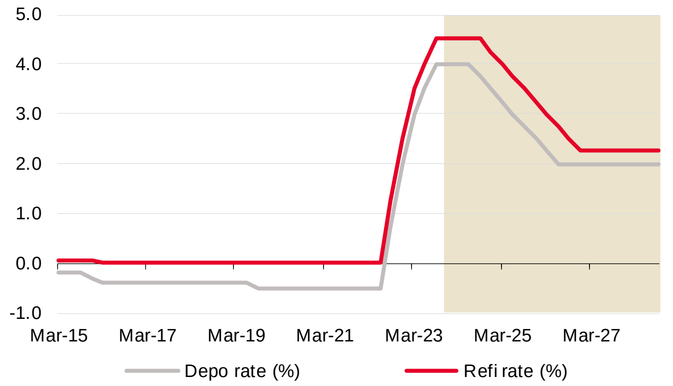
Economic data late last year did not impress. German industrial output contracted for the sixth consecutive month in November and, in combination with weak retail sales, caused the economy to contract by 0.3% qoq in 4Q, according to preliminary estimates (estimated on the basis of full-year GDP growth of -0.3%). According to the latest data, the German economy avoided a technical recession, as GDP for 3Q23 was revised from -0.1% qoq to 0.0%. Nevertheless, growth prospects remain subdued, and we expect the economy to virtually stagnate until 4Q of this year. The euro area as a whole should be slightly better off this year. Household consumption should be the main driver of the recovery, supported by the historically low unemployment rate mentioned above, high excess savings and solid wage growth. In addition, higher interest income and strong fiscal support to date are supporting real disposable household income. In order to prevent consumption from rising, households would have to start saving even more, which we consider unlikely. Moreover, firms still have a stock of cheap liquidity that they drew on during the COVID crisis. They can therefore invest despite the tight monetary conditions. The risk is posed by rising labour costs, which will start to eat into their previously high profit margins. For the whole of this year, GDP growth is therefore expected to reach 0.8% in the euro area, according to our estimate.

Euro area GDP growth will be driven by consumption



Source: SG Cross Asset Research/Economics

ECB will cut in September for the first time



Source: SG Cross Asset Research/Economics

CEE: monetary policy easing has started

Polish central bank will stay put for longer after last year's rate cut.

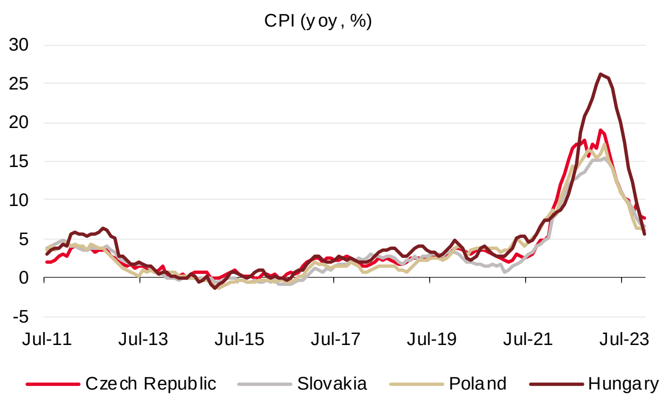
The National Bank of Poland (NBP) has left interest rates unchanged since October last year, when it cut them by 25bp to 5.75%. We do not expect further monetary easing in the first half of this year. Although Polish inflation slowed significantly (to 6.2% yoy in December), this was mainly due to the extension of the zero value added tax on food and energy price subsidies. According to NBP Governor Glapinski, inflation may return to the central bank's tolerance band of 2.5% +/- 1pp in 1Q24 as a result of these measures, combined with a strong Polish zloty, weaker domestic demand and globally falling energy prices. However, at the end of the year, when the support measures are lifted, inflation is likely to temporarily jump sharply to levels of around 6-8% yoy. Moreover, according to Governor Glapinski, 2H24 economic trends are hard to predict and a lasting return to the inflation target is unlikely until 2025. For these reasons, we believe that NBP interest rates will remain unchanged until 3Q24, when we expect them to be cut further (by 25bp in July followed by another 25bp cut in

October). Given the good shape of the domestic economy, we expect the Polish domestic currency to appreciate towards levels around EURPLN 4.25 by the end of this year.

Hungarian central bank will continue easing monetary policy.

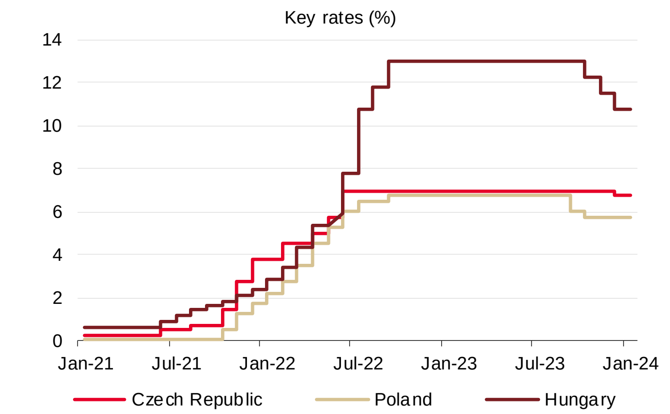
The Hungarian central bank (MNB) continued to ease monetary conditions in the fourth quarter of last year. It cut the key three-month deposit rate by 225bp to the current 10.75% during 4Q23. The bank has said it will continue easing monetary policy. Moreover, the last meeting showed that 75bp cuts may no longer be in play, as they have been, and that the same may be true of 100bp cuts. Our estimate envisages a decline in the key three-month deposit rate to 6.75% by the middle of this year, with the key three-month deposit rate at 5.50% at the end of the year. Thus, the Hungarian forint is likely to be held in a band of EURHUF 375-385 by the central bank's policy. If the currency weakens too much, the central bank may slow or stop the interest rate cuts. If, on the other hand, the forint strengthens too much, it can allow the MNB to accelerate easing monetary policy.

Inflation in the region is falling (%, yoy, HICP)



Source: Macrobond, Economic & Strategy Research, Komerční banka

Central banks started rate cut cycle



Source: Macrobond, Economic & Strategy Research, Komerční banka, data at 23 January

Macroeconomic forecast

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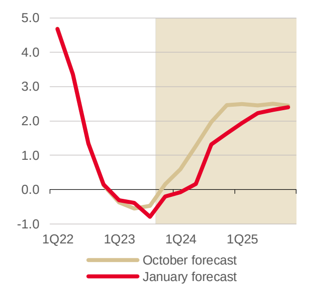
Major changes

GDP:
We expect the economy to have contracted by 0.4% last year and to grow by just 0.8% this year. Compared with our October forecast, the estimate for both years is lower. Recent data shows that the economic recovery is likely to be more gradual than we originally anticipated. However, it should still take place. As in the previous forecast, we expect the main driver of this recovery to be a gradual increase in household consumption, supported by a resumption of real wage growth and a reduction in the high level of savings.

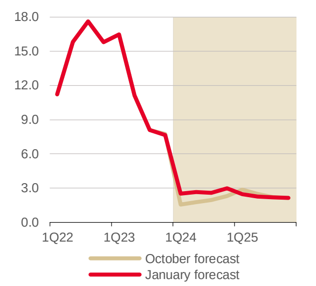
Inflation:
After 10.7% last year, we expect inflation to fall sharply to 2.7% this year. In our October forecast, however, our estimate for 2024 was even lower, at 1.9%. The revision is mainly due to a stronger increase in regulated energy prices from January this year than we had initially expected. As in the previous forecast, we continue to expect core inflation to remain above the CNB's 2% target in both 2024 and 2025.

Changes to GDP forecast (%, yoy)



Source: CZSO, Economic & Strategy Research, Komerční banka

Changes to CPI forecast (%, yoy)

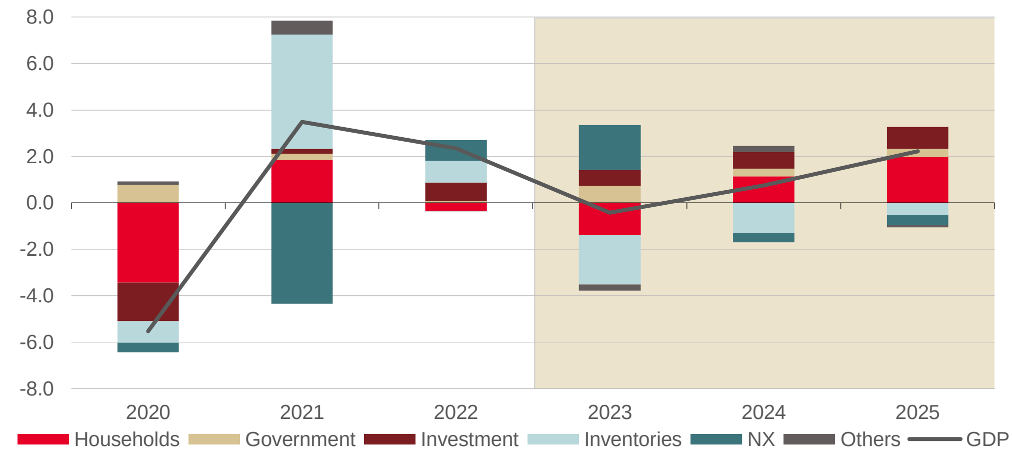


Source: CZSO, Economic & Strategy Research, Komerční banka

Inflation to remain above target despite a weak economy

The Czech economy has not grown for more than a year. On the contrary, we estimate that real GDP contracted by 0.4% in 2023, mainly due to a decline in household consumption caused by the sharp fall in the purchasing power of wages. The economic situation should improve this year, albeit very slowly. We expect real wages to rise again after two years of decline, contributing to a recovery in consumer demand. The gradual reduction in high household savings should also help. However, low industrial production combined with weak external demand is likely to weigh on the economy. We thus expect GDP to grow by only 0.8% this year. Nevertheless, weak domestic and external demand has contributed to a rapid fall in inflation. After 10.7% last year, we expect inflation to average 2.7% this year. With regulated price growth still high and core inflation only fading slowly, the central bank is unlikely to achieve its 2% inflation target this year.

We expect the economy to grow by 0.8% this year, after a decline of 0.4% in 2023 (%, pp, yoy)

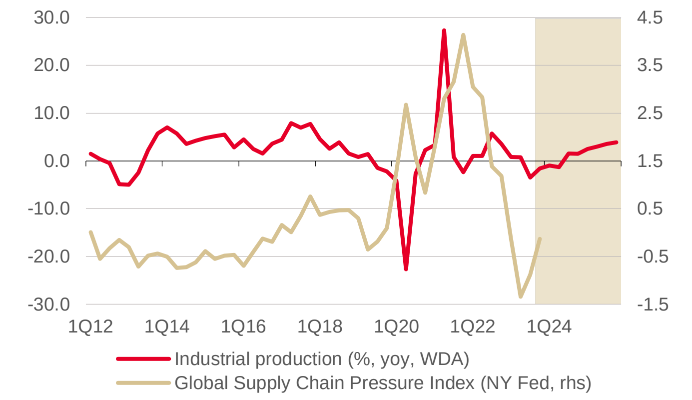


Source: CZSO, Economic & Strategy Research, Komerční banka

Stronger domestic demand to support gradual economic recovery

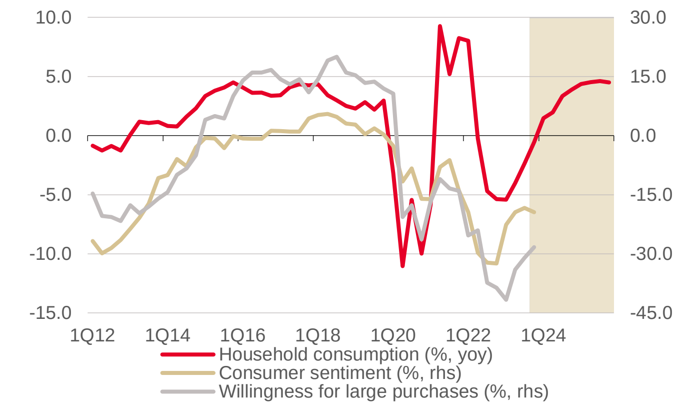
The Czech economy contracted sharply in 3Q23, mainly due to the usually volatile inventories. GDP dropped by 0.6% qoq vs a 0.1% qoq decline in our October forecast. This only reinforces the fact that the economy has remained weak after being roughly flat in 1H23 and experiencing a mild recession in 2H22. Compared with the pre-pandemic 4Q19 figures, economic activity was 1.6% lower in 3Q23. Inventories accounted for 0.5pp of the decline in 3Q23 and their contribution to qoq GDP growth was negative for a fifth consecutive quarter. The pace of inventory accumulation is thus gradually normalising. This may be related to the renewed functioning of supply chains and weak domestic demand. Inventories have long been associated with a higher degree of uncertainty and are often subject to statistical revisions. However, we expect the downward trend to continue for some time and inventories to remain a significant drag on economic growth, at least this year. Developments in other components of GDP have not been favourable either. Household consumption, which had grown by a promising 0.6% qoq in 2Q23 after a long series of declines, fell again by 0.4% qoq in 3Q23. The level of real consumer spending in 3Q23 was in line with that at the turn of 2016 and 2017 (-9% vs 4Q19). The main reason for this unfavourable development was the sharp drop in real wages to a level last seen at the end of 2017. Fixed investment was lower by 0.6% qoq in 3Q23, after a rapid growth of 4.8% qoq in 2Q23. This may be related to the deteriorating situation in the manufacturing sector, where output fell by a significant 3.1% qoq in 3Q. This was mainly due to temporary supply bottlenecks for production parts in the automotive industry, which also likely led to the negative contribution of net exports to qoq GDP growth (-0.1pp in 3Q23).

Global supply chains resumed their operations in 2023



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

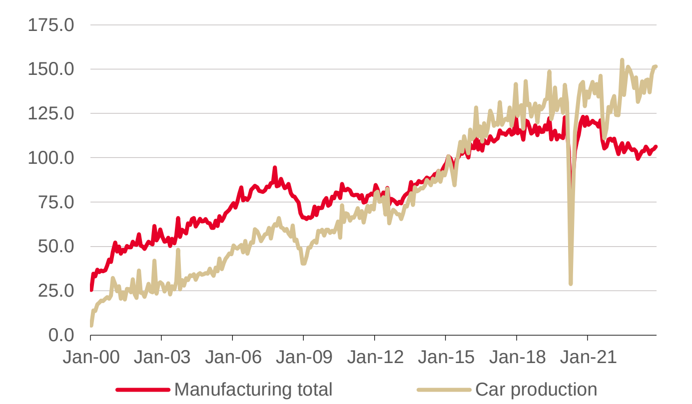
Household consumption is the main driver of economic recovery



Source: CZSO, Economic & Strategy Research, Komerční banka

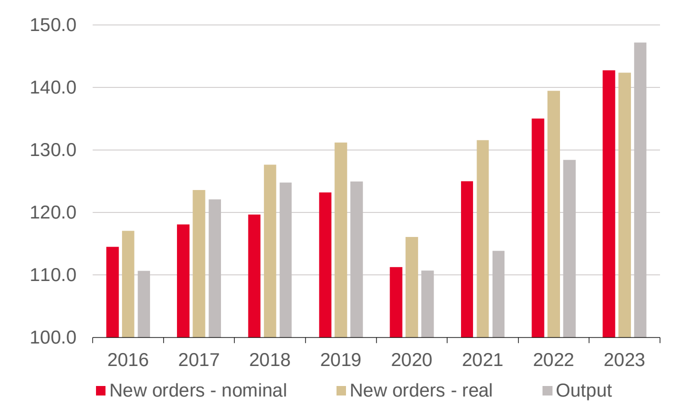
We expect GDP to have increased by 0.2% qoq in 4Q23, which would imply a contraction of the economy by 0.4% in 2023. Our 4Q23 GDP estimate is unchanged from our October forecast. We expect household consumption to have contributed to the modest recovery in 4Q23, growing by 0.5% qoq according to our estimate. Monthly data for retail sales and services point to an increase in demand, although consumer sentiment remains low. A renewed qoq rise in real wages should help. We also expect industrial production to have grown qoq in 4Q, as input supply problems in the automotive industry have eased. We expect this to be reflected in a rise in fixed investment (+0.4% qoq) and a positive contribution from net exports (+0.1pp), albeit offset by a negative contribution from inventories (-0.4pp). Overall, however, 2023 is likely to be characterised by an economic downturn, related to a fall in household consumption and lower inventory accumulation. This is likely to be countered by rapidly rising net exports, which reflect the export of previously unfinished goods rather than actual industrial production, along with lower domestic demand. Industrial production fell sharply in 2023, by around 1%, according to our estimate. One factor was a decline in foreign demand. The German economy, which is important for Czech foreign trade, contracted by 0.3% last year, according to a preliminary estimate.

Total real volume of new industrial orders stops falling; automotive outperforms the rest of manufacturing (SA, 2015=100)



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

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

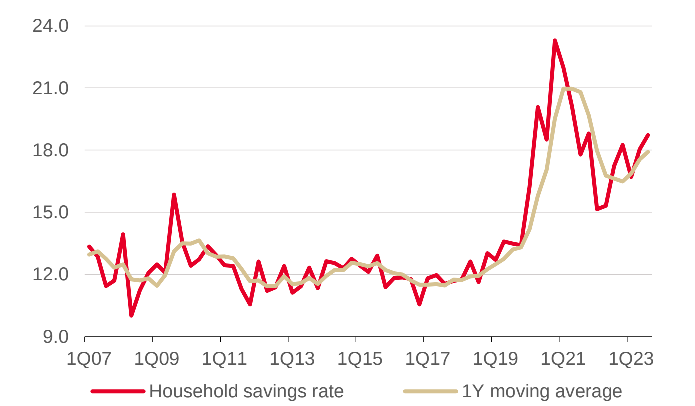


Source: CZSO, Economic & Strategy Research, Komerční banka
Note: All three indicators refer to car production. The average for 2023 is calculated from available data from January to November.

We expect the recovery to be gradual and the economy to return to pre-pandemic levels only in 4Q24.

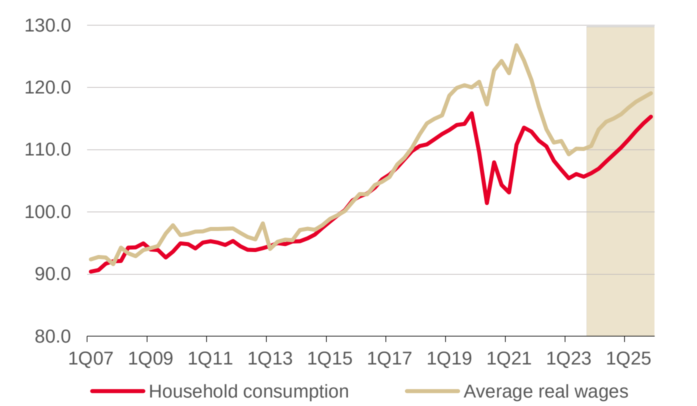
According to our forecast, the Czech economy will grow by just 0.8% this year, before accelerating to 2.2% next year. This is a downgrade from our previous forecast of 1.6% growth in 2024 and 2.5% in 2025. We expect higher household consumption to be the main driver of this year's modest economic recovery. This should be supported by a renewed rise in real wages and a gradual reduction in the high level of savings. However, we continue to believe that the recovery in consumption will be gradual, with a return to pre-pandemic levels only in 1H26, according to our forecast. This is indicated by the structure of savings as a part of them are in the less liquid forms. In addition, some households are likely to channel their savings into the housing market. Demand for home ownership and property investment has been dampened by high interest rates over the past two years. Now that interest rates are starting to fall, recent data suggest that the housing market is rebounding. We also expect fixed investment to increase in 2024. Ongoing labour shortages, energy savings due to high energy prices and a general push towards more sustainable production methods should contribute to this. The government then promises to invest in transport infrastructure. Moreover, investment in all these areas are likely to be boosted by EU funds. We expect a negative contribution to economic growth this year from the aforementioned inventories and net exports. Net export figures should reflect the gradual fading of the positive effect of the export of previously unfinished production and weak industrial output. We expect industrial production to be broadly flat this year after a decline in 2023, although we forecast growth to resume from 2Q24. A rebound in domestic demand is then likely to increase imports. Overall, we expect the economy to operate below its potential throughout 2024. Tight monetary policy and fiscal consolidation will contribute to this. However, our GDP estimate for this year remains subject to a number of uncertainties. These relate mainly to the extent of the recovery in domestic demand, which will depend on wage growth and inflation in 2024, as well as the performance of other economies.

Over the forecast horizon, we expect a gradual reduction of the still rapidly growing savings (% of disposable income, SA)



Source: CZSO, Economic & Strategy Research, Komerční banka

Household consumption to recover as real wage growth resumes (2015=100)



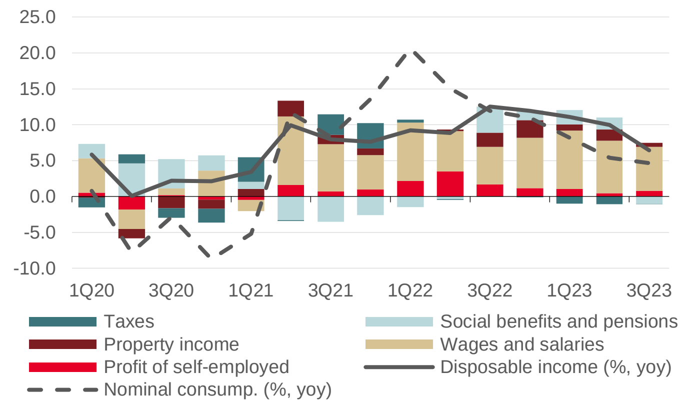
Source: CZSO, Economic & Strategy Research, Komerční banka

Real wages set to rise again, boosting household spending

Ongoing labour shortages, the reversal of the earlier sharp decline in household purchasing power and strong corporate financial positions should contribute to sustained higher nominal wage growth.

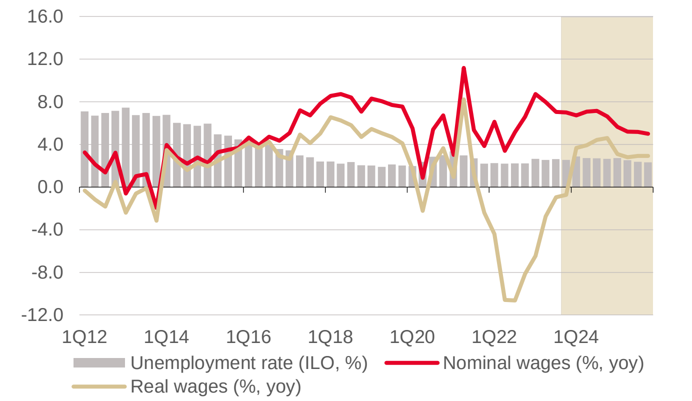
We expect wage growth to reach 6.9% this year, a slight deceleration from 7.7% last year. Compared with the October forecast, our estimate for 2023 is unchanged, while that of this year has been lowered from the original 7.6%. The parallel steep fall in inflation should help real wage growth to recover after two years of decline. Average real wages have fallen by a combined total of around 11% in 2022 and 2023. This year we expect an increase of 4.2%. The compensation for the previous drop is thus likely to only be partial, which is another reason why we expect to see just a modest recovery in household consumption. According to our forecast, real wages will not return to pre-pandemic levels until 2026. Continued growth in nominal wages should be supported by the ongoing labour shortage and the strong financial position of the corporate sector, which has rapidly increased its profitability in recent quarters. As a result of sustained weak demand and continued wage growth, the imbalance between profits and wages as a share of gross value added is set to gradually narrow. The weak performance of the economy has not yet translated into a significant rise in unemployment and, in our view, will not do so over the forecast horizon. As in the previous forecast, we expect the ILO unemployment rate to remain below 3% and the share of unemployed persons to remain below 4% over the forecast horizon.

The impact of rapidly rising pensions and social benefits on household disposable income growth has diminished



Source: CZSO, Economic & Strategy Research, Komerční banka

Real wages are set to start growing this year, helped by continued low unemployment and sharply falling inflation



Source: CZSO, Economic & Strategy Research, Komerční banka

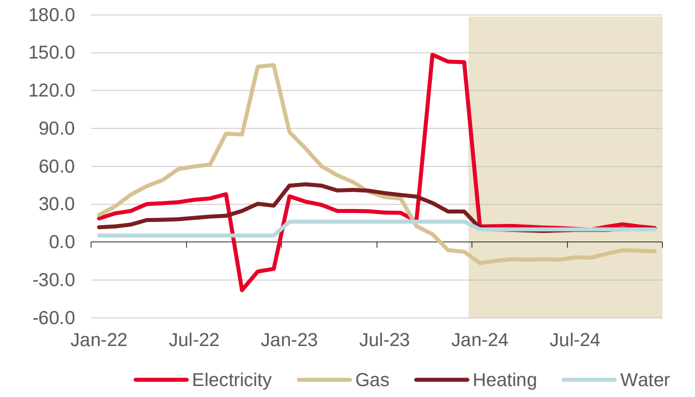
Inflation to fall sharply this year, but not enough to reach the 2% target

Inflation in 4Q23 was broadly in line with our forecast. It averaged 7.6% yoy, only a tenth lower than we had expected. In October, inflation rose sharply from 6.9% to 8.5% yoy due to the purely technical effect of the lower comparison base from 4Q22, when the special energy tariff was introduced. However, this effect partly faded in the last two months of 2023, and the long-awaited fall in food prices and continued weak demand were also reflected in headline inflation. As a result, headline inflation in December returned to the September level of 6.9% yoy, and without the base effect would have been 4.2% yoy, according to the CZSO. The impact of weak demand was visible in core inflation, which fell from 5.9% yoy in 3Q23 to 3.9% yoy in 4Q23, fully in line with our October forecast. The mom momentum of core inflation was significantly lower than at the beginning of 2023. Nevertheless, it gradually picked up towards the end of the year, reaching close to 3% on an annualised basis. In our view, this could be a sign of a partial recovery in consumer demand.

The sharp rise in regulated energy prices is likely to keep headline inflation above 2% this year.

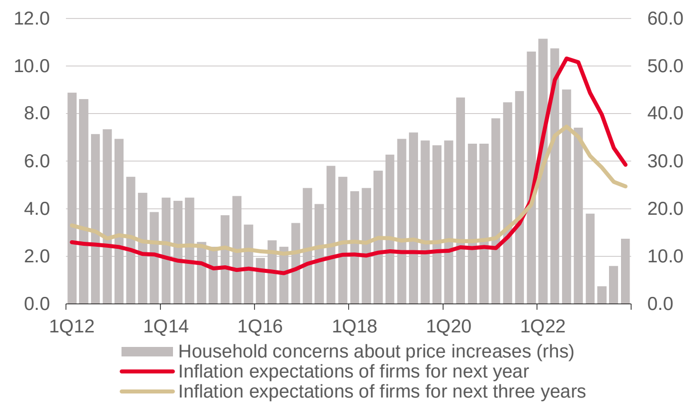
Our estimate is that inflation fell slightly below 3% yoy in January, where it should remain for most of this year. We expect inflation to average 2.7% in 2024, significantly higher than in our October forecast (1.9%). The main reason is an increase in regulated energy prices announced at the end of last year, which was higher than we had expected. According to the Energy Regulatory Office, the regulated part of the consumer price for electricity will increase by 65.7% on average from January, while that of gas will rise by 38.8%. As a result, we estimate that the final price of electricity for households will rise by around 12% this year. On the other hand, we estimate a decline of around 12% for gas, as the share of the regulated component in the final price is much lower in this case, as is the size of the regulated price increase. Moreover, the average electricity price is likely to reflect the gradual expiry of earlier fixed-price contracts, which were concluded in a much better market environment. This will offset the reduction for customers still paying prices at the level of the government cap. Prices for heat and water supply are also likely to rise markedly in 2024 (around +10%), with the additional impact of the increase in the VAT rate from 10% to 12%. Public transport prices should also go up, as the December data already showed. Overall, our forecast assumes a 4.6% increase in regulated prices this year, including a 53% increase in the annual motorway toll from March 2024.

With the exception of gas, we expect most utility prices to rise by around 10% on average this year (%, yoy)



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

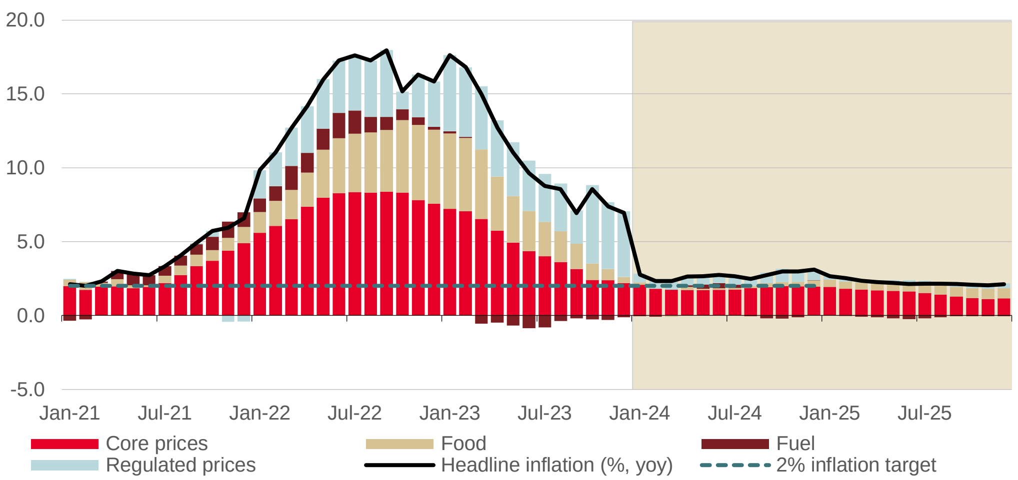
Inflation expectations by firms remained at elevated levels, while concerns about price increases by households rose slightly (%)



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

The inflation forecast is influenced by a number of changes in indirect taxes. These came into effect with the introduction of the government's austerity package at the beginning of this year. While the base VAT rate remains unchanged at 21%, since January there has been a single rate of 12% instead of two reduced rates of 15% and 10%. For the purpose of calculating inflation, the most weighted groups of items in the consumer basket affected by the reduction in the VAT rate are construction works and food (excluding beverages). In both cases the VAT rate fell from 15% to 12%. However, apart from construction works, most services have seen an increase in the VAT rate. This is the case, for example, for catering, accommodation and hairdressing services, as well as for admission to sporting and cultural events. We estimate the overall impact of the VAT changes on inflation this year at -0.4pp and describe it in more detail here: https://bit.ly/VAT_changes_EN. However, we estimate that this impact on lower inflation this year will be fully offset by increases in excise duties on tobacco and alcohol. Overall, we expect the impact of indirect tax changes on inflation to be broadly neutral this year. Excise duties on tobacco and alcohol will continue to rise in the coming years. Between 2025 and 2027, we estimate that the increase in excise duties will add 0.2pp to inflation in each of these years.

We expect inflation to decline to 2.7% this year from 10.7% last year (%, pp, yoy)



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

We expect core inflation to ease only gradually and to remain above the CNB's 2% target this year and next. This will be driven by the recovery in consumer demand that we forecast.

We expect core inflation to remain relatively high this year, while final food prices should fall slightly. According to our forecast, food prices including all beverages and tobacco (a price aggregate monitored by the CNB) excluding VAT should rise by only 0.6% on average this year. By the end of 2023, food prices were already showing lower price dynamics, as falling prices for food and agricultural producers start to take effect. This should continue in 2024, contributing to lower food price growth than that of what we expect for core prices. Including VAT, we expect final food prices to fall by almost 1% on average in 2024. We estimate the impact of VAT rate changes within the food price aggregate at -1.4pp, with the lower VAT on food partly offset by an increase in VAT on soft drinks from 15% to 21%. We expect core inflation to decline from 7.6% last year to 3.2% this year. The higher VAT on services, a recovery in demand and a tight labour market should keep core inflation above the 2% target. Meanwhile, the spillover effects from a significant increase in regulated energy prices for businesses could also have an impact. We expect core inflation to accelerate to 3.5% yoy by the end of this year. However, this will be due to the lower base of 2H23, when core inflation moderated significantly compared to 1H23. We should see the same profile for regulated prices, as the market components of energy prices started to decline in 2H23. As a result, we also expect headline inflation to accelerate slightly to around 3% yoy by end-2024.

We expect headline inflation to be 2.7% this year, down from 10.7% last year, and to fall further to 2.2% next year. Core inflation is likely to remain above the central bank's 2% target this year and next. We expect core inflation to reach 2.4% in 2025 as the recovery in consumer demand, supported by renewed real wage growth, should continue. However, excluding the impact of higher excise duties (+0.2pp), headline inflation will likely be on target in 2025. The inflationary risk of our forcast is the renewed problems seen in sea transport.

Monetary policy

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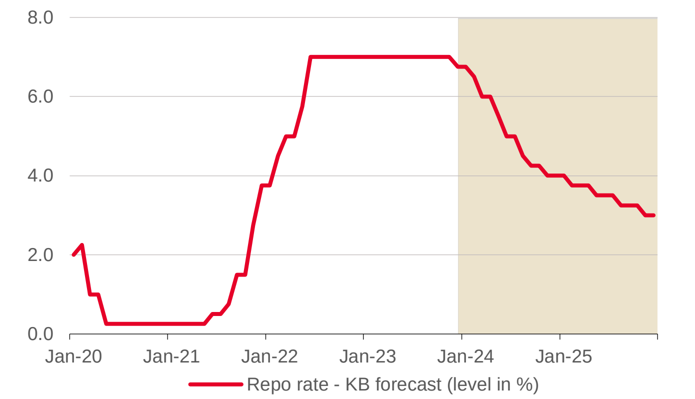
CNB rate cuts this year will depend on January inflation figure

The Czech National Bank is likely to continue with the interest rate cuts it began before Christmas. This should be supported by the ongoing weakness of the economy and a marked decline in inflation. However, we expect the bank's board to remain cautious early this year and to refrain from increasing the pace of rate cuts until after the January inflation figure is published. This is also likely to be the key factor in determining the extent to which interest rates will fall this year. We expect the repo rate to fall to 4% by the end of 2024 and to reach the policy-neutral level of 3% by the end of 2025. Monetary policy should thus remain restrictive in both years, as we expect core inflation to only subside gradually.

The central bank is behind the curve in terms of its staff forecast for interest rates, so its policy is tighter than would be optimal from this point of view.

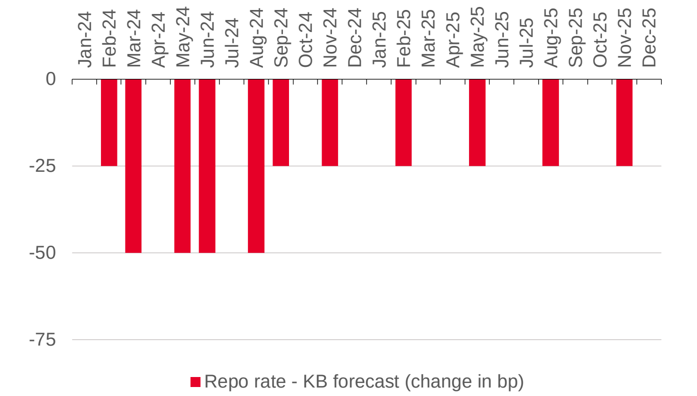
The downturn in the Czech economy in 3Q23 was stronger than the central bank had expected, but inflation was broadly in line with its forecast. The CNB had expected GDP to contract by 0.2% qoq in 3Q23 vs the actual -0.6% qoq. Net exports and fixed investment fell short of the CNB's November forecast, while household consumption fully met the central bank's expectation. The same is basically true for average nominal wage growth, which was 7.1% yoy in 3Q23 vs the CNB's estimate of 7.0% yoy. The central bank forecast inflation to average 7.5% yoy in 4Q23, a tenth lower than the actual figure. Core inflation, on the other hand, came in slightly below the CNB forecast (4.0% yoy vs 3.9% actual). Thus, the newly released data can be seen as slightly less inflationary than the CNB forecast, mainly due to the weaker economy. This reinforces the fact that monetary policy is tighter than would be optimal, according to the CNB staff forecast. The CNB forecast had advised the board to cut the key repo rate to an average of 6.5% in 4Q23, while the average remained at 7%. In the end, the board decided to cut rates by 25bp at its December meeting, but this left the average for 4Q almost unchanged. The repo rate now stands at 6.75%. The koruna weakened from an average of EURCZK24.1 in 3Q23 to EURCZK24.5 in 4Q23, slightly stronger than the central bank's forecast of EURCZK24.6.

We expect the repo rate to fall to 4% by the end of this year, but not to reach the policy-neutral level of 3% before the end of 2025



Source: CNB, Economic & Strategy Research, Komerční banka

We expect the CNB to accelerate its interest rate cuts after the release of January's inflation data



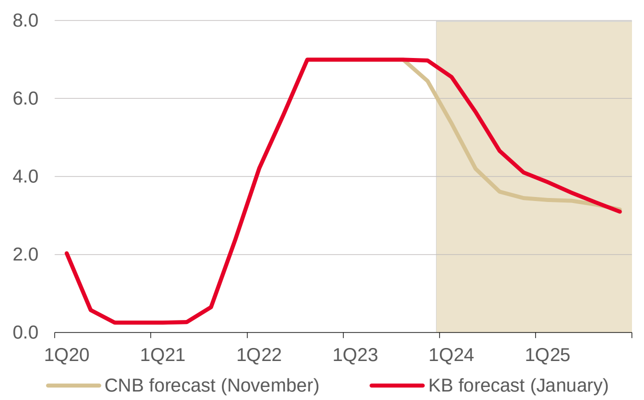
Source: Economic & Strategy Research, Komerční banka

We expect the bank board to remain cautious at the start of this year, but to pick up the pace of its rate cuts after the January inflation figures are released. The board has been expressing concern about January inflation for some time, and this was probably the main reason for cutting rates only marginally last year. We therefore believe that the February meeting, which takes place exactly one week before the release of January inflation data, will be marked by a 25bp rate cut, as was the case in December. However, we do not think the CNB will refrain from cutting altogether in February. A certain dovish turn in the board's

Weak economic performance should lead to a rapid decline in CNB interest rates this year. However, we do not expect the repo rate to reach its policy-neutral level of 3% before the end of 2025, as core inflation is likely to decline only gradually.

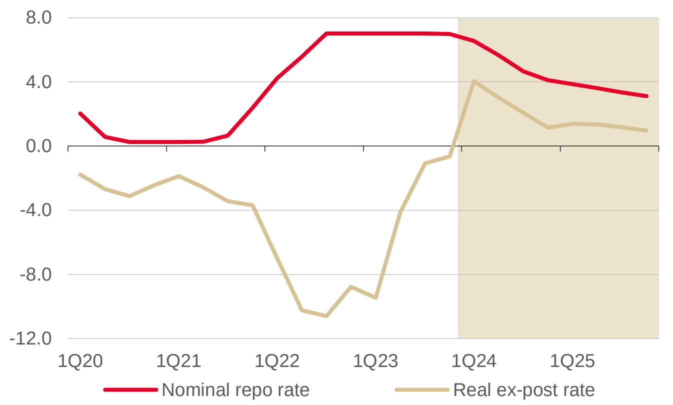
thinking was evident in the minutes of the December meeting. The minutes put more emphasis on the disinflationary signals coming from the economy. So, in our view, interest rate developments are likely to be strongly influenced by the January inflation data, which will be published on 15 February. This is likely to determine to a large extent how far the CNB will ultimately cut rates this year. The January figure usually sets the level around which annual inflation will hover for the remainder of the year. And it is the development of annual inflation that has historically played a key role in the board's communication. As mentioned above, we expect inflation to fall slightly below 3% yoy in January, bringing it within the CNB's tolerance band (+/-1pp around the 2% target). This sharp decline, together with the continued weakness of the economy, should prompt the bank board to accelerate the pace of rate cuts. From March to August inclusive, we expect a 50bp cut at each meeting, positioning the key repo rate close to 5% by mid-year. This will partially reduce the mismatch between economic conditions and the level of interest rates. We expect only the standard 25bp cuts in September and November, followed by no change in December. The repo rate should therefore reach 4% by the end of the year. In 2025, we expect a 25bp cut at each meeting when a new CNB staff forecast is presented. As a result, the repo rate is unlikely to fall to the policy-neutral level of 3% until the end of 2025.

The decline in the repo rate is likely to be slower than that indicated by the CNB forecast (%)



Source: CNB, Economic & Strategy Research, Komerční banka

Monetary policy will be very restrictive this year, with interest rates still high and inflation falling rapidly (%)



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

The CNB's monetary policy is therefore likely to remain restrictive this year and next. Indeed, the structure of inflation will be less favourable than the headline figure. According to our forecast, core inflation is set to remain close to or slightly above 3% yoy throughout this year. As mentioned in the macroeconomic forecast section, we expect core inflation to rise to 3.5% yoy towards the end of the year as a result of the lower comparison base. Similarly, in its most recent forecast, the CNB estimated that core inflation will average 3% in 2024. It was a sufficient decline in core inflation that Governor Michl made mention of any rate cut thus being conditional. The emphasis on core inflation is also evident in the statements of the other board members. Given our forecast for core inflation, we see there being little chance of rates falling below 4% by the end of the year. In our view, the board's approach will remain cautious and we therefore do not expect more than a 50bp cut at any one meeting. Our interest rate forecast remains subject to a high degree of uncertainty, as we believe that the CNB steps will depend on newly released data and possible risks to inflation. Our interest rate path implies that the central bank's policy will remain tighter than the CNB's staff forecast would suggest. This, together with other influences, will result in only a gradual recovery of the Czech economy.

Fiscal policy

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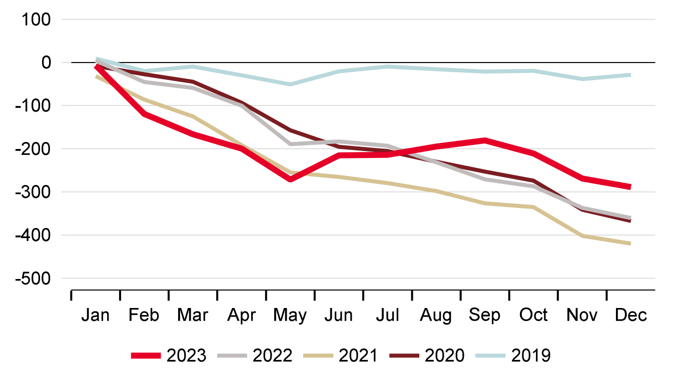
Debt growth slowdown

Last year's state budget deficit of CZK288.5bn was slightly smaller than planned. This year, we expect the deficit to fall to CZK250bn due to the government's consolidation efforts combined with the unwinding of some extraordinary support measures and the recovery of the domestic economy. This implies the general government deficit is set to fall markedly below 3% of GDP for the first time in four years. Equally, this means total public finance debt would continue to rise, but only slowly relative to nominal gross domestic product.

Last year's budget in line with plan

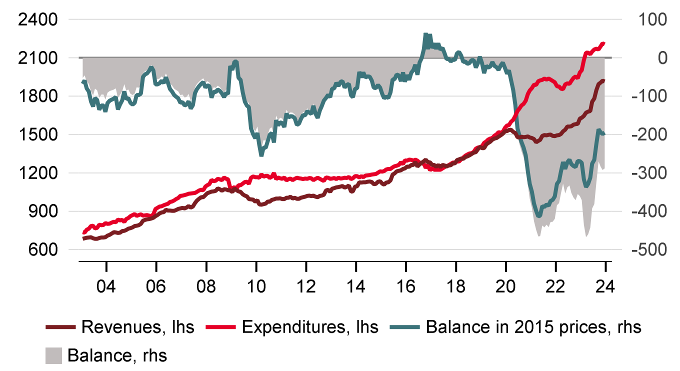
The state budget closed 2023 with a deficit of CZK288.5bn. In a year-on-year comparison, this is a CZK71.9bn milder deficit and CZK6.5bn better result compared to the approved plan of CZK295bn. In December itself, the deficit widened as in the previous two months. Although the state collected the second advance payment of the windfall tax (WFT) and the final instalment of the corporate income tax, current and capital expenditures traditionally increase at the end of the year. A part of the extraordinary expenditure (amounting to about CZK14bn) related to corporate compensation will be paid at the beginning of this year.

State budget balance (CZKbn, ytd cumulative)



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

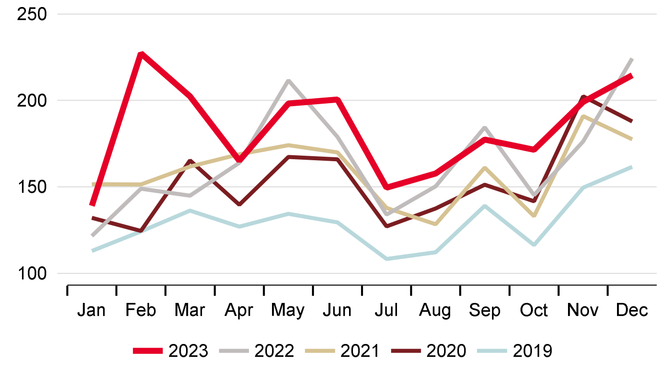
Budget revenues and expenditures (CZKbn, 12m cumulative)



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

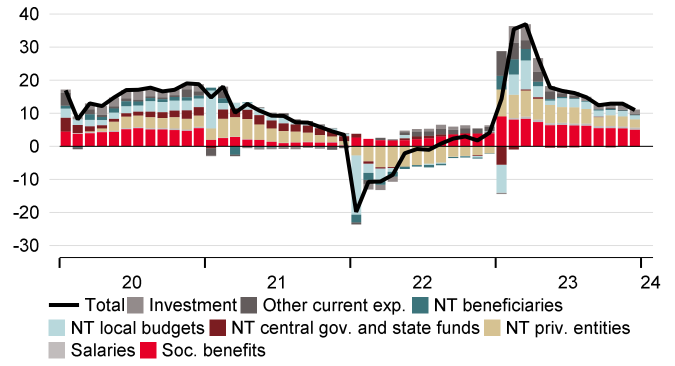
Expenditures for 2023 as a whole increased by CZK217.8bn (+11%) year-on-year. This was mainly due to an increase in the item with the largest weighting, social benefits (+CZK100.1bn yoy), which mainly reflected an increase in old-age pensions (+CZK97.1bn yoy). Meanwhile, the pension insurance system itself reached a record deficit of CZK73bn last year after -CZK21bn in 2022. The year-on-year increase in spending was further boosted by compensations to households and firms for energy prices, higher investments and debt servicing costs, increased spending on salaries of primary and secondary school employees, and higher payments for state-insured persons into the health insurance system.

State budget expenditure (CZKbn, non-cumulative)



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

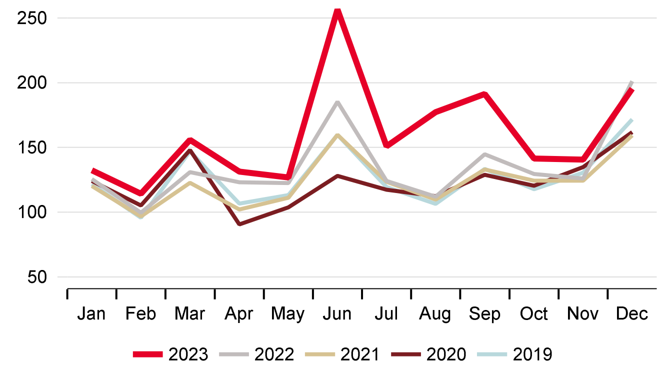
State budget expenditure (%, pp, yoy, ytd cumulative)



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

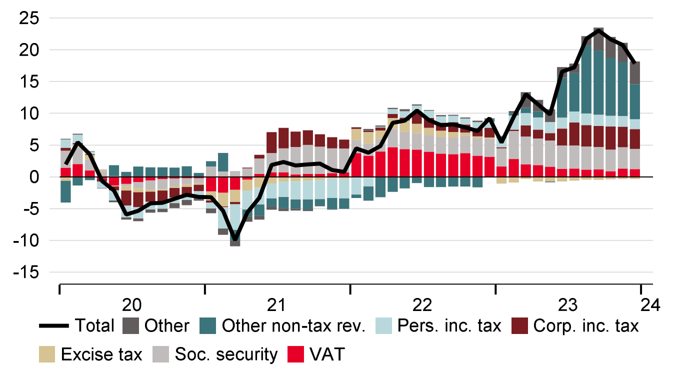
Total revenues since the beginning of the year were higher by CZK289.7bn year-on-year and by 17.8% in relative terms. The highest contributors to the increase were extraordinary taxes in the form of WFT and the levy on excess revenues of electricity producers, EU funds (National Recovery Plan), social contributions, corporate income tax and the dividend from state-controlled company, CEZ. On the other hand, the collection of the second most important revenue item by weight, VAT, saw a 5.8% increase on a full-year basis, reflecting the decline in household consumption due to the fall in real wages and the persistently high savings rate. However, monthly VAT collections in November and December may show some promise of a recovery in household consumption this year. On the other hand, the 33.1% year-on-year increase in corporate income tax collections (excluding WFT) exceeded the full-year target by a significant 28.3%, thus confirming the solid profitability of firms.

State budget revenue (CZKbn, non-cumulative)



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

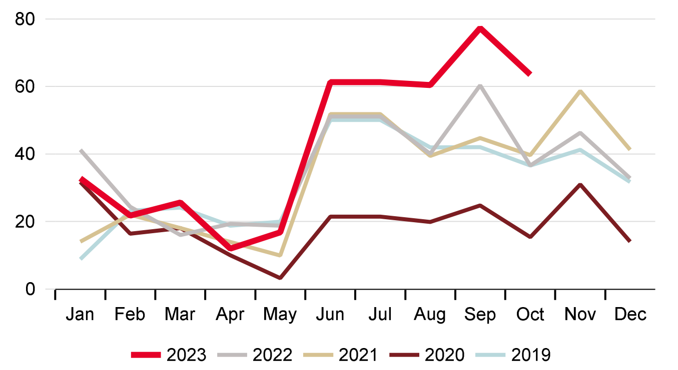
State budget revenue (%, pp, yoy, ytd cumulative)



Source: Ministry of Finance, Macrobond, Economic & Strategy Research, Komerční banka
Note: Other revenue includes EU funds for example

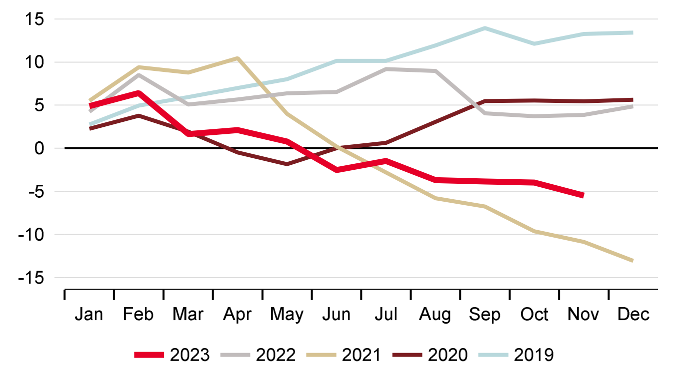
By the end of October last year, the budgets of local governments had run a ytd surplus of CZK63.4bn. Year-on-year higher revenues (by CZK86.8bn, +14.4%) exceeded the increase in expenditures (CZK59.9bn, +10.6%), which resulted in a year-on-year increase in the positive balance of the balance by CZK26.9bn. The accumulation of municipalities' funds in bank accounts continued. At the end of September, according to the Ministry of Finance, municipalities and regions had a total of CZK492.8bn in their accounts, while their debt amounted to CZK90.8bn.

Municipal finances (CZKbn, ytd cumulative)



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

Health insurers' finances (CZKbn, ytd cumulative)



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

State budget deficit to fall to CZK250bn this year

The consolidation package will contribute to reducing the state budget deficit. However, the expected recovery of the domestic economy and the abolition of measures related to high energy prices will also play a role. According to the approved budget, these factors will be partly offset this year by an increase in spending on defence (2% of GDP), education (teachers' salaries), servicing the national debt, and payments for state-insured persons to the public health insurance system.

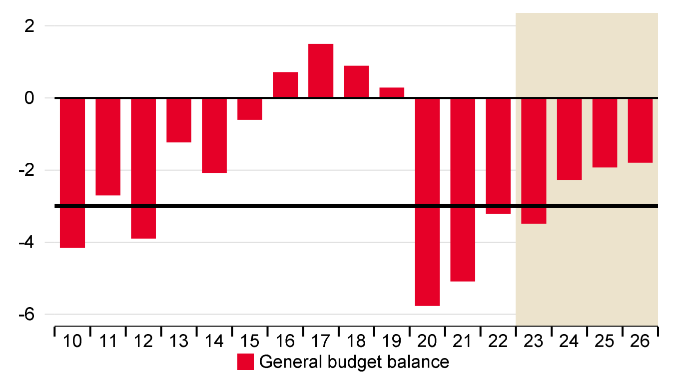
We expect a slight reduction in the state budget deficit in line with the Ministry of Finance's medium-term outlook in future years. Thus, the deficit should reach CZK235bn in 2025 and CZK220bn in 2026.

Public finance forecasts

	2021	2022	2023e	2024f	2025f	2026f
Balance (% GDP)	-5.1	-3.2	-3.5	-2.3	-1.9	-1.8
Fiscal effort* (pp GDP)	-0.8	0.6	0.2	0.5	0.1	0.0
Public debt (CZKbn)	2 566.7	2 997.6	3 285.6	3 535.6	3 770.6	3 990.6
Debt ratio (% GDP)	42.0	44.2	44.7	46.1	47.0	47.7

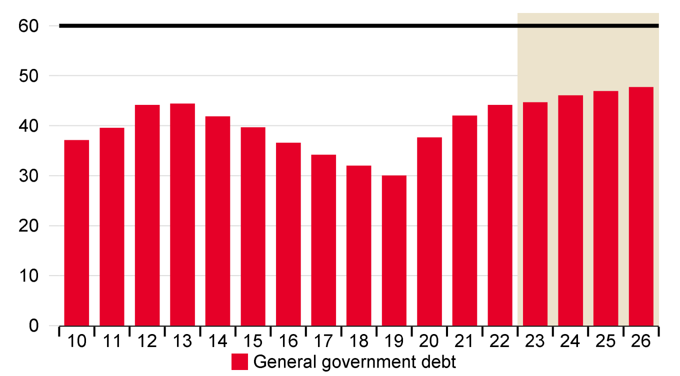
Source: CZSO, Macrobond, Ministry of Finance for published data, Economic & Strategy Research, Komerční banka
Note: Fiscal effort is measured as the year-on-year change in the public finance balance, adjusted for the economic cycle and one-off operations on GDP in pp.

Public finance balance (% of nominal GDP)



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

Public debt (% of nominal GDP)



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

Public finance deficit to fall to below 3% of GDP in 2024 for first time in four years

This year, we expect the general government deficit to ease significantly to 2.3% of GDP. The general government deficit as a whole should be lower again compared to the state

In our view, this year's public finances will end with a significantly lower deficit relative to GDP than last year (2.3% of GDP after 3.5% of GDP).

budget. However, the traditionally surplus performance of municipalities is set to be partly offset by the deficit performance of the State Fund for Transport Infrastructure. As a share of GDP, the deficit is expected to return below 3% of GDP for the first time since 2019. Public sector debt as a share of GDP is projected to grow by an average of 1pp per year over the 2024-2026 period to reach 47.7% of GDP in 2026.

Structural imbalances in public finances persist. Although the consolidation package is a welcome contribution to reducing the gap between public revenues and expenditures, it is, in our view, only the first necessary step towards a correction. This is because these efforts are largely offset by new spending in the most important chapters, which will also be automatically indexed (pensions, education, defence and health). As a result, the structural deficit still remains around 2% of GDP (we estimate that it will fall to 2.0% of GDP this year from 2.5% of GDP in 2023). The medium-term imbalances due to unfavourable demographic developments, which will start to become pronounced from the 2030s onwards, will also require a change in the parameters of the pension system (e.g. linking the retirement age to life expectancy beyond 2030).

Summary forecast table

	Q2 23	Q3 23	Q4 23	Q1 24	Q2 24	Q3 24	Q4 24	Q1 25	2022	2023	2024	2025	2026	2027
GDP and its breakdown														
GDP (real, yoy, %)	-0.4	-0.8	-0.2	-0.1	0.2	1.3	1.6	1.9	2.4	-0.4	0.8	2.2	2.2	1.9
Household consumption (real, yoy, %)	-4.0	-2.4	-0.6	1.5	1.9	3.3	3.9	4.4	-0.8	-3.1	2.7	4.5	2.7	1.7
Government consumption (real, yoy, %)	3.8	3.9	4.4	3.4	2.2	0.7	0.2	0.6	0.3	3.8	1.6	1.7	1.6	2.0
Fixed investments (real, yoy, %)	3.8	3.9	3.4	4.9	0.8	2.2	2.6	3.1	3.1	2.5	2.6	3.4	2.8	2.2
Net exports (contribution to yoy)	2.5	1.1	1.2	-0.2	-0.4	-0.3	-0.6	-0.5	0.9	1.9	-0.4	-0.4	0.1	0.2
Inventories (contribution to yoy)	-2.5	-2.5	-2.7	-2.6	-1.1	-0.9	-0.6	-0.6	0.9	-2.1	-1.3	-0.5	-0.1	0.1
Monthly data from the real economy														
Foreign trade (CZKbn)	36.9	-0.6	68.3	59.2	52.8	7.7	25.4	67.8	-204.8	143.6	145.0	140.9	164.2	204.7
Exports (nominal, yoy, %)	0.6	-7.1	0.2	0.3	0.9	9.1	2.6	6.7	13.6	0.8	3.0	6.1	6.1	7.5
Imports (nominal, yoy, %)	-8.7	-12.3	-10.1	-1.5	-0.5	8.2	6.8	6.2	18.5	-6.8	3.1	6.4	5.8	6.9
Industrial production (real, yoy, %)	0.8	-3.5	-1.6	-1.0	-1.3	1.5	1.4	2.5	2.8	-0.9	0.2	3.2	3.6	3.7
Construction output (real, yoy, %)	-4.1	-2.3	0.0	-5.9	1.0	4.8	7.1	6.7	3.6	-1.8	1.7	4.0	3.0	3.8
Retail sales (real, yoy, %)	-6.0	-3.2	-0.3	1.6	4.0	4.3	3.6	2.6	-3.1	-4.2	3.4	2.3	2.1	1.6
Labour market														
Wages (nominal, yoy, %)	8.0	7.1	7.0	6.7	7.1	7.1	6.6	5.6	5.3	7.7	6.9	5.2	4.5	4.3
Wages (real, yoy, %)	-2.7	-1.0	-0.7	3.7	3.9	4.4	4.6	3.1	-8.4	-2.7	4.2	2.9	2.3	2.1
Unemployment rate (MLSA, %)	3.5	3.6	3.6	3.9	3.6	3.7	3.6	3.8	3.4	3.6	3.7	3.5	3.3	3.5
Unemployment rate (ILO 15+, %)	2.6	2.6	2.6	2.9	2.7	2.7	2.6	2.7	2.2	2.6	2.7	2.5	2.4	2.6
Employment (ILO 15+, yoy, %)	1.7	1.4	1.4	0.7	0.2	0.2	0.3	0.5	-0.8	1.4	0.4	0.5	0.3	0.0
Consumer and producer prices														
CPI Inflation (yoy, %)	11.1	8.1	7.6	2.5	2.7	2.6	3.0	2.5	15.1	10.7	2.7	2.2	2.1	2.1
Taxes (contribution to yoy inflation)	0.2	0.2	0.1	0.0	0.0	0.0	0.0	0.2	0.6	0.1	0.0	0.2	0.2	0.2
Core inflation (yoy, %) (*)	8.7	5.9	3.9	3.2	3.0	3.2	3.5	3.0	13.2	7.6	3.2	2.4	1.7	1.9
Food prices (yoy, %) (*)	11.8	7.3	2.6	0.0	0.5	0.6	1.2	1.6	12.8	10.0	0.6	1.9	2.0	1.9
Fuel prices (yoy, %) (*)	-21.8	-15.5	-7.6	2.2	8.3	0.2	-1.8	-2.8	34.1	-12.4	2.2	-2.8	3.2	1.9
Regulated prices (yoy, %)	25.2	19.9	33.2	4.4	4.0	4.3	5.8	1.3	20.9	27.8	4.6	1.5	2.0	2.0
Producer prices (yoy, %)	3.9	1.3	0.9	0.0	3.4	3.3	3.0	2.0	24.3	5.3	2.4	1.3	1.0	1.2
Financial variables														
2W Repo (%, average)	7.0	7.0	7.0	6.6	5.7	4.7	4.1	3.9	6.0	7.0	5.2	3.5	3.0	3.0
3M PRIBOR (%, average)	7.2	7.1	7.0	6.8	5.9	4.9	4.4	4.1	6.3	7.1	5.5	3.7	3.3	3.3
EUR/CZK (average)	23.6	24.1	24.5	24.8	24.9	24.8	24.7	24.6	24.6	24.0	24.8	24.5	24.1	23.9
External environment														
GDP in EMU (real, yoy, %)	0.5	0.1	0.5	0.7	0.7	0.9	0.8	0.9	3.5	0.6	0.8	1.1	1.4	1.2
GDP in Germany (real, yoy, %)	0.1	-0.4	0.1	0.3	0.2	0.2	0.3	0.5	1.9	-0.1	0.2	0.8	1.1	1.0
CPI in EMU (yoy, %)	6.2	4.9	3.0	3.1	3.1	2.8	2.8	2.4	8.4	5.5	3.0	2.0	2.1	2.0
Brent oil price (USD/bbl, average)	77.3	82.4	86.0	90.0	90.0	85.0	85.0	84.1	101.0	82.5	87.5	82.8	79.9	75.3
EUR/USD (quarter eop, year average)	1.09	1.09	1.08	1.10	1.12	1.14	1.16	1.18	1.05	1.08	1.13	1.20	1.25	1.26

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

Czech IRS market and government bonds

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Drop followed by stabilisation

The sharp decline in global market interest rates in connection with continuing disinflation and the turnaround in communication by key central banks was also significantly reflected in the koruna yield curve in the past quarter. We expect the shorter end of the curve to have more room to fall as domestic monetary policy rates continue to ease. In general, however, we believe that further significant declines in CZK market interest rates should be prevented primarily by the expected upward correction in euro market interest rates. Also, CZGB yields have, in our view, already experienced their biggest fall. However, a reduction in issuance activity this year could contribute to a further slight decline.

Czech IRS market: 'higher for longer' no longer

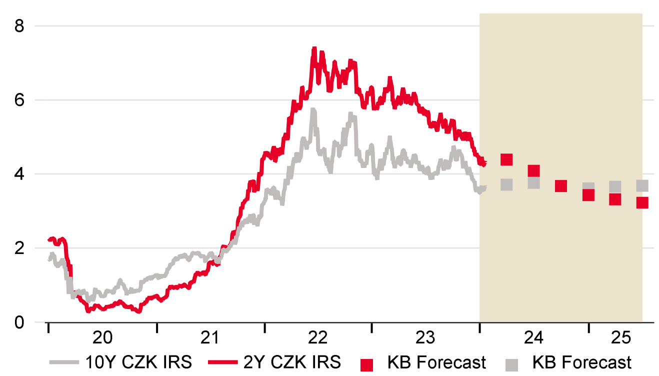
A further decline in CZK market interest rates should be prevented mainly by the expected upward correction in euro rates. The inverse shape of the yield curve will likely persist for most of this year.

The CZK IRS curve had fallen significantly since the beginning of 4Q. The decline in shorter maturities was probably related to the start of the domestic rate-cut cycle but also to a pivot in the communication of future steps by key central banks. Amid continuing disinflation, those banks abandoned the 'higher for longer' mantra and started to discuss easing monetary policy. This was reflected partly in longer-term yields, with euro interest rates falling more sharply than dollar market rates, mostly as a result of continued strong US economic data and disappointing eurozone data, particularly for German economy.

In our view, the decline in domestic monetary policy rates will be somewhat slower than markets expect. According to market contracts, the CNB repo rate will fall to around 3.25% by the end of the year. From our perspective, this is quite aggressive given the expected inertia of core inflation. We foresee a more cautious approach by the CNB, with the repo rate unlikely to fall below 4% this year.

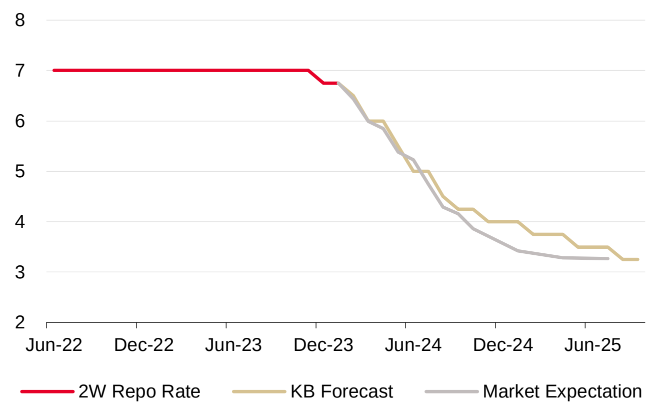
Market interest rates with shorter maturities may still fall, while we see limited scope for a further reduction in longer maturities. Compared to the market, we believe that the decline in yields will be somewhat more gradual, reflecting in particular our expectation of a more moderate easing of monetary policy by the ECB and, to a lesser extent, by the CNB this year. For longer-term koruna rates, we see limited scope for a more significant decline, as the effects on one hand of fading high inflation and on the other of a recovery in domestic economic activity combined with a correction of the previous decline in euro market interest rates should roughly offset each other.

IRS forecast (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Expected CNB key interest rate path as of 23 January 2024 (%)



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

The continuation of the CNB's rate-cut cycle should help to gradually normalise the shape of the domestic yield curve. Given that we forecast the equilibrium repo rate of 3% to not be reached until the end of 2025, we expect the inverse shape of the curve to endure for most of this year.

CZK IRS outlook (end of period, %)

	1Q24f	2Q24f	3Q24f	4Q24f
2y	4.40	4.10	3.65	3.45
5y	3.60	3.55	3.40	3.35
10y	3.70	3.75	3.65	3.60

Source: Economic & Strategy Research, Komerční banka

Euro market still offers lower interest rates

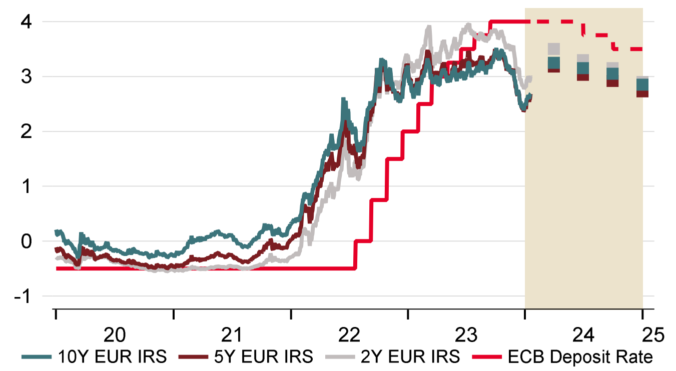
With the global fall in market interest rates, fixing conditions have improved again. Rates in the forward market are lower than spot IRS and even lower than we expect on a 1y horizon. **Noticeably lower interest rates compared to the CZK IRS still prevail in the euro area,** but the gap could temporarily reduce. SG economists expect a recovery in the euro area this year, which should keep inflationary pressures and ECB interest rates elevated. This is also why the market-implied pace of ECB rate cuts (around 140bp by year-end) seems too sharp to us. In the short term, we could therefore see some correction of the fall in euro rates since the end of last year.

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

Forward	Maturity 1Y	2Y	3Y	5Y	10Y
Spot	5.24	4.29	3.92	3.67	3.66
3M	4.47	3.89	3.65	3.50	3.58
6M	3.82	3.51	3.39	3.36	3.51
1Y	3.18	3.16	3.18	3.26	3.48
2Y	3.14	3.18	3.19	3.33	3.56
3Y	3.21	3.22	3.34	3.45	3.65

Source: Bloomberg, Economic & Strategy Research, Komerční banka, as of 23 January 2024

Euro area rates (%)



Source: Bloomberg, SG Cross Asset Research/Economics

Supply of CZGBs to decrease this year

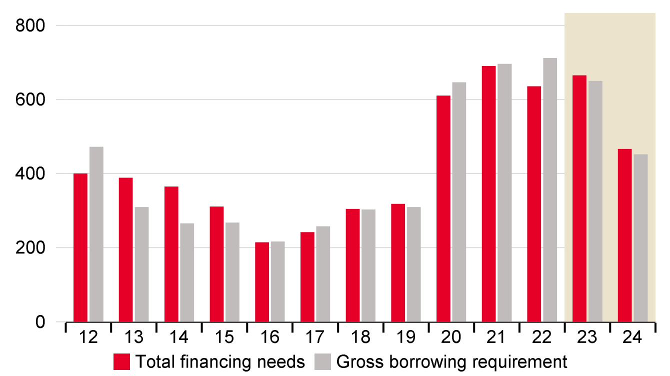
Lower maturing debt redemptions, as well as the easing of the state budget deficit, will likely result in much-reduced issuance this year. We expect the state budget deficit to head towards CZK250.0bn this year after last year's CZK288.5bn. Combined with other financing needs (mainly maturing bond repayments), we estimate total gross CZGB issuance of CZK354.6bn this year. The supply of CZGBs could thus decrease by around CZK150bn yoy, on our estimates. The Ministry of Finance (MinFin) is planning to offer an indicative CZK75.0bn of CZGBs in 1Q24 and CZK300-400bn in 2024 as a whole. A euro bond issue will also be in play, with the MinFin preferring to use the domestic market to cover foreign currency financing needs. Overall, we expect a total financing need this year of CZK466.8bn (6.1% of GDP) compared to last year's CZK660.0bn (9.0% of GDP).

Funding programme and issuance activity (CZKbn)

	2024	
	MinFin	**KB**
State budget deficit	252.0	250.0
Transfers and other operations of state financial assets	4.4	4.4
T-bonds denominated in local currency redemptions	138.0	138.0
T-bonds denominated in foreign currency redemptions	24.4	24.4
Redemptions and early redemptions on savings bonds	5.0	5.0
Money market instrument redemptions	44.4	44.4
Redemption of T-bills		9.3
Redemption of other money market instruments		35.1
Repayments on credits and loans	0.6	0.6
Total financing needs	**468.8**	**466.8**
Money market instruments		50.0
T-bills		20.0
Other money market instruments		30.0
Gross issuance of CZK T-bonds on domestic market		354.6
Gross issuance of EUR T-bonds on domestic market/eurobond		24.8
Gross issuance of government savings bonds		2.4
Received credits and loans		20.0
Financial asset and liquidity management		15.0
Total financing sources		**466.8**
Gross borrowing requirement		**451.8**
Net CZGB issuance		**216.6**

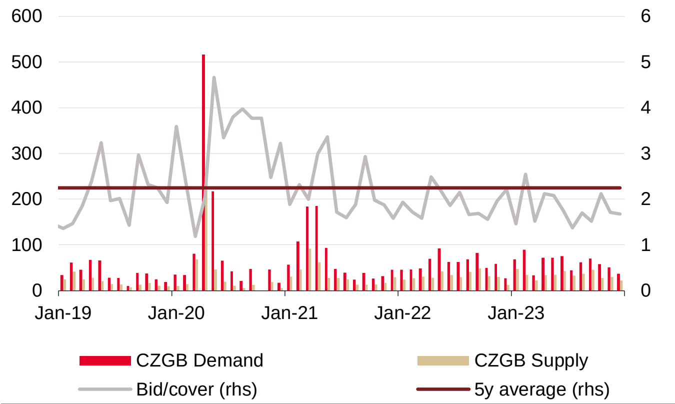
Source: MinFin, Economic and Strategy Research, Komerční banka

Financing needs (CZKbn)



Source: MinFin, Economic and Strategy Research, Komerční banka

CZGB primary market (CZKbn)



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

CZGB yield forecast (end of period)

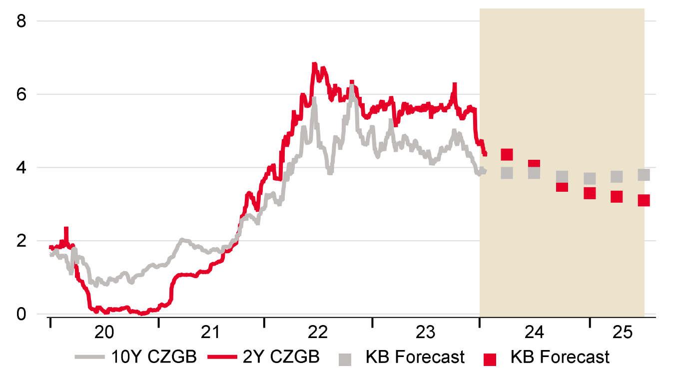
	1Q24f	2Q24f	3Q24f	4Q24f
2y CZGB yield (%)	4.35	4.05	3.50	3.30
5y CZGB yield (%)	3.80	3.65	3.35	3.20
10y CZGB yield (%)	3.85	3.85	3.75	3.70
10y CZGB ASW (bp)	15	10	10	5

Source: Economic & Strategy Research, Komerční banka

Decline in CZGB yields will be rather gradual

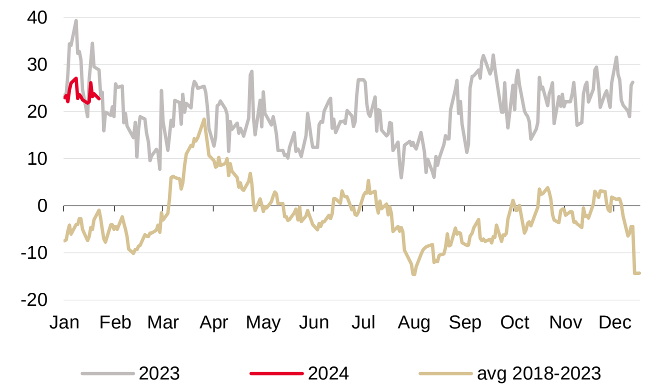
Similarly to the CZK IRS, the CZGB yield curve has fallen significantly since the beginning of 4Q23. This too was probably primarily a reflection of developments on global markets. Overall, as in the case of market interest rates, bonds with shorter maturities should have more room to fall this year. The decline in yields at longer maturities should be only moderate due to the expected correction in global yields.

CZGB yield forecast (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

10y CZGB ASW (bp)



Source: Bloomberg , Economic and Strategy Research, Komerční banka

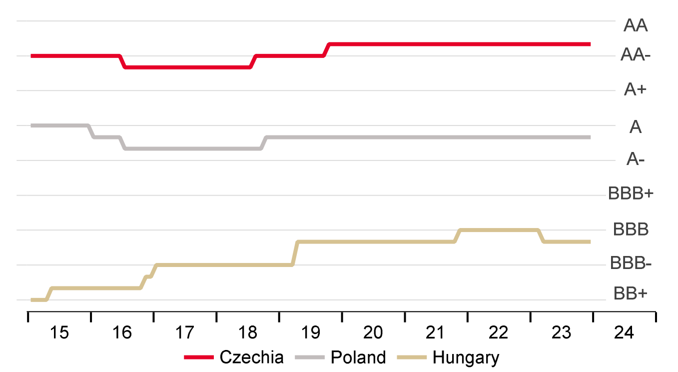
Czech sovereign rating unchanged. Last November, Moody's kept its rating unchanged but improved the outlook from negative to stable, mainly due to reduced dependence on Russian gas. According to the agency, there is limited risk of long-term adverse effects on the economy from higher energy prices. It also assessed the government's fiscal efforts positively. The Czech Republic still has the best sovereign rating of all Central and Eastern European countries and is above the average of euro area member states. Within the Central European region (Czech Republic, Poland, Hungary), countries with better ratings have historically also had lower spreads to German Bunds.

Sovereign rating overview

	Local currency	Outlook	Foreign currency	Outlook	Next rating review
S&P	AA	STABLE	AA-	STABLE	12.04.2024
Moody's	Aa3	STABLE	Aa3	STABLE	02.02.2024
Fitch	AA-	NEGATIVE	AA-	NEGATIVE	23.02.2024

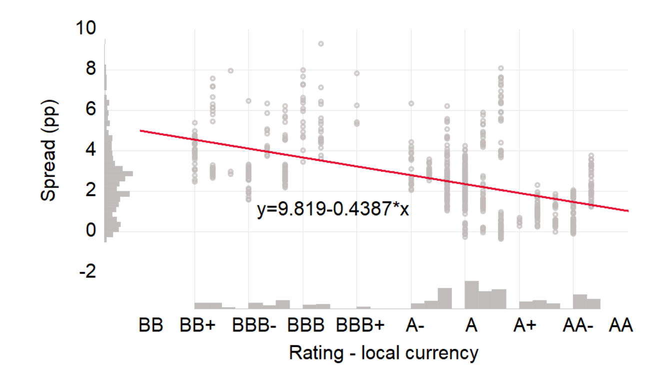
Source: Bloomberg , Economic and Strategy Research, Komerční banka

Rating – local currency (average of Fitch, S&P and Moody's)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Rating and spread to 10y Bund in Central European countries



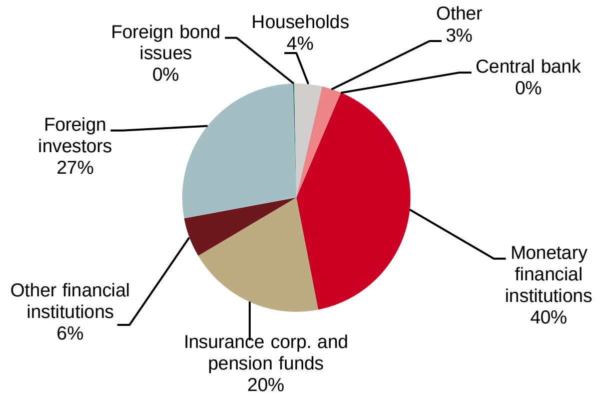
Source: Bloomberg, Economic and Strategy Research, Komerční banka
Note: Data for Czechia, Poland and Hungary

Government bond overview

Government bond overview									Rich-cheap analysis											
Bond		Dur.	Issued last 90D	Issuance limit	Yield	Δ1W	Δ1M	FX hedged	ASW	Δ1W	Δ1M	Min	90D	Max	Z-Score	Rank	Spline spread	Rank	Carry Roll 90D	Rank
5.70	May-24	0.3	0.0	100%	5.16	28	47	2.83	-139	19	52	-255		-139	3.3	1	-25.2	2	-447.1	24
0.00	Dec-24	0.8	0.0	34%	4.96	-5	1	3.57	-56	0	4	-123		-54	2.2	2	-29.8	1	-85.6	23
1.25	Feb-25	1.0	0.0	100%	4.55	-8	-14	3.28	-81	-4	5	-88		-9	-1.4	22	4.1	16	-81.5	22
2.40	Sep-25	1.6	0.0	85%	4.21	-9	-30	3.21	-42	5	-16	-64		0	-0.7	16	16.8	23	-56.0	21
6.00	Feb-26	1.9	5.1	71%	3.79	-1	-19	2.82	-56	-1	-3	-73		-33	-0.5	9	44.2	24	-50.3	20
1.00	Jun-26	2.3	0.0	100%	3.98	-7	-20	3.08	-28	-6	-21	-41		-1	-1.0	20	16.4	22	-39.8	19
0.25	Feb-27	2.9	8.4	100%	3.89	0	-11	3.03	-8	-2	-4	-30		10	-0.1	4	10.7	19	-31.5	18
2.50	Aug-28	4.2	0.0	94%	3.76	0	-1	2.93	-1	1	0	-11		20	-0.6	13	0.5	14	-20.9	17
5.50	Dec-28	4.2	0.0	68%	3.69	1	2	2.89	-9	0	0	-22		9	-0.5	10	4.4	17	-20.6	16
5.75	Mar-29	4.4	4.2	121%	3.76	0	-1	2.96	4	0	1	-5		20	-0.7	14	-4.4	11	-19.1	15
2.75	Jul-29	4.9	0.0	100%	3.78	-2	-2	2.94	7	-6	-1	-4		21	-0.6	12	-7.4	8	-16.7	14
0.05	Nov-29	5.6	0.0	58%	3.78	-2	1	2.92	3	-3	-1	-3		23	-1.4	21	-8.7	7	-14.1	13
0.95	May-30	5.9	0.0	100%	3.78	-1	2	2.93	5	-4	-1	2		21	-1.8	24	-9.5	6	-13.0	11
5.00	Sep-30	5.6	0.0	101%	3.79	1	3	2.98	10	1	4	-2		22	-0.2	5	-10.3	5	-13.2	12
1.20	Mar-31	6.5	0.0	100%	3.82	-1	2	2.96	10	-1	0	5		22	-0.9	17	-11.8	4	-10.6	9
6.20	Jun-31	5.8	0.0	72%	3.77	2	1	2.97	6	-1	-1	0		22	-0.9	18	-6.0	9	-12.0	10
1.75	Jun-32	7.5	0.0	100%	3.80	0	5	2.94	5	0	0	2		19	-1.7	23	-3.3	12	-8.4	6
4.50	Nov-32	7.1	30.5	38%	3.85	2	6	3.04	13	0	4	4		23	-0.4	8	-5.2	10	-8.6	7
2.00	Oct-33	8.5	0.0	100%	3.87	2	6	3.01	11	-1	0	5		21	-0.7	15	-0.3	13	-6.6	4
4.90	Apr-34	7.8	3.4	49%	3.88	4	7	3.09	16	2	4	6		26	0.1	3	2.0	15	-7.3	5
3.50	May-35	9.0	0.0	48%	3.90	3	9	3.08	12	1	4	5		26	-0.4	7	9.0	18	-6.3	2
4.20	Dec-36	9.8	0.0	100%	3.91	2	7	3.15	13	0	1	5		27	-0.6	11	14.5	21	-6.5	3
1.95	Jul-37	11.2	0.0	34%	3.94	5	8	3.11	12	3	5	2		23	-0.2	6	12.5	20	-6.2	1
1.50	Apr-40	13.4	3.8	47%	3.98	4	4	3.14	10	5	0	4		30	-0.9	19	-13.3	3	-9.2	8

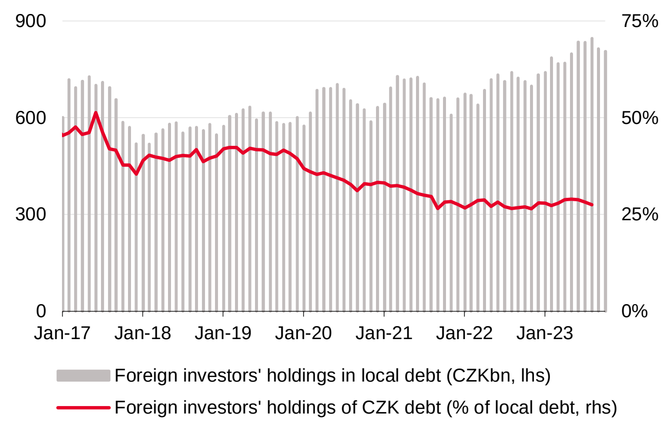
Source: Economic & Strategy Research, Komerční banka; Note: more details in CZGB Auction Alerts

Holdings of CZK government debt (November 2023)



Source: MinFin, Economic & Strategy Research, Komerční banka

The share of non-resident bondholders has roughly stabilised



Source: MinFin, Economic & Strategy Research, Komerční banka

Czech FX market

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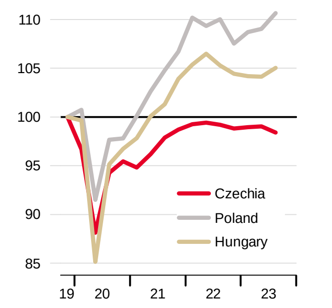
Reversal of weakening trend in sight

The unconvincing performance of the domestic economy and narrowing interest rate differential are not conducive to short-term appreciation of the koruna, in our view. Moreover, a likely recovery in the domestic economy this year should be driven mainly by household consumption, with an increase in exports likely largely offset by higher imports in the external trade balance. Nevertheless, after an initial weakening, we expect the koruna to resume slight appreciation against the euro from the second half of this year amid improved global sentiment towards emerging market currencies and a gradual improvement in the fundamentals of the domestic economy.

Real GDP in CE region (4Q19 = 100)

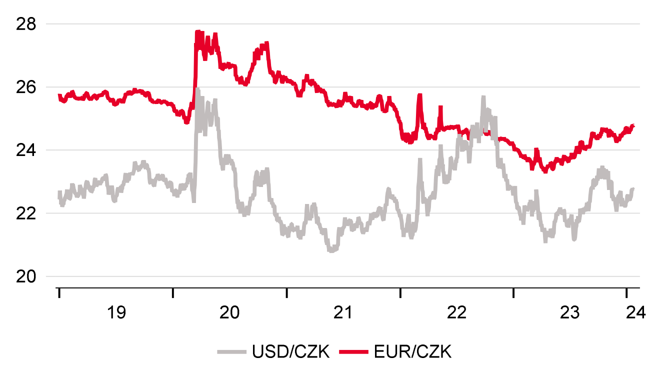


Source: Macrobond, Economic and Strategy Research, Komerční banka

Koruna lagged the region last year

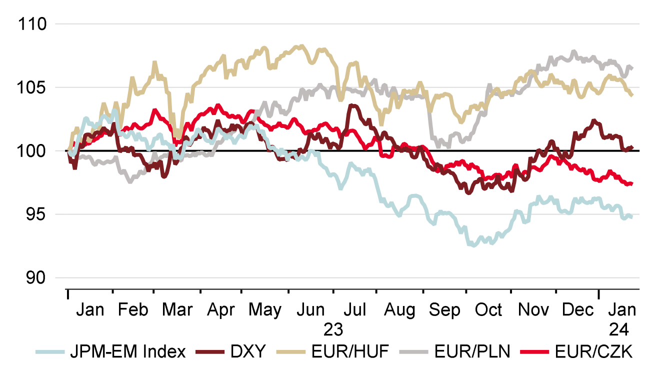
The koruna was the only CE currency to weaken against the euro in 2023. Global market sentiment, against a backdrop of monetary policy rate cuts in the final quarter of last year, was generally not very supportive of emerging currencies. The aggregate index of these currencies (JPM-EM) was broadly flat throughout 4Q23, although the US dollar lost slightly over the same period. The domestic economy did not fare well at the end of last year either, in our view, and remains well below pre-pandemic levels. Poland and Hungary, on the other hand, were 10.6% and 5% above their 4Q19 performance in 3Q23, respectively.

CZK exchange rates



Source: Bloomberg, Economic and Strategy Research, Komerční banka

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



Source: Bloomberg, Economic and Strategy Research, Komerční banka
Note: A value above 100 indicates an appreciation of the CZK, PLN or HUF against the EUR or the Emerging Market Currency Index (JPM-EM), or a weakening of the Dollar Index (DXY) from 1 January 2023.

Fundamentals still weak but should gradually improve

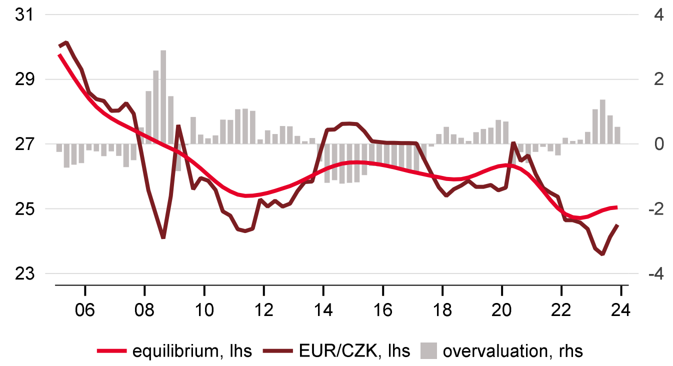
We are not significantly changing our forecast for EURCZK. Worse economic developments domestically and abroad, together with globally lower interest rates, should leave fundamentals roughly unchanged in relative terms.

In our view, factors supportive a weaker koruna will prevail until about the middle of this year. Amid continued tight monetary policy abroad and the start of the CNB's rate-cutting cycle, the koruna's advantage in the form of the interest rate differential (measured by the difference between two-year CZK and EUR market interest rates) has already fallen by around three-quarters (from 6pp to 1.4pp) from its peak in July last year. We expect a further temporary narrowing in our view current overly aggressive market pricing of the ECB's pace of monetary policy easing (c.140bp drop in the key rate priced in by the end of the year). At the same time, we estimate that the koruna is still slightly overvalued given the weak economic fundamentals, even if this has already eased considerably compared to the first half of last year. For 4Q23, we estimate the equilibrium level of EURCZK at 25.0. However, we see this starting to decline in the following quarters, which, combined with a slight depreciation of the spot exchange rate, would essentially eliminate the overvaluation.

EURCZK and interest rate differential

Source: Bloomberg, Economic and Strategy Research, Komerční banka

Equilibrium EURCZK exchange rate



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

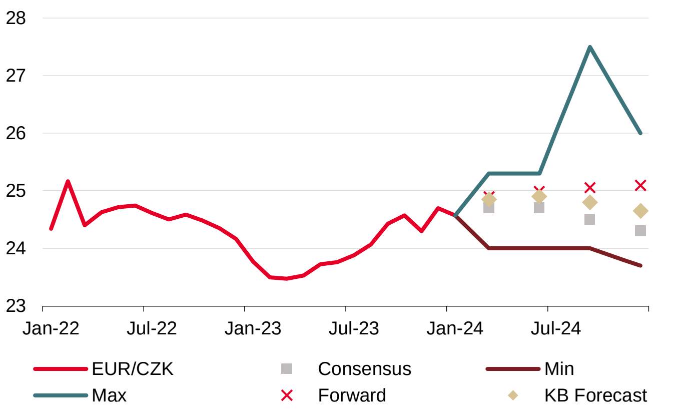
Depreciation pressures should be outweighed mainly by the weakening of the USD, in addition to the expected recovery in external demand in the second half of the year. We forecast that EURUSD could move to 1.16 by the end of 4Q24, mainly due to the Fed cutting rates by more than the ECB. More generally, however, retreating risk aversion in the context of a US soft landing should also help increase flows into emerging market currencies at the expense of the US dollar. The koruna should also benefit from slowing domestic inflation, leading the domestic economy to close the inflation gap with the euro area. By contrast, given the expected structure of GDP growth, recovery is unlikely to prompt significant appreciation. Indeed, the positive effect of the likely increase in exports should be offset by an increase in imports related to the recovery in household consumption, which should be the main driver of domestic GDP growth. The programme to sell off part of the proceeds from the CNB's foreign exchange reserves, which resumed last August and is capped at EUR300m, should have a negligible effect on the exchange rate. Overall, we expect the koruna to reach its weakest levels against the euro in the first half of the year before gradually appreciating again. At year-end, we see EURCZK at 24.65.

Koruna exchange rate forecast (end of period)

	1Q24f	2Q24f	3Q24f	4Q24f
EUR/CZK	24.85	24.90	24.80	24.65
USD/CZK	22.60	22.20	21.75	21.25
EUR/USD	1.10	1.12	1.14	1.16

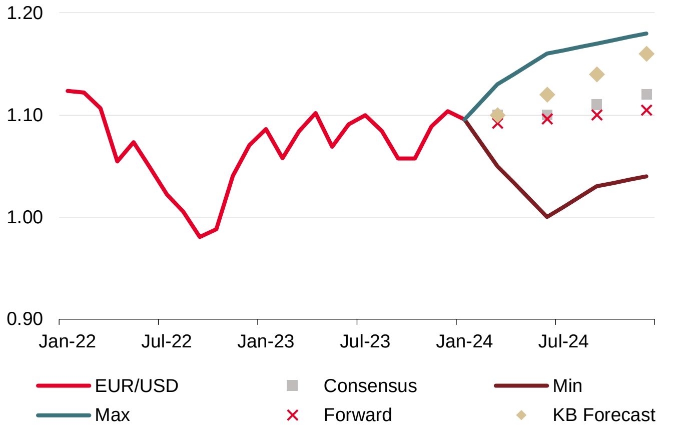
Source: Economic and Strategy Research, Komerční banka, SG Cross Asset Research

Expected EUR/CZK path, Bloomberg consensus (as of 23 January 2024)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Expected EUR/USD path, Bloomberg consensus (as of 23 January 2024)

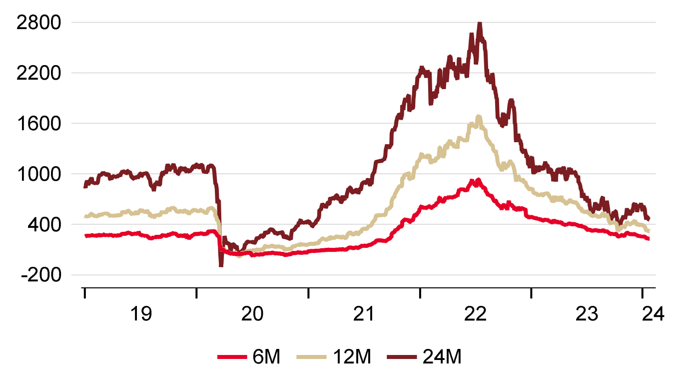


Source: Bloomberg, Economic and Strategy Research, Komerční banka, SG Cross Asset Research

Balance of risks tilted slightly towards weaker koruna

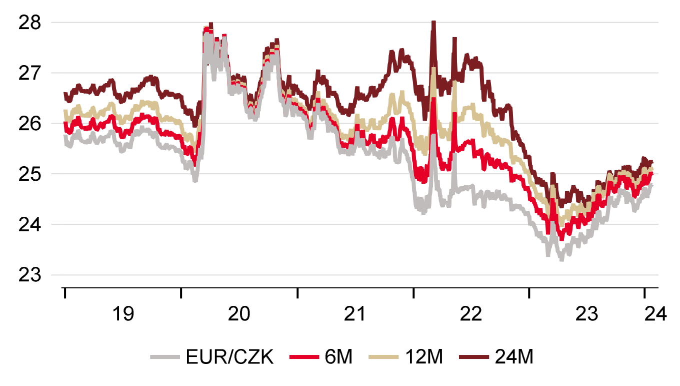
As regards domestic factors, we perceive a risk of faster-than-expected CNB rate cuts in the coming months. This could in turn partly offset an earlier start to monetary easing by the ECB in the event that the euro area economy recovers more slowly. Global sentiment towards emerging markets could be exacerbated by worsening geopolitics. A general risk is the evolution of the US dollar, which could stay strong for longer in a scenario other than a soft landing. In our view, this could happen not only if the US economy continues to perform robustly, but also in the event of a deep recession, which could trigger safe-haven demand for the US dollar in the foreign exchange market amid heightened risk aversion.

Forward points



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Forward vs spot exchange rate: EUR/CZK



Source: Bloomberg, Economic and Strategy Research, Komerční banka

The weakening of the koruna has slightly improved hedging conditions for exporters. Should monetary policy in the euro area be eased by less than the market anticipates, we would expect some narrowing of the interest rate differential and therefore a decline in forward points. However, a weakening of the spot exchange rate would likely roughly offset the impact on forward exchange rates.

Banking sector

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Credit activity on track to strengthen this year

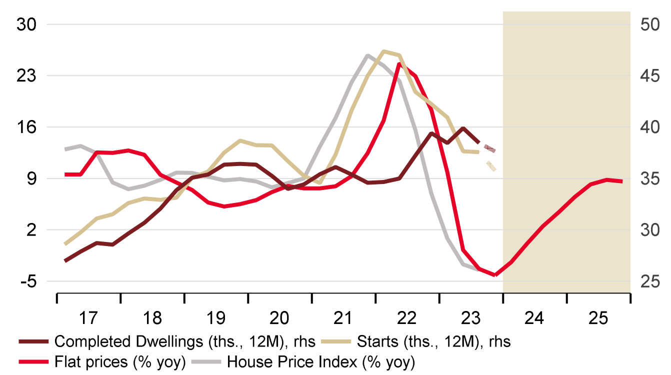
Credit activity in the economy is likely to increase gradually this year in view of the easing of domestic and foreign monetary policy alongside strengthening domestic economic growth, especially in the latter half of 2024. However, we believe that the high level of households' and firms' own funds is likely to slightly dampen financing needs. We expect the accelerating recovery of the mortgage market – thanks to the decline in interest rates and the easing of DSTI and DTI limits – to contribute to the resumption of house price growth this year after last year's very mild downturn. In line with our expectation for investment growth, the credit impulse of non-financial corporates should gradually strengthen over the course of 2024. Deposit growth is also likely to slow this year in view of lower interest yields and a recovery in investment. We expect the tightened monetary policy and weak economic growth to lead to a delayed rise in the share of non-performing loans, albeit from very low levels, attesting to the robustness of household and corporate balance sheets.

Firm recovery in the mortgage market to spur renewed house price growth

The downturn in the housing market has mostly past. We expect a gradual resumption of house price growth as mortgage activity rebounds more firmly.

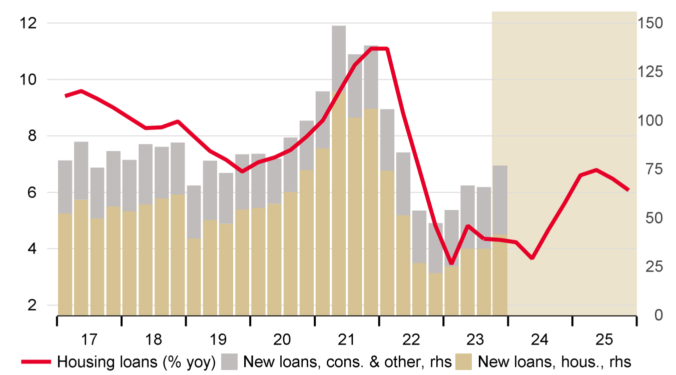
The downturn in the residential housing market likely peaked last year and it was relatively mild. Asking prices for flats were down by only 4.2% yoy at end-2023. According to the house price index (HPI), prices no longer contracted qoq in 3Q23 and were roughly flat on a seasonally adjusted basis. We expect house prices to resume an upward trajectory this year. Nevertheless, housing affordability, through the lens of a house price-to-income ratio, continues to improve moderately, owing to primarily continued wage growth. This has at least partially offset the previous marked deterioration due to house price increases, which were among the highest in the EU. However, mortgage availability remains low due to high interest rates. By our estimates, the strengthening of the mortgage market in view of the decline in interest rates and the abolishment of the DSTI and DTI mortgage limits should contribute significantly to the acceleration of house price growth, especially in 2H24. This should also be supported by the realisation of pent-up demand and high household savings. We expect house prices to rise by 1.2% on average this year, and even stronger next year (8%). For a more detailed overview of the residential property market, see Box 1.

House price growth likely to resume this year



Source: CZSO, Economic & Strategy Research, Komerční banka
Note: Data on dwelling completions and starts (as of November 2023) is extrapolated and only indicative for 4Q23. 12M denotes 12-month trailing sum.

Mortgage market to rebound more tangibly this year (CZKbn)



Source: CNB, Economic & Strategy Research, Komerční banka

The thawing of the mortgage market is likely to accelerate this year. While the volume of (pure) new housing loans fell sharply last year compared to 2022 (-28% ytd in November), activity started to pick up more strongly in 2H23, although volumes remain subdued. We expect a more pronounced decline in mortgage rates, which have fallen only marginally recently, to provide a stronger boost. The recent sharp decline in market interest rates is likely to gradually feed through to cheaper mortgages too. Credit spreads, or the difference between the interest rate on new mortgages and the corresponding market IRS, have widened considerably. Mortgage rates are likely to fall more markedly as they normalise. However, the question remains as to the intensity and speed with which mortgage offer rates will reflect lower IRS. Expensive short-term funding in the face of a persistently inverted yield curve, combined with our expectation for the CNB to cut rates to "only" 4% by end-2024, may limit the scope for significant reduction in mortgage rates. Nonetheless, significantly lower rates in 2H24 are likely to accelerate recovery in the mortgage market, by our estimates. Rates for longer fixed-term mortgages could remain elevated due to refinancing concerns, although these should be partially alleviated by the amendment to the Consumer Credit Act (effective from September 2024). We expect the mortgage market to grow by 5.6%[1] this year, which we deem to be consistent with a volume of new mortgage loans slightly above CZK200bn.

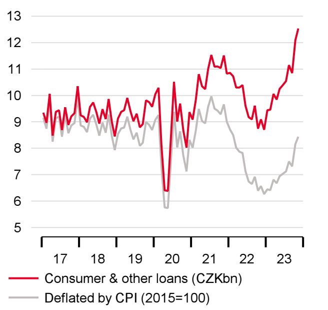
Bank loans and deposits (%, yoy)

	Q2 23	Q3 23	Q4 23	Q1 24	Q2 24	Q3 24	Q4 24	Q1 25	2022	2023	2024	2025	2026	2027
Bank loans														
Total	6.3	5.5	5.1	5.6	4.6	4.9	5.7	6.4	6.2	5.4	5.2	6.4	6.0	5.6
Households - real estate loans	4.8	4.4	4.3	4.2	3.7	4.7	5.6	6.6	7.9	4.2	4.5	6.5	5.2	4.9
Households - consumer loans	9.8	9.9	8.6	7.7	6.5	6.9	7.4	7.9	7.3	8.8	7.1	7.8	6.7	5.8
Corporate loans	5.9	4.3	5.4	5.5	3.6	4.5	5.9	6.1	6.8	4.6	4.9	6.2	6.0	5.8
Deposits														
Total	7.7	8.0	9.1	8.1	7.5	5.3	5.7	5.2	6.8	8.1	6.6	4.9	4.8	4.6
Households	6.0	7.0	7.1	7.7	7.7	7.1	6.5	5.8	4.2	6.5	7.2	5.3	4.7	4.5
Non-financial corporations	13.7	1.2	6.9	1.2	-0.8	4.6	4.1	3.7	7.3	7.9	2.3	3.4	3.6	3.8
Others	6.5	14.8	16.3	14.1	13.2	2.9	5.4	5.1	11.7	11.4	8.9	5.3	5.6	5.2
Ratios														
Loans/GDP	59.0	59.2	58.2	58.6	58.7	59.4	59.0	59.5	61.4	58.9	58.9	59.8	60.8	61.7
Deposits/GDP	95.9	95.8	87.0	96.5	98.0	96.4	88.1	97.0	95.2	93.4	94.8	94.8	95.3	95.8
Loans/deposits	61.6	61.9	66.9	60.7	59.9	61.6	66.9	61.4	64.7	63.1	62.3	63.2	63.9	64.5
Interest rates														
Real estate loans	5.4	5.5	5.4	5.2	4.8	4.3	3.9	3.8	4.5	5.4	4.6	3.7	3.7	3.8
Consumer loans	9.5	9.5	9.2	9.4	9.2	8.8	8.3	7.9	9.1	9.4	8.9	7.6	7.2	7.7
Corporate loans	8.7	8.5	8.6	8.4	7.5	6.5	6.0	5.7	7.9	8.7	7.1	5.3	4.7	4.7
Share of NPL														
Real estate loans	0.7	0.7	0.7	0.8	0.9	1.0	1.0	1.1	0.7	0.7	0.9	1.2	1.2	1.4
Consumer loans	3.9	4.0	3.9	4.4	5.2	5.6	6.0	6.3	4.1	3.9	5.3	6.6	6.9	7.6
Corporate loans	3.0	2.7	2.7	2.9	3.2	3.4	3.6	3.7	3.5	2.9	3.3	3.8	3.5	4.0

Source: CNB, CZSO, Macrobond, Economic & Strategy Research, Komerční banka
Note: Quarterly values are end of period. Full year values are averages.

We don't expect the rebound in household consumption to lead to excessive borrowing.

Consumer and other loans



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

Household indebtedness to rise only slightly

The strong growth in the stock of consumer loans reflects the elevated price level. While real household consumption remained subdued last year, the volume of new consumer and other credit rose by more than 8% ytd in November. After growing by 8.6% in 2023 (KBe), we estimate the growth in the stock of consumer loans to reach 7.4% this year. This is higher than our previous (October) forecast of 6.5%, but it should also reflect the higher inflation estimate for 2024 and lower market interest rates. Nevertheless, we don't think that the recovery in household consumption will result in a large surge in borrowing, as we expect both solid wage growth and high household savings to mainly support consumption. Hence, we expect indebtedness, as measured by the stock of consumer credit to GDP ratio, to rise only marginally – by less than 0.1pp to 4.6% of GDP in 2024.

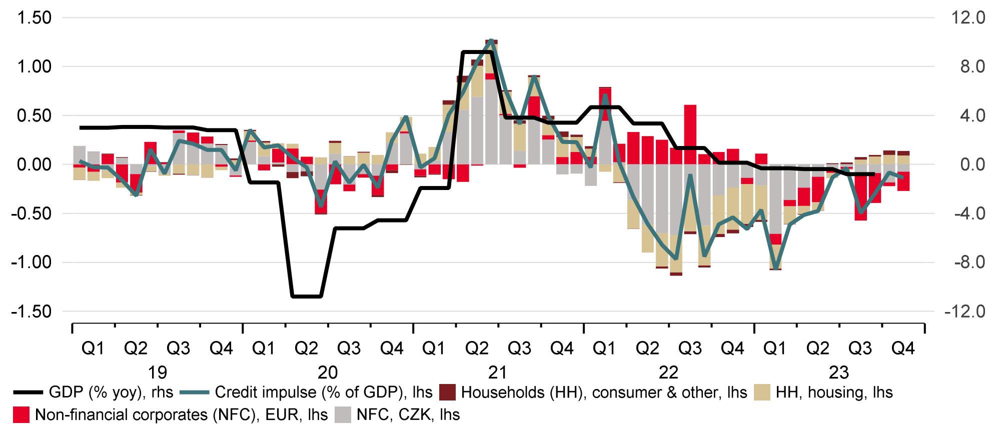
[1] If not stated otherwise, values refer to the end of the period.

Credit impulse of non-financial corporates to boost investment this year

Credit activity by non-financial corporates is likely to gradually pick up with stronger economic growth and lower interest rates.

Tightening domestic and foreign monetary policy cooled credit activity by non-financial corporations (NFCs) considerably last year. As of November 2023, the volume of new koruna and euro loans were down by almost 40% and 32% ytd, respectively. The gradual easing of monetary conditions and the increase in aggregate demand are likely to improve the willingness of firms to invest. This should also be helped by the recent sharp drop in market interest rates, which has effectively eased the broad financial conditions. Nevertheless, despite the CNB rate cutting cycle, we believe that interest rate levels are likely to remain restrictive. In view of strong corporate balance sheets amid heightened profit margins, low leverage, high levels of liquidity and low default rates, the surge in investment could be swift. However, this is conditional on there being a sufficient decline in interest rates. Moreover, a large liquidity buffer will allow them to finance less capital-intensive investments. We expect the credit impulse in the economy to gradually increase and materially strengthen in 2H24 on the back of stronger economic growth, renewed confidence and significantly lower interest rates. This is likely to also result in a gradual rise in NFC indebtedness and the loan-to-deposit ratio. Euro-denominated loans are likely to maintain their relative interest rate advantage this year. However, it is likely to significantly reduce given our expectations of earlier and faster rate cutting by the CNB compared to that of the ECB. We have revised down this year's growth in NFC loans to 5.9%, reflecting the lower GDP growth estimate as well as the unfavourable outlook for industry, which accounts for a large share of domestic credit demand.

The credit impulse is likely to gradually strengthen this year



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

Note: Credit impulse is defined as the change in the volume of new borrowing, often given as a % of annual GDP. The presented credit impulse represents the yoy change in new borrowing of the non-financial private sector to trailing 12M nominal GDP. It is further broken down according to the use of the loan for households and currency denomination for firms. As opposed to monthly credit indicators (last data point from November 2023), GDP (as of 3Q23) is a quarterly indicator.

Deposit expansion is set to slow this year as interest rates fall

By our estimates, deposit growth should slow this year in view of lower interest rates and stronger investment activity.

Following last year's strong growth, which was supported by high household savings and corporate profitability, we expect deposit growth to slow this year. The slowdown in household deposits growth reflects our expectations for a recovery in consumer spending. Nevertheless, their volume is likely to remain elevated given the commitment made in savings products and interest income. However, as interest rates fall, we expect the outflow to non-bank solutions in search of higher returns to intensify. In the case of more interest-sensitive corporate deposits, the outflow may be even greater. Given this and our expectations of strong investment growth this year, we expect the slowdown to be more pronounced in their case. We do not expect deposit growth to significantly outpace loan growth again this year and estimate that deposits will grow by 6.6% yoy on average, after 8.1% (KBe) in 2023.

Low default rates document the sound financial footing of both households and corporates.

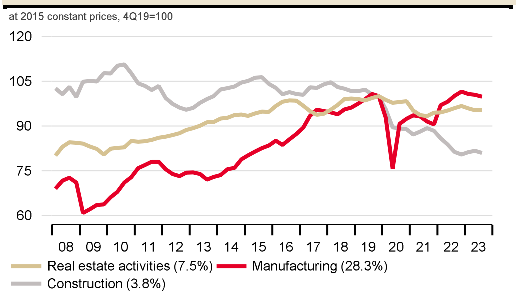
Default rates remain very low, although they are likely to rise slightly

Despite the weak economic growth last year and high interest rates, default rates remain subdued. While non performing loan (NPL) volumes are higher yoy in some segments (financials, consumer and housing loans), NPL ratios remain very low. This reflects fundamentally sound household and corporate balance sheets, which establish a solid starting position for the resumption of stronger economic growth this year. However, tighter financial conditions are still likely to result in a modest rise in NPL ratios, but should not pose a major risk to bank's loan portfolios. This is also evidenced by the latest CNB bank lending survey, according to which banks do not expect a material rise in loan losses in the near term. At the same time, in the face of weaker credit demand, the banks continue to not tighten credit standards – with the exception of consumer credit.

Box 1: Housing market likely to gradually revive this year

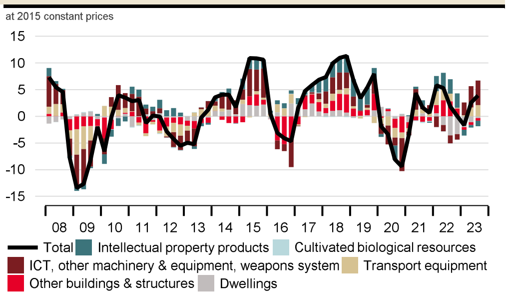
The real estate sector is one the most sensitive sectors of the economy to interest rates. This is portrayed by the decline in gross value added and investments in the construction and real estate sector. Tightening domestic and to some extent foreign monetary policy cycles have combined to cool the sector down significantly. This process likely peaked last year, at least as far as the residential segment is concerned. In this box, we assess the downturn in the housing market and set out our expectations for a gradual recovery and resumed house price growth this year.

Gross value added by sector



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka
Note: Values in brackets indicate the share of individual sectors in total gross value added

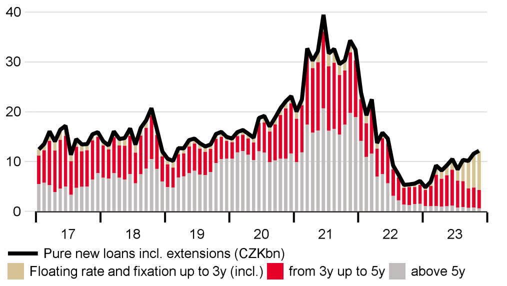
Gross fixed capital formation (% yoy, pp)



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

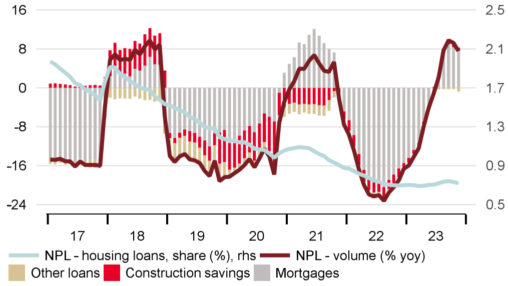
But given a weak domestic economy and the high interest rates that continue to hamper it, the downturn in the housing market is actually quite mild. Asking prices for flats were down only 4.2% yoy in 4Q23, and the qoq decline eased further to -0.1% in 4Q. The house price index (HPI) showed a 3.5% yoy decline in 3Q23, with prices no longer falling qoq and roughly flat on a seasonally adjusted basis. The residential property market has by no means experienced a large sell-off. This is partly due to fundamentally strong household balance sheets amid low unemployment, high accumulated savings and very low loan default rates. Moreover, the aggregate impact of higher interest rates on the household debt burden has so far been limited thanks to long terms for fixed-rate mortgage loans, especially those initiated in 2020-21 given their large volume. Higher debt servicing is also being offset by higher interest income given households' position as net lenders within the banking sector.

Mortgage volumes on the rise but still subdued



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

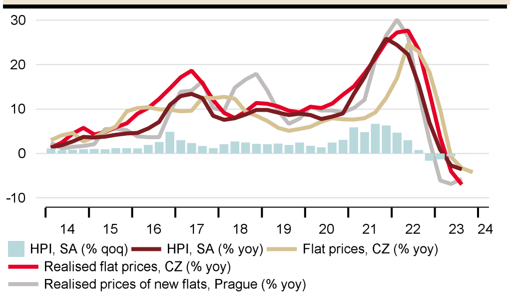
Default rates on housing loans remain low



Source: CNB, Macrobond, Economic & Strategy Research, Komerční banka
Note: NPL=non-performing loans

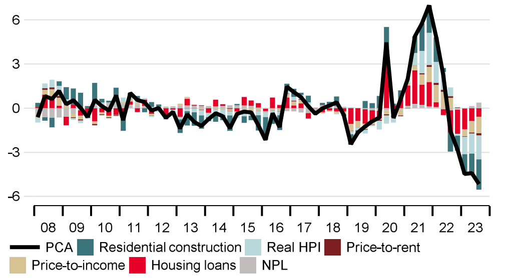
Following Cár and Vrbovský (2019)[2], we constructed a **composite index of fundamental property market indicators** that captures the residential real estate cycle.[3] As of 3Q23, the index was significantly negative, and it likely remained close to these values over the rest of the year given the continued decline in house prices, only a slight improvement in housing affordability and limited residential construction. All components were contributing significantly to the cyclical downturn, except non-performing loans (NPLs), which have a consistently small impact on the overall indicator. The biggest drags have been subdued residential investment and real house prices, reflecting lower construction in response to weak demand coupled with high interest rates and high inflation, which has depressed real asset prices. The slowdown in mortgage lending is also a significant factor.

Downturn in the housing market is tame



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka
Note: Asking prices for flats are available for 4Q23, in other cases the data is until 3Q. HPI = House price index.

Composite index of the housing market



Source: Macrobond, Economic & Strategy Research, Komerční banka
Note: The upward spike in 2020 is largely affected by refinancing and renegotiations of existing loans and does not represent an increase in pure new loans.
Note: PCA=Principal component vector

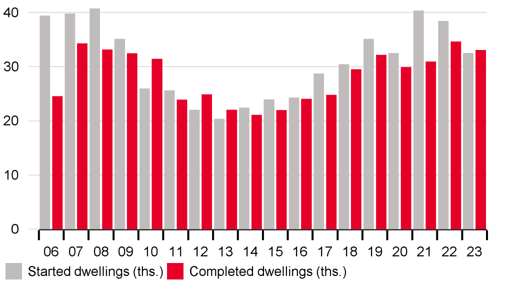
Housing market activity likely to pick up more strongly this year. We expect house price growth to gradually resume as mortgage financing becomes more accessible thanks to lower interest rates and the easing of the DSTI and DTI mortgage limits from July 2023 and January 2024, respectively. In inflation-adjusted terms, we estimate only a marginal gain in real house prices by end-2024 of 1.5% after the previous deep plunge. However, on average, real house prices are still likely to fall (-1.5%) this year. Domestic residential property assets are thus likely to offer little, if any, upside to inflation this year. With residential construction constrained, there is little to suggest a quick turnaround. The number of new residential building permits in November ytd was the lowest on record (since 2002), and the number of

[2] Cár, M., & Vrbovský, R. (2019, March). Composite index to assess housing price development in Slovakia. https://www.nbs.sk/_img/documents/_publik_nbs_fsr/biatec/rok2019/03-2019/05_biatec19-3_car.pdf

[3] The composite index is the result of Principal Component Analysis (PCA). The indicators are adjusted in the form of deviations from long-term trends, which are simplified by approximating them using the Hodrick-Prescott filter. These include house price-to-income ratio, price-to-rent, real house prices, the ratio of new housing loans to household disposable income, the share of residential construction in total gross fixed capital formation and the share of non-performing housing loans. Compared to the original configuration of Cár a Vrbovský (2019), the index is slightly modified.

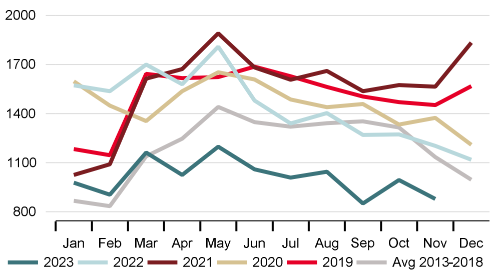
housing starts was down significantly from the previous two years. However, there was a substantial amount of new units coming onto the market that were started in 2021-22. This is likely to be the case also this year.

Construction of flats slowed significantly



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka
Note: Totals as of November (December 2023 data is not yet available)

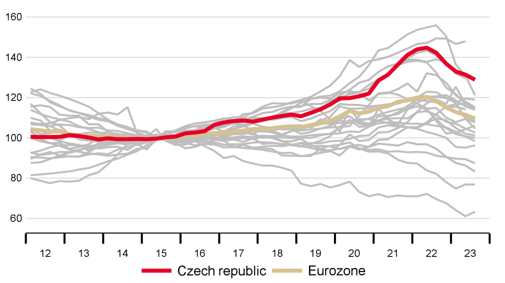
Number of new residential building permits



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

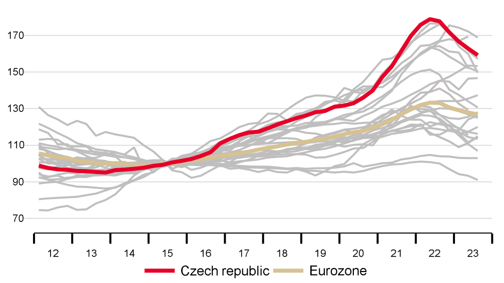
Residential construction is likely to recover gradually as monetary policy is eased and inflationary pressures in the construction sector have abated considerably. However, our expected interest rate path sees CNB monetary policy remaining restrictive. Moreover, euro interest rates – also crucial for real estate financing – are also likely to remain elevated, as we see the ECB taking a cautious approach to rate cuts (see the *External environment* chapter). The lingering effects of tight monetary policy, both domestic and foreign, are thus likely to impede a sharp recovery in private investment in the construction sector.

House price-to-income ratio (2015=100)



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

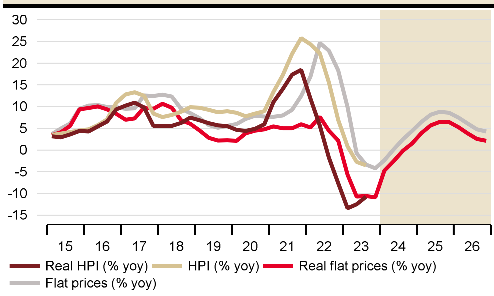
House price-to-rent ratio (2015=100)



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

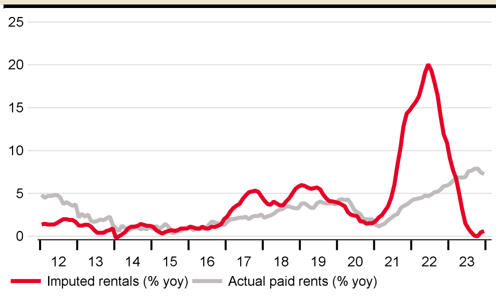
With the thawing of mortgage lending and amid pent-up demand, consumers could return to the housing market quite strongly. This may also be supported by high accumulated household savings, which were more likely to be hoarded by the middle- and upper-income percentiles that have a lower marginal propensity to consume. Savings could thus not only represent a mild boost to consumption but also find their way into the housing market and subsequently boost demand for owner-occupied housing, which is fundamentally strong in Czechia, as evidenced by its high share of overall housing.

House price growth should slowly resume



Source: CZSO, CNB, Macrobond, Economic & Strategy Research, Komerční banka
Note: Deflated using CPI (2015=100).

Low housing affordability pressuring rents



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

The combination of a stronger recovery in housing demand and slow revitalisation of residential construction may exacerbate the supply/demand imbalance in the housing market. This could exert substantial upward pressure on prices in the coming years, leading to a significant real appreciation of real estate assets and exacerbating their overvaluation, which the CNB estimated at around 60% by 2Q23.[4] We expect house price growth to gradually accelerate to 4.4% yoy by end-2024. A stronger expansion is likely next year, when yoy growth could average 8.0%, on our estimates. The earlier marked deterioration in the housing affordability, high interest rates and a delayed response to price developments in the economy are likely to maintain upward pressure on rents, which are a lagging indicator. While the yoy growth slowed in the last two months of 2023, the question remains as to what extent this year's expected increases will reflect previous high price growth given inflation indexation clauses and other arrangements. In addition, the low level of housing affordability, albeit improving slightly, inevitably increases demand for rentals, which may also put pressure on rents. However, in terms of domestic inflation, the weight of rents in the CPI basket is much lower than that of owner-imputed rents, which reflect, among other things, house prices. Nevertheless, rents inflation appears to be more persistent due to their lagged nature.

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[4]According to the latest Financial Stability Report (CNB, Autumn 2023), at the end of 2Q23 house prices were overvalued by 60% from a model-based macroprudential perspective and 20% from a valuation perspective (relevant mainly for investment flats for rental purposes). However, the overvaluation has already moderated slightly. The Financial Stability Report (Autumn 2023) is available here: https://www.cnb.cz/en/financial-stability/publications-on-financial-stability/Financial-Stability-Report-Autumn-2023-00001/.

Key economic indicators

Macroeconomic indicators – long-term outlook

		2020	2021	2022	2023	2024	2025	2026	2027
GDP	real, %	-5.5	3.5	2.4	-0.4	0.8	2.2	2.2	1.9
Inflation	average, %	3.3	3.8	15.1	10.7	2.7	2.2	2.1	2.1
Current account	% of GDP	2.0	-2.8	-6.1	1.0	0.2	0.3	0.4	0.7
3M PRIBOR	average, %	0.9	1.1	6.3	7.1	5.5	3.7	3.3	3.3
EUR/CZK	average	26.5	25.6	24.6	24.0	24.8	24.5	24.1	23.9
USD/CZK	average	23.2	21.7	23.4	22.2	22.1	20.5	19.4	19.0

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

FX & interest-rate outlook

		23-01-2024	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
EUR/CZK	end of period	24.9	24.85	24.90	24.80	24.65	24.60
USD/EUR	end of period	1.09	1.10	1.12	1.14	1.16	1.18
CZK/USD	end of period	22.9	22.60	22.20	21.75	21.25	20.85
3M PRIBOR	end of period, %	6.59	6.20	5.20	4.45	4.15	3.90
10Y IRS	end of period, %	3.73	3.70	3.75	3.65	3.60	3.65

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

Monthly macroeconomic data

		IV-23	V-23	VI-23	VII-23	VIII-23	IX-23	X-23	XI-23	XII-23
Inflation (CPI)	%, yoy	12.7	11.1	9.7	8.8	8.5	6.9	8.5	7.3	6.9
Inflation (CPI)	%, mom	-0.2	0.3	0.3	0.5	0.2	-0.7	0.1	0.1	-0.4
Producer prices (PPI)	%, yoy	6.4	3.6	1.9	1.4	1.8	0.8	0.2	0.8	1.4
Producer prices (PPI)	%, mom	-1.2	-0.8	-0.3	-0.1	0.2	0.3	-0.1	-0.4	-0.5
Unemployment rate	% (MLSA)	3.6	3.5	3.4	3.5	3.6	3.6	3.5	3.5	3.7
Industrial production	%, yoy, c.p.	-1.2	-2.3	0.9	-3.2	-2.2	-7.7	8.0	-2.7	n.a.
Industrial sales	%, yoy, c.p.	6.8	1.4	2.5	-2.7	-3.5	-7.0	11.3	-3.6	n.a.
Construction output	%, yoy, c.p.	-8.9	-5.0	0.9	-2.1	-2.6	-2.2	2.9	-6.5	n.a.
External trade	CZKbn (national met.)	8.7	9.4	18.8	-6.7	-5.7	11.8	14.7	30.8	n.a.
Current account	CZKbn	30.2	-7.8	-47.9	-13.5	6.9	11.2	19.8	43.5	n.a.
Financial account	CZKbn	26.9	-21.3	-3.3	-20.9	-8.5	28.4	17.6	47.2	n.a.
M2 growth	%, yoy	7.5	7.3	8.1	9.3	8.5	8.2	8.0	7.9	n.a.
State budget	CZKbn (YTD cum.)	-200.0	-271.4	-215.4	-214.1	-194.6	-180.7	-210.7	-269.1	-288.5
PRIBOR 3M	%, average	7.18	7.18	7.15	7.11	7.10	7.09	7.05	7.06	6.97
EUR/CZK	average	23.4	23.6	23.7	23.9	24.1	24.4	24.6	24.5	24.5
USD/CZK	average	21.4	21.7	21.9	21.6	22.1	22.9	23.3	22.6	22.4

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

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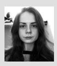
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